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6-7 October 2016

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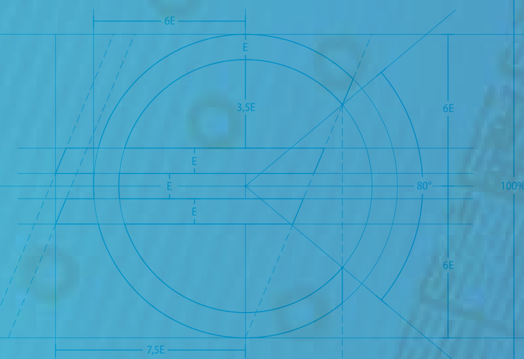

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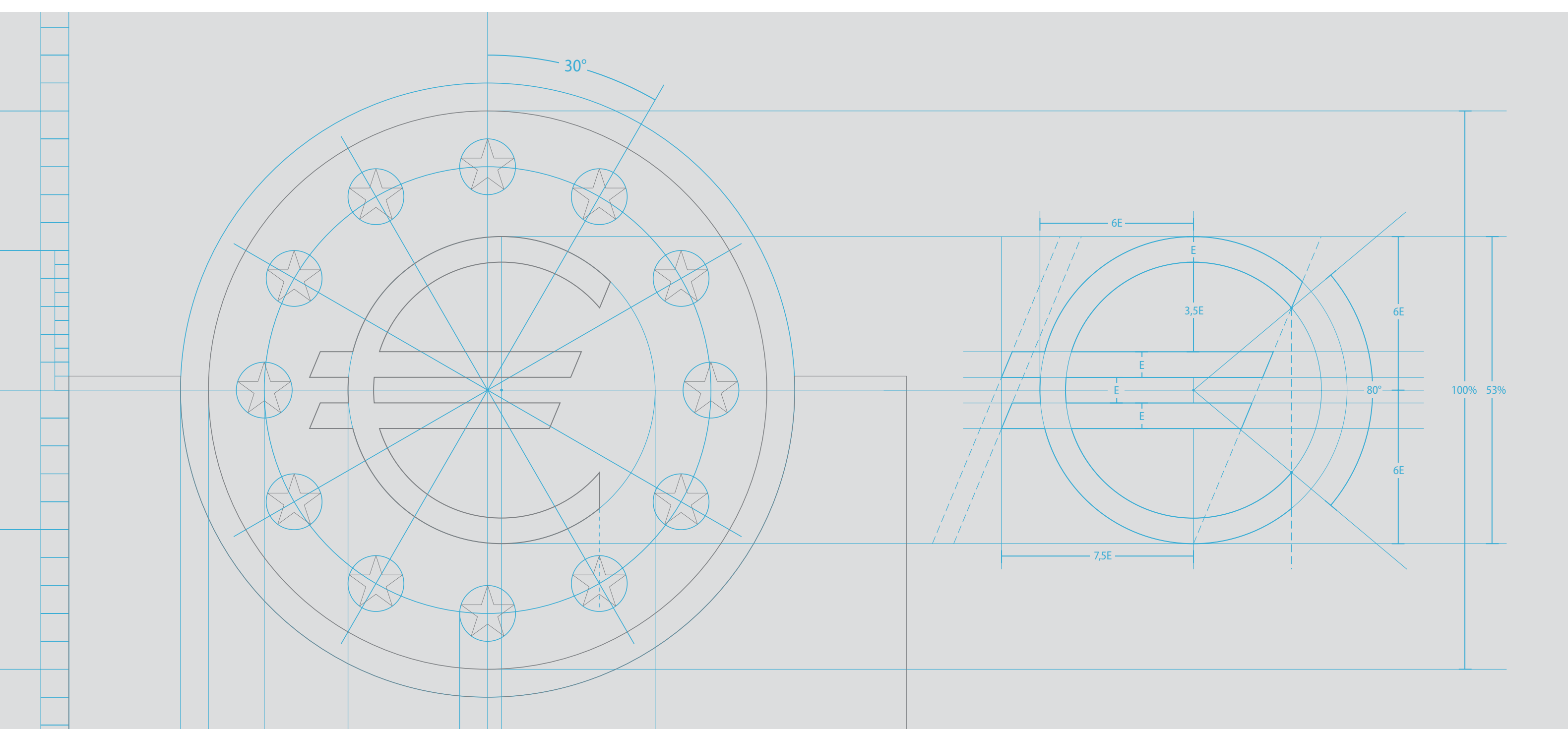
In memory of Ron Luberti,
General Counsel of De Nederlandsche Bank
and member of the Legal Committee of the ESCB



Contents

Chapter I — Legal issues on government debt restructuring 5

Reflections on the feasibility of a sovereign debt restructuring mechanism in the euro area 6
By Yves Mersch

Sovereign debt restructuring in the IMF experience 14
By Ross Leckow and Julianne Ams

The importance of being standard 23
By Anna Gelpern

The Greek debt restructuring of 2012 46
By Lee C. Buchheit

A view from Greece: the need to restructure Greece's debt 52
By Georgios Kyrtsos

How to fill the international law *lacunae* in sovereign insolvency in European Union law? 56
By Rosa María Lastra

How could the general principles of national insolvency law contribute to the development of a state insolvency regime? 64
By Christoph G. Paulus

Debt restructuring in the light of *Pringle* and *Gauweiler* – flexibility and conditionality 78
By Michael Ioannidis

Issues and possible reforms in the context of a euro area/EU sovereign insolvency framework 93
By Otto Heinz

A sovereign debt restructuring mechanism for the euro area? No bail-out and the monetary financing prohibition 104
By Heribert Hirte

Chapter II — Legal developments in the ESCB central banking functions 109

Legal analysis in a changing environment 110
By Yves Mersch

Technological innovations and the future of payments 112

Introduction 113
By Chiara Zilioli

Distributed ledger technologies in financial markets?: An introduction and some points of interest for legal analysis 117
By Andrea Pinna

Virtual currencies: the regulatory challenges 132
By Ross Leckow

Retail instant payments and digital innovation – an overview of risks and challenges 143
By Phoebus Athanassiou

Collateral issues 149

Introduction 150
By Otto Heinz

Legal shortcomings of financial market integration in the context of collateral taking: a market infrastructure perspective 153
By Markus Mayers

Collateral: need for legislative changes? 163
By Kestutis Laurinavicius

Central banks' relations with auditors (scope of control/audit gap/accountability) 174

Introduction 175
By Christian Kroppenstedt

The external audit of the ECB – an analysis of Article 27 of the Statute of the ESCB 178
By David Baez Seara and Simona Lambrinoc-Schanz

The impact of the establishment of the SSM on the relationship between De Nederlandsche Bank and the Netherlands Court of Audit 192
By Willem Bovenschen

Unified administrative law at the European level 197

Introduction 198
By Eleni Koupepidou

The SSM Framework Regulation as a source of ECB administrative procedural law 202
By Klaus Lackhoff

Primary law requirements for administrative procedures in the case-law of the Court of Justice 211
By Karl-Philipp Wojcik

Managing administrative complexity in resolution: the recent experience in Italy and its lessons from a European Union perspective 220
By Monica Marcucci

Experience gained in the application of national law at European level 236

Introduction 237
By Niall J. Lenihan

When does national law transpose a directive? 247
By Andreas Witte

Level playing field: towards a more uniform application of banking legislation 260
By Lucía Arranz

The application of national law by the ECB – a maze of (un)answered questions 270
By Alexander Kornezov

Procurement law and central banking 283

Introduction 284
By Mikael S. Stenström

The principles of ECB procurement rules, with a special focus on cooperation agreements 290
By Isabell Koepfer

EPCO – Coordinating joint procurements in the Eurosystem/ESCB 306
By Tamás Csepely-Knorr

The interaction between European Union, ECB and national laws in the context of procuring euro banknotes 315
By Torsten Schäfer

The EU and EMU as correlated institutions beyond the State – Keynote speech 335
By Jaap Hoeksma

Concluding remarks 349
By Chiara Zilioli

Chapter I — Legal issues on government debt restructuring

Reflections on the feasibility of a sovereign debt restructuring mechanism in the euro area

By Yves Mersch[1]

1 Introduction

I would like to make a number of observations in this paper about the legal environment for government debt restructuring in the euro area. I have divided my remarks into two sections. First, I will set out some broad policy observations. I wish to recall the foundations of the economic and monetary union (EMU), emphasising that sovereign default is a fact of economic life, and noting the lessons to be learned from the crisis of 2010. I will also consider an example from another jurisdiction before stressing the need to examine options for strengthening the architecture of the EMU in a holistic manner.

Second, I will set out some more specifically legal considerations, describing the existing contractual framework for sovereign debt restructuring in the euro area and considering how that contractual framework might be enhanced. As a final point I will set out some very preliminary observations on the establishment of a statutory sovereign debt restructuring mechanism (SDRM).

2 Policy observations

2.1 Foundations of the Economic and Monetary Union[2]

In the EMU, where the responsibility for monetary policy is assigned to the European Central Bank (ECB) while fiscal policy remains the remit of each individual Member State, sound policies at the national level are crucial for the smooth functioning of the union. High debt burdens and unsustainable fiscal policies are particularly problematic in a monetary union in which member countries share a single currency but lack monetary policy autonomy and an exchange rate channel as short-term stabilisation tools.

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[1] Member of the Executive Board, European Central Bank. I am grateful to Niall Lenihan, Christophe Kamps, Kristine Drevina and Cristina Checherita-Westphal for their comments on an earlier version of this paper. The views expressed are mine and do not necessarily reflect those of the ECB or the Eurosystem.

[2] For detail see European Central Bank (2012).

To safeguard the value of the single currency, the policy framework of the EMU was designed to ensure sound national fiscal policies in all euro area Member States. Moreover, from the early stages of EMU preparation, the Delors Report already indicated that markets on their own may be imperfect devices for encouraging disciplined national fiscal policies, likely to "either be too slow and weak or too sudden and disruptive" (Committee for the Study of Economic and Monetary Union (1989)).

Hence, to strengthen the incentives for prudent public finances and complement market disciplining forces, explicit rules and commitments under the Treaty on the Functioning of the European Union were deemed essential. First, the Treaty prohibits monetary financing of public debt through the direct borrowing of Member States from the ECB or national central banks (NCBs) (Article 123 TFEU). Second, the no bailout clause (Article 125 TFEU) prohibits the possibility of the fiscal obligations of one Member State being assumed by the Union or another Member State. Finally, explicit fiscal rules, coupled with the idea of peer surveillance and sanctions, were laid down in the Treaty and reinforced by the Stability and Growth Pact.

The no bailout clause implied that sovereign default was, in principle, deemed a genuine possibility. However, the Treaty did not include provisions ensuring that cross-border spillovers of default would not threaten the very existence of the monetary union.

2.2 Sovereign default is a fact of economic life

Sovereign default, though a rare event in advanced economies after 1950s, is a fact of economic life. Cases of debt restructuring following or preventing outright default have been relatively pervasive in recent history (over 500 since the 1980s), with middle and high income (mostly emerging) economies accounting for about one-third of the cases.[3] In advanced economies, as defined today, outright defaults, particularly on domestic debt, have been rare events in modern times. However, there have been cases of more recent debt restructuring and defaults, including the large restructuring of Greek debt in 2012 and the 2008 Icelandic default on bilateral loans. Moreover, in the more distant past, among the current members of the euro area, Austria, Greece, Germany, Italy, Portugal and Spain have each experienced at least one case of sovereign default since 1824, most of these defaults occurring during the period of the gold standard.[4]

2.3 Lessons from the crisis

The euro area sovereign debt crisis of 2010 revealed not only important deficiencies in the EMU architecture, but also was a reminder that sovereign default is a relevant issue in a monetary union, even one of advanced economies. Given deep economic

[3] Sources: Cruces and Trebesch (2013); Das, Papaioannou and Trebesch (2012).

[4] As pointed out in Gianviti et al. (2010), based on data from Sturzenegger and Zettelmeyer (2006).

and financial interlinkages, cross-border spillovers of sovereign distress in the euro area were quick to take their toll, reinforced by the sovereign-bank nexus. Market discipline failed before the crisis, with spreads of Greek over German yields not reflecting default risk, whether because markets were myopic or assessed the no bailout clause not to be credible.

The European governance framework, which lacked credible enforcement, was consequently reinforced in 2011. In addition, the EMU has now various crisis mechanisms in place, in particular the temporary liquidity provision for sovereigns under the European Stability Mechanism (ESM). It has been building the Banking Union, including the single resolution mechanism for banks, and is preparing for further reforms in the context of the Five Presidents Report (European Commission (2015)).

Apart from institutional arrangements, the EMU needs strong market discipline in good times through a credible no bailout clause. The euro area needs markets to anticipate sustainability problems. Being able to distinguish early on between liquidity and solvency problems and the acknowledgement of sovereign debt restructuring as a real possibility would underpin the credibility of the no bailout clause.

The EMU also needs clarity in its policy frameworks. The crisis and post-crisis experience has shown that "the constructive ambiguity" embedded in the Treaties, for example with respect to the (market) interpretation of the no bailout clause, has not really been useful.

2.4 An example from another jurisdiction

As regards the experience of other jurisdictions, it may be observed that the current US system is characterised by an absence of any constitutional authority for the federal government to bail out states and by a bankruptcy code for municipalities (Chapter 9).[5] In practice, the establishment of a no bailout principle for the US states, following several state defaults in the 1840s, is derived from bottom-up initiatives to implement balanced budget rules, strengthened by federal budget expansion. As suggested by some authors,[6] the no bailout principle is credible because the US system contains several flanking elements. The federal government offers insurance to states through provision of the area-wide *safe* asset in the form of US Treasury securities, its responsibility for macroeconomic stabilisation and dealing with insolvent banks.

5 As pointed out in Rogoff and Zettelmeyer (2002) and Das et al. (2012), many of the early SDRM proposals evoked an analogy to the procedures under the US Bankruptcy Code for corporate debt restructuring (Chapter 11) or the bankruptcy of municipalities (Chapter 9).

6 See, for instance, Henning and Kessler (2012).

2.5 Need to examine options to strengthen EMU architecture in a holistic manner

This suggests that also in the euro area reforms to further deepen the EMU should be pursued holistically, as a system, and not in isolation. An insolvency procedure for euro area sovereigns has been proposed by many in the literature[7] as a vehicle to strengthen the ex ante incentives for sound policies and right pricing of risks, and thus increase the credibility of the no bailout clause. At the same time, as recently emphasised by the President of the ECB,[8] one needs to carefully examine first any consequences that such a mechanism would have in terms of financial, monetary and fiscal stability in the euro area. Therefore, any proposal for an insolvency procedure for euro area sovereigns needs to be assessed in conjunction with other risk reduction and risk sharing mechanisms currently proposed for the EMU. I am referring in particular to the completion of the Banking Union through a fiscal backstop and a European Deposit Insurance Scheme, which would ensure that sovereign default does not threaten financial stability, and the creation of a euro area safe asset and a euro area fiscal capacity, which would ensure that cross-border spillovers of sovereign default remain contained. Moving in this direction will take time and would require far-reaching changes in the governance of the EMU and, consequently, to the legal framework. This brings me to the second part of my paper.

3 Legal observations

3.1 The existing contractual framework for sovereign debt restructuring in the euro area

Turning to the legal aspects of a sovereign debt restructuring mechanism, I would like to start by making a point that is perhaps obvious to some readers. Namely, there is already a sovereign debt restructuring mechanism in the euro area. This mechanism is primarily a contractual one and comprises three main elements.

First, the European Stability Mechanism Treaty (ESM Treaty) has required the mandatory inclusion of model euro area collective action clauses (CACs) in all new euro area government securities with a maturity above one year since 1 January 2013.

Under these euro area CACs,[9] the key financial terms of a bond may be modified in relation to either a single or multiple bond series, facilitating aggregated voting by bondholders across bond series.

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[7] See, inter alia, Gianviti et al. (2010), European Economic Advisory Group (2011), Fuest et al. (2016), Corsetti et al. (2015).

[8] See ECB (2016).

[9] See Common Terms of Reference of the Euro area model CAC, 17 February 2012, available at https://europa.eu/efc/sites/efc/files/docs/pages/cac_-_text_model_cac.pdf

Different approval thresholds apply to single-series and cross-series modifications. For a single series, the threshold for modifications is not less than 75% of the aggregate principal amount of the outstanding bonds represented at a meeting, or not less than two-thirds of the aggregate principal amount of outstanding bonds for a written resolution.

For a cross-series modification, there is a double threshold. In the case of bondholder meetings, 75% of the aggregated principal amount of the outstanding bonds represented at all the quorate meetings, taken together, plus two-thirds of the outstanding bonds represented at each individual meeting, is required to achieve a restructuring. In the case of a written resolution, not less than two-thirds of the aggregate principal amount of outstanding bonds, taken together, combined with more than 50% of the outstanding bonds for each individual issue, is necessary.

The *second* main element of the existing sovereign debt restructuring mechanism in the euro area is the fact that the bulk of government bonds issued prior to the mandatory inclusion of the euro area model CACs in accordance with the ESM Treaty are governed by the national law of the euro area Member State. For example, in Greece prior to the Greek debt restructuring, only 7.3% of Greece's debt was governed by foreign law. In this situation the sovereign is in a powerful position to legislate for sovereign debt restructuring, subject to ensuring compliance with overriding constitutional constraints, for example, balancing private property rights against the exigencies of the common good.

This is what happened in Greece, where legislation was adopted retrofitting a CAC into all outstanding bonds governed by Greek law. The CAC imposed by the Greek sovereign went further than the euro area model CACs. For voting purposes claims across all of the affected bond issues were aggregated and two-thirds of the outstanding principal amount (based on a quorum of 50%) was necessary to agree on restructuring, thus eliminating blocking holdouts in individual issuances. In addition, the Greek Council of State issued a ruling on 21 March 2014 holding that it is lawful for an issuer to renegotiate the terms of its bonds based on the general legal principle of *rebus sic stantibus* (fundamental change in circumstances).

The *third* main element in the existing sovereign debt restructuring mechanism in the euro area relates to the bonds governed by foreign law issued by euro area Member States. The ECOFIN President announced as far back as April 2003 that Member States will use the CAC framework developed by the G10 in their government bonds issued under foreign laws. However, these CACs do not include any aggregation feature.

From these three elements it can be seen that most euro area government debt contains contractual arrangements enabling debt restructuring. However, certain categories of debt still escape the CACs. For example, the euro area model CAC is not mandatory in the case of short-term debt instruments with a maturity of one year or less, and debt under loan agreements is subject to bespoke documentation.

3.2 How might the existing contractual framework for sovereign debt restructuring in the euro area be enhanced?

This brings me to the second part of my legal remarks. Can this existing contractual sovereign debt restructuring mechanism be enhanced?

The most important feature of CACs is to enable a qualified majority of bondholders of a specific bond issuance to bind the minority of the same issuance to the terms of a restructuring. Most of the outstanding CACs allow for the possibility that a creditor, or a group of creditors, can obtain a "blocking position" in a particular series and effectively block the restructuring of that particular series.

The euro area model CAC represented an improvement compared to traditional CACs, because it allows for aggregated voting across multiple bond issues, albeit subject to the double threshold voting structure mentioned above.

The euro area model CAC could be revised to introduce a more robust aggregation feature designed to limit the problem of holdouts, building on the International Monetary Fund (IMF) staff's recent suggestions.[10] Such an aggregation feature would be built on a single-threshold voting procedure calculated on an aggregated basis across all affected bond series. A series-by-series vote would no longer be necessary, thus ensuring that a creditor could no longer hold out simply by purchasing a controlling position in a particular issuance.

In order to provide adequate safeguards to ensure inter-creditor equity, the issuer could only resort to such a single threshold voting procedure if it offered all affected bondholders the same instrument or other consideration or an identical menu of instruments. The relevant voting threshold for a single threshold voting procedure could be set at 75% of the aggregated outstanding principal of all affected series.

No amendments to the ESM Treaty would be necessary in order to revise the euro area model CAC along these lines. Naturally, it would be necessary to investigate the legal effects of such a change under the laws of the Member States concerned.

3.3 Preliminary observations on the establishment of a statutory sovereign debt restructuring mechanism

An alternative to a contractual sovereign debt restructuring mechanism would be to develop a statutory mechanism. The idea is not novel. The IMF put forward a detailed proposal for an SDRM in 2001. It was envisaged that the SDRM would be based on the IMF Articles of Agreement, so that all IMF members would adhere to it. The proposal did not reach the required level of support across the IMF's constituencies.

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[10] See IMF (2014). In this context, see also the multiple series aggregation single limb voting procedure provided for under the International Capital Market Association's Standard Aggregated Collective Action Clauses (CACs) for the Terms and Conditions of Sovereign Notes, available at http://www.icmagroup.org

The key features envisaged in the IMF's SDRM proposal were the following. First, the SDRM would be activated only following a request from a member indicating that the debt to be restructured is unsustainable. Second, a creditor committee would be established to address debtor, creditor and inter-creditor issues. Third, priority financing could be ensured by excluding certain transactions from restructuring with the approval of 75% of the outstanding verified claims. Fourth, an independent dispute resolution forum would be established to verify claims, adopt rules regarding the voting process, certify restructuring agreements, suspend legal proceedings and adjudicate disputes.

Various proposals for a euro area SDRM have been tabled since 2010[11] and even earlier.[12] They all entail at least three building blocks: a financial body to provide the financing; an economic body to assess debt sustainability, calibrate the debt relief and oversee the economic adjustment of the debtor; and a legal body to resolve disputes.

While the financing body, the ESM, is already in place, the two other elements of a euro area statutory SDRM require amendments to the ESM Treaty, adoption of a new intergovernmental agreement, and possibly even amendments to the Treaty on European Union and the Treaty on the Functioning of the European Union.

The choice between these legal avenues would depend on the specific features of a European SDRM. For example, any automaticity in subjecting the indebted sovereign to a debt restructuring in the absence of any request on its part would only be possible with the prior agreement of the Member States participating in the SDRM. Further, conferring jurisdiction on an independent judicial body requires either an intergovernmental agreement to establish such a body, or an amendment to the Treaties if there is a wish to confer jurisdiction on a specialised chamber of the Court of Justice. Any proposal to automatically extend the maturities of outstanding sovereign bonds in the event of financial assistance from the ESM would require a robust legal basis.

I wish to close by emphasising that, clearly, such an ambitious project would require extensive legal reflections.

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[11] See, for example, Andritzky et al. (2016), Deutsche Bundesbank (2016) and Gianviti et al. (2010).

[12] See, for example, Hagan (2005).

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Sovereign debt restructuring in the IMF experience

By Ross Leckow and Julianne Ams[1]

1 Introduction

Sovereign debt is a matter of great importance to the International Monetary Fund (IMF). It is in the interests of sovereign debtors, creditors, and the international system as a whole for debts to be paid under their original terms to the extent possible. However, there are occasions where a country's sovereign debt restructuring becomes inevitable - often in the context of a balance of payments crisis in which the IMF is asked to provide financial assistance. In this role, the IMF pays considerable attention to how it might facilitate the debt restructuring process to ensure the process runs in an efficient and orderly manner.

The IMF has put in place a well-developed policy framework regarding the treatment of sovereign debt. In 2013, the IMF's Executive Board endorsed a comprehensive work programme to review this framework.[2] The work was divided into four work streams that broadly fit into the three stages of a restructuring. The first stage of a restructuring is the *trigger* that causes a country to decide to restructure its debt. Because the provision of financial assistance by the IMF is often linked to a debt restructuring, this work stream focused on the IMF's lending framework and its determination of when financing would be contingent on a debt restructuring. The second stage is the *process* by which a restructuring takes place - namely, the way the debtor engages with its creditors, official and private. Two work streams addressed the restructuring process, focusing on the policies on arrears to official bilateral and private creditors, respectively. The last stage of the restructuring process concerns the treatment of *holdout creditors* to ensure that the restructuring agreed by most creditors is binding on the whole creditor body. The final work stream focused on strengthening the so-called "contractual" framework.

This article discusses the IMF's review of its policy framework on sovereign debt. It examines each stage of the restructuring and the related work streams in turn: (1) the trigger for restructuring and the IMF's lending framework; (2) the restructuring process and the IMF's arrears policies; and (3) the "holdout" problem and the contractual framework.

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[1] Ross Leckow is Deputy General Counsel and Julianne Ams is Counsel at the IMF. The views expressed in this article are those of the authors and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

[2] "Public Information Notice: IMF Executive Board Discusses Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework", 23 May 2013; see "Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework", 26 April 2013 (hereinafter the "2013 Paper").

2 Triggering a restructuring - the IMF's lending framework

The IMF is often called upon to assist member countries experiencing problems. Under its Articles of Agreement, the IMF may provide financial assistance to its member countries to help to resolve balance of payments difficulties in a manner that ensures medium-term viability and repayment to the IMF.[3] The IMF normally provides financial assistance in support of a programme of economic reform that the member implements in order to resolve its balance of payments difficulties; the financial arrangements that support these programmes establish conditions attached to the disbursement of resources, and IMF policies establish limits on the amount of access to its resources that members will normally be granted.[4]

When faced with such balance of payments crises, the IMF makes financing decisions that, in practice, act as the trigger for many debt restructurings. As the IMF may only provide financial assistance to a member if it is satisfied that that member's programme is likely to resolve the member's balance of payments difficulties, the IMF will only do so if it is satisfied that the member's debt is sustainable; pouring money into an unsustainable debt situation will not resolve the member's balance of payments problem and may, in fact, exacerbate it by saddling the country with additional, senior, debt.[5]

Where a member is requesting "exceptional access" - that is, very high levels of IMF financing above the IMF's normal access limits - this concern is even more acute, given that such members normally have lost market access by the time they approach the IMF. In such cases, the IMF requires that debt be sustainable with a "high probability".[6] In the context of the euro area crisis, the IMF introduced one exception to this "high probability" requirement: where a member sought exceptional access and the IMF believed that debt was sustainable but could not make this determination with high probability, the IMF could still lend if there was a high risk of international systemic spillovers.[7] This so-called "systemic exemption" allowed the IMF to provide financing to Greece in 2008.

Given this lending framework, the IMF's decision on whether debt is sustainable may act as the final push toward a restructuring. Where a member country has approached the IMF for financing but the IMF is of the view that the member's debt is not sustainable (or, for exceptional access, not sustainable with high probability), the member would have to undergo a debt restructuring in order to access IMF financing.[8]

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[3] Articles of Agreement of the International Monetary Fund, Article I(v).

[4] For general information on the IMF's lending activities, see the factsheet available at www.imf.org

[5] See 2013 Paper, Section II.

[6] "Selected Decisions and Selected Documents of the International Monetary Fund", 37th Issue, 31 December 2013, page 471, Decision No 14064, as amended, para. 3(b).

[7] ibid.

[8] See 2013 Paper, Section II.

The IMF revisited this lending framework and concluded its work early in 2016.[9] During this exercise, the IMF tried to address two concerns. The first of these was that the requirement that the IMF be able to say with high probability that debt is sustainable in exceptional access cases may have led to unnecessary restructurings; a debt restructuring may have been required under the lending framework even though the debt may very well have been sustainable, just not with high probability. Because restructurings are costly for all parties, unnecessary restructurings should be avoided.

To respond to this concern, the IMF introduced some flexibility into the lending framework to allow for policy responses that are better calibrated to a member's debt vulnerabilities.[10] Following the reforms, the IMF will now be prepared to provide exceptional access to a member whose debt is sustainable but not with high probability "so long as the member also receives financing from other sources during the programme on a scale and terms such that the policies implemented with programme support and associated financing, although they may not restore projected debt sustainability with a high probability, improve debt sustainability and sufficiently enhance the safeguards for Fund resources".[11] In concrete terms, when dealing with cases where such a member has lost market access, the IMF would provide financing above normal access limits if the member engages in a "debt reprofiling" (i.e. an agreement with creditors to extend the debt maturities without any significant reduction of net present value).[12] In these circumstances, the objective would then be for the IMF-supported programme, coupled with the reprofiling, to restore market access without a deeper debt restructuring. This additional flexibility is perhaps equivalent to a creditor standstill until there is greater certainty as to whether a deeper restructuring may be needed. One of the benefits of this approach is that a reprofiling maintains private sector exposure, as opposed to a bail-out, where private-sector debt is replaced with harder-to-restructure official-sector debt.

The second concern the IMF addressed was the harm the systemic exemption potentially posed to the debtor, creditors, and the international system. The fundamental problem with the systemic exemption from the IMF's perspective was that it allowed the IMF to lend to a member without *any* restructuring of its claims - that is, without addressing the economic fundamentals of the member's balance of payments problem.[13] By allowing the use of the systemic exemption to delay necessary remedial measures, the IMF was running the risk of actually abetting the member's impairment of its own economic prospects and weakening its ability to repay the IMF. Further, the result would not necessarily help the creditor community, as the replacement of maturing private sector claims with IMF credit effectively subordinated remaining

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9 "The Fund's Lending Framework and Sovereign Debt – Preliminary Considerations", 22 May 2014; "Press Release: IMF Executive Board Discusses the Fund's Lending Framework and Sovereign Debt", 20 June 2014; "The Fund's Lending Framework and Sovereign Debt – Further Considerations", 9 April 2015 (hereinafter the "April 2015 Lending Framework Paper"); "Press Release: IMF Executive Board Approves Exceptional Access Lending Framework Reforms", 29 January 2016.

10 ibid.

11 "Press Release: IMF Executive Board Approves Exceptional Access Lending Framework Reforms", 29 January 2016.

12 April 2015 Lending Framework Paper, Section II.

13 ibid., Section III.

private sector claims to the claims of the IMF. Finally, it was unclear that the systemic exemption actually diminished contagion across economies, which was the very purpose of its introduction.[14] Contagion is often founded on uncertainty, and when the market has already recognised that a restructuring is required, delaying that measure does not address the underlying concerns.

In the recent reforms, the IMF eliminated the systemic exemption and called for sovereigns that have concerns about contagion to be the ones to address it.[15] In the rare circumstances where the IMF cannot determine that the member's debt is sustainable with high probability but other members are concerned that even a reprofiling poses unmanageable risks of contagion, the IMF may lend without a reprofiling where the other sovereigns themselves provide the financing and safeguards needed to address underlying concerns as to the sustainability of the debt.

3 Managing the restructuring process - the IMF's arrears policies

The second stage of a restructuring is the process by which a restructuring takes place. Once a sovereign debtor decides a restructuring is needed, the question arises of how it engages with creditor groups in the restructuring process to ensure a high level of participation and an efficient resolution. The IMF avoids direct involvement in debtor-creditor discussions, as these are best left to the contractual parties. However, the IMF is interested in a possible by-product of the process: arrears.

The IMF does not like external payments arrears, since they harm debtor-creditor relations, are not good for the effective resolution of a member's debt problems, and harm the international system.[16] For a long time, the IMF maintained a policy of non-toleration of arrears - i.e. it would not provide financing if a member country was in arrears to official or private creditors.[17] However, in the 1980s, in the context of the Latin American debt crisis, private banks began to delay reaching agreement on the restructuring of sovereign arrears in order to extract more favourable terms from sovereign debtors that could not access IMF financing without such restructuring. In these circumstances, where private creditors exercised an effective veto over IMF financing, instances of debtor distress became more serious and ultimately harmed creditors as a group. To address this problem, the IMF introduced the lending into arrears (LIA) policy, which permits the IMF to lend to members in arrears to private creditors where that member is, inter alia, making a good faith effort to reach agreement with those creditors.[18] For official bilateral (sovereign) creditors, the policy on non-toleration of arrears was maintained even after introduction of the LIA policy:

[14] ibid.

[15] ibid., Section III.C.

[16] See 2013 Paper, Annex I.

[17] For a description of the evolution of the arrears policies, see 2013 Paper, Annex I.

[18] "IMF Policy on Lending Into Arrears to Private Creditors 1999"; "Fund Policy on Lending Into Arrears to Private Creditors – Further Consideration of the Good Faith Criterion", 30 July 2002; "The Acting Chair's Summing Up – Fund Policy on Lending into Arrears to Private Creditors – Further Consideration of the Good Faith Criterion", 4 September 2002.

the IMF would not provide financing to a member unless a rescheduling was agreed with the Paris Club or the official bilateral creditor(s) agreed to the IMF financing despite the arrears.[19] [20] The IMF's arrears policy for official bilateral creditors was reviewed in December 2015 to address two main problems.[21]

First, the Paris Club, in some cases, had come to play too prominent a role in the rescheduling process. Under IMF policy, where a Paris Club agreement was reached, the IMF would assume that arrears to non-Paris Club official bilateral creditors would be resolved on terms comparable to those agreed to by the Paris Club.[22] This approach worked well for many years but became less tenable with the proliferation of important non-Paris Club creditors. In circumstances where the majority of official bilateral creditors of a member country did not participate in the Paris Club, a generous treatment by a small group of Paris Club creditors would "deem away" all remaining official bilateral arrears - in practice, it would remove all IMF policy protections from the non-Paris Club creditors and require the IMF to assume for the purposes of the debtor's financing envelope that the non-Paris Club creditors would provide the same generous treatment.[23] The reform addressed this "tail wagging the dog" problem. Under the IMF's new policy, the Paris Club remains the first "port of call" for debt restructuring, since it is currently the only standing forum for official creditor action.[24] However, in order to "deem away" non-participating creditor arrears for IMF purposes, the Paris Club agreement has to account for a majority of financing required from official bilateral creditors under the IMF-supported programme.[25]

The second problem addressed by the reforms concerned the possibility of non-cooperating official bilateral creditors. In cases where a member's debt was not subject to the Paris Club process (e.g. because it was owed entirely to non-Paris Club creditors or the Paris Club was not able to reach an agreement), each official bilateral creditor had effective veto power over IMF financing - that is, the IMF could not lend unless each official creditor reached a restructuring agreement or agreed to the IMF financing despite the arrears.[26] This put the restructuring at risk from official creditors in the same way it had been from private creditor holdouts in the 1980s. Under the 2015 reform, the IMF brought the policy for official bilateral creditors more in line with the LIA policy, by allowing the IMF to provide financing in the face of arrears to a non-cooperating official bilateral creditor if, inter alia, the debtor is

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[19] See "Selected Decisions and Selected Documents of the International Monetary Fund", 37th Issue, 31 December 2013, "Summing Up by the Acting Chairman—Settlement of Disputes Between Members Relating to External Financial Obligations—Role of the Fund, June 22, 1984" (describing reliance on Paris Club practices), at p. 121; and "Summing Up by the Chairman—Fund Involvement in the Debt Strategy, May 23, 1989", at p. 462 ("The Fund's policy of nontoleration of arrears to official creditors remains unchanged.").

[20] The IMF also maintains a policy of non-toleration of arrears to multilateral creditors, which this article does not address. See "Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework", 26 April 2013, Annex I, para. 13.

[21] "Reforming the Fund's Policy on Non-Toleration of Arrears to Official Creditors", December 2015 (hereinafter the "2015 Arrears Paper").

[22] See 2013 Paper, Annex I.

[23] For a further description of the issue, see 2015 Arrears Paper, Section II.

[24] See ibid., Section III; ibid., Press Release.

[25] ibid., Press Release.

[26] For a further description of the issue, see ibid., Section II.

making a good faith effort to reach agreement with the creditor.[27] However, there is a twist. The IMF also recognised the special role of official creditors in global finance - sovereigns often provide financial support for public policy reasons rather than to make a profit.[28] Therefore, the policy put in place an additional creditor safeguard: the IMF will only lend in the face of arrears to official bilateral creditors if doing so will not have an undue negative effect on the IMF's ability to mobilise official financing packages in future cases.[29] Whether there would be such an effect is a decision for the creditor group (as represented on the IMF's Executive Board) to make, but considerations taken into account include the non-cooperating creditor's track record and whether the amount the creditor is being asked to contribute is disproportionate to that being asked from other official bilateral creditors.[30]

The other aspect of this work on the "process" of a debt restructuring is the review of the LIA policy for arrears to private creditors.[31] This work is ongoing, and IMF staff have been consulting with the private and public sectors on the relevant issues. In the next few months, the Executive Board is expected to address this together with several cross-over issues identified in the context of the policy on arrears to official bilateral creditors.[32]

4 The holdout problem - strengthening the contractual framework

The final stage of a restructuring concerns the problems of collective action and holdout creditors. The IMF has long recognised that holdout behaviour can impose costs in the course of a debt restructuring.[33] While support for a rapid restructuring is in the interest of private creditors as a group, individual creditors may hesitate to agree out of concern that other creditors may hold out and press for full repayment on the original terms. In 2003, the IMF sought to address this issue through a "contractual" approach by endorsing the inclusion of series-by-series collective action clauses (CACs) in international sovereign bond instruments.[34] [35] These

27 ibid., Press Release.

28 ibid., Sections II and III.

29 ibid., Press Release.

30 ibid.

31 See 2013 Paper, Section III.D.

32 See 2015 Arrears Paper, Section I.

33 See, e.g., "Collective Action Clauses in Sovereign Bond Contracts – Encouraging Greater Use", 6 June 2002.

34 "Collective Action Clauses: Recent Developments and Issues", 25 March 2003.

35 The IMF has focused on "international sovereign bonds", meaning a bond (1) issued or guaranteed by a government or a central bank; (2) governed by a law other than the law of the issuer or giving a foreign court jurisdiction over any claims that may arise under the bond; and (3) that is a freely traded debt instrument with fixed maturity, normally in excess of one year. See "Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring", October 2014 (hereinafter, "2014 Contractual Framework Paper"). The IMF's focus on foreign law-governed bonds "has been motivated by a recognition that, with respect to bonds governed by domestic law, the legal leverage possessed by holdout creditors is more limited given the capacity of the sovereign debtor to modify its domestic law". ibid. However, the IMF does not necessarily support "a retroactive modification of domestic law governed contracts through legislation (as was done in the case of Greece in 2012)". ibid.

mechanisms allow a restructuring agreed by a qualified majority of creditors to be binding on the entire creditor body in a given series where the necessary voting threshold (usually 75% of outstanding principal) in that series is reached. The IMF revisited the market-based approach in October 2014, following extensive consultations with the private and official sectors, to strengthen the contractual framework given two weaknesses exposed by recent events.[36]

First, in the recently-settled Argentina bondholder litigation, a New York court interpreted the boilerplate *pari passu* clause in Argentina's bonds in a manner that prohibited Argentina from making a payment on its exchange bonds (i.e. bonds that were exchanged in the restructuring agreements concluded in 2005 and 2010) unless it first made full payment on the holdout bonds - that is, bonds whose holders did not agree to the restructurings offered by Argentina.[37] This was inconsistent with the prevailing market view that the *pari passu* clause was a "ranking" provision that protected only the creditors' legal rank.[38] To avoid Argentina-type interpretations with respect to future bond issuances, the IMF endorsed a modification of the *pari passu* clause (that would be included in new or amended bond contracts) that explicitly excludes the obligation to make rateable payments.

Second, the 2012 Greek debt restructuring, where only 17 of 36 foreign law-governed bond series reached the CAC voting threshold, showed the limitations of series-by-series CACs.[39] Because such CACs work on an issue-by-issue basis, it is possible for a creditor or group of creditors to obtain blocking positions in individual bond issuances and, in this manner, frustrate the completion of a broad restructuring of the member's debt. To address this issue, the IMF's Executive Board endorsed a single-limb voting procedure as part of a voting menu reflected in the model clauses published by the International Capital Market Association.[40] This allows for a single vote across all series, which makes a holdout strategy very difficult and costly, as the holdout would have to get a blocking position across the universe of bonds included in the restructuring. It does not shift legal leverage from the creditors to the debtor, but rather from individual creditors to creditors as a group. In this manner, it gives creditors, as a group, greater control over the process. However, in adopting such an approach, the IMF recognised that to ensure market acceptance, the voting procedure should adequately safeguard inter-creditor equity, for instance to prevent large issuances from taking advantage of smaller ones.[41] In this regard, if the single-limb procedure is used, the "uniformly applicable requirement" must be met. Namely, the same instrument or menu of instruments has to be offered to the holders of all

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[36] 2014 Contractual Framework Paper.

[37] See *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012) *and NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230 (2d Cir. 2013). See also 2014 Contractual Framework Paper at Box 1.

[38] 2014 Contractual Framework Paper, Annex I.

[39] 2013 Paper, Section III.B.

[40] "Press Release: IMF Executive Board Discusses Strengthening the Contractual Framework in Sovereign Debt Restructuring", 6 October 2014 (hereinafter, "2014 Contractual Framework Press Release"). See also International Capital Markets Association, "Standard Collective Action and Pari Passu Clauses for the Terms and Conditions of Sovereign Notes".

[41] 2014 Contractual Framework Paper.

bonds covered by the restructuring proposal.[42] Moreover, the single-limb voting procedure affords flexibility by allowing for differentiation among bondholders. More specifically, if the debtor wants to differentiate among groups of issuances, it can offer different instruments to different groups of bondholders under a single-limb procedure so long as the uniformly applicable requirement is met within each group.[43] The voting menu approach gives a debtor the option of using a series-by-series or two-limb voting procedure.

The IMF's approach to the collective action problem, of course, will only be successful if it is actually implemented by parties to bond contracts. So far, uptake has been quite good in respect of international sovereign bonds: between the Executive Board's endorsement of the policy changes described above in October 2014 and 15 March 2016 about 67% of new international bond issuances (in nominal principal terms) included both enhanced CACs and *pari passu* clauses.[44] [45] However, this does not address the stock of bonds without the new contractual provisions, which accounts for 89% of the USD 935 billion of sovereign bonds outstanding. The G20 has been calling for more work to be done to address the outstanding stock issue but, in the current environment, there seems to be little appetite for conducting liability management exercises solely to include the enhanced provisions.[46]

5 Conclusion

Sovereign debt restructurings are costly for all involved, but the IMF's work is aimed at ensuring that necessary restructurings can be as painless as possible, facilitating the debtor's return to economic viability. The work is not yet done - the review of the LIA policy is still underway, and the Executive Board will continue to receive progress reports on the uptake of enhanced contractual provisions. However, it is hoped that the reforms undertaken since 2013 will ensure that the IMF's involvement will enable future restructurings to be less costly and more effective.

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[42] ibid.

[43] ibid.

[44] Representing 92 issuances from 37 issuers, totalling USD 154 billion (drawn from IMF data). See also "Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts", September 2015; Briefing for G20 Meeting, "Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts", 6 April 2016.

[45] Since 1 January 2013, standardised aggregation clauses with a two-limb voting structure ("Euro CACs") have been included in all new euro area government bonds with a maturity above one year. Taking into account the fact that bond issuances by euro area sovereigns are, in most cases, governed by domestic law, and that this type of CAC has been positively received by market participants over recent years, IMF Executive Directors considered that this two-limb approach is appropriate for such bonds (2014 Contractual Framework Press Release). The statistics on uptake do not reflect euro area sovereign issuances.

[46] G20 Leaders' Communiqué, Antalya Summit, 15 to 16 November 2015 ("We ask the IMF, in consultation with other parties, to continue promoting the use of [strengthened collective action and pari passu clauses] and to further explore market-based ways to speed up their incorporation in the outstanding stock of international sovereign debt."); Communiqué, G20 Finance Ministers and Central Bank Governors Meeting, Shanghai, 27 February 2016 ("We look forward to the report by the IMF, in consultation with other parties, on the progress in implementing the enhanced collective action and pari passu clauses and further explore market-based ways to speed up their incorporation in the outstanding stock of international sovereign debt.")

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The importance of being standard

By Anna Gelpern[1]

Contract standardisation serves many important functions in the sovereign debt market: among these, it saves time and money in preparing documents and endows widely-used terms with a shared public meaning, which in turn saves investors the costs of acquiring information, facilitates secondary market trading and reduces the scope for mistakes in the judicial interpretation of contract terms. Sovereign debt issuers and investors claim to value standardisation and list it as an important contractual objective. Issuers generally insist that their bond contracts are standard and reflect market practice. Variations from past practice and market norm must be explained in disclosure documents and through market outreach. Standardisation is not just part of the fabric of market expectations: international policy initiatives to prevent and manage financial crises rest on the assumption that sovereign debt contracts follow a generally accepted standard. Such initiatives would make no sense in the absence of standardisation.

In fact, sovereign bond contracts are not nearly as standardised as market participants and policy makers seem to suggest. It is common to see a handful of negotiated terms embedded in a mish-mash of different generation industry models, sprinkled with bits of creative expression that no one can explain, usually attributed to some long-forgotten lawyers. At least some of the variation appears to be deliberate. However, to the extent that it is inadvertent, variation can be costly. For example, it can make contracts internally inconsistent, vulnerable to opportunistic lawsuits and errors of judicial interpretation. Variation could also make debt instruments less liquid, especially during periods of market stress.

The problem of inadvertent variation would diminish substantially if sovereign debt markets were to adopt a more centralised, modular approach to contracting, whereby a subset of widely-used non-financial terms would be produced by an authoritative third party (a public, private, or public-private body) and incorporated by reference in individual transactions. Debtors and creditors would have to add party- and transaction-specific terms, and could still depart from centrally-produced default terms. However, any variation would be in a separate document, which would make it salient and thus easier to detect and evaluate than under the prevailing contract production regime. Market participants and the courts could rest assured that the terms purporting to be standard were in fact standard and that any departures from the standard were intentional and meaningful. Centralised production of standard terms would maximise the advantages of standardisation, amplify the signalling capacity of bespoke terms, facilitate the diffusion of optimal contract innovations across the sovereign debt market and reduce the legacy stock problem that has

[1] Professor, Georgetown Law and non-resident senior fellow at the Peter G. Peterson Institute for International Economics. I am grateful to the participants in the conference at the ECB and the University of Virginia Law School for insights that contributed to this essay, and to Sebastian Röing for research assistance.

stumped policy makers and market participants[2]. Terms that have lost relevance through boilerplate iteration over time would be revised or culled more readily than they are today.[3]

Centralised and modular contracting is not new in finance. Versions of the practice just described, where an industry group supplies core terms for contracts spanning an entire market, exist in foreign exchange and derivatives markets, as well as in trade finance.[4] More distant analogues, where certain default terms are supplied by statute or treaty, are also common, especially in civil law systems.[5] The Uniform Commercial Code, adopted by US states, and the UN Convention on Contracts for the International Sale of Goods are among the examples from common-law jurisdictions. Most industry and statutory models of standardisation share three key features: central production of some terms, modularity (enabling combinations of customised and standard terms, selected from a menu)[6] and a commitment to revision.

In many ways, sovereign bonds are ideal candidates for centrally produced modular contracts. They tend to be actively traded, serve as price benchmarks for other borrowers and as collateral for other financial products, and are often favoured by regulated financial firms. Minimising information and transaction costs and errors of interpretation is especially important in such a market.

The transition would not require a radical departure from current contracting practice. Sovereign debt contracting already has elements of modularity and centralisation. For instance, non-financial terms of domestic government debt are typically found in regulations; financial terms are announced at transaction time. External government debt commonly follows the practice of issuing multiple series of bonds with different financial terms pursuant to a single indenture or fiscal agency agreement, for example, under medium-term note (MTN) programmes and "shelf" registration filings with securities regulators. government debt management fora, financial industry associations and *ad hoc* groups of senior policy officials already issue non-binding guidance on sovereign debt contracts, invest in diffusing this guidance and coordinate ongoing reforms.

For all these reasons, sovereign debt markets could plausibly achieve a higher degree of standardisation by switching to robustly centralised, modular contract production. Such reform would bring new political economy challenges. Sovereigns,

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[2] International Monetary Fund (IMF), *Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts* (September 2015), available at: http://www.imf.org/external/np/pp/eng/2015/091715.pdf, pp. 9-10.

[3] Stephen J. Choi, G. Mitu Gulati and Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate* (November 25, 2016), Working Paper, available at: www.ssrn.com/abstract=2835681

[4] Boilerplate as a public good, and the case for contract production by trade groups and other nonprofits, are analysed in Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 Michigan Law Review 1075 (2006).

[5] *See, for example,* Claire A. Hill and Christopher King, *How Do German Contracts Do as Much with Fewer Words?*, 79 Chicago-Kent Law Review 889 (2004).

[6] An extensive theoretical treatment of modularity in standard-form contracts is found in in Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, 104 University of Michigan Law Review 1175 (2006).

along with their public and private creditors, would have to agree on a body to draft and periodically update standard terms, coordinate their adoption, maybe even to issue authoritative interpretations. Sovereign governments, foreign and domestic creditors, civil society and international institutions would all have a stake in the outcome of this body's work. If the centrally produced terms were to function as a strong default, their political salience would be high, raising barriers to coordination. Since sovereign debt markets are hierarchical and segmented both among issuers and investors, status and representation concerns would loom large. Finally, there would certainly be constituencies against change in any form, including lawyers and bankers in New York and London, who may have to give up influence and at least a portion of their fees, as well as those issuers and investors who would prefer to drown their idiosyncratic terms and arbitrage opportunities in the noise of apparently unintentional variation.

Despite these caveats, moving to more robust standardisation makes sense for the foreign sovereign debt market, if not for sovereign debt in general. The remainder of this essay elaborates the argument. Part I defines standardisation and considers its benefits and costs in financial contracts. Part II discusses sovereign debt contract production, reform initiatives and the controversy over variation in the *pari passu* clause, which featured in recent sovereign debt litigation. Part III touches on statutory and judicial solutions to the problem of incomplete standardisation and elaborates an alternative solution, featuring centralised production of terms. Part IV outlines what centralised and modular contracts might look like in foreign sovereign debt and raises possible objections to such a contracting regime. I conclude by identifying the implications for research and policy.

1 Why standardise?

1.1 You know a term is standard when

Classic law texts on contract standardisation treat standard ("boilerplate") terms as if they were identical within the standard: at the extreme, comprising the same words in the same order, with the same punctuation.[7] If the assumption is essentially correct, then even small variations in language must be presumed to be intentional and treated as meaningful by the parties and the courts.[8] On the other hand, if the concept of "standard" allows some scope for variation without necessarily altering the effect of the contract term – perhaps as a matter of individual or firm drafting style, or local idiomatic usage – then the parties and the courts would have to first

[7] See Marcel Kahan and Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or the Economics of Boilerplate)* Virginia Law Review, Vol. 83, Issue 4 (May 1997), pp. 713-770.

[8] See, for example, the following papers: Marcel Kahan and Shmuel Leshem, "Moral Hazard and Sovereign Debt: The Role of Contractual Ambiguity and Asymmetric Information," Working Paper (29 February 2016) available at: www.law.uchicago.edu/files/file/moral_hazard_and_sovereign_debt.pdf and Mark C. Weidemaier and Mitu Gulati, *A People's History of Collective Action Clauses*, 54 Virginia Journal of International Law 1 (2014).

decide whether the words before them mean to convey a distinct meaning or merely express the same thing differently.

Standard contracts, like standard terms, can also range from identical to broadly similar, or "of the same type." For example, a standard consumer loan agreement might be entirely pre-printed, with only a few blanks to be completed at the closing by a bank clerk. A standard sovereign or corporate bond might contain a customary set of terms arranged in the usual order; however, not all terms are found in all bond contracts, some terms might come in several distinct yet standard "flavours," while other term types might permit a measure of variation within an accepted range. Thus two bonds might contain very different negative pledge clauses, yet both clauses would be considered standard - provided the standard comprises several alternatives, or permits variation - and, as a consequence, the bonds would be considered standard as well.

Some terms or variations are found only in bonds of a particular credit quality, or in a certain geographic region. The resulting contract is standard *for its type*, for example, an emerging market sovereign bond issued in London, or a Latin American corporate bond issued in New York.

Investors might take a checklist approach to contract analysis, asking simply whether a term type is present in the contract: is there a negative pledge clause? [9]They might also ask whether the term itself is "standard," meaning whether it follows one of the accepted conventions for the relevant market. If enough of the customary terms are present and standard, the contract would be treated as standard. Only rarely would the investor parse the wording of a term to assess whether it departs from the standard and thus represents a risk or an arbitrage opportunity.

1.2 Benefits

Standard-form contracts are ubiquitous; their advantages in lowering transaction costs and conveying information are well-rehearsed.[10] These advantages are especially pronounced in financial contracts among sophisticated parties. This subsection provides a very brief summary.

Standardised contracts are quicker and easier to produce. Reproducing and customising standard forms saves research, drafting and negotiation costs over generating text from scratch. Contract counterparties may pay less to service providers and middlemen, such as lawyers and investment bankers arranging the transaction. Even if it did not produce cost savings overall, standardisation can help deploy the resources allocated to contract production more efficiently. This is because the time and energy that might have been spent drafting and analysing

9 For example, Bloomberg offers a bond-level covenant checklist as part of its fixed-income portfolio management toolkit. If a bond contains one of the listed covenants, the word "Yes" appears opposite the covenant name. The screen contains no further information on the nature and content of the covenant, which only makes sense if all covenants that go by the same name have the same substantive effect.

10 See, for example, Klausner and Kahan, *supra* footnote 7, for a good overview.

frequently-used terms can now be devoted to novel and transaction-specific challenges. As an additional benefit, compressing the transaction preparation period allows issuers and investors to take advantage of time-sensitive market opportunities.

Widespread, repeated use imbues standard terms with a meaning shared among the relevant market participants. This has multiple important implications for financial contracts. Shared meaning reduces the cost of information acquisition in secondary market trading. Buyers and sellers who know that a bond contract is standard do not need to research its meaning before deciding whether to trade it. Conversely, variation becomes more salient against a background of standard terms. The combination of a strong standard and deliberate, easily discernible variation in contract terms makes it easier to convey information - for example, to signal willingness or ability to repay.

Standard terms with shared meaning can become important tools in coordinating market-wide response to shocks and other contingencies. Contracts can effectively codify market practices and spur the development of institutional infrastructure, for example, to guide the parties through early termination and substitute performance, procedures for interest rate and exchange rate calculation, as well as notice, payment and settlement mechanics. If a dispute over the meaning of a standard term goes to court, the existence of a shared meaning can save adjudication costs and help avoid interpretation error. Judges can (and generally must) presume that the parties used standard terms in standard ways, which are easier to access than the parties' idiosyncratic, subjective meanings.[11]

1.3 Costs

The downsides of standardisation, like its advantages, are related to its coordination properties. For example, if all contracts provide for the same response to counterparty financial distress, or to drastic exchange rate depreciation, standard-form contracts can amplify financial contagion: all market participants might rush to sell at the same time.[12] Furthermore, standardisation can raise the cost of individual judicial errors even if it were to reduce the overall incidence of such errors. When a standard term is misunderstood and misapplied by a court, the immediate effect is market-wide, potentially triggering a different form of contagion.

The risk of judicial misconstruction is particularly high when old boilerplate terms remain in standard-form contracts despite losing all or most of their practical relevance. Such contractual "black holes"[13] are ripe for exploitation by enterprising litigators, who can convince a court to fill them with new meaning and potentially

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[11] For an influential framing of judicial treatment of standard and customised terms, see Charles J. Goetz and Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms*, 73 California Law Review 261 (1985).

[12] See, for example, Erik F. Gerding, *Contract as Pattern Language*, 88 Washington Law Review 1323 (2013).

[13] Choi, Gulati and Scott, *supra* footnote 3.

trigger a market shock. On the other hand, standard terms can become self-perpetuating and impede the very sort of innovation that might avoid or correct judicial mistakes, or improve procedures to deal with crises.

A host of collective action problems may stand in the way of changing standard terms for the better. A new term might be costly to design but easy to replicate, dissuading potential first movers from investing resources they would find hard to recoup. Debtors may resist deviating from the standard for fear of sending a negative signal to the market.[14] A novel term, even one designed to correct an earlier judicial misunderstanding, can be misconstrued by a court; in any event, its meaning may not be settled for some time.[15] A contract containing the new term may be less liquid for as long as traders are unsure of its meaning, or how it fits into the institutional ecosystem that developed around the old boilerplate. Debtors and creditors may also delegate the task of updating their standard-form contracts to outside law firms, which come with their own organisational barriers to innovation.[16]

In sum, contract standardisation has many benefits, but also comes with costs, including a tendency to amplify contagion from interpretive and other shocks and to stunt optimal innovation. I consider these benefits and costs in the context of foreign sovereign bonds in Part II. Part of the challenge with these bonds is the apparent lack of consensus on the sort of standardisation that should prevail in any given case - identical words/identical effect, or different words/identical effect - and whether sovereign debtors, their creditors, their citizens and other stakeholders in fact understand and intend the type of standardisation they are getting.

2 Are sovereign bond contracts standard?

2.1 Contract form and contract production

At the highest level of generality, there are two kinds of sovereign bond contracts: domestic and foreign. Most sovereign debt belongs in the former category; it is issued under the debtors' own law and in their domestic markets. Domestic sovereign bond terms vary considerably across countries, reflecting local legal and market idiosyncrasies. Within each sovereign's domestic debt stock, non-financial terms tend to be consistent: they are not negotiated from issue to issue, but are typically published in government regulations. Foreign sovereign debt - here, debt issued under foreign law, usually outside the borrower's jurisdiction - tends to adopt

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[14] Why change the negative pledge clause unless you plan to pledge? Why provide for a restructuring process if you do not plan to restructure?

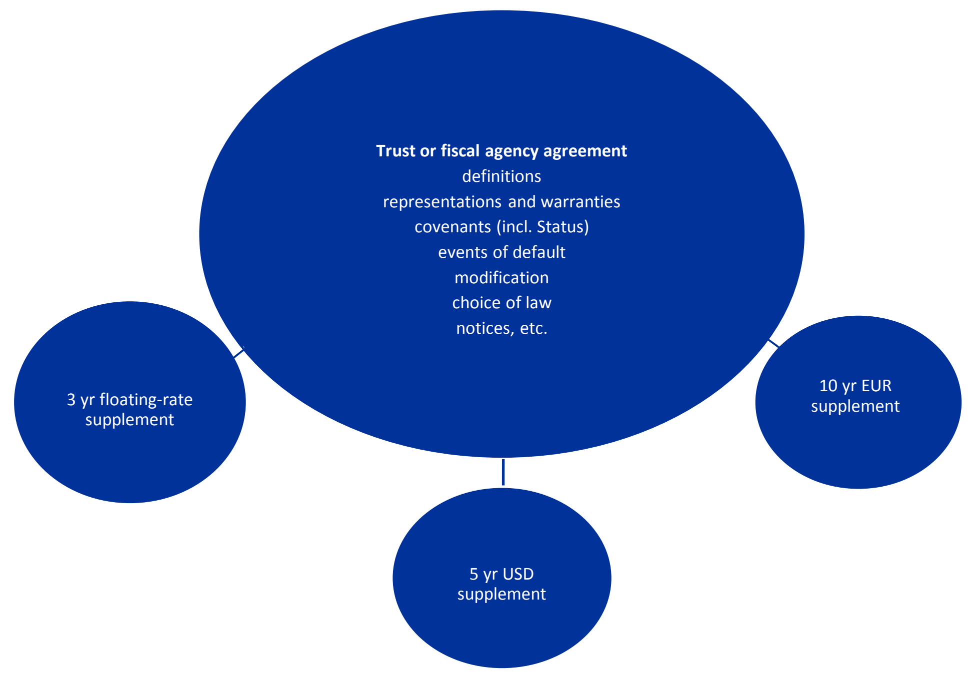
[15] See, for example, Goetz and Scott, *supra* footnote 11.

[16] See, for example, Mitu Gulati and Robert E. Scott, The Three and a Half Minute Transaction Boilerplate and the Limits of Contract Design, University of Chicago Press, 2013; Barak D. Richman, Contracts Meet Henry Ford, 40 *Hofstra Law Review,* 77 (2011).

the contracting customs of its chosen law market.[17] New York and English law dominate this category and are the focus for the remainder of this essay; however, German, Japanese and Swiss law contracts, among others, have been important for some sovereigns.

New York and English law sovereign debt securities are issued under a contract that describes the relationship between the debtor and the securities holders, including the holders' rights *vis-à-vis* one another and the sovereign. This contract – a trust indenture (New York), a trust deed (London), or a fiscal agency agreement – contains the core non-financial debt terms and may append a form of the security or securities to be issued. It has become common for sovereign borrowers to issue multiple series of securities under a single trust document or fiscal agency agreement, which contemplates a range of financial terms to be spelled out in future supplemental agreements. Figure 1 illustrates:

Figure 1
Sovereign bond contract architecture



There is a modular, hub-and-spokes quality to this contract. Non-financial terms, which range from ministerial to substantively significant (notably including waiver of immunity, governing law, status, payment, events of default and modification procedures) are agreed with the sovereign's investment bankers and produced by outside counsel, all paid by the issuer. Although parts of the negotiation and drafting process have become compressed with the advent of word processing and other

[17] The practice is not uniform. For example, scholars have documented a handful of instances of sovereign bonds issued in London under New York law, using English-law drafting conventions. See, for example, Mark Gugiatti and Anthony Richards, *The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers*, 35 Georgetown Journal of International Law 815 (Summer 2004).

technologies, it entails substantial individual input and personal interaction, that is to say real people haggling over words.[18] Once settled, core non-financial terms stay unchanged for years, as the sovereign periodically sells securities with maturities between one and thirty years under the same contract.[19] On the other hand, transaction-specific terms, such as principal and interest, term structure, currency, indexation, and others that directly determine payments due under the contract, might change whenever the sovereign goes to market, while incorporating the core by reference. Normally, neither the core nor the transaction-specific terms are negotiated with individual primary market investors; however, investment bankers managing the offering are supposed to keep up with market sentiment and solicit investors' views to ensure a successful distribution. Potential future buyers of distressed bonds in the secondary market, who tend to be quite specialised and do not normally participate in primary offerings, have even fewer ways of conveying their contract preferences.

Core non-financial terms in sovereign debt contracts exhibit a remarkable degree of continuity on the one hand, with functionally similar terms and even some of the same words appearing in 19th, 20th and 21st century bonds. They exhibit an equally remarkable degree of variation among terms in contemporary contracts that purport to be functionally similar, if not identical.

2.2 A case study in variation: the *pari passu* clause

While there is no comprehensive study of non-financial term variation in sovereign bonds, some contract provisions have been the subject of exhaustive studies. Foremost among these is the *pari passu* (equal step) clause, typically found under the heading "Status," which has appeared with slight variations in sovereign bond contracts since at least the 19th century. The most prominent contemporary variations of the clause are set forth below:

- **Version 1**

The Securities are general, direct, unconditional, unsubordinated and unsecured obligations of [the sovereign] … and [the sovereign] shall ensure that its obligations hereunder shall rank *pari passu* among themselves and with all of its other present and future unsecured and unsubordinated [external debt] … (used by Belize in 2013 under New York law)

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[18] See, for example, Gulati and Scott, *supra* footnote 16.

[19] For example, Kazakhstan issued ten- and thirty-year securities under its new MTN Programme in 2014, after a long period out of the market. See, for example, Moody's Investors Service, *Rating Action: Moody's assigns provisional senior unsecured (P)Baa2 rating to Kazakhstan's $10 billion MTN programme* (8 October 2014) (also announcing ratings for the first two eurobonds issued under the programme).

- **Version 2**

[Version 1] + The payment obligations of [the sovereign] under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated [external debt]. (used by Argentina in 1994 under New York law)

- **Version 3**

[Version 2] + … save only for such obligations as may be preferred by mandatory provisions of applicable law. (used by Ukraine in 2012 under English law)

- **Version 4**

The Securities are the direct, unconditional and general and … unsecured obligations of [the sovereign] and will rank equally with all other evidences of indebtedness issued in accordance with [this agreement] and with all other unsecured and unsubordinated general obligations of [the sovereign] for money borrowed. … Amounts payable in respect of principal of (and interest on) the Securities will be charged upon and be payable out of the [sovereign treasury], equally and ratably with all other amounts so charged and amounts payable in respect of all other general loan obligations of [the sovereign]. (used by Italy in 2003 under New York law)

The *pari passu* clause in sovereign bonds has attracted tremendous market, policy and academic attention since 2000, when an Elliott Associates investment fund holding defaulted Peruvian debt got a Brussels commercial court to rule in its favour based on contract language similar to Version 2 above, which mentions "payment obligations." The court decided that Peru breached an obligation to pay its creditors equally and enjoined Euroclear from processing payments to the holders of Peru's restructured debt until Elliott was paid in full.[20] Peru quickly settled and Elliott recouped several times its investment.

More than a decade later, US Federal courts in New York reached the same conclusion in a lawsuit against Argentina by a different Elliott affiliate, again using Version 2 of the clause. The courts ruled against Argentina despite interventions by the US Executive and the governments of Brazil, France and Mexico, among others, each of which insisted that the *pari passu* clause, including Version 2, could not be construed to require full payment to the holdouts. Argentina initially refused to settle. Court injunctions blocked the government from servicing $29 billion of restructured debt, as well as from issuing new debt targeting foreign investors.

Leaving aside the merits of Belgian and US court decisions as a matter of law, they presented a policy conundrum. On the bright side, they paved the way to a new, potentially generalisable method of enforcing sovereign debt. A sovereign that sought to make a credible contractual commitment to repay could do so now by adopting Version 2 of the *pari passu* clause, construed by the courts to require rateable payment to holdouts and backed by the courts' injunctive power. Adopting

[20] *Elliot Assocs., L.P. v. Banco de la Nacion*, General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, 26 September 2000).

Version 4 of the clause, which conveys an even clearer commitment to pay, would have a similar effect. On the dark side, enforcement would come at a very high cost to the borrowing country, with potentially significant externalities. Breaching either Version 2 or Version 4 of the clause could bring about a financial boycott of the sovereign, starving the country of foreign exchange and cutting it off from trade. If the sovereign attempted to pay despite the injunction, court sanctions could disrupt systemically important payment and settlement systems, all in the name of full payment for a small minority of enterprising holdouts.

After its courts ruled in favour of the holdouts in lawsuits against Peru and Nicaragua, Belgium quickly enacted a statute shielding Euroclear from injunctions.[21] Soon after, a court in London declined to interpret the *pari passu* clause in the Congo's debt contracts, recognising that third parties would bear the brunt of any injunctions blocking payments to sovereigns.[22] Together, Belgian legislation and judicial reticence in the United Kingdom reduced the policy salience of the *pari passu* clause in the euromarkets. After *pari passu* reoccupied centre stage as a debt enforcement tool in New York in 2011, the options for managing its impact shrank dramatically. The Supreme Court effectively foreclosed the judicial path for the time being, when it refused to review lower court injunctions. Belgian-style legislation had no prospect in the United States. For those who worried about *pari passu* and its spillover effects on the international financial system, contract reform was all that was left.

2.3 Boilerplate shock and boilerplate reform

US federal courts in New York were under the impression that Argentina's version of the *pari passu* clause was unusual. Researchers found otherwise:

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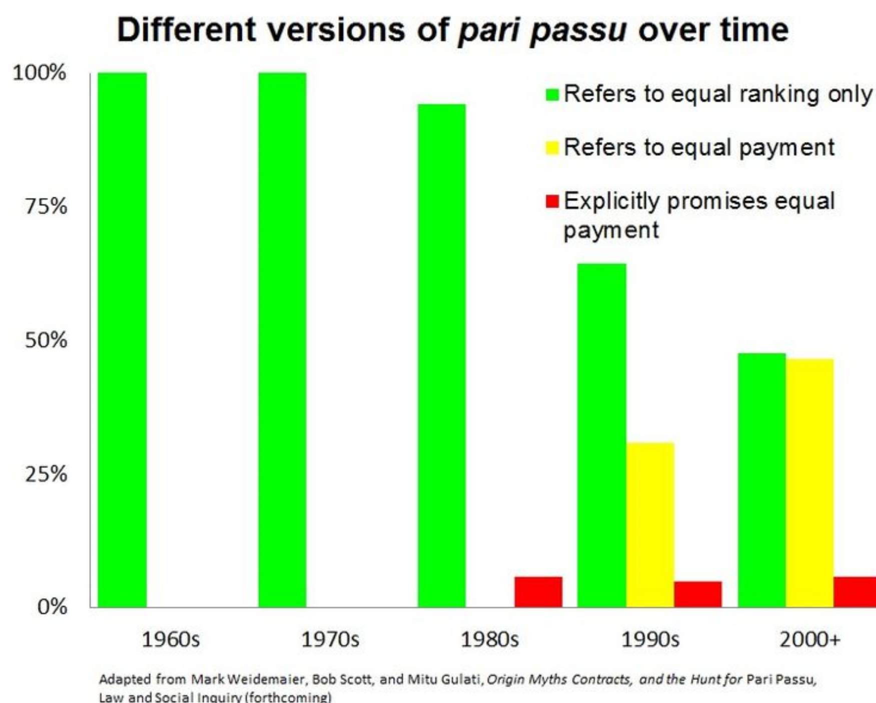
21 For the decision against Nicaragua, later overturned on unrelated grounds, see *Republic of Nicaragua v. LNC Investments and Euroclear Bank S.A.*, Docket No. 240/03 (Brussels Commercial Ct. 11 September 2003). For a description of the statute, see Nationale Bank van België/Banque Nationale de Belgique, Financial Stability Review 2005, pp. 162-163.

22 "This point is, I think, closely allied to the seventh point, which concerns the nature of the relief sought generally, which is directed towards the coercion of third parties rather than securing immediate compliance by the defendant. Because I regard this last point as determinative, I regard it as unnecessary to attempt any analysis of the pari passu clause. In any event, with all respect to Cresswell J, who did not have the advantage of the observations of the amicus which have been made to me, that question would be better addressed in a debate as between the original parties to an agreement in which the clause appears and, moreover, in a case where the party seeking to enforce the clause does not derive its title in substantial part from original parties who have already colluded in its apparent breach." *Kensington Int'l Ltd. v. Republic of the Congo*, 2002 No. 1088, [2003] EWHC 2331 (Comm) (Commercial Ct. 16 April 2003).

Figure 2

Pari passu clause variations



Source: Weidemaier et al. 2013

Since the revival of the foreign sovereign bond market in the 1990s, a growing number of sovereigns had chosen the "payment" version of the clause (Version 2), which made them vulnerable to injunctions in the aftermath of the Peru and Argentina rulings. The classic Version 1 of the clause, which promised equal ranking without reference to payment, seemed insulated from enforcement injunctions until another US court, responding to a copycat complaint against Grenada in 2013, left open the possibility that even a simple promise to rank *pari passu* might be read as supporting an injunction.[23] More recently, researchers have identified a separate category of contracts (labelled Version 3 in the typology above), which on the one hand use the vulnerable "payment" wording, but also apparently allow the debtor to pass a mandatory domestic law preferring its other payment obligations. Ukraine enacted just such a law in 2015, in an attempt to neutralise its Version 3 *pari passu* clause.[24] Finally, there was a noticeable if small contingent of Version 4 clauses, which promised rateable payment in no uncertain terms. On the whole, the growing prevalence of Version 2 clauses, along with the many variations on the *pari passu* theme unearthed in the wake of recent lawsuits, has sown confusion about the nature and effect of standardisation in sovereign bond contracts and the precise nature and scope of the threat to the system from *pari passu.*

[23] The court refused to dismiss the case and ordered it to proceed to trial on the assumption (albeit for the sake of argument) that Grenada's Version 1 clause was "similar" to Argentina's Version 2 clause, see *Export-Import Bank of the Republic of China v. Grenada*, Opinion and Order, 13 Civ. 1350 (HB) (SDNY) (19 August 2013), p. 5, see http://www.creditslips.org/files/grenada.districtcourtdecision081913.pdf. The case was settled without a definitive ruling on the meaning of Grenada's Version 1 clause.

[24] No court has construed a Version 3 clause to date.

Beginning in 2012, an informal working group[25] of policy officials, debt managers, market participants, lawyers and academics considered options for revising the *pari passu* clause, as well as majority modification CACs, in foreign sovereign bonds.[26] The group's work culminated in the release of new model clauses by the International Capital Market Association (ICMA), endorsed by the Group of 20 and the IMF.[27] The new *pari passu* clause reads as follows:

- **Version 5 (ICMA Clause)**

The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank *pari passu*, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, provided, however, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa.

The new model clause, which reflected several rounds of consultation with market participants, combined the simple ranking formulation of the old *pari passu* clause (Version 1) with an express disavowal of the rateable payment interpretation that had supported injunctions against Argentina and Peru. The disavowal stripped *pari passu* of its recently-acquired powers; however, the range of sovereign misdeeds it proscribed was vanishingly narrow, most likely limited to domestic laws subordinating the creditors.[28]

2.4 The Un-Boilerplate

The reformulated *pari passu* clause was incorporated in ICMA's Primary Market Handbook, a guidance document addressed to its membership, which includes most major financial market participants, including issuers, buy-side and sell-side investors. Although members are expected to follow the guidance, it is a relatively soft coordination device: the model clause language is seen as a public good; it is neither strictly mandatory, nor rigorously policed.[29] The IMF similarly does not mandate the inclusion of particular language in its sovereign members' contracts; it

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25 The author of this essay participated in the working group.

26 See, for example, Mark Sobel, *Strengthening collective action clauses: catalysing change—the back story*, Capital Markets Law Journal (2016) 11 (1): 3-11 first published online January 11, 2016, and Anna Gelpern, Ben Heller and Brad Setser, "Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Bonds" in Martin Guzman, Jose Antonio Ocampo and Joseph E. Stiglitz, Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises (Initiative for Policy Dialogue at Columbia 2016).

27 See, for example, Sobel, *supra* footnote 26.

28 The argument for the narrow reading is articulated in, for example, Lee C. Buchheit and Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 Emory Law Journal 870 (2004) and Phillip Wood, *Pari Passu Clauses – What do they Mean?* 18 Butterworths Journal of International Banking and Financial Law 371 (2003)

29 Compare Davis, *supra* footnote 4. The handbook is available at: http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/ipma-handbook-home/

merely recommends the inclusion of terms (such as ICMA clauses) that would have the desired policy effect.[30]

Nonetheless, the entire coordination effort that brought about Version 5 of the *pari passu* clause was premised on a high degree of contract standardisation. The goals of reducing uncertainty and containing the spillover effects of *pari passu* as an enforcement tool would hardly be advanced if sovereigns and their creditors all varied significantly from the model clause, leaving future courts to sort out the mix of common standard and idiosyncratic meaning they sought to convey. Yet variation is precisely what happened immediately following the release of ICMA's version of *pari passu* in August 2014. The examples below illustrate:

- **Ghana (September 2014, English law)**
  The Notes constitute direct, unconditional and … unsecured obligations of the Issuer and … rank and will rank *pari passu*, without any preference among themselves and with all other present and future unsecured and unsubordinated **obligations** of the Issuer, **save only for such obligations as may be preferred by mandatory provisions of applicable law**, provided, however, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other unsecured and unsubordinated obligations of the Issuer and, in particular, shall have no obligation to pay other unsecured and unsubordinated obligations of the Issuer at the same time or as a condition of paying sums due on the Notes and vice versa.

- **Kazakhstan (November 2014, English law)**
  The Notes will at all times rank *pari passu* without preference among themselves and at least *pari passu* **in right of payment**, with all other unsecured External Indebtedness of the Issuer from time to time outstanding, provided, however, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to the Notes or any other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa.

- **Vietnam (November 2014, New York law)**
  The Notes shall at all times rank without any preference among themselves and **equally** with all other present and future unsecured and unsubordinated External Indebtedness … provided, however, **consistent with similar provisions in the Government's other External Indebtedness**, that this provision **shall not be construed** so as to oblige the Government to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, it **shall not be construed** so as to

[30] See, for example, IMF, *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring* (Staff Report and Press Release, October 2014) available at: http://www.imf.org/external/np/pp/eng/2014/090214.pdf, and Chanda DeLong and Nikita Aggarwal, Strengthening the contractual framework for sovereign debt restructuring—the IMF's perspective, Capital Markets Law Journal (2016) 11 (1): 25-37 first published online January 11, 2016.

oblige the Government to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa.

- **Mexico (November 2014, New York law)**
  The debt securities rank and will rank without any preference among themselves and **equally** with all other unsubordinated public external indebtedness of Mexico. It is understood that this provision **shall not be construed** so as to require Mexico to make payments under the debt securities ratably with payments being made under any other public external indebtedness.

Each of the above "early adopter" clauses includes the central innovation of ICMA's model, the disavowal of rateable payment; each might be sensibly classified as a "Version 5" clause. However, Ghana combines the Version 5 disavowal with additional flexibility to enact domestic laws subordinating the bondholders, also in Version 3. Kazakhstan's Version 5 incorporates a reference to payment, echoing Version 2, which had prompted the latest contract reform effort. Vietnam's and Mexico's clause replaces the Latin "*pari passu*" with the English term "equally," and appears to address the disavowal of rateable payment to the courts ("shall not be construed"). Vietnam moreover tries to extend the disavowal to its outstanding debt, which did not explicitly reject the rateable payment meaning.

What to make of this variation? It is easy enough to find an explanation for each of the early adopter clauses: some lawyers combined ICMA's model with their clients' old boilerplate; others sought to reconcile the language drafted by ICMA's English lawyers with local market conventions, in effect proposing a distinct-but-consistent New York standard.[31] Some or all might have thought that their phrasing was more elegant, or did a better job of protecting their clients on the margins. In public, everyone claimed that their clause followed ICMA recommendations endorsed by the IMF and that any variation from the model was non-substantive. This was quite unsettling in the wake of recent sovereign debt lawsuits, which showed, if anything, that variation as such posed a risk. Reigning in variation that turned out to be problematic *ex post* was an important objective for the public-private collaboration that yielded ICMA's model *pari passu* clause.

Even if one found ICMA's model clunky, or worse, internally inconsistent for promising equal treatment except when it really mattered, the model had the advantage of industry and public sector backing, along with well-publicised, accessible drafter's intent.[32] Years from now, a court construing early variations on ICMA's model *pari passu* clause would be hard-pressed to conclude that any of them were non-substantive, a product of mindless copying.[33] After all, these had to be among the most carefully considered *pari passu* clauses of all time. *Pari passu* had

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[31] ICMA formally introduced the New York model in May 2015. See http://www.icmagroup.org/resources/Sovereign-Debt-Information/

[32] See, for example, Stephen J. Choi and G. Mitu Gulati, *Contract as Statute* 104 Michigan Law Review 1129 (2006) (addressing the problem of discerning the parties' intent in boilerplate terms) and Davis, *supra* footnote 4.

[33] See, for example, Gugiatti and Richards, *supra* footnote 17.

been the focus of policy and market attention for three years leading up to their production. The lawyers, bankers and officials responsible for contract design either participated in working group efforts directly, engaged in consultations or were targeted in outreach efforts early on. As a result, a future court might well conclude that any early adopter who chose to depart from the model did so deliberately, to achieve an objective distinct from that of the model. If this were not the result debtors and creditors had intended, perhaps their lawyers did not do their jobs: variation might indicate a persistent agency problem.[34] An investor mindful of this prospect would see a wealth of arbitrage opportunities.

Another challenge arises from the way in which contracts are revised. Sovereigns typically do not update their outstanding contracts and only incorporate innovations in new issue documentation. IMF staff estimated that, when the ICMA released the latest model *pari passu* clause, the stock of foreign sovereign bonds outstanding was approximately $900 billion, of which 71% would mature within a decade.[35] Even if all new bonds adopted ICMA model clauses, it would take over a decade for the entire stock to transition to the new standard. Until then, reformed and unreformed contracts, each "standard" for its time, would trade in parallel. If bond market participants viewed the old bond contracts as structurally senior or subordinate to the new, the result would be a fragmented, stratified debt stock vulnerable to opportunistic intervention.

2.5 Whither sovereign debt contracts?

The *pari passu* episode, which began with a Belgian court ruling against Peru and ended (for now) with the introduction of ICMA clauses, highlighted several features of contracting in the foreign sovereign debt market. First, the market has at least two distinct and widely used standards – English law and New York law – which claim to achieve the same goals with different combinations of words.

Second, each of the two standards permits a degree of variation, including borrowing from one another, which the drafters (rightly or wrongly) describe as non-substantive. Apparently routine departures from the standard are almost never tested in court; when they are, some pose a real risk of divergent interpretation and market disruption. The risk of disruption is highest when there is no compelling evidence of market usage to give a contract term contemporary meaning.[36] Doctrinally, it must mean *something* – in practice, it could mean *anything*. The "payment" version of the *pari passu* clause used by Peru and Argentina, which eminent lawyers had described as functionally equivalent to the "ranking" version, is a case in point.

The third feature of sovereign debt contracting is its apparent susceptibility to coordination by public and private actors. The production of ICMA model third-generation CACs and *pari passu* clauses in 2014 and 2015 is only the latest

[34] See, for example, Gulati and Scott, *supra* footnote 16.

[35] IMF, *supra* footnote 29, p. 33.

[36] See, for example, Choi, Gulati and Scott, *supra* footnote 3.

example of such coordination. From 2010 to 2013, European debt officials managed the adoption of second-generation CACs in euro area government bonds, implementing their governments' commitment in the Treaty establishing the European Stability Mechanism.[37] That initiative was styled as a successor to an earlier drafting effort under the auspices of the Group of Ten from 2002 to 2003, which led to the adoption of first-generation CACs in New York-law bonds issued by emerging market governments, as well as in European foreign sovereign bonds - and the first recommendation concerning CACs in the ICMA handbook.[38] ICMA's predecessors in the London market, along with a handful of industry groups in New York and Washington, engaged with the official sector for almost a decade leading up to the 2003 reform. In the early 1990s, bankers and officials worked closely together to design the Brady Bonds, which became the preferred vehicle for restructuring sovereign debt to banks. The Emerging Market Traders Association (EMTA) almost immediately began producing market practice and trading documentation for these bonds, helping to spur a sovereign bond market revival after half a century of inactivity.[39] The experience of the League of Nations Committee for the Study of International Loan Contracts in the 1930s, responding to an earlier wave of sovereign defaults, suggests that the roots of coordination and public-private collaboration in sovereign debt contracting run extremely deep, even if the results fall short of the stated objectives.[40]

3 A more standard standard

3.1 Room for improvement

Fallout from the latest *pari passu* episode suggests that the sovereign debt market could benefit from more robust contract standardisation. Pervasive minor variations make it hard for market participants and the courts to distinguish between lawyerly noise and deliberate customisation. Investors tempted to consider bond contracts solely through the prism of a yes/no covenant checklist might end up with treasure or unexploded ordnance in their vaults.[41]

Debtors and their investment bankers are reluctant to change bond contracts to improve crisis management, which most describe as a remote contingency, for fear of sending a negative signal and raising their cost of borrowing. On the rare

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[37] See, for example, the following documents available at: http://europa.eu/rapid/press-release_DOC-12-3_en.htm and http://europa.eu/efc/collective-action-clauses-euro-area_en

[38] See, for example, the following documents available at: http://europa.eu/efc/collective-action-clauses-euro-area_en and http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/primary-market-topics/collective-action-clauses/

[39] See, for example: http://www.emta.org/template.aspx?id=58

[40] The committee was active between 1935 and 1939. It mobilised experts from the financial industry, lawyers, academics, and government officials, and produced a report recommending changes in sovereign debt documentation and practice. League of Nations Report of the Committee for the Study of International Loan Contracts, Geneva (1939).

[41] Knowing that a bond has a *pari passu* clause or a CAC is close to meaningless without knowing what kind of *pari passu* clause and what kind of CAC it contains.

occasions when contracts do change, the large stock of legacy bonds detracts from the benefits of innovation and creates opportunities for abuse. Paradoxically, policy interventions to reform sovereign bond contracts to limit the cost of financial crises appear to be premised on a far greater degree of standardisation than that which prevails in the market. In some cases, reform initiatives open the gates of innovation only to amplify the range of variation.[42]

Two broad approaches have been proposed to deal with aspects of this problem in relation to sovereign debt. The first is a sovereign bankruptcy treaty, which would override a subset of sovereign bond contract terms in a crisis, and facilitate a restructuring. The treaty would have to reflect a global consensus on topics such as the meaning of equal treatment, and chart an intelligible a roadmap for restructuring.[43] It could be drafted to apply to the old contracts and deal with the problem of outstanding stock. At the other extreme, scholars have recently proposed giving judges the ability to declare a standard term meaningless when presented with compelling evidence that it has lost content from decades of rote repetition and random, acontextual variation.[44] This approach could also address the outstanding stock problem, albeit in a more limited, *ad hoc* fashion.

A third possibility might combine contract, statute and interpretation in a single institutional mechanism. The derivatives industry offers an example.

3.2 Contract as market

The global over-the-counter (OTC) derivatives market is organised around a common contract produced and copyrighted by the International Swaps and Derivatives Association (ISDA), which underpins transactions referencing close to $500 trillion in notional amounts outstanding.[45] The ISDA master agreement functions as the hub for contract modules that, together with the master agreement, make up a derivatives contract. These include relationship-specific schedules and annexes negotiated among market participants. Product-specific sets of definitions correspond to particular types of transactions, such as interest rate, equity, or credit default swaps. Transaction-specific confirmations contain the relevant financial terms and incorporate the master agreement, the schedules and any other relevant parts of the contract apparatus by reference. In the example depicted in Figure 3, the darkly-shaded modules are transaction-specific, the medium-shaded module is relationship-specific and the unshaded modules are standardised. The entire structure, comprising all transactions across a bilateral relationship, constitutes a single

[42] See, for example, Anna Gelpern and Mitu Gulati, *Innovation after the Revolution: Foreign Sovereign Bond Contracts Since 2003*, Capital Markets Law Journal 4 (no. 1): 85–103.

[43] For a recent overview of the debate, see, for example, 41 Yale Journal of International Law, Special Edition on Sovereign Debt (2016).

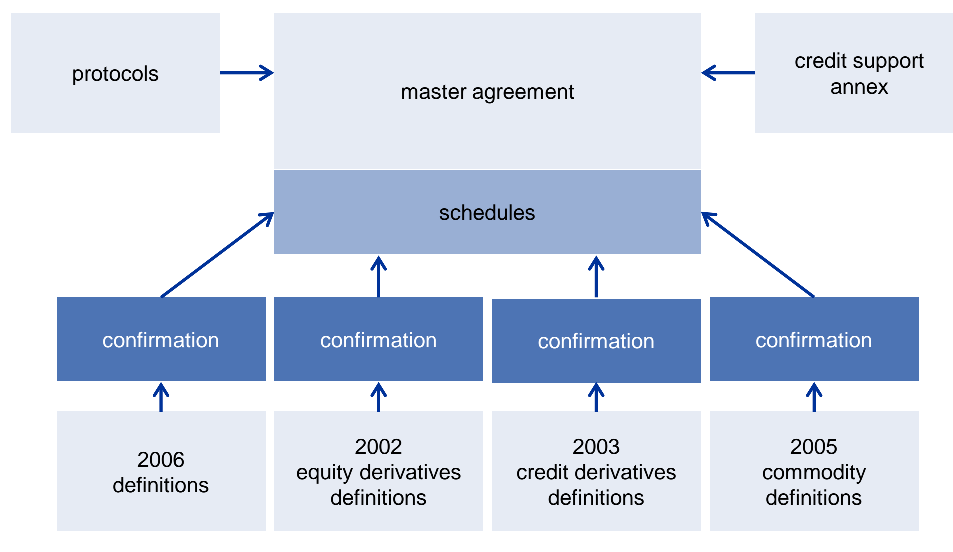
[44] Choi, Gulati and Scott, *supra* footnote 3.

[45] Notional amounts outstanding. The Bank for International Settlements OTC derivatives statistics up to the first half of 2016 are available at: www.bis.org/statistics/derstats.htm (Table D5).

contract, enabling the counterparties to manage the relationship on a portfolio basis.[46]

Figure 3

Derivatives contract architecture – an illustration



Robust standardisation need not mean enforced uniformity. In Figure 3, the parties are free to customise, so long as they do so in designated places – schedules and confirmations – which makes departures from the standard easier to spot and to analyse (and, as many commentators have noted, creates a barrier to variation). This structure also offers a partial solution to the outstanding stock problem in contract reform. The ISDA protocol process, first used in 1998 in as part of the transition to European economic and monetary union, gives members the option of acceding to a common document (a protocol) amending the master agreement. ISDA posts the protocol on its website and keeps a tally of adherents. Once two members have agreed to adhere to a common protocol, they have effectively amended their bilateral contracts to reflect the new terms.[47] Protocols reduce the need for bilateral negotiations, while reassuring market participants that the amendment in fact reflects industry preference. The solution to the stock problem is only partial, however, since when a new generation master agreement comes out, transactions governed by the old master agreement do not move to the new standard.

ISDA started out as a dealers' group in the 1980s, responding to demand for a common "vocabulary" in the transatlantic derivatives market. Although it is still

[46] For an accessible overview of the ISDA contract architecture, see GuyLaine Charles, *The ISDA Master Agreement, Part I: Architecture, Risk, and Compliance*, Practical Compliance and Risk Management for the Securities Industry (January-February 2012) and GuyLaine Charles, *The ISDA Master Agreement, Part II: Negotiated Provisions*, Practical Compliance and Risk Management for the Securities Industry (May-June 2012).

[47] ISDA's description of the protocol process, "About ISDA Protocols" is available at: http://www2.isda.org/functional-areas/protocol-management/about-isda-protocols/

dominated by large financial institutions, the group has expanded its membership over time to include smaller funds, non-financial companies that use derivatives for risk management, and service providers. It has also sought to ensure that its contracts are enforceable around the world. ISDA's contracts are drafted by outside lawyers and in-house staff, working under the auspices of ISDA's documentation committee. The committee has thousands of members, although only a small subset participate actively. The same actors decide when a new master agreement or a new set of definitions might be needed to address a new product, responding to regulatory or market developments.

Since its inception, ISDA's work has expanded beyond contract drafting, to other areas of market practice, infrastructure, contract interpretation and private adjudication. Owing to the transnational reach of its contracts, their widespread adoption and high degree of standardisation, ISDA has become an indispensable intermediary between market participants, governments and international regulatory fora, projecting quasi-statutory power across its market. For example, in 2012, it worked with policy makers to minimise market disruption from the Greek debt restructuring,[48] while in 2014 and 2015, it published protocols to facilitate market-wide recognition of national laws for resolving large cross-border financial institutions, the result of intense collaboration with the Financial Stability Board (FSB) and regulators in major financial jurisdictions.[49]

ISDA may be the best known instance of centralised, modular contracting in the financial industry, but it is not unique. For example, the foreign exchange market, with its daily turnover exceeding $5 trillion,[50] also uses a structure comprising standard-form master agreements, schedules, definitions and procedures, for foreign exchange and currency options transactions. The contracts are drafted by financial industry lawyers working with major foreign exchange market participants. In the United States, the drafters are part of the Financial Market Lawyers Group, sponsored by the Federal Reserve Bank of New York. The financial firms are represented by regional trade associations.[51] Like the push to standardise derivatives documentation, centralised production of standard-form foreign exchange contracts began in the 1980s; in both cases, standardisation gets much credit for the explosive market growth.

More distant analogues go back to the interwar period in the first half of the 20th century, and include initiatives such as the Uniform Customs and Practice for Documentary Credit (UCP) in trade finance that grew out of international banks'

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48 See, for example, Anna Gelpern and Mitu Gulati, *CDS Zombies*, 13 European Business Organisations Law Review 347 (2012).

49 See, for example, David Geen, Seth Grosshandler, Katherine Hughes, Igor Kleyman, Knox L. McIlwain, Samantha Riley, and M. Benjamin Snodgrass, *A Step Closer to Ending Too-Big-to-Fail: The ISDA 2014 Resolution Stay Protocol and Contractual Recognition of Cross-border Resolution*, 35 Journal on the Law of Investment and Risk Management Products 35:3 (April 2015), and http://www2.isda.org/functional-areas/protocol-management/protocol/22. The protocols are available at ISDA, *supra* footnote 46.

50 BIS Triennial Central Bank Survey: Foreign exchange turnover in April 2016 (September 2016, updated December 11, 2016) available at: http://www.bis.org/publ/rpfx16fx.pdf

51 Financial Markets Lawyers Group, Documentation: FXC Master Agreements, available at: https://www.newyorkfed.org/fmlg/documentation/master.html

attempt to coordinate their practices with respect to documentary letters of credit. UCP is produced under the auspices of the International Chamber of Commerce (ICC) Banking Commission, which now also publishes practice documents in other areas of trade finance, oversees their revision and issues authoritative interpretations.[52]

In all these examples, financial industry members came together to produce a set of contract terms, which were then adopted wholesale, with limited variation, across the target market. The industry body took responsibility for the ongoing revision of standard terms and, increasingly, for their interpretation, which has elicited deference from the courts.[53] Over time, the industry body engaged in repeated instances of collaboration with governments and international organisations. Standard-form contracts became the basis for more elaborate interweaving and institutionalisation of policy and market practice even in the absence of treaties or statutes. The next part considers whether such a model might be suitable for the foreign sovereign debt market.

4 Who is afraid of sovereign boilerplate?

It would not take much to map ISDA's modular contract design illustrated in Figure 3 onto the existing foreign sovereign bond contract structure in Figure 1. An industry body such as ICMA, perhaps in collaboration with a public institution such as the IMF or the FSB, and a rotating complement of sovereign debt managers and their lawyers, could draft the core non-financial terms of a New York trust indenture or English trust deed, including representations, covenants and events of default. The standard form might offer a menu of options for some terms, and make other terms optional. The draft would be released for a period of public consultation, including market and civil society outreach, on the administrative law model. At the conclusion of the consultation process, the result would be posted on a dedicated website along with any public comments received as part of the process. Sovereign borrowers would then incorporate the resulting terms by reference in future transactions, with customised terms confined to separate schedules.

The drafting group would meet regularly, say, twice a year, to consider recent developments and the potential need to revise or augment the standard form. Additional extraordinary meetings might be called in response to events that require prompt contract adaptation. Proposed revisions would be issued in a protocol, so that they might operate retroactively among any debtors and creditors who agreed to adhere to them. To minimise the legacy stock problem and the associated free-riding opportunities, the initial agreement could stipulate that protocols winning the

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[52] See, for example, Janet Koven Levit, *A Bottom-Up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments*, 30 Yale Journal of International Law 125 (2005). UCP underwent its sixth revision (UCP 600) in 2007. For the text of UCP 600 and the current range of ICC Banking Commission activities, see the commission website, at http://www.iccwbo.org/advocacy-codes-and-rules/areas-of-work/commission-on-banking/

[53] Levit, *supra* footnote 52.

adherence of a specified majority of outstanding bond holders affected by the proposed revision would bind all the remaining holders as well.

Such an approach to sovereign bond contracting would help ensure that standard portions of the contract are in fact standard and vetted by the relevant stakeholders, adding an element of public accountability that is mostly missing today. It would expressly acknowledge variations within the standard and highlight deviations from the standard. It would also facilitate ongoing collective revision of the terms, although it would also dampen individual initiative. To counter the tendency to boilerplate ossification and encourage culling, the drafting group could get standing authority to initiate revisions following regular reviews. Over time, the group may issue authoritative interpretations of its standard terms and articulate best practices with respect to disclosure, debtor-creditor engagement, and other process matters.[54]

What is not to like in such an approach?

Although the centralised and modular contract production could have important advantages over the status quo, it would also pose new challenges. First, there is the matter of constituting the drafting group. It is implausible and undesirable for sovereign borrowers simply to delegate their debt contracts to a private industry body comprising large financial firms, or even to other governments. On the other hand, a drafting committee comprising all sovereign governments borrowing in the international markets under foreign law would be unwieldy. Rotating the membership in a way that ensures balanced representation from different regions and income groups may be acceptable to most sovereigns, but political sensitivities would remain.

Market participants would face representation challenges of their own: most existing industry bodies tend to skew in favour of the largest financial firms, which have more bargaining power and greater capacity to dedicate personnel to industry business. Distressed debt investors and others who normally eschew primary offerings, have no direct input in contract terms for the time being; market participants disagree on the extent to which secondary market prices convey such investors' views regarding contract terms. In the new drafting process, funds known for aggressive enforcement tactics would probably insist on being included; however, their contract preferences might well differ from those of the larger and more passive investors, who dominate primary markets today.

Second and related, decision-making rules would represent another hurdle: anything other than consensus would be controversial, but consensus might be unachievable. For example, the existence of a newly robust standard form contract, and the resulting presumption that any deviation from it is meaningful, could make deviation more costly. Countries that fear penalties for deviation might block agreement on a standard they dislike, raising the barrier to innovation higher for everyone.

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[54] The existing Principles for Stable Capital Flows and Debt Restructuring, initiated by the Institute of International Finance (IIF), the Principles for Sovereign Lending and Borrowing and Sovereign Restructuring issued by the United Nations Conference on Trade and Development (UNCTAD), the UN General Assembly resolutions on sovereign debt restructuring, as well as ICMA's latest disclosure requirements promulgated as part of the model CACs, could all be harnessed as part of this effort.

Third, the new contracts would have to account for existing and future market segmentation. For example, it is generally understood, though rarely acknowledged in public, that sovereigns with different credit ratings may have different foreign bond contracts. At the moment, much of this segmentation in contract drafting is relatively subtle and easy to hide in the din of apparently random variation. This also makes it easier for countries to change their contracts below the radar screen as they move up and down the credit ladder. A centralised drafting effort might produce different standards for different market segments, for example, by geographic region, credit quality, currency, or governing law, effectively forcing countries to classify themselves, a politically fraught outcome. It could also choose to issue a single standard and leave market segmentation to the schedules, where differences attributable to hierarchical factors could be muted more easily. An overly large menu of standards, or a single standard contemplating substantial variation in the schedules, would detract from the goal of robust standardisation, although neither is likely to be fatal to the overall effort.

Fourth, there is the matter of getting sovereign governments to follow through on their commitments to standardise. No one can force a country to adopt a particular contract term or contracting process, a challenge evident in the IMF's soft-touch approach to endorsing ICMA clauses and its predecessors. However, to the extent that new, centrally-produced terms would be accepted as the market standard, sovereigns might come under pressure from their investors to adopt such terms. Clearing and payment systems might also make access conditional on the adoption of the terms. Favourable treatment of centrally-produced contracts under bank, insurance, asset management and pension fund regulations would make them more liquid, creating additional adoption incentives.

Fifth, an attempt to centralise contract production could face opposition from the lawyers and bankers who currently produce sovereign bond contracts and are rather protective of their creative output. Even if such objections all amounted to rent-seeking, they would be hard to ignore, especially since the new regime would want to harness these actors' expertise and documentation archives. On the bright side, lawyers active in the sovereign debt market are a relatively small community, comprising a few dozen lawyers, mostly within large firms. It is quite possible that all or most would find a role in negotiating relationship- and transaction-specific terms for existing clients and also participate in the group drafting effort.

Finally, it is quite possible that the current, very incomplete standardisation in fact reflects the preferences of sovereign borrowers and their creditors. Most sovereigns issuing bonds abroad under foreign law may well prefer a world where contracts are ambiguous and noisy, even though they harbour latent risks of the sort that materialised in the case of Argentina. Modern-day reform initiatives to introduce CACs and change the *pari passu* clause tried hard to mute any signal from contract change. On the other hand, the average investor may prefer to trade contracts that are "standard enough," so that in most cases, careful analysis of the terms does not pay off. The small minority investing based on a thorough reading of the contract may be only too happy to keep the arbitrage opportunity to itself.

The foregoing objections are illustrative. The broad concern is that, in exchange for greater standardisation and more "statute-like" contracts, the sovereign debt market would find itself struggling with new and thorny political economy challenges. Centralised contract production would reallocate transactional and governance resources; it would empower some actors and constrain others. It is hard to tell in the abstract whether the trade-off would be an improvement on balance. That judgment would depend on specific institutional features of the new regime, and the resulting balance between stability and innovation, broad-based representation and individual initiative, among others.

Conclusions

Recent litigation and contract reform initiatives in the foreign sovereign debt market highlight the risks of haphazard, incomplete standardisation. While deliberate variation in contract terms can convey information, save borrowing costs and improve the parties' capacity to deal with contingencies, it is far from certain that existing variation is either deliberate or optimal.

Further research into the nature and extent of variation in sovereign bond terms beyond CACs and the *pari passu* clause would help diagnose the extent of the problem. It would also help identify how many distinct, more-or-less internally coherent documentation standards exist in the foreign sovereign debt market, so that parties' claims that their contracts are standard for one market segment and functionally equivalent to another, could be verified. Ascertaining the market standard or standards should inform the decision to proceed with more robust standardisation.

Pending further research, it makes sense to take sovereign borrowers and their creditors at their word: if robust standardisation is an important contracting objective, the sovereign bond market can get much closer to it with just a few relatively modest steps. Harnessing existing coordination mechanisms and contracting practices in the market, sovereigns and other stakeholders could, at a minimum, produce a standard set of core non-financial terms to be incorporated by reference in their transactions. Governance would present the biggest obstacle to standardisation on this model. Nonetheless, the centralised, modular contract alternative is worth a try given the risks embedded in the current regime and the difficulty of implementing statutory solutions. If debtors and creditors reject it, maybe they do not want to be standard after all.

The Greek debt restructuring of 2012

By Lee C. Buchheit[1]

Proposition one: All sovereign debt crises are perfectly predictable, but only in retrospect.

Prior to the Hellenic Republic joining the euro area in 2001, Greece's borrowing costs were significantly higher than other European countries whose creditworthiness was judged by the market to be higher. Shortly after joining the euro, however, the risk premium on Greek government bonds (GGBs) narrowed considerably, to the point that Greece was able to borrow at a spread of only about 20 basis points over Germany. Judging only by this convergence in bond pricing, the markets appeared to regard the euro area as tantamount to a fiscal union, not just a monetary union, notwithstanding an express "no bailout" provision in the Treaty on the Functioning of the European Union.

Proposition two: Give politicians an opportunity to borrow vast amounts of money at low interest rates and they will borrow vast amounts of money.

Successive administrations in Greece embraced this new-found market access to cover budget deficits, bloat the public sector payroll, expand the pension system and generally distribute largesse in politically expedient ways. Greece's public sector debt exploded.

Proposition three: Definitely unsustainable debt stocks cannot be sustained indefinitely.

A reckoning was only a matter of time. That time arrived in the autumn of 2009 when a new administration in Athens announced that Greece's budget deficit was not 4% of GDP (as claimed by the outgoing administration) but was rather closer to 12.5% of GDP (it was actually closer to 15%).[2] The markets reacted predictably to this news. The Republic found it increasingly difficult (and more expensive) to refinance maturing debt through new issuances of GGBs. Market access was lost altogether in early 2010.

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1 Partner at Cleary Gottlieb Steen & Hamilton LLP.

2 The story is told in International Monetary Fund (2013).

1 The official sector response

In the spring of 2010, the official sector (in this context, the European Union, the International Monetary Fund (IMF) and the European Central Bank (ECB)) had a choice: either countenance a restructuring of Greece's bond indebtedness (in aggregate, more than EUR 300 billion) or lend Greece the money to pay its maturing bonds. They chose the latter.

In May 2010, the EU and the IMF extended a EUR 110 billion credit line to Greece in the context of an agreed adjustment programme.[3] Much of that money was earmarked to pay maturing GGBs in full and on time. A similar policy of fully bailing out private sector lenders to European sovereigns was later to be followed in Ireland, Portugal and Cyprus.

There were several motivations for this full bailout policy. First and foremost was a fear of contagion. If Greece restructured its bond indebtedness, so the argument went, might not markets lose faith in other European sovereign borrowers, perhaps bringing upon the continent a general financial conflagration? In addition, most GGBs were owned by commercial banks in northern Europe, mainly French and German banks. Could all of those institutions endure the balance sheet trauma that would follow a Greek sovereign debt restructuring? Finally, there was the fear in some quarters, most prominently at the ECB, that tolerating a sovereign debt restructuring in the European Monetary Union could indelibly stain the reputation of the euro as an international reserve currency.

2 Summer 2011 – The tide turns

By the summer of 2011 it had become clear to some observers, particularly those at the IMF, that a Greek sovereign debt restructuring was inevitable. The only question was whether that axe would fall on the neck of the bondholders (who had lent the money in the first place) or on the necks of the official sector players and their long-suffering taxpayers (who, under the full bailout policy, were inexorably displacing private sector lenders). The official sector continued to be sharply divided on the question of whether a restructuring of GGBs would be permitted. The official sector eventually concluded that Greece would be allowed to propose a restructuring of the GGBs that remained in the hands of private sector creditors, but only in a "voluntary" transaction that did not involve a default or the triggering of the credit default swaps that had been written on Greek sovereign debt.

With this limited licence, the Greek authorities negotiated in July 2011 the terms of a complicated, but financially very mild, debt restructuring with an ad hoc committee representing the holders of GGBs. Inevitably, the process was given a euphemism -- private sector involvement or "PSI". This proposed transaction, dubbed "PSI 1", quickly became bogged down in August and September 2011 as the creditor

[3] ibid, p. 9. The IMF's contribution amounted to EUR 30 billion, 3 212% of Greece's quota at the Fund; the largest Fund programme ever relative to a country's quota.

committee attempted to determine the preferences of GGB holders for the various restructuring options that were to be included in the offer. From the standpoint of the bondholders, this proved to be a fatal mistake.

The Greek economy continued to weaken while the creditor committee canvassed GGB holders to determine their restructuring preferences. In the eyes of the IMF at least, the light dusting of the Greek debt stock resulting from PSI 1 would not have been enough – not nearly enough – to place that debt stock on a sustainable basis. In the late evening of 26 October 2011, stretching into the early hours of 27 October, the official sector therefore reversed its original policy of forbidding a Greek debt restructuring. At about 3:00 am Central European Time on 27 October, Greece was commanded to restructure what was left of its debt in the hands of private sector creditors (about EUR 206 billion) – with at least a 50% nominal reduction in the size of that debt stock – as a condition of continued official sector assistance to Greece. This was to be PSI 2.

The official sector instructed the financial result of PSI 2; it did not confide the method by which that result was to be secured. That part was left in the hands of the Greek authorities. Whatever was to be done, however, had to be done quickly. Greece had EUR 14.4 billion of GGBs maturing less than six months later (on 20 March 2012) and the official sector made it clear that no funds had been budgeted in their programme to pay that maturity. A failure to restructure the entirety of that EUR 14.4 billion maturity by the time the sun rose on 21 March 2012 would therefore have placed Greece into an outright payment default.

The official press release announcing PSI 2 persisted in describing participation in the transaction as “voluntary” on the part of the affected creditors. It was a curious use of the word. GGB holders were to be asked voluntarily to surrender at least 50% of the nominal amount of their claims, to accept a concessional interest rate on what remained and to defer payment of that remainder for 30 years.

The reality was that for almost two years, holders had watched maturing GGBs paid out of the proceeds of official sector loans to Greece. They had seen the same policy implemented in Ireland and Portugal. Investors had repeatedly heard senior European officials, including senior ECB officials, promise that there never could, ever would, be a default on euro area sovereign debt.[4] In short, GGB holders had every reason to believe that when push came to shove, the official sector would cough up the money to pay maturing GGBs, including the 20 March 2012 maturity. The idea that a savage debt restructuring of the kind contemplated by PSI 2 would be voluntarily accepted by all or even most GGB holders was therefore fatuous. Inevitably, many creditors were bound to decline participation in a “voluntary” PSI 2 transaction, thus testing whether the official sector really had the stomach to tolerate a messy, litigious sovereign debt default in the euro area. “Argentina in the belly of Europe”, as it was then described.

4 See Buchheit, L.C. and Gulati, G.M. (2016).

3 The Greek Law on bondholders

Greece escaped this fate only by virtue of one feature of its debt stock – approximately 93% of outstanding GGBs were governed by Greek law. No emerging market sovereign borrower that had restructured its external debt over the last forty years had enjoyed this "local law" advantage. Virtually all emerging market sovereign debt is governed by a foreign law, usually the law of New York State or of England. Because most Greek government bonds were governed by Greek law, however, the Greek Parliament had it within its power to enact legislation that would facilitate a restructuring of those instruments. Parliament elected to use this power.

On 23 February 2012, the Greek Parliament passed the Law on bondholders. This law effectively retrofitted a collective action mechanism to the portion (the vast majority) of the debt stock that was governed by Greek law. Under the terms of the law, if holders of at least 50% in aggregate principal amount of the Greek law-governed GGBs voted either in favour or against the proposed amendment and at least two-thirds of the principal amount voted accepted the terms of a debt restructuring, their decision would bind all other holders of those instruments. The Law on bondholders thus embodied the notion of supermajority creditor control of the process, very much along the lines of the class voting mechanism prescribed in domestic insolvency regimes for corporate debtors.

4 PSI 2

PSI 2 was formally launched on 24 February 2012. It called for a 53.5% nominal haircut on affected bonds (the official sector had increased the target size of the nominal haircut on 21 February 2012 in light of the continuing deterioration of the Greek economy) with a long-term stretch out of the remaining claims. PSI 2 inflicted a 79% net present value loss for creditors. The Government's offer was accepted by enough holders to trigger the collective action mechanism of the Greek Law on bondholders.

The terms, and the results, of PSI 2 are shown on in the tables and figures below. It was the largest, and in many ways the most complicated, sovereign debt restructuring in history. Approximately EUR 100 billion of Greek government debt was written off by this one transaction. The first closing occurred on 12 March 2012, just eight days before the EUR 14.4 billion GGB maturity fell due. The Hellenic Republic therefore never defaulted on any of its external debt; a fate it missed by eight days.

Thirty-six series of GGBs were governed by English law, each with its own collective action clause. The required supermajority bondholder consent to join the restructuring was obtained for 17 of these series of English law GGBs. Holdout creditors had acquired blocking positions in the other series, however, and those series stayed out of the restructuring. Approximately 97% of the eligible debt stock was covered by the PSI 2 restructuring.

5 Postscript

The validity of the Greek Law on bondholders, upon which the entire success of the PSI 2 transaction rested, was later the subject of legal challenges in national courts (both in Greece and Germany), in a major International Centre for Settlement of Investment Disputes arbitration, and in proceedings before the European Court of Human Rights.[5] None of these legal challenges has been successful.

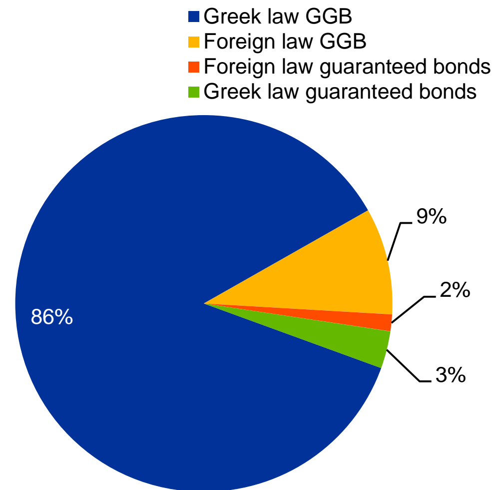
Terms of the PSI 2 invitations

	Description of basic terms
General	Holders of old bonds were invited to: (a) tender to exchange their old bonds for PSI 2 consideration; (b) consent to the amendment of old bonds to impose PSI 2 consideration on 100% of the series (all Greek law GGBs & 36 foreign law GGBs and guaranteed bonds)
Face amount of PSI consideration	31.5% new bonds + 15% short term European Financial Stability Facility (EFSF) notes + accrued interest (6-month EFSF notes) + GDP-linked securities
Interest rate	Years 1-3: 2% Years 4-9: 3% Year 10: 3.65% Years 11-30: 4.3%
Net present value discount	Approximately 79%
Maturity	30 years (amortising)
Sweeteners	EUR 30 billion in 1-2 years EFSF notes
Other	Co-financing, GDP-linked securities
Payment of accrued interest	In the form of 6-month EFSF notes

[5] *Mamatas and Others* v. *Greece* (application nos. 63066/14, 64297/14 and 66106/14). See European Court of Human Rights press release of 21 July 2016, ECHR 256 (2016).

Eligible pool of debt (EUR 205.5 billion)

Breakdown of EUR 205.5 billion PSI 2 pool (by outstanding principal)



Results – Participation (post third settlement of 25 April 2012)

- EUR 199 billion of EUR 205.5 billion
- 96.9% participation
- EUR 100 billion private debt reduction
- Credit default swap (CDS) credit event
    - Announcement that 100% of Greek law GGBs became subject to mandatory exchange triggered a credit event
    - Final price in CDS auction: 21.5%

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A view from Greece: the need to restructure Greece's debt

By Georgios Kyrtsos[1]

The issue of the Greek public debt dominates political and economic life in Greece since 2009. It also affects European politics and the functioning of the euro area.

Greece started implementing its first financial assistance programme and the Memorandum of Understanding (MoU) attached to it in May 2010. At the time Greece's public debt was in the range of €330 billion, equivalent to 146% of GDP. Greece received a loan of €110 billion in order to avoid imminent bankruptcy.

The first bail-out programme did not prevent a further increase in Greece's public debt. In 2011 it rose to €356 billion – the equivalent of 172% of GDP. In October 2011 European leaders decided in favour of an ambitious PSI (private sector involvement) that eventually led to a 53% haircut in public debt held by the private sector of a total amount of €107 billion.

After the PSI the Greek debt was reduced to €303 billion, or 157% of GDP. Greece reached an agreement with its partners on the second financial assistance programme thus securing a loan of €130 billion.

In December 2012 European leaders also decided in favour of a future rescheduling of Greece's public debt, provided the country proceeded in the direction of the necessary structural reforms and secured a steady and increasing primary budget surplus.

The situation of the Greek economy improved in 2014 and Greece was able to organise its first exit in the international markets. Nevertheless, Greece's debt increased to €319 billion, the equivalent of 180% of GDP.

The electoral victory of the radical left-wing party Syriza in January 2015 led to the implementation of a radical economic policy and the confrontation of the Tsipras-Varoufakis government with the European institutions, the euro area governments and Greece's creditors. In the summer of 2015 the Tsipras government performed a U-turn in its economic policy in order to avoid the country's exclusion from the euro area. Since then the Greek government has been collaborating with the representatives of the so-called quartet (the European Commission, the European Stability Mechanism, the European Central Bank and the International Monetary Fund) in an effort to manage the social and economic crisis and find a solution to the problem of the Greek public debt. As we speak, Greece's debt is in the region of €320 billion and corresponds to 182% of GDP.

[1] Member of the European Parliament.

Summarising what has happened in the past six years, we can say that Greece's public debt has been stabilised, with the help of the 2012 PSI, in the range of €320 billion.

Unfortunately, GDP went down during this period – the cumulative reduction of GDP since 2008 is estimated at around 25% – so the Greek debt which stabilised in absolute numbers went up as a percentage of GDP from 146% to 182%. The increase of public debt as a percentage of GDP casts a shadow on Greece's ability to service it and forces all the protagonists of the Greek crisis to start once again talks about rescheduling the debt.

Any rescheduling of the debt will have to follow the rules decided by the Eurogroup in May 2016. According to its statement on Greece:

"The Eurogroup also agrees to establish a benchmark for assessing sustainability of the Greek debt, according to which under the baseline scenario of a debt sustainability analysis (DSA), Greece's gross financing needs should remain on a sustainable path.

The Eurogroup foresees a sequenced approach, whereby a package of debt measures could be phased in progressively, as necessary to meet the agreed benchmark on gross financing needs and subject to the pre-defined conditionality of the ESM programme. The Eurogroup reconfirms that nominal haircuts are excluded, and that all measures taken will be in line with existing EU law and the ESM and EFSF legal frameworks. The Eurogroup will consider:

- For the short term: possibilities to optimise debt management of the programme.
- For the medium term: the Eurogroup asks the EWG to explore specific measures (such as longer grace and payment periods) which can be used, if necessary, at the end of the ESM programme, conditional upon the successful implementation of the ESM programme, as well as such measures as the use of the SMP and ANFA equivalent profits.
- For the long term: the Eurogroup stands ready, if necessary, and conditional upon compliance with the primary surplus targets, to further assess at the end of the programme the need for possible additional debt measures to ensure Greece's gross financing needs remain on a sustainable path."[2]

It is obvious that we are confronted with the need to devise a new scenario for the long-term management of the Greek debt. Two-thirds of Greece's debt is controlled by euro area governments (EFSF, ESM and bilateral loans), 4.7% by the ECB and another 4.7% by the IMF.

The long-term management of the Greek debt has to be the result of a compromise between the interested parties.

[2] 9 May 2016. "EFSF" refers to the European Financial Stability Facility; "EWG" the Eurogroup Working Group "SMP" the Securities Markets Programme; and "ANFA" the Agreement on Net Financial Assets.

The Greek government and the Greek political system need the restructuring of Greece's debt in order to convince public opinion that the country will eventually return to a path of economic and social development. The Governor of the Bank of Greece Mr Stournaras, the leader of the main opposition party Mr Mitsotakis, and Prime Minister Mr Tsipras all support, in their own way, the reduction of the primary budgetary surplus target from 3.5% of GDP in 2018 to 2% of GDP during the following years through debt reduction. Their objective is to loosen the fiscal policy so as to help finance the development of the Greek economy.

The IMF supports a radical restructuring of the Greek debt but insists on the implementation of measures that will help to reduce the cost of the social security-pension system and control the structural fiscal deficit. The IMF also supports an additional reduction in the cost of labour so as to try to boost the competitiveness of the Greek economy.

The Greek government supports the idea of a radical restructuring of the Greek debt so as to attain debt sustainability but tries to avoid, for obvious political reasons, implementing the measures proposed by the IMF.

The European Commission tries to accommodate the Greek government by supporting IMF proposals for a radical restructuring of the debt and, at the same time, interpreting in a very open-minded way Greece's obligations that stem from the third financial assistance programme and the Memorandum of Understanding attached to it.

The Eurogroup is more demanding as far as the Greek government's economic policy is concerned. The majority of the ministers of finance of the euro area countries want to make sure that the Greek government does its homework in terms of pension reform, privatisations and structural changes before it proceeds to a major rescheduling of the Greek debt. The euro area governments have entrusted the ESM with the task of preparing the short and medium-term measures that will reinforce the sustainability of the Greek debt but will not take the political risk associated with the long-term rescheduling of the Greek debt in the immediate future.

It seems that the German government will avoid any major decisions on the subject before the September 2017 legislative elections. We will have to wait and see how the political situation in the euro area countries evolves during the next twelve months in order to reach a conclusion whether there will be a major push in the direction of long-term rescheduling of the Greek debt. For instance, if extreme right-wing forces prevail in Austria, the Netherlands and especially Italy or France, the political management of the Greek debt will become even more difficult at the European level.

The Greek government insists that decisions on rescheduling the Greek debt have to be taken after completion of the second evaluation of the implementation of the third bail-out programme before the end of 2016. The popularity of the Greek government and the Prime Minister Mr Tsipras keeps falling due to the high social cost of the policies implemented. The radical left-wing party Syriza promised to increase pensions, the minimum wage and unemployment benefits and to reduce taxation,

especially for small and medium-sized enterprises, professionals and farmers in order to win two consecutive elections in 2015. Government policy moves in the opposite direction and 50% of those who voted for Syriza in September 2015 have already distanced themselves from the radical left-wing party.

In this context the only good news that would help the Greek government to address negative public opinion is an agreement on the rescheduling of the Greek debt. For the reasons we explained, this agreement will have to wait the results of consecutive European elections in 2017 and even the completion of the implementation of the third financial assistance programme as agreed at Eurogroup level in May 2016. Nevertheless, the Greek government will exert its influence in order to have at least the outline of a future agreement so that it can sell it to the Greek public and open the way to Greece's participation in the programme of quantitative easing applied by the ECB.

I think that we are not going to have a comprehensive agreement on the rescheduling of the Greek debt in 2016 or 2017, but we have to reach a political compromise on how we will manage the situation in the future in order to convince the IMF to remain in the Greek programme and avoid misunderstandings and tensions between the Greek government and its European partners and creditors.

In my view, we are approaching the problem of the Greek debt in the wrong way because we put the emphasis on haircuts and rescheduling. The best way to move forward is by supporting the Greek economy, investing in Greece and making sure that GDP grows at an annual rate of 2-3% in the foreseeable future. It is a difficult and costly enterprise since the Greek economy suffers from a lot of structural problems; the Greek government is not pushing forward the modernisation of the Greek economy; and our European partners and creditors are not really willing to support their arguments in favour of developing the Greek economy with the necessary investment. Nevertheless, it will cost less to the European taxpayer and the European economy in general to support an ambitious investment plan in favour of Greece rather than the rescheduling of the debt which cannot be serviced by an economy which is in constant decline.

I conclude by underlining that the Greek economy and the political system need an agreement on the rescheduling of the Greek debt. This agreement will be the product of political compromises and will facilitate the management of the Greek economy without solving major problems. We need an ambitious investment policy supported by European funds and major European enterprises as well as a major change in the economic policy implemented by the Greek government in the direction of less taxation and more business opportunities to guarantee the sustainability of the Greek debt.

How to fill the international law *lacunae* in sovereign insolvency in European Union law?

By Rosa María Lastra[1]

Introduction

In the twenty-first century sovereign debt problems are not just the domain of emerging market economies. They have also become a feature of the economic environment in a number of developed countries in particular in the context of the euro area debt crisis. This contribution considers a key theme from the legal perspective, namely the *lacunae* of international law in sovereign insolvency and how to fill them in European Union law.

Talking about sovereign debt we are reminded, on the one hand, of the concept of state sovereignty, a concept anchored in constitutional and administrative law and, on the other hand, of the workings of the financial markets since debt instruments are obligations to pay. With the advent of the restrictive theory of sovereign immunity, it is financial markets rather than sovereigns that provide the framework for the understanding of sovereign debt.[2] At stake is the interaction between the public interest of sovereign governments and the private interests of financial market participants.

With these ideas in mind, and considering the dichotomy between global financial markets and national legislation, we analyse the current situation from the perspective of: (i) the law applicable to the restructuring of sovereign debt; (ii) the limitations of entrusting the resolution of conflicts to national courts of justice; (iii) the fact that the conditionality of the International Monetary Fund (IMF) operates as a substitute for collateral in sovereign loans and; (iv) the public policy considerations in a broad sense, in particular the protection of human rights and the defence of democracy. After examining the implications of the current legal framework for the Member States of the Union/euro area, we conclude with some brief final remarks.

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[1] Professor of International Financial and Monetary Law, Centre for Commercial Law Studies, Queen Mary University of London, 67-69 Lincoln's Inn Fields, London WC2A 3JB, r.lastra@qmul.ac.uk. This contribution is based on the paper presented at the conference organised by the European Central Bank on 6 October 2016 in Frankfurt and I am grateful to the participants and the other speakers (Yves Mersch, Chiara Zilioli, Anna Gelpern, Lee Buchheit, Ross Leckow, Georgios Kyrtsos, Christoph Paulus, Michael Ioannidis, Otto Heinz and Heribert Hirte) for their insightful remarks during the conference. I thank Lucía Satragno, doctoral candidate at the World Trade Institute, University of Bern for research assistance.

[2] The 'restrictive theory' of sovereign immunity considers that a sovereign state can be subject to civil proceedings in foreign courts in relation to their commercial activities. See generally Boccuzzi, Jr, C.D., Brennan, M.M. and Johnston, J.H., "Defences", in Lastra, R.M. and Buchheit. L. (eds.), *Sovereign Debt Management*, OUP, 2014, p. 105.

1 First *lacuna* – the applicable law

There is no coherent international legal framework for the resolution of sovereign debt crises. Relying upon a 'multi-level governance'[3] methodology that assesses which functions are conducted at the national, regional and international level, it is clear that when it comes to sovereign debt, national law still reigns supreme. Notwithstanding the predominance of the national dimension there are some European initiatives (notably the European Stability Mechanism Treaty, ESM)[4] as well as some international proposals in the form of soft law that suggest the emergence of a transnational solution to what effectively is a transnational problem, for example the principles on responsible sovereign lending and borrowing promoted by the UNCTAD[5] (United Nations Conference on Trade and Development).[6]

Beyond the examples of 'top-down soft law' (rules or principles) like the ones issued by the UNCTAD, the standardisation of contractual documents relating to the sovereign debt issuance has achieved a level of harmonisation that can be characterised as 'bottom-up soft law' because of the widespread acceptance of collective action clauses (CACs).[7] This standardisation has been accepted by the International Capital Market Association (ICMA)[8] and institutions such as the IMF.

Sovereign states issue debt in the form of bonds that are subject to the national laws of the jurisdiction in which they have been issued or to the law of a reputable international financial centre (usually the law of the State of New York or English law). Sovereign bonds are not *acta jure imperii* but *acta jure gestionis*, commercial transactions that are subject to the laws of private contracts.[9] Sovereign debt

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[3] On the theory of "multilevel governance" see Cottier, T., "Multilayered Governance, Pluralism and Moral Conflict", Vol. 16, Issue 2, *Indiana Journal of Global Legal Studies*, 2009, p. 647; ibid, "Towards a Five Storey House", in Joerges, C. and Petersmann, E.U. (eds.), *Constitutionalism, Multilevel Trade Governance and International Economic Law,* Hart Publishing, 2011, pp. 495-532; and Petersmann, E.U., "Framework of Analysis: Multilevel Governance", in Cottier, T., Lastra, R.M., Tietje, C. and Satragno, L. (eds.), *The Rule of Law in Monetary Affairs,* OUP, 2014.

[4] The European Stability Mechanism (ESM) is the crisis resolution mechanism for countries of the euro area. The ESM issues debt instruments in order to finance loans and other forms of financial assistance to euro area Member States. The decision leading to the creation of the ESM was taken by the European Council in December 2010. The euro area Member States signed an intergovernmental treaty establishing the ESM on 2 February 2012. The ESM was inaugurated on 8 October 2012. For further information see www.esm.europa.eu

[5] See generally Bohoslavsky, J.P. and Li, Y., "UNCTAD Principles on Responsible Sovereign Financing" in Lastra, R.M. and Buchheit, L. (eds.), *Sovereign Debt Management*, OUP, 2014. UNCTAD is a permanent intergovernmental body established by the United Nations General Assembly in 1964.

[6] Christoph Paulus argues that "there are numerous general principles of insolvency law which either perfectly fit the needs of a sovereign debt restructuring proceeding or which, at least, could easily be adjusted to those needs" and considers that "a structured proceeding is desirable and that it should (or at least, could) be based on various elements adopted from insolvency law and to be adjusted to the specifics of a sovereign default." See Paulus, C.G., "How could the general principles of national insolvency law contribute to the development of a state insolvency regime?", paper presented at the conference organised by the European Central Bank in Frankfurt on 6 October 2016.

[7] For a discussion on CACS please see Hagan, S., "Debt Restructuring and Economic Recovery" in Lastra, R.M. and Buchheit, L. (eds.), *Sovereign Debt Management*, OUP, 2014.

[8] See www.icmagroup.org

[9] See Goode, R., *Commercial Law,* 2nd edition, London: Penguin Books, 1995, p. 21. "When in 1981 the House of Lords decided to abandon the old rule and bring English law into line with that of other jurisdictions by removing sovereign immunity in relation to the trading activities of the state, it thereby received into English law a restrictive doctrine of sovereign immunity which had by that time become adopted by almost all influential trading nations".

documentation typically provides – through a waiver of sovereign immunity – for the sovereign's consent to a foreign jurisdiction and judgment enforcement proceedings.

2 Second *lacuna* – the courts

In the absence of a treaty concerning the mechanisms for sovereign debt restructuring at the international level (either in the form of an SDRM, Sovereign Debt Restructuring Mechanism, in accordance with the proposals that would have given this role to the IMF, or an international tribunal to deal with these issues), litigation relating to sovereign debt issues is subject to the judgment of national courts of justice.[10]

A large number of voices consider that this situation is clearly inadequate. Lee Buchheit lucidly explains it: "In the light of eternity, we have thus established a framework that makes sovereigns accountable to the judiciary for the performance of their sovereign debt contracts even though everyone recognises that the judiciary is wholly irrelevant in the face of a large sovereign debt problem."[11]

The World Trade Organization (WTO) with its legal and institutional framework for the implementation and monitoring of trade agreements and for the resolution of disputes that arise from the interpretation and implementation of these agreements (commercial disputes) provides a model to follow, given its international and independent character.

3 Third *lacuna* – collateral

IMF conditionality operates as a substitute for collateral in the case of sovereign lending.[12] Conditionality refers to the policies and procedures developed by the Fund to govern the access to and the use of its resources by member countries. Since these resources exist for the benefit of the entire membership and are finite, their use need be temporary and consistent with the purposes of the Fund.[13] This is a very important feature given the inability of creditors to seize sovereign assets in case of non-compliance by the sovereign state debtors.

The case of the Argentinian sailing ship – ARA Libertad – acts as a prime example to explain why this third *lacuna* in international law is problematic.[14] The Argentinean

[10] See the report of Johannesburg issued by the 'Sovereign Bankruptcy Group' of the International Law Association, 27 July 2016, http://www.ila-hq.org/en/study-groups/index.cfm/cid/1046

[11] See Buchheit, L.C., 'Sovereign Debt in the Light of Eternity' in Lastra, R.M. and Buchheit, L. (eds.), *Sovereign Debt Management*, OUP, 2014.

[12] For a complete analysis on the role of the IMF in the restructuring of sovereign debt see the chapter I wrote, "The Role of the International Monetary Fund" in Lastra, R.M. and Buchheit, L. (eds.), *Sovereign Debt Management*, OUP, 2014. As a response to the crisis in the euro area and the ongoing litigation against Argentina, the IMF published in April 2013 a comprehensive paper setting the new path for the Fund in sovereign debt workouts, Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework, April 2013.

[13] For more detail please see IMF Conditionality – A Factsheet, September 2016

[14] NML Capital Ltd v Republic of Argentina, Second Circuit Decision.

ship ARA Libertad was detained in Ghana for ten weeks following a court order obtained by NML Capital Fund (MLP Neuberger Berman Income Fund Inc., a subsidiary of Elliot), a creditor of Argentina, in December 2012. The ship was freed after the International Tribunal for the Law of the Sea ruled that Ghana had to release the ship. This incident is a sign of the despair with which an investment fund such as NML had tried to seize assets of the Argentine Republic abroad, since they are generally protected by sovereign immunity. The then president of Argentina, Cristina Fernández, claimed that the military vessel was a symbol of sovereignty and national dignity.

When it comes to the design of conditionality, the IMF is the institution that has the 'know how' and the experience garnered through the years (often through 'trial and error'). IMF conditionality is what gives credibility to the financial assistance the Fund provides to members experiencing balance of payments problems. It also has a catalytic function for those countries to regain access to private capital markets. The design of conditionality in IMF-supported programmes often entails a difficult balancing act (a judgment based on the information available via surveillance) between 'imposing' austerity or painful economic restructuring and understanding the strength of the underlying social fabric of a nation and its ability to withstand painful reforms so as to avoid social unrest or, even worse, revolts and revolutions.[15]

We need to rethink conditionality in the context of Union law. Though explicit conditionality was not part of the original Treaties, in the aftermath of the global financial crisis, conditionality is now firmly inserted in the Union process. It appears in Article 136(3) of the Treaty on the Functioning of the European Union (TFEU): "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality".[16] It is behind the ESM Treaty, behind the announcement by the ECB of the Outright Monetary Transactions programme[17] and behind the advent of European banking union. It has become part of the case-law of the Court of Justice of the European Union in particular in the *Pringle* case and in the judgment in the Case C-62/14 *Gauweiler and Others*.[18]

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[15] Hayk Kupelyants mentions in his PhD thesis different factors that affect the states' capacity to comply including culture, record of previous debt restructurings, contingent liabilities, currency or maturity mismatches, the nature of the investor base, macroeconomic stability, market sentiment, professionalism of the state's institutions, the level of development, the amount of government revenues, etc. See Kupelyants, H., *Sovereign Defaults before Domestic Courts,* doctoral thesis (to be published in 2017).

[16] On 25 March 2011 the European Council adopted Decision 2011/199/EU, adding a third paragraph to Article 136 TFEU (OJ L 91, 6.4.2011, p.1). This paragraph authorised euro area Member States to establish a permanent stability mechanism that would operate under strict conditionality. These conditions are implemented through a Memorandum of Understanding (MoU) reflecting a macroeconomic adjustment programme concluded with ESM members concerned (Article 13(3) ESM Treaty). For a detailed explanation about the EU/IMF conditionality in the context of the Union please see the recent article by Annamaria Viterbo, 'Legal and Accountability Issues Arising from the ECB's Conditionality', Vol. 1 No 2, *European Papers*, 2016. Viterbo argues that the shift to explicit conditionality in the Union (with the amendment of the TFEU) improves legal certainty and predictability even when concerns about democratic accountability and domestic interference are still in place.

[17] See ECB, *Technical Features of Outright Monetary Transactions,* press release dated 6 September 2012, available at http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

[18] C-370/12 *Pringle*, ECLI:EU:C:2012:756 and C-62/14 *Gauweiler and Others*, ECLI:EU:C:2015:400.

Any public intervention in government debt or bank rescues now needs to be justified by conditionality. Conditionality acts as a means to counter moral hazard and as a prerequisite to any debt restructuring in the euro area.[19]

4 Fourth *lacuna* – considerations of human rights and protection of democracy

A significant *lacuna* in sovereign insolvency concerns the obligations under international law regarding human rights. The current notion of sustainable debt does not encompass an assessment of the impact that the austerity measures imposed by the restructuring programmes or the sovereign debt reduction may have on human rights (socio-economic rights) or on the defence of democracy.

The national courts dealing with sovereign debt issues do not consider in their rulings (actually it is not their competence) the impact that the sovereign debt restructuring and related austerity measures may have for the debtor countries.[20] These are very important issues in the European context, given that populism thrives on the popular discontent that often accompanies austerity measures.

As a response to the deficiencies of the legal system at the domestic level, the UN General Assembly adopted Resolution 68/304 on 9 September 2014 in which it decided to elaborate a multilateral legal framework for sovereign debt restructuring processes through a process of intergovernmental negotiations.

On 10 September 2015 the UN General Assembly adopted Resolution 69/319 declaring that sovereign debt restructuring processes should be guided by nine basic principles, including the right to sovereign debt restructuring, good faith, transparency, equitable treatment, sovereign immunity, legitimacy, sustainability and the principle of majority restructuring.[21]

The United Nations independent expert on foreign debt and human rights, Juan Pablo Bohoslavsky has proposed the following six human rights benchmarks:

1. The new legal framework should include an explicit reference that debt restructuring must be compatible with existing human rights obligations and standards.

2. Risk assessments and debt sustainability analysis carried out prior to a debt restructuring need to include human rights impact assessments.

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[19] Michael Ioannidis, "Debt restructuring in the light of *Pringle* and *Gauweiler – flexibility and conditionality"*, paper presented at the conference organised by the European Central Bank in Frankfurt on 6 October 2016.

[20] For an analysis of the relationship of human rights and austerity measures see Krajewski, M., "Human Rights and Austerity Programmes" in Cottier, T., Lastra, R.M., Tietje, C. and Satragno, L. (eds.), *The Rule of Law in Monetary Affairs*, OUP, 2014.

[21] Resolution 69/319, Basic Principles on Sovereign Debt Restructuring Processes.

3. The future multilateral framework on debt restructuring should address adequately negative human rights impacts caused by hold outs.

4. Debt restructuring should ensure that minimum essential levels of the enjoyment of economic, social and cultural rights can be satisfied even in contexts of financial crisis and retrogressive measures affecting the enjoyment of these rights should be avoided.

5. The human rights principles of impartiality, transparency, participation and accountability should be reflected in a new legal framework for debt restructuring.

6. International and regional human rights protection mechanisms, national human rights institutions and civil society organisations should be able to play a role in the decision making process of debt restructurings.[22]

Sovereign debt crises have multi-dimensional effects. They are not isolated events; sovereign debt crises are typically accompanied by banking crises, economic crises, social crises and also political crises. And they exacerbate the inter-temporal problems of debt repayment.[23]

5 Implications for euro area Member States

The inadequate state of affairs at the international level (the previously mentioned *lacunae*) presents specific challenges for the European Union, in particular for those Member States of the euro area that have been facing severe problems in the light of the vicious link between bank debt and sovereign debt.

Antonio Sáinz de Vicuña considers that the sovereign debt crisis in the euro area has many peculiarities that should be taken into account as regards debt restructuring. He considers that the most relevant are: the absence of powers to devaluate, to use internal inflation and to establish exchange controls, and the prohibition on bail-outs by other Member States.[24] Consequently, and as a response to the sovereign debt crisis, an ad hoc architecture to deal with euro area debt problems has emerged, first with the European Financial Stabilisation Mechanism

[22] Bohoslavsky, J.P., Towards a Multilateral Legal Framework for Debt Restructuring: Six Human Rights Benchmarks States Should Consider, January 2015. Also see, ibid, Effects of Foreign Debt and Other Related International Financial Obligations of States on the Full Enjoyment of all Human Rights, Particularly Economic, Social and Cultural Rights, Annual Report to the 71st session of the UN General Assembly.

[23] See, Lastra, R.M., 'The Role of the International Monetary Fund' in Lastra, R.M. and Buchheit, L. (eds.), *Sovereign Debt Management*, OUP, 2014.

[24] For an explanation of how a sovereign debt restructuring in a monetary union differs from the general case of sovereign debt restructuring, see Antonio Sáinz de Vicuña, 'Restructuring in a Monetary Union: Legal Aspects', in Lastra, R.M. and Buchheit, L. (eds.), *Sovereign Debt Management,* OUP, 2014.

and the European Financial Stability Facility, and then with the European Stability Mechanism Treaty (ESM).[25]

The ESM is not a fully fledged sovereign debt restructuring mechanism. It was modelled as a 'mini IMF', with an added bank recapitalisation feature. The ESM is a bail-out fund and one of its key features is the mandatory inclusion of CACs in euro area sovereign bonds from 2013 (Article 12. 3 ESM Treaty).[26] But the ESM Treaty rests upon an intergovernmental structure over-imposed on the Union structure and provides financing subject to strict conditionality.[27]

The Union should establish a specific procedure for assessing debt sustainability in the participating Member States. For the time being the ESM seems to rely on the IMF's debt sustainability analysis regarding its determination of what constitutes sustainable debt. But since the European Commission already monitors the macroeconomic conditions of Member States (multilateral surveillance), it could prepare 'debt sustainability assessments', thus assisting the ESM in gathering the information it requires to make adequate funding decisions.

The ESM could also adopt – through an amendment of its treaty – a notion of sovereign debt sustainability consistent with international and European human rights law.

The Union should establish an independent court or a forum to deal with the resolution of sovereign debt disputes,[28] either by amendment to the Treaties (e.g. by providing a different chamber to deal with sovereign debt litigation in the Court of Justice of the European Union) or via an intergovernmental treaty.

The justification for establishing such a European court or forum could be based on some of the arguments put forth in the genesis of European banking union. The use of European funds for the rescue of national banks highlighted the need to establish independent European supervision (the Single Supervisory Mechanism, SSM, as the first pillar of the banking union). Heribert Hirte has proposed the introduction of a "Resolvency Court" (drawing on Christoph Paulus' term of "resolvency" instead of the ill-sounding "insolvency"…) by modification of the ESM Treaty.[29] Christoph Paulus

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[25] For a detailed description of the new architecture created in the euro area to tackle the sovereign debt problems, see Chapter 8, section G of my book *International Financial and Monetary Law* (second edition, OUP, 2015). Also see Lastra, R.M. and Louis, J.M., 'European Economic and Monetary Union: History, Trends and Prospects', 32(1), *Yearbook of European Law*, and Viterbo, A., 'The Impact of Sovereign Debt on EU Monetary Affairs', in Cottier, T., Lastra, R.M., Tietje, C. and Satragno, L. (eds.), *The Rule of Law in Monetary Affairs*, OUP, 2014.

[26] From January 2013 all Member States of the euro area should include CACs in their euro area sovereign bonds issuance whether local or international http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf

[27] The ESM Treaty was subject to constitutional review in several euro area Member States, especially Germany. For further details see chapter 8 of Lastra, *International Financial and Monetary Law* (second edition, OUP, 2015).

[28] See chapters 9 and 10 of Lastra, *International Financial and Monetary Law* second edition, OUP, 2015.

[29] See Heribert Hirte, "A sovereign debt restructuring mechanism for the euro area? No bail-out and the monetary financing prohibition", paper presented at the conference organised by the European Central Bank in Frankfurt on 6 October 2016.

has also advocated a permanent court of arbitration to deal with the resolution of sovereign debt conflicts.[30]

6 Concluding observations

This contribution has examined several international law *lacunae* in sovereign insolvency, considering how to fill them in Union law. We need more coherent and predictable international and/or regional systems to address sovereign debt problems and crises.

The need for a supra-national structure underlies the case for a European sovereign debt restructuring mechanism. The Union could provide, through the establishment of a European court or forum for resolving sovereign debt conflicts, a regional solution that could then serve as an international benchmark.

[30] See Paulus, C.G., 'A Resolvency Proceeding for Defaulting Sovereigns', 24 Norton Journal of Bankruptcy Law and Practice 2015, S. 376 ff.

How could the general principles of national insolvency law contribute to the development of a state insolvency regime?

By Christoph G. Paulus[1]

It is a fact that lawyers rarely, if ever, invent new legal instruments. Looking through more than 2000 years of legal history reveals lawyers' preferred method for regulating new phenomena, namely to look for existing rules dealing with a similar phenomenon and to adapt and adjust this pre-existing law to the needs and peculiarities of the new phenomenon (cf. Paulus (2002)). It is, therefore, quite obvious that the existing insolvency law regime has at least the potential to significantly contribute to the construction of a state insolvency regime. As will be shown in this paper, essential similarities exist – irrespective of the differences which, as a matter of fact, need to be respected and taken into account.

1 General principles

It is only in the past 40 years that commercial insolvency law has become a potential model for sovereign debt restructuring. For millennia before that, insolvency law had been almost exclusively confined in its methods to liquidation of the debtor's assets; they were sold to others so that, in the end, the debtor was left with little or nothing. However, with the enactment of the US Bankruptcy Code in 1978, the debtor reorganisation tool of Chapter 11 came into existence and started its triumphant advance all over the globe. Instead of liquidation, the debtor is helped to remain in business. This is exactly what a sovereign debt restructuring is all about: reducing the existing and strangulating debt amount to a sustainable level so that normal life can go on.

But it is not just the outcome of modern insolvency law which constitutes a fitting starting point for constructing a sovereign debt restructuring mechanism; it is also the underlying situation of a common pool problem: in either the sovereign or the commercial case, the debtor does not have the means to fully satisfy its creditors. In order to obtain a debt reduction, the debtor is bound to negotiate with its creditors. Insolvency law supports such negotiations by liberating them from the commercial unanimity requirement and replacing it by a majority vote. Hold-out strategies are, thus, aggravated and debt reductions are facilitated; both results are highly desirable in the sovereign context as well. All that is needed here is the establishment of a mechanism to structure the negotiation process.

[1] Professor of Insolvency Law at the Humboldt-Universität Berlin.

But even beyond the common pool problem and the tool of structured negotiations, there are further principles of insolvency law which could be transplanted into the sovereign context – if they are not already used in present day debt restructuring efforts (on what follows, cf. ILA Report, 2016): In order to ensure transparency (which is key for successful negotiations), creditors should be involved in the negotiation process from the very beginning; insolvency law, therefore, provides the concept of a creditors' committee, which is involved in all major steps and deliberations in the course of a proceeding. Moreover, despite the often -particularly in German doctrine - claimed centrality of pari passu distribution (or par condicio creditorum), insolvency law has for literally millennia dealt with the breach of this principle by admitting priorities. The most prominent priority was and still is the "prince penny", i.e. the tax privilege. There are still today insolvency laws which provide for dozens of priorities, but they are well-functioning insolvency laws. Therefore, the priority claimed usually by multilateral entities such as the International Monetary Fund (IMF) or the European Stability Mechanism (ESM) for their repayment is, in principle, not ideal but does not at all speak against adaptation of insolvency law.

By its mere existence, insolvency law exercises a certain disciplining function both for debtors and creditors, preventing (or, rather, curbing) thereby risky strategies (moral hazard); this can aptly be deducted from all those efforts which are undertaken by various industries to get around the insolvency risk (Paulus (2014b)). Fostering responsible, i.e. disciplined, sovereign lending and borrowing is the primary focus of UNCTAD's respective principles (UNCTAD 2012). Therefore, establishing a structured proceeding would bring the additional advantage of strengthening those efforts. It should be noted, additionally, that within the European Union –for precisely this reason of budgetary discipline – the existence of the credible threat of an effective sovereign debt restructuring mechanism is indispensable for the credibility of a bail-out prohibition (Zettelmeyer (2016)).

Moreover, insolvency law applies a mechanism which is key for any restructuring. The German word *Zwangsgemeinschaft* describes this mechanism nicely: all participants – i.e. the debtor and its creditors – are, as it were, placed into the same boat which allows, most importantly, all of them to be subject to a majority vote. Whereas outside of the proceeding the unanimity principle applies, within the proceeding a majority vote suffices to bind all creditors – which proves to be the best method to cope with hold-outs. As will be shown below, many of the proposals for a structured proceeding struggle with the attempt to achieve such a binding effect; suffice it to mention the common distinction between a statutory approach and a contractual one (Paulus (2003)).

To sum up, there are numerous general principles of insolvency law which either perfectly fit the needs of a sovereign debt restructuring proceeding or which, at least, could easily be adjusted to those needs. However, two more things should be mentioned here:

- Firstly, the nomenclature of the procedure is of the essence. Given the widespread stigma of insolvency all over the world (maybe with the exception of the United States), it is highly advisable to avoid this word; this author's

preferred terminology is therefore “resolvency” as it indicates the way back to debt sustainability.

- Secondly, the psychological element should not be underestimated; the biggest advantage of any structured proceeding is that it gives guidance to the actors in a typically chaotic situation. Sovereign defaults usually do not form part of the everyday business of heads of government or finance ministers. They and their staff usually find themselves – more or less all of a sudden – on territory unknown to them, their constituency, their creditors, and the general public. The multi-dimensionality and complexity of this situation would automatically be reduced if there was a procedure already in place setting out the various steps that needed to be taken.

2 A structured proceeding

It follows from the foregoing that a structured proceeding is desirable and that it should (or, at least, could) be based on various elements adopted from insolvency law and to be adjusted to the specifics of a sovereign default. This leads to the next question, namely, which structure or which procedure should be chosen? Multiple proposals do exist (IMF 2013), most recently supplemented by the UN’s adoption of soft law principles (Guzman and Stieglitz (2016)); they can be categorised in different ways, first and foremost by the distinction between a statutory approach and a contractual one. In what follows the structures are chosen in order of increasing complexity.

2.1 Minimally invasive: anti-vultures-statute

Given the strong scepticism on the official side about establishing any sort of procedure, a very modest form of “procedure” with almost no elements of insolvency law would be the following:

According to the IMF, a debt restructuring proceeding for sovereigns is necessary in order to overcome the hold-out strategy (IMF 2013). One way of dealing with this strategy is presently being tested by Belgium. A law was enacted on July 12, 2015, which prevents any Belgium judge from adjudicating (or, in case of an enforcement, permitting) more than the purchase price paid by the party when and if this party is to be qualified as a vulture fund. This law is presently being challenged before the Belgium Constitutional Court but, nevertheless, the French and the German legislatures seem to be considering the adoption of a similar law in their respective jurisdictions.

It would be less harmful for the secondary market if the limit were more flexible (Paulus (2016)). The admissible limit could be the purchase price plus, e.g., 25% (or any other percentage below 100), or, if the issuing country reaches an agreement with the majority of the other bond holders, to limit the amount to what the plaintiff would have received if it had not held out. In the latter case, the result of the

agreement between the sovereign and its majority creditors would elegantly be stretched to unfold general validity.

2.2 Contractual solution: resolvency proceeding

An example of the so-called contractual approach would be the resolvency proceeding. A common feature of all respective proposals is that they try to achieve the abovementioned “enforced community” (Zwangsgemeinschaft) through a consensual tie, i.e., all those (but only those) who sign the contract are bound by the rules. In contrast, the statutory approach creates the “enforced community” through statute, or an international treaty.

The resolvency proceeding is built on three steps (Paulus (2014a)): (i) a contractual clause (2.2.1), (ii) a resolvency forum (2.2.2), and (iii) procedural rules enacted by this forum (2.2.3). The hold-out issue will then be addressed separately (2.2.4).

2.2.1 Contractual clause

The resolvency clause needs to be implemented into every borrowing instrument of a sovereign. In its simplest version, it could be phrased thus: “In cases of default, the issuing sovereign is permitted to activate the collective action clauses, or to activate a resolvency proceeding by filing the relevant petition with the Resolvency Court.”

The contractual approach, most prominently represented by the collective actions clauses, leaves it to the respective sovereigns to contractually determine the procedure in all its details. Irrespective of some considerable deficiencies (these clauses do not provide fresh money, and they address just the debt structure and not the debtor’s economic situation), this approach seems to be – at least for the time being – the present day state of the art. It is, thus, consistent that the Treaty establishing the ESM (Article 12(3)) explicitly prescribes the inclusion of such clauses in most euro denominated bonds. Accordingly, it would not require much of an adjustment to align the resolvency proposal with the ESM mechanism (Paulus and Tirado (2013)).

Given this state of affairs, the resolvency proceeding takes advantage of this approach. After all, it is less ambitious than the statutory approach and it allows for an easier realisation of the concept. There is no need to enter into an international agreement or to enact a statute; instead, it suffices to include the said contract clause into any borrowing agreements. Accordingly, the resolvency procedure can be established without being dependent on a supra-national legislative body. One of its drawbacks is, however, that it takes some time before all instruments are equipped with the relevant clauses.

2.2.2 Resolvency Forum

It is part of the abovementioned reduced ambition to refrain from developing elaborate substantive rules and to confine the proposal to the constitution of a resolvency forum. It should be noted that such self-restraint is not without historical precedent: In the 1960s, when decolonialisation changed the global political map, the details of an international investment protection system became the subject of heated debates. The antagonistic interests of investors and the newly liberated sovereigns lead to an amalgam of highly complex and intricate problems which appeared unsolvable for quite some time. Yet ultimately a solution was found in the creation of the International Centre for the Settlement of Investment Disputes (ICSID) at the World Bank. This is just an arbitration platform for disputes arising out of investment disputes, which offers procedural rules and support but no substantive law. As a consequence, arbitral awards rendered under the auspices of this Centre in the last 50 years or so nowadays add up to a considerable body of public international investment protection law. It is this model which gives reason for some optimism that a resolvency law will evolve in the long run under the auspices of an appropriate institution.

But the ICSID model is not the only one for the overall concept of a sovereign debt tribunal; there are further models for the details of a sovereign debt tribunal. Suffice it to refer to the Iran-US Claims Tribunal or its less prominent counterpart for Iraq. And finally, the IMF's Sovereign Debt Restructuring Mechanism (SDRM), too, provided for the establishment of a supervisory institution. It is particularly this latter concept that should serve as a model for the Resolvency Forum: Accordingly, the Forum would consist of a president and a pool of around 30 supervising judges. The president and its office would be the only permanent staff; the supervising judges would remain in their respective positions and become actual supervising judges only when and if they are appointed by the president for a particular case. According to the complexity of the case, five or seven judges would be appointed and would then form "the Resolvency Forum". The advantage of this approach is that it reduces the costs associated with the tribunal; the judges would be paid only when acting as supervising judges, and by the debtor sovereign.

Apart from having an outstanding reputation both as professionals and as regards social competence, the supervising judges should be in a position to rapidly develop expertise in all resolvency issues. Therefore, the pool of potential supervising judges should be limited to a small number. The selection of the potential supervising judges must be guided by various diversification criteria such as different nationality, professions, and backgrounds.

The experiences with the IMF proposal teach us that the location of the Resolvency Forum is an important issue. It would, accordingly, be unacceptable to connect the tribunal with any of the existing credit institutions such as the European Central Bank in Frankfurt; the same is true also for any of the Brussels institutions as they are (or appear to be) guided by specific political interests. Given this, possibly the optimal solution would be to have a special and independent chamber established at the European Court of Justice in Luxembourg. But since this would require a rather time-

consuming legislative act, under Article 257 TFEU, the second best solution under the present circumstances appears to be to have the Resolvency Forum established at the Permanent Court of Arbitration (PCA) in The Hague. This would be an act of incidental consistency: apparently, the idea of creating there a bankruptcy court for sovereigns was indeed circulated at the time of the PCA's foundation – i.e. some 115 years ago.

2.2.3 Procedural rules

The last step for the constitution of a resolvency regime is that the Resolvency Forum lays down its rules of procedure. The comparison with the creation of the ICSID suggests that these rules should be more or less restricted to providing a platform on which the stakeholders of a sovereign default are bound to find a solution under the auspices of the Resolvency Forum. This is all the more advisable as the history of the last 100 years of sovereign defaults has shown that the prevalent solution for those situations has been negotiations. Therefore, what should be sought is a platform that offers sufficient space and a structure for such negotiations.

Given this point of departure, it is possible to draft the rules of procedure in cautious analogy to modern commercial insolvency law. To get a better understanding of this proposal, it is certainly helpful to begin with a coherent description of how the envisaged Resolvency Procedure would work from beginning to end (2.2.3.1). Thereafter, a couple of selected issues are addressed in some more detail in order to demonstrate that the considerable existing legal problems can be overcome (2.2.3.2).

2.2.3.1 The resolvency procedure: an overview

The procedure begins with the debtor country's application. It must be accompanied by the presentation of a restructuring plan, describing meticulously in every detail how the debtor envisages the restructuring of its debt. It must consist of two parts: on the creditor side, the plan must explain which concessions are requested from the creditors or which exchange offers will be submitted; on the debtor side, the plan must state which contributions the debtor itself is ready to undertake. Note that the plan is, at this stage of the procedure, just a proposal or draft that will be subject to manifold changes, adaptations, and amendments in subsequent negotiations with the creditors. Here at the commencement of the procedure, it serves as a kind of entry control: it is the Resolvency Forum's (i.e. the freshly appointed supervising judges') first task to examine the feasibility, fairness and reasonableness of the plan.

The creditors are grouped together into classes, which, of course, has to be done in accordance with rational and verifiable criteria – this is not necessarily identical with a classification along the lines of the bond issuances. This is an essential feature of the proposed procedure since discussion about and final voting on the plan will be done through the groups. Even if the consent of each single group should be

needed, such group formation implies that not every single creditor needs to concur; instead, it suffices that the (however determined qualified) majority of, e.g., 66%, 75%, or 85% of the creditors within one group do so. Thus, if only a simple majority within a group is required, the consent of 50% + 1 is sufficient.

However, before it comes to the voting, the debtor and the creditors must sit at the same table and discuss the proposed plan. Because of the predominantly positive experiences for instance in the course of the Greek restructuring, a creditors' committee should also be appointed right from the commencement of the case and should have a right to participate in all relevant negotiations. This serves primarily as a trust-building measure for the creditor community as a whole. In order to reduce the mass of creditors and in order to enable meaningful discussions, it would be possible to appoint special representatives – as is provided for, for instance, in many modern Debenture Bond Acts.

As a matter of fact, the parties involved in these discussions will engage in tough negotiations; it is to be assumed that every side will argue strongly for its own benefit. The Resolvency Forum's rules, however, should not contain any substantive prescriptions; the result of the negotiations should be left to the balance of powers. This is all the more advisable as one important feature of the rules should be that different groups can be treated differently. Given this peculiarity, it is possible to take full account of a widespread concern among politicians: namely to bring together small creditors into a separate group which could receive 100 % satisfaction whereas other groups with, e.g., institutionalised creditors, are to accept a "haircut" of 50%. The flexibility of potential solutions in this context is as large as contractual freedom allows for adaptations to the individual case.

It is not necessarily mandatory that these negotiations are connected with those which the debtor country is likely to conduct at the same time with potential new lenders. After all, in a situation like the one envisaged here, the debtor will be in dire need of fresh money. Primary candidates for those negotiations will be the IMF or the ESM. But alternatively, or additionally, there is a certain possibility that, depending on the acceptance and the reaction of the capital market to the commencement of the resolvency procedure, the debtor is able to get money even from the capital market (bonds) at tolerable interest rates. This depends, of course, on how the market interprets the debtor state's decision to go through a resolvency proceeding. But whoever the respective lender is, it might be interested and should be permitted to participate in the plan negotiations – at least as an observer. After all, this would increase the disciplining effect on the debtor, which is certainly one of the most important side effects of the entire Resolvency Procedure.

After a pre-determined period of time, the voting must be done. The debtor is dependent on the creditors' majority's consent and is, accordingly, again under a certain disciplining pressure, since without an accepted plan, the debtor's debt situation remains unchanged. This dependency on the creditors is a kind of compensation for what will be described in more detail below: namely the exclusive right of the debtor to trigger the commencement of the procedure. One could think about mitigating this dependency by reducing the requirement of unanimity regarding the groups' consent (importantly, however, not the voting requirements within any

one of the groups). One could, for example, also think along the lines of what in commercial insolvency law is known as the “cram down rule”, which, under certain circumstances, allows a plan to be deemed as accepted when and if the (simple or qualified) majority of groups do concur.

If the plan is accepted, the Forum must approve it by examining the legal correctness of the proceeding up to that point. Given this requirement, it is advisable to have the supervising judges present all the time during the negotiations. They should function as moderators but should also be endowed with decision powers for certain disputes.

If, however, the necessary majority for the plan’s acceptance is not achieved, a second chance should be granted; i.e. re-negotiations should be possible, although just for a rather limited period of time. When and if this second attempt also fails, the European Monetary Union (unlike the situation of other over-indebted sovereigns) could possibly provide for a whole range of sanctions up to the exclusion of that particular sovereign from the Union – which would likely be the most severe of such sanctions. However, the failure of the plan’s acceptance could likewise be within the sphere of responsibility of one (or more) of the creditors’ who try to ‘hold out’. With the Forum’s moderation a situation like that could be sanctioned by withdrawing that creditor’s voting right or interpreting its vote as a ‘yes’ after special investigation of the result’s fairness and reasonableness. In this way, both sides could be disciplined.

2.2.3.2 Selected issues in detail

1. A fundamental element of any proceeding like the one presented here is, as a matter of course, the conditions under which the resolvency proceeding shall actually commence. The commercial insolvency law of, for instance, the German Insolvency Ordinance provides three reasons to commence proceedings: insolvency, imminent insolvency, and over-indebtedness. None of them is transferable to the realm of sovereign default and a resolvency proceeding. The IMF imposed in this context the requirement of “unsustainability of debts”, meaning therewith (roughly speaking) that the debt burden has become too high to reduce the principal amount and to be captured, thus, in what is commonly called a ‘debt trap’.

   But the question is if there is any need for a specific reason to commence at all. It might suffice to have instead a subsequent abuse control. As will be discussed in more detail below, it would be one of the Resolvency Forum’s primary tasks to examine the commencement prerequisites right at the beginning of the procedure. If they are not fulfilled, the proceeding would not commence and the debtor country would be obliged to look for alternative solutions – an intentionally unpleasant alternative to abusing the procedure.

2. In the IMF’s proposal for the SDRM, too, only the debtor country had the right to petition for the commencement of the proceeding. This might not be ideal from the perspective of disciplining the debtor; but the fact that the debtor is a sovereign state means that there is no alternative. A petition by a creditor might

pressure the debtor into taking extreme actions which, in the worst case, are not needed at all. Moreover – and probably most importantly – the likelihood of such an option being politically acceptable is minimal at best. Germany, France, or any other country would be unlikely to agree to submit themselves to such a regime.

However, in view of what has earlier been said about the advantage of any insolvency proceeding – namely its disciplining function for all stakeholders just by the mere fact of its existence – the present proposal might appear as unilaterally favouring the debtor's position. If only the debtor has the right to trigger the procedure, it can use this as a bargaining chip for its negotiations, for instance, at the Paris Club or the London Club, or in its negotiations with the private sector; the creditors have nothing to counter against this. Nevertheless, for the reasons already set out, this imbalance must be tolerated and will in any case be compensated by other measures disciplining specifically the debtor – for instance the abovementioned need for the creditors' consent to the plan.

3. Given the mere procedural approach of the resolvency procedure, the attribution of competences to the Resolvency Forum is essential for success or failure of the proposal. It should be noted, however, that at this point in the proposal's evolution, it is only possible to present an overview of *potential* competences. Further refinement will certainly be needed in due time.

- Possibly the Forum's single most important task is to examine whether the application constitutes a potential abuse on the part of the petitioning sovereign; if so, the application will be rejected. The supervising judges have, accordingly, to review the debtor's justification for the commencement of the procedure as presented in the submitted plan. It should be noted that the conferral of this task on the Forum underscores the care and attention needed in the selection of the supervising judges' pool. They will need to have extensive political, economic and legal knowledge to carry out such an examination, which entails verifying the debtor's claim that all existing sources of income and other assets have been exhausted in that part of the draft plan that deals with the debtor side. The options available are innumerable: (further) privatisations might be as possible and reasonable as improving the tax collection system or increasing certain taxes; saving options might be available by cutting salaries in the public sector (for instance, reducing or eliminating the 13th month's salary), further exploiting certain commodities that have not yet been (fully) exploited, or selling gold reserves etc. To get an idea of the range of possibilities, it could be helpful to study the conditionality catalogues of the IMF or World Bank, which these institutions have previously prepared for borrowing states.

- The verification of claims might also be seen as one of the key tasks of the Forum. But, as a matter of fact, here too, the devil is in the detail: which claims are to be included in the resolvency proceeding? Just foreign ones or also domestic ones? Claims just against the state or also those against the national bank, the subdivisions such as Länder, provinces, regions, etc., or state owned enterprises? Only contractual claims or also those based on other grounds?

The preferable (but, of course, somewhat ambitious) answers to these selected questions are: Bearing in mind the need to overcome the selectivity of the Paris Club or London Club and to strive for an all-encompassing resolvency proceeding all claims should be included – be they foreign or domestic (possibly including the domestic tax or wage claims); the debtor should include all those entities which have no separate legal existence (the others are subject to the general insolvency law); and there should be a restriction to contractually founded claims because for the time being the Forum's competence can be founded only on a contract.

- It is by no means a marginal task of the supervising judges to moderate the negotiations and to check the legitimacy of the group formation, i.e. whether or not objective, coherent criteria have been applied on the creditor side of the draft plan. For reasons explained below, the debtor state is thereby not bound to form an extra class for all and every bond issuance. Alternatively, the classification could be done on the basis of different risk calculations.

- A final competence of the Resolvency Forum could be the dispute resolution within the proceeding. The details should be elaborated by taking inspiration from existing commercial insolvency jurisdictions such as Austria or the US. They confer far reaching competences upon their insolvency courts regarding the resolution of disputes between the parties. Such a concentration (in the commercial context labelled as "vis attractiva concursus") serves the purpose of the proceeding's acceleration and streamlining. In addition to dispute resolution, it would be possible to think about permitting the supervising judges to serve as mediators or conciliators – in a similar way to what is done in the ICSID tribunals.

4. The time factor is of vital importance in any restructuring and, consequently, in any resolvency procedure as well. Therefore, it is key to take this facet into consideration and to provide for rather strict time frames in order to prevent strategic abuse by either side in prolonging or shortening the procedure for their own benefit. However, it is to be assumed that, in most cases, it will be the debtor country which pushes for acceleration; since the earlier the plan is accepted, the earlier the state can begin with the realisation of the resolvency measures. Based on this assumption the focus of timing rules should be in imposing discipline on the creditors. Those rules could include, for instance, the right to ad hoc-interventions of the judges or fixed time frames after which the majority requirements could change.

5. If the plan is accepted by the prescribed majority vote and if the Forum has ultimately certified the legality of the procedure, this Forum order will be the basis for all subsequent legal changes and obligations arising from the plan. The creditors' "haircuts" are effective as of this time as are the debt deferral agreements, etc. But as of this time the debtor state, too, is obliged to begin with all those measures (apart from submitting the changed debt instruments to the creditors) which, pursuant to the accepted plan, are to be done by the debtor – for instance, cutting salaries, privatisation operations, exploring new (or increasing existing) taxing sources, etc.

However, it is possibly not an entirely unlikely scenario that, once the plan has been accepted and the debt burden is accordingly reduced, the debtor becomes somewhat hesitant or less enthusiastic about complying with the imposed obligations of the plan: all of a sudden, it might feel inclined to postpone the promised tax increase until after the elections the following year, or decide that the sale of certain shares is "unfortunately" presently not appropriate, etc. In such a case, the creditors would have recourse to the courts (whichever these might be in the given case), but, even if successful in the end, might have to wait months, if not years, for the final decision. Therefore, effective resolvency rules should provide for ongoing supervision by the judges in this plan-realisation period in order to impose discipline on the debtor here, too. The sanction against such – culpable –delaying action of the debtor could be modelled on section 255 of the German Insolvency Ordinance: the Forum could be given the power to revoke the plan – with the consequence that the status quo ante is re-established and all claims do exist as they had been before the plan acceptance.

2.2.4 Hold-out strategies

It has already been mentioned that the hold-out problem is a primary concern in designing a workable and efficient sovereign debt restructuring instrument. It is, thus, a touchstone of the resolvency procedure as described here if at all and how it deals with this problem.

Giving the debtor state the legitimation to determine the classification of groups according to reasonable and verifiable standards – which need not necessarily coincide with the bond issuances – aggravates ex ante preparations of hold-outs or vulture funds for expected resolvency proceedings. Simply put, this ex ante uncertainty increases the costs of buying blocking minorities.

Additionally, since the Resolvency Forum is to be seen as an arbitration tribunal, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards becomes applicable. Accordingly, when the Forum's final confirmation decision on the plan becomes binding, the contents of the plan are to be recognised at least by the courts of the (currently) 149 member states of this Convention. Thus, when this decision reduces the face value of a given debt instrument to 50% of its face value, this has to be recognised and accepted automatically by those courts. A law suit pleading for the full face value amount would have to be rejected. A decision in favour of the hold-out plaintiff would have to take into account that this claim legitimises payment only up to that percentage that is determined in the confirmed plan.

2.3 Model law

The most ambitious but also most efficient method of creating an "enforced community" (*Zwangsgemeinschaft*) would be if the UN, for instance, submitted a

model law (or, alternatively, a multilateral treaty) to the community of sovereigns that deals in detail with the resolvency of a sovereign (Paulus (2003)). It is widely accepted that any state in the world has the power and the right to create such enforced community in the event that one of its subjects goes bankrupt; this is also true if such a subject is itself a public law entity, such as a municipality. The next logical step is that an enforced community would also be established if the state in question has its own insolvency regulated. In order to avoid unjust individual legislation, however, it is indispensable that there is just one regime which all state resolvency laws have to follow closely. And this would be the said model law which could be implemented by means of the IMF's and the World Bank's conditionality.

This solution has the advantage of avoiding the main flaw of the IMF's proposed SDRM, i.e. a collision of interests; the UN usually is not a creditor to the countries concerned here. This "separation of powers", however, does not necessarily mean that the IMF's and World Bank's role in a state insolvency proceeding would be automatically reduced to a mere creditor position like any private bond holder. Not only is the information pooled in these institutions about the economic situation of the states indispensable for any effective resolvency proceeding; they are also to be treated separately – not because they are the "law makers" but because (and to the degree that) they are lenders of last resort. Since what they do in this respect would be qualified in a private law setting as "Sanierungskredit" or credit given for reorganisation purposes. There are many examples in existing insolvency laws of giving priority to such credits.

Another advantage of the model law proposal is that it applies to all types of lending. It thus avoids the potential temporary nature of the other existing proposals. The details of the proceeding could be very much the same as the ones described above as procedural rules in the Resolvency Mechanism. Once adopted in a particular state, the statute would come into effect immediately instead of over a transition period of up to several decades in which all debt instruments would have to include a resolvency clause. The same is true with regard to potential subsequent changes, amendments, or improvements. They will probably be needed; after all, the task is so new and the enactment of a resolvency law would be so novel that unforeseen or unforeseeable issues are almost bound to arise.

2.4 Final remarks

A widely used argument against the introduction of any one of the proposed instruments is that it would change dramatically the existing situation with unpredictable (and potentially catastrophic) consequences. This is probably not untrue, but is not wholly realistic, since the legal framework of every jurisdiction is prepared to cope with this kind of shock by establishing transition periods during which all parties involved and all stakeholders can (and must) adjust to the new instruments and conditions.

The situation in Europe after the outbreak of the Greek crisis in early 2010 shows the dangers of employing ad hoc solutions, as has been done for millennia. The process

gets politicised and tensions emerge; all of the sudden, the project of a unified Europe is endangered irrespective of its much higher importance, seen from a historic and political perspective. If a neutral procedure such as a Resolvency Forum had been in place, any comparisons with Hitler or other apportionments of blame from one nation to the other, could have been avoided.

It is particularly the last point – in combination with the advantage of giving guidance in a chaotic situation – that urges one to believe and hope that the time is more than ripe for entering the stage in which an orderly and structured resolvency proceeding for sovereigns exists. Needless to say, the overall global indebtedness reinforces this argument; satisfying the existing claims in accordance with rules such as section 362 of the German Civil Law Book is illusionary. Therefore, other and more effective solutions need to be established.

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Debt restructuring in the light of *Pringle* and *Gauweiler* – flexibility and conditionality

By Michael Ioannidis[1]

1 Introduction

What can the recent case-law of the Court of Justice on the euro area crisis teach us with regard to the restructuring of sovereign debt held by the public sector? What are the limits and conditions set by the Court for such a potential restructuring? This contribution approaches these questions by focusing on the relevance of the *Pringle* and *Gauweiler* judgments of the Court of Justice for the restructuring of debt owed to public sector creditors, namely Member States, the European Union, and the European Central Bank (ECB). This is indeed the form of restructuring that seems most relevant at the moment. Greek debt is predominantly held by euro area countries (bilaterally or through European financial assistance mechanisms such as the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF)), the European Union (through the European Financial Stabilisation Mechanism, EFSM), and the Eurosystem (as a result of the Securities Markets Programme (SMP) and Agreement on Net Financial Assets (ANFA)).[2] The potential restructuring of debt held by public sector creditors raises difficult questions regarding its compatibility with Articles 125 and 123 TFEU. Some observers argue, for example, that any waiver of Greek debt held by central banks violates the prohibition of monetary financing, and that any waiver of Greek debt held by the European Union or euro area financial facilities violates the no bail-out clause.[3]

To address the question of the compatibility of public sector debt restructuring with Union law, one needs to take a closer look at the recent case-law of the Court of Justice. The milestone judgments in *Pringle* and *Gauweiler*, although not dealing with restructuring measures, but with financial assistance and unconventional monetary measures, are of great importance for the design of possible debt restructuring measures that involve public sector creditors. They set the basic guidelines for any form of public intervention in the field of debt, be it through assistance, monetary interventions, or debt restructuring. There are two basic guidelines: first, the willingness of the Court to take a flexible position towards public interventions in the field of debt; second, the recognition that moral hazard, the danger that Union financial assistance or debt relief might distort the incentives of domestic policymakers to reform their economies, is a major concern for the post-

[1] Senior Research Fellow, Max Planck Institute for Comparative Public Law and International Law.

[2] For more detail, see Hofmann (2016), p. 7 et seq.

[3] Hofmann (2016), p. 3.

crisis economic constitution of the Union. In order to counterbalance this threat, the Court accepted the remedy developed by political institutions: any assistance should be tied to "strict conditionality".

Both these elements are highly relevant for debt restructuring in the euro area. The Court should be expected to read Articles 125(1) or 123(1) TFEU (depending on the exact measures and the types of creditor involved) flexibly with regard to debt-restructuring initiatives. It also seems plausible to expect that any such measures will have to face moral hazard scrutiny and will therefore be tied to conditionality. Conditionality in turn raises the much debated question of economic sovereignty. As experienced so far in the euro area crisis, conditionality is the most invasive instrument of economic policy and results in a unique transfer of powers from the domestic level to the institutions responsible for conditionality monitoring. Debt restructuring is thus necessarily connected to the broader debate on the economic governance of the Union. The bottom line of this contribution is that thinking about debt restructuring in the euro area also requires *thinking about economic sovereignty and the sharing of competences in the field of economic policies*.

2 Debt restructuring in the light of *Pringle* and *Gauweiler*

2.1 The original Maastricht arrangement

In the Maastricht Treaty, the idea that prevailed was that financing of euro area countries should be left to the markets. Member States that required funds beyond those they received from taxation should obtain them from capital markets. Market interest rates were in turn ascribed a disciplining function.[4] If a Member State was spending more than justified by its fundamentals, it was expected that creditors would increase their interest rates and induce the reckless Member State to reconsider its policies. No public institution, such as a Union fund or a central bank, was deemed to be in a position to fulfil these twin tasks of funding and disciplining. This market-based paradigm of government financing was mainly guaranteed by two provisions: Article 125(1) TFEU prohibited the European Union and other Member States from assuming the financial commitments of a Member State; and Article 123(1) TFEU prohibited the ECB from engaging in monetary financing. These provisions had a common objective; they were meant to signal to the markets that, apart from in exceptional cases falling under Article 122 TFEU, euro area countries should bear the market costs of their economic policies without any involvement from domestic or Union public institutions.[5]

In the Maastricht market-based credit system, the role of Article 125(1) TFEU was to signal to market actors that they should not misinterpret the participation of a Member State in the Economic and Monetary Union (EMU) as an implicit guarantee

[4] Hentschelmann (2011), p. 284; Ohler (2013), para. 3.

[5] Pipkorn (1994), p. 275; Hentschelmann (2011), p. 285; de Gregorio Merino (2012), p. 1625; Siekmann (2013), para 29.

of its debt by the Union or other Member States.[6] It was assumed that if such an implicit guarantee existed, markets would operate on the basis of lower risks than appropriate and would charge lower interest rates that did not adequately take into account underlying risks. Such “distorted” interest rates would not reflect the actual creditworthiness of Member States, would not offer an incentive to change unsustainable policies, and would fuel the appetite for more debt than appropriate – the moral hazard problem.[7] Article 125(1) TFEU was drafted specifically to prevent such a distortion of the credit-market pricing mechanism by providing that, with respect to issues of debt, the Member States were on their own.[8] In the field of debt, neither creditors nor Member States should expect solidarity, except in cases of emergency that fell under Article 122 TFEU.

The seemingly broad prohibition of financial assistance enshrined in Article 125(1) TFEU was coupled with Article 123(1) TFEU. Article 123(1) TFEU prohibits the ECB and the national central banks (NCBs) from purchasing national debt instruments directly from Member States.[9] Like Article 125(1) TFEU, this “monetary no bail-out clause” was also introduced into Union law in order to safeguard the market-based paradigm outlined above[10] and to ensure that Member States obtained credit under market conditions.[11] If the ECB was allowed to assume the task of a lender of last resort, governments would have an incentive to issue more debt than appropriate. In addition, since the Maastricht paradigm left economic and budgetary decisions to the Member States, there was a need for a clear-cut rule prohibiting the exploitation of any implicit guarantee provided by their common central bank to finance their sovereign and largely independent decisions in the field of economic policy.

Despite their seemingly clear rationale outlined above, namely to guarantee that sovereign debt would be governed only by market logic, both provisions were ultimately read by the Court of Justice as allowing public intervention in the field of debt under certain conditions.[12] In two milestone judgments, *Pringle* and *Gauweiler*, the Court eventually permitted public interventions that go beyond the market-oriented principles of Maastricht. Although these judgments were made in relation to measures of financial assistance and monetary intervention rather than debt relief, both findings, namely the flexible reading of Articles 125(1) and 123(1) TFEU and the limits arising from moral hazard considerations, are relevant to debt restructuring. The following section focuses more closely on the aspects of this case-law that are relevant for debt restructuring.

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[6] The first sentence is addressed to the European Union and the second to the Member States, acting individually or in concert; see Tuori and Tuori (2014), p. 123.

[7] The moral hazard is that both creditors (markets) and debtors (States) might engage in transactions with risks higher than those they would have been willing to take if the implicit guarantee of a third party had not been there.

[8] Louis (2010), p. 978; Hentschelmann (2011), pp. 287-288; de Streel (2013), p. 349.

[9] Unlike in other jurisdictions, the role of the Union’s central bank is prescribed in constitutional terms; see Tuori and Tuori (2014), p. 162.

[10] Kämmerer (2013), paras. 2-5. See also Article 21.1 of the Statute of the European System of Central Banks and of the European Central Bank (the Statute of the ESCB).

[11] Kämmerer (2013), para. 5.

[12] For more detail, see Ioannidis (2016).

2.2 Debt restructuring in the light of *Pringle*

As noted above, Greek debt is now predominantly owed to the International Monetary Fund (IMF), euro area countries (in the context of the Greek Loan Facility, GLF), the EFSF, the ESM, and a small amount to the European Union under EFSM funding.[13] Restructuring of these debts could be seen as a form of "assumption of liabilities" that is prohibited by Article 125(1) TFEU both for Member States and the European Union. Indeed, directly assuming the liabilities of a Member State (something explicitly prohibited by Article 125(1) TFEU), or offering loans through which old liabilities are paid and then waiving these loans (which is the case with a restructuring of debt held by the public sector) seem to be interchangeable measures.[14] This is definitely the case when the waiver is aimed at offering public *assistance* to the debtor Member State. However, there may well be valid *market-based considerations* for a public sector creditor to be involved in debt restructuring. If there is a danger that, without restructuring, the public sector creditor would be exposed to greater losses due to the potential inability of the debtor to pay its (unstructured) debt, then the purpose of the involvement is not to offer the debtor an alternative means of funding (which is the case that the drafters of Article 125 TFEU had in mind), but to protect the creditor's own investment. This type of involvement seems to be outside the scope of Article 125 TFEU and as such is not covered by the prohibition. Of course, it is difficult to determine whether the motivation for restructuring is based on such considerations or is aimed at offering further assistance. Nevertheless, this is important for the application of Article 125 TFEU, and for this reason is a decisive part of the debt sustainability analysis.

Even if this is not case, however, and the restructuring is aimed more at offering further public assistance to the debtor than protecting the investment of the creditor, *Pringle* attests to the willingness of the Court to accept its legality.

In *Pringle* the Court initially accepted the original Maastricht arrangement when it comes to public assistance in debt problems. According to the Court of Justice, "the aim of Article 125 TFEU is to ensure that the Member States follow a sound budgetary policy …. The prohibition laid down in Article 125 TFEU ensures that the Member States *remain subject to the logic of the market when they enter into debt, since that ought to prompt them to maintain budgetary discipline*."[15] Eventually however, it substituted this market-discipline model with the new post-crisis reality, based on public transfers and public scrutiny of domestic economic policies. "However", the Court goes on to say "Article 125 TFEU *does not prohibit the granting of financial assistance* by one or more Member States to a Member State … provided that the *conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy*."[16] The Court justifies this unexpected turn from markets to public institutions with reference to the ultimate goal of market discipline – to induce sound budgetary policies by the Member States and

[13] Hofmann (2016), p. 8 et seq.

[14] Hofmann (2016), p. 24.

[15] Case C-370/12 *Pringle*, ECLI:EU:C:2012:756, para. 135 (emphasis added).

[16] ibid., para. 137 (emphasis added).

ensure the financial stability of the monetary union.[17] Through this interpretation, the Court transformed the meaning of Article 125 TFEU from a provision prohibiting the European Union or Member States from discharging the debt burden of another Member State to a norm allowing public assistance under certain conditions. That means that, even if the dominant component of debt-restructuring measure is to provide some form of assistance to the debtor, it may still be allowed under Article 125 TFEU, provided that two conditions are met: such measures need to be indispensable to safeguard the stability of the euro area, and they need to be subject to "strict conditionality".[18]

It must be emphasised here that the text of Article 125 TFEU contains no hint of these two requirements – especially that of conditionality. Yet the Court interprets the provision in the light of the overarching meta-objective of "sound budgetary principles", establishing Article 125 TFEU as an additional legal source for conditionality. Thus any cross-border transfer of public funds in the form of assistance (and possibly also any form of debt restructuring that touches upon debt owed to Member States or the Union) should be accompanied by an extension of the Union's control powers in order to be deemed to be compatible with Article 125 TFEU. As Tuori and Tuori (2014) note, "*Pringle* constitutionalised the curtailment of sovereignty which beneficiary States must accept as a price for financial assistance."[19] This should also be expected in the case of assistance in the form of debt restructuring.

There is also an additional, final point in *Pringle* that merits attention in the context of a potential debt restructuring. In some passages of its judgment, the Court seems to require a third condition, next to indispensability for safeguarding the stability of the euro area and "strict conditionality", namely that the Member State remains responsible for its debt commitments. In paras. 137 to 139 the Court notes time and again, first, that financial assistance does not release the debtor from its initial debt, since it "remains responsible for its commitments to its creditors", and, second, that it actually creates new debt owed to the ESM that must be eventually repaid by the recipient Member State together with "an appropriate margin".[20] If that is read as an additional requirement, it could be argued that *Pringle* precludes debt relief altogether. Although the relevant passages are not very clear, this third element does not seem to be developed by the Court as an additional requirement. A closer reading of the relevant paragraphs shows that the Court has carefully chosen language that is descriptive of the operation of the ESM under the Treaty establishing the European Stability Mechanism (ESM Treaty) rather than prescriptive, reading these as obligations stemming from Article 125 TFEU.

In any case, the ESM interest rate is already a subsidised interest rate: loans from the ESM and its predecessors are offered at rates that are significantly lower than the recipient Member State would have paid in the market. The "appropriate" margin

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[17] ibid., paras. 135-136.

[18] ibid., paras. 136-137.

[19] Tuori and Tuori (2014), p. 189.

[20] Case C-370/12 *Pringle*, ECLI:EU:C:2012:756, para. 139.

in the Maastricht paradigm is the market rate; in the post-*Pringle* era it is set by the Eurogroup and the ESM. Under this post-*Pringle* interpretation of Article 125 TFEU, a further reduction in interest rates, an extension of loan maturities or even a reduction in the nominal value of the debt could be deemed to be consistent with Article 125 TFEU.[21] In both cases, public sector creditors discharge the debt burden of a Member State. In one case indirectly, by offering lower interest rates than markets would require, and in the other case directly, by lowering the debt that the Member State owes to them. In *Pringle* the Court sanctioned the retreat from the market-based paradigm and radically transformed the meaning of Article 125.[22] Allowing the rate to be set by public actors rather than markets is a profound change that allows a clear distinction to be made between a pre-*Pringle* and a post-*Pringle* interpretation of Article 125 TFEU. There are very good reasons to believe that the public-assistance paradigm was not what the drafters of this provision had in mind. After *Pringle* however, this is more or less irrelevant. It is this new meaning of Article 125 TFEU that matters when assessing the legality of any future debt restructuring and, for good or bad, this seems to allow broad leeway to the Member States and the Union.

2.3 Debt restructuring in the light of *Gauweiler*

How should the potential involvement of the Eurosystem, which holds Greek bonds as part of its SMP/ANFA programmes, be assessed in the light of the *Gauweiler* case? *Gauweiler* concerned the second pillar of the market-based paradigm, i.e. the prohibition of monetary financing enshrined in Article 123(1) TFEU. Although an outright monetary transaction (OMT) cannot be deemed to have directly violated Article 123(1) TFEU, since government bonds are purchased not on the primary market but on the secondary market, its action could nevertheless be deemed to have had an effect equivalent to purchase on the primary market, "undermining the effectiveness of the prohibition in Article 123(1) TFEU".[23] Could the involvement of the ECB in a debt restructuring have such an "equivalent effect", violating Article 123(1) TFEU? One critical passage in *Gauweiler* that is particularly relevant for assessing the legality of restructuring the debt held by the ECB is paragraph 126, in which the Court ruled that

> *"although the lack of privileged creditor status may mean that the ECB is exposed to the risk of a debt cut decided upon by the other creditors of the Member State concerned, it must be stated that such a risk is inherent in a purchase of bonds on the secondary markets, an operation which was authorised by the authors of the Treaties, without being conditional upon the ECB having privileged creditor status."*

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[21] See also Hofmann (2016), pp. 26-27.

[22] For more detail, see Ioannidis (2016).

[23] Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:400, para 97. The Court also makes reference in paragraph 101 to recital 7 in the preamble to Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles [123 TFEU] and [125(1) TFEU] (OJ L 332, 31.12.1993, p. 1), according to which purchases made on the secondary market may not be used to circumvent the objective of Article 123 TFEU.

In this passage, in which the Court supports its finding that OMTs do not violate Article 123 TFEU, the Court recognises that losses are an inherent danger in the open market operations of the ESCB. This is also implicit in Article 33 of the Statute of the ESCB, which explicitly provides for the allocation of potential losses of the ECB.[24] In a debt-restructuring context, this means that the legality of SMP (or OMT) debt purchases will not be called into question retrospectively if the Eurosystem is outvoted in a debt restructuring process. However, saying that losses are possible if the ECB is outvoted does not mean that the ECB can acquiesce to them and forgive debt owed to it. Advocate General Cruz Villalón hinted at this distinction in paragraph 235 of his Opinion, noting that "the ECB will not actively contribute to bringing about a restructuring but will seek to recover in full the claim securitised on the bond".[25] Since the Court was not asked to rule on this issue, however, the question remains open. Would the ECB be in violation of Article 123 TFEU if it "actively" agreed to a debt restructuring?

Given the original purpose of Article 123(1) TFEU, the most obvious answer to that question would be that a decision to agree to debt refinancing would undermine the effectiveness of the prohibition in Article 123(1) TFEU and would thus amount to prohibited monetary financing. Such a decision would definitely be more than simply accepting the "inherent risk" of buying bonds in the secondary market. *Gauweiler*, like *Pringle*, however, shows a clear tendency of the Court to look at the purpose of Article 123(1) TFEU in a totally new light. As in *Pringle*, in order to ascertain whether OMTs could have produced such an equivalent effect, the Court turned to the objective of Article 123(1) TFEU. The Court, however, did not focus on the immediate objective of the Article, namely to safeguard the pricing and disciplining function of credit markets, but, as in *Pringle*, went directly to the meta-objective, namely "to encourage the Member States to follow a sound budgetary policy" and to avoid "excessively high levels of debt or excessive Member State deficits".[26] According to the Court, in order to pass the test of Article 123(1) TFEU, OMTs should not lessen the impetus of Member States to follow a sound budgetary policy.[27] Advocate General Cruz Villalón explicitly connected this requirement to the "undoubtedly legitimate" interest "in eliminating any hint of 'moral hazard' that may result from a significant intervention by the ECB on the government bond market".[28] The Court sided with this view, ruling that

> *"the fact that the purchase of government bonds is conditional upon full compliance with the structural adjustment programmes to which the Member*

[24] Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:400, para. 125.

[25] See also Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:400, para. 118: such practice "does not imply that the ESCB waives its right to payment of the debt, by the issuing Member State, once the bond matures".

[26] Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:400*,* para. 100. For a reading of this finding in favour of allowing greater discretion to Union institutions, see Goldmann (2016), p. 122 et seq.

[27] Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:400*,* para. 109.

[28] Opinion of Advocate General Cruz Villalón in Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:7, para. 145; see also para. 141.

States concerned are subject precludes the possibility of [OMTs] acting as an incentive to those States to dispense with fiscal consolidation…"[29]

Indeed, the main argument of the Court in favour of the compatibility of OMTs with Article 123(1) TFEU is that the meta-objective of "sound budgetary policies" is served through non-market means. As in *Pringle*, the Court recognises the danger of moral hazard. As a remedy, it accepts the ECB version of conditionality incorporated in its OMT programme. In sum, it seems that the post-*Gauweiler* meaning of Article 123 TFEU might even cover something more than simple losses from a debt restructuring *imposed* upon the ECB. Whereas it is clear that the central banks of the ECSB cannot acquire national debt for the purpose of waiving it,[30] the situation is different in relation to debt they hold at the time of a debt restructuring. In the event that some form of debt reduction is deemed necessary to safeguard "an appropriate monetary policy transmission and the singleness of the monetary policy",[31] even an active engagement of the ECB in the restructuring of the debt it holds might be treated as acceptable by the Court. Although this wider reading of Article 123 TFEU is more difficult than a similar reading of Article 125 TFEU described above, it should not be ruled out that ECB participation in some form of restructuring – such as the extension of maturities or the lowering of interest rates – could be sanctioned by the Court.[32]

2.4 *Pringle*, *Gauweiler* and the transformation of Union law

In sum, three basic findings can be derived from this brief analysis of *Pringle* and *Gauweiler* with regard to their relevance for debt restructuring. First, they mark the transformation of the original market-based Maastricht paradigm to a model that allows public interventions in sovereign debt, such as financial assistance, non-conventional monetary issues, and probably also debt restructuring. Both *Pringle* and *Gauweiler* should be read as bringing about a constitutional transformation in the area of Member State debt. On one hand, as shown above, it is extremely difficult to argue that the measures assessed by the Court were permissible under Articles 125(1) and 123(1) TFEU as those articles were initially interpreted. On the other hand, insisting that Articles 125(1) and 123(1) TFEU still prohibit financial assistance, and even some forms of debt restructuring, after these judgments is not only impractical, but also at odds with the new meaning these provisions have acquired after *Pringle* and *Gauweiler*.

Second, both decisions recognise moral hazard as major concern in this process of transforming Union constitutional law. Explicitly or implicitly, in both cases the Court is mindful of the danger that going beyond the Maastricht principles and allowing public intervention in the way markets treat sovereign debt might distort the incentives for domestic governments to engage in necessary reforms. The

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29 Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:400*,* para. 120.

30 Hofmann (2016), p. 17.

31 Case C-62/14, *Gauweiler and others*, ECLI:EU:C:2015:400, para. 47; see also para. 50.

32 For an opposing opinion, see Hofmann (2016), pp. 27-28.

transformation of the meaning of Articles 125(1) and 123(1) TFEU thus gave rise to fears of moral hazard and brought about, as a necessary complement, the transposition of disciplining power from the market to European public institutions in the form of new economic governance and especially conditionality.

Third, the Court sides with the Union institutions when it comes to the means to counter the moral hazard problem. Conditionality is deemed to be a necessary and sufficient means to achieve the meta-objectives of a "sound budgetary policy" and "fiscal consolidation" that have been read by the Court as the ultimate rationales of Articles 125(1) and 123(1) TFEU. In the following two sections, this contribution will briefly consider the issues of moral hazard and conditionality.

3 Euro area debt restructuring and moral hazard

The central idea behind moral hazard is that guaranteed assistance provided by others entails a risk that the recipient's incentives will be distorted in a way that leads to less than optimal decisions.[33] This distortion stems from the fact that the costs of the recipient's conduct are ultimately born by another person.[34] As Reinhart and Rogoff (2016) note with regard to moral hazard, "[t]he problem is that if one provides insurance to everyone everywhere, with no conditions, some players are going to misbehave."[35] Thus, at the core of moral hazard is the disconnect between the decision-maker and the ultimate risk-bearer. This is a common problem in a variety of fields of economic and social interaction, such as insurance, labour contracts, healthcare, and delegation.[36] In insurance, for example, moral hazard refers to the tendency of insurance cover to alter an individual's incentive to prevent loss: if costs are borne by another actor, individuals have less incentive to act prudently so as to avoid them.[37]

A number of solutions have been suggested to counter moral hazard. One of them is to monitor the care that the insured takes to prevent loss and/or to make insurance conditional on such care.[38] However, conditionality and monitoring are not the only ways to address the problem of moral hazard. As Kenneth Arrow noted in one of the essays that framed the moral hazard debate, alternative relationships may also contribute to cooperation and risk-sharing. In such communities "relations of trust and confidence between principal and agent are sufficiently strong so that the agent will not cheat even though it may be 'rational economic behaviour' to do so."[39] Such relations of trust and community thus form a different mechanism for controlling moral hazard, next to monitoring and making the assistance subject to conditions.

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[33] As the term implies, moral hazard relates to risks generated or augmented by conduct attributable to the insured – rather than factors beyond their mastery. For an extensive discussion of the term's origins, see Baker (1996), p. 244 et seq.; Rowell and Connelly (2012), p. 1051.

[34] See Hale (2009), p. 5.

[35] Reinhart and Rogoff (2016), pp. xli-xlii.

[36] Baker (1996), p. 237; Rowell and Connelly (2012), p. 1052.

[37] Shavell (1979), p. 541.

[38] A third way is to offer only partial coverage against loss; see Shavell (1979), p. 541.

[39] Arrow (1968), p. 538.

In the field of international financing, there are two questions related to moral hazard. The first question is whether international public assistance (via the IMF or the ESM, for example) distorts the incentives of creditors, who may ascribe less value to the possibility of not being repaid. This is called the "creditor moral hazard".[40] The second question is whether international assistance or debt relief has an effect on the policies of recipient countries, which might take less care to adopt measures that could prevent a crisis. For the topic under discussion in this contribution, it is this second form of moral hazard that is more relevant. By offering assistance or debt relief, the argument goes, lenders such as the IMF and the ESM might encourage borrowers to take risks and maintain inefficient economic structures – which will ultimately lead to public debt problems.[41] National governments have little incentive to change the policies that produced economic difficulties if the cost of these mistaken policies is ultimately borne by third parties – those offering financial assistance.

Explicitly or implicitly, moral hazard was the concept that framed the political and legal debate during the euro area crisis. It defined how governments shaped the new euro area assistance mechanisms, how the ECB designed its bond purchase programmes, and how the Court of Justice assessed their legality. Empirical evidence also shows that moral hazard was the concept used most heavily by leading German newspapers in order to present their problem diagnosis, the criteria of evaluation and their recommendations, while it was popular in Spain as well.[42] Wolfgang Schäuble, one of the most influential actors during the crisis, summarised the incentive-distortion potential of Union intervention as follows: "Moral hazard is not benign. Setting the wrong incentives would mean stabbing reformist governments in the back. By suggesting that uncompetitive economic structures can endure, we would buoy the populists, scapegoat-seekers and illusion-peddlers who lurk at the fringes of our political landscapes. By discouraging reform, we would not solve Europe's imbalances but make them permanent."[43]

This basic idea of moral hazard has, implicitly or explicitly, framed much of the debate on the euro area crisis and has played a significant role in shaping the transformed economic constitution that the Union ultimately acquired. Importantly, conditionality compensated for the lack of Arrow's "alternative" relationships of trust and commonality of interest, which proved to be lacking in the Union during the crisis. Following these debates, all financial assistance mechanisms, the GLF, the EFSF, the EFSM and the ESM, are based on conditionality. As described above, this choice was not only sanctioned by the Court of Justice in its *Pringle* and *Gauweiler* decisions, but was even turned to a constitutional requirement inherent in Articles 123(1) and 125 TFEU(1). In order to allow the more flexible reading of these provisions, the Court required in exchange that the moral hazard problem is faced

[40] See e.g. Bratis, Laopodis and Kouretas (2015).

[41] Lane and Phillips (2000). IMF-related moral hazard also has a creditor side, namely the hypothesis that "expected IMF support to a country may provide an implicit guarantee to its creditors regarding their returns, which motivates them to take excessive risks." Evrensel and Kutan (2004). The creditor side of moral hazard is only of secondary concern in this paper.

[42] Drewski (2015), pp. 18-19, 23.

[43] Schäuble (2012).

and that the gap opened by abandoning the market-based paradigm in favour of public-intervention is covered by conditionality.

Moral hazard considerations are also relevant with regard to debt restructuring. Economists often refer to the moral hazard of restructuring debts, meaning that allowing debt relief might encourage careless economic policies and the irresponsible accumulation of debt that created the problem in the first place. Similarly, in the case of financial assistance, debt restructuring might protect reckless actors from the consequences of their risky behaviour and distort incentives to change such behaviour. More concretely, in the context of the euro area, Member States that face acute problems in their economic fundamentals, like rigidities in product and labour markets, might have less incentive to undertake reforms if they are offered the easier escape route of cancelling some of their debt. Eventually, debt relief might ease pressure and allow inefficient economic structures to perpetuate – and even generate another crisis in future. Given this similarity with the financial assistance debate discussed above, it should come as no surprise that, in public debates, debt restructuring is closely associated with conditionality. And considering the case-law of the Court in *Pringle* and *Gauweiler* it should also come as no surprise that the Court of Justice might treat conditionality as a prerequisite for any restructuring of debt held by the public sector.

4 Conditionality and the rearrangement of economic sovereignty in the euro area

If this reading of the case-law of the Court is correct, it means that any form of (further) deviation from the market-based principles of Maastricht will need to be offset with conditionality. Conditionality is thus a means to counter moral hazard that should be expected to be part of any sovereign debt restructuring that involves European sovereigns and the Eurosystem. Through moral hazard considerations, the restructuring of public debt is therefore linked to the broader question of where power lies in the economic governance of the Union. However, conditionality requires a thorough rethinking of what economic sovereignty means within the euro area. The problems that arise with regard to conditionality in the Union legal context are not addressed in this contribution.[44] However, a few things can be noted on how financial assistance conditionality challenges some of the basic assumptions of Union constitutional law.

Union financial assistance conditionality is the most intrusive and challenging of the instruments adopted to tackle the euro area crisis. Macroeconomic adjustment programmes are broad in scope, go *very deep in regulating details* of social and economic policies, are supported by an *elaborate monitoring mechanism*, and their non-observance is tied to high costs. Never before have the Union institutions been

44 See Ioannidis (2014); Kilpatrick (2014); Baraggia (2015).

involved in such close surveillance and micro-management of a wide spectrum of policies. Some authors have even spoken of an "*über-Europeanization*".[45]

Perhaps the most difficult problem with Union financial assistance conditionality, as emerged during the crisis and was essentially reaffirmed by Regulation (EU) No 472/2013 of the European Parliament and of the Council,[46] is its *obscurity*. For policies implemented through the mechanisms of conditionality, it is often very difficult to say to what extent they are imposed by lenders' representatives (the Troika[47] in its various incarnations), reflect government choices, or are the result of compromise.

Attribution problems are, of course, a general problem in multi-level governance.[48] Sometimes this difficulty is called the paradox of shared responsibility:[49] as responsibility is scattered among more actors, the discrete responsibility of each of them diminishes, allowing actors to engage in blame-shifting with regard to the undesired effects of their decisions.[50] Conditionality, however, brings this problem to a totally new level. Attribution errors with regard to responsibility for decisions as important as those concerning the pension or healthcare systems are of cardinal importance for democratic politics. Conditionality, as it has been practiced in recent years, has the potential to distort retrospective and prospective mechanisms of democratic accountability.[51] Retrospectively, national governments may be held responsible (or be praised) for decisions that have been actually formulated and imposed by the Troika. Similarly, governments may use conditionality as a mask, allowing them to pursue unpopular economic agendas and then shift the blame onto the Troika. Prospectively, political competitors, such as opposition parties, may suggest alternative policies that in reality they cannot follow. Some actors may thus be punished for decisions that they could not change, while others may be rewarded for promises that they cannot keep.

This obscurity frustrates one of the basic purposes of public law, namely to allow the proper allocation of responsibilities for public decisions, and has profound implications for democratic accountability. Democratic accountability of any form of Union governance is, however, a general postulate of Union constitutional law. Article 2 TEU raises democracy to a value of the Union and Article 10 TEU sets out the two sources of democratic legitimacy in the Union, namely European citizenry, as expressed through the European Parliament, and domestic democratic polities.[52] Union law thus raises radically different legitimacy expectations than an international

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45 Featherstone (2011).

46 Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability (OJ L140, 27.5.2013, p. 1).

47 The European Commission, the European Central Bank and the International Monetary Fund.

48 See Papadopoulos (2010).

49 Bovens (1998), p. 45 et seq.

50 ibid. p. 46.

51 See Papadopoulos (2010).

52 On the dual structure of Union's democratic legitimacy, see Oeter (2010); Peters (2001), pp. 209, 219.

organisation, such as the IMF. Therefore, simply replicating IMF governance structures is not sufficient for Union conditionality.[53]

To what extent is there a legal obligation to uphold these basic principles in the context of conditionality governance? On 20 September 2016, the Court of Justice delivered a milestone ruling regarding the applicability of the Charter of Fundamental Rights of the European Union to conditionality. Until now there has been significant uncertainty as to whether the memoranda of understanding containing the conditions of assistance had to comply with the Charter. In the *Ledra Advertising* case the Court ruled that

"in the context of the adoption of a memorandum of understanding such as that of 26 April 2013 [with regard to Cyprus], the Commission is bound … to ensure that such a memorandum of understanding is consistent with the fundamental rights guaranteed by the Charter." [54]

Ledra Advertising offers an important addition to the matrix of cases that should be taken into consideration when it comes to designing debt restructuring measures. It sets out as a fundamental principle that conditionality measures must also be scrutinised on the basis of fundamental rights as guaranteed by the Charter. We shall not expand on the implications of this requirement for concrete policies here. However, the *Ledra Advertising* case makes a statement of broader significance. It rules that conditionality policy, despite its complicated legal status, does not escape the basic constitutional principles of Union law, such as fundamental rights – and, apparently, also democracy.

Conditionality is a necessary complement to the new economic governance. This is not only for political and economic reasons but, as this contribution has argued, also from a legal perspective. The abandonment of the Maastricht paradigm by the Member States and the Court makes conditionality a necessary requirement for any form of public assistance – be it in the form of financial packages or debt restructuring. The new challenge is how to make conditionality compatible with basic principles of Union constitutional law.

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[53] See Ruffert (2011), p. 1790.

[54] Joined Cases C-8/15 P to C-10/15 P *Ledra Advertising* v *Commission and ECB*, ECLI:EU:C:2016:701, para. 67.

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Issues and possible reforms in the context of a euro area/EU sovereign insolvency framework

By Otto Heinz[1]

Introduction

There have been times when a Eurosystem representative could not have possibly spoken about sovereign debt restructuring, certainly not in a European context. Default or debt reduction was deemed to be incompatible with the euro area, which was also evident in the initial opposition by the ECB to the Greek private sector involvement (PSI).

Times have clearly changed. Whilst the Eurosystem clearly cannot be identified as an advocate of or expert in debt restructuring, nevertheless we have a clear and increasing interest in the matter – admittedly, we always had it through the collateral framework with sovereign bonds playing an important role. The crucial financial stability considerations, in particular during the Greek and Cypriot crises, brought sovereign debt further to the forefront of the interest of the Eurosystem. Such interest has not subsided in view of the different monetary policy purchase programmes relating to sovereign bonds introduced in recent years.

Key objectives

A lot of very valuable points have been made about sovereign debt restructuring during this conference. I would like to add a few observations in the specific context of the euro area. The starting point should clearly be the objectives to be achieved when shaping the framework relating to sovereign debt restructuring in Europe. I have singled out the following goals: (i) to deal with the problem of hold-out creditors efficiently; (ii) to ensure that debt restructuring is not unduly delayed and, if there are serious concerns about debt sustainability, that measures are taken to address them early enough; and (iii) to clarify a rule-based framework for official sector involvement in sovereign debt restructuring.

There is clearly a myriad of issues one can select when trying to improve the sovereign debt restructuring framework in Europe and elsewhere and this selection is admittedly subjective. Nevertheless I believe there is indeed a need to be selective for the sake of efficiency and a timely solution despite the very clear political

[1] Head of the Financial Law Division, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

difficulties of the exercise. Achieving these objectives would be significant progress towards having an efficient debt restructuring framework in the euro area. This would be essential for a predictable business environment, legal certainty, financial stability and ultimately for the purposes of completing the single currency project. The euro area should not be paralysed by issues and concerns about the sustainability of debt of a euro area Member State. Now that there is relative calm after the storm, it is time to deal with the issue.

1 Dealing with hold-outs

The first objective in my subjective list of priorities relates to the issue of hold-out creditors.[2] I believe there is reasonable consensus among policymakers that hold-out creditors are seriously detrimental to the objective of ordinary debt restructuring. The funds paid to them are lost resources and they clearly compromise a possible equitable solution among the creditors and the debtor. It is enough to refer to the Greek PSI, where issues relating to vulture funds as hold-out creditors were also prominent, or the protracted litigation of Argentina with its hold-out creditors that paralysed the country and in fact jeopardised its arrangement with creditors that at the end consented to a debt restructuring. To clarify: the issue is not with the fact that investors also in sovereign debt want to maximise their returns. Indeed it is useful to have some secondary market liquidity for sovereign debt even in distressed times. Investors, however, that aim to base their business model on being a hold-out creditor in sovereign debt restructuring are clearly detrimental to the common good.

1.1 Collective action clauses

As regards hold-outs, collective action clauses ("CACs") are the starting point also in the European context. As other speakers have mentioned, one can confirm also from the European experience that there is merit in single limb collective action clauses with aggregation features. In itself it is of course a welcome and significant development that collective action clauses are being introduced at all in the bond documentation of euro area sovereigns, in particular following the requirement decided by the Euro Group, as reflected in recital 11 of the European Stability Mechanism (ESM) Treaty:

"In its statement of 28 November 2010, the Euro Group stated that standardised and identical Collective Action Clauses ('CACs') will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro area government bonds. As requested by the European Council on 25 March 2011, the

[2] A "hold-out" situation occurs when some creditors hold back from accepting an exchange offer made by the issuer in an attempt to restructure outstanding bonds and try to retain the right to demand repayment of their bonds at par (the full nominal amount). It is argued that hold-outs pose a litigation threat to the sovereign borrower and may significantly undermine its ability to service the new bonds it has issued to the creditors participating in the exchange. See the July 2011 issue of the ECB Monthly Bulletin, Box 2, Collective action clauses for new euro area government bonds, page 80.

detailed legal arrangements for including CACs in euro area government securities were finalised by the Economic and Financial Committee."

It is, however, somewhat unfortunate that the euro area model CAC reflects a rather complicated two-limb approach and as such does not effectively deal with the hold-out issue. On the one hand it makes debt restructuring rather difficult when requiring a certain majority both per series and in aggregate in case there is an attempt to implement cross-series modifications – which is in fact typically essential to address any debt sustainability issues. On the other hand, when requiring a majority per series, it is still clearly possible to build hold-out positions, although the level of holding in percentage terms necessary to block the amendment of one issue is higher than usual, hence it is more difficult to build a blocking minority. Single limb collective action clauses with aggregation features, for example as advocated by the International Capital Market Association (ICMA), would deal with the hold-out issue more effectively, also facilitating ordinary sovereign debt restructuring. Such single limb CACs should be applied together with some safeguards to protect minority creditors (for example the overall majority required needs to be set high enough, there should be appropriate disenfranchisement provisions, the offer/terms of the new bonds should apply to all creditors in an identical manner, etc.).

We at the ECB have recently conducted a survey of sovereign bonds outstanding in the euro area, ISIN[3] by ISIN, with a view to examining if they have collective action clauses and, if so, with what features. We found the following: (i) the majority of bonds still have no CACs at all; (ii) the majority of those bonds that have incorporated CACs contain the euro area model CAC; and (iii) the majority of outstanding debt is issued under local law.

Whilst politically it is difficult, the above constellation offers a possibility, at least in theory, for a legislative solution whereby at least domestic law governed bonds, which represent the majority of the outstanding debt stock, could be retrofitted with CACs – preferably under the improved standard. This was in effect the solution employed in the context of the Greek PSI as well. As one would expect it was legally challenged by investors, inter alia claiming that the retroactive introduction of such CACs is against the constitutional order. Such challenges failed, however, given that we are potentially only talking about the improvement of the framework and the introduction of a voting mechanism, and not about haircuts imposed without the consent of at least the majority of the creditors. Any curtailing of creditors' rights would be dependent on the consent of the majority of the creditors themselves. Actually it should also be acknowledged that if the threshold for the required majority was to be retrofitted at an unreasonably low level, it would increase the chances of a successful challenge. Furthermore it should also be acknowledged that it is not entirely certain how such a solution would be viewed legally in different jurisdictions, noting, however, that it is a lot easier and less controversial to make such changes affecting bond documentation in "peace times" rather than just at the eve of a debt restructuring, as it happened in Greece.

[3] International Securities Identification Number.

To ensure that sovereign bonds issued in the euro area contain CACs and according to the improved standards would represent a major step towards setting up the required infrastructure for sovereign debt restructuring. In addition, this proposed solution would have the added benefit that it would also reduce any discrepancy in the bond documentation of the same issuer, which is still frequently the case. Indeed it would also be helpful for the ECB with respect to its purchase programmes as the level of the required majority in CACs is the key consideration to decide when the Eurosystem would have a blocking minority through its often significant holdings of sovereign debt. If possible, central banks prefer to avoid such blocking minorities, i.e. to stand in-between debt restructuring and the prohibition of monetary financing. For this blocking minority issue (i.e. when the holding of central banks is above the level of holding without whose support there can be no affirmative vote of debt restructuring) not only the holdings under the different monetary policy purchase programmes, but also any other holdings are relevant (in particular holdings under foreign reserves or pensions), aggregated among the ECB and the Eurosystem national central banks (NCBs).

1.2 Other legislative solutions

When talking about legislative solutions in the context of hold-outs, one needs to mention Belgium and the UK legislation of recent years against vulture funds. Both laws aim to legally limit what vulture funds can claim from the issuer to the amount that was actually paid for the sovereign debt by such creditor in the secondary market. They would no longer be able to claim the face value of their holdings, which they typically purchase at a price significantly below par. Admittedly the scope of the UK legislation is narrower than that in Belgium, as most notably the UK HIPC law only applies in the case of debt of highly indebted, typically poor African states. [4]

Whilst recognising their merit, both pieces of legislation were also criticised on several grounds – one reason was the claim that such national initiatives are insufficient and only international initiatives can make a real difference. Given the prominence of English law governing sovereign debt and also given the importance of Euroclear based in Belgium these two pieces of legislation are certainly not without use. Nevertheless rules of wider application would of course be fundamental.

One other idea that comes to mind is that which our esteemed friend Lee Buchheit put forward. He proposed to use the ESM Treaty to provide immunity to any assets, including commercial assets, owned by countries party to the ESM Treaty (ESM Members) and thereby ruling out their attachment at least in the territory of these countries. Here again, similar to collective action clauses, amending the ESM Treaty is a potential solution, admittedly only for the euro area.

[4] Heavily Indebted Poor Countries (HIPC).

2 Debt restructuring early enough

Another key although even more political issue is the second objective, i.e. that debt restructuring is not delayed too much and is implemented when debt sustainability requires it. There is a long literature as to why the debt sustainability problem can cause harm to the economy if it is not tackled early enough. If debt restructuring is delayed and, in particular, if it is then conducted in a disorderly manner, it would typically exacerbate economic problems and cause stagnation over an extended period of time. In such an uncertain economic situation the country would most likely lose access to international capital markets and it would also be difficult for existing investors to manage their holdings. There would be pressure on the currency, asset prices, the banking sector and on the economy in general and, as a self-fulfilling prophecy, the likelihood of debt becoming unsustainable would further grow. There is merit in dealing with the issue, although the related political difficulties are of course evident.

In this context I would only highlight two points – related to debt sustainability and GDP-linked bonds.

2.1 Debt sustainability

In order to tackle debt sustainability issues early enough, one also needs some clear rules about debt sustainability itself. In this context it is worth recalling the current rule on debt sustainability in the ESM Treaty (Article 13).

1. An ESM Member may address a request for stability support to the Chairperson of the Board of Governors. Such a request shall indicate the financial assistance instrument(s) to be considered. On receipt of such a request, the Chairperson of the Board of Governors shall entrust the European Commission, in liaison with the ECB, with the following tasks:

   (a) to assess the existence of a risk to the financial stability of the euro area as a whole or of its Member States, unless the ECB has already submitted an analysis under Article 18(2);

   (b) to assess whether public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF;

   (c) to assess the actual or potential financing needs of the ESM Member concerned.

2. On the basis of the request of the ESM Member and the assessment referred to in paragraph 1, the Board of Governors may decide to grant, in principle, stability support to the ESM Member concerned in the form of a financial assistance facility.

The ESM Treaty is very brief on the issue. It only provides that in connection with a request for stability support, on receipt of such a request, the ESM must entrust the European Commission, in liaison with the ECB, to assess whether public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF, which of course has a more elaborate practice relating to debt sustainability assessment. It is notable that the ESM Treaty does not even explicitly say whether public debt needs to be sustainable in order to provide ESM funds. It only explicitly requires the assessment of the issue although one could of course argue that the purpose of the assessment is in fact to ensure that ESM funding is provided when debt is sustainable. In any case, the ESM Treaty does not provide any further details or does not provide any incentives to address the issue in a timely manner. Trying to make the matter more rule based would be certainly beneficial, whilst politically of course clearly sensitive, in particular when one tries to clarify the rules and is having to apply them at the same time.

There are some proposals that go further in trying to address the issue of debt sustainability. Some propose that contractual arrangements should be put in place for automatic debt restructuring where the debt level reaches a certain point. Here again, linking the idea to an ESM programme could offer itself as a way to facilitate the implementation of such a solution. Whilst such a proposal clearly has its merits (i.e. addressing the issue directly, being rule based and no long negotiations needed once it is triggered), I have to admit that I am more sceptical about the feasibility of such radical concepts that go beyond what is customary in a sovereign debt restructuring context. Given that it would in effect mean that consent would be provided in advance to give up contractual rights; it would not be conceivable to introduce it retroactively in bond documents. Introducing it to new bonds only would then potentially mean two classes of debt for the same issuer (one with and one without an automatic debt restructuring mechanism), which questions the attraction of this second class of bonds to investors, as the ones with the first class could effectively become free-rider hold-outs. Yet to amend all bond documentation (including existing ones) by way of legislation is not feasible either – unlike the retrofitting of sovereign bonds with CACs, such a new clause in effect retroactively imposing debt restructuring on bondholders under certain conditions is expected to be successfully challenged in several jurisdictions. There are arguably more straightforward issues to resolve first.

2.2 GDP-linked bonds

The second point I would like to make in this context is that the types of sovereign debt instruments could be beneficial for the debt sustainability issue and the problem of debt restructuring being delayed too much. New forms of sovereign bonds with more equity-like features could be considered along the lines of the relatively new concept of GDP-linked bonds. Such securities would adjust the debt burden in line with GDP, i.e. with the evolution of economic performance of the country, basically increasing payments in good times but decreasing them in the case of economic difficulties, thereby decreasing the likelihood of a default. Unlike GDP warrants they would not be traded separately from the main debt obligation. It is still to be seen if

such a product being developed would get acceptance in the market. There are several issues still to be resolved, for example the reliability of GDP data, as the data would be the basis for adjusting the issuer's payment obligations. Such securities, alongside other potential contractual solutions, could arguably be a useful way to decrease the likelihood of the need to have sovereign debt restructuring.

3 Official sector involvement

Finally one could consider the usefulness of establishing a clearer framework for official sector involvement with sovereign debt restructuring in Europe – be it about the ESM, the Member States or the Eurosystem as creditor to Member States.

3.1 Eurosystem

Whilst the matter is very difficult and political, having clarity would certainly be beneficial. In particular one would expect that investors in sovereign bonds could better calibrate their risk assessment thereby facilitating investment decisions and investment activity. For example, there was much discussion about the possible preferential status of the ECB (and Eurosystem NCBs) in the wake of the Greek PSI, where the Eurosystem was exempted from haircuts imposed on other creditors. Investors, not only the directly affected ones, complained about uncertainty and the fact that they are now de facto subordinated to central banks. Actually the ECB never claimed (or denied, for that matter) having formal preferential status as such with respect to its policy portfolios.

In the *Accorinti II* case[5] where the exemption of the Eurosystem was challenged by investors before the Court of Justice of the European Union, the Court held that the applicants, as private investors who purchased Greek bonds solely in their private pecuniary interest, were in a different situation from that of the Eurosystem central banks whose investment decision was exclusively guided by objectives in the public interest – the EU law principle of equal treatment was not breached.

"In the present case, the applicants proceed from an incorrect premiss by claiming that all individuals who acquired Greek bonds, as 'private' savers or creditors of the Hellenic Republic, on the one hand, and the ECB and Eurosystem national central banks, on the other hand, were, in the light of the principles and the objectives of the relevant rules on which the actions complained of were based, in a comparable, or indeed identical, situation, for the purposes of the application of the general principle of equal treatment. That argument fails, in particular, to have regard to the fact that, by purchasing Greek bonds, notably on the basis of Decision 2010/281, the ECB and those national central banks acted in the exercise of their basic tasks, pursuant to Article 127(1) and (2) TFEU and, in particular, the first indent of Article 18(1) of the Statute, with the aim of maintaining price stability and the sound administration of

5 Case T-79/13 *Accorinti and Others*, ECLI:EU:T:2015:756.

monetary policy, and also within the limits defined by the provisions of that decision (see recital 5 of that decision).

[…]

Consequently, it must be held that the applicants, as investors or savers who acted on their own behalf and in their exclusively private interest to obtain the maximum return on their investments, were in a different situation from that of the Eurosystem central banks. Although, under the applicable private law, when purchasing State bonds those central banks, like the private investors, acquired the status of creditors of the issuing and debtor State, that single point in common cannot justify their being regarded as being in a comparable, or indeed identical, situation to that of those investors. In fact, such an approach, taken solely from the viewpoint of private law, does not take account of either the legal framework of the operation involving the purchase of those bonds by the central banks or the public-interest objectives which those banks were called upon to pursue in that context under the applicable rules of primary law, the principles and objectives of which must be taken into consideration when assessing the comparability of the situations in question in the light of the general principle of equal treatment …

It must therefore be concluded that the applicants, as private investors who purchased Greek bonds solely in their private pecuniary interest, whatever the precise reason for their investment decisions may have been, were in a different situation from that of the Eurosystem central banks whose investment decision was exclusively guided by objectives in the public interest, as referred to in Article 127(1) and (2) TFEU, read with Article 282(1) TFEU and also the first indent of Article 18(1) TFEU and Article 18(1) of the Statute. Thus, as the situations at issue were not comparable, the conclusion and implementation of the exchange agreement of 15 February 2012 cannot constitute a breach of the principle of equal treatment."

In the *Accorinti II* case the Court further held that pari passu treatment of investors is not part of the EU legal order as such, and in any case the clause needed to be interpreted in the light of the distinct situations of different investors.

"In the second place, as regards the complaints based on the pari passu clause, it should first be observed that it has not been demonstrated that such a rule exists in the EU legal order.

[…]

Incidentally, in so far as a rule which imposed the pari passu principle would entail equal treatment for creditors without taking into account the distinct situations of, in particular, private investors, on the one hand, and the Eurosystem central banks, acting in the exercise of their tasks pursuant to Article 127 TFEU and Article 18 of the Statute, on the other hand, the recognition of such a rule in the EU legal order might well be incompatible with the principle of equal treatment, as referred to in paragraph 87 above."

In connection with two subsequent purchase programmes of the Eurosystem, the OMT and the PSPP,[6] the Eurosystem nevertheless declared that it would accept pari passu treatment with respect to its purchases under these programmes. This was done in order to encourage private investors that do not particularly appreciate subordination.

Of course whatever the Eurosystem does is challenged in this field. In the *Gauweiler* case exactly the opposite – this perceived waiver by the Eurosystem of its perceived privileged creditor status was challenged before the Court of Justice of the European Union. [7] The Court, however, concluded that "although the lack of privileged creditor status may mean that the ECB is exposed to the risk of a debt cut decided upon by the other creditors of the Member State concerned, it must be stated that such a risk is inherent in a purchase of bonds on the secondary markets, an operation which was authorised by the authors of the Treaties, without being conditional upon the ECB having privileged creditor status." Accordingly, this was held to be compatible with the monetary financing prohibition.

Interestingly, the Advocate General's opinion in the *Gauweiler* case added that accepting pari passu treatment may be regarded as a means that seeks to ensure that the ECB disrupts the normal functioning of the market as little as possible.

"Finally, I think that the point should also be made that a purchase by the ECB, as a non-preferential creditor, of the debt securities of a Member State will inevitably involve a degree of distortion of the market, which appears to me, however, to be tolerable from the point of view of the prohibition in Article 123(1) TFEU. By contrast, as has been explained in point 183 of this Opinion, purchases made with the status of preferential creditor deter other investors, since they send out the message that a significant creditor, in this case a central bank, will be given preference over other creditors in the recovery, with the impact that that will have on demand for bonds. Accordingly, I take the view that pari passu clauses may be regarded as a means that seeks to ensure that the ECB disrupts the normal functioning of the market as little as possible, which, ultimately, involves a further guarantee of compliance with Article 123(1) TFEU."

All in all it appears that the Eurosystem enjoys considerable discretion on the matter, subject to of course the hard constraints of Article 123 TFEU. The special nature of the Eurosystem's policy portfolios was recognised by the courts and accordingly the privileged treatment accorded by Greece was upheld. At the same time the intention of the Eurosystem not to make use of privileged treatment with respect to certain purchase programmes was also accepted by the courts as a valid decision, which is an important matter as much from a legal as from a reputational point of view. How it squares with the status of the IMF, the ESM and the Member States as creditors, how private versus public sector creditors are supposed to participate in a sovereign debt restructuring in the euro area is arguably still not an entirely rule-based matter.

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[6] Outright Monetary Transactions Programme and the Public Sector Purchase Programme.

[7] Case C-62/14 *Gauweiler and Others*, ECLI:EU:C:2015:400.

3.2 European Stability Mechanism

As regards the ESM at least there is some limited clarity. In recitals 13 and 14 of the ESM Treaty the following is stated:

"(13) Like the IMF, the ESM will provide stability support to an ESM Member when its regular access to market financing is impaired or is at risk of being impaired. Reflecting this, Heads of State or Government have stated that the ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM. This status will be effective as of the date of entry into force of this Treaty. In the event of ESM financial assistance in the form of ESM loans following a European financial assistance programme existing at the time of the signature of this Treaty, the ESM will enjoy the same seniority as all other loans and obligations of the beneficiary ESM Member, with the exception of the IMF loans.

(14) The euro area Member States will support equivalent creditor status of the ESM and that of other States lending bilaterally in coordination with the ESM."

In other words, the ESM Heads of State or Government have stated that the ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM. It is further stated that the euro area Member States will support equivalent creditor status of the ESM and that of other States lending bilaterally in coordination with the ESM.

The legal value of such statements of intent only in the preamble to the ESM Treaty is a question in itself. If nevertheless implemented in national laws, one could still assume that it can cover only liabilities issued under domestic law or under one of the euro area Member State laws but not government bonds, say under English or New York law. One can also note that the ESM Treaty appears to recognise the IMF's preferred creditor status and ranks the ESM just below it, whilst it promises to support (as opposed to grant) equivalent status to Member States lending bilaterally along the ESM.

4 Some limited conclusions

There is a clear need for improvements in the debt restructuring framework also in the euro area. As we have seen in particular through the practice of the Greek PSI as underpinned by the euro area sovereign debt crises in general, the legal, political and institutional infrastructure to deal with such matters is in clear need of development. Having said this, it should also be recognised that a lot of progress was achieved in this field within a short time. All this was greatly accelerated by the sovereign crises, but such a framework put together in haste by definition cannot be complete. We need to use calmer times to develop the framework.

As mentioned before, it is advisable to focus only on a few key issues. There are of course always a lot of issues that could be singled out with a view to improving the sovereign debt restructuring framework in Europe and elsewhere. The priority issues

I would pick are (i) dealing with hold-outs efficiently; (ii) ensuring that timely measures relating to debt are taken if debt sustainability requires it; and (iii) clarification of the framework for official sector involvement in sovereign debt restructuring. Of course sovereign debt restructuring is a politically sensitive topic, which is an additional reason to be selective with the objectives.

It is possible to have a regional solution, i.e. a euro area set-up. Admittedly the best would be to have a global framework as sovereign debt and investment in it is a truly global matter, with global stakeholders and global consequences. Shaping the global set-up is clearly essential but it is a difficult matter with solutions that typically take at least decades to achieve. Whilst such global efforts, as led by the IMF, should definitely be pursued further, there is a need at the same time to act faster in Europe. Such European action could of course also be at the level of the Union, in theory preferable, but again, both the need and the feasibility of action is stronger in a narrower context, namely in the euro area.

There is a clear need for legislative solutions. Or, to be more precise, legislative solutions offer themselves as feasible in particular in the context of the euro area. One could rely mainly on the ESM Treaty – in fact this was also the approach when the first elements of the euro area debt restructuring framework were identified and set. It is nevertheless also clear that in the sovereign debt context one cannot proceed on the basis of legislative solutions alone. Some additional contractual solutions should also be contemplated, in particular with a view to being anti-cyclical, i.e. to smooth the debt burden. The main problem is that pure contractual solutions typically take a long time to fully implement as existing debt stock would normally need to mature. Europe and the euro area arguably need swifter action.

Finally I would like to note that I very much enjoyed and appreciated the valuable contributions of the distinguished speakers on this panel on sovereign debt and the lively debate with the audience. We need many more similar exchanges and similar events going forward.

A sovereign debt restructuring mechanism for the euro area? No bail-out and the monetary financing prohibition

By Heribert Hirte[1]

The monetary union in Europe is one of the major achievements of the European Union. For European citizens, it is – apart from the Schengen Treaty – probably the most visible and most positive sign of the "ever closer Union". However, with the recent financial crisis it has come under significant pressure. Since exchange rate adjustments are not possible, other solutions to cope with the respective different economic situations of the Union's Member States must be considered. This paper examines the possibility of an organised procedure to govern a Member State insolvency and in particular its restructuring in order to restore solvency.

1 General background

1. De facto bail-outs (under the European Stability Mechanism (ESM)) and (perceived) infringements of the monetary financing prohibition of Articles 123 and 125 of the Treaty on the Functioning of the European Union threaten trust in the European Union and in the European institutions in particular. This is at least the situation in Germany. The question of whether or not the ECB's actions formally accord with the European legal framework – as has been confirmed (in my view correctly) by both the Court of Justice of the European Union and the German *Bundesverfassungsgericht* as to the ECB's OMT programme[2] – remains of minor importance within a climate of general criticism of Europe and the European institutions. In particular, the perception prevails that the "rule of law" has been replaced by a continuous and "flexible" policy-making procedure.

   Greece is the focal point of this discussion, although, contrary to current public perception, the economic questions and this discussion should not only be "about Greece", but should remind us that we have similar historical cases with, for example, Argentina, Germany (a couple of times), and California. In many

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[1] Dr. iur. (Köln), LL.M. (Berkeley), Universitätsprofessor, Geschäftsführender Direktor des Seminars für Handels-, Schifffahrts- und Wirtschaftsrecht der Universität Hamburg, Mitglied des Deutschen Bundestages.

[2] *Bundesverfassungsgericht* (Federal Constitutional Court). Outright Monetary Transaction programme. See Case C-62/14 *Gauweiler and Others*, ECLI:EU:C:2015:400; and *Bundesverfassungsgericht* (Zweiter Senat), Judgment of June 21, 2016 – 2 BvR 2728/13, 2 BvR 2729/13, 2 BvR 2730/13, 2 BvR 2731/13, 2 BvE 13/13.

countries of the "Third World" the insolvency of states is an even more common phenomenon – and will likely increase due to climate change.

2. In a currency system in which exchange rate adjustments are not available (any more), "insolvency" and insolvency regulation are a natural response, especially when compared to US regulations.

   The "practical" (and therefore political) problem, however, is that the formal regulation of a State's insolvency will potentially affect many countries. My following ideas are the fruits of two very different roots. First, as a professor of law, I have researched and taught in the area of insolvency law for decades. Second, since 2013, I have been a Member of the *Deutscher Bundestag* and a member of its Committee on the Affairs of the European Union and the *rapporteur* for questions concerning the Economic and Monetary Union. Thus, I am speaking here in two capacities!

3. It is mainly this political background that supports my argument that we have good momentum for action, in particular as questions of the sovereign debt restructuring are closely connected to the creation and/or perfection of the capital markets union. In detail:

   A real capital markets union (as well as a banking union) requires clear and foreseeable regulation of the insolvency of (Member) States, specifically sovereign debt restructuring:

   - due to the linking of capital markets (as well as banks) with their host States, since deficits of the secondary market on credit have an impact on banks and thus on States;
   - in insolvency, due to the (extent of the) "crown privilege" (a sovereign's privilege in the distribution of an insolvent's assets).[3]

4. In any event, it should be kept in mind that the insolvency of States is only at first glance comparable to the insolvency of private individuals. Mainly, an insolvency trustee is not possible, due to the State's inalienable autonomy in political affairs. For the same reason, there can be no seizure of the State's assets and, again related to this, no insolvency dividend. On the other hand, these features well known from the insolvency of private individuals are not necessary, as there is no limitation of assets of States as States can simply increase their taxes (for more details, see the paper by *Paulus*, in this volume).

An insolvency procedure for States, therefore, is rather a procedure to restructure a State's debts in order to regain solvency ("*resolvency procedure*").

5. The possibility of a State's (formal) insolvency should be addressed with three main economic and political aspects in mind.

[3] See Hirte, H., "The role of the Judiciary", Panel discussion at the conference *Convergence of insolvency frameworks within the European Union – the way forward*, 12 July 2016, available at http://ec.europa.eu/justice/civil/files/insolvency/presentations/h_hirte_en.pdf

First, providing States with a formal insolvency mechanism may increase their costs of financing, even for those who are the least likely to face insolvency.

Second, it will lead to immediate budgetary effects because losses due to a settlement – insolvency-related or otherwise – become final, and, thus, introducing a formal insolvency procedure for insolvent Member States into the European framework will require an adjustment to the no-bail-out provision of Article 125 TFEU.

And, finally, it may worsen the State's position in the capital market for so long as competing States are not exposed to a risk of insolvency. The question here, however, is not *whether* a line should be drawn, but instead *where* the line should be drawn. By addressing Member States' insolvency, one could argue that all States are being treated equally. When looking at the United States and Japan, and perhaps even China, as the main competitors in the capital market, a distinction could be made between these foreign states as competitors of the European Union as a whole and competitors of the individual Member States. Regulating insolvency of the Union as a whole versus regulating the insolvency of an individual Member State could be treated differently – as is already the case in the United States. In other words: regulation of the insolvency of Member States does not necessarily require applying the same set of rules to the Union.

2 Key elements of a European insolvency/resolvency procedure for States

This leads to the question: what should be the key elements of a European insol-vency/resolvency procedure for States?

1. The main (insolvency) principle is clear: creditors in the same class must receive equal treatment (which, in part, has already been protected by the mandatory collective action clauses (CACs)).

   Second, the debtor State needs protection against the "first come, first served" principle which is the ordinary payment rule outside of insolvency. (In the United States, this effect is very colourfully labelled as insolvency "protection" with the outcome of improving the creditors' equal treatment as a mere side effect of the main goal.)

   And, finally, the aim of the procedure should be a restructuring of the financial structure of the debtor (State) in order to permit a sustainable financing structure, typically after extensive reforms (privatisations, tax increases).

   As an overall principle, the distinction between the inability of a debtor to pay its debts and its mere unwillingness to do so has to be highlighted. This calls for adequate measures of control as to the insolvency of a State.

2. When dealing with these key principles, two obstacles should be addressed. One is a common concern about the equal treatment principle that some creditors (or State creditors) have better possibilities for enforcement. Here, in order to protect equal treatment, regulation should address this risk by counter-incentives or the like.

   And second, the risk of a *unilateral* declaration of insolvency (in spite of alternative restructuring possibilities) ought to be reduced. Here, too, it is necessary that an independent body be involved in the decision to initiate formal insolvency proceedings.

   Finally, a clear risk of any resolvency procedure for Member States is that the insolvency remedy may require departure from the euro area. As political acceptance of any regulatory solution for a sovereign's insolvency is likely to require that a State have the right to remain in the euro area, focus should be directed to a solution which permits an insolvency/resolvency within the euro area – as is the case for US municipalities under Chapter 9 of the US Bankruptcy Code [4] and discussed for US states.

3. As a solution to the problems outlined above, the introduction of a "European Resolvency Court", established by modifying the ESM Treaty, seems to provide the most adequate answer so far.

   The rules of the European Resolvency Court should, at a minimum, include:

   - which entit(ies) can file to initiate proceedings;
   - the procedure for establishing an independent body tasked with both opening the proceedings as well as the necessary negotiations between creditors and the debtor State;
   - the procedure for settlement ratification; and
   - the procedure for implementation of the settlement.

3 First steps

Having outlined a desirable overall solution, it should be kept in mind that there are simple "first steps" that can easily start us moving in the right direction. A first such step would be to improve equal treatment of (bond) creditors, whose rights should

[4] A threshold issue in municipalities claiming relief under Chapter 9 is obtaining the obligatory consent of the State. Notable examples of municipal bankruptcies include that of Orange County, California (1994 to 1996) and the bankruptcy of the city of Detroit, Michigan (2013). See, on the Orange County bankruptcy, *Alliance Capital Management L.P. v. Co. of Orange (In re Co. of Orange)*, 179 B.R. 185 (Bankr. C.D. Calif. 1995) rev'd in part, SAVC 95-341-GLT [AR] (C.D. Calif. July 12, 1995); and *In re Co. of Orange*, 179 B.R. 195 (Bankr. C.D. Calif. 1995). See generally: Baldassare, M., *When Government Fails: The Orange County Bankruptcy*, Berkeley, University of California Press, June 1998; Mayer, T.M., "State Sovereignty, State Bankruptcy, and a Reconsideration of Chapter 9", *American Bankruptcy Law Journal*, 85(4), pp. 363, 2011; Miller, A.B and Tanenbaum, J.L., "Four recent decisions in the Orange County case attempt to balance state sovereignty interests and the goals of Chapter 9", *National Law Journal*, August 14 1995, B4, B6.

not only be aggregated by class but also as a whole (unlike how it stands currently, specifically Article 12(3) ESM Treaty) [5]. Preferably, as introduced in Greece by national legislation in the meantime, a "single limb aggregation" in collective action clauses should also be provided for on the European level.[6]

Second, an automatic stay during the negotiation of a rescue programme should be considered. And, finally, a legal basis should be considered for protecting all existing securities if the lack of solvency is due (only) to liquidity rather than structural reasons (which, here again, would need to be assessed by an independent body).

4 Conclusion

As a primary solution I suggest the introduction of a "Resolvency Court" by amending the ESM Treaty.

As first steps going in this direction, we should:

- streamline the provision on CACs in the ESM Treaty to allow a single limb aggregation;
- make sure that the start of negotiations on a rescue programme could be regarded as an automatic extension of the State's securities;
- and provide for prolonging all existing securities provided that the insolvency is due (only) to liquidity rather than to structural reasons.

[5] Article 12(3) reads: "Collective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical."

[6] In its judgment dated 8 March 2016 (VI ZR 516/14), the German *Bundesgerichtshof* (Federal Court of Justice) held as inadmissible due to the sovereignty of the Greek State claims by German holders of Greek bonds for damages allegedly suffered owing to the Greek debt restructuring.

Chapter II — Legal developments in the ESCB central banking functions

Legal analysis in a changing environment

By Yves Mersch[1]

Recent years have brought significant financial, political and social challenges. The most serious one for central banks has been the financial crisis, which has had long and deep repercussions. In Europe, but also at global level, we witnessed unprecedented shock to be dealt with under severe time pressure.

Our societies and legal systems have reached a crossroads. But we still have the choice to define the trajectory for the future, through decisions that are either more audacious or more cautious. To take the best decisions, we need to enquire critically, heed the lessons of the past, and we also need to look ahead and anticipate. This is why I greatly value wide-ranging research and deep analysis, set in a broad context and taking a long-term view.

The European Central Bank (ECB) itself has been caught in this evolutionary process. We have acted, over time, to redress the situation, within our mandate, first with traditional monetary policy tools, in particular, the lowering of the policy interest rates. Subsequently, we had to progressively expand our action by adopting other measures, “non-standard measures”, which, while available in our toolbox, had no precedent in central banks’ activities, in particular, the negative interest rate policy, the targeted longer-term refinancing operations and the asset purchase programmes.

Some of these measures have been challenged in court and the legal arguments have become critical when we had to justify our actions.

The ECB, in cooperation with national supervisors, has also conducted European banking supervision for almost two years now. Its role vis-à-vis banks has broadened and become altogether more complex.

All these developments have inevitably given rise to some difficult legal questions. We had to explore, for example: the interpretation of collateral adequacy in monetary policy operations, as required by the Statute; the balance between the ECB’s decision-making effectiveness, on the one hand, and its commitment to increased transparency, on the other; or the functioning, for the first time for a Union institution, within a hybrid system, in which the ECB itself has to apply national law in the supervisory field. Last, but not least, we played our role in the regulatory and technological developments relevant for our activities.

[1] Member of the Executive Board, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

Given all the challenges we are facing, we need to draw on legal support that is sound and competent, able to capture the fine nuances involved in the decision-making process and creative enough to explore new legal avenues, drawing principles also from other areas of law. For this reason, I strongly support the efforts of the ECB's Legal Services to develop its research and academic skills and its knowledge base in addition to conducting its daily business. This is true for both its internal and external strategy.

On the external side, in addition to ad hoc, smaller-scale events, a legal conference is organised at the ECB every year, with slightly different formats and programmes of particular relevance to central bank lawyers, regulators and academics, as well as to policymakers.

Intellectual exchange and sharing of experiences on these topics with lawyers from other central banks and international financial institutions is very beneficial to deepening the legal analysis and the legal support to the decision-making process.

The wide range of topics at this year's conference touch on some of the issues I have mentioned, bringing together the perspectives of colleagues from the ECB, national central banks and other European Union institutions. The programme reflects the idea that the recent developments offer many insights resulting from recent developments as well as the need to adapt to a changing world and to anticipate and foster safe and efficient solutions.

Technological innovations and the future of payments

Introduction

By Chiara Zilioli

Distributed ledger technologies in financial markets?: An introduction and some points of interest for legal analysis

By Andrea Pinna

Virtual currencies: the regulatory challenges

By Ross Leckow

Retail instant payments and digital innovation – an overview of risks and challenges

By Phoebus Athanassiou

Introduction

By Chiara Zilioli[1]

1 Background observations

The speed of technological innovation increasingly outpaces that of regulatory responses to it. This is why the challenge for regulators and policy-makers when faced with new technologies is how to limit the risks for consumers, investors and the public at large without, at the same time, stifling progress and the economic benefits that technological innovations promise to deliver.

Distributed ledger technologies (or DLTs) – one of the most prominent examples of digital financial innovations – have the potential to revolutionise financial markets and their supporting infrastructures.[2] Distributed ledgers are essentially databases which are shared across a network in order to record and validate financial transactions in different locations without the need for trusted third parties.[3] Payments, in general, and retail payments, in particular, are amongst the most promising areas for the future application of DLTs and digital financial innovation.

2 DLTs and virtual currencies – risks and challenges

DLTs increase the efficiency of payments by reducing the settlement time, the related costs (especially with cross-border payments), the required procedural steps and the layers of intermediaries involved. Since the database is shared and validated by all participants, even in the absence of a trusted third party the risk is assessed as remaining low.

Technological advances linked to the emergence of DLTs also have the potential to increase the choice of means of payment and the range of value transfer methods. Virtual currencies are one of the better-known examples of DLT-driven innovations in the field of payments. The term "virtual currency" denotes privately issued, alternative means of payment, which do not represent a claim against a central bank or another public authority. Whilst they are not legally established as currencies and do not enjoy the status of legal tender, with the agreement of the parties they may be convertible into fiat money or legally established currencies and they can be used as consideration for the purchase of goods and/or services, without the need for recourse to a custodial payment service provider.

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[1] Director General Legal Services, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

[2] "There is no single DLT, … we are speaking of a variety of different fabrics, the design of some solutions being tailored to the specific needs of the financial industry", in Mersch (2016f).

[3] See Mersch (2016c).

On the other hand, virtual currencies, and their use for the settlement of payment obligations, can give rise to various legal, regulatory and public policy issues and concerns. First and foremost is the issue of the definition of virtual currencies (and related terms such as digital currencies and cryptocurrencies) as distinct from fiat currencies. From a European Union law perspective, virtual currencies do not qualify as currencies.[4] Consistent with the approach already adopted, or currently under consideration in a number of jurisdictions where virtual currency exchange platforms are regulated,[5] it would be useful for the concept of a virtual currency to be defined so as to clarify its precise legal status and the legal consequences of its issuance and use. Given that virtual currencies are not money, it would be more accurate to regard them as a means of exchange, rather than as a means of payment.[6]

Moreover, virtual currencies raise a number of regulatory concerns. These include the difficulty for regulators to establish ways to exercise control over transactions settled in virtual currencies (with related concerns that such technologies might be used to circumvent anti-money laundering and counterterrorism legislation); the higher volatility associated with them compared with centrally issued currencies[7] (with related issues of consumer and investor protection and information); the risk that the holders of virtual currencies may not be able to exchange their holdings against goods, services or fiat currencies, as virtual currencies do not enjoy legal tender status; and, last but not least, the risk that any decentralised form of money, once it becomes quantitatively relevant, entails for the ability of central banks to exercise control over the supply of money in the economy and, by implication, also for price stability.

While DLTs can be applied in the field of payments to facilitate faster (or instant) cashless payments, their potential uses could transcend traditional payments. As noted by the Committee on Payments and Market Infrastructures (CPMI) of the Bank for International Settlements (BIS), the distributed ledger technology underlying many digital currency schemes could have applications going beyond payments.[8]The Financial Action Task Force (FATF) has, for its part, noted that non-payment uses of virtual currencies may include store-of-value products for savings or investment purposes, such as derivatives, commodities, and securities products.[9] More recent digital currencies, which are based on more sophisticated distributed

[4] Union primary law and Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro (OJ L 139, 11.5.1998, p. 1) clearly provide that the euro is the single currency (and the only legal tender) of the Union's economic and monetary union, i.e. of those Member States which have adopted the euro as their currency.

[5] The reference is to Canada, Japan or the United States. See also the draft of the Uniform Law Commission on the Regulation of Virtual Currency Business Act, http://www.uniformlaws.org

[6] The ECB has proposed to state explicitly in the relevant Union legislation that virtual currency does not possess the legal status of currency or money: see para 1.1.3 and proposed Amendment 2 in Opinion of the ECB of 12 October 2016 on a proposal for a directive amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (CON/2016/49) (OJ C 459, 9.12.2016, p. 3). https://www.ecb.europa.eu/ecb/legal/pdf/con_2016_49_with_technical_working_document_.pdf

[7] In this respect, see Mersch (2014).

[8] CPMI (2015).

[9] FATF (2015).

ledger and block chain technology, have a larger array of uses, going beyond payment purposes (including for example, online casinos).

3 Concluding remarks

It is evident even from this very synthetic introduction to the topic of digital financial innovation, virtual currencies and the future of payments that there are several challenging issues related to the development and exploitation of digital innovations. Study on this topic is one of the main priorities in the analysis and in the work of most international financial bodies, international think tanks and international and national legislators. No less importantly, they are amongst the issues that we, at the ECB and in the Eurosystem, have been exploring and will continue exploring, going forward. We need to identify the opportunities and the challenges of digital financial innovations, the real-world financial-sector specific applications of digital innovations and their impact on financial market infrastructures and central banks, on the conduct of monetary policy and on the fulfilment of our mandate; as monetary policy regulators, as overseers and as a European institution, contributing to the achievement of the Union objectives, in particular balanced economic growth and stability of the financial system.

We are privileged to have here a diverse and distinguished panel, presenting the preliminary views of the ECB, of the IMF and of the BIS on these complex issues. Some answers might be offered in their presentations; but I am sure that several questions will still remain to be explored. What is clear is that "DLT has the potential to fundamentally change securities and payments business",[10] and that it could be nothing short of a "game changer in the market".[11] The discussion on this topic at this conference aims at being a stimulus to keep inquiring into this potential and into the benefits that the future use of DLT could bring, in terms of new services and also new asset classes.[12]

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[11] Mersch (2016b).

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Distributed ledger technologies in financial markets?: An introduction and some points of interest for legal analysis

By Andrea Pinna[1]

1 Introduction

Although "distributed ledgers" were first developed in the realm of virtual currencies, they have emerged since 2014 as an innovation that may change the current paradigm of financial markets, particularly as far as market infrastructures are concerned. This note introduces some definitions and concepts that will assist in obtaining an understanding of the potential implications of distributed ledger technologies (DLTs) for financial markets. Its specific purpose is to provide a non-self-explanatory view of those features that may be relevant from the perspective of legal and regulatory analysis.

Distributed databases have been used widely for decades, allowing participants who are spread across different locations to read the content of a collection of data usually stored and managed by a single institution at one or more sites, and often to have the possibility to propose updates. The term "distributed ledger" has been recently coined to identify a type of distributed database whose content is not just proposed via – and distributed to – a number of computers. In fact, distributed ledgers are characterised by the possibility, for some or all different users, to share the responsibility of database management although they do not necessarily trust one another and to validate the insertion of new data records which can nevertheless considered reliable.

Distributed ledgers can then be seen as a particular type of distributed database – a "shared database" – where a set of mostly well-known technologies are combined in new ways to allow for the division of responsibility as to what information shall be considered up-to-date. A task of this kind is not trivial. A number of new solutions have been suggested since the Bitcoin blockchain was first proposed (Nakamoto 2008) to solve the difficulties posed by sharing a database to transfer value with no single validating authority. The issues at stake are not new in the field of distributed systems and include, inter alia, malicious behaviour (such as double-spending, repudiation, and Sybil attacks) and the possibility that different users rely on inconsistent versions of the data (because of network latency or the validation of conflicting forks).

[1] Market Infrastructure Expert, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

DLTs are a diverse set of solutions that combine database technology and cryptography in order to tackle the two abovementioned issues by allowing ultimate cryptographic auditing of users' activity – in some cases giving economic incentives – and by providing traditional and new mechanisms to achieve consensus among users on the status of the database over time. Looking at the still mutable DLT landscape at a low level of granularity, one could currently divide DLTs into: (1) **blockchains**, where changes to the identities of users entitled to send so-called "transaction outputs" are validated in batches (*blocks*) which are then linked together via cryptographic techniques (*hashing*); (2) **consensus ledgers**, where snapshots of balances associated with each participant are updated in rounds by users; and, more recently, (3) **synchronised bilateral ledgers**, where counterparts can update the subset of information that refers directly to their bilateral activity (possibly with other elected parties also accessing these records) and make some of that information available to a broader set of users. **Smart contracts** are another technology that can be associated with DLTs. In these contracts, counterparties certify that assets are to be transferred or accepted on their behalf via automated procedures when pre-specified events happen either inside or outside the ledger.

2 Relevance of DLTs for financial markets

Opinions diverge on whether DLTs can really be considered innovative from an IT perspective. What matters for present purposes is that these technologies could prove highly relevant to financial market infrastructures, institutions and regulators in the event that they are ever used to record financial transactions or asset holdings in the realm of payments and securities transactions. The main peculiarity of distributed ledgers resides in the opportunity they provide for the network of users – or system participants, in the case of market infrastructures – to rely on a shared source of reliable information even when a central entity is not available, either by choice or by accident, and distributed consensus is needed to ensure that such information is correct and consistent across sites.

Decentralisation of ledgers could represent a paradigm shift in financial markets, where payments and trade instructions are currently executed and settled via book-entry in proprietary databases kept by financial intermediaries and market infrastructures. Widespread adoption of DLTs could in theory mean that market players would interact by participating in a distributed ledger system, in the most extreme scenario with individuals managing their own distributed market infrastructure with no intermediation by any regulated institutions (see Pinna and Ruttenberg (2016)).

The possibility to adopt DLTs in the future is envisaged by some market participants for a number of reasons. The first potential benefit is that of cybersecurity. Current database systems have a number of tools in place to avoid the consequences of a so-called single point of failure – i.e., the problem that if a single computer in the network (typically the server of the central institution) breaks down, the system is not able to recover quickly enough to ensure the fulfilment of crucial tasks. Replication of data across multiple sites with database management

capabilities has been used for long time to solve this problem. Depending on the type of DLT under consideration, the issue of single point of failure would be further reduced by allowing a large number of machines to constantly participate in the provision of core services and to disregard the possibility of a limited number of them being hacked or offline.[2] This potential gain has to be traded off against the possibility that faults in the protocol governing the distributed ledger turn the latter into a new single point of failure. That may become a crucial issue since new and untested consensus mechanisms are finding their way into some DLT projects.

Secondly, sharing relevant data along the value chain from trading to reporting would allow financial market participants to avoid costly and error-prone reconciliation processes. These processes require dedicated back-office infrastructures whose fixed cost is particularly relevant in a market environment with low interest rates. Potential cost-savings for financial institutions – if and when DLTs are proven to be safely scalable – extend also to the possibility of increasing the automation of internal and regulatory reporting. Many DLT developers envisage the possibility of regulators being able to retrieve transaction data autonomously from the ledger, which would improve their ability to spot the build-up of excessive risks in real time. However, interoperability among the DLT systems of financial market infrastructures, intermediaries and regulators is necessary to achieve these efficiency gains. The possibility to operate on the basis of a common set of updated information implies that the use of DLTs may facilitate the shortening of settlement cycles. Again, interoperability is crucial, both among DLTs used to share management of possibly separate ledger in different market segments and between such DLTs and any non-DLT legacy system.

Reflections over shortening settlement cycles warrant a number of caveats, since such a change would have major impacts on investors: on the one hand, quicker settlement would limit both settlement and principal risk – two types of risk referring to the possibilities that a trade is not settled and that the non-defaulting party needs to find a replacement for it, possibly at a different price. Shorter settlement cycles would also lower the amount of collateral required to hedge counterparty risk and the exposure of an investor's capital to any residual risk (e.g. market risk and operational risk). On the other hand, shorter settlement cycles diminish or even exclude the possibility of netting, which is the practice of summing all debits and credits between two counterparties over an interval of time (e.g. a trading day) so that only net exposures are settled and a limited amount of cash and/or securities is eventually required for delivery. The settlement of transactions in transferrable securities that are executed on trading venues in the European Union takes place in two business days, or "T+2". That means that a trader typically bears settlement risk for two more days after the trading day, enjoying at the same time the possibility to deliver only a limited netted amount of cash or securities to each counterparty at the end of the cycle. In the extreme case of instantaneous settlement, the risk of a party failing to deliver the asset would be eliminated. That

[2] It is important to note that the performance of a DLT system usually decreases, in terms of speed and throughput, with the number of computers that take part in each validation and need to exchange messages to find consensus on it.

means, however, that both counterparties need to have the securities/cash ready for settlement as soon as each individual payment or securities transfer order is posted.[3]

The trade-off between settlement speed and liquidity needs shows that services currently provided by financial market infrastructures and intermediaries are justified on grounds that go well beyond the lack of a shared database. Complex trade-offs are in place and need to be thoroughly understood. Settlement cycles have been gradually compressed over time, from times when technology was a real constraint (e.g. due to the need to physically deliver securities certificates) to the current situation in which direct connectivity to settlement systems such as TARGET2 and Target2-Securities allows for immediate settlement. Hence, the current constraint is only partly technical and also has to do with business/functional and legal/regulatory fragmentation. Whereas the latter is an obstacle to straight-through processing that DLT per se cannot resolve, harmonisation of functional processes require coordinated efforts by market participants and fit the cooperative nature of a DLT system well.

Most of the potential benefits of possible future adoption of DLT do not come from the performance of a specific technology, but from the potential to make changes in industrial organisation. Before a payment instruction or a transfer of securities produces a change of ownership in respect of the relative assets, a number of steps and institutions are involved in the way in which financial markets are currently organised (see figure 1). Investors usually participate in a financial market via their commercial bank or stock brokerage firm, without having any direct involvement in what happens after a payment is sent or a securities trade is agreed upon.[4] Ultimate settlement of these transactions happens only at the level of central bank accounts and the central securities depository, respectively.[5] Before reaching settlement, however, a plethora of intermediaries are involved in different capacities. These include, inter alia, custodians and global custodians, correspondent banks, clearing members, and settlement agents. All these market players typically have their own internal databases to keep track of their positions vis-à-vis peer institutions that operate above and below them along the value chain of the transaction. That is the layer where most of the abovementioned potential benefits from DLT adoption may materialise. Before settlement takes place, the clearing layer manages counterparty risk for most but not all transactions and provides netting benefits.

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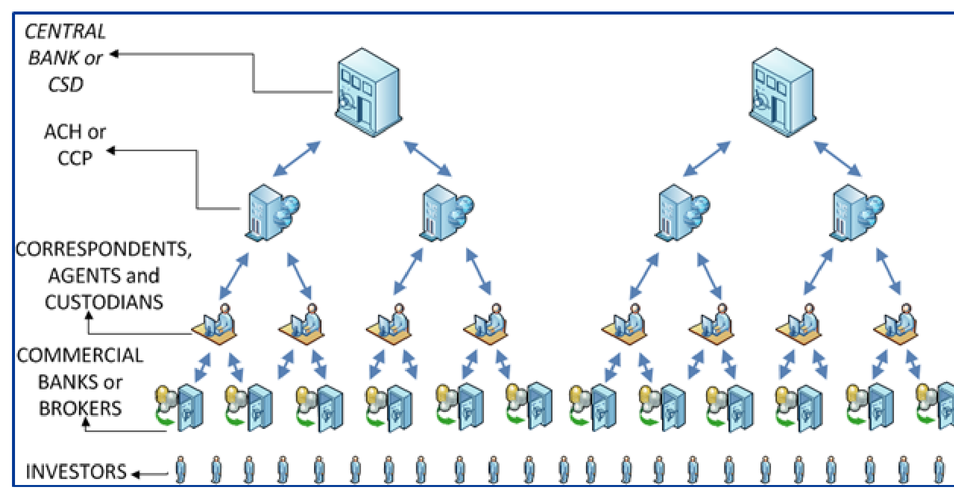
[3] An intermediate alternative could exploit the fact that most DLTs currently settle transactions in batches – often called blocks – to net transactions before validation. This netting reintroduces risk and, in the case of exchange traded securities, a third contractual dimension (settlement time) is added to those of price and quantity.

[4] This note focuses on post-trading and does not consider the possibility of DLTs being applied to trading and price formation.

[5] A noteworthy exception is that of internalised transactions – i.e. transactions where both parties hold their assets with the same custodian.

Figure 1
Simplified current post-trade market organisation



The situation described above gives an idea of the extent of the reconciliation efforts required to keep all internal databases of different post-trade institutions in sync. This creates room for errors and is certainly inefficient, since intermediaries providing a range of services – e.g. collateral management, corporate actions services, fiscal treatment and the identification of investors – cannot rely on a common platform to gather and transfer information and instructions along the value chain. European financial markets have benefited from the harmonisation of legal/regulatory, functional, and technical aspects that has led to the successful launch of Target2-Securities in the settlement layer.[6] The same degree of interoperability has not been achieved in other layers of post-trading, and industry-wide efforts towards technological innovation may help in this respect.

3 Points of interest from the perspective of legal analysis

3.1 Accountability and access rules

Participants in a DLT system can play different roles. A **developer** provides the protocol and writes the code that defines the interaction among participants and the functioning of the ledger in all respects. **Users** access the network by means of cryptographic keys that allow (at least) the reading and proposing of transactions involving their assets in the ledger. Users can also act as **validators**, receiving update proposals on which they achieve consensus with peers to update the set of shared information accordingly. Users acting as gatekeepers may be requested, in

6 By September 2017, 21 European markets will be connected to the T2S platform that the Eurosystem has provided to ensure that holders of accounts in different settlement systems can have their trades settled on the same conditions as in domestic transactions.

some DLT implementations, to give access to indirect participants and to verify and connect their legal identities in the "real" world with those used in the DLT network.

The rules governing access to the system and the roles played by its participants are likely to be the key features of DLTs from the point of view of legal analysis and enforceability.[7] DLTs are a diverse set of technologies. This diversity appears in the range of IT standards such as database structures, validation methods, cryptographic functions, programming languages and messaging used. However, the actual implementation of a DLT system can be similarly diverse when it comes to defining the network of business and legal relations among their participants. With respect to access to the system, one can identify at least three different types of DLT network (see Table 1). **Unrestricted systems** are those like the original Bitcoin blockchain, where any unknown entity uses the DLT and can play any role. In a **restricted egalitarian system**, all participants can still play any role but participation is restricted to identified and accountable entities. Finally, **restricted tiered systems** do not only restrict participation to identified and accountable entities but also introduce separation between the roles that each participant may play in the network.

Table 1

Access to the system

Restricted tiered systems	Restricted egalitarian systems	Unrestricted systems
Only **identified and accountable entities** use the DLT and can be assigned **different roles**	Only **identified and accountable entities** use the DLT and can **play any role**	Any **unknown entity** uses the DLT and can **play any role**

These three different configurations of a DLT system have clear legal implications. First, restricted systems provide tools to hold participants accountable for their activity in the ledger, whereas unrestricted systems do not. With a focus on financial markets, that matters for know-your-customer (KYC), anti-money laundering (AML) and counter-terrorist financing (CTF) programs. The operators of an unrestricted system should be mindful of their possible responsibilities in the event that illegal activities are carried out on or facilitated by the distributed ledger. Terms and conditions can be defined, in restricted systems, to allocate responsibilities to accountable legal entities.

It should be emphasised that access rules matter greatly for safety and efficiency, and the adoption of unrestricted DLT systems appears very difficult in mainstream public financial markets. That can be asserted not only based on the likely opposition of regulators to capital flows among unaccountable entities, but also based on the impact of open access on the performance of consensus processes used in the ledger. When the identity of users cannot be ascertained, they cannot be held responsible for their activity in the ledger and – in simple scenarios such as one-head-one-vote – can interfere with its functioning. The tools used to make such a possibility unlikely, such as the Hashcash proof-of-work (Back (1997))

[7] The rules governing access to the system restrict the choice of validation mechanisms that can be used, which in turn, indirectly but decisively, affect the performance and safety of any specific DLT. This topic is beyond the scope of this note.

adopted in respect of Bitcoin, are inefficient and certainly cannot prevent misbehaviour by attackers motivated by incentives that are not purely economic, such as geopolitics or ego.

Unrestricted DLTs could find their way into niches of financial markets. Whereas these DLT applications are currently unlikely to have a substantial impact on financial stability and on the efficiency of the financial markets, they still deserve the attention of legislators in order to ensure that investors are protected and for AML/CTF. Requiring KYC when an exchange between a fiat and a virtual currency takes place is not enough to address this issue, since the same virtual currencies can be used to purchase goods and services directly from merchants. When the latter exchange virtual currency into fiat currency, possibly after a number of transactions via the DLT network, information on their customers is not disclosed. Moreover, the ownership of non-marketable securities could be exchanged via a private DLT network and entitle anonymous owners to receive cash flows from the issuer over time.

3.2 Law applicable to the system

Different DLT configurations show very different probabilities of successful application in different business situations. The degree of decentralisation, i.e. the number of participants who share the responsibility to validate transactions, is inversely related to the speed of the validation process. This is due to the need for validators in a DLT network to exchange messages to achieve consensus. The geographical dispersion of validators plays a role in this respect, since the speed of data communication is limited and the latency of exchange of messages across jurisdictions may be critical for applications that require high volumes. Hence, it seems unlikely that all users interested in a given DLT use case can always play an active role in the shared management of the ledger, particularly across the globe. That has implications for legal analysis, since accountable entities (and legislators) from a limited number of jurisdictions are more likely to be able to solve issues such as what law is applicable to activity in the DLT network. In some current Union legal acts, such as the Settlement Finality Directive[8] (see Article 2(a)), the possibility for participants to decide what national legislation shall apply to a settlement system is already acknowledged. Although a revolutionary worldwide DLT network with anonymous users would certainly pose complex issues of a legal nature, a solution among financial institutions in the Union may be a more realistic initial proposal for discussion.

[8] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L 166, 11.6.1998, p. 45).

3.3 Data protection

Another legal issue with deep roots in the technical aspects of DLT is that of data protection. Replication of a whole ledger recording transactions among a range of users certainly poses risks to data privacy and, in the case of public ledgers where there is no possibility to modify previous transactions, it excludes the “right to be forgotten” under Regulation (EU) 2016/679.[9] Although cryptographic techniques could be used to encrypt data that are distributed across DLT participants, it is impossible to exclude that future technologies will be able to decrypt those publicly available data. Hence, unless DLT participants use different and fully unrelated public keys in each transaction (with costs and delay to be ascertained for the operation of the DLT system), replication of the ledger across non-fully trusted parties are likely to remain an issue regardless of ongoing discussions on encryption techniques.

To be more precise, data replication raises new confidentiality issues as soon data will be held by unregulated institutions or competing market players – whereas regulated financial market infrastructures have provided confidentiality to market participants for a long time. When analysing the legal implications of the potential adoption of DLT in financial markets, it may be useful to assess whether the issue of full replication of distributed ledgers matters at all. Whereas a certain degree of duplication is essential to DLTs and brings potential improvements to cyber resilience, the level of duplication that is necessary to allow fully distributed validation in unrestricted and in egalitarian restricted DLT networks may be incompatible with data privacy and, as noted above, impairs the speed and scalability of the system.

3.4 Impact on market structure

The solution that unrestricted DLTs have put forward to improve the functioning of financial markets is that of a revolutionary distributed ledger where investors and issuers interact in a peer-to-peer way, with no need for intermediaries and regulated institutions (see Figure 2). Public authorities are, predictably, showing scepticism towards these DLTs. This is due not only to the lack of accountability mentioned above, but particularly to the fact that the frequent absence of any form of clear governance hampers the possibility to swiftly resolve glitches, update protocols, and address concerns that may emerge as user requirements and the outside market evolve. The debate over Bitcoin block size and the Ethereum forks are clear indicators of such concerns.

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[9] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) (OJ L 119, 4.5.2016, p. 1).

Figure 2
Unrestricted peer-to-peer market organisation

Financial market participants are developing restricted DLT solutions that may benefit from the distributed nature of DLTs, yet allowing for a proper governance structure and the accountability of all participants (see Figure 3). In these systems, some financial institutions would still be in the picture, while the entities that would disappear would be those whose only business function was to provide a workaround in respect of previous inefficiencies. Some intermediaries could redefine their business, for instance by providing liquidity to DLT participants in spot transactions, as is likely to be required in the case of shorter settlement cycles where the absence of netting gains would need to be filled by a provider of real-time lending services for cash and securities.[10]

The responsibility for clear governance along with other responsibilities would remain with regulated institutions simply because some features of current financial intermediation are not negotiable, often due to their legal implications: settlement finality needs to be defined by a clear point in time in the validation process, perhaps with a specific golden copy of records held by a system operator to provide transfer of legal title. Accountability is required in order to protect investors. Moreover, emergency situations need to be handled by specific governing bodies with which public authorities can interact in the interests of society at large. This is reflected in current regulation. For instance, although the Central Securities Depositories Regulation[11] allows outsourcing even of core services[12] that are provided by a CSD, the latter remains responsible for such services and for

[10] Sending a buy order for a security may unleash a delivery versus collateral versus payment (DvCvP), which would simultaneously transfer collateral to a cash lender, cash to the seller and securities to the buyer, thus achieving instantaneous settlement of all these transactions.

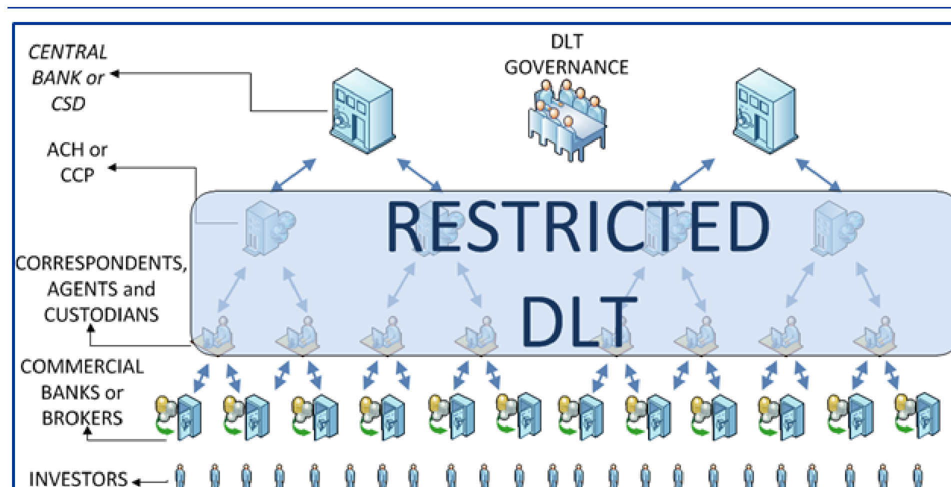
[11] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (OJ L 257, 28.8.2014, p. 1).

[12] Core CSD services are defined in the Central Securities Depositories Regulation as notary, central maintenance of accounts, and settlement.

managing the associated risks (see Article 30(1)). Whereas the allocation of responsibilities in a distributed system is straightforward in the case of a single entity that uses its fully trusted nodes to provide and operate the ledger, financial market participants may need creative ways to identify who is responsible for a DLT system where different entities have the possibility to create assets and to validate asset transfers in the ledger. A consortium-type operator could be appointed by validators, or each validator might take responsibility for transactions they happen to validate first. Any governance model needs in any case to allocate clear responsibilities vis-à-vis users and regulators.

Figure 3

Market organisation with restricted (possibly tiered) DLT



3.5 Legal nature of records and messages in the ledger

Many of the legal implications of the potential adoption of DLT may hinge on the definition of what is exchanged via transaction messages among participants. Would a distributed ledger be the new way to perform the same bookkeeping function as is provided by current settlement systems, possibly using messages exchanged through the network as a representation of cash and securities recorded outside the DLT network? Or would the DLT network exchange a new type of bearer asset that, by coding smart contracts, could also automatically perform actions that are only indirectly[13] controlled by the issuer or owner(s)? The first possibility resembles the situation in respect of securities dematerialisation, where regulatory reform was prompted to avoid the issues caused by the use of certain outdated business processes. In relation to the second, new technologies and business processes would be the driving force behind pleas for regulatory change in what appears to be mostly uncharted territory.

Legislators have mostly focused on the original Bitcoin blockchain and have referred to virtual currency as an all-encompassing definition. However, it may

[13] An example of indirect control is that of smart contracts whose operations are non-deterministic.

be useful to recognise that DLTs offer the possibility to transfer something more than currency – a unit of account, a means of payment, and a store of value.[14] Furthermore, the value exchanged does not need to be virtual – it may be issued by some central banks, public authorities or regulated institutions.[15] Building on aspects of what was done in the past and looking to where DLT may lead financial intermediation in the future – provided that market players have an interest in it and public authorities find it sufficiently safe to allow its adoption – current regulation may possibly benefit from more general and yet precise definitions. That is particularly important in the case of assets that are not only represented in the ledger but also exist in the ledger as bearers transmitting financial claims, whether the latter are currency or securities.

It may be reasonable to apply pieces of legislation intended to avoid issues associated with virtual currencies to a broader concept of assets that can be exchanged via DLT networks: digital financial assets (DFAs). From a functional point of view, anything exchanged via DLT networks in financial markets is indeed a valuable digital item – i.e. a digital asset – that represents a currency, security, traded commodity or anything of a financial nature, as opposed to other digital assets such as songs, movies, etc. Provisions on KYC, AML, and CTF, as well as the issues of applicable law, settlement finality, tax jurisdiction and the enforceability of smart contracts, are not specific to virtual currencies but apply to any DFA, such as non-marketable and marketable securities or derivatives.

3.6 Legal nature of smart contracts

Further creative thinking may be necessary to understand the legal implications of smart contracts. These are – once more from a functional perspective – scripts that guarantee the execution of agreements between their signatories. From a legal point of view, the issue of whether such automated procedures are interpreted as tools that execute the agreement between the parties to it or as agreements in their own right enforceable regardless of whether they reflect the intentions the parties certainly matters. If one concluded that smart contracts are not contractual agreements in their legal sense, but rather a way of executing a separate contract, it would be necessary to allow for the stopping of the execution of such scripts. That is particularly relevant in relation to involved contracts that may fail to capture and enforce the actual intentions of the parties, as testified to by the well-known DAO heist. Ongoing cross-industry efforts to develop standards for smart templates may help reconcile the nature of smart contracts with that of traditional agreements written in plain text.

[14] See European Central Bank (2012).

[15] See European Banking Authority (2014).

3.7 Accounts in the distributed ledger

In the current EU financial markets, marketable securities exist and are exchanged among investors insofar as they are recorded in the account structures of a range of financial institutions. Recording of securities in the issuance account allows the issuer central securities depository (CSD) to issue financial claims in relation to the issuing entity. Settlement accounts at the CSD, together with the accounts maintained by intermediaries at lower levels of the value chain, allocate those same securities to final investors and clarify who holds what (either directly or via holding chains).[16] The same types of contractual relationships are possible in a DLT environment.

The recording of asset holdings in the name of an investor in a DLT network, or the storage of credentials and additional services related to those assets, could be considered as the DLT equivalent of an account agreement between provider and receiver of such services. However, the bare possibility that different peers might momentarily hold inconsistent information before consensus is achieved among participants raises the issue of where the relevant "account" is actually held and when the update of any account can be considered final. That is particularly important in relation to operational issues, when consensus mechanisms in the DLT network might fail and, as distinct from centrally managed databases, reconciling the information held by different participants would not be a trivial task.

3.8 Settlement finality

The fact that different participants contribute to the validation of transactions in a DLT system may call for new concepts of settlement finality. Settlement finality is a core aspect of modern financial markets. The need to have clear definitions concerning the point at which an order becomes irrevocable in relation to counterparties and when those parties have discharged their contractual obligations is clearly catered for in current Union regulation and it is directly applicable to systems where a single institution keeps the relevant record. Some DLT proponents suggest that the irreversibility of transactions in a distributed ledger is sufficient to achieve finality. That is a misconception, since every update to a distributed ledger can be reversed whenever the participants who agree on such action invest either a sufficiently high computational power (when proof of work[17] is used), or a large

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[16] An issuing entity could also use a distributed ledger to maintain the register of securities holders or of their nominees, either by means of an agent or directly especially in the case of private companies.

[17] "Proof of work" is a consensus algorithm that uses economic incentives to induce validators to update the ledger only with "licit" transactions that complies with the rules of the DLT network. In practice, it requires participants to bear the cost of electricity and hardware to validate transactions. It remunerates such effort only if validated transactions are confirmed as licit by other participants ex-post.

enough share of assets/collateral registered in the network (when proof of stake[18] is used), or the administrator rights that are typically granted to a single, although participated, governing body (when a governing body has the possibility to amend the ledger, e.g. for dispute resolution). Moreover, whereas some consensus methods used in DLT applications are deterministic, others are “probabilistic” in the sense that the reversal of a previously agreed update cannot be precluded. A legal concept of finality shall be applied to any distributed system used in financial markets to state clearly when – and where, given the distributed nature of transaction validation and the possibility of temporary inconsistencies – final settlement is achieved. The identification of a “golden copy” of information, to be held by a system operator reporting what validators have agreed in the network, could also simplify the legal treatment of finality in relation to egalitarian DLT systems.

3.9 Challenges for regulators

Regulation in the realm of financial market infrastructures focuses in some cases on entities rather than functions. This has at least two implications when looking at technological innovation. On the one hand, a regulated financial infrastructure is *a priori* able to use DLT or any other technology to perform its tasks, e.g. as a central securities depository, provided that the overseer does not spot issues as to the use of the technology. On the other hand, an entity that has not received the same official recognition cannot perform the same task either using DLT or without DLT. Such differential treatment is certainly justified, as the responsibilities of a financial market infrastructure are relevant from all points of view and the technology used is not the regulators’ only concern. However, the innovative features of DLTs might possibly reduce certain risks and prompt a rethink on licensing and on the rules relating to access to accounts in settlement systems.

Concluding remarks

DLTs are a diverse set of technologies that allow users to share a set of consistent information, in different capacities. It is necessary to understand some of their technical and functional features in order to grasp what kind of business relations could emerge if a DLT were to be adopted by financial market participants, particularly in the case of market infrastructures. The fact that different features are specific to different implementations of this technology means generic discussions as to the implications of “the” DLT are likely to miss some key points.

[18] “Proof of stake (with native assets)” is a consensus algorithm whereby validators vote on the validity of new transactions and receive their voting rights in proportion to their holding of native assets in the network. If non-licit transactions are validated or licit ones are not validated, the consequent loss of trust in the network shall affect the validator via a drop in the value of its native asset holding. In the case of “Proof of stake (with collateral)” participants receive voting rights in proportion to their collateral posted either inside or outside the DLT network. Collateral of the proponents is forfeited if a validated transaction is then found to be invalid.

The legal analysis could benefit from focusing on those features that are found in each specific DLT implementation – possibly disregarding implementations that seem unfit for financial market activity. The present note suggests as follows: a DLT is compatible with the full accountability of its users; the regulation currently in force may be sufficient to resolve the question of which law is applicable, at least in certain cases confined to the jurisdictions of Member States; data in the ledger can be protected by trusted institutions and be shared in accordance with confidentiality requirements; and market infrastructure would likely remain in the picture to ensure that this confidentiality is maintained as well as to provide clear governance in respect of the ledger and its related applications.

Technological innovation introduces some new regulatory challenges. These have to do with, for instance, the following: the nature of the assets exchanged in a distributed ledger for financial applications, in respect of assets that are intended as DFAs and not as a simple representations of assets held outside the DLT network; the nature of smart contracts, if the parties delegate the interpretation of their wishes to a non-deterministic script and particularly when there is no easy way to stop it or to amend it in case of need; the concept of an account and identification of the relevant account provider; the need to find a point in time, and a location, at which to define a new transaction (ledger update) as final from a legal perspective, particularly when validation is probabilistic; and the possible pressure to reassess the eligibility of different entities to participate in the post-trading market, to reflect the new possible functions and resilience DLT might introduce if adopted.

In order to achieve substantial efficiency gains, a common approach, a set of standards and harmonisation to achieve interoperability are required, possibly at a global level. It is important to realise that most potential benefits of the possible adoption of DLT in the future come from changes in market organisation facilitated by the use of DLT, not from IT performance. It should also be noted that DLT does not *per se* eliminate the need for some kind of financial institutions. This is partly due to the relatively poor performance of a DLT system when the provision of its core functions is not restricted to a limited number of participants.

The role of financial market infrastructures is also necessary because some of their functions are non-negotiable due to their legal implications, which include, *inter alia*, settlement finality, governance of the system and the accountability of the notary function. That does not mean, of course, that the market landscape will remain unchanged if DLTs are adopted in the future. The possibility of business processes undergoing radical innovation increases the likelihood that new entities (provided they are able to demonstrate their capability to bear the responsibilities of a financial market infrastructure) may break into the post-trading industry, either to provide new services in their own right or in cooperation with incumbent accountable institutions. DLTs may of course eliminate the need for some financial institutions and layers of intermediation, but that applies only to specific entities whose current role is to bypass data fragmentation and the lack of functional/legal harmonisation that coordinated efforts towards the adoption of DLTs may help to resolve.

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Virtual currencies: the regulatory challenges

By Ross Leckow[1]

1 Introduction

Technological innovation is transforming the financial services industry. The popular press is filled with stories about new technologies and startups that have the potential to fundamentally change the way in which financial services are provided. Many new technologies offer the hope of a financial system in which services are provided more quickly and cheaply and to a much wider range of consumers than was imaginable even a few years ago. The emergence of virtual currencies has been an important development in this field. Virtual currencies offer the promise of a global system of payments and transfers that would be far more efficient than that currently in existence. But they also pose risks. These risks range from the hypothetical to the immediate, and are attracting the attention of regulators around the world.

This paper examines the role that virtual currencies can play in the financial system, the challenges they pose for regulators, and the approaches that regulators are adopting in response. The paper begins with a brief description of virtual currencies and the manner in which they operate, and then examines four basic questions: (1) why national authorities should regulate virtual currencies; (2) the challenges that virtual currencies pose for regulators; (3) which aspects of virtual currencies should be the subject of regulation; and (4) how a regulatory regime could be most effectively designed. The paper ends with a discussion of the future of regulation in this field. In examining these questions, the paper focuses on decentralised virtual currencies (or "cryptocurrencies"), and pays particular attention to regulation in the field of anti-money laundering and combatting the financing of terrorism (AML/CFT).

As a starting point, it is important to note that the International Monetary Fund (IMF) is closely observing the development of virtual currencies. The IMF's interest stems, in particular, from its purposes under its Articles of Agreement (the IMF's constituent document), to "promote exchange stability, maintain orderly exchange arrangements" and to "assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade".[2] In January 2016, the IMF published a paper entitled "Virtual Currencies and Beyond:

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1 Deputy General Counsel, International Monetary Fund. The views expressed in this article are those of the author and do not necessarily represent the views of the IMF, its Executive Board, or IMF management. The author gratefully acknowledges the advice and assistance of Ms Yasmin Almeida, Research Officer at the IMF in preparing this article.

2 Articles of Agreement of the International Monetary Fund, Article I(iii) and (iv).

Initial Considerations"[3] (hereinafter "Virtual Currencies and Beyond"). This paper represented the first effort by IMF staff to examine virtual currencies and their implications. IMF staff are continuing to study developments in the area of virtual currencies as well as in finance and technology (hereinafter "FinTech") more broadly.

Virtual currencies are also attracting attention from other international organisations and national authorities. Important studies have been published, in particular, by the ECB, the European Commission, the Committee on Payments and Market Infrastructures and, at national level, the Bank of England and the Bank of Canada.[4]

2 What are virtual currencies?

Virtual currencies are digital representations of value issued by private developers and denominated in their own unit of account. They can be obtained, stored and transferred electronically and used for a variety of purposes by parties who agree to use them.

Virtual currencies fall within the broader concept of "digital currencies" but differ from other forms of digital currencies in at least one important respect: they are not denominated in a *fiat* currency.[5]

Virtual currency schemes comprise two important features: (1) the virtual currency itself or digital representation of value that parties hold and use; and (2) the underlying framework of rules and protocols that govern the operation of the system. It is this framework that governs the issuance and redeemability of virtual currencies, their use and circulation, and the payment and settlement process.

There are many different types of virtual currencies and virtual currency schemes. Some virtual currencies are *non-convertible* (i.e. they cannot be converted into fiat currency) and can only be used between participants inside the system for specified purposes. Other virtual currencies are *convertible* – that is, they can be converted into fiat currency and used for the purposes of making payments in the real economy.

Virtual currency schemes can be centralised, decentralised or a hybrid between the two. In a centralised system, the system is administered by a central private party. In a decentralised system, the central administrator is replaced by the protocols that govern the operation of the system, and many administrative functions are performed by the system's participants themselves.[6] As payments and transfers are

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3 Available on the IMF's website at www.imf.org.

4 See, in particular: "Virtual currency schemes", ECB (2012); "Virtual currency schemes – a further analysis", ECB (2015); "The Digital Agenda of Virtual Currencies: Can BitCoin Become a Global Currency?", European Commission (2015); "Digital Currencies", Committee on Payments and Market Infrastructures (2015); John Barrdear and Michael Kumhof, "The macroeconomics of central bank issued digital currencies", Staff Working Paper No. 605, Bank of England (2016); Wilko Bolt and Maarten R.C. van Oordt, "On the value of virtual currencies", Staff Working Paper 2016-42, Bank of Canada (2016).

5 "Virtual Currencies and Beyond", p. 7.

6 ibid., p. 9.

made, the participants in a decentralised scheme verify whether the transferor has the necessary funds and, if so, record the transaction as having been completed. Participants who perform this verification function (known as “miners”) are then rewarded through the issuance of newly-minted units of the virtual currency. This verification process has the dual function of ensuring the validity of the transaction without the involvement of a central trusted intermediary (e.g. a bank), and introducing new units of the cryptocurrency into the system.

The virtual currencies that form part of these decentralised systems are known as “cryptocurrencies”. While there are a number of cryptocurrencies whose model may vary, Bitcoin is the most well-known example. A key feature of a cryptocurrency scheme is the “distributed ledger technology” underlying the system. In contrast to the traditional financial system where trusted intermediaries (e.g. banks) maintain the ledgers and accounts and verify the validity of particular transactions, the ledgers in a cryptocurrency scheme are distributed to each participant. In the Bitcoin model, as transactions are executed and verified by participants, the ledgers are periodically updated with new transactions recorded in the distributed ledger. As such, the distributed ledger, or “blockchain”, provides a complete and immutable record of all transactions that have ever taken place within the system. For each unit of virtual currency, the distributed ledger provides a complete history of every transaction that has ever taken place involving that particular unit.

Three other important features of cryptocurrencies should be noted.[7] First, most cryptocurrency schemes (including Bitcoin) only allow for the issuance of a finite number of cryptocurrency units. Second, cryptocurrencies are “pseudo-anonymous”: while all cryptocurrency transactions are recorded in the distributed ledger available to all participants, the users behind these transactions are known only by their cryptocurrency “addresses” and not by their real identity. As such, cryptocurrencies are more transparent than cash but less transparent than other forms of online payment. Finally, cryptocurrencies challenge the fundamental principles underlying fiat currencies: while fiat currencies are backed by the credibility of the issuing central bank and government, cryptocurrencies are not backed by any source and their value is determined entirely by the willingness of users to accept them.

There are several different ways in which cryptocurrencies can be acquired. In addition to the acquisition of cryptocurrencies through the “mining” process described above, they can be purchased in a virtual currency exchange (an online service provider that buys and sells cryptocurrencies against fiat currencies and other cryptocurrencies), a trade platform, or directly from another holder of cryptocurrencies. Cryptocurrencies can be held in a “wallet”, typically maintained with a wallet provider or exchange.

[7] ibid.

3 Why regulate virtual currencies?

There is no doubt that virtual currencies have the potential to provide substantial benefits to the financial system, market participants, and consumers. They enable direct "peer-to-peer" transactions and eliminate the need for an intermediary or central clearinghouse. As such, they have the potential to enhance the efficiency of the financial system by enabling the making of payments – including cross-border payments – more quickly and cheaply than ever before. They could deepen financial inclusion, in particular, in the developing world by significantly improving the opportunities for fast low-cost cross-border remittances, and by bringing the "unbanked" of many developing countries into the financial system.

At the same time, cryptocurrencies pose risks. In "Virtual Currencies and Beyond", IMF staff identified six potential risks.[8] These risks can be placed on a continuum, some of which are more remote and others which are more immediate.

In the longer term and at the more remote end of the spectrum, there are two risks. First, the widespread use of virtual currencies could complicate the conduct of monetary policy – for example, where the use of a cryptocurrency in a jurisdiction becomes so widespread that it undermines the conduct of the authorities' *monetary policy* which relies on the use of a fiat currency. Second, there is a risk that the use of cryptocurrencies in a country could become such an important part of the financial system that it would pose risks to *financial stability* – for example, through the failure of an important part of a cryptocurrency infrastructure or a key participant within the system. Both of these risks may be viewed as remote at this stage as the total amount of cryptocurrencies in circulation is still very small. For example, as of October 2016, there were somewhat more than 15 million bitcoins in circulation worth approximately USD 9.7 billion according to *blockchain.info,*[9] while US dollars of a value of approximately USD 1.48 trillion were in circulation according to the U.S. Federal Reserve System.[10]

Beyond these more remote risks, the IMF paper identified four risks that are more immediate in nature. These are outlined below.

Cryptocurrencies present opportunities for *fraud*. Because the cryptocurrency market is still opaque and the regulatory framework still in the process of development, cryptocurrencies present opportunities for scams including the theft of units of cryptocurrency through fraud or hacking. In 2013, for example, the U.S. Securities Exchange Commission filed a complaint against a company engaging in a bitcoin-denominated "Ponzi" scheme pursuant to federal securities legislation that prohibits fraudulent offers and sales of securities.[11] In 2014, what was then then the largest Bitcoin exchange in the world, Mt Gox, filed for bankruptcy in Japan after announcing that nearly half a billion dollars' worth of bitcoins held for customers had gone

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8 At pp. 27-35.

9 Sources: https://blockchain.info/charts/total-bitcoins; https://blockchain.info/charts/market-price; https://blockchain.info/charts/market-cap

10 Source: https://www.federalreserve.gov/faqs/currency_12773.htm

11 *SEC v. Shavers*, E.D. Tex. (August 6, 2013).

missing. The CEO of Mt Gox was subsequently charged with embezzlement by the Japanese authorities.[12]

Cryptocurrencies also facilitate *tax evasion*. As participants in a cryptocurrency scheme do not have to fully disclose their identity and can engage in peer-to-peer transactions without an intermediary, cryptocurrencies make it easier for market participants to hold and use funds without disclosing them to the authorities.

Cryptocurrencies can be used to *circumvent exchange and capital controls*. By facilitating the making of cross-border payments and transfers outside of the banking system, users can avoid the application of exchange or capital controls that banks, in some countries, are required to observe. Rather than purchasing foreign currency and transferring it abroad through an authorised bank, market participants can purchase cryptocurrency and transfer it abroad on a peer-to-peer basis. Such practices have already been reported in countries such as Venezuela and China where exchange and capital control regimes remain in place.[13]

Furthermore, cryptocurrencies may be used to facilitate *money laundering and terrorist financing*. The pseudo-anonymous and peer-to-peer nature of cryptocurrency schemes make them an ideal mechanism through which to disguise the illicit origin or destination of funds.[14] There have already been a number of serious and well-publicised cases of money-laundering involving cryptocurrency schemes. For example, Bitcoin was used as the currency of choice in "Silk Road", a "dark web" market place for illegal goods that was shut down by US law enforcement authorities in 2013.[15]

If regulation is unnecessary for more remote risks, it is necessary to prevent the types of abuses described above, even if cryptocurrencies are not yet widely used. The question therefore arises: if cryptocurrencies are to be the subject of regulation, what are the challenges that national authorities will have to confront in regulating them?

4 What are the challenges of regulation?

In designing a regulatory framework, it is important to note four challenges that cryptocurrencies pose. Specifically these are as described below.

They pose a *definitional* challenge. Cryptocurrencies (and virtual currencies more generally) combine the properties of currencies, commodities, and payments systems. Their classification as one or the other will have implications for their regulatory treatment. Different regulatory agencies within a jurisdiction may classify

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12 "Mt Gox founder Mark Karpelès charged with embezzlement", *Financial Times*, 11 September 2015.

13 "Virtual Currencies and Beyond", p. 31.

14 Anonymising service providers known as "tumblers" assist in obfuscating a transaction chain and more effectively concealing the identity of a user.

15 "Manhattan U.S. Attorney announces seizure of additional $28 million worth of Bitcoins belonging to Ross William Ulbricht, alleged owner and operator of 'Silk Road' website", Press Release, Department of Justice, U.S. Attorney's Office, Southern District of New York, 25 October 2013.

them in different ways, depending on their own policy priorities. In the United States, for example, the Financial Crimes Enforcement Network (FinCEN), the national financial intelligence unit, treats virtual currencies as "value" for the purposes of AML/CFT regulation,[16] while the Internal Revenue Service treats them as "property" for the purposes of federal taxation,[17] and the Commodities Futures Trading Commission defines them as "commodities" for its own regulatory purposes.[18]

The use of cryptocurrency within a cryptocurrency scheme is difficult to monitor. Their pseudo-anonymity and potential for peer-to-peer transactions make it difficult, in some cases, to determine the identity of a user, or that person's use of the currency within the system.

The transnational reach of cryptocurrencies may complicate regulation. Asserting jurisdiction over a particular virtual currency transaction, market participant or scheme may prove challenging in some cases.

Finally, the decentralised nature of cryptocurrencies challenges conventional regulatory models. Cryptocurrency schemes eliminate the role of traditional intermediaries that are normally the focal point of regulation. For example, in the field of exchange control, it is the banks and other financial intermediaries that play a critical role in ensuring that particular payments and transfers of currency are made in a manner that complies with applicable exchange control regulations. Within a cryptocurrency scheme, these traditional intermediaries are generally not present.

5 What should be the subject of regulation?

Against this background, in the design of a regulatory framework for cryptocurrencies, what should be the subject of regulation? Conceptually, there are three broad features of a cryptocurrency system that may be subject to regulation.

First, regulation could apply to the *cryptocurrency scheme itself* – that is, the protocol, procedures and rules governing the operation of the system to which all participants in the system must adhere. Second, regulation could apply to the *uses* which market participants make of a cryptocurrency, including the making of payments, or the exchange of cryptocurrency for fiat currency. Third, regulation could apply to the *users of the system*, including service providers within the system.

For now, regulation has focused on the *uses* that can be made of cryptocurrencies and the *service providers* in the virtual currency sphere. Less focus has been placed on regulating a cryptocurrency system itself. Regulation of a decentralised virtual

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[16] "Application of FinCEN's regulations to persons administering, exchanging or using virtual currencies", Guidance, Department of the Treasury Financial Crimes Enforcement Network, FIN-2013-G001, 18 March 2013.

[17] Notice 2014-21, Internal Revenue Services, March 2014 – available at https://www.irs.gov/pub/irs-drop/n-14-21.pdf

[18] *Order: Coinflip, Inc., d/b/a Derivabit, et al*, US Commodity Futures Trading Commission, 17 September 2015.

currency system may prove extremely difficult as there is no central authority that controls the system and that could be made the subject of regulation.[19]

6 How should a regulatory framework be designed?

Against this background, how should a regulatory framework for cryptocurrencies be designed? In these early days, countries have taken a broad range of approaches. National responses have ranged from a completely *laissez-faire* approach, to issuing advisories warning of the risks associated with cryptocurrencies (e.g. fraud and theft), to restricting or banning their use[20]. In addition to enforcing existing laws, in particular criminal laws prohibiting fraud and money laundering, some jurisdictions have taken a step further and extended the application of selected financial and consumer protection legislation and regulations to virtual currency-related uses and/or intermediaries. This has notably been done by issuing interpretative guidance on their applicability.

Enforcement presents a major challenge for regulators. As the business model for cryptocurrency schemes differs fundamentally from traditional payment models, regulators are adopting adopt new approaches to ensure that certain types of regulation are observed. An important example of this development is in the field of AML/CFT. In many countries, it is the banks and conventional providers of money or value transfer services that typically play a key role in ensuring that AML/CFT regulations are observed in the payment sphere.[21] These entities are required to take the necessary “preventive measures” (e.g. customer due diligence, record keeping, suspicious activity reporting) to ensure that they know the identity of their customers and that they understand the purpose and intended nature of the business relationship. Without traditional financial institutions to play this role in the virtual currency sphere, regulators have had to look at new types of service providers on whom responsibility for AML/CFT compliance should fall.

The Financial Action Task Force (FATF) has provided guidance on the application of the global AML/CFT standards (the FATF standards) to virtual currencies. Its guidance focuses on how the risk-based approach inherent in the FATF standards can be applied in the context of virtual currencies. One particularly important issue it has addressed concerns who, in the absence of traditional regulated entities like

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[19] In the United States, “administrators” of virtual currency schemes are considered to be “money transmitters” and, therefore “money services businesses” that, under the Bank Secrecy Act, are required to register with the Department of the Treasury and to develop AML//CFT programmes. See FIN-2013-G001, “Application of FinCEN’s Regulations to Persons Administering, Exchanging or Using Virtual Currencies”, 18 March 2013. Administrators are more common in centralised virtual currency schemes. Identifying an “administrator” in a hybrid or decentralised scheme may be more challenging.

[20] See “Virtual Currencies and Beyond”, pp. 25 and 42.

[21] Under the international standards, financial institutions as well as designated non-financial businesses and professions are required to implement AML/CFT preventive measures (see the 2012 FATF 40 Recommendations).

banks, would be responsible for ensuring the rules are observed. The guidance also points out which recommendations are relevant in relation to virtual currencies.[22]

In the world of cryptocurrencies, there are two possible points of intersection at which AML/CFT obligations may be imposed. The first stage may be called the *gateway*. This exists at the point where a user purchases or sells units of cryptocurrency in exchange for *fiat* currency. The purchase or sale of cryptocurrency is the principal point of entry into and exit from the cryptocurrency sphere. The second point may be found *within* the cryptocurrency system – that is, when units of cryptocurrency are being held or transferred between participants.

In identifying intermediaries upon whom to impose AML/CFT obligations, FATF has looked to the "gateways" between the virtual currency world and the traditional financial sector. It has called for the obligation to apply preventive measures to be imposed on the "gatekeepers" – in particular, the virtual currency exchanges through which market participants purchase virtual currency to enter the system or to sell it for *fiat* currency to leave the system. The FATF guidance links virtual currencies and virtual currency exchanges to the definition of a "financial institution", meaning that virtual currency exchanges are considered "covered entities" under the FATF standard.[23] As is the case with traditional financial institutions, virtual currency exchanges would then be required by national authorities to perform customer due diligence, keep records and report suspicious transactions to the AML/CFT authority in the relevant country in the event that the FATF guidance were to be followed in that jurisdiction.

A number of countries (e.g. Germany, the United Kingdom, the United States, and Canada) have taken similar approaches in practice.[24] In the United States, FinCEN has issued guidance clarifying that virtual currency exchanges are "money services businesses" for the purposes of US AML/CFT legislation and, as such, are required to apply AML/CFT preventive measures.[25]

The effectiveness of the approach set out in the FATF guidance will depend on how the virtual currency market evolves. Requiring gatekeepers to take preventive measures is certainly an important step forward in combatting money laundering and terrorist financing. However, as the virtual currency market evolves and new money laundering and terrorist financing typologies emerge, the effectiveness of this approach will need to be reassessed. More generally, the cryptocurrency world is still small, and most users will likely have to convert their holdings into *fiat* currency at some point. However, the volume of cryptocurrency in circulation may grow to the point that "cashing out" will no longer be necessary. In these circumstances, it may become necessary to extend regulation to other virtual currency network participants

[22] "Virtual Currencies: Key Definitions and Potential AML/CFT Risks" (FATF, 2014); "Guidance for a Risk-Based Approach to Virtual Currencies" (FATF, 2015).

[23] Within a centralised virtual currency scheme, the concept of a "covered entity" would also include the central administrator of the system.

[24] "Virtual Currencies and Beyond", p. 28.

[25] See FIN-2013-G001 (FinCEN, 2013).

such as wallet service providers and payment processors that operate entirely within the system.

Some regulators have already begun to move towards this approach. A proposal was adopted by the European Commission in July 2016 to amend Directive (EU) 2015/849,[26] which concerns the prevention of the use of the financial system for the purposes of money laundering or terrorist financing. In particular, this proposal provides for an expanded definition of "obliged entities" to include both virtual currency exchanges and providers of certain types of digital wallets in which users may hold units of cryptocurrency that are referred to as "custodian wallet providers". These are identified as "wallet providers offering custodial services of credentials necessary to access virtual currencies". While this definition may not include all types of digital wallet providers currently operating in the virtual currency sphere (e.g. non-custodian wallet providers), it does go beyond the gateways that have so far been the target of regulation. The imposition of such obligations with respect to other types of wallets with more complex rules of access (e.g. multi-signature wallets) may prove to be more difficult.

Even within such a framework, the enforcement of AML/CFT regulations in the cryptocurrency sphere may prove challenging. While a growing segment of transfers and transactions are being conducted with the involvement of exchanges or wallet service providers, it is still possible for a user to make a transfer without using an intermediary. It remains to be seen whether the portion of the market that exists outside the reach of intermediaries will shrink to the point where money launderers will be unable to perform transactions in the volumes they need. Moreover, even where virtual currency exchanges are subject to regulation, the effectiveness of imposing freezing and seizing orders with respect to funds held in cryptocurrencies is not clear.[27]

Beyond the area of AML/CFT regulation, some jurisdictions are subjecting the new virtual currency service providers to more comprehensive licensing regimes. Many of these requirements are motivated more by concerns over consumer protection rather than over financial stability. Many such jurisdictions are clarifying that some types of virtual currency service providers – in particular, exchanges – fall within the licensing requirements for money transmitters within the jurisdiction. As a result, these entities are subject to licensing regimes that impose fit and proper requirements on their management and owners (for instance by examining the experience and backgrounds of the chief officers and significant shareholders) and also impose requirements in respect of the entity's financial soundness including minimum capital levels and the reserves they are required to maintain.

A few jurisdictions are establishing licensing regimes that apply specifically to virtual currency service providers. An example of this is the New York BitLicense adopted

[26] Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC, 2016/0208 (SWD/2016/0224 final - 2016/0208 (COD)). See also European Commission Press release, "Commission strengthens transparency rules to tackle terrorism financing, tax avoidance and money laundering" (5 July 2016).

[27] "Virtual Currencies and Beyond", p. 28.

by the New York Department of Financial Services in 2015. This framework sets out a comprehensive regime for the licensing of a broad range of virtual currency service providers, including exchanges, wallet service providers, and dealers.[28] The licensing process examines the appropriateness of the owners and principal officers of the business, the capital position and reserves of the business, its programmes and arrangements for AML/CFT compliance and the maintenance of cyber-security, and its procedures for the disclosure of potential risks to customers. The regulator's assessment of the financial position and reserves of the business takes a risk-based approach that examines the nature of the business being conducted.

While recognising the need to impose AML/CFT obligations on certain service providers, some jurisdictions have in parallel put in place "regulatory sandboxes" to foster responsible innovation. In an effort to ensure that regulation does not stifle innovation, a few countries (e.g. the United Kingdom, Singapore) have put in place regulatory sandboxes that allow FinTech startups of many different types (including virtual currency companies) to test new products with a small number of actual users in a simulated environment.[29] These sandboxes provide a safe space for innovation to happen without potentially adverse effects for financial markets or consumers. Within the sandbox, certain regulatory requirements may be relaxed for a specified period of time. However, some jurisdictions (e.g. Singapore) specify that regulatory requirements will be fully enforced even within the sandbox.

7 Conclusions

As we are at an early stage of market development for cryptocurrencies, it is not surprising that we are also at an early stage in the design of a regulatory environment for their use. While a great deal of progress has been achieved in thinking through the issues in some areas, more work will need to be done or redone as cryptocurrencies continue to evolve.

Moving forward, what principles should guide the development of regulatory frameworks for cryptocurrencies? The key guiding principle should recognise the need to draw an appropriate balance between regulation and innovation. While cryptocurrencies do present risks, they also offer the potential to significantly enhance the efficiency and inclusiveness of the global financial system. Regulators therefore need to put in place frameworks that guard against risk but in a manner that does not stifle innovation. Regulatory approaches will also need to be flexible, and able to adapt to potentially significant changes as the virtual currency landscape continues to evolve. Regulators will need to take into account the novel business models inherent in cryptocurrency schemes and decide on the appropriate degree of integration (if any) between the conventional financial system and the cryptocurrency world. Finally, more will need to be done to develop an effective regulatory

[28] http://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf, New York State Department of Financial Services (2015).

[29] See "Regulatory Sandbox", Financial Conduct Authority (2015); "U.K. Takes Novel Approach on FinTech". *Wall Street Journal* (11 April 2016); "Consultation Paper: FinTech Regulatory Sandbox Guidelines", Monetary Authority of Singapore (2016).

framework at international level. International bodies have an important role to play in this respect, in studying cryptocurrencies and in discussing potential regulatory approaches. In the longer term, consideration could be given to the development of international standards and best practices, as some standard-setting bodies like FATF have already clarified the application of their standards to virtual currencies. But these are still early days in the development of cryptocurrencies and the regulatory frameworks that apply to them. While much more work remains to be done, it is work that calls for a cooperative effort on the part of the entire international community.

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Retail instant payments and digital innovation – an overview of risks and challenges

By Phoebus Athanassiou[1]

The focus of this short paper is on one possible area of application of digital innovation (or 'FinTech'), namely faster (i.e. 'instant' or 'real-time') retail payments[2] and the related legal and operational issues. Before we delve into the substance (Sections 2 and 3), a few words are apposite, by way of introduction, on what instant retail payments are about and what their relation is to FinTech (Section 1). The final section of this paper sets out a number of concluding remarks (Section 4).

1 Retail instant payments: definition, benefits and links to FinTech

Retail instant payments are, in a sense, already a reality. An over-the-counter cash payment, at a supermarket or a petrol station, is an instant, real-time payment, since the obligations to which the relevant payments relate are discharged instantly by the physical act of tendering banknotes or coins. But these are not the type of instant payments we are interested in here: our interest is, instead, in 'cashless' instant payment solutions, available 24/7, all year round, irrespective of how the relevant payment may have been initiated, whether through a traditional payment channel (such as a debit or a credit card), the Internet, or a portable device (such as a smartphone or a tablet). Although retail instant (or near-instant) payment solutions are a reality in some European countries (such as Denmark, Poland, Sweden and the United Kingdom)[3] cashless retail payments are not instant in most parts of the European Continent. This will no doubt come as a surprise to most end-users: in fact, all that is instant when paying by credit card or PayPal is the mere confirmation of the payment instructions and of the accompanying payment information.

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[1] Principal Legal Counsel, Directorate General Legal Services, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

[2] The Euro Retail Payments Board (ERBP) has defined instant payments as "electronic retail payment solutions available 24/7/365 and resulting in the immediate or close-to-immediate interbank clearing of the transaction and crediting of the payee's account with confirmation to the payer (within seconds of payment initiation). This is irrespective of the underlying payment instrument used (credit transfer, direct debit or payment card) and of the underlying arrangements for clearing (whether bilateral interbank clearing or clearing via infrastructures) and settlement (e.g. with guarantees or in real time) that make this possible." See ERBP, Statement following the second meeting of the ERPB, 1 December 2014.

[3] In truth, most of the "instant" payment systems in question settle payments in batches, despite the fact that they do so with the benefit of several intraday settlement cycles, thanks to which they can achieve finality faster than the competition. Thus, while "faster", most of these payment systems are not, in truth, "instant".

By contrast, the actual crediting of funds to the payee's account (the acid test for declaring a payment to qualify as "real-time") is not instant. As for cross-border instant payments, these are very much a thing of the future, whether in Europe or beyond.

Turning to the link between retail instant payments and FinTech, it is worth noting that, while consumer demand for real-time payments has no doubt been inspired by the broader digitisation and digitalisation trends sweeping across other sectors of the economy (with an emphasis on the e-commerce sector), the actual path towards the achievement of instant (or faster) payments does not necessarily pass through technological innovation. Instant payments are, in theory, already possible, despite the fact that the most widely used payment option, across most retail payment systems, is the 'slow', low-cost payment option, requiring payment system participants to submit their payment instructions to the system operator for clearing, netting and, finally, settlement in batches.[4] Moreover, it is conceivable that instant or faster payments could be achieved through improvements in the capacity of existing market infrastructures, without the need to resort to technological innovation.

However, technological innovations, such as distributed ledgers,[5] Blockchain[6] and smart contracts,[7] and the use of innovative means of payment, such as virtual currencies (e.g. bitcoins or altcoins), have the potential to increase the speed at which retail payments are executed, while at the same time reducing their cost: indeed, technological innovations hold the promise of achieving genuinely instant payments. How? In a nutshell, it is by removing intermediaries – and, with them, the delays and costs that their involvement in the payment processing cycle entails – that technological innovation can dramatically increase the speed of payments and, what is more, significantly reduce their cost. It follows that there are at least two principal paths to be taken towards instant payments: one that embraces FinTech and its expected benefits in terms of disintermediation,[8] and another one that relies, by and large, on existing infrastructures (even if subject to certain adjustments) and existing market intermediaries, with an emphasis on banks and other, established,

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4 Most payment systems will qualify either as "net" or as "gross settlement" payment systems. Net settlement payment systems are those where the final settlement of funds occurs on a net basis, at a designated time of the day (typically, end-of-day). "Real-Time Gross Settlement" or "RTGS" systems are those where the settlement of funds occurs on a gross basis (meaning that payment instructions are processed on a one-by-one basis, without netting), and where final settlement is made on a real-time basis during the day, to guarantee the immediate finality of payments. Retail payment systems tend to be net settlement systems, whereas large-value payment systems are, increasingly, RTGSs. By achieving finality earlier, RTGS payment systems are deemed to be superior to net settlement systems in terms of settlement risk, despite being typically more costly for users.

5 The reference is to shared databases (or records) of transactions, assets or balances. Distributed ledgers owe their name to a combination of their functional equivalence to the ledgers traditionally used in finance (originally in physical form) in conjunction with their sharing (or "distribution") among the participants to a common network.

6 The reference is to the technological underpinning of the Bitcoin network. For an account of its features and operation, see Nakamoto, S., Bitcoin: A peer-to-peer electronic cash system, 2008.

7 Absent a commonly accepted definition, these can be defined as 'contractual-type arrangements' embedded in computer code, which the relevant computer code will execute automatically as soon as certain pre-programmed and contractually pre-agreed conditions have been satisfied.

8 The reference here is to "intermediation" in the narrow sense of the term (defined as the process of facilitating the indirect channelling of funds from lenders to borrowers) but, also, to the role that different financial institutions (and, especially, banks) play as key components of the payment system, with bank deposits being accepted as means of payment for goods and services.

payment service providers (PSPs). Which of these two paths the market will eventually follow, with the support of the official sector, will largely depend on the extent to which FinTech can deliver on its promises, on the risks that its deployment may entail for counterparties to payment transactions, and on whether these can be overcome through technical, legal or other means.

One final point worth making by way of introduction is this: promoting instant cashless payments in the retail space makes sense both legally and from a business perspective.[9] Legally, payment transactions that can be processed and settled within seconds (rather than within hours or days) are less vulnerable to credit and operational risks compared with those placed in a queue, with the main type of risk being that of the insolvency of the payer or the payer's bank.[10] From a business perspective, instant cashless payments make it possible to conduct transactions outside business hours, while at the same time reducing costs and facilitating specific types of payments, such as those due to workers remunerated on a one-off basis, those made to recipients without adequate access to the banking system, those relevant to foreign remittances, and those necessary in emergencies where speed is of the essence. To the extent that FinTech can facilitate instant payments, without generating novel legal or operational risks, it can arguably make an invaluable contribution towards overcoming the patent inefficiencies of the current payment environment, especially in its cross-border dimension.[11]

2 Instant payments and their challenges: an overview

Despite their potential, instant cashless payments come with several challenges, which FinTech could perhaps mitigate but, most probably, not altogether extinguish. To better understand what these are, it may be helpful to take a step back and reflect on the basics of all payment transactions. To every payment there is, apart from the initiation leg, also a clearing and a settlement leg.

Starting with the clearing leg, there is at present no Europe-wide instant clearing arrangement. Without it, cross-border cashless payments cannot but expose the recipients of funds and their banks (as PSPs) to credit risks and costs, resembling more credit-based transactions which may never be settled for lack of settlement funds.[12] Clearing solutions could either originate with the private sector or, failing a satisfactory private sector solution, the public sector. At the time of writing, the European Payments Council (EPC) was working on a SEPA-wide clearing initiative,

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[9] For an account of the benefits of instant payments see EPC, Report on Instant Payments Submitted to the June 2015 Meeting of the Euro Retail Payments Board, 30 June 2015.

[10] This is without prejudice to the mitigation of this risk through the concept of finality, and the finality protection that legal regimes afford to transactions processed within designated systems in the event of the insolvency of one or more of the counterparties to protected transactions.

[11] The Federal Reserve System concluded, in 2015, that the international payment system lacks transparency and is "slow, inconvenient, [and] costly" (Federal Reserve System, Strategies for Improving the U.S. Payment System, 26 January 2015, page 25, footnote 35).

[12] Digital innovation could have a key role to play here by effectively dispensing with the need for clearing for payment transactions executed between the owners of settlement assets native to a shared ledger.

on which it hoped to be in a position to deliver in the foreseeable future.[13] There may well be room for public sector initiatives in this space.

Moving to the settlement leg, Article 69(1) of the Payment Services Directive[14] states that the payer's PSP is to ensure that the amount of the payment transaction is credited to the payee's account with the payee's PSP, at the latest by the end of the next business day. Further acceleration would clearly be necessary for cashless payments to qualify as "instant payments". More importantly, instant settlement is not something that one can meaningfully hope to achieve by way of legislation: what is required to make it possible is a market infrastructure capable of fulfilling the need for instant (or near-instant) cashless payments. For this, enhancements may be necessary to TARGET2 or EURO1 or to closed retail payment systems operated by banks or payment platforms, such as PayPal.[15]

Would the above challenges disappear if instant payments were to be achieved through recourse to FinTech? Probably not or, at least, not in all cases.

Blockchain and distributed ledger technologies (DLTs) can move money quickly and cost-efficiently, but it is not immediately clear against whom the parties to a payment transaction executed through a shared ledger can have redress if funds are lost or misdirected, nor is it clear which court could claim to exercise personal jurisdiction over such a dispute. Similarly, the use of smart contracts to automate payments promises to speed up payments, but it is not necessarily clear whose contractual liability would be engaged if 'smart contracts' were to generate unintended results or outcomes that the contracting parties had not anticipated at the time they concluded the contract. It follows that, despite its enabling potential, FinTech would not represent a remedy for all of the challenges inherent in instant payments. Moreover, as we will see in the following section, instant payments are apt to give rise to a number of additional, mostly legal, concerns, which FinTech may either not address or could, in extremis, exacerbate, without prejudice to its spectacular promises in terms of the speed of settlement or the cost benefits that its deployment may bring.

3 Instant payments, legal challenges and FinTech's contribution to overcoming them

There are a number of additional, largely legal, concerns posed by instant cashless payments, which the application of FinTech cannot (necessarily) address, and which

[13] Single Euro Payments Area. For an account of the EPC's work on instant payments see: http://www.europeanpaymentscouncil.eu/index.cfm/sepa-instant-payments/epc-work-on-instant-payments/

[14] Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC (OJ L 319, 5.12.2007, p. 1).

[15] Digital innovation could dramatically increase the speed of settlement, through recourse to distributed ledgers and Blockchain-type technology, by crediting funds instantly to the account of the payee (provided both the payer and the payee hold accounts, and funds, within the same ledger) without the need for recourse to intermediaries, and without the delays (and costs) that their involvement currently entails.

its eventual deployment could, in some respects, amplify. The remainder of this section seeks to provide a non-exhaustive summary thereof, in the hope of drawing attention, in the process, to some of the apparent weaknesses of technological innovation that are often forgotten in the noise of positive public opinion about its possible future use.

A first point of concern is the protection of payments from external threats (including cyber-threats):[16] the immediacy of instant payments makes them a prime target for external, fraudulent attacks. The use of Blockchain and distributed ledgers could, potentially, be advantageous in terms of enhanced security, thanks to their use of cryptography and the level of protection that this can offer. But, as the attacks on Bitfinex and The Dao demonstrate, Blockchain and DLTs are not immune from external threats.[17]

Linked to the preceding point, a second area of concern is error detection and remediation: the immediacy of instant payments makes it harder to detect errors and correct them, since the window of opportunity for either is narrower compared with ‘slow’ and/or manually processed payments. The use of “smart contracts” to pre-programme and automate payments could considerably speed up payments but, at the same time, it could render error remediation, in particular, a challenging task, since the key selling point of “smart contracts” is their automaticity and their irreversibility.

A third point of concern involves legal and regulatory compliance. It is not enough for an instant payment solution to process payments within seconds: it is also essential that it integrates security and validation processes consistent with anti-money laundering (AML) rules and regulations and that it can comply with local know-your-customer (KYC) regulations. The use of distributed ledgers or virtual currencies in the context of retail payments can make compliance with AML and KYC rules and regulations difficult, as it may not always be readily clear which entity is to shoulder the regulatory compliance burden (especially in the context of a payment facilitated through use of a distributed ledger). This could prove to be a disincentive to the widespread adoption by the market of FinTech solutions in the field of payments, where AML and KYC rules and regulations loom large for obvious public policy reasons.

A fourth and final point of concern is “interoperability”.[18] It could be argued that speed should not be the focus of attention, and that the most intractable problem is, in fact, how to enable fast payments across different systems (from a PayPal

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[16] For a reflection of the acute interest of the official sector in cyber-security matters, especially in a payments context, see Committee on Payments and Market Infrastructures, Cyber resilience in financial market infrastructures, November 2014.

[17] Bitfinex, once the largest Bitcoin exchange globally, was the victim of a hack, which resulted in the theft of the private keys of many of its customers. The Dao was a decentralised, computer-operated fund management company, established through crowd-funding, whose software was weak; an unknown party exploited that weakness to empty more than $40 million worth of ether (a virtual currency similar to bitcoin).

[18] The reference, here, is to the in-built potential of payment systems to communicate with other systems without any effort on the part of their end-users. For an account of issues specific to payment systems interoperability see CGAP, Interoperability in Electronic Payments: Lessons and Opportunities, 2012.

account to an account held with a commercial bank or with the Bitcoin network). FinTech alone cannot resolve the issue of interoperability, as technology is not the obstacle to the achievement of interoperability, and as FinTech-powered platforms are not per se interoperable unless conscious efforts are made, at the level of their operators, to connect them through technical “bridges” or other comparable means. Ironically, existing interoperability issues are likely to be exacerbated by an eventual proliferation of FinTech-facilitated payment platforms, with novel interoperability concerns likely to arise as ways are sought to connect innovative distributed payment platforms to existing ones (so called “legacy platforms”).[19]

4 Concluding remarks

Arguably, FinTech can help bring about instant (or faster) cashless payments by removing intermediaries and, with them, the delays and costs that their involvement in the payment processing cycle entails. However, FinTech is not the only path to them: instant payments are already technically possible (even if their cost can be, at present, prohibitive); alternatively, it is conceivable that these could be achieved through medium-scale improvements in the system capacity of existing market infrastructures.

Once the headline challenges have been overcome – and there is no indication that they cannot be overcome, whether through regulatory or other means – an increasing number of financial actors are likely to want to at least test technological innovations, whether in the field of retail payments or beyond, allowing, in the process, those of us whose payment habits remain antiquated to catch up with the 21st century.

[19] The Euroclear response to the ESMA call for evidence states: “Introduction of numerous new DLT platforms without standardisation or harmonisation could hinder the realisation of the benefits of DLT and could undo the numerous standardisation and harmonisation efforts performed by public authorities, regulators and industry over the last decade.” See Distributed ledger technology applied to securities markets, September 2016.

Collateral issues

Introduction

By Otto Heinz

Legal shortcomings of financial market integration in the context of collateral taking: a market infrastructure perspective

By Markus Mayers

Collateral: need for legislative changes?

By Kestutis Laurinavicius

Introduction

By Otto Heinz[1]

Collateral is a central concept in banking, and accordingly quite an old one as well. It is important for the market in normal times as well, but its significance increases considerably in times of stress. In addition to the market, the same is true for central banks.

The Eurosystem and the ECB, responsible for defining and implementing the monetary policy of the Union, have a significant interest in issues relating to financial collateral. The central importance of collateral for the implementation of monetary policy is expressly recognised in the Eurosystem's constitutional framework – the Statute of the European System of Central Banks and the European Central Bank.[2]

Article 18.1 provides that '[in] order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may … conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.' In these liquidity-providing credit operations, adequate collateral therefore has a particular legal status and meaning in the Eurosystem's institutional legal framework. From a legal perspective, the concept of 'adequate collateral' is dual-faceted. First, it implies that the Eurosystem should be protected from incurring losses as a result of counterparty risk in its credit operations. Second, it requires that sufficient volumes of collateral are available to a broad set of counterparties so that they can obtain the necessary amount of liquidity in a smooth and well-organised manner. This ultimately ensures that the ECB can fulfil its mandate effectively, inter alia, by steering interest rates, managing liquidity in the market and signalling the monetary policy stance.[3]

These legal principles on adequate collateral are expanded upon and given operational effect in the legal acts establishing the Eurosystem's collateral framework: the Eurosystem's general collateral framework is set out in our General Documentation.[4] It reflects the 'single list of collateral', i.e. the same set of collateral eligibility rules across the Eurosystem. It was a major milestone in building the single currency to have created this single list, having unified the previously fragmented framework. But we have hardly had time to celebrate this achievement; and the financial crises started to test our framework from 2007 onwards. On the one hand it tested collateral the way collateral is tested, i.e. to what extent it protects the Eurosystem from losses. And it tested the collateral framework from the perspective

[1] Head of the Financial Law Division, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

[2] Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank (OJ C 326, 26.10.2012, p. 230).

[3] See the article entitled 'The Eurosystem collateral framework throughout the crisis', Monthly Bulletin, July 2013, p. 71.

[4] Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (OJ L 91, 2.4.2015, p. 3).

of its ability to react to the crises and the sudden explosion of liquidity needs of counterparts. This later consideration prompted the creation of the additional temporary collateral framework. As the financial crisis deepened and became more entrenched following the Lehman Brothers collapse in September 2008, a series of temporary measures increasing the range of acceptable collateral were introduced in order to expand the liquidity provision to support bank lending and to households and non-financial corporations.

The adequacy of this additional framework could not be compromised – it is a requirement in the Statute after all. What instead could be temporarily compromised is the policy objective that all collateral should be single list collateral with the same eligibility requirements across the euro area. It was necessary to open the reserves of different assets, suitable as collateral, in the different jurisdictions.

Combined, these frameworks determine the type and the legal and economic characteristics of collateral which may be accepted by the Eurosystem in credit operations. In general, one can say that it is an inclusive mix, which seeks to reflect and accommodate the distinctive legal and economic contexts of the Eurosystem's counterparties. Eligible assets include both marketable and non-marketable assets, i.e. debt instruments such as corporate bonds, uncovered bank bonds, covered bonds and asset-backed securities as well as credit claims, while certain limitations are placed on the place of issuance, the type and residence of issuers, debtors and guarantors, the denomination and the credit quality of the issuer, debtor and guarantor.

Despite the need to eventually add the temporary set of collateral, the flexible and inclusive nature of the Eurosystem collateral framework has always been a distinctive feature compared with other central banks. This broad range of collateral accepted by the Eurosystem meant that it was capable of reacting quickly and effectively to the issues raised by the financial crisis. In the initial phase of the crisis, during which euro area money market conditions deteriorated, the Eurosystem was able to swiftly expand liquidity-providing operations, facilitated by the broad range and availability of collateral to collateralise these operations. This ultimately permitted the Eurosystem to fulfil the traditional central bank's role of lender of last resort as interbank credit flows dried up.

In the subsequent stages of the crisis, monetary policy measures have focused on addressing impairments to the monetary policy transmission mechanism caused by the sovereign debt crisis, through the announcement of the Outright Monetary Transactions (OMT) programme, and in more recent times, the risk of deflation through a series of asset purchase programmes more commonly known as quantitative easing. The latter asset purchase programmes involve, since January 2015, the monthly purchase of €60 billion (or, since March 2016, €80 billion[5]) in Eurosystem-eligible collateral in the form of bonds issued by governments, State entities and supranational issuers, covered bonds, asset-backed securities and

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5 In the meantime, the Governing Council has decided that the monthly purchases would be reduced to €60 billion per month from April 2017.

corporate bonds. While these programmes inject large amounts of liquidity into the markets, large-scale outright purchases of assets necessarily reduce the volumes of collateral assets which would otherwise be available to market participants, e.g. to collateralise repos or other derivative transactions. To offset these potential side-effects and safeguard liquidity conditions and collateral availability in euro area debt markets, the Eurosystem also makes assets purchased under the public sector and corporate bond purchase programmes available for securities lending transactions.

With this background I have the pleasure to introduce a central bank expert panel appropriate for the topic.

- We have Sarah Palmer, who is in charge of asset-backed securities (ABS) and structured finance issues in our Legal Services. Despite the seemingly down-to-earth topic, Sarah will launch the panel in the style of a James Bond movie, presenting a huge turmoil in the opening scene, in different exotic locations including the United States, Germany and Iceland. She will walk us through two cases studies, one involving Lehman Brothers, the other the Icelandic banks that defaulted during the crises and when collateral needed to be worked out.
- I am also glad to have with us Markus Mayers, who is a distinguished market infrastructure expert at the ECB. Markus will also focus on issues and problems, in particular describing the operational and legal barriers affecting the cross-border use of collateral and affecting post-trade, i.e. as regards the acquisition and disposition of collateral. He will also offer a glimmer of hope when describing the beneficial role of TARGET2-Securities, addressing some of the issues.
- The third member of our panel is a lawyer with special expertise in financial infrastructure matters. Kestutis Laurinavicius will conclude the panel offering mainly legislative solutions, thereby solving all the problems in 007 style, although the only real conflict Kestutis will tackle is conflict of law issues.

As we have quite a few issues to cover, without further ado I would kindly ask the first speaker to take the floor.

Legal shortcomings of financial market integration in the context of collateral taking: a market infrastructure perspective

By Markus Mayers[1]

1 Introduction

In its Green Paper[2] and Action Plan on Building a Capital Markets Union,[3] the European Commission has declared its intention to support collateral markets, in order to promote cross-border investments and enhance the resilience of cross-border settlement and collateral flows.

Strengthening collateral markets requires, above all, that the legal framework on financial collateral arrangements, on which market participants rely, be improved. At the moment, legal provisions relating to financial collateral can be found in several European Union legal acts: the 1998 Settlement Finality Directive (SFD),[4] the 2002 Financial Collateral Directive (FCD)[5] and several post-crisis legal instruments, including the 2012 European Market Infrastructures Regulation (EMIR),[6] the Central Securities Depositories Regulation (CSDR)[7] as well as the 2015 Securities Financing Transactions Regulation (SFTR).[8]

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[1] Adviser, Directorate General Market Infrastructure and Payments, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

[2] Green Paper on Building a Capital Markets Union, Brussels, 18.2.2015, COM(2015) 63 final, p. 5.

[3] Communication from the Commission to the European Parliament, the Council, the European Economic And Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, Brussels, 30.9.2015 COM(2015) 468 final, p. 22, 24.

[4] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L166, 11.6.1998, p.45).

[5] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L168, 27.06.2002, p. 43).

[6] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).

[7] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (OJ L 257, 28.8.2014, p. 1).

[8] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse (OJ L 337, 23.12.2015, p. 1).

2 Increasing collateral demand in cross-border transactions

The provision of financial collateral is very important for the smooth settlement of financial transactions.

First, according to Article 18.1 of the Statute of the European System of Central Banks and the European Central Bank, adequate collateral is needed for the Eurosystem's credit operations, including intraday credit. Collateral for intraday credit (e.g. in TARGET or TARGET2-Securities (T2S)) is necessary in order to ensure smooth settlement of financial market transactions in central bank money. Collateral has to be "adequate" in quality and quantity. Quality is ensured through the eligibility criteria specified in the Eurosystem legal framework for monetary policy instruments known as "General Documentation".[9] Quantity refers to the need to provide enough good quality collateral at the right place and at the right time.

Second, newly introduced regulation imposes increased collateral requirements for market participants and financial market infrastructures. Article 59(c), (d) and (e) of the CSDR requires that central securities depositories (CSDs) which are authorised to provide banking-type ancillary activities are able to fully cover corresponding credit exposures to individual borrowing participants. CSDs need to use liquid collateral with minimal credit and market risk and have to apply conservative haircuts and concentration limits on collateral values. In addition, Article 11(3) of the EMIR imposes on financial counterparties the obligation to have risk-management procedures in place. These procedures include the timely, accurate and appropriately segregated exchange of collateral with respect to over-the-counter (OTC) derivative contracts. Moreover, under Article 46 of the EMIR, a central counterparty (CCP)[10] must accept highly liquid collateral with minimal credit and market risk to cover the CCP's exposures to its clearing members. In particular, it must collect initial margin and default fund contributions (Articles 41 and 42 of the EMIR). In case of default of a clearing member, a CCP must use the margins posted by that clearing member and the default fund contributions prior to using other financial resources to cover losses (Article 45 of the EMIR). Finally, CCP interoperability requires the provision of margin (Article 53 of the EMIR).

Increasing collateral demand requires safe and efficient cross-border use of collateral. However, there are significant barriers to the efficient and safe cross-border use of collateral in the Union.

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9 Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60), OJ L 91, 2.4.2015, p.3.

10 See Article 2(1) of the EMIR: "CCP" means a legal person that interposes itself between the counterparties to the contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

3 Operational barriers to the efficient cross-border use of collateral & T2S

Efficient use of collateral requires that sufficient collateral will always be available at the right place and at the right time. Collateral is still held in multiple pools across Member States. This can lead to operational fragmentation and silos.[11] In addition, the collateral giver and the collateral taker will in many cases not hold their securities accounts in the same CSD or securities settlement system. As a result, financial market participants may need to hold multiple securities settlement accounts across Member States.

T2S,[12] the pan-European platform for centralised delivery-versus-payment (DvP) securities settlement in central bank money operated by the Eurosystem, contributes significantly to the removal of operational barriers for financial market participants. The most important contribution of the T2S platform is that it allows for the consolidation of multiple securities settlement accounts in one single account in T2S. The consolidation of cash and securities settlement on T2S means that less collateral is needed for settlement purposes. Market participants are therefore per se not required to hold buffers of collateral in multiple European markets.[13] Furthermore, T2S allows for immediate reuse of collateral. In addition, a special functionality in T2S (the so-called T2S auto-collateralisation) enables automated use of collateral in order to obtain the liquidity necessary for real-time settlement.[14]

In addition, T2S acts as a catalyst for legal harmonisation. For instance, all CSDs migrating to T2S have to comply with the rules on settlement finality, as governed by the T2S Framework Agreement[15] as well as with the T2S harmonisation standards, for example in the area of corporate actions.[16]

Despite these positive developments, T2S does not per se contribute to the removal of the legal barriers identified in the 2001[17] and 2003[18] Giovannini reports.

4 Legal barriers to safe cross-border use of collateral

Under the current regime, financial market participants have to deal with a rather fragmented legal framework on collateral arrangements, which does not always

[11] ISSA, Report on Collateral Management, July 2016, p. 24.

[12] T2S went live on 22 June 2015. There have been three migrations waves so far and two more are expected. The last migration wave is planned for September 2017. Ultimately, 18 out of the currently 25 eligible securities settlement systems will have migrated to T2S.

[13] Bayle (2016).

[14] For more information see Manaa (2012).

[15] https://www.ecb.europa.eu/paym/t2s/pdf/csd_FA/T2S_Framework_Agreement_Schedules.pdf

[16] http://www.ecb.europa.eu/paym/t2s/progress/pdf/subcorpact/20130516-t2s-market-claim-standards-ag-approved-march.pdf?c9ff3488f7660466f76ce5001da27606

[17] The Giovannini Group, Cross-border clearing and settlement arrangements in the European Union, Brussels, November 2001.

[18] The Giovannini Group, Second Report on EU Clearing and Settlement Arrangements Brussels, April 2003.

allow the safe cross-border use of collateral. The most significant legal barriers are as follows: uncertainty as to the acquisition of collateral in legal terms (4.1), complicated rules on the re-use of collateral (4.2), shortcomings in the enforceability of close-out netting arrangements (4.3) and lack of clarity as to the law applicable to collateral arrangements (4.4). It is also noteworthy that market participants are not offered transparency or choice as to the whether their collateral is held at a financial intermediary or a CSD directly. Lack of transparency as to the collateral holdings might affect free choice and competition among CSDs, or between CSDs and other intermediaries (global custodians).

4.1 Lack of harmonised rules on the acquisition of collateral

Cross-border collateral flow is hampered by the lack of harmonised rules on the acquisition of collateral (collateral ownership rights).[19] The full harmonisation of national laws on the acquisition of cash, bearer securities or book-entry collateral is hardly feasible. However, certain short-term harmonisation measures are possible.

The harmonisation of certain aspects of the acquisition of book-entry collateral forms part of the general discussion on the acquisition and disposition of intermediated securities, which is to be addressed in a future securities law legislation (SLL). In its action plan on building a capital markets union, the Commission has declared its intention "to take forward early targeted work on uncertainty surrounding securities ownership".[20] In that context, the preparatory works of the Legal Certainty Group and the Clearing and Settlement Advisory and Monitoring Experts' (CESAME) Group, and in particular the proposed SLL,[21] are relevant. The proposed SLL adopts a functional approach with regard to the acquisition of intermediated securities (including outright transfers of collateral, title transfer collateral arrangements (TTCAs)) or limited interests in intermediated securities (e.g. usufruct or security rights, including securities financial collateral arrangements). It requires that Member States recognise the debit/credit of an account as a method for the acquisition of securities or limited interests in securities (Principle 4(1)). It also provides that Member States may allow for the acquisition of securities or limited interests in securities under the following methods: earmarking, conclusion of control agreement, conclusion of an agreement in favour of the account provider (Principle 5). The proposed SLL also contains rules on "good faith acquisition". In particular, it protects the rights of an acquirer, unless it knew that the credit/earmarking should not have been made (Principle 8).

The adoption of an SLL would establish legal certainty as to the acquisition of collateral ownership rights (priority of securities and good faith acquisition) and, thus,

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19 Paech (2013) p. 24 *et seq.*

20 Communication from the Commission to the European Parliament, the Council, the European Economic And Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, Brussels, 30.9.2015 COM(2015) 468 final, p. 23.

21 See European Commission, Legislation on Legal Certainty of Securities Holding And Dispositions, Consultation Document of the Services of the Directorate-General Internal Market and Services Brussels, DG Markt G2 MET/OT/acg D(2010) 768690.

render unnecessary the revision of the FCD. However, the Commission has, in the past, failed to put forward the SLL due to lack of political consensus. Should the SLL project fail again, a limited revision of the FCD in that respect should be considered. Such a reform should be compatible, to the extent possible, with the preparatory work on the SLL.

4.2 Uncertainty as to the right of use and reuse of collateral

In a security financial collateral arrangement (SFCA), the right of reuse stands for a mechanism where a security interest is combined with a right of disposal for the collateral taker. In an SFCA, the title to collateral remains with the collateral provider. The reuse of collateral may affect the legal position of the collateral provider, when the reuse is not accompanied by the transfer of equivalent collateral. If the collateral taker exercises his right of reuse, the collateral provider loses its legal title and the third party (which is the counterparty of the collateral taker) acquires title on the assets initially provided as collateral. The collateral provider has a mere contractual claim against the collateral taker to return the collateral (or to provide equivalent collateral under Article 5(1) of the FCD). In the event of the insolvency of the collateral taker, that claim of the collateral provider is unsecured.

Several Union legal acts address the right of use or reuse of collateral. It is noteworthy that there are several terminological disparities. Article 2(1)(m) of the FCD, Article 16(8) of the Markets in Financial Instruments Directive (MiFID/MiFID II)[22] and Article 39(8) of the EMIR refer to a “right of use”, whereas Article 22(7) of the UCITS V,[23] Article 21(10) and (11) of the Alternative Investment Fund Manager Directive (AIFMD)[24] and Article 3(12) of the SFTR refer to a “right of reuse”. The lack of uniform terminology and definition of the right of use or reuse may result in legal uncertainty, since it is not clear whether these terminological discrepancies have a legal value or are merely of a technical nature.

In order to protect the collateral provider, Union legal acts require its consent. However, the consent requirements vary considerably across different legal acts. Whereas Article 5(1) of the FCD merely requires the consent of the collateral provider, Article 16(8) of the MiFID/MiFID II refers to the “express consent” of the client. Article 39(8) of the EMIR requires the clearing member should give its consent to reuse “in writing”. Article 15(2) of the SFTR provides for “prior express consent, as evidenced by a signature, in writing or in a legally equivalent manner”. Article 21(10) and (11) of the AIFMD and Article 22(7) of the UCITS V set out more detailed consent standards. This patchwork of consent requirements makes reuse of

[22] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

[23] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (OJ L 302, 17.11.2009, p. 32).

[24] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

collateral more difficult for collateral takers. Therefore, it would be appropriate to align the consent requirements across the relevant Union legal acts.

In that context, we should also recall the financial stability concerns related to the reuse of collateral. The Financial Stability Board's Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos[25] stressed that "[r]e-hypothecation of client assets can create financial stability risks especially if clients are uncertain about the extent to which their assets have been re-hypothecated, or about the treatment in case of bankruptcy. For example, uncertainty may increase the possibility of a run on a prime-broker if there are concerns about its credit worthiness". These concerns have not been addressed at Union level. In order to prevent systemic risks and enhance protection of the collateral provider, it could be considered whether priority rules on the satisfaction of claims arising out of the re-use of collateral could be harmonised at Union level, and whether such claims could be given higher priority status than unsecured claims.[26]

4.3 Enforceability of close-out netting agreements

Close-out netting agreements can take various forms. In general, they include three steps: (i) the early termination of financial transactions between two counterparties upon a default event, (ii) the valuation, i.e. the determination of the replacement costs of each transaction, and (iii) the determination of the net balance, i.e. the obligations of the parties are netted against each other in order to determine the final net amount.[27]

Article 7 of the FCD affords protection to close-out netting agreements in case of insolvency of one of the parties to the collateral arrangement. There is an ongoing debate as to whether close-out netting agreements should enjoy such a special insolvency treatment. In particular, it is argued that close-out netting agreements usually lack transparency. As a result, unsecured creditors cannot properly assess the transaction risks and adjust their interest rates. In addition, they shift the monitoring costs to general (unsecured) creditors. Close-out netting is also believed to exacerbate systemic risks, in particular where a large number of financial participants exercise their termination rights against a defaulting counterparty.[28] Finally, it is argued that close-out netting agreements are designed in order to favour big players, such as credit and financial institutions or insurance undertakings.[29] Despite the abovementioned legitimate concerns, close-out netting agreements are, under the current practice in the financial markets, a valuable tool. Apart from the protection against counterparty risk, net positions form the basis for the calculation of the capital requirements of credit institutions under the Capital Requirements

[25] http://www.fsb.org/wp-content/uploads/r_130829b.pdf, p. 5.

[26] Johansson (2010) p. 151, 161.

[27] Peeters in Keijser (2014), p. 55.

[28] Paech (2013), p. 11 *et seq.*

[29] See Johnson (2009), p. 115 *et seq.*

Regulation (CRR).[30] In addition, close-out agreements enable financing without providing other security interests. Therefore, European businesses could secure better financing conditions and free capital for investments and job creation, which are principal goals of the capital markets union. Accordingly, a future recast of the FCD should keep the preferential insolvency treatment of close-out netting agreements and enhance their enforceability.

Under the current regime, there is legal uncertainty as to the enforcement of close-out netting agreements in cross border settings in case of a defaulting counterparty.

First, due to the diverging implementation of the FCD across Member States, parties should carry out due diligence in order to ascertain whether a close-out netting agreement falls under the scope of protection of the FCD and is enforceable in the insolvency of a counterparty.

Second, national rules implementing Article 7 of the FCD may fail to safeguard that close-out netting agreements are legally sound in the event of the insolvency of one of the counterparties. A prominent example is provided by a recent netting-unfriendly decision of the German *Bundesgerichtshof*, the Federal Court of Justice (BGH)[31] on the enforceability of a close-out netting clause provided for in the *Deutscher Rahmenvertrag für Finanztermingeschäfte*. The decision was rendered in a case involving two German counterparties of an insolvent English institution belonging to the Lehman Group. The BGH decided that the close-out netting clause is null and void, since it runs counter to § 104 InsO (*Insolvenzordnung*, the Insolvency Statute), which determines the calculation method (*Berechnungsmethode*) for the compensation claim (*Ausgleichsanspruch*). This caused the immediate reaction of the German Federal Financial Supervisory Authority (BaFin).[32] It issued an Allgemeinverfügung on the same date of the publication of the BGH decision, in order to ensure that – despite the BGH decision – close-out netting agreements entered into by a supervised institution would be enforceable. The German Ministry of Justice announced on the same day a legislative change and published an amendment proposal for § 104 InsO at the end of July.[33]

Third, the enforcement of a close-out netting agreement might be hampered by the operation of insolvency set-off.[34] This is the case, for instance, in English law, where the insolvency set-off has a retroactive effect (it operates at the time of the opening of insolvency proceedings), is mandatory and cannot be excluded by agreement between the parties. The non-defaulting party may find that before exercising its termination rights (service of notice of early termination, where the standard documentation does not provide for an automatic termination) under the close-out

[30] See Report from the Commission to the Council and the European Parliament, Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC), Brussels, 20.12.2006, COM(2006)833 final, p. 10. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p.1).

[31] BGH, 9.6.2016 – IX ZR 314/14, ZIP 2016, 1226.

[32] https://www.bafin.de

[33] https://www.bmjv.de

[34] Geoffrey and Parsons (2016), p. 232.

netting agreement, insolvency set-off has occurred (e.g. obligations due and payable at the time of the opening). This might have a negative impact on the solvent counterparty, where it is "out of the money" at the time of the opening of the insolvency proceedings. Therefore, it should be made clear that insolvency set-off rules are disapplied in order to give full effect to close-out netting agreements.[35]

Fourth, close-out netting agreements are possibly subject to the preference rules of the lex fori concursus (Article 7 FCD, read in the light of recital 15 of the FCD).[36] The preference rules of the Member States are not harmonised. The discrepancies among national preference rules can result in legal uncertainty in cross-border transactions. It is noteworthy that Member States have taken different approaches as to whether close-out netting agreements are subject to national insolvency avoidance rules. For instance, insolvency avoidance rules are not applicable to close-out netting agreements (Art. L211-36-1 *Code monétaire et financier*). In Germany this question is disputed in the legal theory.[37]

Finally, the FCD does not provide any special conflict of laws rules for close-out netting arrangements.[38] As a result, close-out arrangements are subject to the conflict of laws rules of the Rome I Regulation.[39] Accordingly, close-out netting agreements are, as a matter of principle, subject to the law chosen by the parties (Article 3(1) Rome I Regulation). The parties can choose any law, not only the law of one Member State. Due to the Master Agreements established by the International Swaps and Derivatives Association (ISDA), most close-out netting agreements are subject to English or US law. However, the Rome I Regulation sets limits to the power of the parties to choose the applicable law. In particular, Article 3(3) of the Rome I Regulation provides that where all other elements relevant to an agreement are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement. In practical terms, this means that where two German counterparties have concluded an ISDA Master Agreement including a choice in favour of English law, the chosen law will not prevent the application of mandatory provisions of German law if all other elements of the contractual relationship point to Germany.

[35] Cf. the facts in *Lehman Firth Rixson* case [2012] EWCA Civ 419; the insolvency administrator could have invoked insolvency set-off but did not.

[36] Keijser, (2006), p. 292.

[37] Fuchs (2013), p. 167 ff.

[38] The only conflict-of-laws provision relating to close-out agreements is Article 25 Banks Winding Up Directive (Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions (OJ L 125, 5.5.2001, p. 15)), according to which netting agreements are subject to the law chosen by the parties. The International Institute for Unification of Private Law (UNIDROIT) Principles on close-out netting do not contain any conflict of laws rules on close-out netting agreements either. The initial Principle 9 under the preparatory works of the UNIDROIT Principles on close-out netting, according to which close-out netting agreements were governed by the law chosen by the parties, was abandoned in the final text. This can be attributed to the lack of political consensus as to whether parties should be allowed to choose a netting friendly law which excludes the application of the rules of the lex fori concursus.

[39] Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) (OJ L 177, 4.7.2008, p.6).

4.4 Applicable law to book entry security collateral arrangements

The current collateral legal framework does not establish legal certainty with regard to the law that governs book entry security collateral arrangements.

Under Article 9(2) of the SFD, collateral security provided to participants and/or central banks of the Member States or the ECB are subject to the law of the Member State where the register or the account or centralised deposit system is located.

Article 9(1) of the FCD points to the law of the place of the relevant intermediary (PRIMA rule), i.e. of the country in which the relevant account is maintained. The PRIMA rule under the FCD is quite limited in scope. It applies to the legal nature and proprietary effects of the book entry security collaterals, the requirements for the perfection of a collateral arrangement, the priorities, the good faith acquisition and the realisation of collateral (Article 9(2)).

It is questioned whether the PRIMA approach under the SFD and FCD yields an appropriate connecting factor for book-entry security collateral, i.e. whether the applicable law can be ascertained in advance, precisely and with certainty. This is mainly attributed to the fact that intermediaries' accounts do not have a location;[40] their "location" is to be determined with reference to other factors.[41] Intermediaries rely on computer records, which can be accessible by any of the intermediary's branches.[42] In the context of T2S, the T2S Advisory Group (T2S AG) conducted a survey on "Conflict of Laws Issues".[43] The results of this survey reveal that the PRIMA rule has not been interpreted uniformly. Member States employ diverging criteria for determining the PRIMA location (i.e. account of the intermediary's books or account where the intermediary's entitlement to the securities is recorded/location of a CSD).

A further unclear point is the possibility of renvoi. Whereas Article 9(1) of the FCD makes clear that the reference to the law of a country is to be understood as reference to its domestic law, disregarding the rules of private international law of that country, the SFD is silent in this respect. As a result, the T2S AG survey on "Conflict of Laws Issues" shows that Member States have adopted diverging approaches as to the possibility of renvoi.

In light of these considerations, the clarification of the PRIMA rule should be considered.[44] In any case, it is necessary to align the conflict of laws rule ("connecting factor") for collateral arrangements under the FCD with the conflict of laws rule under the SFD and any possible conflict of laws rule under the future SLL.

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[40] Rogers (2006), 304 *et seq.*

[41] An efficient solution would be the adoption of the so-called branch/office approach, i.e. place of the branch of the intermediary that actually maintains the account: Relevant would be the law of the country, where the intermediary effects or monitors securities entries or effects payments or processes corporate actions. The clarification of the PRIMA rule is the most feasible approach.

[42] Yeowarts and Parsons (2016), para 13.85.

[43] http://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item_4_20151116.pdf

[44] See Eurosystem contribution to the European Commission's Green Paper, p. 24.

In addition, a possible revision of the SFD should ensure that the possibility of renvoi is excluded.

5 Conclusions

The FCD was introduced to strengthen legal certainty for financial collateral arrangements and create a protective regime to ensure the enforceability of such arrangements regardless of the insolvency of the collateral provider. It is true that the SFD and the FCD have improved cross-border collateral flow significantly. However, legal uncertainties still remain and need to be addressed in the context of the Commission's current initiative on building a capital markets union. In particular, a future revision of the Union legal framework on collateral arrangements should focus on the harmonisation of rules on acquisition of collateral as well as the uncertainties surrounding the reuse of collateral, the enforceability of close-out netting agreements and the law applicable to book entry security collateral arrangements.

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Collateral: need for legislative changes?

By Kestutis Laurinavicius[1]

1 Introduction

Collateral matters. In a world where central banks and other market participants accept collateral in increasing amounts and market participants are able to rely on netting effects and for risk exposure purposes to take into account the value of the collateral held, the legal soundness of collateral arrangements is of utmost importance. This contribution briefly discusses the current legal framework for collateral in the Union and mentions several elements of this framework that could be further enhanced (section 2). An area of increasing focus is the effect of a possible default of major market participants and thus the framework within which such market participants could be resolved in an orderly manner. Section 3 of this contribution discusses the interaction between two very different but nevertheless interlinked areas – collateral law and resolution law and highlights some areas which could benefit from more legal certainty. Finally, in section 4 we discuss conflict of laws issues, an area in which numerous legislative initiatives have been proposed and which remains a challenge for regulators and market participants alike. The contribution concludes with several remarks about the future reforms.

2 Union legal framework for collateral arrangements

The notion of collateral usually implies that there are certain financial or other assets provided to the collateral taker or otherwise assuring him that certain financial obligations will be fulfilled. Such legal constructions are typically made by means of a contract and parties to the contract may agree on various terms under which such collateral would be created and enforced. Nevertheless, contract law with respect to collateral is closely connected with property law, insolvency law and conflict of laws areas. This means that legal certainty for collateral arrangements will be achieved only if all these areas of law provide for an efficient mechanism to create proprietary interests in assets used as collateral, are clear about the effect of insolvency or similar events on the rights of the parties to collateral arrangements and if it is clear which law applies to various aspects of collateral in cross-border constellations.

To enhance legal certainty, collateral law reforms were enacted in a number of jurisdictions, primarily to the extent they related to financial contracts, such as repurchase agreements and the pledge of financial assets between financial institutions. In the European Union, such reforms gathered pace at the turn of the

[1] Head of the Market Infrastructure Law Section, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

century, as it became obvious that a robust legal framework was needed to support the future single monetary policy and to reduce systemic risks in view of the increasing importance of cross-border activity in financial markets and more generally in the context of OECD countries developing their domestic frameworks for collateral.[2]

The adoption of the SFD[3] was a key step in implementing these reforms, aiming to minimise the disruption to a payment or settlement system caused by insolvency proceedings against a participant in that system and to protect collateral provided to central banks. Article 9 of that Directive provides that the collateral taker's rights to collateral are not affected by an insolvency of the collateral provider where such collateral is provided in connection with a payment or settlement system or to a central bank. The increased protection granted to payment and settlement systems and central banks is to be understood as facilitating an efficient functioning of the financial system where financial flows between central banks, financial institutions, businesses and individuals are processed and where monetary policy and other public policies pursued by relevant authorities can be implemented without interruptions, thus ultimately safeguarding financial stability.

As the scope of protection under SFD was limited and given the important role of collateral in modern finance and the increase of cross-border financial transactions, a more comprehensive reform of collateral law was deemed to be necessary. Hence FCD[4] was adopted, creating a partially harmonised framework for the use of collateral in the Union. Within the limited scope of FCD, covering mainly financial institutions and their counterparties,[5] most of the formal requirements for collateral arrangements have been removed and the exercise of rights by collateral takers has been protected against the negative effects of insolvency. Unlike previous initiatives in the area of financial markets, the degree of harmonisation to be achieved by FCD was more comprehensive and marked a shift of paradigm by the legislator, contributing to further integration of financial markets in the Union.[6]

More specifically, FCD requires the removal of almost all formal requirements for the creation, validity, perfection, enforceability or admissibility in evidence of collateral arrangements. The only formal requirements imposed by FCD are that collateral must be in the possession or control of the collateral taker, that the provision of collateral must be evidenced in writing and that the collateral arrangement itself must be evidenced in writing or in a legally equivalent manner. FCD requires the disapplication of certain provisions of insolvency law, such as zero hour rules. It also introduces a number of rules facilitating the exercise of rights by the collateral taker,

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2 Devos, D. (2003), p. 261.

3 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L166, 11.6.1998, p.45).

4 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L168, 27.6.2002, p. 43).

5 The scope, in particular as regards the categories to which a collateral taker and a collateral provider must belong, is set out in Article 1(2) and (3) FCD. Member States had the possibility of further extending the scope of the Directive, see below in this Section 2. As to the criticism of the scope of FCD, in particular with regard to smaller entities, see Keijser T. (2006), p. 317 et seq.

6 Löber, K. (2005), p. 72.

for example, allowing the collateral taker to realise collateral by sale, appropriation or set-off. In security financial collateral arrangements, i.e. where no title to collateral is transferred to the collateral taker, a right of use is established and thus the collateral taker may exercise this right and transform the provision of collateral into a title transfer (with a corresponding obligation to return the same type of securities).[7]

Moreover, FCD requires Member States to recognise that title transfer collateral arrangements are effective in accordance with their terms thus removing the risk that such arrangements would be deemed hidden security collateral arrangements without a title transfer. It has been argued that this requirement makes the development of a common European property law possible, as title transfer for security purposes had not previously been a traditional feature of Member State property law.[8] Finally, FCD establishes a general conflict of laws rule relating to the account to which securities used as collateral have been credited. Thus issues like the legal nature and proprietary effects of book entry securities collateral are to be determined in accordance with the law of the country in which the account is maintained.[9]

Leaving aside the question of a need for more uniform implementation, certain aspects of FCD require clarification. One such aspect is the requirement that collateral must be in the possession or control of the collateral taker. While FCD does indeed require a form of “possession” or “control” of collateral by the collateral taker,[10] these concepts are left undefined. This raises questions such as whether the collateral taker is considered to have the right of control over collateral assets and where the collateral provider has the possibility to withdraw assets, it is unlikely that such control can be proven.[11] The concept of control or possession is determined by various legal and operational elements. The Court of Justice has confirmed that the taker of collateral may be regarded as having acquired possession or control only if the collateral provider has been prevented from disposing of such assets.[12] In terms of rights granted to the parties, those can vary considerably and might include the right of the collateral provider to freely withdraw assets from its own or the collateral taker’s account or, for example, only being able to withdraw excess assets or substitute assets with other assets while preserving the overall value of collateral

7 The extent of this right of use is determined by the existence and the terms of security financial collateral arrangements.

8 See Basedow, J., Hopt, K., Zimmermann, R., Stier, A. (2012), p. 694. It should be pointed out here that FCD only requires Member States to recognise the concept of title transfer for security purposes. They are not required to define, to any great extent, its substantive elements, and those Member States which only choose to transpose the wording of Article 6 FCD into national law have essentially granted full discretion to parties to such arrangements to define their terms.

9 See Section 4 for further details.

10 Articles 1(5) and 2(2).

11 See Proctor, C. (2015), p. 644.

12 Case C-156/15 *Private Equity Insurance Group*, ECLI:EU:C:2016:851, para. 44. Arguably, the Court has not shed any further light on the question as to whether legal or factual control (or both) are required. The Opinion of Advocate General Szpunar was clearer on this point and indicated that the collateral taker has to obtain not only practical control but also the right to prevent the withdrawal of collateral assets (see para. 51 of that Opinion). The approach taken by UK courts is that administrative control over the assets on an account is insufficient and for the purposes of obtaining possession or control, legal control is required, so that the collateral taker is able to prevent the collateral provider from using the assets. See, for example, Hingston, L. (2016), p. 526.

assets. The degree to which the collateral provider needs to be prevented from disposing of collateral is however not clear and parties will need to identify precisely the specific circumstances in which FCD conditions are deemed to have been fulfilled.

Clarification is also needed on the precise circumstances in which collateral is deemed to have been acquired. FCD only suggests that good faith acquisition is governed by the law of the country in which the account is maintained,[13] even though arguably in the context of the level of harmonisation aimed at by FCD it should have also included a specific substantive rule on such acquisition of collateral. This would of course necessitate a clarification whether the acquisition is to be linked to the credit and debit of the relevant accounts or to other factors. Nevertheless, in cases where there is disconnect between owning an underlying security and book entries on securities accounts, the true ownership or collateral rights will be determined solely by those local rules.

The fundamental objective behind the introduction of SFD and FCD was clear – to increase legal certainty concerning the rights of collateral takers in default or insolvency and to contribute to the stability of the financial system. Nevertheless, the transposition of those Directives revealed the absence of uniform implementation and the presence of issues of interpretation. Complications also arise from the fact that Member States have either followed FCD provisions in their entirety, made exclusions more nuanced or in fact extended its scope.[14] The initial framework governing collateral arrangements has been supplemented with various other rules set out in numerous pieces of Union law, mainly in various rules of a regulatory nature, for example, the rules on re-use in SFTR.[15] It is thus likely that due diligence that may be required in specific circumstances involving collateral arrangements would often be a multi-jurisdictional exercise, entailing significant costs.

3 Collateral rights and financial stability

With the development of comprehensive resolution regimes for financial institutions,[16] it is possible that larger financial institutions will be subject to resolution and their situation will be addressed by resolution authorities by taking certain resolution action. To facilitate this, jurisdictions have employed various tools to prevent market participants from taking unilateral action that would prejudice the resolution process. In particular, the concern is that the termination of financial

[13] Article 9(2)(c).

[14] For details, see Löber, K., Klima, E. (2006), pp. 207-208, and European Commission (2006), pp. 8-9.

[15] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (OJ L 337, 23.12.2015, p. 1). See for example Article 15 on the right of re-use.

[16] Such as the one covering systemically important banks, see FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2014. Within the Union, such regime has been translated into Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 (BRRD). (OJ L 173, 12.6.2014, p. 190).

contracts (which may form a significant part of the entity's business) would frustrate continuity and the implementation of resolution measures[17] and some commentators have argued that the exercise of close-out netting rights might also exacerbate systemic risks and that the existence of less than transparent processes and the potential for the unequal treatment of various market participants are problematic. It is also argued that if all or most of the outstanding financial contracts were to be allowed to be terminated at once, the failing entity might be left with only problem assets, which will make resolution more difficult.[18]

In the context of collateral arrangements, measures facilitating resolution would typically translate into a prohibition on the termination of such arrangements (and exercise set-off, appropriation or similar rights) purely on the basis of a counterparty becoming subject to resolution or the resolution authority adopting certain resolution measures. Even if termination rights are exercisable, resolution authorities would have the possibility to temporarily stay termination and other rights, without prejudice to the right to terminate where the counterparty defaults on its substantive obligations.[19]

Although these reforms have helped to facilitate possible resolution processes, they have also added a layer of complexity with respect to the rights of collateral takers. Essentially, collateral takers face uncertainty about the precise conditions under which they can exercise their rights under the collateral arrangement and, in particular, in which circumstances arrangements can still be terminated and what are the obligations the breach of which may be grounds for termination. The situation is further complicated where there are cross-border elements in the arrangement, such as the location of collateral in another jurisdiction, the need to recognise the effect of resolution measures across several countries, potentially mandatory insolvency laws etc. Note that FCD also allows Member States to introduce additional restrictions.[20] Finally, while BRRD explicitly amended FCD, it did not amend SFD, a situation which has resulted in some degree of uncertainty about whether collateral rights protected under SFD remain unaffected.[21]

4 Conflict of laws issues

In situations where securities are held via several layers of securities settlement systems and where such systems and intermediaries offering services to their clients are located in different countries, issues of which law should apply to which aspects of such relationships are often unclear. If a financial institution or another

[17] Financial Stability Board (2014), Annex 5, para. 1.1.

[18] Johnson, V. (2009); see also Paech, P. (2013), pp. 11-12.

[19] See Financial Stability Board (2014), section 4. Temporary stay powers and the prohibition on termination are also foreseen in BRRD.

[20] Article 1(6).

[21] Recital 93 of the BRRD suggests that BRRD does not affect the operation of SFD-designated systems or the right to collateral security guaranteed by Article 9 of the SFD; however, collateral arrangements of central banks appear to fall under Article 68 of the BRRD, which prohibits the termination of contracts in cases of resolution, where substantive obligations continue to be performed.

counterparty becomes insolvent, such proceedings will be typically conducted in accordance with relevant local insolvency law rules and some of those rules will be considered mandatory, i.e. overriding the choice of the parties of another law governing the collateral arrangement. The question often arises as to how a collateral arrangement governed by another law should be qualified for the purposes of insolvency proceedings conducted by local courts or administrators.

To solve such uncertainties, SFD introduced the so-called PRIMA rule (place of the relevant intermediary approach).[22] Article 9(2) of that Directive essentially states that where securities or rights in securities are provided as collateral, in the context of systems or to central banks, the determination of the rights of collateral takers in relation to those securities is governed by the law of the Member State in which the relevant register, account or centralised deposit system is located. Broadly the same approach was subsequently followed in WUD[23] and FCD,[24] albeit with a slightly different wording.[25] Thus the place of the intermediary, or rather of the account, determines which law applies to proprietary aspects of the use of securities as collateral. Neither SFD nor FCD specify where the account is deemed to be maintained,[26] although some Member States have added specifications that were aimed at clarifying the matter but turned out to be different interpretations.[27] The way SFD and FCD provisions are formulated implies that the current PRIMA rule is a mandatory rule of law and its application may not be altered by an agreement between relevant parties. The conflict of laws rule adopted in SFD, WUD and FCD is limited to the scope of those directives, although some Member States chose to extend the rule to cover securities accounts more generally.[28] The importance of clarity on the law applicable to payment and settlement systems and other infrastructures is highlighted also in the CPSS/IOSCO Principles for financial market infrastructures.[29] Thus in principle it should be clear which law governs the transfer of securities as collateral, although there appears to be some legal uncertainty as to whether the assignment of rights in securities, as opposed to a transfer of securities,

[22] Prior to this rule, a variety of additional approaches existed, e.g. the law under which the securities were issued, the law of the place where the paper securities were located or the law of the place where the initial electronic record was made. Paech, P. (2011), p. 22. Some commentators argued in favour of what became the PRIMA rule and this approach was followed in SFD and subsequently in other legislation. Devos, D. (2003), p. 272.

[23] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (OJ L 125, 5.5.2001, p. 15). See Article 24, which applies not only to collateral arrangements but to all securities accounts maintained by credit institutions.

[24] Article 9(1).

[25] Article 2(1)(h) FCD also clarifies that the relevant account may also be maintained by the collateral taker if it is on that account that entries are made to provide collateral to the collateral taker.

[26] The draft FCD contained a paragraph clarifying that the relevant account would be deemed to be maintained at the office or branch of the intermediary, provided that this intermediary allocates the account to that office or branch for purposes of reporting to its account holders or for regulatory or accounting purposes or, otherwise, at the place of establishment of the intermediary or its branch. See Article 10(2) of the Proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements, (COM/2001/0168 final). These specifications were removed before the adoption of FCD, as it was envisaged that further clarification might be added once the Hague Securities Convention was finalised. See Devos, D. (2003), p. 272.

[27] European Commission (2006), p. 11.

[28] For example, Finland and Germany. See Löber, K., Klima, E. (2006), p. 212.

[29] CPSS/IOSCO (2012), Section 3.1.11

may be subject to Article 14 of the Rome I Regulation,[30] at least in some Member States.[31]

The PRIMA rule has been widely debated, as there are views that this rule lacks precision and in any event the physical location of infrastructure supporting the intermediary and/or accounts run on it may be dispersed across several jurisdictions, thus making it more difficult to determine the most appropriate jurisdiction governing proprietary aspects of securities. More flexible rules advocating a possibility for the parties to select applicable law have also been proposed, in particular in the Convention on the law applicable to certain rights in respect of securities held with an intermediary (Hague Securities Convention).

The Hague Securities Convention opted for a complex test that would still require some link to the intermediary and the location of its offices. According to the Convention, certain proprietary aspects of securities[32] are in principle to be determined under the law governing the account agreement or otherwise the law chosen by the parties. Parties' choice of law is somewhat restricted, as the Convention imposes a number of conditions, requiring the intermediary to maintain a link to the chosen jurisdiction, such as an office effecting or monitoring entries to securities accounts or identification as maintaining accounts in that jurisdiction.[33] The Convention also provides for a fallback solution where there is no specific law designated by the parties to govern their agreement.[34] Nevertheless, certain factors are to be disregarded when determining the applicable law, such as the issuer's place of incorporation or the location of certificates representing an interest in securities[35] and ancillary activities, such as data processing, are deemed to be irrelevant in determining whether the relevant office is considered to maintain the securities account.[36] Despite the presence of those rules, some experts argue that it is possible for regulators or supervisors to add further specifications that private operators should follow, for example, by requiring that the law governing a payment or settlement system should also be the law governing securities on accounts within that system.[37] The Commission's legal assessment was less unequivocal on this point, suggesting that it was not clear that the freedom of choice of law established by the Convention would allow the Union to keep the requirement that the law chosen by the participants in the system should be that of a Member State.[38] The Convention was initially supported by the Commission, but later it withdrew its proposal to ratify the Convention, once it became clear that there was insufficient political support for its ratification.[39]

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[30] Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) (OJ L177, 4.7.2008, p. 6).

[31] See European Commission (2016), point 3.2, and the references cited there.

[32] Those aspects are listed in Article 2(1).

[33] Article 4(1).

[34] Article 5.

[35] Article 6.

[36] Article 4(2).

[37] Sigman, H., Bernasconi, C. (2005), p. 32.

[38] European Commission (2006a), p. 21.

[39] See also the resolution of the European Parliament of 14 December 2006, P6_TA(2006)0608.

The test offered by the Hague Securities Convention reflects a tendency towards allowing parties to choose applicable law. The main argument in favour of this approach is the (almost insurmountable) difficulty given the increasing importance of technology and the dispersion of various technical or business activities in relation to securities accounts, in determining precisely the location where an account is maintained. Reliance on certain factors evidencing a link to a particular place is not straightforward and may not give enduring certainty over the applicable law.

A reiteration of the PRIMA rule was included in the European Commission's proposal on legislation on legal certainty of securities holding and dispositions.[40] The proposal further specified that where an account provider has branches located in other jurisdictions, the account is deemed to be maintained by the branch which handles the relationship with the account holder and otherwise by the account provider's head office. The proposal therefore attempted to align slightly different criteria outlined in SFD, FCD and WUD and also to extend them to all securities held through an account, as opposed to the limited scope governed by the three directives. It is noteworthy also that the intention under the proposal was not to list all possible factors determining which branch handles the relationship in the rule on applicable law but to include such considerations in a recital of the proposed legal instrument. For instance, the recitals were to have referred to the branch where the account was opened, the branch administering payments or corporate actions related to securities, while the physical location of supporting infrastructure was to have had no determining effect. The account provider would have had to communicate the location of the account to the client, even if such communication would not be decisive and could be altered by a court interpreting the facts of the case.

Another legislative initiative containing a proposal on the conflict of laws rule was the draft CSDR.[41] Article 46 of the draft CSDR included the PRIMA rule (reference to the place where the account is maintained),[42] with an additional clarification that where the account is used for settlement in a securities settlement system, the applicable law is the one governing that securities settlement system and otherwise the account is presumed to be maintained at the place where the CSD has its habitual residence. The applicable law would determine "proprietary aspects", without elaborating which specific aspects would be captured by the rule,[43] and in any event this would have applied only to the accounts maintained by CSDs. Ultimately no consensus was reached on the proposed conflict of laws rule and the final text of the CSDR was adopted without it.

[40] European Commission (2010), p. 23ff.

[41] Proposal for a Regulation of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directive 98/26/EC. COM/2012/073 final.

[42] Recital 36 of the draft CSDR suggested that the proposed conflict of laws rule followed the approach taken in the existing legislation.

[43] Somewhat confusingly, recital 36 of the draft CSDR referred to 'ownership aspects'.

5 Conclusions

As outlined in this contribution, the legal framework for collateral arrangements has undergone several important waves of reform and is currently at the stage where some legislative improvements could and should be made, mainly to remove some of the uncertainties that have arisen in the process of implementing FCD. The Commission has also a key role in ensuring a more harmonised implementation of FCD.

Moreover, ways to adopt the set of exceptions and additional rules brought in by the introduction of resolution regimes will need to be found, without prejudice to the overall level of protections accorded to collateral arrangements. To this end, it would be appropriate to find a politically acceptable scope of protections, covering entities that actively participate in financial markets and contribute to their liquidity.

Also, it is clear that current conflict of laws rules will require some modification and a choice will need to be made as to which direction such reforms should take, given the need to enhance legal certainty and taking into account the less prominent role played by the physical location of infrastructures or offices. Given the difficulties in agreeing to the solution adopted in the Hague Securities Convention and assuming that insistence on a connecting factor determining the "location" of securities is still thought to be desirable, a solution will need to be found. This could include prescribing a precise rule on the location of securities, thus leaving no discretion to the parties. In this respect, the location of securities might be linked to the location of an intermediary, supplemented by additional regulatory clarifications to resolve remaining uncertainties regarding, for example, branches or other offices. Alternatively, the parties could be allowed, in some cases, to determine the location of the relevant securities account, with some safeguards where appropriate. These approaches may need to be revisited in light of future developments.

A more comprehensive securities law reform has been on the regulators' agenda for some time. The Commission has conducted two public consultations on the harmonisation of securities law.[44] The preparation of these consultations was based also on the advice of a Commission advisory group made up of academics and other experts from public and private institutions.[45] This initiative has stalled. In its latest communication on the Capital Markets Union, the Commission announced that it will undertake targeted work with respect to conflict of laws issues and that, separately, a public consultation will be launched on the most appropriate way forward to remove barriers in the post-trading environment.[46] It would thus appear uncertain if a comprehensive reform on substantive securities law will be launched shortly.

On a more global level, the Geneva Securities Convention[47] containing a set of substantive law rules on securities was adopted, but did not enter into force. A

[44] See European Commission (2009) and European Commission (2010).

[45] See for example Legal Certainty Group (2008).

[46] European Commission (2016a), p. 6.

[47] Unidroit Convention on substantive rules for intermediated securities.

comprehensive reform of substantive securities laws would likely need to encroach on aspects of property, commercial and company law, not to mention insolvency and tax law and a regulatory perspective. For example, the reform which clarifies which rights an investor has vis-à-vis the intermediary is helpful, but if it does not deal with the rights the investor has vis-à-vis the issuer, comparability of the "harmonised" regimes will not be complete. A more limited reform, adopting a minimum harmonisation approach, may also be feasible. This would, nevertheless, require Member States to adopt or adjust their current frameworks governing substantive aspects related to securities. This also entails the risk that Member States might adopt more or less identical harmonised rules, thereby adding to the uncertainty in the legal framework.

In the short-term, a reform of conflict of laws rules is to be preferred; however, adoption of comprehensive substantive rules on securities should be the ultimate goal and it is hoped that such legislation will remove most of the uncertainties currently surrounding legislation on cross-border holdings of securities and collateral.

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Central banks’ relations with auditors (scope of control/audit gap/accountability)

Introduction

By Christian Kroppenstedt

The external audit of the ECB – an analysis of Article 27 of the Statute of the ESCB

By David Baez Seara and Simona Lambrinoc-Schanz

The impact of the establishment of the SSM on the relationship between De Nederlandsche Bank and the Netherlands Court of Audit

By Willem Bovenschen

Introduction

By Christian Kroppenstedt[1]

The third panel was devoted to a discussion of national central banks' (NCBs') relations with auditors (scope of control/audit gap/accountability). The panel explored several issues related to the mandate of auditors in relation to central bank activities and, in particular, the precise scope of national audits in relation to the European System of Central Banks (ESCB) and the Single Supervisory Mechanism (SSM), the claimed existence of an audit gap resulting from the transfer of supervisory tasks to the SSM and the relationship between the ECB's accountability obligations and the audit scope of the European Court of Auditors. The panellists looked at those audit issues from three different perspectives: (1) from the perspective of the ECB ("The external audit of the ECB – an analysis of Article 27 of the Statute of the ESCB"), (2) from the perspective of an NCB in its capacity as competent national authority ("The impact of the establishment of the SSM on the relationship between De Nederlandsche Bank and the Netherlands Court of Audit") and (3) from the perspective of the European Court of Auditors ("The European Court of Auditors: audit of the SSM").

By way of context and in order to facilitate an understanding of the relevant issues, this introduction briefly sets out the audit frameworks of the Eurosystem[2] (Section 1) and the SSM (Section 2).

1 Audit framework of the Eurosystem

The audit framework for the Eurosystem is laid down in Article 27 of the Statute of the European System of Central Banks and of the European Central Bank (the "Statute of the ESCB"). It is based on three pillars and is derived from the fact that the NCBs form an integral part of the Eurosystem for the functions which they perform under the Statute of the ESCB.

The first pillar is the audit of the accounts of the ECB and the euro area NCBs by independent external auditors recommended by the Governing Council and approved by the Council. Under this audit pillar auditors have full power to examine all books and accounts and to obtain full information about the transactions of the ECB and NCBs.[3]

[1] Deputy Director General Legal Services, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

[2] Reference is made solely to the Eurosystem as the relevant audit provision of the Statute of the ESCB only applies to NCBs of Member States whose currency is the euro.

[3] Article 27.1 of the Statute of the ESCB.

The second pillar is the audit of the ECB by the European Court of Auditors. This audit is limited to an examination of the operational efficiency of the management of the ECB.[4]

The third pillar is the audit under the national law of euro area NCBs by state audit offices or similar bodies to monitor their activities and use of public finances. Such audits are subject to safeguards to ensure compliance with the principle of central bank independence laid down in European Union law.[5] In particular, such audits should not interfere with Eurosystem related tasks and should not prejudice the first pillar audit.[6]

2 Audit framework of the SSM

The audit framework of the SSM is laid down in Article 20(7) of the SSM Regulation.[7] It is based on three pillars but differs somewhat from that of the Eurosystem due to the conceptual differences between the Eurosystem and the SSM. National competent authorities (NCAs), unlike the case with the Eurosystem, do not form an integral part of the SSM. The SSM-related responsibilities of the NCAs which are also euro area NCBs do not form part, moreover, of the Eurosystem-related functions. The specific tasks relating to the prudential supervision of credit institutions were transferred to the ECB, while responsibilities were assigned also to the NCAs.

The first pillar is the audit of the accounts of the ECB by independent external auditors recommended by the Governing Council and approved by the Council.[8] Under this audit pillar auditors have the full power to examine all books and accounts and to obtain full information about their transactions, including those arising from SSM tasks transferred to the ECB. This audit pillar does not cover the accounts of the NCAs, including those which are euro area NCBs.

The second pillar is the audit of the ECB by the European Court of Auditors. When examining the operational efficiency of the management of the ECB under Article 27.2 of the Statute of the ESCB, the European Court of Auditors is also to take into account the supervisory tasks conferred on the ECB by the SSM Regulation.[9]

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4 Article 27.2 of the Statute of the ESCB.

5 Article 130 of the Treaty on the Functioning of European Union and Article 7 of the Statute of the ESCB.

6 Opinion CON/2016/24. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

7 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

8 Article 27.1 of the Statute of the ESCB.

9 Article 20(7) of the SSM Regulation. This provision was introduced into the draft SSM Regulation at an advanced stage in the legislative process. It appeared for the first time (worded as it is now) in the Presidency proposal of 16 November 2012. From a conceptual point of view it could even be argued that Article 20(7) of the SSM Regulation is declaratory in nature as Article 127(6) of the Treaty does not empower the Council to amend Article 27 of the Statute of the ESCB by means of secondary law.

The third pillar is the audit under the national law of the NCAs (including NCAs which are also euro area central banks, for the performance of supervisory activities) by state audit offices or similar bodies to monitor their activities and the use of public finances. The scope of this audit has varied greatly according to the applicable national law. In some cases supervisory tasks have not been subject to any audit at all, while in others the audit has been limited to the assessment of operational efficiency. In yet other cases the audit has covered compliance with the rules and principles of financial prudence, efficiency and usefulness. Unlike for the Eurosystem, there is not yet an established doctrine in Union law on the nature of the safeguards to be applied to such audits.

In a recent opinion,[10] the ECB recommended safeguards for third pillar audits in order to ensure compliance with the principle of independence specific to banking supervision laid down in Article 19 of the SSM Regulation. In the same opinion, the ECB pointed out that such audits should: (1) not extend to the application and interpretation of supervisory law and practices in the context of the SSM; (2) not interfere with and not include the tasks conferred on the ECB by the SSM Regulation nor be extended so that it results in an indirect audit of the ECB; and (3) be carried out on a non-political, independent and purely professional basis. These safeguards reflect the specific nature of the SSM and the institutional framework in which it operates.

It remains to be seen whether the establishment of the SSM will lead to a convergence of the scope of third pillar audits. Any differences that persist will frame future discussions on the audit gap, and the scope of the first and third pillar audits.

3 Key points arising from the panel discussions

All the relevant issues were successfully raised in the three presentations and the subsequent panel discussion. The audience gained a good understanding of the different perspectives on the relationship between NCBs and NCAs with auditors and their diverging requirements. We can conclude from the proceedings that the audit framework for SSM-related activities is complex and merits further research. While it is clear that differences exist in the scope of the audit performed by the European Court of Auditors in relation to the supervisory tasks and activities of the ECB compared to at least some of the audits performed by the supreme audit institutions of Member States, it is not clear how such a divergence can best be redressed.

An initial response may lie in a convergence of the scope of the third pillar audit of the NCAs participating in the SSM by supreme audit institutions. A move towards consensus on the exact meaning of “an examination of the operational efficiency of the management of the ECB” in relation to its supervisory tasks would also be beneficial.

[10] Opinion CON/2016/24.

The external audit of the ECB – an analysis of Article 27 of the Statute of the ESCB

By David Baez Seara and Simona Lambrinoc-Schanz[1]

1 Introduction

The ECB has a particular status as an audited entity. Compared to the situation for other European Union institutions, the European Court of Auditors (ECA) has a limited role as the ECB's external auditor, since it may only examine the operational efficiency of the ECB's management. The limited scope of the ECA's mandate vis-à-vis the ECB precludes it from auditing the ECB's financial accounts, which are audited by independent external auditors recommended by the Governing Council and approved by the Council of the European Union. These independent external auditors, which are normally audit firms, also audit the financial accounts of the euro area national central banks (NCBs).[2]

The justification for this particular status of the ECB as an audited entity is to be found in the concepts of independence and accountability. The ECB is independent according to Article 130[3] and Article 282(3) TFEU. The latter provides that the ECB is independent in the exercise of its powers and in the management of its finances. It specifically requires all Union institutions, and thus also the ECA, to respect the ECB's independence. The accountability requirements to which the ECB is subject are laid down in the TFEU and the Statute of the European System of Central Banks and of the European Central Bank (Statute of the ESCB) in particular in Article 284 TFEU. There are further accountability requirements laid down in the SSM Regulation,[4] which confer on the ECB specific tasks relating to the prudential supervision of credit institutions.

The analysis that follows explains the audit arrangements applicable to the ECB and euro area NCBs under Article 27 of the Statute of the ESCB and clarifies how Article 27 relates to the relevant secondary Union legislation. Particular attention is paid to

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[1] Legal Counsel and Senior Legal Counsel respectively in the Institutional Law Division, European Central Bank. The views expressed are those of the authors and do not necessarily reflect those of the ECB or the Eurosystem. We would like to thank Christian Kroppenstedt for helpful comments on an earlier version of this contribution.

[2] According to Jan Inghelram the audit task of the ECA vis-à-vis the ECB is shared with an independent external auditor due to a "political compromise between opponents and advocates of public control over the Bank". See Inghelram (2000) at p.132.

[3] Article 130 TFEU is reflected in Article 7 of the Statute of the ESCB. Both Articles apply to national central banks of the ESCB.

[4] Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

the auditing of the ECB as a banking supervisor and to the Union legislative innovations regarding the auditing of financial accounts, also known as statutory audits.

2 Legal framework

The provisions governing the external audit of the ECB are laid down in Article 27 of the Statute of the ESCB.

Article 27.1 of the Statute of the ESCB provides that the ECB accounts should be audited "by independent external auditors recommended by the Governing Council and approved by the Council". Article 27.1 of the Statute of the ESCB also extends this requirement to euro area central banks, in line with the principle of independence enshrined in Article 130 TFEU.

Article 27.2 of the Statute of the ESCB provides that the ECA audit of the ECB only applies to "an examination of the operational efficiency of the management of the ECB". This limitation extends to the ECB's new functions within the single supervisory mechanism (SSM). In this respect, Article 20(7) of the SSM Regulation provides that "[w]hen the European Court of Auditors examines the operational efficiency of the management of the ECB under Article 27.2 of the Statute of the ESCB and of the ECB, it shall also take into account the supervisory tasks conferred on the ECB by this Regulation."

3 Audit by the ECA

3.1 Limits of the ECA's mandate under Article 27 of the Statute of the ESCB

Article 287 TFEU states that the ECA "shall examine the accounts of all revenue and expenditure of the Union. It shall also examine the accounts of all revenue and expenditure of all bodies, offices or agencies set up by the Union in so far as the relevant constituent instrument does not preclude such examination."

While Article 287 TFEU requires an examination of all Union revenue and expenditure, it should be noted that the ECB is special among the Union institutions in that it has a legal personality distinct from the Union and manages its finances independently (Article 282(3) TFEU). The ECB, unlike the other Union institutions and most Union bodies, offices and agencies, is not financed by the Union budget. Therefore the provisions of Article 287 which set out the powers of the ECA vis-à-vis the other Union institutions must be read in the light of the limitations provided in Article 27 of the Statute of the ESCB as regards the ECA's powers vis-à-vis the ECB.

Article 27 of the Statute of the ESCB imposes two limits on the ECA's mandate to audit the ECB. First, Article 27.1 of the Statute of the ESCB provides that the ECB's

accounts must be audited “by independent external auditors recommended by the Governing Council and approved by the Council”, and not by the ECA. This is an explicit derogation from the regime of Article 287 TFEU which empowers the ECA to perform such audits.[5] In examining the wording of Article 287 TFEU, it should be noted that the audit powers described in Article 287(1) TFEU relate to the examination of the Union institutions’ and bodies’ financial accounts. The accounts of the ECB are drawn up in accordance with the accounting policies established by the ECB’s Governing Council. The ECB’s independent external auditors are mandated under Article 27.1 of the Statute of the ESCB to (i) express an opinion on whether the annual accounts provide a true and fair view of the ECB’s financial position and the results of its operation; (ii) evaluate the adequacy of the internal controls applied to the preparation and presentation of the annual accounts and (iii) assess the appropriateness of the accounting policies used by the ECB.

Second, Article 27.2 of the Statute of the ESCB mandates the ECA to audit the “operational efficiency of the management of the ECB”. This provision results partially from the ECA’s mandate as the independent external auditor of the Union institutions under Article 287 TFEU. When the European Monetary Institute’s (EMI) Statute was drafted it was proposed that the audit of the EMI, the ECB’s predecessor, would be limited to the external audit of the accounts performed by audit firms. No role was foreseen for the ECA. During the discussions on the draft EMI Statute, the United Kingdom raised the issue that audit firms only look at the reliability of the accounts and the legality of the transactions, while “the man in the street also wanted to know whether the EMI’s budget was spent efficiently (and not lavishly)”.[6] Therefore, the EMI Statute provided that the ECA will assess the ‘’operational efficiency of the management’’ of the EMI. The same provision was taken over in the Statute of the ESCB.

Article 287(2) TFEU allows the ECA to perform audits on the sound financial management of Union institutions and bodies. However, as regards the ECB the ECA may only examine the operational efficiency of the ECB’s management. Audits on sound financial management, so-called compliance audits, which relate to the compliance of the audited entity’s activities with the regulatory provisions governing the economic and financial management of the entity are excluded as regards the ECB. The justification for this limit is based on the highly intrusive nature of such audits, which may extend to an examination of the effectiveness of an institution’s activities. Such a high level of scrutiny would be hard to reconcile with the principle of independence laid down in Article 130 TFEU.

Audits that focus on “the operational efficiency of the management of the ECB” are limited to the internal procedures of the audited entity such as its organisation in relation to the external provision of services and goods, staff administration or the

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5 Article 27.1 of the Statute of the ESCB also applies to euro area NCBs, thus the state auditors of euro area Member States are not allowed to perform audits on the financial accounts of the relevant NCBs. The audit of the financial accounts of the euro area NCBs by independent external auditors appointed according to Article 27.2 of the Statute of the ESCB may also be seen as a limitation of the mandate of the national state auditors under national law regimes in so far as national state auditors may be entrusted with the external audit function of the public sector.

6 See C.C.A van den Berg (2005), pp. 158 and 163.

management of information technology projects. The narrower scope of these audits in relation to their examination of sound financial management excludes an effectiveness-based examination of the entity's decisions and policies.

Accordingly, and taking into account the restrictions imposed by Article 27.2 of the Statute of the ESCB, it is commonly understood that the ECA's operational efficiency audit permits an evaluation of the adequacy of the governance process and internal controls, but does not extend to the areas of policy analysis and decision-making in order to preserve the ECB's (monetary and supervisory) policy independence. Hence, ECA only possesses powers to perform audits in relation to organisational and administrative aspects of the ECB. "Efficiency" under Article 27.2 of the Statute of the ESCB is thus interpreted in a purely administrative sense, preventing the ECA from reviewing the policies enacted by the ECB or the compliance of these policies with the ECB's principal objectives. *In concrete terms*, the ECA may review the decision-making process for policies but it may not review the substance of the actual policy decisions. For the actual policy decisions the ECB is accountable according to the TFEU, the Statute of the ESCB, the SSM Regulation and the accountability arrangements adopted on the basis of those legal provisions."[7]

3.2 Audit by the ECA in the context of the supervisory tasks entrusted to the ECB

With the establishment of the SSM and the ECB taking on the task of supervising credit institutions, the ECA's interest in auditing the ECB has increased. However, although the scope of the ''operational efficiency of the management of the ECB'' has also been challenged in relation to the ECB's supervisory tasks of the ECB, it remains the case that the ECA's mandate is limited according to Article 27.2 of the Statute of the ESCB also as regards the supervisory tasks conferred on the ECB by the SSM Regulation. This is explicitly laid down in Article 20(7) of the SSM Regulation, which provides that "[w]hen the European Court of Auditors examines the operational efficiency of the management of the ECB under Article 27.2 of the Statute of the ESCB and of the ECB, it shall also take into account the supervisory tasks conferred on the ECB by this Regulation."

This means that the ECA may only perform audits on the operational efficiency of the ECB's management in the area of supervision and that it may not perform the type of examination provided for in Article 287(1) and 287(2) TFEU.

The ECA does not appear to agree with this interpretation and it has stated that insofar as the ECB's SSM functions are concerned the concept of the operational

[7] See for instance Article 284(4) of the TFEU, Article 15.3 of the Statute, Article 20 of the SSM Regulation, the Interinstitutional Agreement between the European Parliament and the ECB regarding the SSM tasks conferred on the ECB (OJ L 320, 30.11.2013, p.1) and the Memorandum of Understanding between the Council of the EU and the ECB on cooperation related to the SSM.

efficiency of the ECB's management includes an examination of sound financial management on the part of the ECB.[8]

The contact committee of the supreme audit institutions of the European Union (of which the ECA is a member) shares the ECA's opinion.[9] On 25 September 2015 the contact committee stated that an audit gap has emerged in those euro area Member States where the mandates of the national state auditors over national banking supervisors that existed prior to the establishment of the SSM have not been replaced by a similar level of audit scrutiny over the supervisory activities attributed to the ECB.[10] The statement does not specify the euro area jurisdictions that are affected by the so-called audit gap nor does it provide examples of audits carried out by national state auditors that go beyond operational efficiency for the supervisory tasks that have now been transferred to the ECB. Moreover, even if in a number of national jurisdictions the national state auditors are legally empowered to carry out examinations of the national supervisory authorities that go beyond operational efficiency, it is not possible to fully establish whether such examinations were in fact carried out. Nonetheless, in order to bridge this alleged audit gap, the contact committee has proposed in the above-mentioned statement to consider strengthening the ECA's mandate concerning the audit of the SSM, including the clarification and/or amendment of Article 20(7) of the SSM Regulation. This position differs from the ECA's approach of searching for a comprehensive interpretation of the relevant provisions of the Statute of the ESCB and the SSM Regulation in order to overcome the restrictions on the ECA audit mandate. In this sense, the contact committee simply recognises the limitations of the ECA's mandate as regards the ECB's supervisory functions and proposes an amendment to Article 20(7) of the SSM Regulation.[11]

In our view, there are two reasons why ECA's mandate may not be extended beyond what is provided for under Article 27.2 of the Statute of the ESCB. First, the legal provisions regarding the ECB's independence, in particular Article 130 TFEU, require the ECB to be as independent as a supervisor as it is as a monetary authority,[12] despite the fact that it is subject to greater accountability arrangements in its function as a supervisor. Therefore, the principle of independence justifies the limitation of the ECA's mandate in relation to both the ECB's supervisory and monetary policy functions. Second, an amendment to the SSM Regulation cannot amend or redefine the scope of Article 27.2 of the Statute of the ESCB, which does not make any

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8 See, European Court of Auditors (2014), p. 39. It is unclear which specific legal provisions would warrant such a reading of Article 27.2 of the Statute of the ESCB in the context of the ECB's supervisory functions.

9 The list of members is available at www.eca.europa.eu

10 See www.eca.europa.eu

11 An implicit call for a reform of the audit framework of the ECB as established under primary and secondary Union law was also made by the ECA in its 2014 landscape review of Union accountability and public audit arrangements. According to this report, the monitoring and evaluation of the effectiveness and implementation of the new roles assumed by the ECB "ought to include the robustness and appropriateness of accountability and audit arrangements in the light of ongoing experience". A more straightforward proposal for a revision of the relevant legislation may have been inconsistent with the ECA's understanding of its mandate in the context of the ECB's supervisory functions.

12 See for a comparison Lambrinoc, S., (2016), pp. 221-238.

distinction between the various tasks conferred on or to be conferred on the ECB under the Treaties.

4 The selection of independent audit firms for examining euro area central banks' financial accounts

Article 27.1 of the Statute of the ESCB establishes the obligation for the euro area central banks to appoint external auditors, recommended by the Governing Council and approved by the Council of the European Union, to examine their financial accounts. For this purpose the Governing Council adopts a recommendation addressed to the Council of the European Union indicating the name of the audit firm selected by the ECB or the euro area NCB as external auditor and the term of the appointment.

In order to make an informed decision when adopting the recommendation, the Governing Council has developed non-binding standards addressed to the euro area central banks as the appointing authorities. These non-binding standards, formally named "Good practices for the selection and mandate of external auditors according to Article 27.1 of the ESCB/ECB Statute" (Good Practices), allow the Governing Council to assess the statutory auditors selected by the euro area central banks.[13] The Good Practices were adopted in 2006.

The appointment process for the external auditors of the euro area central banks is complex and has several phases and actors.

The first phase requires the relevant euro area central bank to carry out a procurement procedure. This phase starts with the publication of a call for tenders in the Official Journal of the European Union and ends when the euro area central bank has selected an independent audit firm to be appointed as its external auditor.

The second phase requires the appointing authorities to provide the ECB's decision-making bodies with the relevant information on the selection procedure and the audit firm selected.

The third phase requires the ECB's decision-making bodies to assess the information received and for the Governing Council to adopt a formal recommendation to the Council of the European Union endorsing the audit firm proposed by the euro area central bank.

The fourth phase requires the Council of the European Union to issue a decision approving the selection of the proposed audit firm as the bank's external auditor.

Finally, the process ends with the formal appointment of the external auditor by the euro area central bank and the signing of a multi-year contract with the audit firm for the provision of external audit services.

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13 The latest version of the Good Practices is available on the ECB's website at www.ecb.europa.eu

5 The Good Practices for the selection and mandate of the independent external auditors

Since their adoption by the Governing Council in 2006, the Good Practices have established standards for (i) selecting and evaluating external auditors; (ii) the procurement procedure that the ECB and the NCBs should carry out; (iii) the duration of the external auditor's mandate; and (iv) *strictu sensu* criteria for the external auditor's independence. The main goal of the Good Practices is to provide guidance to euro area central banks on the independence and objectivity of the statutory auditors.

According to Good Practice # 1 on the selection and evaluation conditions for external auditors, only auditors that have been approved under the applicable professional regulations of a Union Member State, are registered in a public register and subject to a system of quality assurance may be selected as external auditors. Although the Good Practices have a non-binding character, it should be noted that some of their provisions have been taken over from binding Union legislation or are laid down in national law that applies to the NCBs, and thus these elements are de facto binding. For example, national law provisions exist to establish how audit licences are awarded, the relevant entity awarding these licences or the system of oversight in place for the performance of the regular quality assurance reviews.

According to Good Practice # 2 on procurement procedure, the euro area central banks should appoint their external auditor for a maximum period of seven years in accordance to the principles of equal treatment, non-discrimination and transparency recognised in Directive 2014/24/EU[14] and incorporated in the national law applicable to the NCBs. In the case of the ECB these so-called public procurement principles are contained in Decision (EU) 2016/245.[15] In addition to this, Good Practice # 2 reiterates the wording of Article 27.1 of the Statute of the ESCB by indicating that the appointment of an external auditor should take place after its approval by the Council of the European Union, following the recommendation adopted by the Governing Council. The repetition of this provision aims to ensure that the euro area central banks are aware of the need to obtain the approval of the Council of the European Union before they may appoint the audit firm they have selected as their external auditor for the relevant period.

According to Good Practice # 3 on the conditions related to the mandate of external auditors, the euro area central banks should establish a defined multi-year mandate. The external auditors should be rotated from their audit engagement at least every seven years. This is in line with the maximum mandate of seven years indicated in Good Practice # 2. In addition, Good Practice # 3 provides an assurance for external auditors or audit firms that any divergence of opinion with a central bank regarding

[14] Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC (OJ L 94, 28.3.2014, p. 65).

[15] Decision (EU) 2016/245 of the European Central Bank of 9 February 2016 laying down the rules on procurement (ECB/2016/2) (OJ L 45, 20.2.2016, p. 15)

an accounting matter or the audit procedure should not be a ground for the dismissal of the external auditors.

Good Practice # 4 refers to the *strictu sensu* independence of the external auditor. In this respect it requires that the euro area central banks verify annually whether the external auditor or audit firm provides non-auditing services to the central bank and/or is involved in management decisions. The term "non-auditing services" refers to a specific range of services other that the examination of the accounts of the central bank (i.e. expert services unrelated to the audit, tax consultancy, design and implementation of internal control, etc.).[16] Accordingly, the auditor or audit firm selected as external auditor will not be eligible for a number of contractual opportunities that might arise within the central bank. This may represent too heavy a burden for some auditors or audit firms who may prefer to bid for more profitable consultancy services with the central bank rather than being limited to a contract with the central bank for the provision of external audit services for a number of years. Likewise, some euro area central banks, in particular those which are also prudential supervisors, may face difficulties in finding audit firms willing to participate in the procurement procedures for the appointment of external auditors.

6 Regulation (EU) No 537/2014 and its potential impact on the selection and mandate of the independent external auditors

Directive 2006/43/EC[17] establishes the Union regulatory framework for statutory audits applicable to euro area central banks. Article 2 of the Directive defines statutory audit as an audit of annual financial statements or consolidated financial statements in so far as required by Union law.[18] This Directive was last amended by Directive 2014/56/EU[19] to provide for a higher degree of harmonisation of the national laws. The amendment of Directive 2006/43/EC was part of a broader legislative package on the reform of the audit market which also included the adoption of Regulation (EU) No 537/2014[20]. While the Good Practices have been amended to remain consistent with Directive 2014/56/EU, the Governing Council still needs to assess whether it should make further amendments to these non-binding

[16] These services are listed in a footnote to Good Practice #4.

[17] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (OJ L 157, 9.6.2006, p. 87).

[18] Article 2(1) of Directive 2006/43/EC defines the concept of statutory audit in the following manner: "statutory audit means an audit of annual financial statements or consolidated financial statements insofar as: (a) required by Union law; (b) required by national law as regards small undertakings; (c) voluntarily carried out at the request of small undertaking which meets national legal requirements that are equivalent to those for an audit point (b), where national legislation defines such audits as statutory audits."

[19] Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (OJ L 158, 27.5.2014, p. 196).

[20] Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC (OJ L 158, 27.5.2014, p. 77).

standards in order to align them with the new conditions introduced by Regulation (EU) No 537/2014, in particular as regards the independence requirements.

In this respect, it should be noted that by contrast with Directive 2014/56/EU, which applies to statutory audits in general, Regulation (EU) No 537/2014 only applies to those statutory audits of public-interest entities. Accordingly, only euro area central banks that are qualified as public-interest entities under national law are directly affected by the content of Regulation (EU) No 537/2014.

6.1 Good Practices as a soft-law instrument consistent with Union law

The Good Practices have so far been in line with the key provisions of Union legislation on statutory audits. Indeed, when the Good Practices were first drafted and approved in 2006, they already took into consideration the relevant Union legislation, and more concretely Directive 84/253/EEC.[21] Nevertheless, and with the aim of ensuring the independence of statutory audits, certain aspects of the Good Practices go beyond the requirements established in Union legislation. For example, the requirement of a multi-year mandate for the external auditor is not laid down by Directive 2006/43/EC, and nor was it included in Directive 84/253/EEC.[22]

Already in 2006 Good Practice #1 required that external auditors must be approved “under the applicable professional regulations of EU Member States” and that these Member States “are expected to approve as auditors natural persons or firms who satisfy formal conditions such as good repute, educational qualifications, professional competence, theoretical knowledge and practical training”. This was an implicit referral to Articles 3 to 19 of Directive 84/253/EEC which established all the conditions that a person must fulfil to obtain the authorisation or approval to perform statutory audits. Good Practice #1 has remained essentially unchanged since 2006 despite the adoption of Directive 2006/43/EC. Only a small amendment was made in 2008 regarding the need for the ECB to have its external auditor certified in one Union Member State, since the approval conditions for the external auditors established in Directive 2006/43/EC are not directly applicable to the ECB.[23]

Good Practice #2 has been modified over time to include, together with the reference to the basic public procurement principles of equal treatment, non-discrimination and transparency, the condition that the procurement procedure for the selection of external auditors should be carried out at least once every seven years. This requirement, included in the revision of the Good Practices of 2008, is absent from Directive 2008/43/EC and therefore should be understood as an effort on the part of

[21] Eighth Council Directive 84/253/EEC of 10 April 1984 based on Article 54 (3) (g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents (OJ L 126, 12.5.1984, p. 20). This Directive was repealed by Directive 2006/43/EC.

[22] Regulation (EU) No 537/2014 refers in Article 17(1) to an initial engagement of at least one year.

[23] The lack of changes to the wording of Good Practice #1 lies in the fact that the conditions for approving or certifying external auditors are implemented by the Member States. Accordingly, the generic reference stating that the audit must be carried out only by auditors approved under the applicable professional regulation of an EU Member State, together with the indication that the Member States are expected to approve auditors who satisfy certain formal condition, is sufficient to direct the NCB to the relevant EU and national provisions.

the Governing Council to enhance the independence of the central banks' external auditors. This is also in line with Good Practice #3 which recommends the rotation of the external auditor at least every seven years. Another indication, included in the 2008 revision of the Good Practices is the requirement for those central banks that have had several auditors jointly approved by the Council of the European Union, to inform the Governing Council if they envisage changing the ranking of these auditors or dropping an auditor from the list. This inclusion responds to the particular circumstances of certain NCBs (that due to their national regulations must establish a ranking of selected external auditors) and it aims to safeguard the integrity of the procurement process and the approval procedure established by the Council of the European Union.

In relation to Good Practice #3, while the reference to a multi-year mandate has been there from the adoption of the first version of the Good Practices in 2006, the requirement to rotate the audit engagement has evolved over time. The 2006 version of the Good Practices distinguished between the auditor as a physical person (that should rotate the audit engagement within a maximum period of five years) and the audit firm (with a rotation requirement of seven years). The 2008 amendment to the Good Practices introduced a maximum period of seven years both for auditors and audit firms. The rotation requirement and the establishment of a maximum time limit for carrying out a new procurement procedure produce the same result: the audit engagement may not last for more than seven years. Finally, the indication in the final paragraph of Good Practice #3 that any divergence of opinions between the external audit and the central bank regarding accounting treatment or audit procedures should not be a ground for the dismissal of the external auditor reflects the view that a fully-fledged independent external audit assessment must be free from intimidation or threats.[24] This requirement has remained unchanged since the adoption of the Good Practices.

The wording of Good Practice #4 has become stricter since the entry into force of Directive 2006/43/EC. By contrast with the original version which referred in a generic manner to the need for the central banks to "ensure" the independence of the external auditor, the current version establishes a more prescriptive approach requiring central banks to verify annually whether or not the external auditor is providing non-audit services to the audited central bank and whether or not it is in any way involved in the management decisions of the audited central bank. The aim is to prevent any conflict of interest that might give rise to intentional oversights. This requirement regarding the independence of the external auditor is derived from Article 22(1) of Directive 2006/43/EC which indicates that "Member States shall ensure that, when carrying out a statutory audit, a statutory auditor […] is independent of the audited entity and is not involved in the decision-taking of the audited entity […] [and that] her or its independence is not affected by any existing or potential conflict of interest". The requirement for an annual verification can also be found in the second subparagraph of Article 22(1), which affirms that

[24] Commission Recommendation of 16 May 2002 - Statutory Auditors' Independence in the EU: A set of Fundamental Principles (2002/590/EC) (OJ L 191, 19.7.2002, p. 22) defines the threat of intimidation as the possibility that an auditor might be deterred from acting objectively by threats from or out of fear of, for example, an influential or overbearing client.

"[i]ndependence shall be required at least during both the period covered by the financial statements and the period during the statutory audit is carried out." This exclusion of the possibility for the central bank to select as external auditor any firm which already provides non-auditing services goes beyond the more nuanced approach of Directive 2006/43/EC, which only seems to exclude those non-audited services that might compromise the external auditor's independence. The absolute exclusion of the provision of non-audit services established in Good Practice #4, offers a higher standard than that established by Directive 2006/43/EC as well as an unambiguous policy that central banks must exclude from their procurement procedures any audit firms already engaged in the provision of any non-audit services.

6.2 Eventual incorporation of stricter requirements for the selection and mandate of external auditors in line with Regulation (EU) No 537/2014

Regulation (EU) No 537/2014 has a narrower scope than Directive 2006/43/EC as it only applies to statutory audits of entities qualified under national law as public-interest entities. Accordingly those euro area NCBs which are qualified in national law as public-interest entities are bound by the Regulation. In addition, this Regulation imposes stricter independence requirements than those established under Directive 2006/43/EC on the public-interest entities to which it applies. From the perspective of Article 27.1 of the Statute of the ESCB the stricter and directly applicable requirements established by Regulation (EU) No 537/2014 may pose concerns in relation to the consistent application of the Good Practices. This is due to the fact that the concept of "public-interest entity", insofar as NCBs are concerned, is governed by national law. In this respect Article 2(13)(d) of Directive 2006/43/EC defines public-interest entities as "entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees." Euro area NCBs which fall within the definition of public-interest entities have no option but to comply with the requirements of the Regulation. However, if the requirements of the Regulation differ from those established in the Good Practices then the aim of having a harmonised procedure in order to ensure the independence of the external auditors in charge of auditing the financial accounts would no longer be fulfilled. In this context, the Governing Council will need to choose between having different standards in relation to the independence of the statutory auditors (Regulation (EU) No 537/2014 for those euro area NCBs qualified as public-interest entities and the Good Practices for the remaining euro area central banks) or aligning the Good Practices with the requirements established by Regulation (EU) No 537/2014.

Regulation (EU) No 537/2014 does not impose specific requirements for the qualifications that statutory auditors must possess since this is considered to be already covered by Directive 2006/43/EC, hence Good Practice #1 is unaffected by the Regulation. However, Good Practice #2 may need to be amended as regards the

time limits for the procurement procedure for selecting the external auditors or audit firms. In this respect, the second subparagraph of Article 17(1) of Regulation (EU) No 537/2014 provides for a maximum duration of audit engagements of ten years while the current version of the Good Practices indicates that the procurement procedure for the selection of the statutory auditors should be carried out every seven years. An amendment of the Good Practices is not strictly necessary since Regulation (EU) No 537/2014 only establishes the 10-year period as a maximum duration, however, the Governing Council may decide to amend Good Practice #2 to avoid the possibility of practical inconsistencies between a binding and a soft-law instrument.

The maximum duration of 10 years introduced by Regulation (EU) No 537/2014 directly affects Good Practice #3 which requires that the statutory auditor "should be rotated from the external audit engagement at least every seven years", and thus Good Practice # 3 may also need to be amended. In addition, consistency with Regulation (EU) No 537/2014 may also require the inclusion of cooling-off periods for the auditor or the audit firm and for the key audit partner. In this respect, Article 17(3) and 17(7) establish respectively a cooling-off period of 4 years for the audit or the audit firm, and of 7 years for the key audit partners responsible for carrying out the statutory audit.[25]

The most substantial impact of Regulation (EU) No 537/2014 on the Good Practices relates to the prohibition for the statutory auditor to provide non-auditing services to the audited Eurosystem central bank. In this respect, Regulation (EU) No 537/2014 further develops the precautionary approach for handling conflicts of interest, as laid down in Article 22 of Directive 2006/43/EC, by establishing a prohibition for the external auditor to directly or indirectly provide certain non-audited services to the audited entity. Article 5 of the Regulation establishes a comprehensive list of non-audit services which includes: tax services, services that involve playing any part in the management or decision-making of the audited entity; bookkeeping and preparing accounting records and financial statements; payroll services; designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information; valuation services; legal services; services related to the audit entity's internal audit function; services linked to the financial, capital structure and allocation, and investment strategy of the audited entity;[26] promoting, dealing in, or underwriting shares in the audited entity; and certain human resources services. In order to be consistent with Regulation (EU) No 537/2014, Good Practice #4 would need to be amended in line with the new approach introduced in Article 5 of the Regulation. Accordingly, the absolute requirement to appoint external auditors that do not provide non-audit services to the

[25] The concept of "key audit partner" is defined in Article 2(16) of Directive 2006/43/EC as: "(a) the statutory auditor(s) designated by an audit firm for a particular audit engagement as being primarily responsible for carrying out the statutory audit on behalf of the audit firm; or (b) in the case of a group audit, at least the statutory auditor(s) designated by an audit firm as being primarily responsible for carrying out the statutory audit at the level of the group and the statutory auditor(s) designated as being primarily responsible at the level of material subsidiaries; or (c) the statutory auditor(s) who sign(s) the audit report."

[26] Except for the provision of assurance services in relation to the financial statements; such as the issuing of comfort letters in connection with prospectuses issued by the audited entity.

contracting euro area central bank would need to be amended to include in Good Practice #4 a list of prohibited non-audit services similar to that established in Article 5 of the Regulation.

From a practical perspective, the introduction of such an approach in Good Practice #4 may require a case-by-case analysis on the part of the Governing Council as to whether the particular non-audit service that the selected statutory auditor may be providing to the contracting central bank falls within the scope of the prohibited non-audit services. The need for such an assessment may further complicate the decision-making process prior to the adoption of a recommendation by the Governing Council according to Article 27.1 of the Statute of the ESCB.

7 Conclusions

The legal framework for the external audit of the ECB and the organisational measures taken on the basis of the legal framework ensure a good framework for the audit of the operational efficiency of the ECB's management and of the accounts of the euro central banks. With regard to the latter, the Governing Council should ensure the sound implementation of the audit framework in consistency with existing Union legislation.

Admittedly, the mandate of the ECB's two external auditors, i.e. the ECA and the independent audit firm, is limited in scope to specific areas in order to respect the ECB's independence and the applicable Union legal framework. Furthermore, the independent audit firms (or auditors) appointed as external auditors to examine the euro area central banks' accounts perform the function of a statutory auditor. Both audits together complement each other to provide an assurance to the general public that the ECB's resources are managed properly. In a world where central bank independence is increasingly challenged, we anticipate that the scope of the audit of the ECB's activities will continue to be challenged. Whilst an open dialogue on this matter is welcome and should not be hindered, we think that any action adopted at Union level should take into account the underlying reasons behind the current procedures and should not ignore the legal provisions already in place.

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The impact of the establishment of the SSM on the relationship between De Nederlandsche Bank and the Netherlands Court of Audit

By Willem Bovenschen[1]

1 Introduction

The Single Supervisory Mechanism (SSM) has its own accountability framework. One of its particularities is that under the SSM national competent authorities (NCAs) remain accountable for their supervisory activities to national parliaments on the basis of national law. Where NCAs act under the SSM Regulation,[2] such as to supervise less significant banks, accountability arrangements under national law apply. This paper examines the Dutch situation and the powers of the Netherlands Court of Audit vis-à-vis De Nederlandsche Bank (DNB). It concludes with some general comments on the accountability framework of the SSM.

2 Pre-SSM relations between DNB and the Netherlands Court of Audit

According to the Dutch Constitution,[3] the Court of Audit[4] is responsible for examining the State's revenues and expenditures.[5] The organisation, composition and powers of the Court of Audit are regulated by the Government Accounts Act.[6] Up to the beginning of the 21st century DNB had not been brought under the competence of the Court of Audit. It was the overhaul of the Dutch financial supervisory system that opened the door of DNB for the Court. The Act regulating the merger between DNB and the Pensions and Insurance Supervisory Authority of the Netherlands (PVK) specified that the existing powers of the Court of Audit with regard to pension fund supervision remained.[7] In 2007 all national DNB tasks were also brought within the

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1 Legal counsel, De Nederlandsche Bank. The views expressed in this article are that of the author and cannot be attributed to De Nederlandsche Bank. Dedicated to Ron Luberti: Amore, more, ore, re, nascuntur amicitiae.

2 Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

3 The Constitution of the Kingdom of the Netherlands 2008

4 In Dutch: "Algemene Rekenkamer".

5 Article 76 of the Constitution of the Kingdom of the Netherlands 2008.

6 Comptabiliteitswet 2001.

7 Fusiewet De Nederlandsche Bank N.V. en de Stichting Pensioen- & Verzekeringskamer 2004.

scope of the Court's competence. However, although the Court did have the power to audit DNB in respect of its supervisory and other national tasks as of 2007, it had no access to confidential supervisory files. DNB was bound by professional secrecy obligations deriving from the Capital Requirements Directive that prevented the sharing of such specific information.[8] For the Court, such access was a prerequisite for it to carry out its tasks.[9] After a change to the Directive in this respect,[10] initiated by the Netherlands, such access became feasible. The applicable supervisory legislation was also amended as of May 2014 and the Court of Audit was provided with the authority to access confidential supervisory files. Half a year later the SSM became operational.

3 The SSM Regulation and state auditors

Chapter IV of the SSM Regulation sets down an accountability regime for the SSM. Article 20 states that the ECB is accountable to the European Parliament and that the European Court of Auditors will examine the operational efficiency of the management of the ECB, including the supervisory tasks conferred on it. Article 21 also provides for a certain accountability of the ECB vis-à-vis the national parliaments of Member States. Hence the SSM Regulation provides for ECB accountability in respect of the SSM that is threefold: accountability vis-à-vis (i) the European Parliament, (ii) national parliaments and (iii) the European Court of Auditors.

With respect to NCAs, the SSM Regulation merely states the following: *This Regulation is without prejudice to the accountability of national competent authorities to national parliaments in accordance with national law for the performance of tasks not conferred on the ECB by this Regulation and for the performance of activities carried out by them in accordance with Article 6* [i.e. the supervision of less significant institutions].

What does this mean for the accountability of an NCA vis-à-vis a State auditor? First, one could consider the accountability of an NCA vis-à-vis a State auditor to be a part of parliamentary accountability. However, if this were to be the correct reading, the drafting of the accountability framework would be inconsistent. Recital 56 of the SSM Regulation mentions that national accountability is still warranted because of the impact of an NCA's tasks on public finances in a Member State and that accountability arrangements that are provided for under national law should continue to apply. The recital does not limit NCA accountability to national parliaments.

8 Articles 44 to 52 of Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177, 30.6.2006, p.1).

9 www.courtofaudit.nl/english/Publications/Audits/Introductions/2013/01/Letter_to_the_House_of_Representatives_on_limited_powers_to_audit_financial_supervisors

10 Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

On the other hand one could argue that NCA accountability vis-à-vis a State auditor for SSM activities is no longer feasible. Other than for the ECB, Articles 20 and 21 of the SSM Regulation make no reference to NCA accountability vis-à-vis a State auditor. Furthermore it is the ECB that is responsible for the effective and consistent functioning of the SSM and it is the ECB that will be accountable.

4 Accountability of DNB vis-à-vis the Court of Audit

In 2007 the Government Accounts Act brought DNB within the scope of the competence of the Court of Audit. Although the Court of Audit is entitled to audit DNB pursuant to Article 91 of the Act, this competence is limited to "national tasks" performed by DNB.[11] Tasks of DNB concerning the implementation of the Treaty on the Functioning of the European Union are outside the Court's competence. The explanatory memorandum to the Act clarifies that it is envisaged that DNB's tasks in the context of the European System of Central Banks (ESCB) are exempted from the scope of competence of the Court of Audit.[12]

The Court of Audit can carry out so-called performance audits that concern both the **effectiveness** of the relevant policies as well as the operational management **efficiency**. The scope of such an audit is broader than what the European Court of Auditors is entitled to audit at the level of the ECB.

In order to carry out an audit, the Court of Audit can gather information, demand records and documents of any type and set up investigations. Since May 2014 Article 1:93d of the *Wet op het financieel toezicht* (Financial Supervision Act)[13] allows the Court of Audit to demand access to confidential information obtained by DNB in the execution of its supervisory tasks, if such information is necessary for the Court to carry out its public tasks. DNB is required to comply with such requests. Given that the Government Accounts Act was drafted prior to the SSM it is not self-evident whether the SSM tasks of DNB (e.g. the prudential supervision of less significant credit institutions) were meant to be considered in or outside the scope of the Court of Audit under Dutch law.

DNB is deemed to be within the scope of competence of the Court of Audit in view of its SSM activities. First, the Bank Act 1998 considers DNB's supervisory tasks to be national tasks. Second, having regard to Article 127(6) of the TFEU, the European legislator has attributed supervisory tasks to the ECB. The SSM Regulation in that respect states that NCAs have a duty to cooperate in good faith and are to assist the ECB. In other words, banking supervision has become a European matter to which task DNB as a national competent authority contributes in accordance with the framework of the SSM Regulation.

[11] Article 91(4) of the Government Accounts Act.

[12] Explanatory memorandum, TK, 2005-2006, 30 660, No 3.

[13] Implementation of Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

5 Current practice

In relation to the frequency of audits and the national tasks of DNB as an NCA, the Court of Audit announced in 2010 that it will audit DNB on an ad hoc basis and not periodically. Recent audits in DNB were performed in 2009 concerning the system of supervision of financial market stability, and in 2011 concerning DNB's supervision of the financial stability of banks.

In 2016 the Court of Audit started an audit of DNB's prudential supervision of less significant banks in the Netherlands. This audit is part of a parallel audit by several State auditors on the design and functioning of supervision of less significant banks.

The audit of DNB will address the regulatory and legislative requirements, the design of supervision, the functioning and the risks identified.

Under Dutch law confidential information that is obtained from another supervisory authority cannot be disclosed by DNB unless there is an explicit approval from the authority that provided the information.[14] Consequently, the ECB's agreement is sought before disclosing documents and records originating from the ECB.

In one of its opinions the ECB recommended that an audit of a State auditor should: (a) not extend to the application and interpretation of supervisory law and practices; (b) not interfere with the tasks conferred on the ECB by the SSM Regulation, nor be extended to result in an indirect audit of the ECB; and (c) be carried out on a non-political, independent and purely professional basis.[15]

6 Concluding remarks

The launch of the SSM has changed the organisation of banking supervision in the euro area fundamentally. The overall prudential supervisory authority has been raised to the euro area level. The responsibility for the prudential supervision of significant banks has been transferred from DNB to the ECB. As a national competent authority, DNB continues to exercise direct supervision on the less significant banks. The SSM resulted in changes for accountability as well.

First, an audit deficit has emerged with regard to the supervision of significant banks in the Netherlands. Prior to the SSM, DNB was responsible and accountable for all aspects of prudential supervision of these banks. The Court of Audit was entrusted with the independent external control of banking supervision. After the entry into force of the SSM Regulation, the Court of Audit is no longer competent to examine the functioning of the supervision of significant banks in the Netherlands. Since such supervision is the ECB's task it is the European Court of Auditors that is responsible for any audits. However, the European Court of Auditors has limited powers when it comes to the ECB. Where, in the pre-SSM era, certain State auditors could examine

[14] Article 1:93 of the Financial Supervisory Act.

[15] Opinion of the European Central Bank of 18 December 2015 on certain amendments to Banka Slovenije's institutional framework (CON/2015/57).

the functioning of supervision and had access to files on significant banks held by their national supervisory authorities, under the SSM the European Court of Auditors has no powers to examine the ECB's supervisory activities. Hence, one can conclude that the possibilities for independent external control of supervision have decreased, resulting in what some call the "audit gap".[16]

Second, there is no harmonised approach within the SSM when it comes to the accountability of supervision of less significant institutions. DNB continues to exercise direct supervision on the less significant banks in the Netherlands. The accountability framework for the SSM activities of DNB is dependent on Dutch national law. Under Dutch law there is a Court of Audit with a mandate to audit the supervisory activities of DNB as the national competent authority. The same is true for, inter alia, Germany, France, Cyprus, Austria and Finland. However, in a number of Member States, the State auditor has no mandate to audit such supervisory activities. The result being a lack of harmonisation when it comes to accountability for SSM activities.

Last, but not least, the risk exists that audits by State auditors of NCAs result in an indirect audit of the ECB. The conclusions of a State auditor on the SSM activities of an NCA may also have a bearing on the ECB's role within the SSM. If not only for the fact that all material decisions taken by a national competent authority are, or should be, brought to the attention of the ECB prior to decision-making by the NCA. Since indirect ECB audits are to be avoided, see Section 5, the scope of a national audit seems to be a delicate matter.

The described peculiarities of the SSM accountability framework result from the fact that an existing EU institution such as the ECB, which has its own tailor-made accountability framework, has been entrusted with a task such as supervision. One could wonder whether the accountability framework for the SSM would have been the same if supervision had been entrusted to a new European institution. The peculiarities of this accountability arrangement have led to a public debate[17] and one can only expect the issue of accountability of the SSM to emerge on the European agenda again.

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[16] Statement by the Contact Committee of the Heads of the Supreme Audit Institutions (SAIs) of the Member States of the EU and the European Court of Auditors (ECA), 14 October 2011.

[17] See footnote 16 and a letter of Court of Audit to the Dutch Parliament of 2 July 2014.

Unified administrative law at the European level

Introduction

By Eleni Koupepidou

The SSM Framework Regulation as a source of ECB administrative procedural law

By Klaus Lackhoff

Primary law requirements for administrative procedures in the case-law of the Court of Justice

By Karl-Philipp Wojcik

Managing administrative complexity in resolution: the recent experience in Italy and its lessons from a European Union perspective

By Monica Marcucci

Introduction

By Eleni Koupepidou[1]

With the entry into force of the SSM Regulation,[2] the task of prudential supervision of credit institutions has been conferred on the ECB. As a result and for the purpose of carrying out its supervisory tasks, the ECB applies substantive law on the one hand and administrative procedural rules on the other.

As far as substantive supervisory law is concerned, the ECB applies all relevant European Union law. Where Union law in this area is composed of directives, it applies the national legislation transposing those directives.[3] Where the relevant Union law is composed of regulations and currently those regulations explicitly grant options for Member States, the ECB also applies the national legislation exercising those options.[4]

When applying procedural law, for example for the adoption of supervisory decisions, the ECB invariably applies Union administrative rules, and not national procedural rules.[5] The ECB is a Union institution and is as such bound in its decision-making procedures by Union rules and general principles on due process and transparency.[6]

This has led some commentators to argue that there is no "European administrative law". Although this statement is true to the extent that there is no coherent and comprehensive set of codified rules of administrative law, a fragmented framework covering the execution of the powers of Union institutions does exist. The Union's existing administrative rules and principles on good administration are scattered across a wide variety of sources: primary law, the case-law of the Court of Justice, secondary legislation, soft law and unilateral commitments by the Union's institutions.[7]

These different layers of administrative procedural rules provide an effective system for the protection of individual rights, assuaging past concerns in certain national

1 Head of the Supervisory Law Division, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

2 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

3 Article 4(3) of Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation)(ECB/2014/17) (OJ L 141, 14.5.2014, p. 1).

4 ibid.

5 In some cases Union administrative rules explicitly refer to national rules. For example, Article 93 of the SSM Framework Regulation provides that the relevant national competent authority (NCA) shall notify without undue delay the ECB of any change to the members of the management bodies of a significant supervised entity informing it of the time limit within which a decision has to be taken and notified in accordance with the relevant national law.

6 Recital 54 of the SSM Regulation.

7 European Parliament resolution of 15 January 2013 with recommendations to the Commission on a Law of Administrative Procedure of the European Union (2012/2024(INL)).

legal orders regarding an alleged lack of fundamental rights standards in Union law. Nevertheless, the non-codified nature of this regime poses challenges for practitioners in determining the exact scope of administrative activities and raises the question of whether the ECB can and should further codify the rules of administrative procedural law.

In this light, this panel focused on the different sources of administrative law that should be applied by the ECB in performing its supervisory tasks. The diversity of national laws created by the legislators in different Member States in implementing the relevant Union law was not addressed.

1 Primary law as a source of Union administrative law

The application of Union procedural law itself should avoid or eliminate non-uniform practices across different jurisdictions, in particular where the ECB makes use of powers under the national banking laws transposing directives (for example, Directive 2013/36/EU).[8]

On 15 January 2013 the European Parliament adopted a resolution to remedy this lack of a comprehensive package of Union administrative law.[9] According to the Report of the Committee on Legal Affairs of the Parliament,[10] the fact that the Union lacks a coherent and comprehensive set of codified rules of administrative law makes it difficult for citizens and economic operators to understand their administrative rights under Union law. Citizens are entitled to expect a high level of transparency and efficiency, as well as an expedited and effective response from the Union's administration.

In this broader context, it is worth examining in more detail the different sources of Union administrative law in order to clarify what legal standards are applied by the ECB in carrying out its supervisory tasks. Only once these sources have been examined will it be possible to establish whether the level of protection of individual rights is adequate and effective in the absence of a coherent set of rules of administrative law.

The Treaty on the Functioning of the European Union and the Treaty on European Union contain a number of provisions establishing administrative rules to be applied in the exercise of administrative tasks such as the adoption of supervisory decisions, which include the principle of proportionality[11] and the principle of lawfulness of

[8] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

[9] European Parliament resolution of 15 January 2013 with recommendations to the Commission on a Law of Administrative Procedure of the European Union (2012/2024(INL)).

[10] Committee on Legal Affairs report of 12 November 2012 with recommendations to the Commission on a Law of Administrative Procedure of the European Union (2012/2024(INI)).

[11] Article 5(4) TEU states as follows: "Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties."

administration.[12] Furthermore, Article 41 of the Charter of Fundamental Rights of the European Union establishes a "right to good administration".

In addition, the case-law of the Court of Justice has further developed well-established procedural principles which apply to Member States' procedures in community matters and which should *a fortiori* apply to direct administration by the Union.[13] The most important of these general principles are the principles of legality and proportionality, legal certainty, protection of legitimate expectations, the right to be heard, and due process in general.

In this context, Karl-Philipp Wojcik, a member of the Commission's Legal Service, gave a presentation on the primary law requirements for administrative procedures and the case-law of the Court of Justice.

2 Secondary law as a source of Union administrative law

The Union has developed through its secondary law an ad hoc series of administrative procedures applying to different areas of the institutions' activities. In the case of the ECB and the exercise of its supervisory tasks, the SSM Framework Regulation is one such source of administrative rules developed by the ECB. The SSM Framework Regulation covers, among other aspects, the right to be heard (Article 31), access to files in an ECB supervisory procedure (Article 32), requirements for ECB supervisory decisions (Chapter 2 of Title 2) and cooperation between the ECB and NCAs in carrying out various other tasks.

A further layer of administrative procedural rules has been developed in the ECB's day-to-day practice. For example, in accordance with the principle of proportionality, instead of issuing outright rejections, approvals are granted subject to conditions.

The practical day-to-day application of the SSM Regulation and the SSM Framework Regulation raises a number of questions. For example, to what extent do the administrative rules in the SSM developed on the basis of secondary law (the SSM Regulation and the SSM Framework Regulation) comprehensively cover all the procedural aspects necessary for the ECB to carry out its supervisory tasks?

Klaus Lackhoff, Head of the Banking Law Section of the ECB Legal Services, which advises the SSM on all aspects of its activities, gave a presentation on the SSM Framework Regulation as a source of the ECB's administrative law. In his presentation, he touched upon the issue of whether there is any scope for further codification of the administrative rules applicable to the ECB and the NCAs in their supervisory tasks within the SSM.

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[12] Article 2 TEU states as follows: "The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities." [underline the words "the rule of law"]

[13] European Parliament resolution of 15 January 2013 with recommendations to the Commission on a Law of Administrative Procedure of the European Union.

3 Union administrative law in resolution

In the sphere of resolution, an area outside the ECB's competences but very interesting to observe and compare from a procedural perspective, procedural rights and safeguards may be applied in a different manner. The Bank Recovery and Resolution Directive[14] (BRRD) respects the fundamental rights and observes the rights, freedoms and principles recognised by the Charter of Fundamental Rights of the European Union, and, in particular, the right to property, the right to a fair trial and the right of defence.[15] However, the different objectives of resolution justify the different, and in some cases, limited application of those rights. For example, remedies for a wrongful decision are limited to the award of compensation for the losses suffered by the affected parties and should not affect any subsequent administrative act or transaction concluded on the basis of an annulled decision.[16]

The issue may be raised therefore as to how procedural rights and safeguards in this complex institutional architecture are applied also taking into account the different resolution objectives. Monica Marcucci, senior legal counsel at Banca d'Italia and expert on financial regulation and insolvency law, shared her insights on how to manage administrative complexity in resolution and its lessons from a Union perspective.

[14] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

[15] Recital 130 of the BRRD.

[16] Article 85(4) and recital 91 of the BRRD.

The SSM Framework Regulation as a source of ECB administrative procedural law

By Klaus Lackhoff[1]

1 Background to the legal problem

By centralising the supervision of significant credit institutions at the ECB, the Single Supervisory Mechanism (SSM) Regulation[2] entrusts the ECB with the role of an administrative agency for the direct supervision of significant credit institutions. As such it requires a procedural law.

From this perspective, "administrative (procedural) law" can be described as the entirety of the provisions that determine the activities of the ECB directed towards the preparation, adoption, implementation or enforcement of ECB supervisory decisions or other binding acts in specific cases.[3]

This article briefly describes the different sources of the administrative procedural law (Section 2) before looking in more detail at the SSM Framework Regulation[4] as a source of administrative procedural law (Section 3). Thereafter, the provision on the motivation of supervisory decisions is reviewed as an example of an administrative procedural provision in more detail (Section 4). The question is then raised whether the administrative procedural provisions of the SSM Framework Regulation should be amended (Section 5). The final section concludes.

2 Overview of the sources of ECB administrative procedural law

The administrative procedural law which the ECB applies when carrying out the tasks conferred on it by the SSM Regulation has various sources, among others the Treaties, the Charter of Fundamental Rights of the European Union and the general

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1 Head of Section, Supervisory Law Division, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

2 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

3 Compare Article 2(20) and (26) of the Framework Regulation.

4 Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation)(ECB/2014/17) (OJ L 141, 14.5.2014, p. 1).

principles of Union law. They are discussed in more detail in the article by Karl-Philipp Wojcik.[5]

The SSM Regulation is another source of administrative procedural law. It is so in particular in a threefold manner.

First, the SSM Regulation explicitly requires that all[6] supervisory proceedings comply with due process requirements. This includes, in particular, the right to be heard and the right of access to the ECB's files (Article 22 SSM Regulation). By requiring this, the SSM Regulation spells out what applies anyway as any procedure of the ECB in its supervisory function has to comply with these requirements already based on higher ranking Union law. These requirements are detailed further in the Framework Regulation, which we will discuss later.

Second, the SSM Regulation determines the decision-making process – the non-objection procedure – for supervisory decisions.

Third, the SSM Regulation contains specific procedural provisions with regard to the so-called common procedures: (i) authorisations, (ii) withdrawals of authorisations, and (iii) the assessment of the acquisition or increase of a qualifying holding. Although the ECB is the sole decision-maker in these proceedings, the SSM Regulation intended to build the influence of the national competent authorities (NCAs) into the procedures. With regard to these procedures, among others the question of the relationship between national and ECB procedural laws is relevant.

The rules on authorisation provide for a two-part procedure. The first part is a "national part". It may end with the rejection of the application by the NCA or a draft ECB decision – prepared by the NCA – suggesting to grant the authorisation. The "national part" of the procedure carried out by the NCA has to comply with national procedural laws. So, for example, national procedural law determines whether a hearing is required. The second part – let's call it the "ECB part" – is subject to the procedural rules applying to the ECB. Here a hearing is required if the ECB decides to reject the application or grants the authorisation but with conditions not included in the application.

With regard to the withdrawal of an authorisation, the procedural structure is not as clear as in the case of an authorisation. The ECB may withdraw an authorisation on its own initiative or upon a proposal of the home NCA. Must the NCA hear the relevant institution under national procedural rules before making such a proposal? Or is making such a proposal an integral part of an ECB supervisory procedure so that only a hearing by the ECB should and may be carried out?

The same question occurs with regard to assessing the acquisition of a qualifying holding. There the SSM Regulation stipulates that the ECB assesses the case based upon a proposal by the NCA. As the NCA proposal is obligatory one could argue

5 See Wojcik, Karl-Philipp, "Primary law requirements for administrative procedures in the case-law of the Court of Justice", *ESCB Legal Conference 2016*.

6 The SSM Regulation exempts the exercise of investigatory powers (Article 22(1) SSM Regulation), but that can be questioned.

that, at least in this case, the activity of the NCA is part of an ECB procedure and therefore should not be subject to national procedural requirements – like a hearing requirement.

Further articles of the SSM Regulation with procedural relevance are:

- Article 23 which requires the ECB to establish an effective whistle-blowing procedure;
- Article 24 providing for the possibility of an internal administrative review of ECB supervisory decisions[7];
- Article 25 spelling out the separation between the supervisory and the monetary policy functions of the ECB; and
- Article 27 stipulating standards of professional secrecy and rules for the exchange of information.

In addition to the SSM Regulation, the SSM Framework Regulation[8] and the ECB Rules of Procedure contain procedural rules. So the latter contains, for example, provisions on the decision-making process, legal instruments and, among others, formal requirements like the signature on supervisory decisions. After a recent amendment they must be signed by the Secretary of the Governing Council.[9] The Framework Regulation will be discussed in more detail in the following section.

Finally, national procedural rules implementing the Capital Requirements Directive (CRD IV) or making use of an option under the Capital Requirements Regulation (CRR) have to be applied by the ECB.[10] That national law implementing a directive or making use of an option under a regulation has to be applied by the ECB if it contains procedural rules follows from Article 4(3) of the SSM Regulation. This Article provides that the ECB must apply national law transposing directives or making use of options when carrying out its supervisory tasks. Moreover, Article 93 of the Framework Regulation stipulates that the NCA must inform the ECB in connection with any fit and proper procedure “of the time limit within which a decision has to be taken and notified in accordance with the relevant national law”. One may want to add “in accordance with the relevant national law implementing – in a broad sense – CRD IV” as the CRD IV (Article 91) does not provide for such time limits. This necessary respect for national laws bears also a cost. Diverging time limits for fit and proper proceedings in different national laws impede the work of a single supervisor.

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[7] See Lackhoff, K. and Meissner, M., “Contesting Decisions in the Single Supervisory Mechanism: What Banks Must Observe for a Proceeding at the Administrative Board of Review”, *Journal of International Banking Law and Regulation*, 2015, Vol. 30, Issue 5, p. 285.

[8] See footnote 4.

[9] Article 17a.4 of the ECB Rules of Procedure as amended by Decision (EU) 2016/1717 of the European Central Bank of 21 September 2016 (OJ L 258, 24.9.2016, p. 17).

[10] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338); and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

And, more generally, a detailed but diverging implementation of the CRD IV by different Member States creates operational obstacles for a single supervisor.

3 The SSM Framework Regulation as a source of ECB administrative procedural law

The SSM Framework Regulation aims to codify – at least partially – the procedural provisions applying to supervisory procedures. This is, among others, evident from the heading of its Title 2, "General provisions relating to due process for adopting ECB supervisory decisions", and the scope of its provisions. They define the parties to ECB supervisory procedures, discuss when a representation is possible, stipulate general procedural obligations, the right to be heard, the right of access to files, and the motivation requirements. Furthermore, the SSM Framework Regulation determines when the application of a supervisory decision can be suspended and how supervisory decisions should be notified.

Like the provisions of any codification the existing rules raise issues; just two examples with regard to the hearing may be mentioned here.

As any ECB regulation, the Framework Regulation has to comply with higher ranking law. The case-law of the Court of Justice of the European Union[11] requires that whenever the Union administration adopts a measure which has an adverse effect on the rights or interests of a person, this person must have the right to be heard. There is the tendency to extend this right to third parties who would not be the direct addressees of the intended measure. The Framework Regulation requires ("only") that the addressee of an ECB supervisory decision is heard. Should the ECB follow a literal understanding of the Framework Regulation (Article 31) or should it also hear persons that are not the addressees of an ECB supervisory decision? And, if so, whom? Those that are directly and individually concerned by a measure? And who are they?

- Are they the shareholders in the case of the withdrawal of an authorisation? I do not think so as they are not singled out like an addressee and, in principle, no interest deviating from the interest of the institution should exist so they are therefore not individually concerned.
- Is it a manager in the case of a negative fit and proper decision whose addressee is, according to national law, the bank? This is less clear.

The exceptions to the ex-ante right to be heard are another issue. The SSM Regulation (Article 22(1)) and the Framework Regulation provide for an exception to the ex-ante right to be heard if it is necessary to avoid significant damage to the financial system. This threshold may be too high. What if a moratorium based on national law and in respect of the branch of a credit institution from a Member State

[11] C-32/95 P, *Lisrestal*, ECLI:EU:C:1996:402, para. 24 ff.; T-260/94, *Air Inter*, ECLI:EU:T:1997:89, para. 63.

that introduced capital transaction controls needed to be adopted quickly in order to avoid unequal effects for depositors: wouldn't it be justified in such a case that only an ex-post hearing is carried out?

The growing together of national and supranational supervision also provides legal peculiarities. Such a peculiarity is the notification of the ECB decision on an application for authorisation. The ECB is the only supervisor that can grant an authorisation to carry out the business of a credit institution. The ECB decision to grant or reject such authorisation is nevertheless notified by the relevant NCA to the applicant. This is a peculiarity but can raise issues that are relevant for the access to the court: does the NCA notify the decision in line with the national rules for notification or as an assistant/agent of the ECB under Article 35 of the Framework Regulation? Whatever the decision, the point in time when the two-month period for an action for annulment starts may deviate (Article 263(4) TFEU).

4 Motivation

Another example of a procedural provision is Article 33 of the Framework Regulation. This provision requires, in line with Article 41(2) of the Charter and Article 296(2) of the TFEU,[12] that ECB supervisory decisions are motivated, i.e. accompanied by a statement of reasons containing the material facts and legal reasons on which the decision is based. Unless an ex post hearing is justified, an ECB supervisory decision may only be based on facts and objections on which a party has been able to comment.[13] It can be concluded that also the objections have to be mentioned in the statement of reasons.

The statement of reasons consequently has to cover all the aspects to which the hearing extends and has to explain – based on and underpinned by facts – the breaches/likely breaches/other circumstances[14] that justify the supervisory measures. It has to spell out the underlying deliberations in a transparent manner to the addressee and so that the Court of Justice can, based on the statement of reasons, review the legality of the decision.[15] The statement must not include contradictions, preventing the addressee from understanding the real reasons for the decision.[16] The degree of detail required for sufficient motivation depends on the

[12] See also Ohler, C., *Bankenaufsicht und Geldpolitik in der Währungsunion*, 2015, § 5 para. 204.

[13] Article 33(3) SSM Framework Regulation.

[14] See Article 16(1)(c) SSM Regulation.

[15] C-521/09 P, *Elf Aquitaine SA*, ECLI:EU:C:2011:620, para. 147: "… the statement of reasons required under Article 253 EC must be appropriate to the measure at issue and must disclose in a clear and unequivocal fashion the reasoning followed by the institution which adopted that measure in such a way as to enable the persons concerned to ascertain the reasons for it and to enable the competent Court of the European Union to exercise its jurisdiction to review legality (see *France* v *Commission*, paragraph 35, and *Deutsche Telekom* v Commission, *paragraph 130*)." Elf Aquitaine SA.

[16] T-587/08, *Del Monte*, ECLI:EU:T:2013:129, para. 279: "A contradiction in the statement of the reasons for a decision constitutes a breach of the obligation laid down in Article 253 EC such as to affect the validity of the measure in question if it is established that, as a result of that contradiction, the addressee of the measure is not in a position to ascertain, wholly or in part, the real reasons for the decision and, as a result, the operative part of the decision is, wholly or in part, devoid of any legal justification (Case T-5/93 *Tremblay and Others* v *Commission* [1995] ECR II-185, paragraph 42, and Case T-65/96 *Kish Glass* v *Commission* [2000] ECR II-1885, paragraph 85)". Del Monte.

specific circumstances of each case but, in general, decisions require a more detailed statement of reasons than legal acts of general application. But, also in the case of a decision, it is not necessary that the statement deals with all aspects raised by the addressee but rather displays the main reasons backing the decision.[17] However, merely referring to an applicable provision of law, or paraphrasing it, is not sufficient.[18] The first court case brought against a decision of the ECB raises in particular the question whether the significance decision is sufficiently justified.[19]

5 Should the SSM Framework Regulation be amended?

The aspects that are codified may leave here and there room for improvement but also what is not codified may be an issue.

With the resolution of the European Parliament of 9 June 2016 and the draft regulation for an open, efficient and independent European Union administration, the codification of general administrative procedural provisions may be on the agenda. One of the issues that is covered in this draft regulation and is also relevant for the SSM is the rectification and withdrawal of supervisory decisions. If, for example, a credit institution applies for the permission to repurchase a Tier 2 instrument but is thereafter not able to repurchase all such instruments, it still has to deduct them because the permission exists. Consequently, the credit institution has an interest in the withdrawal of such a decision. Withdrawing such a decision based on an application is possible, but codifying the withdrawal right for this and other more complex situations may nevertheless enhance legal certainty.

Other aspects of administrative law not covered in the SSM Framework Regulation are conditions precedent, conditions subsequent and obligations connected with an ECB supervisory decision. Conditions and obligations are often imposed in other areas of European Union law. According to Article 8(2) of the EC Merger Regulation,[20] the Commission may attach to its decision declaring a concentration compatible with the Common Market conditions and obligations intended to ensure that the undertakings concerned comply with the commitments they have entered into vis-à-vis the Commission with a view to rendering the concentration compatible with the Common Market. According to Article 9(4) of the State Aid Procedure

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17 *Elf Aquitaine SA*, para. 150: “It is settled case-law that the requirement to state reasons must be assessed by reference to the circumstances of the case, in particular the content of the measure in question, the nature of the reasons given and the interest which the addressees of the measure, or other parties to whom it is of direct and individual concern, may have in obtaining explanations. It is not necessary for the reasoning to go into all the relevant facts and points of law, since the question whether the statement of reasons meets the requirements of Article 253 EC must be assessed with regard not only to its wording but also to its context and to all the legal rules governing the matter in question (see, inter alia, *Commission* v *Sytraval and Brink’s France*, paragraph 63; Case C-413/06 P *Bertelsmann and Sony Corporation of America* v *Impala* [2008] ECR I-4951, paragraphs 166 and 178; and Deutsche Telekom v Commission, paragraph 131).” See footnote 15.

18 C-378/00, *Commission* v *Parliament and Council*, ECLI:EU:C:2003:42, para. 68; and T-404/11, *TCMFG*, ECLI:EU:T:2013:194, paras. 23, 24.

19 See the article “Erste Klage gegen EZB-Aufsicht: L-Bank zieht mit Freshfields vor das EuG”, available at www.juve.de

20 Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) (OJ L 24, 29.1.2004, p.1).

Regulation,[21] the Commission may attach to a positive decision conditions subject to which aid may be considered compatible with the internal market and may lay down obligations to enable compliance with the decision to be monitored ("conditional decision"). Moreover, numerous Member State laws provide for the possibility to impose conditions and obligations in administrative decisions. Finally, the Court of Justice recently accepted that restrictions or requirements may be attached to the approval of a qualifying holding provided that it ensures that the requirements stipulated by law for approving the acquisition are fulfilled.[22]

On this background it is reasonable to conclude that also ECB supervisory decisions may be adopted subject to conditions and/or obligations. This is also supported by the proportionality principle which requires that decisions comply with the criteria of suitability, necessity and proportionality in the strict sense.[23] Approving the acquisition of a qualifying holding under a condition precedent is more likely to be proportional than rejecting it outright. The challenge with conditions is to formulate them in such a specific manner that it is easy to assess whether they are fulfilled. If a condition or obligation is attached to a decision responding to an application, a hearing is required unless the specific condition or obligation was already included in the (amended) application.

In a supervisory law context, one can expect the following three types of conditions and obligations:

Designation	Content
Condition precedent	A condition precedent stipulates that an ECB supervisory decision (e.g. a permission approving the acquisition of a qualifying holding) will only take effect if certain specifically spelled out circumstances are fulfilled.
Condition subsequent	A condition subsequent stipulates that an ECB supervisory decision shall cease to be effective if certain circumstances are fulfilled.
Obligation[24]	An obligation requires the addressee to carry out certain measures; it is added as an ancillary measure to another decision (e.g. a permission).

An example of the application of a condition precedent would be a Supervisory Review and Evaluation Process (SREP) decision making a reduction of the Pillar 2 requirement[25] subject to the implementation of certain measures by the credit institution (e.g. the reduction of the non-performing loan ratio to a specified level). Another example would be a decision authorising the acquisition of a qualifying holding subject to the condition precedent that the acquirer carries out a capital increase prior to the acquisition in order to ensure its financial soundness. An example of an obligation could be the obligation to participate in specified training courses in a fit and proper decision.

[21] Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (OJ L 248, 29.4.2015, p. 9).

[22] Case C-18/14, CO Sociedad de Gestion y Participación and others, ECLI:EU:C:2015:419.

[23] Schwarze, J., *European Administrative Law*, revised 1st edition, 2006, pages 853 et seq.; Craig, P., *EU Administrative Law*, 2nd edition, 2012, pages 590 et seq.

[24] Other terms that are used for these instruments are conditions (in a broader sense) or supporting requirements.

[25] That is, the capital add-on based on Article 16(2)(a) of the SSM Regulation.

Conditions may be inserted into a non-discretionary ECB supervisory decision only with a view to ensuring that the prerequisites under which the decision has to be adopted are fulfilled. So, for example, a condition precedent in a qualifying holdings decision may only require the completion of such measures which are necessary to ensure that the application can be approved, as the applicant may demand approval if the requirements are fulfilled.

Obligations as ancillary and/or supporting requirements may be added to a decision in order to ensure that the prerequisites for this decision are fulfilled or on another legal basis. So, in particular, information obligations can be added to other decisions subject to limits set by the proportionality principle, e.g. the obligation to provide information about the repurchase of instruments in the case of a permission to repurchase own funds instruments (Articles 77 and 78 of the CRR). Non-compliance may be subject to administrative penalties.

Another question arising frequently in connection with transactions that provide for universal succession under national corporate law (in particular mergers) is whether such universal succession extends to supervisory approvals, permissions and authorisations (hereinafter "approvals").

So, for example, the question arises whether a new company (NewCo) that is created by merging two credit institutions holds the banking licences of the (two) merged entities. Another example is the question whether a credit institution A – into which credit institution B is merged – becomes by way of universal succession the holder of the Internal Ratings Based Approach (IRBA) approvals of B. This is for example of particular relevance if B held permissions for exposure classes, rating systems and internal model approaches (see Article 143(2) CRR) for which A holds no such approvals. If one follows a strict reading, A could not use the IRBA for such exposures unless either the permissions are transferred to it by way of universal succession or it receives a new permission.

With regard to legal succession, there are two distinct questions: (i) can an approval be transferred (transferability), and (ii) does a legal provision allow for the transfer of the approval. While the latter question is out of the scope of administrative procedural rules it might be possible to determine, on the basis of an analysis of the material law, the criteria that have to be assessed when determining whether a permission can be transferred by way of universal succession. The CRR and CRD IV do not contain any specific rules on the transferability or the transfer of approvals.[26] The Court of Justice generally accepts transfer of permissions in universal successions, but the case-law is limited to specific asset-related permissions like a trademark.[27] However, this case-law cannot be applied one-to-one to all types of administrative permissions.

[26] The following focuses on transferability as rules on transfer by universal succession are provided for in national corporate law.

[27] Joined Cases T-67/00, T-68/00, T-71/00 and T-78/00, *JFE Engineering Group*, ECLI:EU:T:2004:221, para. 46 with reference to Case 92/82, *Gutmann* v *Commission*, ECLI:EU:C:1983:286, para. 2 and Case 294/83, *Les Verts* v *Parliament*, ECLI:EU:C:1986:166, paras. 13-18.

A number of administrative law systems of the Member States follow the approach that a transfer of approvals by universal succession is generally possible, but only if the permission is “asset-related”. This means that an approval is transferable if the permission is attached to a certain asset or contractual relationship and its substance is not affected by the identity of the addressee. On the other hand, if the permission was at least partly granted because of criteria which are related to personal characteristics of the parties involved, a transfer is not possible.

This approach should also be applied with regard to CRR (and CRD IV) approvals. Accordingly, approvals relating to, for example, the IRBA would not be transferable as such approvals require also compliance with requirements relating to the person applying the IRBA (Articles 189 et seq. CRR). This should in the above example not require A to apply the standardised approach; rather the competent supervisor may for a transitional period accept the application without approval if at least a plan to ensure future compliance (compare Article 146 CRR) and an application to this end exist. Nevertheless, it would be helpful if the legislator would provide the supervisor with powers to adopt measures to deal with such transitional situations.

For the authorisation as a credit institution, the ECB seems to reject universal succession, as such a succession – by which a new legal entity “inherits” an existing banking licence – is seen to be in conflict with Articles 14, 33(5) of the SSM Regulation. These articles provide for every authorisation as a credit institution being an ECB authorisation and the ECB is the only competent authority to decide upon such authorisation.

6 Conclusion

The SSM Regulation and in particular the ECB’s SSM Framework Regulation partially codify general provisions of administrative procedural law for banking supervision.

Like all codifications, the SSM Framework Regulation raises issues of interpretation. These need to be clarified with a view to ensuring the effectiveness of the single supervisor but also in light of the higher ranking law.

In order to enhance legal certainty further areas could be codified if the SSM Framework Regulation is amended in the future.

Primary law requirements for administrative procedures in the case-law of the Court of Justice

By Karl-Philipp Wojcik[1]

As many in this audience know from their own experience, the day-to-day supervision of credit institutions is a laborious business, where the banking supervisor takes numerous administrative decisions, some of them of major importance for the bank involved. I am thinking about (i) granting authorisations, (ii) withdrawals of licences and (iii) determining which banks are significant, etc.

When taking such administrative decisions which have an impact on the legal situation of the addressee, the banking supervisor is obviously bound by the law and needs to respect a set of general and specific legal requirements.

Since the adoption and entry into force of the SSM Regulation,[2] the ECB has been directly supervising significant credit institutions.[3] Within the scope of the specific supervisory tasks conferred on it by the SSM Regulation, the ECB, as a European Union institution, is therefore directly exercising administrative powers vis-à-vis credit institutions. Since in most cases Union law is executed not by the institutions themselves, but by Member States and their authorities vis-à-vis individuals and legal persons, direct supervision by the ECB provides an example of an exception, i.e. the direct execution and enforcement of Union law vis-à-vis individuals and legal persons by the European Union.[4]

Against this background, this contribution aims to set out the main Union law requirements for administrative procedures in the case of direct administration by the Union, focusing specifically on the situation of the ECB.[5]

This requires, in a first phase, a brief overview of the sources of Union administrative law for direct administration.

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[1] The author is a Member of the European Commission's Legal Service. The views expressed in this contribution, which slightly adapt and update the author's oral intervention at the conference, are solely those of the author. They do not bind the European Commission.

[2] Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p.63). The ECB assumed its supervisory tasks on 4 November 2014.

[3] The ECB also carries out indirect supervision vis-à-vis less significant institutions with regard to the tasks mentioned in Article 4(1)(a), (c) and (h) of the SSM Regulation.

[4] On the distinction between direct and indirect execution of Union law see, for instance, von Danwitz (2008), p. 312 ff. and Ziller (2007), p. 235, 241 ff.

[5] This contribution does not discuss the Union administrative law requirements incumbent on Member States when they implement Union law.

1 Sources of Union administrative law

As a first observation: there is no general code or European Law of Administrative Procedure. Instead, the sources of Union administrative law from which procedural requirements result are – to quote Paul Craig – "eclectic".[6] Or, to put it in a more critical way by using the words of the European Parliament, administrative law requirements in the Union are "scattered across a wide variety of sources".[7] Hence, anybody trying to determine what the administrative law requirements applicable to a specific procedure are will need to examine a variety of legal sources.[8]

1.1 Primary law

Obviously, **primary law** is a major legal source of administrative law requirements. The Treaties contain a number of provisions which stipulate such requirements.

Maybe the most fundamental principle can be found in **Article 2 of the Treaty on European Union** according to which the Union and accordingly its administration are based on the "rule of law".

The Charter of Fundamental Rights in its Article 41 provides that the **right to good administration** is a fundamental right. In addition, Article 41 of the Charter grants every person the right to have their affairs handled impartially, fairly and within a reasonable time. This right includes every person's right to be heard, their right to have access to their file and the obligation of the administration to give reasons for its decisions. The same article also guarantees the right of every person to have the Union make good any damage caused by its institutions or by its servants in the performance of their duties, in accordance with the general principles common to the laws of the Member States. It also sets out every person's right to write to the institutions of the Union in one of the languages of the Treaties and to have an answer in the same language.

Article 41 of the Charter is complemented by Article 298(1) of the Treaty on the Functioning of the European Union which requires EU authorities to be supported by an "open, efficient and independent European administration".

In addition to these rather high level principles, the Treaty contains some more detailed requirements of a general nature and applicable across sectors. For instance, Article 296 TFEU establishes the duty to give reasons when adopting legal

6 Craig, P. (2012), p. 246.

7 European Parliament resolution of 15 January 2013 with recommendations to the Commission on a Law of Administrative Procedure of the European Union (2012/2024(INL), available at www.europarl.europa.eu

8 For an overview of the argument in favour and against codifying Union administrative law, see for instance, Guckelberger and Geber (2013), p. 105 ff. The European Parliament in its resolution of 9 June 2016 for an open, efficient and independent European Union administration (2016/2610(RSP), recalled its previous resolution calling for a "Union administrative law code" and invited the European Commission to come up with a legislative proposal in that sense: http://www.europarl.europa.eu

acts, while Article 297 TFEU sets out conditions for the authentication and publication of legal acts as precondition of their entry into force.

1.2 Secondary law

More detailed and mainly sector-specific administrative law requirements can be found in some pieces of **secondary legislation**, for instance in regulations in the area of competition law,[9] or in the field of State aid law.[10]

Specifically in the context of European banking supervision, rules of a secondary nature on requirements of administrative procedure can be found in the **SSM Regulation** which in its Article 22 sets out rules on "Due process for adopting supervisory decisions" and in the **SSM Framework Regulation**.[11] The latter includes very detailed rules for the adoption of administrative decisions by the ECB within the SSM.[12]

1.3 Self-binding instruments and soft law

In some cases, individual Union institutions have drawn up unilateral commitments as regards good administrative behaviour. The European Commission, for instance, has annexed a "Code of Good Administrative Behaviour for Staff of the European Commission in their Relations with the Public" to its Rules of Procedure.[13]

Furthermore, the European Ombudsman publishes and regularly updates the "European Code of Good Administrative Behaviour".[14]

None of these instruments have a binding effect on all Union institutions or on the public. However, the Commission's Code is binding on itself, while the European Ombudsman's "European Code of Good Administrative Behaviour" provides guidance and inspiration and exercises a huge influence on the administrative practices of Union institutions and other bodies.

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9 Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (OJ L 1, 4.01.2003, p.1).

10 Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (OJ L 248, 24.9.2015, p. 9).

11 Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (ECB/2014/17) (OJ L 141, 14.5.2014, p.1).

12 With regard to the contribution of Klaus Lackhoff at the conference and in this publication, I will not enter into a discussion on the detailed requirements stemming from the SSM Regulation and the SSM Framework Regulation.

13 Rules of Procedure of the Commission (C(2000) 3614) (OJ L 308, 8.12.2000, p.26).

14 The European Code of Good Administrative Behaviour.

1.4 General principles of Union law

Finally, administrative law requirements stem from the case-law of the European Court of Justice (the "Court").

Since its creation and faced with an incomplete, almost embryonic European administrative law, the Court has developed **"general principles of law"** which fill in the lacunae. True, these general principles are laid down in judgments, not in a code. They nevertheless take the rank of primary law[15] and, together with the abovementioned sources of law, form a complete set of rules of Union administrative law. That also means that any provision of secondary law needs to be interpreted in the light of and in conformity with these general principles of law.[16] In that sense, the Court's role in the area of Union administrative law is not only important when "detecting" "general principles of primary law", but also when it comes to the interpretation of these principles and/or relevant secondary law provisions.

2 Rights of "due process"

Based on this overview of the various sources of Union administrative law, one can distinguish – in very broad terms – two groups of requirements: those which are generally applicable to any administrative action and those which are applicable to specific procedures.

Among the generally applicable requirements stemming from Union primary law are the following: the principle of lawfulness, the principle of legal certainty, the principle of proportionality, the principle of consistency and legitimate expectations, the principle of non-discrimination and equal treatment and the principles of fairness and transparency.

Requirements specifically applicable to procedures leading to the adoption of administrative decisions are the respect of the right to be heard, the right to have access to one's file and the duty to state reasons.

Because of its relevance for the work of the SSM, I would like to focus on the last three requirements which form the concept of "due process". The first two of them are often called – drawing on the French expression of *droits de la défense*[17] – "the rights of the defence".[18]

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[15] von Danwitz (2008), p. 169.

[16] Case T-260/94, *Air Inter*, ECLI:EU:T:1994:265, para. 60.

[17] Schwarze, J. (2006), p. 1243.

[18] See, for instance Case C-394/15 P, *Dalli* v *Commission*, ECLI:EU:C:2016:262, para. 40.

2.1 The right to be heard

We know from the Bible that – and here I cite from the judgment in a famous English case from 1723 – :

Even God himself did not pass sentence upon Adam before he was called upon to make his defence.[19]

In the Union, it was in 1974 that the Court in *Transocean Marine Paint Association* acknowledged that the right to be heard was a general principle of law.[20]

As to its content, the case-law of the Court requires that whenever the Union administration takes a measure which has an adverse effect on the rights or interests of a person, this person must have the opportunity to express their views in writing or orally. There is a tendency to understand the scope of this right broadly: it may also extend to third parties who would not be the direct addressees of the intended measures.[21]

It is obvious that to properly exercise the right to be heard the person concerned needs to be sufficiently informed about the allegations made against him.[22] Or to put it differently: "If someone has a right to be heard, he must be entitled to know what he needs to be heard about."[23]

On that basis the case-law obliges the Union administration to provide the person concerned with an "exact and complete statement of the objections" which the administration intends to raise against them.[24] This does not mean that every single detail needs to be included in the statement of objections. It should be sufficient to communicate the main and material elements of the objections, so that the person concerned can effectively make their views known on all allegations.

As to the timing, the statement of objections and the hearing need to take place in principle during the course of the administrative procedure and hence before the administrative decision is adopted.[25]

However, the right to be heard is not unlimited. Accordingly, the case-law accepts that in exceptional circumstances no hearing takes place. Such exceptions are accepted where, for example, it is **impossible** to grant the right to be heard, because the person concerned cannot be reached or frustrates attempts to be

[19] Cited according to Schwarze (2006), p. 1244.

[20] Case C-17/74, *Transocean Marine Paint Association*, ECLI:EU:C:1974:106, para. 15.

[21] See, inter alia, Case C-135/92, *Fiskano* v *Commission*, ECLI:EU:C:1994:267, para. 39; Joined cases C-48/90 and C-66/90, *Netherlands and Others* v *Commission*, ECLI:EU:C:1992:63, para. 44; Case C-32/95 P, *Lisrestal*, ECLI:EU:C:1996:402, para 21; and Case T-260/94, *Air Inter*, ECLI:EU:T:1994:265, para. 63.

[22] Schwarze, J. (2006), page 1338.

[23] Quoted from the Conclusions of Advocate General Warner, Case 34/77, *Oslizlok*, ECLI:EU:C:1978:101, para. 1125.

[24] Joined cases C-48/90 and C-66/90, *Netherlands and Others* v *Commission*, para. 45.

[25] Case C-458/98 P, *Industrie des poudres sphériques*, ECLI:EU:C:2000:531, para. 99 ("during the administrative procedure").

reached.[26] More importantly, exceptions are accepted where the prior hearing would **defeat the purpose of the decision** or where there is such an **emergency** that measures have to be adopted in order to remove some imminent danger.[27]

2.2 Access to the file

Through access to their file a person will be in a better position to bring counterarguments against an intended administrative measure or when asking the Court for judicial review of such a measure.[28] The case-law has recognised that access to the file is one of the corollary procedural guarantees intended to protect the right to be heard. [29]

Today, the right to access one's file is in addition explicitly enshrined in Article 41 of the Charter. As such it needs to be distinguished from the right of the general public to have access to documents, as enshrined in Article 15 TFEU and Regulation (EC) No 1049/2001.[30] A concerned person may use both routes in parallel to achieve their goals.[31]

In essence, any person who could profit from the right to be heard can request to have access to the file of the administrative proceedings. The administrative authority is then obliged to make available all the documents relied on when making the decision. The authority may not exclude documents from the file which it considers not relevant or detrimental.[32]

Like the right to be heard, the right to access one's file is not without limits: the right to access does not extend to confidential information and to business secrets.

2.3 Duty to state reasons

In contrast to the right to be heard and the right to access one's file, the duty to state reasons is laid down in Article 296 TFEU. The objectives of this requirement are threefold.

- It makes transparent the grounds why a measure has been adopted and gives the affected person the possibility to consider a legal remedy.
- It is instrumental in enhancing administrative self-regulation.

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[26] Joined cases 36/81, 37/81 and 218/81, *Seton*, ECLI:EU:C:1983:152: para. 17.

[27] Case 136/79, *National Panasonic*, ECLI:EU:C:1980:169, para. 21 and joined cases C-402/05 P and C-415/05 P, *Kadi*, ECLI:EU:C:2008:461, para. 338 ff.

[28] Craig (2012), p. 326.

[29] Case T-42/96, *Eyckeler*, ECLI:EU:T:1998:40, para. 78 ff.

[30] Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001 regarding public access to European Parliament, Council and Commission documents (OJ L 145, 31.5.2001, p.43).

[31] Case C-139/07 P, *Technische Glaswerke Ilmenau*, ECLI:EU:C:2010:376, para. 59.

[32] Case T-42/96, *Eyckeler*, ECLI:EU:T:1998:40, para. 81.

- It enables the judiciary to exercise its powers of review.

It is against the background of this rationale that the Court has spelled out the content of the duty to state reasons. It is therefore settled case-law that:

the statement of reasons required by Article 190 of the Treaty [now Article 296 TFEU] *must be appropriate to the act at issue and must disclose in a clear and unequivocal fashion the reasoning followed by the institution which adopted the measure in question in such a way as to enable the persons concerned to ascertain the reasons for the measure and to enable the competent Community court to exercise its power of review. The requirements to be satisfied by the statement of reasons depend on the circumstances of each case, in particular the content of the measure in question, the nature of the reasons given and the interest which the addressees of the measure, or other parties to whom it is of direct and individual concern, may have in obtaining explanations. It is not necessary for the reasoning to go into all the relevant facts and points of law, since the question whether the statement of reasons meets the requirements of Article 190 of the Treaty must be assessed with regard not only to its wording but also to its context and to all the legal rules governing the matter in question.*[33]

Aspects which could influence the intensity of the duty to state reasons are, for instance, whether a measure adversely affects the rights and interests of a person,[34] whether the administration exercises discretion[35] or how closely the addressee has already been involved in the procedure leading to the adoption of the decision.[36]

While the assessment whether the administration has complied with its duty to state reasons is obviously to be made on a case-by-case basis, the Treaty does not exempt any sector of Union direct administration from the scope of this obligation. Therefore, the area of banking supervision, just as other areas such as antitrust or State aid law, does not enjoy any exception to this fundamental right of “due process”.

3 Legal consequences of procedural defects

Finally, it is necessary to briefly touch upon the practically relevant issue of the legal consequences of procedural defects.

Under the conditions set out in Article 263 TFEU, any legal or natural person may ask the European Court of Justice in Luxembourg to annul the administrative decision of a Union administrative body.

With regard to infringements of the rights of the defence stemming from primary law, it is settled case-law, however, that such an infringement does not, ipso facto, make

[33] Case C-367/95 P, *Sytraval*, ECLI:EU:C:1998:154, para. 63.

[34] Case C-400/99, *Italy* v *Commission*, ECLI:EU:C:2005:275, para. 22.

[35] Case C-269/90, *Technische Universität München*, ECLI:EU:C:1991:438, para. 14, 27.

[36] Case C-42/01, *Portugal* v *Commission*, ECLI:EU:C:2004:379, para. 69.

the administrative decision invalid. Instead, the Court takes a more nuanced approach, quite in line with the legal traditions at national level. An infringement of the rights of the defence, in particular the right to be heard, results in the annulment of a decision taken at the end of a procedure only if the outcome of the procedure might have been different without the infringement.[37]

That case-law is not a waiver for the administration enabling it to neglect the rights of defence. It rather means that the Court will carry out a case-by-case analysis of each infringement found.

The absence of reasons or the inadequacy of the reasons stated is qualified as an infringement of essential procedural requirements within the meaning of Article 263(2) TFEU. Involving a matter of public policy, the Union judge must raise it of its own motion.[38] An infringement of the duty to state reasons will in principle lead to the annulment of the vitiated act.[39]

4 Conclusion

Legal requirements for Union administrative procedures are derived from a wide variety of legal sources. Where these requirements stem from primary law, they mostly do not take the form of written primary law, but are laid down in general principles of law as developed by the case-law of the Court. In any administrative procedure, the administration needs to ensure a "due process", respecting the right to be heard, the right to have access to one's file and the duty to state reasons.

This contribution started by saying that the day-to-day supervision of banks is a laborious business, where the authority takes numerous important administrative decisions. Their tasks and efforts merit admiration since it is a huge challenge to comply with all these requirements for taking Union administrative decisions, not even considering that the supervisor also needs to correctly apply the substantive rules of banking supervision.

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[37] Case C-394/15 P, *Dalli* v *Commission*, ECLI:EU:C:2016:262, paras. 40, 41.

[38] Case C-166/95 P, *Commission* v *Daffix*, ECLI:EU:C:1997:73, para. 24.

[39] Lenaerts, Maselis and Gutman (2014), para. 7.158.

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Managing administrative complexity in resolution: the recent experience in Italy and its lessons from a European Union perspective

By Monica Marcucci[1]

1 Introduction

In the regulatory landscape that has emerged in response to the financial crisis the areas of direct administrative and regulatory actions by the Union institutions have multiplied and grown in significance. This has led to a remarkable increase in the scale and extent of the direct impact of the Union decision-making on private citizens and enterprises. Such increase calls for a reflection on the procedural rights and safeguards of private parties in the light of the fundamental principles of Union administrative law in the new framework. The question that concerns us here is the place that the principles of due process, legal certainty and good administration occupy in the complex Union-national model that is the Banking Union.

Resolution, the second pillar of the Banking Union, is a revealing example of how Union administrative structures are being reshaped towards a more co-operative and multi-layered model in which individual rights may be significantly affected by the joint action of both national and Union authorities.

This article will discuss – from the perspective of Union administrative law and related safeguards – the challenges posed by the management of bank crises within the new Union resolution framework. It will also focus on lessons to be drawn from the recent resolution of a number of banks in Italy.

2 Complexity in resolution. The need to take painful decisions under time-pressure

In a resolution scenario a complex legal framework meets a complex factual situation – an emergency – involving a failing bank. The emergency arises from the fact that at the first sign of trouble the charter value of a bank can plummet if its reputation cannot be promptly restored.

When a crisis situation occurs, a resolution authority must work like a team of emergency room doctors: immediate first aid is to be administered following an initial

[1] Senior Lawyer, Legal Department, Banca d'Italia.

diagnostic, in order to stabilize the patient. A plan to restore the ailing patient to full health is then devised. Finally, the plan is put into action. A similar process occurs when the patient at risk is a bank and urgent action, followed by a long term plan, is needed to preserve its vital functions and prevent systemic risk.[2]

An additional feature the two situations share is that in both crisis scenarios it is often necessary to take difficult decisions under intense time constraints. In both cases the sense of urgency often results in the non-observance of certain procedural obligations that would normally apply, such as informing the patient or his relatives (the entity or its stakeholders in the case of a bank) or obtaining the patient's (or the entity's) consent before treatment.

Before considering the scope for procedural rights and safeguards in the intricate institutional architecture governing bank resolution, it is worth stressing that at least one important lesson can be drawn from our emergency room analogy, namely that urgency and life-threatening scenarios can justify significant departures from fundamental rights norms.

3 The Union resolution framework

The various stages in the response from authorities, just like that of emergency doctors to a crisis scenario are perfectly reflected in the newly established resolution regime, which has vested resolution authorities of Member States with a set of emergency tools, the resolution tools, to be used (often in the space of a matter of days) to keep the bank alive and functioning.

The Union legal framework for resolution is made up of two components: the "Bank Recovery and Resolution Directive (BRRD)",[3] which applies throughout the Union to all Member States, and the "Single Resolution Mechanism Regulation (SRMR)"[4] which only applies in the euro area, i.e. within the Banking Union.

The two instruments, in line with the international regulatory response to the crisis,[5] offer a new model for the rapid and seamless management of bank crises. It is a model in which administrative authorities are vested with a set of powerful emergency tools to be used in a way that limits the use of taxpayers' money, requires shareholders and creditors to share the costs of the crisis ("burden sharing"), and protects depositors' rights.

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[2] Dewatripont, Nguyen, Praet, Sapir (2010).

[3] Directive 2014/59/UE of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC (OJ L 173, 12.6.2014, p. 190).

[4] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

[5] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011).

Under the BRRD framework, the resolution tools and mechanisms operate at national level, as the legal provisions transposing the BRRD are to be applied by national authorities, designated to act as Resolution Authorities. The BRRD regime can therefore be described as a decentralised model, where the relevant administrative acts and decisions are essentially under the responsibility of the national authority and are governed by the relevant national procedural rules.

In the euro area the decentralised model of the BRRD has been replaced by the SRM (fully operative since January 1st 2016), whereby important resolution powers have been centralised and are exercised by a Union Agency, the Single Resolution Board (SRB), whose final decisions to take resolution action in respect of an entity must be endorsed by a Union institution (the Commission and, in specific cases, the Council). In addition, National Resolution Authorities (NRAs) retain a role in the process as they are responsible for the resolution of less significant entities and for the execution of the SRB's decision.

To sum up, the architecture of the SRM combines a centralised model, where important powers are exercised at the Union level, with a decentralised execution of decisions, carried out by the NRAs. The legal framework includes another element of interference between national and Union jurisdictions, as the SRB not only has to apply Union law, but, is also confronted with national law, in particular the provisions implementing the BRRD.[6]

The complexity of the institutional framework under the two regimes is intensified by the coexistence and combination of multiple sources of Union law that supplement the resolution framework and are an important part of it.

First, the SSM Regulation enters the picture.[7] Supervision and resolution are closely connected, with resolution coming into play when supervision action has failed to successfully restore a troubled entity to health and the supervision authority, having determined that the entity is failing or likely to fail, decides to involve the Resolution Authority.[8] The supervisory powers of the ECB and the relevant provisions of the SSM Regulation also come into play in the course of a resolution action, whenever the chosen strategy includes the establishment of a bridge bank, which needs to be licenced as a bank, and during the liquidation of the residual entity, whose authorisation will have to be withdrawn.

Second, resolution rules and measures have to operate within the Union State-aid framework whenever the resolution scheme requires the use of public resources, including the use of the resolution fund.

In addition to the relevant Treaty provisions on state aid, state aid to the banking sectors is also subject to the crisis communications published by the Commission

6 Zavvos, Kaltsouni (2014).

7 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L287, 29.10.2013, p. 63).

8 As highlighted by Wymeersh (2015), the resolution decision "*is the moment where prudential action has reached its limits and only the final demise of the bank can offer a solution*".

since the beginning of the financial crisis in 2008, which lay down principles and rules for assessing the compatibility of public aid in support of banks.[9] These communications, although they are only soft law instruments – whose provisions essentially bind only the Commission and not the Member States[10] – play a fundamental role in so far as they influence the operation of the resolution tools and the feasibility of the scheme conceived by the resolution authority.[11] Furthermore, they can have (as I discuss below in Section 7) a direct impact on the rights of the parties that are affected by resolution.

The Resolution Framework also contains lesser rules such as the Regulatory Technical Standard (RTS) drafted by the European Banking Authority (EBA) which only become legally binding once they have been endorsed by the Commission. The BRRD empowers the EBA to draft RTSs to specify various technical aspects relevant for the application of the BRRD provisions. An important set of those standards concerns the valuation under Article 36 of the BRRD, with reference to which the EBA has developed criteria specifying:

(a) the methodology for assessing the value of the assets and liabilities of the failing institution;

(b) the separation of the valuations required by Articles 36 and 74;

(c) the methodology for calculating and including a buffer for additional losses in the provisional valuation.

Finally, another source of soft law in this area is to be found in the Guidelines that the EBA is empowered to issue under the BRRD to regulate various aspects of resolution (to promote, for example, a uniform interpretation of the different circumstances in which an entity is to be considered to be failing or likely to fail; regarding the determination of when the liquidation of the assets or liabilities under normal insolvency proceedings could have an adverse effect on one or more financial markets; on the setting of conversion rates for the purposes of bail-in). These regulatory measures, guidelines and recommendations are not binding on national authorities. However, in accordance with Article 16(3) of the founding

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[9] These communications number seven in total. The first six communications, issued between 2008 and 2010 (the Banking communication, the Recapitalization communication, the Impaired assets communication, the Restructuring communication and the Prolongation communication),were followed in 2013 by a Commission communication replacing the Commission's first 2008 crisis communication and amending some of the Commission's subsequent communications. The 2013 Communication, in specifying the ways in which a capital shortfall is to be addressed, has consolidated and expanded the so called 'burden sharing principle' which requires banks losses to be first absorbed by equity, hybrid capital and subordinated debt holders in order to reduce the capital shortfall as far as possible.

[10] C-526/14, *Kotnik and others against Drzavni zbor Republike Slovenije*. EU:C:2016:570, para. 43.

[11] It is worth noting that "Union State aid framework' is defined in Article 2(1)(53) of the BRRD as "the framework established by Articles 107, 108 and 109 TFEU and regulations and all Union acts, including guidelines, communications and notices, made or adopted pursuant to Article 108(4) or Article 109 TFEU".

Regulation of the EBA[12] the competent authorities are obliged to “make every effort to comply with those guidelines and recommendations”.[13]

This complex set of provisions, with their differing legal status and enforceability makes the job of administrative authorities very difficult as they have to factor a myriad of legal variables into their decisions. In the centralised model of the SRM this already complex architecture is further complicated by the interaction of various jurisdictional levels within the same proceeding: the Union level, where powers are centralised in the hands of Union bodies, and the national level, as NRAs still retain important powers[14]. However, administrative challenges and procedural difficulties may also emerge in the decentralised system of the BRRD, where coordination among various authorities both at national and Union level and interaction between various elements of the national and Union regulatory framework raise delicate issues, namely in terms of transparency, the protection of individual rights and of the possibility for effective judicial review.

4 Administrative safeguards and procedural rights in the BRRD

As one of the defining features of the BRRD resides in granting NRAs extensive powers with potentially far-reaching effects on the property rights of shareholders and creditors, a main concern of the Directive is to provide that the exercise of these powers respects the fundamental principles of the Charter on Human Rights. To this aim, a number of safeguards are laid down to make sure that resolution measures are taken only in situations where it is necessary to pursue the objective of financial stability in the general interest;[15] to guarantee that interference with property rights should not be disproportionate (affected shareholders and creditors should not incur greater losses than those which they would have incurred if the institution had been wound up at the time that the resolution decision is taken (the principle of ‘no creditor worse off’);[16] that no creditor/shareholder should be unduly discriminated;[17] that appropriate (prudent, fair and realistic) valuation of the assets and liabilities of the entity be carried out before any resolution action is taken.[18]

These are substantive safeguards, not specifically related to procedural rights, as they mostly aim at ensuring the compatibility of the BRRD with the constitutional protection of property rights.

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12 Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p.12).

13 On the EBA regulatory tools see Cappiello (2015).

14 See Section 5.

15 See Recital 49 of the BRRD.

16 See Recital 34(1)(g) of the BRRD.

17 See Recital 34(1)(f) of the BRRD.

18 See Article 36(1) of the BRRD.

Conversely, as regards procedural rights and safeguards, it is worth noting that despite the material adverse effects that a resolution decision may have on individual rights, the BRRD contains a surprisingly limited number of provisions of that type. The main set of procedural safeguards can be found in Chapter VIII on "Procedural obligations", where rules are laid down to ensure that resolution actions are properly notified and, subject to certain exceptions, made public. In particular, these rules specify:

(a) the minimum content of the resolution decision. Article 82(2) provides that the reasons for resolution decisions should be specified, including the determination that the institution meets or does not meet the conditions for resolution. This is an expression of the wider rule that Decisions should be motivated, associated with the Right to good administration enshrined in Article 41 of the Charter on Human Rights;

(b) the communication and publicity requirements which the decision has to comply with. In particular, Article 83 requires that the resolution authorities, as soon as reasonably practicable after taking a resolution action, shall notify their decision to the affected institution and to various interested authorities including the relevant competent authority, the central bank, the DGS to which the institution is affiliated, the competent Ministry, the Commission, the ECB, the ESMA, the EIOPA and the EBA;

(c) the publicity regime, according to which the resolution authority shall publish or ensure the publication of a copy of the resolution order, or a notice summarising the effects (in particular, on retail customers) of the resolution action. These are to be published on: (a) its official website; (b) the website of the competent authority, if different from the resolution authority; (c) the website of EBA; (d) the website of the institution under resolution.[19]

These provisions are the only concession to transparency found in the Directive and they all apply to the final resolution decision, i.e. to the culmination of an intricate and often multi-phase process. The rest of the provisions on procedural requirements are aimed at the preservation of confidentiality, to the detriment also sometimes of those private parties who may ultimately suffer a substantive deprivation of their rights.

This is spelled out in Article 84, which sets out a rigorous confidentiality regime that is binding not only on public authorities and their bodies and employees, but also on any person that may be or may have been involved in various roles and positions in the resolution process. The reasons for this approach are set out in Recital 86 of the BRRD, which underlines the sensitivity of information obtained by resolution authorities and their professional advisers in the course of the resolution process and the necessity to keep it strictly confidential before the resolution decision is made public: *"… Any information provided in respect of a decision before it is taken, be it on whether the conditions for resolution are satisfied, on the use of a specific tool or*

[19] Article 83(4).

of any action during the proceedings, must be presumed to have effects on the public and private interests concerned by the action. However, information that the resolution authority is examining a specific institution could be enough for there to be negative effects on that institution".

In summary, information concerning a troubled bank is deemed to be so sensitive that no disclosure is allowed, not only in the course of the implementation of a resolution strategy, but also before any decision on the possible resolution of a bank is taken or even contemplated.

Article 84 specifies the scope of application of the professional secrecy requirement, providing that the prohibition from disclosure applies to any confidential information received in connection with the exercise of resolution functions or in the performance of professional activities related to resolution. The prohibition, however, does not prevent resolution authorities from sharing information with competent authorities and with other Union resolution or competent authorities and with other Union authorities and bodies listed in Article 84(4). In addition, pursuant to the same provision the exchange of information with any other person may be authorised by Member States under strict confidentiality requirements where necessary for planning or executing a resolution action. Apart from these exceptions no other disclosure is sanctioned and any infringement will give rise to civil liability, in accordance with national law. Furthermore, the Directive does not specify the duration of the prohibition, but – based on established Union principles on the access to documents, we may conclude that it is to apply as long as secrecy appears justified having regard to the content of the document. Such a valuation will presumably be made on the basis of "*the possible effects of disclosing information on the public interest …, on the commercial interests of natural and legal persons, on the purpose of inspections, on investigations and on audits."*[20]

Finally, in line with keeping the confidentiality regime on information collected in the exercise of supervision, secrecy is also to apply to healthy banks with respect to information on their capacity to react to hypothetical crisis scenarios. The confidentiality regime applies indeed to any information received by competent and resolution authorities in connection with their functions under the BRRD and therefore extends, *inter alia*, to the content and details of recovery and resolution plans as referred to in the relevant provisions of the Directive.

If information rights of interested parties are restricted in a resolution scenario, due to the confidentiality needs of a resolution action, their rights cannot be affected without granting them the ex post safeguard of appropriate judicial remedies against possible unlawful decisions. Article 47of the Charter of Fundamental Rights establishes the right to refer to an impartial and independent tribunal and the right to effective remedy in case of violation of civil rights (which include property rights).

[20] See Article 84(3).

This principle is explicitly referred to in Recital (88) of the BRRD and is reflected in Article 85 (2), according to which the decisions taken by the resolution authorities should be subject to a right of appeal.

However, the Union legislator is also aware that judicial disputes can inhibit the effectiveness of resolution by delaying the process, creating uncertainty as to the validity of resolution measures and potentially affecting the rights of third party acquirers of assets or shares. Consequently, the BRRD makes sure that resolution is not postponed by judicial proceedings. Indeed, very limited room is left for automatic suspension, as it is presumed to be contrary to public interest (Article 85(4)(a)); and the only remedy granted to affected parties is compensation for damages (i.e. it is not possible to reverse resolution actions taken).[21] In addition, national courts seem to be deprived of the capacity to avail of technical assessments by judicial experts. In accordance with Article 85(3) any review of the resolution decision has to be based on the factual elements as assessed by the independent valuer and the resolution authority concerned. This restriction is justified by the fact that there is no need to second guess the assessment on the situation of the resolved bank as carried out by the independent valuer pursuant to Article 36 BRRD. The requirement that a valuer appointed by the RA be independent should ensure a level of impartiality equal to that which would be achieved by the appointment of a judicial expert. In any case, the provision reflects the highly technical nature of the issues involved in the exercise of administrative discretion in resolution cases that prevents determinations on such issues being reviewed by a court.

5 The Single Resolution Mechanism - preliminary remarks

From January 2016 the Resolution powers in the Banking Union are centralised in the hands of the Single Resolution Board.[22] The institutional architecture created by the SRM Regulation is much more complex than the one resulting from the BRRD framework, due to the possible concurrent involvement of an even larger number of Union and national players in the decision-making process (the Board, the NRAs, the Commission,[23] the Council, the ECB, the ESM). Furthermore, multi-jurisdictional coordination among Union and national players can take place in various stages of a resolution process, including prior to its opening and even in cases concerning less significant institutions. In particular, in the pre-resolution phase of a bank falling under the responsibility of the SRB, national resolution authorities might cooperate with the SRB in the elaboration of the resolution strategy for the failing entity.[24] The

[21] This restriction applies "*where it is necessary to protect the interests of third parties acting in good faith who have acquired shares, other instruments of ownership, assets, rights or liabilities of an institution under resolution*" (Article 85(4)).

[22] The SRB is directly responsible for the resolution of the banking union's cross-border and large banks, which are supervised directly by the European Central Bank; it is responsible for all resolution cases (irrespective of the size of the bank), if resolution requires recourse to the Single Resolution Fund.

[23] The Commission will be playing a dual role both as a concurrent resolution authority – under specified circumstances – and as the state-aid authority.

[24] In this respect, see Article 13.3 SRM, pursuant to which the SRB has "the power to require the relevant resolution authority to draft a preliminary resolution scheme for the institution or group concerned".

SRB, in turn, can still have a significant say on a crisis affecting a less significant institution, as it is entitled to express its views on draft decisions prepared by national resolution authorities and "indicate the elements of the draft decision that do not comply with this Regulation or with the Board's general instructions".[25]

Finally, as already remarked, the interference between the provisions of the SRM Regulation with the national provisions implementing the BRRD further complicates the picture.[26] However, as to procedural rights and safeguards, the SRM Regulation has not introduced substantial innovations to the general framework resulting from the Directive. Indeed, the same procedural obligations and safeguards established in the BRRD apply – by means of the relevant national transposition laws – to the resolution actions carried out by the Board, when it performs tasks that would be performed by the national resolution authority under the BRRD, i.e., when it acts as the relevant national resolution authority. Hence, the notification and publicity requirements set out in Article 81, as well as the provisions on the content of the resolution decisions as set out in Article 82 apply *mutatis mutandis* to the resolution decisions taken by the Board with reference to the institutions that fall under its responsibility. As to the confidentiality of resolution related information, the secrecy requirements imposed by Article 84 on any national resolution authority evidently apply also to the Board acting in such a role, but they are supplemented by the provisions laid down in Article 88 of the SRM Regulation, which contains the specific professional secrecy requirements that are binding on the members and staff of the Board.

Let us turn our attention now to how the BRRD framework works in practice. Although the SRM in action (i.e. in a crisis scenario with financial stability implications) has, thankfully, not yet been tested, some jurisdictions have already experienced resolution cases under the BRRD. The recent crisis of a number of Italian banks is a telling example of the multiple and delicate procedural and human rights issues involved in resolution.

6 The BRRD resolution framework at work - the Italian banks' crisis of 2015

Just a few days after the entry into force of the national law implementing the BRRD, Italy was forced to test the new resolution provisions in relation to the crisis of four banks (*Banca delle Marche*; *Banca Popolare dell'Etruria e del Lazio*; *Cassa di Risparmio di Ferrara*; *Cassa di Risparmio di Chieti*). These banks were under temporary administration pursuant to the Italian banking law when resolution occurred. They were small or medium sized local banks, whose failure, however, risked having systemic implications due to their key importance in the regional market, in terms of clients and branches. Moreover, urgent action was necessary

[25] See Article 31(1)(d) SRM Regulation.

[26] See Article 5(1) and Article 7(3) SRM Regulation.

because of a highly critical liquidity position, aggravated by a material risk of a bank run.

Before resorting to resolution, alternative remedial options had been conceived by the temporary administrators in the pre-resolution phase. In the months prior to the adoption of the law implementing the BRRD – Legislative Decree 180/2015, which came into force on the 16th of November 2015 (hereinafter 'Resolution Act') - the Italian authorities examined solutions for a restructuring of the four distressed banks through a contribution by the Interbank Deposit Protection Fund (FITD). But these solutions had to be abandoned due to constraints arising from the application of the Commission's rules on State aid.[27]

Once it became clear that all of the banks in question were no longer in a position to respect the capital requirements, and that all the conditions for resolution were satisfied, resolution decisions were adopted by Banca d'Italia (one for each of the four banks) and approved by the Ministry of finance on 22 November 2015. The resolution schemes aimed at maintaining access to the critical functions of the four banks and avoiding unpredictable spill-over and contagion, thereby protecting clients' funds and assets. The decisions highlighted how an ordinary insolvency procedure could not meet those objectives to the same extent.

In the light of the existing constraints and regulations, "the solutions adopted on 22 November, while certainly not painless, minimised the cost of the intervention, safeguarding to the greatest extent possible the rights of depositors and creditors".[28]

It was, however, a considerable challenge to put in place a solution based on legal rules that had just been enacted a few days earlier and had introduced into the legal framework innovative and as yet untested tools.

Based on a provisional valuation of the assets and liabilities of the banks carried out by Banca d'Italia itself (due to the urgency of the situation), the resolution strategy was identified, as well as the specific tools to be applied. They were as follows:

- the write-down of capital instruments;
- the transfer of assets and liabilities of the banks to four bridge banks;
- the disposal of the bad loans portfolio of all four banks to a new entity (the REV – Gestione Crediti S.p.A. ('REV')) in charge of managing the run-off;
- the use of the Resolution Fund, administered by Banca d'Italia, to cover the residual losses of the banks and inject capital into the bridge banks and the REV.

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[27] The European Commission deemed that despite the private nature of the financial resources of the Italian DGS, its intervention in support of a troubled bank with the aim of preventing the worsening of the crisis would qualify as public aid and would be a trigger of resolution under the BRRD. As to the qualification of the DGS support as public aid, see Commission Decision of 23.2.2015 on the State Aid SA.39451 (2015/C) (ex 2015/NN) — State support to Banca Tercas. (OJ C 136, 24.4.2015, p.17). The Commission ruling on Banca Tercas has been appealed by Italy and the case is pending (Case T-98/16, Italy v. Commission, application 4.3.2016, OJ C 145 25.04.2016, p. 34*).*

[28] See Banca d'Italia (2016).

The original banks became residual boxes in which the losses and their absorption instruments were contained; they were immediately liquidated. The bridge banks retained the old names but prefixed by “New” and continued their activities with the aim of marketing the businesses through a short-term open and transparent competitive procedure;

Since the resolution plans envisaged the provision of financial resources by the resolution fund – i.e. public funds were needed to resolve the banks – the strategy had to be approved by the Commission.

The resolution process also involved the ECB which, in its role as the supervision authority, had the responsibility to deliver the authorisation (banking licence) to the bridge banks and to withdraw the licence of the four failing/residual banks which were to be put into forced liquidation.

7 Resolution and legal challenges

The complexity of the resolution procedure – which requires the involvement of various actors both at national and Union level and the adoption of countless administrative orders and measures – poses significant legal risks. In the case of the Italian banks anything less than perfect co-ordination could have hindered a successful conclusion to the events of that memorable weekend of late November 2015 and this could have led to an irreversible deterioration of the crisis. The process was a success however, and the four New banks were ready to resume activities on Monday morning,[29] after a long resolution week-end.

From an administrative law perspective, a risk may still exist that possible inconsistencies or anomalies are present in the various measures or occur in the course of the procedure. Such an occurrence would not only expose the national resolution authority to liability, but might even put at risk the stability of the resolution measures in the (albeit unlikely) event that one could prove that the keeping in place of said measures would be contrary to a compelling public interest.[30]

In general, considering the material alteration that resolution measures bring about on the structure of the resolved entities and on the individual rights of their shareholders and creditors, the probability of legal disputes is quite high. Indeed, the resolution measures adopted in Italy gave rise to extensive legal actions brought by shareholders and holders of subordinated debt whose rights were cancelled upon resolution. There are currently 10 cases pending before the administrative Court in Rome whereby the annulment/revision of the resolution decrees adopted by Banca d’Italia is sought. Despite the claimants’ requests for precautionary orders, no

[29] In order to speed up the process the bridge banks were established by a Law Decree (Law Decree no. 183/2015), so as to derogate from certain company law formal requirements for incorporation.

[30] This derives from Article 85(4) of the BRRD, which provides that the presumption that a suspension of the enforcement of a resolution decision would be against the public interest is rebuttable, if it can be proved that the suspension of the effects of the resolution decision would allow the pursuit of a higher public interest.

suspension of the disputed measures has been granted,[31] and a final decision on the merit is currently underway.

By looking at the complaints raised in the various cases, we can get some indications as to what are the most delicate aspects of the resolution procedure from an ex-post perspective and what safeguards are necessary for the adoption of the various relevant acts.

1. A first group of claims submitted to the Italian Court concerned constitutional issues, and were based on the alleged violation of Articles 42 and 47 of the Italian Constitution enshrining the fundamental principles of the protection of property and the protection of savings. It was argued specifically that the measure of write-down should have not been applied to financial instruments held by investors before the entry into force of the national law implementing the BRRD, as such retroactive effect would breach the legitimate expectations of the holders of these instruments and would constitute an unlawful deprivation of their rights. Banca d'Italia, relying on recent decisions of the European Court of Human Rights[32] and the Court of Justice,[33] pointed out that in severe states of distress where the capital value is negative and the company's assets do not offset losses – as was the case with the banks in question –, holders of capital instruments have already lost their capital investment so that their substantive situation is unaffected by an administrative order imposing the cancellation of their rights. This, indeed, would simply align the face value of the affected instruments to their real economic value. Banca d'Italia further observed that discriminating between shareholders and creditors according to the date of subscription of the relevant instruments would constitute an unjustified violation of the principle of equal treatment of creditors.

2. Another element that was challenged in all cases concerned the outcome of the valuation of the assets and liabilities of the ailing banks performed by Banca d'Italia (namely, the value assigned to the banks' NPL (non-performing loans) – portfolios). The question arose as to whether, the deviation from ordinary accounting standards had led to the emergence of higher losses than those effectively existing at the time the resolution strategy was conceived. It was even claimed that the failing or likely to fail requirement in itself only arose as a consequence of the resolution action and did not exist prior to that action.

   Assessment of the bank's assets pursuant to Article 36 of the BRRD is a crucial element as the resolution strategy and its impact on individual rights is necessarily shaped by the outcome of such assessment.

   In determining the value of the NPL portfolios of the banks, Banca d'Italia had to follow the criteria laid down in the Resolution Act (which, in line with Article 36

[31] *Ibid.*

[32] ECHR, 10 July 2012, application 34940/10, *Grainger and others against the United Kingdom.*– (HEDEC, [2012] ECHR 1675).

[33] ECG, 19 July 2016, C-526/14, *Kotnik and others against Drzavni zbor Republike Slovenije* (EU:C:2016:570, paragraphs 74-75, 77-78).

BRRD, requires a fair, prudent and realistic valuation) and the RTS issued by the EBA; it was also bound by the indications given in this respect by the Commission in its decisions on the compatibility of the resolution schemes submitted by the Italian authorities.[34] Namely, in those decisions the Commission indicated the haircuts which under the Communication from the Commission on the treatment of impaired assets in the Community banking sector[35] had to be applied for the contribution by the Resolution fund to be held compatible with the State-aid rules. The methodology for this assessment diverges from that used in routine accounting practice and it is difficult to say – due to the multiple technical variables involved in the judgement – whether the specific percentages of haircut that were applied by the Commission were correct and reasonable in the circumstances.

In the case of the Italian banks, however, given the size of the losses (which indicated technical insolvency), even if the assessment of bad loans had been less severe, the situation of the affected shareholders and creditors would remain unchanged. In fact, according to the State aid rules and the BRRD, in a resolution all the initial losses are borne by shareholders and, immediately afterwards, by subordinated bondholders. Accordingly – as in the case of the four banks, after the cancellation of shares and subordinated debts, extensive losses still persisted – only the Resolution Fund would have benefited in that it would have had to cover a lower amount of losses.

The situation might however be different in other cases, where for instance a less severe valuation would allow the avoidance of or would limit the bail-in of other debts.[36] In these cases, the situation of creditors could substantially change depending on the assessment of deteriorated debts. Creditors, however, do not participate in the sub-proceeding that takes place before the Commission (i.e. the state aid proceeding) prior to the adoption of the final scheme by national authorities. These parties, who are in fact the most affected by the Commission's decision (in as much as the haircut indicated therein will indirectly determine the amount of losses to be borne by shareholders and creditors), have also limited opportunities to claim for ex-post compensation at national level.[37] Even if the Commission's decisions were to appear manifestly wrong or unreasonable, the decisions adopted by the National authority pursuant to those decisions could not be overturned in court, as domestic judges are not permitted themselves to declare Union acts unlawful. If a national court has serious doubts as to the validity of such acts, it must make a

[34] SA. 39451, SA. 41925, SA. 41134, SA. 43547. The public version of these decisions is not yet available.

[35] Communication from the Commission on the Treatment of Impaired Assets in the Community Banking sector of 25 February 2009, (OJ C 72, 26.03.2009, p. 1).

[36] Bail-in could not be applied in the resolution of the four banks, as according to the Italian law implementing the BRRD the entry into force of the provisions on bail-in was postponed to 1 January 2016.

[37] As the scrutiny to be carried out ex post by the independent expert for the purposes of the definitive assessment of the assets and liabilities of the Bank pursuant to Article 36 and for the purposes of Article 74 of the BRRD cannot lead to a re-assessment of those criteria, it would be very unlikely – unless factual mistakes have occurred in the application of those criteria – that affected creditors would be granted a right to compensation from the resolution fund.

preliminary reference to the Court of Justice under Article 267 TFEU. It is unlikely, however, that affected parties would be in a position to take specific action in this respect, especially given the fact that they are not entitled to have access to the Commission's decision and the publication of such decisions is normally delayed for confidentiality reasons; in addition, private parties may not always be aware of the material effects that the Commission ruling as such may have on their individual rights. It must also be borne in mind that decisions by the Commission in the field of state-aid are subject to a stringent confidentiality regime and entail a high degree of technical discretion that leaves very limited room for challenges on the merits of the case.

The possibility for effective judicial review seems therefore significantly constrained by the complexity of the interaction between the state aid proceedings before the Commission and the national resolution proceeding.

3. Another claim made by some claimants revolves around the conduct of the Supervision authority in relation to alternative plans whose implementation began prior to resolution but could not be put forward because of the state-aid related objections made by the Commission. A former shareholder of one of the banks written down in resolution objected that no explicit response had been given to the request of the DGS to be authorised to subscribe a capital increase that would have helped in preventing the deterioration of the business.[38] According to the claimant, the expiration of the deadline for rejecting the request would legally equate to the acceptance of the request and – in any case – were it to be interpreted as a dismissal, it would contravene the principle of good administration enshrined in Article 41(1) of the Charter of Fundamental Rights, as that principle entails inter alia "the obligation of the administration to give reasons for its decisions".

   Banca d'Italia adduced many reasons to refute these arguments. A jurisdiction exception was raised in relation to the exclusive competence of the ECB in authorising the acquisition of qualifying holdings in banks; it was also objected that the claimant lacked the *locus standi* for such a claim, as only the DGS would be entitled to claim against the absence of an express decision rejecting its request for authorisation.

   The Court's decision is pending and it is impossible to anticipate what the outcome will be on this issue. However, regardless of the final outcome, it's clear that in the current case an express refusal decision would have eliminated any room for challenge, and that a similar overlapping of procedures should be prevented in the future so as to avoid any uncertainty as to the status and result of the authorisation procedure.

[38] The case concerned *Cassa di Risparmio di Ferrara*, whose shareholders, in an attempt to restore the viability of the entity, prior to resolution had approved a capital increase to be subscribed by the Italian DGS. Before subscribing the capital increase, the DGS submitted to Banca d'Italia a request for authorisation to the subscription of a qualifying holding in the bank's capital, pursuant to Article 19 of the Banking law and Articles 4 and 15 of the SSM Regulation. This request was then notified by Banca d'Italia to the ECB for the appropriate follow up.

4. In some cases claimants have complained that there were offers for acquisition or mergers by private investors and that Banca d'Italia had not adequately demonstrated that the related negotiations had failed or why these offers had not been considered. In relation to this type of claim (which was however abandoned in the course of the current proceedings) it might be difficult to gather the documentation proving that negotiations on offers by private investors had failed and were no longer available when resolution was decided (while initial offers or expressions of interest might be formally recorded, this is often not the case for the cessation of negotiations). This is therefore an aspect that should be taken into consideration and sufficient evidence of the evolution of negotiations with private investors should be collected by the relevant competent authority and transmitted to the resolution authority. This would enable the latter to motivate its assessment on the resolution requirement concerning the absence of alternative measures in accordance with Article 17(1)(b) of Legislative Decree 180/2015 (which transposes Article 32(1)(b) of the BRRD).

   The high number of legal challenges arising from the resolution action taken by the Italian authorities is not surprising, given the impact on individual rights that resolution measures have; and given the newness of the legislation and the complexity of the process as a whole. Nonetheless given that this has been the outcome in situations in which the banks involved were technically insolvent there is an even greater 'likelihood' of litigation in cases where the crisis is less severe and the violation of regulatory requirements by a bank less significant. It is therefore of paramount importance that the necessary administrative proceedings be carried out with great caution that each step of the process be motivated and that all necessary documentation be kept as proof of the appropriateness of the authority's action.

8 Conclusions

The world of resolution is unique, where urgency dictates extraordinary procedural rules. Both the SRMR and the BRRD seek an adequate balance between administrative fundamental principles (good administration, transparency, due process) and urgency/confidentiality needs. New resolution structures and mechanisms come with a steep learning curve and their outcomes are very often likely to face legal challenges due to the complexity of the regulatory and administrative architecture on the one hand and the direct impact of the newly established administrative powers on the rights of Union citizens, on the other. To facilitate the process, appropriate arrangements are needed to ensure close intra-jurisdiction coordination and the respect of the various procedural steps involved in resolution action. This would help avoid the rights and interests of the affected parties ending up in a 'black hole', in the uncertain space between situations covered by review mechanisms at Union level and those provided under national law. Good procedures lead to good substance. Experience shows that efficiency cannot justify an absence of procedures and procedural rights.

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Experience gained in the application of national law at European level

Introduction

By Niall J. Lenihan

When does national law transpose a directive?

By Andreas Witte

Level playing field: towards a more uniform application of banking legislation

By Lucía Arranz

The application of national law by the ECB – a maze of (un)answered questions

By Alexander Kornezov

Introduction

By Niall J. Lenihan[1]

Much of the European Union's substantive banking law takes the form of directives, most notably the Capital Requirements Directive (CRD IV).[2] As a result, under existing case-law of the Court of Justice, these provisions cannot, absent national implementation, be applied directly to the detriment of private parties, as would typically be warranted in banking supervision matters.

The SSM Regulation[3] approached this dilemma by means of a novelty. Article 4(3) of the Regulation requires the ECB, for the purpose of carrying out the tasks conferred on it by the Regulation, to apply all relevant Union law, and where this Union law is composed of directives, the national legislation transposing those directives. In addition, where the relevant Union law is composed of regulations and where currently those regulations explicitly grant options for Member States, the ECB is required to apply also the national legislation exercising those options. Finally, in accordance with Article 9(1) of the SSM Regulation, to the extent necessary to carry out the tasks conferred on it by the Regulation, the ECB may require, by way of instructions, national competent authorities (NCAs) to make use of their powers, under and in accordance with the conditions set out in national law, where the SSM Regulation does not confer such powers on the ECB.

A provision mandating a Union institution to apply national legislation transposing Union directives did not previously exist in the body of rules concerning the interplay between Union and national law. It has created a number of challenges for practitioners. How do you identify which national laws constitute the transposition of a directive, and which do not? Is the ECB bound by interpretations of national provisions established by national courts and authorities, or should it develop its own interpretations, possibly using rules of interpretation different from those used in the jurisdiction in question? Are the constraints on the exercise of these powers – such as fundamental rights or limitations on administrative discretion – those existing in Union or national law? The ECB is gradually building up its own administrative practice answering these questions. It is likely that these questions will also be addressed by the Court of Justice, potentially leading to refinements to the case-law on the direct effect of directives.

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1 Senior Adviser, Legal Services, European Central Bank. The author wishes to thank Iliyan Bakalov, Principal Lawyer-Linguist, for his advice in the preparation of this paper. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

2 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

3 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

The three articles which follow shed some light on these questions. Andreas Witte is Principal Legal Counsel in the Supervisory Law Division of the ECB. He offers a distinctive perspective, based on his day-to-day experience as a lawyer at the ECB. Lucía Arranz is Director of the Legal Department of the Banco de España. Under the SSM Regulation the ECB carries out its tasks within a single supervisory mechanism (SSM) composed of the ECB and NCAs, including the Banco de España, which has been responsible for the supervision of private banks since 1921.[4] She brings a national perspective, based on her practical experience of working as a lawyer at a national banking supervisory authority. Judge Alexander Kornezov is a Judge at the General Court. With his many years of experience of Union law as a judge, practitioner and academic, Judge Kornezov brings fresh insights as to how these questions might be addressed within the overall framework of the Union legal system.

By way of introduction, I will attempt to briefly summarise these three contributions. However, as with any summary, I cannot do justice to the three contributions, but only offer a pointer to their depth and richness.

1 Andreas Witte: When does national law transpose a directive?

Mr Witte suggests that the novelty of the ECB as a Union institution applying national legislation transposing Union directives is that it introduces a kind of hybrid into Union law, since the decisions adopted by the ECB on these national legal bases are acts of Union law, not national law. Any discretion left by them will be exercised by the ECB in accordance with Union, not national, administrative law rules concerning the limits of discretion, and judicial review lies with the Court of Justice only, since national courts do not have the power to annul acts of Union law.

Mr Witte notes that this novelty is limited in scope, as Article 4(3) of the SSM Regulation only requires the ECB to apply that part of national legislation which constitutes a transposition of relevant Union law. Where national law cannot be regarded as a transposition of relevant Union law, the ECB cannot apply it itself. Rather, it may give instructions under Article 9(1) of the SSM Regulation to the NCA in question to apply the national law.

Mr Witte outlines the difficulties in applying these provisions, given that it is not typically obvious whether a piece of national legislation actually transposes a directive. While in many Member States, there is a practice of including an explicit reference to the directive in the national legislation transposing it, this does not solve the problem of determining the transposing character of national legislation. The question of whether a particular national law transposes a directive needs to be assessed under Union law, with the Court of Justice as the authoritative interpreter of Union law. Also, the methods used by Member States to transpose a directive differ

[4] Under the Ley Cambó (Banking Law) of 29 December 1921.

vastly, ranging from directives being copied almost verbatim into national legislation to the incorporation of directives into the overall structure and system of national legislation, which is an approach that is common in the field of banking supervision. Examples of diverging national transpositions in the banking supervisory area include pre-approval requirements for bank mergers or demergers which are not specifically mandated under Union law, or the approval of the appointment of a bank's audit firm.

Mr Witte notes the limited usefulness of existing case-law in assisting where to draw the line between what is and is not a transposition of a directive. There is a large body of Union jurisprudence concerning the compliance by Member States with their transposition obligations. However, since Member States are generally free to do more than is required by a directive, the upper boundary – where the transposition of the directive ends and autonomous, non-transposing national law begins – does not have to be addressed in the legal proceedings underpinning this jurisprudence. There is also a nascent body of case-law addressing the application of the Charter of Fundamental Rights to Member States "only when they are implementing Union law". However, this case-law concerns the protection and enforcement of individual rights, and is thus of limited value for the rather different context of delineating competences in the multi-level governance framework of the SSM.

Mr Witte notes that this state of affairs has left the ECB needing to find its own approach towards determining whether a particular national law transposes a directive and is thus available for direct application. The spectrum of options is wide: at one end, one could adopt a restrictive, literal interpretation focussing on the nature of the supervisory tool in question, whereby only supervisory tools explicitly provided for in the directive text are considered transpositions. At the other end of the spectrum, a more purposive, teleological interpretation would be possible, whereby every tool which can be used to promote the objectives of prudential supervision would be considered a transposition of Union law. It is clear that this analysis is of a qualitative character that cannot be dealt with in terms of "hard science". In essence, what has to be ascertained is whether the power under the national law in question is so strongly related to a matter largely governed by Union law to justify the conclusion that the law in question constitutes, for the Member State in question, the achievement of the results sought by Union law,[5] rather than results pursued by the Member State autonomously. It is to be expected that a growing amount of practical experience in the application of national law by the ECB, and potentially also clarifications from the jurisprudence of the Court of Justice, will cast more light on this matter.

Looking forward, Mr Witte argues that it would be too easy to simply call for directives to be replaced by regulations as the legislative tool of choice for Union banking legislation. There are certainly many reasons to place greater reliance on regulations rather than directives, and no doubt the general trend in the years to come will go in this direction. The complete elimination of directives should, however, not be expected as a "quick fix" that will be available soon. There would also be

[5] See the wording of the third paragraph of Article 288 TFEU.

constraints in primary legislation: the CRD IV, with its elaborate provisions on the "European passport", was based on Article 53(1) TFEU, which allows only for the adoption of directives. It is not very likely that the Member States will agree on a Treaty amendment solely for the purpose of facilitating the application of Article 4(3) of the SSM Regulation. What will be required in the more immediate future is clarity, both in doctrine and in practice, as to where to draw the line between transposing and non-transposing legislation.

2 Lucía Arranz: Level playing field – towards a more uniform application of banking legislation

Ms Arranz addresses the experience gained within the SSM in applying national legislation and possible ways forward in order to foster a higher degree of regulatory integration. While the ECB has successfully managed to apply the national legislation of 19 Member States in the first two years of the SSM, the application of national legislation adds complexity to the system, both from an operational and a legal point of view, and raises level playing field issues.

From an operational point of view, Ms Arranz notes that this system requires more personnel with different legal backgrounds and implies a higher degree of reliance on the legal knowledge and expertise of NCAs. At the same time it reduces efficiencies in the decision-making process, as decisions cannot all be treated in the same manner since national specificities must be respected.

From a legal point of view, Ms Arranz notes that this application of national legislation by a Union institution raises many questions. First, can the ECB directly apply directives, considering that the direct effect doctrine has traditionally been considered applicable against the State (vertical direct effect) and not against individuals (horizontal direct effect)?[6] Will the ECB be considered similar to a State for the purposes of this doctrine? Second, can the ECB directly exercise additional powers not contemplated in Union legislation which are granted to supervisors by national legislation (e.g. the approval by the supervisor of the bank's statutes or approval of mergers)? Third, does the ECB need to follow national procedural rules? The ECB is subject to the general principles of Union administrative law, derived from the Treaties. However, given that the ECB must apply national law transposing directives, Ms Arranz suggests that procedural rules regulated in national laws transposing directives (e.g. the deadline to take a decision) might be applicable to the ECB. Fourth, does the ECB need to follow the interpretations of national rules set out by NCAs and/or national courts? In interpreting national provisions transposing directives, Ms Arranz argues that the ECB should (1) interpret national provisions transposing directives in the light of the directive (indirect effect of directives or the principle of harmonious interpretation);[7] (2) consider the specificities of national legal

[6] Case C-152/84 *Marshall v Southampton and South-West Hampshire Area Health Authority (Teaching)*, EU:C:1986:84.

[7] Case C-14/83 *Von Colson and Kamann v Land Nordrhein-Westfalen*, EU:C:1984:153.

systems and traditions; and (3) have regard to the principle of legitimate expectations when departing from previous interpretations of national supervisors.

Ms Arranz notes that the application of the national legislation of 19 Member States gives rise to level playing field issues. Although those level playing field issues are inherent to the Union legal framework, the areas not fully harmonised become more visible – and harder to explain – when the decisions are adopted by one single supervisor in a centralised manner, as they might be perceived by the credit institutions and the public at large as inconsistent cases of unequal treatment.

Ms Arranz notes that the ECB has worked intensively over the past two years in order to achieve a higher degree of harmonisation in the application of national legislation. In this respect she highlights the adoption of Regulation (EU) 2016/445 of the European Central Bank on the exercise of options and discretions available in Union law (ECB/2016/4)[8] (and the corresponding Guide) as a major milestone, which allows the ECB to exercise certain options and discretions in a harmonised manner for significant institutions in the euro area. She also mentions the great effort that has gone into ensuring harmonisation in supervisory practices (e.g. in the field of fit and proper assessments and the assessment of specific aspects of acquisitions of qualifying holdings).

Ms Arranz considers that further harmonisation is still needed as the application of a wide array of different pieces of national legislation is far from optimal for the SSM. She identifies various possible ways forward to foster further integration. First, the Union could move towards a more uniform framework for Union banking legislation, by favouring recourse to regulations over directives, reducing the number of options and discretions granted to Member States in both the Capital Requirements Regulation (CRR)[9] and CRD IV; and introducing further harmonisation in certain areas that have proven particularly cumbersome (e.g. authorisations of merger and demergers or amendment of a bank's statutes). However, this avenue has a clear political dimension, since Union legislation applies in all 28 Member States, while the SSM applies only in the 19 euro area Member States. Second, a more uniform application of Union banking legislation could be achieved by introducing national discretions embedded in the CRR and CRD IV at the level of NCAs instead of at the level of Member States (i.e. more options and discretions for NCAs and fewer for Member States). This would allow a uniform application of those options and discretions by the ECB for all significant institutions in the euro area Member States while, at the same time, leaving a margin for NCAs outside the SSM to exercise those options and discretions in a different manner. Third, the ECB could have greater recourse to soft law instruments, by providing more supervisory guidance and developing more uniform interpretations of national laws transposing directives.

8 Regulation (EU) 2016/445 of 14 March 2016 on the exercise of options and discretions available in Union law (ECB/2016/4) (OJ L 78, 24.3.2016, p. 60).

9 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

Ms Arranz concludes by speculating whether it might be legally possible, as a matter of Union law, to develop two different sets of rules in the area of banking regulation, one for euro area Member States and one for all Member States, without putting into question the basic concept of a single internal market in the Union. In this respect, she highlights that the Bank Recovery and Resolution Directive (BRRD)[10] is applicable for the Union as a whole in the area of resolution, and that the SRM Regulation[11], an equivalent regulation adopted on the basis of Article 114 TFEU,[12] directly applicable in a subset of Member States. As recitals 12 and 18 of the SRM Regulation assert, ensuring effective and uniform resolution rules across Member States benefits all Member States due to the interdependence of banking systems. In the absence of the Single Resolution Mechanism (SRM), financial crises in euro area Member States would have a stronger negative impact also in non-participating Member States and, therefore, the introduction of the SRM is a measure facilitating the smooth functioning of the internal market. In order to ensure a level playing field within the internal market as a whole, the SRM Regulation is consistent with the BRRD, adapting the rules and principles of that directive to the specificities of the SRM. Based on this precedent, Ms Arranz wonders whether one might conceive of more uniform substantive banking legislation for the SSM, on the basis of Article 114 TFEU, while respecting the singleness of the internal market.

3 Judge Alexander Kornezov: The application of national law by the ECB – a maze of (un)answered questions

Judge Kornezov emphasises that his contribution is a brain-storming exercise, as this is a relatively new area of law and there is currently no case-law of the Union courts which could give direct guidance on these issues.

Regarding the remedies at the ECB's disposal in case of non-transposition or incomplete or wrong transposition of a directive, Judge Kornezov suggests that the most obvious avenue is to ask the Commission to initiate infringement proceedings against the recalcitrant Member State. However, infringement proceedings usually take a few years, and the Court's judgment in such cases is declaratory and does not, as such, ensure immediate redress. Another possibility is to have recourse to

[10] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

[11] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

[12] Article 114 TFEU states as follows: "The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market."

Article 17 of the EBA Regulation[13] under which the ECB may request the European Banking Authority (EBA) to examine an alleged breach or non-application of Union law by a NCA. However, the EBA's recommendation and the Commission's formal opinion under this procedure have no binding legal force. In times of crisis the ECB should be able to act swiftly and achieve immediate results. Otherwise, its newly acquired supervisory powers might be seriously undermined. The ECB should therefore explore other options.

Judge Kornezov notes that it is settled case-law that directives have ascending vertical direct effect, meaning that an individual can rely on a directive against a Member State, which has failed to transpose it (at all or correctly).[14] Conversely, directives have neither descending direct effect, meaning that a Member State cannot invoke a directive against an individual,[15] nor horizontal direct effect, meaning that an individual cannot rely on a directive against another individual.[16] The rationale behind this case-law is the so-called estoppel argument: a Member State that has failed to transpose a directive cannot rely in its defence on that failure against an individual who invokes the directive[17]. Likewise, since directives are addressed to Member States, and not to individuals, they cannot directly create obligations for the latter. Hence, a directive cannot be relied upon against an individual.[18]

Judge Kornezov argues that the ECB should be able to rely upon a directive vis-à-vis national supervisory authorities, since a Member State cannot, based on the estoppel argument, rely on its own failure to implement a directive in order to avoid its obligations stemming from that directive. While the ECB cannot invoke as such a directive against credit institutions, there are a number of avenues which have been elaborated in the Court's case-law which provide alternative redress where directives cannot as such be invoked against an individual.

First, Judge Kornezov notes that the ECB can invoke directives as such against a credit institution where a credit institution is, as a matter of law and/or fact, an emanation of the State (e.g. a State owned or controlled bank).

Second, Judge Kornezov notes that, in accordance with the principle of consistent interpretation, when national authorities apply domestic law transposing a directive they are bound to interpret it, so far as possible, in the light of the wording and the purpose of the directive concerned in order to achieve the result sought by the

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[13] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

[14] Case 41/74 *Van Duyn*, EU:C:1974:133, para. 12; and Case C-434/10 *Aladzhov*, EU:C:2011:750, para. 32.

[15] Case C-152/84 *Marshall v Southampton and South-West Hampshire Area Health Authority (Teaching)*, para. 48; and Case C-91/92 *Faccini Dori*, EU:C:1994:292, para. 20.

[16] ibid.

[17] Case 148/78 *Ratti*, EU:C:1979:110, para.22; Case C-152/84 *Marshall v Southampton and South-West Hampshire Area Health Authority (Teaching)*, para. 47; and Case C-91/92 *Faccini Dori*, EU:C:1994:292, para. 22.

[18] Case C-152/84 *Marshall v Southampton and South-West Hampshire Area Health Authority (Teaching)*, para. 48; and Case C-91/92 *Faccini Dori*, para. 20.

directive, in accordance with Article 288 TFEU. The principle of consistent interpretation is useful in a situation where a provision of national law is capable of different interpretations, some rendering it compatible with Union law, while others not. However, the principle has limitations. The obligation of a national court to refer to the content of a directive when interpreting the relevant rules of domestic law is limited by the general principles of law and cannot serve as the basis for an interpretation of national law *contra legem*. Likewise, if an interpretation that is consistent with Union law runs counter to a general principle of law – in the context of the banking union, these would most often be the principles of legal certainty and legitimate expectations – the ECB would be prevented from relying upon the principle of consistent interpretation. Another obvious limitation is where a directive's provisions have not at all been transposed in national law.

Third, Judge Kornezov notes that the Court has recently introduced another mechanism which, in substance, allows enforcing against a private party obligations stemming from a directive, where that directive gives expression to a general principle of Union law.[19] There are, however, at least two obstacles to applying this analogy in the SSM context. First, this possibility was elaborated for the purpose of overcoming the lack of horizontal direct effect of directives, i.e. where an individual invokes a directive against another individual. The SSM context is different, where the ECB seeks to enforce a directive against a private entity. This relationship might be seen as vertical. Nonetheless, if this case-law is seen rather as a means of enforcing an obligation against a private entity, the question of who invokes the directive (the ECB or a private party) becomes less important. The second obstacle is more difficult to surpass. In these cases the Court reasoned on the basis of a general principle of Union law, as given expression in a directive. In the SSM context, the ECB could invoke the principles of the safety and soundness of credit institutions and the stability of the financial system, as referred to in Article 1 of the SSM Regulation. However, it is questionable whether these principles could be qualified as **general** principles of Union law. It would also be worth exploring the possibility of invoking the principle of equal treatment. Article 1 of the SSM Regulation requires the ECB to perform its supervisory tasks "based on equal treatment of credit institutions". The ECB could argue that the non-application of a sufficiently clear and precise provision of a directive vis-à-vis one credit institution, while the same provision is being enforced against a credit institution in another Member State (because in the first case the directive was not transposed or wrongly so, while in the second case it was correctly transposed), breaches the principle of equal treatment. The main difficulty with this argument is whether a directive in the area of banking law – for example the CRD IV – could be regarded as "giving expression" to the general principle of equal treatment.

Fourth, Judge Kornezov suggests that the judgment in *Viamex*[20] provides another avenue which might be worth exploring in the context of the SSM. There, the Court held that "it cannot be precluded, in principle, that the provisions of a directive may

[19] Case C-144/04 *Mangold*, EU:C:2005:709; and Case C-555/07 *Kücükdeveci*, EU:C:2010:21.

[20] Joined Cases C-37/06 *Viamex Agrar Handel* and C-58/06 *Zuchtvieh-Kontor GmbH (ZVK)*, EU:C:2008:18.

be applicable by means of an express reference in a regulation to its provisions, provided that general principles of law and, in particular, the principle of legal certainty, are observed".[21] In other terms, a directive can be invoked against individuals, if a regulation makes express reference to its provisions. Recital 34 of the SSM Regulation makes express reference to the directives on capital requirements for credit institutions and on financial conglomerates. There is, however, one major difference between the SSM and the *Viamex* case: in *Viamex* there was no equivalent of Article 4(3) of the SSM Regulation, specifically requiring the ECB to apply national law that transposes a directive. If the *Viamex* solution were to apply in the SSM context, it could, as a matter of fact, circumvent the requirements of Article 4(3) of the SSM Regulation, as it would allow the ECB to systematically disregard the applicable national law. Nonetheless, the *Viamex* analogy provides sufficient ground for reflection in view of possible future legislative developments.

Judge Kornezov concludes that there will be cases where the ECB would be unable to rely on any of the abovementioned remedies vis-à-vis credit institutions. The resulting impediments to the effective exercise of the ECB's supervisory powers should, in such circumstances, be addressed either through infringement proceedings or through adopting instructions addressed to NCAs instead.

Turning to the question of which court has jurisdiction to hear challenges against the instructions of the ECB adopted in the context of the SSM, in which the ECB applies national law, Judge Kornezov is of the view that the Court of Justice has exclusive jurisdiction to hear direct challenges against such ECB instructions, regardless of the fact that the ECB has applied national law in these instructions. He offers three arguments to support this conclusion. First, it is Union law that commands the ECB to apply national law. Article 263(2) TFEU states, in particular, that the Court of Justice has jurisdiction in actions brought on grounds of "infringement of the Treaties or of **any rule of law relating to their application**". Second, the instructions of the ECB in the context of the SSM are an act of a Union institution. It is settled case-law[22] that the Court of Justice has exclusive jurisdiction to declare void an act of a Union institution or body. Third, Article 24 and recital 60 of the SSM Regulation point to the same conclusion.

Indirect challenges could however be raised before national courts. This scenario could occur where the ECB addresses its instructions to NCAs, which then give effect to these instructions in a decision addressed to a credit institution. In such circumstances, a credit institution may seek the annulment of the NCA's decision before the competent national court, where it can raise a plea of illegality against the instructions of the ECB. If the national court entertains doubts as to the validity of these instructions, it ought to make a preliminary reference to the Court of Justice.

The question of damages allegedly suffered by a credit institution as a result of the illegal instructions of the ECB and/or of the NCAs can also arise. If the instructions of

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[21] ibid., para. 28.

[22] Case 314/85 *Foto-Frost*, EU:C:1987:452.

the ECB were addressed directly to the credit institution, then the latter should bring its action before the General Court. If, however, the ECB instructed the NCAs, which then gave effect to these instructions in a decision addressed to the credit institution, the question of who bears responsibility for the damage should be resolved. In such a situation, the matter should be brought before the national courts, which may, or must, make a preliminary reference on this point to the Court of Justice.[23]

The topic of judicial control should however not be reduced to matters of jurisdiction and/or admissibility. An equally important question concerns the standard of judicial review. Case-law suggests that the ECB has a broad discretion in matters of a "technical nature" or requiring "complex assessments"[24]. Consequently, an act of the ECB of this nature can be annulled on substance only if a manifest error of assessment can be demonstrated[25]. This standard of review makes it very difficult for applicants to successfully challenge acts of the ECB which contain complex or technical economic assessments. However, there is a question as to whether the standard of judicial review should be stricter in the SSM context, where the ECB can directly impose obligations on credit institutions, potentially affecting their fundamental rights.

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23 Case 314/85 *Foto-Frost*, para. 12. See also recital 61 of the SSM Regulation.

24 Case C-62/14 *Gauweiler and Others*, EU:C:2015:400, para.68.

25 ibid, para. 74.

When does national law transpose a directive?

By Andreas Witte[1]

1 Background to the legal problem

Supervising banks means interfering with private businesses. There are a plethora of actions which a supervisory authority may take and which produce legally binding consequences for the credit institution in question, encroaching upon its freedoms. Some of these take a fundamental character and concern the very existence of the bank, such as granting or withdrawing the banking licence, without which it may not operate; some are of a less existential nature but still have a profound impact on the way the bank conducts its business or is able to expand into new areas of activity, e.g. when the supervisory authority sets the level of own funds which the bank must hold in order to ensure coverage of the risks it is exposed to,[2] or when the supervisory authority determines whether a particular candidate is suitable ("fit and proper" in supervisory parlance) to serve as a member of the bank's board of directors; and some do not appear to be very fundamental but are still necessary for orderly supervision, e.g. when the supervisory authority, in order to obtain the information necessary for the exercise of its tasks, conducts an on-site inspection on a bank's premises or requires the bank to provide certain documents to supervisors. All of these things interfere with fundamental rights protected under Union law and, typically, also national constitutional laws.[3]

As in any system based on the principle of the rule of law, such interference with private rights are tolerable only if the acting authority is equipped with a legal basis, codified in a properly enacted piece of legislation with democratic legitimacy, which covers the supervisory measure that it proposes to take. This is also true for the ECB which, within the framework of the Single Supervisory Mechanism (SSM), is the competent authority for the prudential supervision of significant credit institutions.

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1 Principal Legal Counsel, Supervisory Law Division, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

2 This is done most prominently in the regular supervisory review and evaluation process (SREP), which the ECB conducts once a year for the banks directly supervised by it.

3 All measures by public authorities which constrain the way a bank conducts its own business – in other words, virtually all supervisory activities – interfere at least with the freedom to conduct a business, which has been recognised in the case-law of the Court of Justice (see, e.g., Case C-210/03 *Swedish Match*, ECLI:EU:C:2004:802, para. 73), and now also by Article 16 of the Charter of Fundamental Rights of the European Union (CFR). In addition, other fundamental rights under Union law can be affected, depending on the facts of each case. Rights which are particularly likely to be touched upon by banking supervision include the right to property (Article 17 CFR and Article 1 of the First Protocol to the European Convention on Human Rights), the freedom to choose an occupation (in fit-and-proper cases, Article 15 CFR – in this case the affected right is that of the individual who is to be appointed, not that of the bank), and the inviolability of private premises (in on-site inspections, see the judgment of the General Court of 22 March 2012 in Joined Cases T-458/09 and T-171/10 *Slovak Telekom* v *Commission*, ECLI:EU:T:2012:145).

The ECB has been entrusted by Article 4 of the SSM Regulation[4] with a number of tasks, some of the most important of which are to ensure compliance with prudential requirements (Article 4(1)(d)) and with governance requirements (Article 4(1)(e)) stemming from relevant Union law. Having a task, in the sense of an objective which the ECB is mandated to pursue, is, however, only the beginning of the story; to pursue these tasks, the ECB needs a toolkit of instruments which it can use for this purpose; and, in banking supervision, such instruments typically take the form of the power to issue legally binding acts which impose enforceable obligations on supervised entities. To do so, the ECB needs a legal basis which gives it the power to impose such obligations.

The legal framework of the SSM gives the ECB a wide range of such powers. Some of them are included directly in the SSM Regulation itself, most notably in Article 16(2) which gives a long list of supervisory powers that can be used vis-à-vis supervised entities in the cases referred to in Article 16(1). The ECB's investigatory powers to require information or to conduct on-site inspections are also codified in the SSM Regulation, in Articles 10 and 11. As these provisions are included in a regulation, they are directly applicable in the Member States[5] and override national law. Recourse to national law is therefore unnecessary.

Similarly, supervisory powers can also be found in other regulations, from where they derive their direct applicability. The Capital Requirements Regulation (CRR)[6] includes a large number of powers for supervisors. The body to which this power is entrusted in each Member State is not mentioned by name in the CRR but is referred to as the "competent authority". This term provides the necessary legal link to the SSM, for the SSM Regulation states in the first subparagraph of Article 9(1) that, for the purpose of carrying out its tasks under Articles 4(1), 4(2) and 5(2), the ECB shall be considered the "competent authority".[7] This is complemented by the second subparagraph, according to which, for the same purpose, the ECB shall have all the powers of competent authorities under the relevant Union law, and by the first subparagraph of Article 4(3) SSM Regulation, according to which the ECB shall apply "all relevant Union law". The combined effect of these provisions is that, for the

[4] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

[5] Article 288(2) TFEU. The provision refers to "all Member States". In the case of the ECB, however, this is modified by the principle that the ECB's powers do not extend to Member States which have not yet adopted the euro as their currency (see Article 139 TFEU and Article 42 of the Statute of the European System of Central banks and of the European Central Bank, both of which have the force of primary legislation). As a consequence, the ECB's direct powers are limited to euro area countries. Other Member States have the possibility to voluntarily participate in the SSM by means of concluding a close cooperation with the ECB under Article 7 of the SSM Regulation ("opt-in"). In such cases, however, the ECB exercises its powers in those Member States only by means of instructions to the national competent authority in question, since it has no direct powers in such Member States by virtue of primary legislation (see the second subparagraph of Article 7(1) of the SSM Regulation). As of October 2016, no close cooperation has been concluded with any non-euro area Member State.

[6] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[7] For the Member States participating in the SSM, the designation of the ECB as the "competent authority" in the SSM Regulation therefore overrides the designation of the "competent authority" by each Member State itself, as provided for – before the establishment of the SSM – in Article 4(1)(40) CRR.

tasks listed, and as far as significant institutions in the SSM participating Member States are concerned,[8] a CRR provision that gives power to the "competent authority" has to be read in such a way that "the competent authority" means the ECB. The ECB can then exercise the power in question, and no recourse to national law is necessary. The same goes for other acts of Union law which grant powers to banking supervisors and which take the form of regulations, including tertiary legislation, e.g. regulatory or implementing technical standards developed by the European Banking Authority (EBA) on the basis of Articles 10 and 15 of the EBA Regulation[9] and adopted as a regulation by the Commission on the basis of Articles 290 and 291 of the Treaty on the Functioning of the European Union (TFEU), in conjunction with a specific empowerment in an act of secondary legislation.

A large part of European banking law is, however, still codified in the form of directives. The most important of these is the Capital Requirements Directive (CRD) IV,[10] which together with the CRR forms the backbone of the "single rulebook" – the set of common rules governing the conduct of banks in the internal market and implementing the Basel III framework in Europe. More recently, the Bank Recovery and Resolution Directive (BRRD)[11] also introduced a number of substantive provisions to be applied by the banking supervisory authority, and powers that it can exercise vis-à-vis banks, such as the early intervention powers under Article 27 of the BRRD.

This fact that much of European banking law, both substantive provisions and the legal basis for supervisory powers, still takes the form of directives poses a problem: directives are addressed to Member States,[12] not to private parties within the Member States, which is why they require transposition in the form of the adoption of legislation in the individual Member States which can then in turn be applied in their territory. There is a well-established line of case-law of the Court of Justice concerning the direct effect of untransposed directives, but this doctrine is subject to limitations, most notably the rule that the directive can directly (i.e. independently of the national transposition) be relied on only to the benefit, and not to the detriment,

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[8] This restriction follows from the fact that the adoption of supervisory decisions with respect to less significant institutions remains a task of the NCAs, with the exception of the granting and withdrawal of authorisations and the assessment of qualifying holdings (first subparagraph of Article 6(6) of the SSM Regulation).

[9] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.10.2010, p. 12).

[10] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

[11] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

[12] Article 288(3) TFEU, as well as the last article ("This Directive is addressed to the Member States") of virtually all directives ever adopted.

of private parties[13] – which makes the use of this doctrine difficult to apply for banking supervision, the core of which is the imposition of obligations on private parties.

The best way to make these directive-based powers available to the ECB is, therefore, via the national transposing legislation. The first subparagraph of Article 4(3) of the SSM Regulation, which mandates the ECB to apply all relevant Union law, therefore supplements this by stating that where this Union law is composed of directives, the ECB shall apply the national legislation transposing those directives. This creates a novelty in the system of Union law: it goes without saying that Union institutions and agencies apply Union law – i.e. regulations and the directly applicable provisions of the Treaties. Similarly, it is well established that national authorities apply both their own national law and directly applicable Union law (plus directives, where the requirements for direct effect are met). The recourse to national law by a European body as a basis for the adoption of legal acts is, however, novel and hitherto unheard of.[14] Of course, Union institutions have long dealt with national law in their application of Union law. For instance, where the Commission, in its role as guardian of the Treaties, assesses whether a particular national law violates Union law, or the Court of Justice gives a judicial ruling on such a matter, these Union institutions have to delve into the substance of the national law in question. In such cases, however, national law becomes the object of scrutiny; it does not provide the yardstick against which scrutiny is undertaken, as is the case when the ECB applies national law directly. This novelty introduces a strange kind of hybrid into Union law, since the decisions adopted by the ECB on these national legal bases are, nonetheless, acts of Union law, not national law. Any discretion left by them will be exercised by the ECB in accordance with European, not national,

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13 Case 152/84 *Marshall* v *Southampton and South-West Hampshire Area Health Authority*, ECLI:EU:C:1986:84, para. 48. A good overview of the current state of the law on the direct effect of directives is given (not without criticism) by Chalmers et al. (2010), p. 285 et seq. The complicated question of direct effect among several private parties, and especially the terminological confusion surrounding it, has very recently been discussed by Timmermans (2016). See also the contribution of Judge Kornezov elsewhere in this book.

14 An existing case of application of national law by a Union institution is provided for by Article 272 TFEU, according to which the Court of Justice can, by means of an arbitration clause in a contract to which the Union is a party, be given jurisdiction to give judgment and, for that effect, apply national law in its assessment of the case. In these circumstances, however, the basis for the application of national law by a Union institution is the free will of the parties to the contract who, by virtue of agreeing to this arbitration clause, subject themselves to such jurisdiction. The ECB, in exercising its powers under the SSM, does not depend on the will of any outside party; it applies national legislation by virtue of Union law itself, because the SSM Regulation commands it to do so and commands private parties to be subject to the ECB's supervisory powers, and, in doing so, the SSM Regulation effectively grants the ECB the authoritative powers of the existing national competent authorities. Another important distinction between the scenario under the SSM and the scenario under Article 272 lies in the fact that, in the latter, the determination of the applicable law is more straightforward: typically the parties will include an explicit choice of law clause in the contract; where this is absent, recourse can be made to the usual rules on conflict of laws to determine the substantive rules which the Court of Justice will need to apply. In neither case does the question of whether a particular national law transposes a directive or not arise. More abstractly, it can be said that Article 272 provides for the judicial application of a "foreign" (i.e., non-Union) law by a Union court. This is not at all unheard of, and is rather the main focus of the field of conflict of laws. The SSM, on the other hand, provides for the administrative application of "foreign" law by a Union institution in the exercise of an activity which is ultimately executive in nature when one looks at it through the lens of the separation of powers. This is rather remarkable.

administrative law rules concerning the limits of discretion,[15] and judicial review lies with the Court of Justice of the European Union only, since national courts do not have the power to annul acts of Union law.[16]

2 Direct and indirect ECB powers

This novelty of a European Union institution applying national law is limited in scope; the first subparagraph of Article 4(3) of the SSM Regulation does not require the ECB to apply national legislation in general, but only that part of national legislation which constitutes a transposition of relevant Union law in the form of a directive. Where national law cannot be regarded as a transposition of relevant Union law, the ECB cannot apply it itself; it may, however, give instructions to the national competent authority in question to apply the national law. This establishes a two-step procedure for the application of Union law: an instruction from the ECB to the national competent authority, adopted on the basis of Union law; and, in fulfilment of this instruction, an administrative act under national administrative law adopted by the national competent authority and addressed to the supervised entity in question.

The legal basis for this power of instruction is the third subparagraph of Article 9(1) of the SSM Regulation, which imposes two cumulative conditions for the issuance of such an instruction: (i) the instruction is necessary to carry out the tasks conferred on the ECB by the SSM Regulation, and (ii) the SSM Regulation does not confer such powers on the ECB. The second criterion marks the boundary to the direct application of national law by the ECB under the first subparagraph of Article 4(3) and the first and second subparagraphs of Article 9(1): where the requirements of these provisions are met, i.e., the national legislation in question constitutes a transposition of a directive, the SSM Regulation confers powers – namely the powers under national law – on the ECB.

The question of whether the national law in question constitutes a transposition of Union law thus becomes the decisive dividing line for the mode by which this law is

[15] This difference can matter, since some legal systems follow a different conceptualisation of discretion. German law, for instance, differentiates between *Tatbestand* (facts) and *Rechtsfolgen* (legal consequences). This delineation is based on the “if-then” logic inherent in legal norms: if certain conditions are met, then the authority may take action. *Tatbestand* refers to the formulation of these conditions on the “if” side, whereas *Rechtsfolge* concerns the possibilities for the authority to take action on the “then” side of the norm. Discretion is limited to *Rechtsfolge*, i.e. the authority’s leeway to decide to remain inactive even though the conditions are met, or to choose among several different potential courses of action; the *Tatbestand*, on the other hand, is, in principle not included in discretion but rather subject to unlimited judicial review. Union law does not follow the same logic and treats both sides of the coin as part of a Union institution’s discretion. See e.g. Notle (1994), pp. 196-197.

[16] A direct action for annulment of an ECB decision before a national court would thus be inadmissible, and instead the action for annulment to the Court of Justice under Article 263 TFEU is available. Where, in the context of proceedings before a national court, the validity of an ECB decision becomes of relevance as an incidental question, any national court – not just courts of last instance – which consider the ECB decision illegal and thus of no validity is obliged to refer the question to the Court of Justice for a preliminary ruling under Article 267 TFEU; see Case 314/85 *Foto-Frost* v *Hauptzollamt Lübeck-Ost*, ECLI:EU:C:1987:452.

to be applied in the SSM.[17] Where the national law possesses such a transposing character, it will be applied directly by the ECB vis-à-vis the supervised entity, which is the route provided for in the first subparagraph of Article 4(3) and the first and second subparagraphs of Article 9(1). Where, on the other hand, the national law cannot be regarded as a transposition of a directive, it can be applied by the ECB only indirectly, by means of an instruction to the national competent authority, which will then act in relation to the supervised entity. This is the route provided for in the third subparagraph of Article 9(1). Both modes require that the action of the ECB – either direct application or instruction to the national competent authority – is necessary for the purposes of carrying out the ECB's tasks under the SSM Regulation.

3 The difficulties of identifying whether a national law transposes a directive

3.1 The wide spectrum of transposition techniques

The problem with drawing this line lies in the fact that it is typically not obvious whether a piece of national legislation actually transposes a directive. In many Member States, there is a practice of including an explicit reference to the directive in the piece of national legislation transposing it (e.g. by means of a footnote at the beginning).[18] This does not solve the problem of determining the transposing character of national legislation conclusively – for several reasons. First, such a reference is not strictly mandatory under Union law, so it is not always included.[19] Second, and more fundamentally, the transposition of a directive by a Member State carries with it legal consequences. One of these consequences is, in the area of financial regulation, the availability of this provision to the ECB for direct application under the SSM Regulation, as described above, but long before the conception of the SSM, there were already legal consequences attached to the act of transposing a directive, one being that this was the only way to discharge a Member State's

[17] The fact that the transposing character of the national law in question forms the crucial dividing line becomes particularly clear in the SSM Framework Regulation (Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (OJ L 141, 14.5.2014, p. 1)), an act of tertiary legislation which was adopted by the ECB on the basis of an empowerment in the SSM Regulation to spell out the institutional framework of the SSM in more detail. The title of Article 22 of that Regulation, which deals with the "instruction mode" also provided for in the third subparagraph of Article 9(1) of the SSM Regulation, refers to instances where "the ECB has a supervisory task but no related power". A "power" of the ECB in this sense can also be a power under national law made available to the ECB by virtue of the first and second subparagraphs of Article 9(1) and the first subparagraph of Article 4(3) of the SSM Regulation – and this requires that the national law in question constitutes a transposition. Where this requirement is not met, the ECB "has no related power" and may issue instructions, provided that they are necessary to carry out the tasks conferred on the ECB by the SSM Regulation.

[18] See Funke (2010), p. 158, for the legal basis for these references.

[19] Sometimes a provision requiring such explicit reference is added explicitly in the text of the directive itself (the BRRD, for instance, does so in Article 130(2), and the CRD IV in Article 162(4)), but this is not universal. In the absence of such a provision in the text of the directive, it is hard to argue that such a binding obligation emanates from a more general principle.

obligation to transpose. These legal consequences arise in Union law, which is why the question of whether a particular national law transposes a directive needs to be assessed under Union law; it cannot be left to the Member State's own subjective judgement. In other words, the Member State is free to choose the form and methods of transposition, but it is not free to determine authoritatively whether what it has done is sufficient to meet its transposition obligation, nor whether what it has done meets the requirements for direct application by the ECB under the first subparagraph of Article 4(3) of the SSM Regulation – these determinations involve interpretations of Union law and are therefore within the jurisdiction of the Court of Justice as the authoritative interpreter of Union law. For the same reason, the supporting materials concerning the legislative history of a particular national law (e.g. explanatory memoranda submitted by the government to the legislature when the legislative proposal was tabled, or verbal statements made in the legislature or its committees) about the intention to adopt a particular law in order to transpose a directive are of indicative value, but cannot settle with final and authoritative effect the transposing character of a national law. This transposing character exists objectively and does not necessarily require an intention of the national legislator to that effect.[20]

Third, the methods used by Member States to transpose a directive differ vastly. In some cases, a given directive is copied almost verbatim into a national statute dedicated to the sole purpose of transposing that directive; this approach is best suited for new areas where no prior national legislation exists. In other cases, the substantive provisions required by a directive are incorporated into the established overall structure and system of existing national statutes. This latter approach is quite common in banking supervision, since most Member States already had established banking laws, codified in a single statute or spread over many documents, before the European Communities started to legislate in this area by means of directives in the 1970s, or before they joined the Union in the case of Member States which acceded more recently. In such cases, not even a one-to-one correspondence between specific article in a directive and a national statute can be taken for granted. It is conceivable that within a given provision, e.g. a single numbered article of a national law, directive transpositions and provisions of an autonomous national origin may be combined. In such cases, drawing the line between transposing and non-transposing national provisions is particularly challenging. On a spectrum ranging from perfect correspondence to a complete lack of correspondence between a directive and a national statute, variations between these two extremes are also possible.

[20] This is best illustrated by Case 248/83 *Commission* v *Germany*, ECLI:EU:C:1985:214, para. 49: where a directive enters into force but a Member State already has corresponding provisions in place, the transposition obligation is fulfilled without new enactments. In other words, the transposition chronologically precedes the directive – but it still constitutes a transposition of that directive in an objective sense.

3.2 Examples of diverging national transpositions

Some examples might help illustrate the difficulties. Some Member States include in their legislation a wide range of pre-approval requirements according to which many activities or transactions conducted by banks which are considered to have a severe impact on its prudential requirements must be approved by the competent authority before they can take place. This may, for instance, be the case for mergers with another bank or de-mergers whereby some activities are split off into a separate legal entity,[21] for the establishment of branches in third countries, or for changes to a bank's articles of association.[22]

Such pre-approval requirements are not mandatory under Union law, and, consequently, not all Member States have them. What Member States are obliged to provide for in their laws are powers for the competent authority to require the reinforcement of governance arrangements or to restrict or limit the business, operations or network of a supervised bank (Article 104(1)(b) and (e) CRD IV). However, this wording is, at least at first glance, more reminiscent of an ex post intervention power of the competent authority, rather than an ex ante approval requirement, and this is what other Member States provide for in their laws. There is also the requirement for Member States to give competent authorities "all supervisory powers to intervene in the activity of institutions that are necessary for the exercise of their functions" (Article 64(1) CRD IV), but this is even more difficult to delineate, and it is also highly reminiscent of a differentiation between ex post intervention powers and powers to grant ex ante approvals.

Another area where some national laws go beyond the requirements of Union law is the external audit of credit institutions. The Audit Regulation[23] includes requirements as to the audit itself and the appointment of the auditor, but leaves it, within these limits, to the supervised bank to select its own audit firm. Nonetheless, some national laws require the approval of the appointment by the competent authority. This is not directly provided for in the wording of Union directives, thereby making it difficult to determine whether this constitutes a transposition of Union law and is therefore available for direct application by the ECB, or whether the ECB's powers are limited to indirect application by means of instructions to the national competent authorities.

3.3 Limited usefulness of existing case-law

Existing case-law is only of limited use in assisting where to draw this line. There is, of course, a large body of jurisprudence concerning Member States' transposition obligations. These cases typically arose when the Commission alleged that a Member State had failed to adopt the necessary legislation to transpose a directive,

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[21] E.g. Article 57 of the Italian Banking Act (*decreto legislativo* 385/1993) or Article 77(3) of the Belgian Banking Act (*Loi relative au statut et au contrôle des établissements de credit*).

[22] E.g. Article 56 of the Italian Banking Act.

[23] Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC (OJ L 158, 27.5.2014, p. 77).

or had transposed it wrongly, and initiated enforcement proceedings under Article 258 TFEU. In such cases, however, the line between transposing and non-transposing national law had to be drawn on the lower boundary only: the Court of Justice had to ascertain whether a Member State had done enough to transpose a directive. Member States are, however, free to do more than required under a directive.[24] The upper boundary – where the transposition of the directive ends and autonomous, non-transposing national law begins – does not have to be addressed in the course of such proceedings.

More recently, another area of Union law has arisen where the interplay between a national law and a Union directive becomes of relevance, for rather different reasons: under Article 51(1) of the Charter of Fundamental Rights, the Charter is binding on Member States "only when they are implementing Union law". Even under the assumption that the term "implementing" in this context is broader than "transposition" in the context of legislation transposing a directive,[25] one would assume that this means a national legislature, in adopting a statute, is bound by the Charter if that statute constitutes a directive transposition. There is, thus, a nascent body of case-law addressing this issue from the perspective of the protection of fundamental rights.[26] The usefulness of this line of jurisprudence for the SSM is, however, limited, for two reasons: first, the test which the Court of Justice applies under Article 51(1) of the Charter is not whether the national law transposes a directive, but whether the national law regulates "situations governed by EU law".[27] This is a wider concept than directive transposition: a subject area can be "governed by EU law" if there are legal acts of the Union which set normative rules in the field, even though no provisions from a directive are there that must be given effect domestically by means of transposition. Second, there is, at least at present, no clear line apparent in the case-law which would allow firm conclusions as to whether the Court of Justice applies this test rather restrictively or liberally.[28] Ultimately, one has to acknowledge that the case-law on the Charter of Fundamental Rights took its origin in a specific area of law serving a specific purpose, namely the protection and

[24] Unless the directive constitutes "maximum harmonisation", i.e. prohibits the practice of adopting more stringent national rules than provided for in the directive ("goldplating"). This "maximum harmonisation" nature has to be determined for each directive individually by means of interpretation; it cannot be simply assumed as a general rule. Only in some cases does primary legislation itself explicitly answer the question of whether a given directive is of this character or not (e.g. Article 153(4) TFEU for social policy and Article 193 TFEU for environmental matters).

[25] It appears plausible to argue that "implementation" in the meaning of Article 51(1) of the Charter also includes executive, as opposed to legislative, acts: a national authority applying a rule of a Union regulation, or of a national statute which undoubtedly transposes a directive, to an individual case would also be "implementing" Union law. In such cases a binding effect of the Charter must exist not only in respect of the legislator who enacted the law that is being applied, but also in respect of the executive who is applying it in a specific case. This mirrors the possibility of "as applied" challenges in US constitutional law.

[26] Interestingly, this case-law treats the question predominantly as one of a procedural nature: The jurisdiction of the Court of Justice under the preliminary ruling procedure extends only to the interpretation of Union, not of national, law. This means that a reference under Article 267 TFEU will be inadmissible if no binding effect of the Charter, under Article 51(1), exists for the national legislature.

[27] Case C-650/13 *Delvigne*, ECLI:EU:C:2015:648, para. 26; Case C-265/13 *Torralbo Marcos*, ECLI:EU:C:2014:187, para. 29; Case C-617/10 *Åkerberg Fransson*, ECLI:EU:C:2013:105, paras. 19-22.

[28] See, to that effect, the *Delvigne* and *Torralbo Marcos* cases cited in the previous footnote, in which the Court arrived at diverging results as to the applicability of the Charter. The facts were, of course, rather different, but it is at present not possible to ascertain in abstracto where the ratio lies that distinguished the cases from each other.

enforcement of individual rights, and is thus of limited value for the rather different purpose of delineating competences in the multi-level governance framework of the SSM.

4 Potential approaches

This state of affairs left the ECB needing to find its own approach towards determining whether a particular national law transposes a directive and is thus available for direct application. The spectrum of options that could be considered was wide: at one end, one could adopt a restrictive, literal interpretation focussing on the nature of the power, i.e. the supervisory tool, in question. According to this reading, only supervisory tools explicitly provided for in the directive text are considered transpositions. This would mean that, for instance, the wide range of merger, de-merger, or statute change approval provisions would only be available for indirect application by the ECB in the form of instructions.

At the other end of the spectrum, a more purposive, teleological interpretation would be possible. Under this reading, every tool which can be used to promote the objectives of prudential supervision – such as ensuring sound risk coverage in banks which Union law, most notably in the form of the CRR and CRD IV, promote, would be considered a transposition of Union law.

There are arguments in support of both views. The wide reading can find support in the fact that banking regulation is a field comprehensively governed by Union law, and minimises the need to resort to the two-stage instruction process with the procedural delays and complications which it entails. On the other hand, the restrictive reading is more in line with the sovereign right of Member States to legislate in all areas, including banking regulation. Of course they may only do so as long as they do not violate Union law – but “not violating Union law” is something very different from “transposing Union law”. Likewise, the wide reading leads, in practice, to a conflation of “tasks” and “powers” and is thus challenged by the differentiation which the terminology of the SSM Regulation seemingly draws between the two concepts.[29]

Other considerations do not clearly speak in favour of either view. From a legal certainty perspective, one could argue that the narrow reading, being closer to the wording of the Union law texts, reaches more easily predictable results with a higher degree of justification from a very positivist point of view. However, this reading entails a risk of creating grey areas where the delineation is particularly difficult, thereby increasing the risk of negative (neither the ECB nor the national competent authority asserts competence) or positive (both the ECB and the national competent authority assert competence) conflicts of competence. This risk would be reduced

[29] More evidently, the wide view faces challenges in the light of Article 22 of the SSM Framework Regulation, which is based on the idea that there can be instances where the ECB has a task but no related power (see Footnote 17). It is unclear what scope of applicability would remain for such a provision if the existence of a task automatically generated the existence of a power, which would be the logical conclusion of the wide interpretation.

under a wider reading with its strong preference for a direct competence of the ECB in the area of banking supervision.

Similarly, the need to promote uniform supervisory standards and thus avoid a fragmentation of the SSM along national lines seems, at first glance, to favour a wide reading, treating all of banking regulation as governed by Union law; but it leaves more leeway for Member States to adopt, in their unquestionable power to transpose directives, substantially different provisions which would all likewise have to be applied by the ECB. Under a narrower reading, such divergent national provisions would be less likely to be considered transpositions of Union law and therefore binding on the ECB. This factor, too, does not clearly speak in favour of either approach.

Ultimately, the preferable approach is, presumably, a kind of middle ground between these two extremes. To develop a sound interpretation of the concept of directive transposition, a compromise has to be found which gives due regard to the considerations stated above and is, at the end of the day, also in line with the principles of conferral (Article 5(2) TEU) and subsidiarity (Article 5(3) TEU) as fundamental principles of the multi-level governance framework of the European Union. The ECB is at present in the process of developing a sound and consistent approach to drawing the line between transposing and non-transposing national legislation for the purposes of Article 4(3) of the SSM Regulation. This process is not purely top-down; the decision-making structure of the SSM, where national competent authorities are represented on the Supervisory Board and national central banks[30] on the Governing Council, allows for deliberations and decisions where national expertise and practice are adequately taken into account.[31]

Owing to the nature of this as an ongoing process and to confidentiality considerations, details about the methodology cannot be disclosed at present. It is, however, clear that the analysis is of a qualitative character that cannot be dealt with in terms of “hard science”. In essence, what has to be ascertained is whether the power under the national law in question is so strongly related to a matter largely governed by Union law to justify the conclusion that the law in question constitutes, for the territory of Member State in question, the achievement of the results sought by Union law,[32] rather than results pursued by the Member State autonomously. Such an analysis cannot be derived quantitatively; it requires an evaluating assessment of the national law in question against the directive. It is, however, to be expected that a growing amount of practical experience in the application of national law by the ECB, and potentially also clarifications from the jurisprudence of the Court of Justice, will cast more light on this matter.

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30 Which are in many, but not all, cases identical to the national competent authorities.

31 In addition, the Supervisory Board and Governing Council are supported by a wide range of committees, networks and working groups which bring together ECB experts and their relevant counterparts from national competent authorities and national central banks for the purpose of advising decision-makers on specific questions, making proposals, and delivering opinions and reports on questions referred to them.

32 This formulation is intended to reflect the wording of Article 288(3) TFEU.

5 Conclusion

The bottom line of this paper might seem disappointing at first glance, because it fails to deliver clear-cut answers to the question in the title. This is, however, the result of several factors. The first of them is the novelty of the question asked. As has been pointed out above, the application of non-Union law by the ECB as a Union institution is new, and gives an entirely new relevance to the question of how to distinguish between transposing national legislation and non-transposing national legislation. In the light of this novelty, asking the question and framing it in its context is already an important first step.

The second factor lies in the normative nature of the question. As has already been emphasised, it is not susceptible to a quantitative "hard science" approach to drawing the line that needs to be drawn. In this scenario, the best approach is to find a methodology for drawing that line which leads to reasonable and defensible outcomes, giving best effect to important principles by which the SSM operates, such as legal certainty, the avoidance of fragmentation of the European banking market along national lines, and the maintenance of high supervisory standards. It would be a disservice to search for a more easily applicable "hard science" test if that came at the price of sacrificing these principles.

Lastly, the entire matter is mired in political sensitivities. Even though the ECB and the national competent authorities are all very much aware of, and act in line with, their mutual obligation to cooperate in good faith, questions of powers, competences and responsibility are, by their very nature, close to the heart of supervisory and regulatory authorities. The methodology used for this delineation has to take account of these sensitivities.

Looking forward, it would be too easy to simply call for a *de lege ferenda* solution to the present problem by demanding that directives should be replaced by regulations as the legislative tool of choice for European banking legislation. There are certainly many reasons to place greater reliance on regulations rather than directives, and no doubt the general trend in the years to come will go in this direction. The complete elimination of directives should, however, not be expected as a "quick fix" that will be available soon.[33] What will be required in the more immediate future is clarity, both in doctrine and in practice, as to where to draw the line between transposing and non-transposing legislation. This can be expected to become clearer as the ECB grows more familiar with the application of national law.

[33] There would also be constraints in primary legislation: the CRD IV, with its elaborate provisions on the "European passport", was based on Article 53(1) TFEU, which allows only for the enactment of directives. It is not very likely that the Member States will agree on a Treaty amendment solely for the purpose of facilitating the application of Article 4(3) of the SSM Regulation.

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Level playing field: towards a more uniform application of banking legislation

By Lucía Arranz [1]

1 Introduction

After nearly two years of functioning, we can all agree that there is a Single Supervisory Mechanism (SSM) in the euro area. However, there is not yet a single supervisory law.

Although the Capital Requirements Regulation (CRR)[2] represented a very big step in terms of harmonisation of substantive banking law in the European Union, reducing major sources of national divergences and inconsistencies, the single rulebook for banks still remains, to a certain degree, fragmented.

- Reaching a coherent banking regulatory framework is a lengthy and complex process, both on a technical and political level and, therefore, in some areas the Union legislator either adopted a minimum harmonisation approach or granted options and national discretions[3] (ONDs) to Member States and/or supervisors in order to accommodate national specificities and supervisory traditions. For instance, the CRD IV package offers more than 160 provisions where some discretion remains for supervisors or national governments to decide on the concrete implementation of the Union provisions.
- In addition, when transposing directives, national legislators follow different approaches; some transpose the Union provisions verbatim while others prefer "gold-plating". In addition, different national interpretations arise from the same provisions and are crystallised in national legislation.

This fragmentation has a major impact on the functioning of the SSM, as Article 4(3) of the SSM Regulation[4] establishes that the ECB must "apply all relevant Union law,

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1 Director of the Legal Department, Banco de España.

2 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.06.2013, p.1). The CRR and the Capital Requirements Directive (see footnote 6) are together often referred to as the "CRD IV package".

3 According to the European Banking Authority (EBA), an "option" refers to a situation in which competent authorities or Member States are given a choice on how to comply with a given provision, making a selection from a range of alternatives set forth in Union law; and "national discretion" refers to a situation in which competent authorities or Member States are given a choice whether to apply – or not to apply – a given provision.

4 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p.63).

and where this Union law is composed of Directives, the national legislation transposing those Directives”.[5] In other words, the ECB has to apply the national legislation transposing the Capital Requirements Directive (CRD IV) of 19 Member States. [6]

In the following sections I will briefly cover the experience gained within the SSM in applying national legislation and possible ways forward in order to foster a higher degree of integration in the regulatory field.

2 Experience gained in applying national legislation

The first two years of functioning of the SSM have been very intense and challenging. Throughout that process, the ECB has successfully managed to apply the national legislation of 19 Member States. According to the ECB Annual Report on supervisory activities 2015, last year the ECB dealt with 37 licence authorisations, 61 withdrawals, 137 qualifying holdings, 2,730 fit and proper decisions and 435 passporting procedures, all of them in application of the national legislation transposing the CRD IV.

2.1 Complexity and level playing field issues

However, the application of national legislation adds complexity to the system both from an operational and a legal point of view – and raises level playing field issues.

Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board, gave on 27 January 2016 the following example: “Imagine being a referee in a football match; your main task is to administer the rules of the game. But what if the individual players adhere to different rules? In such a game, you as the referee would be forced to apply different rules depending on the player in question. You would have to judge similar situations in a dissimilar way – a foul by one player might warrant a penalty kick; a foul by another player might not.”[7]

From an operational point of view, it requires more personnel with different legal backgrounds and implies a higher degree of reliability on the legal knowledge and expertise of the national competent authorities (NCAs). At the same time it reduces the synergies and efficiencies in the decision-making process, as decisions cannot all be treated in the same manner since national specificities must be respected.

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[5] Article 4(3) of the SSM Regulation. See footnote 10.

[6] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

[7] Keynote speech by Sabine Lautenschläger at the Workshop of the European Banking Institute (EBI) hosted by the ECB, Frankfurt, 27 January 2016 “Single Supervisory Mechanism – Single Supervisory Law?”

From a legal point of view, this application of national legislation by an institution raises many interesting questions. I will mention some of them.

- Can the ECB directly apply directives? This question is very relevant, especially in cases where a provision from a directive (CRD IV) has not been transposed into national law in time or the transposition is not fully adequate. The CRD IV contains many provisions imposing obligations on credit institutions but the direct effect doctrine has traditionally been considered applicable against the State (vertical direct effect) and not against individuals (horizontal direct effect).[8] However, the rationale behind the direct effect doctrine is that the State (a broad concept thereof) could not take advantage of its own failure to comply with Community law and, therefore, it remains to be seen whether the ECB will be considered similar to a State for the purposes of this doctrine. In any event, the ECB would not be bound by national laws conflicting with directives, as they must be left unapplied according to the case-law of the Court of Justice of the European Union.[9]
- Can the ECB directly exercise supervisory powers granted by national legislation? Very often national legislation grants additional powers to supervisors (i.e. powers not contemplated in Union legislation); this is for instance the case of approval by the supervisor of the bank's statutes or approval of mergers. I will come back to this issue later on as it is a very clear example of level playing field issues.
- Does the ECB have regulatory powers? The ECB is not the Union legislator and, according to Article 4(3) of the SSM Regulation, it is subject to the single rule book (it must apply Union and national legislation). However, the ECB can adopt legal acts, such as regulations and general decisions addressed to credit institutions to the extent necessary to implement specific tasks concerning policies relating to the prudential supervision of credit institutions, and within the

[8] C-152/84 *Marshall* v *Southampton and South-West Hampshire Area Health Authority (Teaching)*, ECLI:EU:C:1986:84.

[9] C-462/99 *Connect Austria Gesellschaft fur Telekommunikation GmbH* v *Telekom-Control-Kommission and Mobilkom Austria AG*, ECLI:EU:C:2003:297.

limits of the single rulebook.[10] Two examples are the Regulation on reporting of supervisory financial information[11] and the Regulation on the exercise of options and discretions available in Union law[12].

- Does the ECB need to follow national procedural rules? The ECB is subject to the general principles applicable to Union administrative law, derived from the Treaties (e.g. Article 298(1) TFEU on an open, efficient and independent European administration), the Charter of Fundamental Rights of the European Union (e.g. Article 41 on good administration), and settled case-law of the Court of Justice on the general principles of Union law (e.g. the principle of good administration,[13] the right to a fair hearing,[14] or the duty to give reasons[15]). Some basic procedural principles (the right to be heard, the right to have access to the file, the duty to give reasons, notification, etc.) have been laid down in the SSM Framework Regulation.[16] Conversely, the ECB is not subject to national administrative laws. However, given that the ECB must apply national law transposing directives, it could be argued that procedural rules regulated in national laws transposing directives (e.g. the deadline to take a decision) are applicable to the ECB.

- Does the ECB need to follow the interpretations set out by NCAs and/or national courts? As supervisors are responsible for overseeing the application

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[10] Article 4(3) of the SSM Regulation: For the purpose of carrying out the tasks conferred on it by this Regulation, and with the objective of ensuring high standards of supervision, the ECB shall apply all relevant Union law, and where this Union law is composed of Directives, the national legislation transposing those Directives. Where the relevant Union law is composed of Regulations and where currently those Regulations explicitly grant options for Member States, the ECB shall apply also the national legislation exercising those options.
To that effect, the ECB shall adopt guidelines and recommendations, and take decisions subject to and in compliance with the relevant Union law and in particular any legislative and non-legislative act, including those referred to in Articles 290 and 291 TFEU. It shall in particular be subject to binding regulatory and implementing technical standards developed by EBA and adopted by the Commission in accordance with Article 10 to 15 of Regulation (EU) No 1093/2010, to Article 16 of that Regulation, and to the provisions of that Regulation on the European supervisory handbook developed by EBA in accordance with that Regulation. The ECB may also adopt regulations only to the extent necessary to organise or specify the arrangements for the carrying out of the tasks conferred on it by this Regulation. Before adopting a regulation, the ECB shall conduct open public consultations and analyse the potential related costs and benefits, unless such consultations and analyses are disproportionate in relation to the scope and impact of the regulations concerned or in relation to the particular urgency of the matter, in which case the ECB shall justify that urgency.
Where necessary the ECB shall contribute in any participating role to the development of draft regulatory technical standards or implementing technical standards by EBA in accordance with Regulation (EU) No 1093/2010 or shall draw the attention of EBA to a potential need to submit to the Commission draft standards amending existing regulatory or implementing technical standards."

[11] Regulation (EU) 2015/534 of the ECB of 17 March 2015 on reporting of supervisory financial information (ECB/2015/13) (OJ L 86, 31.3.2015, p.13).

[12] Regulation (EU) 2016/445 of the ECB of 14 March 2016 on the exercise of options and discretions available in Union law (ECB/2016/4) (OJ L 78, 24.3.2016, p.60).

[13] See, e.g. Joined Cases 7/56, 3/57 to 7/57 *Algera and Others* v *Common Assembly of the ECSC*, ECLI:EU:C:1957:7; Joined Cases 56 and 58/64 *Consten and Grundig* v *Commission*, ECLI:EU:C:1966:41; or Case C-64/82 *Tradax* v *Commission*, ECLI:EU:C:1984:106.

[14] See, e.g. Cases C-100/80 to 103/80 *Musique Diffusion française* v *Commission*, ECLI:EU:C:1983:158; or Case C-322/81 *Michelin* v *Commission*, ECLI:EU:C:1983:313.

[15] See, e.g. Case T-13/99 *Pfizer Animal Health* v *Council*, ECLI:EU:T:2002:209; or Case T-70/99 *Alpharma* v *Council*, ECLI:EU:T:2002:210.

[16] Regulation (EU) No 468/2014 of the ECB of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the ECB and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17) (OJ L 141, 14.5.2014, p.1).

> of prudential requirements by credit institutions, they have the implicit or inherent power to interpret those rules. This power must be understood without prejudice to the competences of courts as ultimate interpreters of the legal order. Therefore, the ECB has the implicit power to interpret national provisions transposing directives. However, in doing so the ECB should take into account the following elements: (i) national provisions transposing directives must be interpreted in the light of the directive (indirect effect of directives or the principle of harmonious interpretation)[17]; (ii) specificities of the national legal systems and national traditions should also be considered; and (iii) the principle of legitimate expectations should also play a role when departing from previous interpretations of national supervisors.

The application of the national legislation of 19 Member States not only adds an additional level of complexity in the system. It also has an impact on the level of comparability of banks, could be a source of regulatory arbitrage and gives rise to level playing field issues. Although those level playing field issues are inherent to the current Union legal framework, the areas not fully harmonised become more visible – and harder to explain – when the decisions are adopted by one single supervisor in a centralised manner, as they might be perceived by the credit institutions and the public at large as inconsistencies or unequal treatment.

Let's take the additional powers granted to supervisors according to national law as an example. The CRD IV provides for a minimum level of harmonisation with regard to the regulation of supervisory powers in order to allow Member States to complement those powers with additional supervisory tools considered also necessary for ensuring effective supervision. Therefore, national legislators in various Member States introduced a wide array of powers, such as for instance the approval of operations of banks in third countries; information rights vis-à-vis external auditors; the approval of mergers/de-mergers or amendments to the bank's statutes; outsourcing related powers; appointment of key function holders and/or external auditors; approval of asset transfers/divestments or strategic decisions; credits to related persons; ancillary conditions to licensing, etc.

According to the European Commission, the ECB's supervisory powers under the SSM Regulation should be construed broadly enough to include those powers given to national authorities by national law for carrying out supervisory functions under the CRR-CRD IV in relation to credit institutions. This view is based on Article 64 of the CRD IV requiring that competent authorities must be given all supervisory powers to intervene in the activity of institutions that are necessary for the exercise of their function under the CRR and CRD IV. Therefore, when a supervisory power granted under national law underpins a supervisory function under Union law and can be subsumed in one of the tasks conferred on the ECB by the SSM Regulation, the ECB is the competent authority. For instance, the ECB has the power to oppose operations of Spanish or Italian significant institutions in third countries but does not have a similar power in relation to Austrian or Finnish banks. The question that

[17] Case C-14/83 *Von Colson and Kamann* v *Land Nordrhein-Westfalen*, ECLI:EU:C:1984:153.

immediately comes to everyone's mind is whether this is really a level playing field within the SSM.

2.2 ECB initiatives to achieve a higher degree of harmonisation

In order to address these issues, the ECB has worked intensively over the past two years in achieving a higher degree of harmonisation in the application of national legislation through different initiatives.

- **The adoption of regulatory instruments**

  The adoption of the Regulation on the exercise of options and discretions available in Union law and the corresponding Guide was a major milestone.

  The ECB set up a High-Level Group which identified about 120 ONDs that could be exercised by the ECB in a uniform way for all significant institutions in the euro area. Those options and discretions cover a wide range of prudential aspects of credit institutions, such as the treatment of deferred tax assets, large-exposure intragroup exemptions and intragroup liquidity waivers. The application of those options and discretions by national competent authorities across euro area countries had been very heterogeneous, raising level playing field issues. The ECB exercises the options and discretions in a harmonised manner throughout the participating Member States ensuring consistency and equal treatment amongst significant institutions. The ECB has also taken into account the general principle of legitimate expectations of supervised credit institutions, acknowledging the need to allow for transitional periods where its exercise of options and discretions significantly departs from the approach taken by the NCAs prior to the entry into force of the Regulation.

- **The development of policy stances**

  Great effort has also gone over the past two years into developing policy guidance on a number of issues in order to ensure harmonisation in applying supervisory requirements and supervisory practices. For example, in the field of fit and proper assessments several policy stances were developed in relation to assessing the sufficient time commitment to perform a management function; the way of counting directorships of a member of the management body; and interviews of candidates or the evaluation of relevant experience. In the field of assessment of acquisitions of qualifying holdings, harmonised guidance has been developed for assessing specific acquirers characterised by a high level of complexity or a lack of transparency.

3 Further harmonisation: possible ways forward

Further harmonisation is still needed as the application of a wide array of different pieces of national legislation is far from optimal for the SSM. There are various possible ways forward to foster further integration.

3.1 Towards a more uniform Union banking legislation

As discussed above, the CRR-CRD IV left plenty of flexibility to Member States and national supervisors. However this legislative package was adopted in 2013, before the SSM was established. Since those national divergences have a clear impact on the functioning of the SSM, the most effective way to ensure further harmonisation and integration in the regulatory field would be to promote the adoption of a more uniform set of substantive banking rules.

This could be achieved through different initiatives:

- favouring the recourse to regulations vs. directives (i.e. more CRR and less CRD IV);
- reducing the number of options and discretions granted to Member States (in both the CRR and CRD IV); and
- introducing further harmonisation in certain areas that have proven particularly cumbersome.

For instance, if the experience gained after two years of applying national legislation shows that the authorisation of merger/demergers or amendment of the bank's statutes are useful tools for supervisors, they should be included in the CRD IV to ensure that all Member States transpose them into national law. Similarly, if minimum harmonisation in the fit and proper assessment of bank managers has given rise to many issues, further harmonisation in terms of, e.g. time commitment should be ensured.

However, this avenue has a clear political dimension. Union legislative texts apply in all (28) Member States while the SSM applies in the (19 euro area) participating Member States. Although for SSM countries the current level of harmonisation of Union banking rules might not be considered optimal for taking full advantage of European banking supervision, non-participating Member States may be more reluctant to move in that direction. Legislative initiatives are normally the result of complex negotiations where national flexibilities play a role in the process of reaching a consensus.

3.2 Towards a more uniform application of Union banking legislation

If there was no political support to have a more harmonised set of Union banking rules, a less ambitious option would be introducing in the CRR and CRD IV national discretion at the level of NCAs instead of at the level of Member States (i.e. more options and discretions for competent authorities and fewer for Member States). This would allow a uniform application of those options and discretions by the ECB for all significant institutions in the participating Member States while, at the same time, leaving a margin for other NCAs to use those flexibilities in a different manner.

Other ways to achieve a more uniform application of Union banking legislation would be intensifying the recourse to soft law instruments by the ECB (more policy stances,

guides and supervisory expectations) and the development of a uniform interpretation of national laws transposing directives (the indirect effect of directives and the principle of harmonious interpretation).

3.3 Towards a more uniform SSM banking legislation?

It is at least worth considering if it would be legally feasible to have a more uniform set of banking rules for the Member States participating in the SSM.

The Decision of the Heads of State or Government concerning a new settlement for the United Kingdom within the European Union approved on 18-19 February 2016, although it never entered into force, included a paragraph that pointed in this direction: "Substantive Union law to be applied by the European Central Bank … including the single rule book as regards prudential requirements for credit institutions … may need to be conceived in a more uniform manner than corresponding rules to be applied by national authorities of Member States that do not take part in the banking union. To this end, specific provisions within the single rulebook … may be necessary."

Would it be possible to have two different sets of rules, one for "SSM" Member States and one for all Member States, without putting into question the whole idea of a single internal market? Could we have a directive applicable for the Union as a whole and an equivalent regulation to be directly applied by the ECB?

In fact, this has already been done within the banking union. Indeed, the Bank Recovery and Resolution Directive (BRRD)[18] lays down the rules for the recovery and resolution of banks in all Member States. However, the BRRD constitutes a minimum harmonised set of resolution rules, tools and powers but leaves discretion to Member States. Given that additional harmonisation was needed for the Single Resolution Mechanism (SRM), the SRM Regulation[19] was adopted on the basis of Article 114 TFEU.[20]

The SRM Regulation establishes the Single Resolution Board (SRB) and grants it certain powers. In addition, the Regulation integrates certain provisions which are parallel to the BRRD, as it was considered that the SRB must base its actions on directly applicable Union law. For certain aspects already covered by the BRRD, a further alignment was also considered indispensable for the proper functioning of the

[18] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

[19] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

[20] Article 114 TFEU: "The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market."

SRM (e.g. the full harmonisation of the hierarchy of claims in resolution, based on the depositor preference principle or the bail-in rules).

Although there were doubts as to whether Article 114 TFEU – a provision fostering the internal market – could serve as a legal basis for establishing the SRM and substantive rules applicable only to a subset of those countries (the participating Member States) it was considered legally sound. As recitals 12 and 18 of the SRM Regulation explain: (i) ensuring effective and uniform resolution rules across Member States benefits all Member States due to the interdependence of banking systems; in the absence of the Single Resolution Mechanism, financial crises in SSM Member States would have a stronger negative impact also in non-participating Member States and, therefore, is a measure facilitating the smooth functioning of the internal market[21]; (ii) in order to ensure a level playing field within the internal market as a whole, the SRM Regulation is consistent with the BRRD, adapting the rules and principles of that directive to the specificities of the SRM.[22]

The question arises as to whether it would be possible to conceive a more uniform substantive banking legislation for the SSM, on the basis of Article 114 TFEU, while respecting the singleness of the internal market. Could a regulation be adopted on the basis of that article replicating some provisions of the CRD IV for the ECB to apply directly? Would that be compatible with Article 4(3) of the SSM Regulation requiring that the ECB applies national law transposing directives?

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[21] Recital 12 SRM Regulation: "Ensuring effective resolution decisions for failing banks within the Union, including on the use of funding raised at Union level, is essential for the completion of the internal market in financial services. Within the internal market, the failure of banks in one Member State may affect the stability of the financial markets of the Union as a whole. Ensuring effective and uniform resolution rules and equal conditions of resolution financing across Member States is in the best interests not only of the Member States in which banks operate but also of all Member States in general as a means of ensuring a level competitive playing field and improving the functioning of the internal market. Banking systems in the internal market are highly interconnected, bank groups are international and banks have a large percentage of foreign assets. In the absence of the SRM, bank crises in Member States participating in the SSM would have a stronger negative systemic impact also in non-participating Member States. The establishment of the SRM will ensure a neutral approach in dealing with failing banks and therefore increase stability of the banks of the participating Member States and prevent the spill-over of crises into non-participating Member States and will thus facilitate the functioning of the internal market as a whole. The mechanisms for cooperation regarding institutions established in both participating and non-participating Member States should be clear, and no Member State or group of Member States should be discriminated against, directly or indirectly, as a venue for financial services."

[22] Recital 18 SRM Regulation: "In order to ensure a level playing field within the internal market as a whole, this Regulation is consistent with Directive 2014/59/EU. It therefore adapts the rules and principles of that Directive to the specificities of the SRM and ensures that appropriate funding is available to the latter. When the Board, the Council and the Commission exercise the powers conferred on them by this Regulation, they should be subject to the delegated acts, and regulatory and implementing technical standards, guidelines and recommendations adopted by EBA on the basis of respectively Articles 10 to 15 and Article 16 of Regulation (EU) No 1093/2010 within the scope of Directive 2014/59/EU. The Board, the Council and the Commission, in their respective capacities, should also cooperate with EBA in accordance with Articles 25 and 30 of Regulation (EU) No 1093/2010 and respond to requests of collection of information addressed to them by EBA in accordance with Article 35 of that Regulation. It is recalled that, according to the last sentence of Recital 32 of that Regulation, 'in cases where the relevant Union legislation confers discretion on […] competent authorities, decisions taken by the Authority cannot replace the exercise in compliance with Union law of that discretion'. The same principle should extend to this Regulation, while fully respecting the principles enshrined in primary Union law. In the light of those key elements EBA should be able to perform its tasks effectively and to secure the equality of treatment between the Board, the Council, the Commission and the national authorities when performing similar tasks."

4 Conclusions

Over the past two years the ECB has risen to the challenge of applying the national legislation transposing the CRD IV of 19 Member States. However, it cannot be denied that it adds complexity to the system, both from an operational and a legal point of view. In addition, divergences inherent to the current Union banking framework become more apparent, affecting the level playing field between SSM institutions.

The SSM needs to work hand in hand with a single regulatory framework and, as long as banking regulation remains fragmented, a full level playing field cannot be ensured by the single supervisor. If the banking union is to reach its full capabilities, further integration, at least for the SSM, is of the essence.

The application of national law by the ECB – a maze of (un)answered questions

By Alexander Kornezov[1]

1 Introduction

The Single Supervisory Mechanism (SSM), which establishes the ECB's competence for the prudential supervision of banks, brought about sweeping changes in the banking sector of the European Union. One of the most striking features of the SSM – and a highly intriguing one from a lawyer's perspective – is the ECB's newly acquired competence to apply the national legislation transposing a Union directive.[2] This is a novelty for the ECB. It is also an astounding legal amalgam insofar as a European institution is required to apply national law. While this is certainly not unprecedented in Union law generally – the Court of Justice of the European Union has been applying national law for decades in the context of Article 272 TFEU[3] – it raises a large number of legal issues.

This contribution seeks to address two of the most salient of these problems. The first concerns cases where a Member State fails to transpose a directive or does so wrongly. Can the ECB, in such a scenario, enforce the directive against a credit institution? And how can the objective of ensuring the efficient exercise of the ECB's supervisory tasks be reconciled with the Court's consistent case-law denying reverse vertical direct effect of directives? What remedies does the ECB have at its disposal for dealing with such cases? This is a matter not only of great practical significance but also of high legal complexity.

The second question that I will address concerns judicial protection. What remedies are available to credit institutions which wish to challenge the acts of the ECB when applying national law? Which court has jurisdiction to hear such actions? What should the standard of judicial review be in this regard?

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[1] Judge at the General Court of the European Union. I wish to thank A. De Gregorio Merino and L. Nizet for their comments on an earlier draft. All views expressed are those of the author.

[2] Article 4(3)(1) of Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (SSM Regulation).

[3] According to this provision, Union courts have jurisdiction to give judgment pursuant to any arbitration clause contained in a contract concluded by or on behalf of the Union, whether that contract be governed by public or private law. Union courts resolve such disputes on the basis of the substantive rules of the national law applicable to the contract – see, for example, judgment of 18 December 1986 in Case 426/85 Commission v Zoubek, ECLI:EU:C:1986:501, para. 10; judgment of 16 July 2014 in Case T-59/11 Isotis v Commission, ECLI:EU:T:2014:679, para. 73 and judgment of 27 April 2016 in Case T-155/14 ANKO v Commission, ECLI:EU:T:2016:245, para. 39.

A word of caution is, however, necessary at this stage. The area of law under discussion is relatively new and still very much under construction. There is currently no case-law of the European courts which could give direct guidance on any of the above-mentioned issues. The following sections therefore seek to explore some of the available avenues for addressing and eventually resolving them. They should therefore be understood as a simple brainstorming exercise rather than as ready-to-use recipes.

2 Remedies in the case of non-transposition or incomplete or wrong transposition of a directive

When applying national law in the context of Article 4(3)(1) of the SSM Regulation, the ECB may be confronted with either the lack of transposition of a directive altogether (or of some of its provisions) or the wrong transposition thereof. In the former scenario, there is no national law to apply. In the latter scenario, the applicable national law is, in the ECB's view, incompatible with the directive. Both scenarios raise the salient issue of the remedies at the ECB's disposal to deal with such non-compliance.

As mentioned above, the most obvious avenue is to ask the Commission to initiate infringement proceedings against the recalcitrant Member State. It may actually be argued that, while the Commission does indeed have a broad – and unamenable to judicial review – discretion when deciding whether to open such proceedings,[4] it should be under an obligation to act, in conformity with the principle of loyal cooperation between Union institutions, when a Member State undermines the powers conferred by the Treaties on another Union institution, in this case the ECB. In any event, given the importance of efficient supervision in the banking union for the European economy as a whole, it is highly likely that the Commission will indeed use its prerogatives under Article 258 TFEU at the ECB's request.

In addition, the ECB should seriously explore the full potential of Article 271(d) TFEU, which empowers it, under certain conditions, to initiate infringement proceedings in respect of national central banks where they fail to fulfil their obligations under the Treaties and the Statute of the ESCB and of the ECB.

A third remedy at the ECB's disposal is the procedure laid down in Article 17 of the EBA Regulation[5] which empowers, in particular, the ECB to request the EBA to examine an alleged breach or non-application of Union law by a competent national authority.

While these avenues are certainly worth exploring, it should be recognised that they do not always provide for efficient solutions. Infringement proceedings usually take

[4] Judgment of 11 August 1995 in Case C-431/92 Commission v Germany, ECLI:EU:C:1995:260, para. 22 and judgment of 6 November 2014 in Case C-395/13 Commission v Belgium, ECLI:EU:C:2014:2347, para. 32.

[5] OJ L 331, 15.12.2010, p.12.

years.[6] Moreover, the Court's judgment in such cases is declaratory[7] and does not, as such, ensure immediate redress. This holds true a fortiori with regard to the procedure laid down in Article 17 of the EBA Regulation, given that, in this context, the EBA's recommendation and the Commission's formal opinion have no binding legal force.

In times of crisis, however, the ECB should be able to act swiftly and achieve immediate results. Otherwise, its newly acquired supervisory powers might be seriously undermined. The ECB should therefore explore other options. The nature and the reach of these options depend, in my view, on the addressee of the acts adopted by the ECB by virtue of the SSM Regulation. The latter confers upon the ECB powers of instruction vis-à-vis, on one hand, national supervisory authorities and, on the other hand, credit institutions. I will discuss these two hypotheses in turn below.

2.1 The ECB's powers of instruction vis-à-vis national supervisory authorities in the case of non-compliance with a directive

It follows from Article 4 of the SSM Regulation, read in conjunction with Article 6(3), that the ECB, when exercising its supervisory powers, can either address its instructions directly to the credit institution(s) concerned or, alternatively, to the relevant national supervisory authority, which could then, as the case may be, give effect or implement these instructions by means of a national decision addressed to the credit institution(s) concerned.

The issue that arises here is whether the ECB can rely on a directive vis-à-vis the national supervisory authorities where the said directive has not been transposed into national law or has been transposed wrongly. As is well-known, the question of whether directives have direct effect depends, in particular, on the legal relationship in the context of which a directive is being invoked. It is settled case-law that directives have ascending vertical direct effect, meaning that an individual can rely on a directive against a Member State which has failed to transpose it (at all or correctly).[8] Conversely, however, directives do not enjoy descending direct effect or horizontal direct effect, meaning that a Member State cannot invoke a directive against an individual[9] and an individual cannot rely on a directive against another individual.[10] The rationale behind this long line of case-law is the estoppel argument: a Member State that has failed to transpose a directive cannot rely in its defence on

6 The average duration of infringement cases against Member States is 30.7 months, http://ec.europa.eu/internal_market/scoreboard/performance_by_governance_tool/infringements/index_en.htm

7 With the exception of infringement actions based on Article 260(3) TFEU, in which the Court may also impose a financial sanction.

8 Judgment of 4 December 1974 in Case 41/74 Van Duyn v Home Office, ECLI:EU:C:1974:133, para. 12, and judgment of 17 November 2011 in Case C-434/10 Aladzhov, ECLI:EU:C:2011:750, para. 32.

9 Judgment of 26 February 1986 in Case 152/84 Marshall v Southampton and South-West Hampshire Area Health Authority, ECLI:EU:C:1986:84, para. 48 and judgment of 14 July 1994 in Case C-91/92 Faccini Dori v Recreb, ECLI:EU:C:1994:292, para. 20.

10 ibid.

that failure against an individual who invokes the said directive.[11] Likewise, since directives are addressed to Member States, and not to individuals, they cannot directly create obligations for the latter. Hence, a directive cannot be relied upon against an individual.[12]

The above-mentioned case-law concerns the situation where a directive is invoked in a dispute between a Member State and an individual or between two individuals. The situation under examination, however, is different: can a Union institution – the ECB – rely upon a directive against a Member State?

As mentioned above, the rationale of the above-mentioned case-law is the estoppel argument. That argument is, in my view, fully pertinent in the case at hand. Indeed, given that directives are always addressed to a Member State, the latter cannot rely on its own incompliance in order to avoid its obligations stemming from the said directive. If we were to deny the ECB to possibility to rely, in such circumstances, on the provisions of a directive, the result would be precisely that: the recalcitrant Member State could take advantage of its own breach of Union law.

Moreover, what seems crucial in the rationale of the case-law discussed above is *against whom* the directive is being invoked, not by whom. What matters here is that a directive cannot be relied upon against a party to whom it is not addressed. Given that directives, including in the context of the banking union, are addressed to Member States, the ECB should be able to rely upon them against Member States.

Interestingly, the Court has already had the occasion to rule that a national authority may rely on a non-transposed directive against an entity which is to be considered an emanation of the State. In *Portgás*, in order to justify this conclusion, the Court referred both to Article 288 TFEU, which obliges all the authorities of the Member States to take all appropriate measures to achieve the result prescribed by the directive, and to the estoppel argument, according to which no authority of a Member State may take advantage of the Member State's failure to fulfil its Union obligations.[13] The same logic should, in my opinion, apply *mutatis mutandis* in a situation where a Union institution relies on a directive against a national supervisory authority.

This is further confirmed by the fact that, once the time limit for challenging the legality of a directive has expired, the Member State is definitively bound by it and is thus precluded from arguing that the directive is invalid. Thus, in infringement proceedings, whereby the Commission alleges that a Member State has failed to

[11] Judgment of 5 April 1979 in Case 148/78 Ratti, ECLI:EU:C:1979:110, para. 22; judgment of 26 February 1986 in Case 152/84 Marshall v Southampton and South-West Hampshire Area Health Authority, ECLI:EU:C:1986:84, para. 47 and judgment of 14 July 1994 in Case C-91/92 Faccini Dori v Recreb, ECLI:EU:C:1994:292, para. 22.

[12] Judgment of 26 February 1986 in Case 152/84 Marshall v Southampton and South-West Hampshire Area Health Authority, ECLI:EU:C:1986:84, para. 48 and judgment of 14 July 1994 in Case C-91/92 Faccini Dori v Recreb, ECLI:EU:C:1994:292, para. 20.

[13] Judgment of 12 December 2013 in Case C-425/12 Portgás, ECLI:EU:C:2013:829, paras. 34-36.

transpose a directive, that Member State is precluded from raising a plea of illegality against that directive.[14]

I therefore conclude that the ECB should be able to rely upon a directive vis-à-vis national supervisory authorities.

2.2 The ECB's powers of instruction vis-à-vis credit institutions in the case of non-transposition or wrong transposition of a directive

The question of whether and, if so, to what extent the ECB can rely upon a directive which has not been transposed, or has been transposed wrongly, in national law vis-à-vis credit institutions is particularly salient, given that, as mentioned above, directives as such cannot create obligations for individuals. It should therefore be clear that the ECB cannot invoke a directive against credit institutions.

This rather obvious conclusion does not, however, exhaust the debate. Indeed, in practical terms, it would greatly diminish the ECB's supervisory powers vis-à-vis credit institutions by excluding the latter from some of the constraints of the SSM and by letting them profit from their Member State's non-compliance, thus enjoying a competitive advantage with regard to their competitors from other Member States. The result of the above would not only undermine the ECB's newly bestowed competence as European-wide watchdog but would also lead to a fracturing of the internal market.

In legal terms, there are a number of avenues which have been elaborated in the Court's case-law which provide alternative redress where directives cannot be invoked against an individual. These avenues can be summarised as follows: (1) a broad interpretation of the notion of the "State"; (b) the principle of consistent interpretation; (c) invoking a general principle of Union law, as given expression in a directive; and (d) the *Viamex* precedent. I will examine in turn these alternative remedies and their relevance in the context of the ECB's supervisory powers vis-à-vis credit institutions.

2.2.1 The notion of "State"

One way of enabling the ECB to invoke directives against credit institutions is by arguing that the latter are, as a matter of law and/or fact, an emanation of the State. If the ECB succeeds in demonstrating that this is the case, then the matter should be tackled along the same lines as the one concerning the invocation of a directive vis-à-vis the national supervisory authorities, as discussed above.

[14] Judgment of 27 October 1992 in Case C-74/91 Commission v Germany, ECLI:EU:C:1992:409, para. 10 and judgment of 29 July 2010 in Case C-189/09 Commission v Austria, ECLI:EU:C:2010:455, para. 15.

It follows from the Court's settled case-law that the obligations arising from directives are binding, inter alia, on bodies or entities, regardless of their legal form, which are subject to the authority or control of a public authority or the State.[15]

To this end, the Court has laid down a number of elements which should be taken into account when examining whether a private entity should be considered subject to the authority or control of the State. These elements include: the share that the State holds in the entity's capital,[16] its voting rights, its representation in the entity's governing bodies, its right to veto the entity's decisions, the possibility for it to intervene in the entity's decision-making process by, for example, issuing instructions,[17] etc.

The suggested avenue might prove particularly useful in the context of the European banking sector, where, in response to the financial crisis, many credit institutions have been bailed out by the State, transforming them de facto into State-owned and/or State-controlled credit institutions.[18] It should therefore be possible to demonstrate, in a number of instances, that the credit institution concerned, despite its legal form, is an emanation of the State. Consequently, the ECB should be able to rely upon a directive against such credit institutions.

2.2.2 The principle of consistent interpretation

If the credit institution in question cannot be regarded as an emanation of the State, the principle of consistent interpretation provides an alternative avenue for ensuring the *effet utile* of directives. According to this principle, when national authorities apply domestic law they are bound to interpret it, insofar as possible, in the light of the wording and the purpose of the directive concerned in order to achieve the result sought by the directive and consequently comply with the third paragraph of Article 288 TFEU. This obligation to interpret national law in conformity with Union law is inherent in the Treaty on the Functioning of the Union, since it permits national courts, for the matters within their jurisdiction, to ensure the full effectiveness of Union law when they determine the disputes before them.[19]

It is true that the above-mentioned case-law is directed at national authorities. However, the obligation to interpret national law consistently with Union law should also extend to Union institutions which have been vested with the competence to

[15] Judgment of 26 February 1986 in Case 152/84, Marshall v Southampton and South-West Hampshire Area Health Authority, ECLI:EU:C:1986:84, para. 49; judgment of 22 June 1989 in Case 103/88 Fratelli Costanzo v Comune di Milano, ECLI:EU:C:1989:256, paras. 30 and 31; judgment of 12 July 1990 in Case C-188/89 Foster and others v British Gas, ECLI:EU:C:1990:313, para. 18; order of 26 May 2005 in Case C-297/03 Sozialhilfeverband Rohrbach, ECLI:EU:C:2005:315, para. 27; see also judgment of 14 June 2007 in Case C-6/05 Medipac - Kazantzidis, ECLI:EU:C:2007:337, para. 43.

[16] Judgment of 5 February 2004 in Case C-157/02 Rieser Internationale Transporte, ECLI:EU:C:2004:76, para. 25.

[17] ibid., paras. 25-26; judgment of 12 December 2013 in Case C-425/12 Portgás, ECLI:EU:C:2013:829, para. 29.

[18] For instance, Fortis has been partially nationalised by the three Member States of the Benelux; Dexia has been recapitalised by France and Belgium; RBS, Lloyds TSB, Standard Chartered and Northern Rock have been partially nationalised by the United Kingdom.

[19] Judgment of 24 January 2012 in C-282/10 Dominguez, ECLI:EU:C:2012:33, para. 24.

apply national law. The opposite would be untenable. Indeed, Union institutions cannot be required to apply national law which is, in their view, inconsistent with Union law.

The ECB should therefore be able to rely on the principle of consistent interpretation. This principle is a particularly powerful tool which enables the ECB to interpret the relevant national law in the light of the wording and the purpose of the directive concerned. In practice, this principle often allows the desired EU-compliant result to be achieved through a skilful interpretation of national law in a way that would render it consistent with the directive. This principle is particularly useful in a situation where a provision of national law is capable of different interpretations, some rendering it compatible with Union law and others not.[20] In such circumstances, it is clear that the consistent interpretation should be given precedence.

However, it must be borne in mind that the principle of consistent interpretation has certain limitations. Thus the obligation on a national court to refer to the content of a directive when interpreting and applying the relevant rules of domestic law is limited by the general principles of law and it cannot serve as the basis for an interpretation of national law *contra legem*.[21] Hence, if the only possible way to render the applicable provision of national law compatible with the directive is to interpret the former *contra legem*, the principle of consistent interpretation cannot be applied. When assessing whether the envisaged consistent interpretation might serve as the basis for an interpretation of national law *contra legem*, the ECB should take account of the case-law of national courts.[22] Similarly, if such consistent interpretation runs counter to a general principle of law – in the context of the banking union, these would most often be the principles of legal certainty and legitimate expectations – the ECB would be prevented from relying upon the principle of consistent interpretation.

The said principle has one further limitation in the specific context of Article 4(3)(1) of the SSM Regulation. Where a directive or a part thereof has not been transposed into national law at all, that principle would be of no use to the ECB. Indeed, in such circumstances, there is no national law that could be interpreted consistently with Union law.[23]

2.2.3 Invoking a general principle of Union law, as given expression in a directive

The Court has recently introduced a third mechanism which, in substance, allows the enforcement against a private party of obligations stemming from a directive (if, of course, its provisions are sufficiently clear, precise and unconditional), if that directive gives expression to a general principle of Union law. This mechanism was

[20] ibid, para. 29.

[21] ibid, para. 25.

[22] By analogy, judgment of 15 January 2014 in case C-176/12 Association de médiation sociale, EU:C:2014:2, para. 40.

[23] By analogy, judgment of 26 September 1996 in Case C-168/95 Arcaro, ECLI:EU:C:1996:363, para. 42.

inaugurated in *Mangold*[24] and confirmed in *Kücükdeveci*[25]. In *Mangold* the Court held that, in a perfectly horizontal relationship, an individual can rely against another private party upon a general principle of Union law which was given concrete expression in a Union directive. Specifically, the Court emphasised that the principle of non-discrimination on grounds of age must be regarded as a general principle of Union law, the observance of which cannot be conditional upon the expiry of the period prescribed for the transposition of the Directive.[26]

This mechanism was confirmed and clarified in *Kücükdeveci*. The Court reiterated that the principle of non-discrimination on grounds of age is a general principle of Union law, now enshrined in Article 21(1) of the Charter of Fundamental Rights of the European Union, and that Directive 2000/78/EC "merely gives expression" to that principle.[27] Consequently, an individual can rely on a "general principle of EU law, as given expression in a directive", in a dispute against another private party in order to set aside national legislation contrary to that principle. The Court has applied this formula in a number of cases since then.[28]

The question thus arises of whether the *Kücükdeveci* formula could be applied in the context of the ECB's supervisory powers vis-à-vis credit institutions. In particular, where a directive has not been transposed or has been transposed wrongly in national law, could the ECB rely upon a general principle of Union law, as given expression in that directive, when issuing instructions to credit institutions?

There are at least two obstacles to applying the *Kücükdeveci* formula by analogy in the context of the SSM. The first one relates to the fact that that formula was elaborated for the purpose of overcoming the lack of horizontal direct effect of directives, i.e. where an individual invokes a directive against another individual. The SSM context is, however, different: the ECB seeks to rely upon a directive against a private entity. This relationship might therefore be seen as vertical. Nonetheless, if the *Kücükdeveci* formula is seen rather as a means of enforcing an obligation upon a private entity, the question of who invokes the directive (the ECB or a private party) becomes less important.

The second obstacle is more difficult to overcome. Critically, in both *Mangold* and *Kücükdeveci* the Court reasoned on the basis of a general principal of Union law, as given expression in a directive. This point is crucial. In *KHS*, for example, the Court held that the right to paid annual leave was a "particularly important principle of European Union social law", further specified in Directive 2003/88/EC.[29] However, it did not apply the *Kücükdeveci* formula, nor did it refer to it. Similarly, in *Dominguez*[30] the Court reaffirmed that the aforementioned right was a particularly important

[24] Judgment of 22 November 2005 in Case C-144/04 Mangold, ECLI:EU:C:2005:709.

[25] Judgment of 19 January 2010 in Case C-555/07 Kücükdeveci, ECLI:EU:C:2010:21.

[26] Judgment of 22 November 2005 in Case C-144/04 Mangold, ECLI:EU:C:2005:709, paras. 74-76.

[27] Judgment of 19 January 2010 in Case C-555/07 Kücükdeveci, ECLI:EU:C:2010:21, para. 50.

[28] See, e.g., judgment of 8 September 2011 in Joined Cases C-297/10 and C-298/10, Hennigs and Mai, ECLI:EU:C:2011:560 and judgment of 26 September 2013 in Case C-476/11 HK Danmark, ECLI:EU:C:2013:590.

[29] Judgment of 22 November 2011 in Case C-214/10 KHS, ECLI:EU:C:2011:761, paras. 23, 31 and 37.

[30] Judgment of 24 January 2012 in Case C-282/10 Dominguez, ECLI:EU:C:2012:33.

principle of Union social law, but concluded that Directive 2003/88/EC cannot "of itself" apply in proceedings exclusively between private parties. It also made no mention of the *Kücükdeveci* formula.

Further clarification was provided two years later in *Association de médiation sociale.*[31] The case concerned a horizontal dispute seeking to enforce the workers' right to information and consultation within the undertaking, laid down in Article 27 of the Charter and in Directive 2002/14/EC. This time the Court expressly refused to apply the *Kücükdeveci* formula. It gave, in essence, two reasons for this. First, Article 27 of the Charter is not as such "fully effective", since it must be given more specific expression in Union or national law.[32] Second, a replay of the *Kücükdeveci* formula – this time through the combination of Article 27 and Directive 2002/14/EC – is not possible either, since neither of them is capable of conferring rights on individuals which they may invoke as such.[33]

In the SSM context, the ECB could invoke the principles of stability of the financial system and of prudential oversight and management of Union credit institutions.[34] However, it is questionable whether these principles could be qualified as *general* principles of Union law. It seems to follow from a combined reading of the above-mentioned case-law that sectoral principles (such as the principles in the sphere of social protection) do not normally qualify as general principles of Union law. Moreover, the principles of stability of the financial system and of prudential oversight and management of Union credit institutions can hardly be regarded as self-sufficient – within the meaning of *Association de médiation sociale* – since they require further specific expression in Union or national law. The analogy here with *Association de médiation sociale* is obvious. While it is true that, in *Ledra Advertising* v *Commission and ECB*,[35] the Court admitted that the stability of the banking system is an "objective of general interest pursued by the European Union", this statement does not, as such, mean that it is a general principle of Union law. It remains to be seen whether the Court might eventually consider it to be such.

It would also be worth exploring the possibility of invoking the principle of equal treatment, which, following the *Kücükdeveci* formula, is to be recognised as a general principle of Union law. This principle is also relevant in the context of the SSM. Indeed, Article 1(1) of the SSM Regulation requires the ECB to perform its supervisory tasks "based on equal treatment of credit institutions". It could therefore be argued that the non-application of a sufficiently clear and precise provision of a directive vis-à-vis one credit institution, while the same provision is being enforced against a credit institution in another Member State (because in the first scenario the directive was not transposed or wrongly so, while in the second scenario it was correctly transposed) breaches the principle of equal treatment. The main difficulty of such an argument is whether a directive in the area of banking law – for example the

[31] Judgment of 15 January 2014 in Case C-176/12 Association de médiation sociale, ECLI:EU:C:2014:2.

[32] ibid, paras. 44-45.

[33] ibid, para. 49.

[34] See Article 1(1) of the SSM Regulation.

[35] Judgment of 20 September 2016 in Joined Cases C-8/15 P to C-10/15 P Ledra Advertising v Commission and ECB, ECLI:EU:C:2016:701, para. 71.

CRD IV – could be regarded as “giving expression” to the general principle of equal treatment. Whereas in *Kücükdeveci* it was obvious that Directive 2000/78/EC merely gave expression to the principle of non-discrimination, the link between the CRD IV and the principle of equal treatment looks more tenuous. The interesting question here would therefore be whether the ECB would be able to rely on that principle, as given expression in a directive, in order to enforce the same regulatory obligations vis-à-vis all credit institutions.

2.2.4 The Viamex precedent

The judgment in *Viamex*[36] provides another avenue which might be worth exploring in the context of the SSM. The case raised the novel question of whether a regulation could validly make certain payments to private parties subject to compliance by those parties with a directive, given that directives cannot of themselves impose obligations on individuals. In the case at hand, a Commission regulation provided that export refunds were not to be paid for animals with regard to which the exporter had not complied with the requirements laid down in the directive on the protection of animals during transport. In other words, the regulation made express reference to a directive by precluding payments to private parties who had failed to comply with it. The Court held that “it cannot be precluded, in principle, that the provisions of a directive may be applicable by means of an express reference in a regulation to its provisions, provided that general principles of law and, in particular, the principle of legal certainty, are observed”.[37] In other words, a directive can be invoked against individuals, if a regulation expressly renders some of its provisions applicable to individuals.

Could the *Viamex* precedent apply by analogy in the SSM context? In both cases, at issue is the application of a regulation in combination with a directive. It could also be argued that the SSM Regulation, like the regulation concerned in *Viamex*, makes express reference to the directives on capital requirements for credit institutions and on financial conglomerates.[38] There is, however, in my view, one major difference between the two cases: in *Viamex* there was no equivalent of Article 4(3)(1) of the SSM Regulation. That provision specifically requires the ECB to apply national law that transposes a directive. If the *Viamex* solution were to apply in the SSM context, it could in fact result in the circumvention of the requirements of Article 4(3)(1) of the SSM Regulation, as it would allow the ECB systematically to disregard the applicable national law. Moreover, the SSM Regulation does not “incorporate” a specific provision of a relevant directive, thus rendering it applicable to credit institutions. Nonetheless, the *Viamex* analogy provides sufficient grounds for reflection in view of possible future legislative developments.

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[36] Judgment of 17 January 2008 in Joined Cases C-37/06 and C-58/06 Viamex Agrar Handels and ZVK, ECLI:EU:C:2008:18.

[37] ibid., para 28.

[38] See recital 34 of the SSM Regulation.

In a nutshell, it follows from all of the above that the ECB may seek to rely on an extensive interpretation of the notion of the "State", as well as on the principle of consistent interpretation vis-à-vis credit institutions in a situation where a directive has not been transposed or has been transposed incorrectly. These tools would not, however, enable it to deal with all inconsistencies, given that, on one hand, many credit institutions cannot be regarded as an emanation of the State, and, on the other hand, the principle of consistent interpretation has its limitations. It might also be worth exploring whether the ECB could rely on a general principle of Union law, as given expression in a directive, as well as on the *Viamex* precedent. While the present state of case-law might suggest that, at this stage, these two avenues are more difficult to pursue, they could, nonetheless, be seen as useful yardsticks for the evolution of both the legislation and the case-law.

There will therefore still be cases where the ECB would be unable to rely on any of the above-mentioned remedies vis-à-vis credit institutions. The resulting impediments to the effective exercise of the ECB's supervisory powers should, in such circumstances, be addressed either through the infringement proceedings (Articles 258 and 271(d) TFEU and/or Article 17 of the EBA Regulation) or by adopting instructions addressed to the national supervisory authorities instead.

3 Judicial review of the ECB's instructions

The question of which court has jurisdiction to hear challenges against the instructions of the ECB, adopted in the context of the SSM, in which the ECB applies national law, has spurred debate with some commentators arguing that national courts should have jurisdiction,[39] while others express the view that the matter comes within the competence of the Court of Justice.[40]

I am of the view that the Court of Justice has exclusive jurisdiction to hear direct challenges against the instructions of the ECB in the context of the SSM, regardless of the fact that the ECB has applied national law in these instructions. There are at least three arguments that support this conclusion.

First, the fact that these instructions apply national law matters little for the purpose of determining which court has jurisdiction. Indeed, the ECB is empowered to apply national law *by virtue of Union law*. In other words, it is Union law that commands the ECB to apply national law. Article 263(2) TFEU states, in particular, that the Court of Justice has jurisdiction in actions brought on grounds of "infringement of the Treaties or of *any rule of law relating to their application*" (emphasis added).

Second, the instructions of the ECB in the context of the SSM are an act of a Union institution.[41] It is settled case-law since the landmark judgment in *Foto-Frost*[42] that

[39] See, e.g., FIDE 2016 Report, European Banking Union, Institutional Report.

[40] ibid.

[41] And not a contract concluded by the ECB which could, depending on its clauses, be subject to a national court's jurisdiction.

the Court of Justice has exclusive jurisdiction to annul or declare void an act of a Union institution or body. Therefore, an application for annulment of such an act can only be brought before the Court of Justice. The exclusive jurisdiction of the Court of Justice to hear such actions is further confirmed by Article 274 TFEU.[43]

Third, the SSM Regulation itself points to the same conclusion. Indeed, Article 24, which lays down the rules on the administrative review of acts adopted by the ECB by virtue of the said Regulation, provides, in paragraph 11, that that review is "without prejudice to the right to bring proceedings before the [Court of Justice] in accordance with the Treaties". This is further confirmed in recital 60 of the Regulation, according to which the Court of Justice is to review the legality of acts of the ECB pursuant to Article 263 TFEU.

Therefore all direct challenges against acts adopted by the ECB by virtue of the SSM Regulation should be brought before the Court of Justice. This applies both to actions for annulment[44] and to actions for failure to act.[45]

Indirect challenges could, however, be raised before the national courts. This scenario could occur where the ECB addresses its instructions to the national supervisory authorities, which then give effect to those instructions in a decision addressed to a credit institution. In such circumstances, the latter may seek the annulment of the national supervisory authorities' decision before the competent national court, where it can raise a plea of illegality against the instructions of the ECB. If the national court entertains any doubts as to the validity of these instructions, it ought to make a reference for a preliminary ruling to the Court of Justice.[46]

The question of damages allegedly suffered by the credit institution as a result of the illegal instructions of the ECB and/or of the national supervisory authorities can also arise. If the instructions of the ECB were addressed directly to the credit institution, then the latter should bring its action before the General Court of the European Union. If, however, the ECB instructed the national supervisory authorities, which then gave effect to these instructions in a decision addressed to the credit institution, the question of who bears the responsibility for the damages should be resolved. If the injury is attributable to the national supervisory authorities (for example, they applied the ECB's instructions incorrectly or exercised discretion), the matter should be brought before the national courts, which may, or must, make a reference for a preliminary ruling to the Court of Justice. If the illegality is attributable to the ECB (i.e. the national supervisory authorities merely enacted the instructions given to them by the ECB), a distinction has to be drawn between the types of pecuniary loss

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[42] Judgment of 22 October 1987 in Case 314/85 Foto-Frost v Hauptzollamt Lübeck-Ost, ECLI:EU:C:1987:452.

[43] "Save where jurisdiction is conferred on the Court of Justice of the European Union by the Treaties, disputes to which the Union is a party shall not on that ground be excluded from the jurisdiction of the courts or tribunals of the Member States."

[44] Article 263 TFEU.

[45] Article 265 TFEU.

[46] Judgment of 22 October 1987 in Case 314/85 Foto-Frost v Hauptzollamt Lübeck-Ost, ECLI:EU:C:1987:452, para. 12.

suffered. If the illegality attributed to the ECB has allegedly caused actual injury to a credit institution (for example, insolvency or a weakening of its competitive position), the action should be brought before the General Court of the European Union;[47] Conversely, if the case is, for example, about undue payment to a national authority, it should be brought before the national courts, which then may, or must, make a reference for a preliminary ruling to the Court of Justice.[48] The same pattern applies mutatis mutandis where it is alleged that the injury was the result of unlawful joint action of the ECB and a national authority.[49]

The topic of judicial control should, however, not be reduced to matters of jurisdiction and/or admissibility. An equally important question concerns the *standard of judicial review*. The analysis of the case-law of the European Courts seems to suggest that the latter allow the ECB broad discretion in matters of “technical nature” or requiring “complex assessments”.[50] Consequently, an act of the ECB of this nature can be annulled on substance only if a manifest error of assessment can be demonstrated.[51] This standard of review thus makes it difficult for applicants to successfully challenge in court any acts of the ECB which contain complex or technical economic assessments.

It must, however, be emphasised that this line of case-law concerns acts of the ECB adopted in the context of its dealings with Member States or, more generally, in the context of its monetary policy. The question of whether the standard of judicial review should be stricter in a situation where the ECB imposes obligations directly on credit institutions is critical, given that, in the context of the SSM, such acts may affect their fundamental rights.

Conclusion

The ECB’s newly acquired competence to apply national law in the context of the SSM raises a myriad of questions in a still-developing area of Union law. The biggest challenge facing the ECB and the European Courts is to find a viable way of reconciling the objective of ensuring the efficient exercise of the ECB’s supervisory powers and the judicial protection of credit institutions, against which a non-transposed or an ill-transposed directive might not, as such, be invoked. The present contribution has explored several avenues for solving this conundrum

[47] For an example, see, by analogy, judgment of 18 September 1995 in Case T-167/94 *Nölle* v *Council and Commission*, ECLI:EU:T:1995:169, paras. 41-42.

[48] For an example, see judgment of 21 May 1976 in Case 26/74 *Roquette Frères* v *Commission*, ECLI:EU:C:1976:69.

[49] For an example, see judgment of 14 July 1967 in Joined Cases 5, 7 and 13 to 24/66, *Kampffmeyer and others* v *Commission of the EEC*, ECLI:EU:C:1967:31.

[50] Judgment of 16 June 2015 in Case C-62/14 Gauweiler and others, ECLI:EU:C:2015:400, para. 68.

[51] ibid, para. 74.

Procurement law and central banking

Introduction

By Mikael S. Stenström

The principles of ECB procurement rules, with a special focus on cooperation agreements

By Isabell Koepfer

EPCO – Coordinating joint procurements in the Eurosystem/ESCB

By Tamás Csepely-Knorr

The interaction between European Union, ECB and national laws in the context of procuring euro banknotes

By Torsten Schäfer

Introduction

By Mikael S. Stenström[1]

Public procurement in the European Union is an expanding field in terms of scope and importance. This development affects also central banks, including the European Central Bank (ECB) where significant procurement experience and expertise have been built up over recent years. The increased economic importance of public procurement requires that the legal regimes for contract award procedures are up to date and fit for purpose. Already the degree of spending through procurement by public entities in the Union, including by the ECB and the national central banks (NCBs) in the Eurosystem and the European System of Central Banks (ESCB), underlines the need for modern legal frameworks that support transparent procedures, fair competition and value for money. Moreover, since the start of the financial crises, public procurement has gained further relevance as a strategic tool to support economic activity and growth within and between Member States, including the possibility for contracting authorities to collaborate and conduct joint procurements through centralised offices on a cross-border basis. It is against this background that the 2016 ESCB Legal Conference explored a number of key challenges in the area of procurement concerning the ECB, the NCBs and the Eurosystem Procurement Coordination Office (EPCO), with a focus on ESCB cooperation and the recent amendments to the legal frameworks for procurement.

1 Union procurement law and the ECB

In October 2015, the European Commission referred to the importance of public procurement for the Single Market and stated that "[p]ublic procurement represents around 19% of EU GDP, with over EUR 2.3 trillion being spent each year by public authorities and utilities. In 2014, the EU adopted a major overhaul of the EU procurement framework, simplifying procedures and making the rules more flexible and adapting them to better serve other public sector policies, in particular innovation. This was aimed at making public procurement more efficient and strategic, fulfilling the principles of transparency and competition to the benefit of both public purchasers and economic operators, in particular SMEs."[2] The ECB is also increasingly purchasing through public procurement, with the scope of the

1 Head of the Legislation Division, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

2 Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *Upgrading the Single Market: more opportunities for people and business*, COM(2015) 550 final, paragraph 3.2. See also the report by former Commissioner Mario Monti, *A New Strategy for the Single Market: At the Service of Europe's Economy and Society*, 9 May 2010; and the Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *Public procurement for a better environment*, 16 July 2008, COM(2008) 400 final. For more details regarding the strategic importance of public procurement in the Union, see also Sanchez-Graells, A., "Collaborative Cross-border Procurement in the EU: Future or Utopia?", *Upphandlingsrättslig Tidskrift*, Vol. 1, pp. 11-37, 2016.

ECB's spending through contract award procedures amounting to approximately EUR 500 million per year,[3] and in 2016 the ECB updated its own procurement rules.[4]

The development of Union procurement law[5] has taken a clear direction towards an increase in transparency and publicity of tender procedures, as reflected prominently in the latest set of Union directives on public procurement from 2014.[6] As a result of successive changes to Union procurement law and the related case-law of the Court of Justice of the European Union, the enforceable rights of suppliers participating in public procurements have increased over time with a focus on transparency and equal treatment and the application of proportionality and non-discriminatory selection criteria to ensure fair competition.

A review of specific procurement matters, in particular in cross-border cases, demonstrates the complexity of applying procurement law. Since the Union procurement regime is set out in directives, Member States have had to follow suit and implement the Union procurement rules in their domestic legislation. Accordingly, the procurement directives apply to Member States and national procurement procedures must comply with the domestic legislation implementing the directives. The provisions of the Union procurement directives do not, however, apply directly to the ECB in view of inter alia the ECB's status as an independent Union institution and the ECB has therefore adopted its own procurement rules[7]. Nevertheless, Union procurement law – and the changes to it – are relevant also for the ECB, as the ECB has to respect the fundamental freedoms under the Treaties, as well as the general principles of Union procurement law and the case-law of the Court of Justice. For instance, recital 2 of the ECB's procurement rules clarifies that the ECB is "committed to the principle of cost-efficiency and seeks the best value for money from the procurement of products, services and works" and recital 4 states that "[t]he ECB respects the general principles of procurement law as reflected in Directive 2014/24 [8] and [the EU Financial Regulation]"[9]. Moreover, the 2016 version

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3 The ECB's more regular procurement activities include in particular the procurement of information technology (hardware and software), consultancy, communication and media services, as well as the rental of office space.

4 Decision (EU) 2016/245 of the European Central Bank of 9 February 2016 laying down the rules on procurement (ECB/2016/2) (recast) (OJ L 45, 20.2.2016, p. 15).

5 There have been several Union procurement directives over the years, starting in the 1970s with Directives 71/304/EEC and 77/62/EEC; followed in the 1990s with Directives 92/13/EEC, 92/50/EEC, 93/36/EEC and 93/37/EEC; then, a decade later, the coordination Directives 2004/17/EC and 2004/18/EC; and, finally, another ten years later, Directive 2014/23/EU of the European Parliament and of the Council of 26 February 2014 on the award of concession contracts (OJ L 94, 28.03.2014, p. 1) ("Directive 2014/23 on concessions"); Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC (OJ L 94, 28.03.2014, p. 65) ("Directive 2014/24 on public procurement"); and Directive 2014/25/EU of the European Parliament and of the Council of 26 February 2014 on procurement by entities operating in the water, energy, transport and postal services sectors and repealing Directive 2004/17/EC (OJ L 94, 28.03.2014, p. 243) ("Directive 2014/25 on utilities").

6 Among the three procurement directives from 2014 (Directive 2014/23 on concessions, Directive 2014/24 on public procurement and Directive 2014/25 on utilities), Directive 2014/24 on public procurement is the most relevant for the present purposes.

7 Decision ECB/2016/2, see footnote 4.

8 Directive 2014/24 on public procurement, see footnote 5.

9 Regulation (EU, Euratom) No 966/2012 of the European Parliament and of the Council of 25 October 2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation (EC, Euratom) No 1605/2002 (OJ L 298, 26.10.2012, p. 1).

of the ECB's procurement rules was adopted on the basis of Article 19 of the Decision on the ECB's Rules of Procedure, which states that the "[p]rocurement of goods and services for the ECB shall give due regard to the principles of publicity, transparency, equal access, non-discrimination and efficient administration".[10]

2 ECB procurement law and practice

As is the case with the Union procurement directives, the ECB's procurement rules have been updated and developed over time. When the ECB was first established, it adopted internal guidelines in the form of administrative circulars to provide a framework for procurement procedures. These administrative circulars were subsequently considered unsatisfactory in view of the significant volume of procurement by the ECB. The ECB therefore decided to develop a set of procurement rules in the form of a public legal act – these rules were adopted and published in July 2007 as a binding ECB decision.[11] Following several technical amendments,[12] the ECB embarked on a more exhaustive review of its legal procurement framework in mid-2015, following the adoption of the new procurement directives.[13] This review led to the adoption of the present recast rules for ECB procurement,[14] which entered into force on 15 April 2016. Whilst the provisions of the Union directives on procurement are not, as such, applicable to ECB procurements, the freedoms under the Treaties and the principles of Union procurement law, such as equal treatment and non-discrimination, are reflected in the latest version of the ECB's legal framework governing ECB procurements.[15]

As a specific observation, the ECB's procurement practice involves the use of framework agreements as an efficient contractual tool. Article 33 of Directive 2014/24/EU on public procurement defines a framework agreement as "an agreement between one or more contracting authorities and one or more economic operators, the purpose of which is to establish the terms governing contracts to be awarded during a given period, in particular with regard to price and, where appropriate, the quantity envisaged". The ECB's procurement rules allow the ECB to use framework agreements to meet a need for repetitious supply of "similar products, services or works without being able to define the exact quantities, delivery times or

[10] See Article 19.1 of the ECB's Rules of Procedure; and Decision ECB/2004/2 of the European Central Bank of 19 February 2004 adopting the Rules of Procedure of the European Central Bank (OJ L 80, 18.3.2004, p.33), as amended by Decision ECB/2009/5 (OJ L 100, 18.4.2009, p. 10), Decision ECB 2014/1 (OJ L 95, 29.3.2014, p. 56), Decision ECB/2015/8 (OJ L 114, 5.5.2015, p. 11) and Decision ECB/2016/27 (OJ L 258, 24.9.2016, p.17).

[11] Decision ECB/2007/5 of the European Central Bank of 3 July 2007 laying down the Rules on Procurement (OJ L 184, 14.7.2007, p. 34).

[12] Decisions ECB/2009/2 of 27 January 2009 (OJ L 51, 24.2.2009, p. 10), ECB/2010/8 of 27 July 2010 (OJ L 238, 9.9.2010, p. 14) and ECB/2012/10 of 19 June 2012 (OJ L 178, 10.7.2012, p. 14), in each case amending Decision ECB/2007/5 laying down the Rules on Procurement.

[13] See references to the EU procurement directives in footnotes 5 and 6.

[14] See footnote 4.

[15] See, with a special focus on cooperation agreements, Koepfer, I., "The principles of ECB procurement rules", 2016 ESCB Legal Conference. For more details regarding the ECB's new procurement rules, see also von Lindeiner, F., "The new procurement rules of the European Central Bank", in *Public Procurement Law Review*, 2016, pp. 213-223.

the detailed requirements".[16] Accordingly, the framework agreement with a supplier sets down the general terms and conditions applicable, but certain more specific aspects are subsequently addressed in "call-offs" or "purchase orders" when the ECB places an order with that same supplier.

The general contract term under the ECB procurement rules should not exceed four years, unless a legitimate reason justifies a longer duration.[17] During this period, both the ECB and the supplier benefit from the efficiency of the framework agreement as a tool under which separate orders can be placed through call-offs without additional steps in terms of procedure. Such a set-up not only saves time and money for both parties, but can also allow the supplier the possibility to offer the procured products or services at a discount in view of the large quantities that may be procured over the lifetime of the framework agreement.[18]

3 EPCO and joint procurements

Directive 2014/24/EU on public procurement[19] promotes the joint procurement of goods and services and the use of centralised purchasing techniques. Joint procurement can be defined as procurement activities conducted jointly by several contracting authorities, with one tender published on behalf of all the participating authorities. The ECB's Decision on the framework for joint Eurosystem procurement[20] defines "joint tender procedure" as a procedure for the joint procurement of goods and services by a "leading central bank" for the benefit of itself as well as other central banks (or other national authorities or Union institutions or international organisations) participating in the joint tender procedure.[21] The benefits for the contracting authorities taking part in the joint procurement include economies of scale, improved contractual conditions, administrative efficiency and the pooling of procurement and other skills on the purchasing side.

The Governing Council of the ECB considers joint procurement to be an instrument to achieve cost-efficiency, effectiveness and best value for money.[22] There are different types of arrangements to organise joint procurements, ranging from loose contractual arrangements for joint tendering to the establishment of a framework and creation of a separate organisation with a mandate to support joint tender procedures. The establishment of EPCO, hosted by the Banque centrale du

[16] Article 18(1) of Decision ECB/2016/2, see footnote 4.

[17] Article 7(1) of Decision ECB/2016/2, see footnote 4. See also Article 33 of Directive 2014/24 on public procurement (see footnote 5) concerning the duration of framework agreements.

[18] For more details regarding framework agreements under Union law, see also Andrecka, M., "Framework agreements, EU procurement law and the practice", *Upphandlingsrättslig Tidskrift*, Vol. 2, 2015, pp. 127-149.

[19] Directive 2014/24 on public procurement, see footnote 5.

[20] Decision ECB/2008/17 of the European Central Bank of 17 November 2008 laying down the framework for joint Eurosystem procurement (OJ L 319, 29.11.2008, p. 76), as amended by Decision (EU) 2016/21 of the European Central Bank of 23 December 2015 (ECB/2015/51) (OJ L 6, 9.1.2016, p.5).

[21] Article 1(g) of Decision ECB/2008/17.

[22] Recital 3 of Decision ECB/2008/17.

Luxembourg as coordinator of Eurosystem and ESCB joint procurements, represents such a separate organisation for joint procurement.[23]

4 Banknote procurement

As a specific case, the procurement of euro banknotes is an interesting example and a good indication of the potential legal complexities in Eurosystem procurement. The issuing of euro banknotes is a public task entrusted to the Eurosystem central banks.[24] The exclusive right of the Governing Council of the ECB to authorise the issue of euro banknotes includes the competence to set the legal framework for the production and procurement of euro banknotes.[25] For obvious reasons, euro banknotes have to be produced in a fully secure, controlled and confidential environment that guarantees a reliable, high-quality and sustained supply over time.[26] The Decision on EPCO and joint Eurosystem procurement is without prejudice to the establishment of the Eurosystem Production and Procurement System (EPPS) relating to the production of euro banknotes.[27] The EPPS consists of two pillars: a group of NCBs producing their euro banknotes using in-house printing works and a group of NCBs that do not have in-house printing works and therefore procure their euro banknotes through tender procedures.[28] In addition to the core procurement rules, a wide range of other legal acts applies to euro banknote production. Notably for the second group of NCBs, this set-up involves the interaction of various rules applying to euro banknote production and procurement at national level, such as Union law, ECB law and national law, which can lead to complex legal application issues.[29]

5 Concluding remarks

Transparent and proportionate procurement rules which give suppliers the opportunity to compete on equal terms and contracting authorities the chance to apply efficient tender procedures jointly and across borders are strategically important. The ECB and the NCBs in the Eurosystem and the ESCB contribute to these strategic objectives through proper legal frameworks and best practices in individual and joint procurement procedures. The following chapters address in more

[23] On joint procurement under the regime applicable to EPCO, see Tamás, C.-L., “EPCO – Coordinating joint procurements in the Eurosystem/ESCB”, 2016 ESCB Legal Conference.

[24] Article 128(1) of the Treaty on the Functioning of the European Union and Article 16 of the Statute of the European System of Central Banks and of the European Central Bank. Further details are laid down in Articles 2 and 3 of Decision ECB/2010/29 of the European Central Bank of 13 December 2010 on the issue of euro banknotes (recast) (OJ L 35, 9.2.2011, p. 26).

[25] Recital 1 of Guideline (EU) 2015/280 of the European Central Bank of 13 November 2014 on the establishment of the Eurosystem Production and Procurement System (ECB/2014/44) (OJ L 47, 20.2.2015, p. 29).

[26] Recital 8 of Guideline ECB/2014/44.

[27] Recital 3 of Decision ECB/2008/17. See footnote 20.

[28] Recital 4 and Articles 3 and 6 of Guideline ECB/2014/44.

[29] See Schäfer, T., “The interaction between European Union, ECB and national laws in the context of procuring euro banknotes”, 2016 ESCB Legal Conference.

detail procurement by EU central banks and the recent amendments to the applicable legal frameworks, including the principles of the ECB's procurement rules; EPCO and the legal framework for joint Eurosystem procurement; and the interaction between Union, ECB and national laws in the context of procuring euro banknotes.

The principles of ECB procurement rules, with a special focus on cooperation agreements

By Isabell Koepfer[1]

1 Legal framework

The European Central Bank (ECB), as an institution of the European Union, has the autonomous power to lay down rules for its internal organisation and administration. By virtue of this general principle of public international law, the ECB is exempt from national laws on the internal organisation and administration of public authorities, and in particular from national budgetary or procurement laws.[2] This general privilege is reflected in national laws which provide for the exemption of international organisations from a particular field of law. For instance, according to Section 100(8) No 6 of the German Act against Restraints of Competition (*Gesetz gegen Wettbewerbsbeschränkungen – GWB*), international organisations are not subject to German procurement rules. European Union (Union) procurement directives[3] are also not applicable to ECB procurements as they are addressed to Member States, not to Union institutions.[4] Furthermore, the ECB is not bound by the rules set out in Title V of the Financial Regulation for contract award procedures conducted by Union institutions, because the ECB has its own budget which is separate from that of the European Union.[5]

This does not mean, however, that the ECB is entirely free to establish its own procurement regime. The principles of the Treaties, and in particular the free movement of goods, the freedom of establishment and the freedom to provide services apply in general to public tender procedures carried out by Union institutions, even if they are not subject to Union procurement directives.[6] Furthermore, the award of contracts by public authorities within the Union must respect the principles deriving therefrom and which have been established by the

[1] Principal Legal Counsel in the Institutional Law Division, European Central Bank. The views expressed are those of the author and do not necessarily reflect those of the ECB or the Eurosystem.

[2] Von Lindeiner (2016); Gruber and Benisch (2007), p. 11.

[3] Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC (OJ L 94, 28.3.2014, p. 65); Directive 2014/23/EU of the European Parliament and of the Council of 26 February 2014 on the award of concession contracts (OJ L 94, 28.3.2014, p. 1).

[4] Case T-553/11 *European Dynamics Luxembourg* v *ECB*, ECLI:EU:T:2014:275, para. 110.

[5] Article 2(b) of Regulation (EU, EURATOM) No 966/2012 of the European Parliament and of the Council of 25 October 2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation (EC, Euratom) No 1605/2002, OJ L 298, 26.10.2012, p. 1 (the “Financial Regulation”).

[6] Case C-324/98 *Telaustria and Telefonadress*, ECLI:EU:C:2000:669, paras. 60-62. See also Arrowsmith (2014), para. 7-26, and von Lindeiner (2016).

Court of Justice of the European Union, such as equal treatment, non-discrimination, mutual recognition, proportionality[7] and transparency. Since the ECB's award and rejection decisions in tender procedures are subject to judicial review by the Union courts, the ECB also needs to take into account the relevant procurement jurisprudence of the Court of Justice.[8]

Against this background, the ECB has established its own legal framework for procurement procedures, first by way of internal guidelines and, as of 2007, on the basis of binding ECB decisions adopted by the Executive Board and published in the Official Journal of the European Union.[9] Since 2007 the ECB has amended its procurement rules on three occasions.[10] Recently, the ECB completely revised its procurement rules and adopted the Decision of the ECB of 9 February 2016 laying down the Rules on Procurement (recast)[11] (the "ECB procurement rules"), which to a large extent draws on the Union procurement directives and the case-law of the Court of Justice. The ECB procurement rules require that all procurements carried out by the ECB respect the principles of transparency, proportionality, publicity, equal access and equal treatment, non-discrimination and fair competition.[12] Furthermore, Recital 4 of the ECB procurement rules states explicitly that the ECB respects the general principles of procurement as reflected in Directive 2014/24/EU and the Financial Regulation. Another important aspect of public procurement is that it involves the spending of public money. As a result, the ECB, as a public institution, is accountable for its actions and is committed to the principle of cost-efficiency. It thus seeks the best value for money for the products, works and services that it procures.

2 Scope of application

The ECB procurement rules apply to the award of supply, services, works and concession contracts. The tender procedure to be followed depends on the estimated contract value thresholds and the items to be procured. The applicable contract value thresholds are in line with the Union procurement directives.[13] Contracts where the estimated value equals or exceeds the applicable threshold

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[7] See Case C-213/07 *Michaniki,* ECLI:EU:C:2008:731, para. 48; Recital 1 and Article 18(1) of Directive 2014/24/EU; Arrowsmith (2014), paras. 7-24 and 25.

[8] Article 40 of the ECB procurement rules.

[9] Decision ECB/2007/5 of 3 July 2007 laying down the Rules on Procurement (OJ L 184, 14.7.2007, p. 34). The legal basis is Article 11(6) of Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank (the "Statute of the ESCB").

[10] Decisions ECB/2009/2 of 27 January 2009 (OJ L 51, 24.2.2009, p. 10), ECB/2010/8 of 27 July 2010 (OJ L 238, 9.9.2010, p.14) and ECB/2012/10 of 19 June 2012 (OJ L 178, 10.7.2012, p. 14), in each case amending Decision ECB/2007/5 laying down the Rules on Procurement.

[11] Decision ECB/2016/2 of 9 February 2016 laying down the rules on procurement (recast) (OJ L 45, 20.2.2016, p. 15), as amended by Decision ECB/2016/17 of 7 June 2016 (OJ L 159, 16.6.2016, p. 21). See von Lindeiner (2016).

[12] Article 3 of the ECB procurement rules.

[13] Commission Delegated Regulation (EU) 2015/2170 of 24 November 2015 amending Directive 2014/24/EU of the European Parliament and of the Council in respect of the application thresholds for the procedures for the award of contracts (OJ L 307, 25.11.2015, p. 5) and Commission Delegated Regulation (EU) 2015/2172 of 24 November 2015 amending Directive 2014/23/EU of the European Parliament and of the Council in respect of the application thresholds for the procedures for the award of contracts (OJ L 307, 25.11.2015, p. 9).

amount are awarded by public tender procedure. Contracts where the estimated value remains below the threshold amounts are awarded through a simplified procedure set out in Chapter III of the ECB procurement rules. Contracts with an estimated value below EUR 20,000 may be awarded directly to one supplier without a tender procedure.[14]

3 Exemptions for special types of contract

Certain types of contract fall outside the scope of the ECB procurement rules.[15] These include, for instance, cooperation agreements between the ECB and other public institutions, contracts for the acquisition or rental of land or buildings, employment contracts, certain research and development contracts, arbitration and conciliation services, in-house contracts and contracts subsidised directly by the ECB under certain conditions.[16] Furthermore, contracts relating to the legal representation of the ECB during or in preparation for court or arbitration proceedings and contracts for exclusive services of notaries, trustees and court officials are also exempt from the scope of the ECB procurement rules. The selection of experts serving as members of high-level advisory boards assisting the ECB in the fulfilment of its tasks is subject to a special procurement procedure.[17]

While these categories of contract are exempt from the ECB procurement rules, this does not automatically mean that such contracts may be awarded directly to any supplier. The conclusion of contracts must either follow a specific procedure (e.g. employment contracts) or be conducted in accordance with a selection process that ensures the best value for money.

4 Exceptions for special cases

The ECB procurement rules set out certain exceptions on the basis of which the ECB may deviate from specific procedural requirements or award a contract directly to one supplier.[18] These concern, for instance, situations where, for unavoidable reasons (i.e. of a technical, artistic or legal nature), the contract can only be awarded to one particular supplier; or situations where, for reasons of extreme urgency which could not be foreseen by the ECB, the time limits for a procurement procedure cannot be met.[19] Further exceptions exist for contracts which have been classified as secret by the ECB or where special security measures are required, such as research and development contracts in the field of banknote security; for supply

[14] Article 37 of the ECB procurement rules.

[15] Article 2(3) of the ECB procurement rules.

[16] Article 2(6) of the ECB procurement rules.

[17] Article 2(5) of the ECB procurement rules.

[18] Article 6(1) of the ECB procurement rules.

[19] This exception should be interpreted in line with Article 32(2)(c) of Directive 2014/24/EU, according to which the circumstances invoked to justify extreme urgency must not in any event be attributable to the contracting authority.

contracts where the relevant products are manufactured purely for the purpose of research, experimentation, study or development;[20] in relation to purchases out of supplier bankruptcy and in the case of additional products acquired under a supply contract where a change of supplier would lead to disproportionate difficulties in operation and maintenance.

These exceptions are based in essence on the cases set out in Article 32(2) of Directive 2014/24/EU. While the Directive restricts these situations to a negotiated procedure without prior publication, the ECB procurement rules allow more leeway, ranging from changing procedural requirements in the procurement process to direct award to one supplier, if appropriate. Where possible, the ECB must ensure competition between several suitable suppliers.[21]

5 Types of procedure

5.1 Public tender procedures

The ECB procurement rules provide for the same public tender procedures as Directive 2014/24/EU: the open (Article 10 of the ECB procurement rules), restricted (Article 11) and negotiated (Article 12) procedures, competitive dialogue (Article 13) and innovation partnership (Article 14).[22] While Directive 2014/24/EU provides that a contracting authority may use the open and restricted procedures for any purchase activity, the ECB procurement rules give priority to the open procedure, as they specify that the open procedure is the standard procurement procedure.

Unlike the open procedure, the restricted procedure is organised in two phases. In the first phase, any interested economic operator may apply to participate, but only those who meet the selection criteria can subsequently submit a tender. A restricted procedure presents certain advantages, in particular if there is a need to limit the circulation of the tender documents for security or confidentiality reasons. On the other hand, a restricted procedure usually takes longer than an open procedure, which might discourage potential tenderers from participating.[23] The minimum time limit for submission under an open procedure is 35 days, for the restricted procedure it is 30 plus 30 days.

A negotiated procedure can be used for the adaptation of readily available solutions or for design or innovative solutions, if prior negotiations are necessary due to the deliverables' specific nature, complexity, legal and financial character and the corresponding risk, and moreover, if the technical specifications cannot be established with sufficient precision.

[20] This does not include quantity production to establish commercial viability or to recover research and development costs, see Article 6(1)(d) of the ECB procurement rules.

[21] Second subparagraph of Article 6(1) of the ECB procurement rules.

[22] For further details on detailed procedural rules, see von Lindeiner (2016).

[23] European Court of Auditors (2016), p. 30.

Competitive dialogue and the newly introduced innovation partnership procedure are special cases of the negotiated procedure. The ECB may apply an innovation partnership procedure for the development of innovative products, services or works not available on the market and for their subsequent purchase, provided that they comply with the performance level and maximum costs agreed between the ECB and the participants in the partnership.

The innovation partnership procedure differs from the competitive dialogue in that the dialogue phase is longer and it is structured in successive phases that follow the sequence of steps in the research and innovation process, which may include manufacturing of products, provision of services or completion of works. The innovation partnership should set intermediate targets to be attained by the partners and provide for payment in instalments. If the tender documents so provide, after each phase the ECB may terminate the innovation partnership or, in the case of an innovation partnership with several partners, reduce the number of partners by terminating individual contracts.

The ECB procurement rules also include special rules on electronic procurement, such as electronic auctions, electronic catalogues and the dynamic purchasing system. The ECB plans to gradually roll out an electronic tendering system which will allow tenderers to submit offers electronically. It has aligned its rules with the general requirements set out in Article 22 of Directive 2014/24/EU in conjunction with Annex IV thereto.

5.2 Three/five quote procedures

Contracts where the estimated value remains below the threshold amounts and services pursuant to Article 6(2) in conjunction with Annex I of the ECB procurement rules are awarded through a simplified procedure – the three or five quote procedure.[24] The Article 6(2) services are those listed in Annex XIV to Directive 2014/24/EU, such as health, social and related services, educational and cultural services, hotel and restaurant services, legal services, investigation and security services. Such categories of services have by their very nature a limited cross-border dimension. Only contracts for such services equal to or above EUR 750,000 are subject to full Union-wide transparency and require the publication of a contract notice in the Official Journal.[25]

In the ordinary three/five quote procedure (without publication requirement), the ECB has the discretion to select the tenderers to be invited, following proper market research and taking into account any possible cross-border interest. Up to a contract value of EUR 50,000, the number of tenderers to be invited is three, and above this value it is five. The process is a one-phase procedure that is largely similar to an open procedure, except that the ECB is free to stipulate the applicable time limits and can choose to conduct negotiations with the tenderers.

[24] Chapter III of the ECB procurement rules.

[25] See Recital 114 of Directive 2014/24/EU.

The three/five quote procedure for Article 6(2) services with a publication requirement is a simplified negotiated procedure. The publication of a contract notice usually leads to expressions of interest from suppliers who are invited to participate in the tender procedure on the basis of selection criteria. Other suppliers that meet the same criteria may also be invited to participate. The deadline for the submission of expressions of interest and tenders can be set at the reasonable discretion of the ECB.

In order to ensure transparency, the ECB publishes annually a list of contracts with a value above EUR 50,000 that have been awarded on the basis of non-public tender procedures or awarded to one particular supplier by way of exception under Article 6(1) of the ECB procurement rules, indicating the value and the subject matter of the contracts and the names of the successful tenderers.

6 Remedies and internal appeal procedure

According to Article 34(3) of the ECB procurement rules, rejected candidates/tenderers may, within 15 days of receipt of the award decision, request the ECB to provide the reasons for rejecting their application or tender and to provide copies of all documents relating to the evaluation of their application or tender. Unsuccessful tenderers whose tender was admissible may also ask for the name of the successful tenderer as well as the key characteristics and relative advantages of its tender. To accommodate this right of access of unsuccessful candidates and tenderers to evaluation documents, there is a standstill period of 10 or 15 days between the award and signature of contracts.[26]

As a further instrument to strengthen the legal remedies of candidates and tenderers in public tender procedures, the ECB procurement rules allow unsuccessful candidates and tenderers to contest the ECB's award and rejection decisions through an appeal to the Procurement Review Body (PRB). The PRB is an internal body composed of senior managers chaired and supported by the ECB's Directorate General Legal Services. The PRB is independent from the office carrying out the award procedure. The appeal procedure is outlined in Article 39 of the ECB procurement rules and further specified in the internal mandate of the PRB. The mandate contains further internal rules on how the decisions are adopted and about the secretariat which assists the PRB in the performance of its tasks.

The PRB examines whether the appeal is admissible and whether the decision of the ECB to reject the application or tender was taken in line with the ECB procurement rules and general principles of procurement law. The PRB may decide that the appeal has suspensive effect, i.e. the tender procedure or the signature of the contract can be suspended until it has decided on the appeal. If the appeal is admissible and well-founded, the PRB will annul the decision of the ECB and order

[26] By analogy with Article 1(5) of Council Directive 89/665/EEC of 21 December 1989 on the coordination of the laws, regulations and administrative provisions relating to the application of review procedures to the award of public supply and public works contracts (OJ L 395, 30.12.1989, p. 33).

the tender procedure or parts of it to be repeated or will take a final decision. If the appeal is inadmissible or unfounded, the PRB will reject the appeal.

The appeal should include all supporting information and reasoned objections. It is not clear whether arguments that are not submitted within the appeal procedure can still be raised in a judicial review at the Court of Justice. In *European Dynamics Luxembourg* v *ECB*, the General Court ruled that the preclusion rule of Article 21(2) of Decision ECB/2007/5[27] only relates to the tender procedure itself and does not extend to court proceedings. This provision bars certain objections relating to the incomplete, inconsistent or illegal nature of tender documentation if they are not raised in time. The General Court drew its conclusion from the unclear wording of the provision.[28] Nevertheless, a general preclusion of arguments which were not submitted in due time, could generally be permissible in the subsequent court proceedings; all the more so, as this is customary and appropriate in most national procurement laws. Furthermore, according to the settled case-law of the European Union Civil Service Tribunal, the rule of correspondence between the complaint and the subsequent action requires that, for a plea before the Courts of the Union to be admissible, it must have already been raised in the pre-litigation procedure.[29]

The deadline for submission of an appeal is 15 days from the receipt of the contested decision.[30] The PRB decides within one month following the receipt of the appeal. Following completion of the appeal procedure, the appellant may seek legal relief from the General Court. Article 40(3) of the ECB procurement rules allows an action to be brought before the Court only following an appeal decision.[31] The deadline for submission to the Court is two months from receipt of the appeal decision by the supplier.

Since the appeal procedure is only admissible in public tender procedures under Chapter II of the ECB procurement rules, claims in all other tender procedures can be brought directly before the General Court.

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[27] The wording of the former Article 21(2) of Decision ECB/2007/5 (now superseded by Article 28(2) of Decision ECB/2016/2) read as follows: “If candidates or tenderers consider that the ECB’s requirements laid down in the contract notice, the invitation to tender or supporting documents are incomplete, inconsistent or illegal or that the ECB or another applicant/tenderer has infringed the applicable procurement rules, they shall notify their objections to the ECB within 15 days. If the irregularities affect the invitation to tender or other documents sent by the ECB, the time limit shall start to run from the date of receipt of the documentation. In other cases, the time limit shall start to run from the moment the candidates or tenderers become aware of the irregularity or could reasonably have become aware of it. The ECB may then either correct or supplement the requirements or remedy the irregularity as requested, or reject the request indicating the reasons therefor. Objections which were not communicated to the ECB within 15 days may not be raised at a later stage.”

[28] See Case T-553/11 *European Dynamics Luxembourg* v *ECB*, ECLI:EU:T:2014:275, paras. 102-105.

[29] See Case T-476/11 P *Commission* v *Moschonaki*, ECLI:EU:T:2013:557, paras. 71 and 72 and the case-law cited. However, in the recent appeal decision relating to Case F-26/12 *Cerafogli* v *ECB*, ECLI:EU:F:2014:218, the General Court seems to establish additional limitations to the rule of correspondence (Case T-787/14 P *ECB* v *Cerafogli*, ECLI:EU:T:2016:633).

[30] This can be either the ECB decision to reject the application or tender or the decision to refuse the request for additional information under Article 34(3) of the ECB procurement rules.

[31] The General Court appears to have accepted the approach by which the ECB established this mandatory requirement for admissibility in Case T-553/11 *European Dynamics Luxembourg* v *ECB*, EU:T:2014:275, although it has not expressly addressed it.

The ECB appeal procedure has proven to be “an effective remedy” and “a robust internal review mechanism”, as recently confirmed by the General Court[32] and the European Court of Auditors.[33] Since the introduction of the PRB in 2007, 40 appeals have been submitted, eight appeals were upheld, 22 were rejected and ten appeals were able to be settled by presenting the appellant with additional information which it had not asked for previously.

7 Forms of cooperation between the ECB and other public institutions

The ECB procurement rules provide for several different forms of cooperation with other public contracting authorities. The ECB can carry out joint tender procedures for its own account and on behalf of certain other public institutions. The ECB can also participate in tender procedures organised by certain other public institutions. Moreover, the ECB can choose vertical and horizontal forms of cooperation with other public contracting authorities which fall outside the procurement regime. In a long series of decisions following its landmark judgment in *Teckal*,[34] the Court of Justice developed the “in-house exemption” as a form of institutionalised vertical cooperation.[35] In another landmark decision, *Stadtreinigung Hamburg*,[36] the Court of Justice held that some forms of non-institutionalised horizontal cooperation also fall outside the scope of the procurement rules. The new Article 12 of Directive 2014/24/EU, which concerns public contracts between entities within the public sector, codifies the case-law of the Court of Justice in relation to vertical and horizontal cooperation.

7.1 Joint tender procedure with the ECB in the lead

The ECB may carry out joint tender procedures for its own account and on behalf of one or more national central banks (NCBs), national supervisory authorities, Union institutions and bodies and/or international organisations.[37] In such cases, the ECB procurement rules apply to the tender procedure. Furthermore, the other participating contracting authorities and the envisaged structure of the contractual relationships need to be specified in the tender documents. The contractual relationships are usually based on framework agreements between the ECB and the supplier (e.g. contract for the benefit of third parties) where the costs are shared by the NCBs of the European System of Central Banks (ESCB) or the Eurosystem, or framework agreements that are concluded between all the parties involved (i.e. the ECB, the participating NCBs and the supplier). In the latter case, the participating

[32] Case T-553/11 *European Dynamics Luxembourg* v *ECB*, ECLI:EU:T:2014:275, para. 32.

[33] European Court of Auditors (2016), Observation 80, p. 43.

[34] Case C-107/98 *Teckal*, ECLI:EU:C:1999:562.

[35] For a list of court rulings in which the in-house exemption established in *Teckal* was subsequently confirmed and further developed, see Wiggen (2014), Footnote 4.

[36] Case C-480/06, *Commission* v *Germany*, ECLI:EU:C:2009:357.

[37] Article 2(2) of the ECB procurement rules.

NCBs can empower the ECB via power of attorney to conclude the framework agreement with the supplier and thus become a direct contractual party. Examples of such joint tender procedures can be found in the area of IT-related services. For instance, the efficient management of documents within the ESCB requires the establishment of a single documentation platform where all the ESCB users can interact by viewing, uploading and modifying documents. The ECB purchases the necessary software and licenses, the use and the costs of which are to be shared within the ESCB. Joint tender procedures that are carried out by the ECB are also relevant for the Single Supervisory Mechanism (SSM) introduced in 2014.[38] Moreover, in order to promote joint purchasing, the ECB and the NCBs within the Eurosystem have established a European Procurement Coordination Office (EPCO) based in Luxembourg which has the task of coordinating joint procurements of the ECB and other institutions of the Union and of the Member States, including national competent authorities within the SSM.[39]

7.2 Participation of the ECB in tender procedures of other contracting authorities

The ECB can also participate in tender procedures organised by Union institutions and bodies, international organisations and public authorities, provided that the rules governing these procurement procedures are in line with the general principles of Union procurement law.[40] In the past the ECB has, for instance, participated in tender procedures for the provision of IT consultancy and other IT-related services carried out by other Union institutions.

7.3 Institutionalised vertical cooperation

Contracts between the ECB and a legal person governed by private or public law are exempt from the ECB procurement rules under the following conditions:

- the ECB exercises control over the legal person similar to that which it exercises over its own business units;
- more than 80% of the legal person's activities are carried out in the performance of tasks entrusted to it by the ECB;

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38 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63) (the SSM Regulation). Collaboration within the supervisory mechanism is governed by Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17) (OJ L 141, 14.5.2014, p. 1).

39 Decision ECB/2008/17 of 17 November 2008 laying down the framework for joint Eurosystem procurement (OJ L 319, 29.11.2008, p. 76), as amended by Decision ECB/2015/51 of 23 December 2015 (OJ L 6, 9.1.2016, p. 5).

40 Article 2(3)(b) of the ECB procurement rules.

- there is no direct private capital participation that ensures a controlling interest in that legal person.[41]

The ECB procurement rules have codified to a large extent the prerequisites for the in-house exemption established by the jurisprudence of the Court of Justice on the basis of the *Teckal* criteria and by Directive 2014/24/EU.[42] There has not yet been a practical case where the ECB itself has made use of the in-house exemption. However, the *Teckal* doctrine is of practical relevance for the Eurosystem in the field of banknotes production, where the Governing Council of the ECB has recently established the legal framework for the production and procurement of euro banknotes in the EPPS Guideline.[43] The Eurosystem Production and Procurement System (EPPS) consists of two pillars. Under the first pillar, NCBs without in-house printing works are responsible for the production and procurement of the euro banknotes that have been allocated to them in accordance with the capital key (tendering group NCBs). To fulfil their obligations, those NCBs carry out tender procedures for the production of euro banknotes individually or jointly with other NCBs in accordance with applicable procurement rules.

Under the second pillar, NCBs with in-house printing works use their in-house printing works for the production of their relevant share of euro banknotes in accordance with the capital key (in-house group NCBs). Some of the in-house group NCBs have established separate legal entities which they control by virtue of the in-house exemption (like the Oesterreichische Nationalbank (OeNB) and the Banco de Portugal); other NCBs, like the Banque de France and the Banca d'Italia, have in-house printing works which are legally and organisationally part of the NCB. The EPPS Guideline provides the mandate for NCBs with in-house printing works to explore the establishment of a separate legal person consisting of their in-house printing works.[44] The conditions to be met for such cooperation largely correspond to the ones established by case-law and enshrined in Directive 2014/24/EU in relation to in-house entities.

7.4 Non-institutionalised horizontal cooperation

Cooperation agreements that serve the fulfilment of public tasks between the ECB and NCBs, other Union institutions and bodies, international organisations and public authorities are exempt from the ECB procurement rules, provided certain conditions are fulfilled: the cooperation must be governed solely by considerations relating to the public interest, in particular the achievement of common, non-commercial objectives, and the parties must perform less than 20% of the relevant activities on

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41 Article 2(4) of the ECB procurement rules which is largely aligned with Article 12(1) of Directive 2014/24/EU.

42 Case C-107/98 *Teckal*, ECLI:EU:C:1999:562; Case C-26/03 *Stadt Halle and RPL Lochau*, ECLI:EU:C:2005:5; Case C-182/11 *Econord*, ECLI:EU:C:2012:758. See also Arrowsmith (2014), paras. 6-166 to 189.

43 Guideline (EU) 2015/280 of the European Central Bank of 13 November 2014 on the establishment of the Eurosystem Production and Procurement System (ECB/2014/44) (OJ L 47, 20.2.2015, p. 29).

44 Article 8(1)(a) of Guideline ECB/2014/44.

the open market. The ECB procurement rules have thus largely been aligned with the prerequisites for exempt horizontal cooperation agreements established by recent jurisprudence of the Court of Justice and Directive 2014/24/EU.[45] Since such cooperation agreements are an instrument that is frequently used between the ECB and ESCB/Eurosystem NCBs, the conditions to be met will be assessed in greater detail below.

In the *Stadtreinigung Hamburg* decision, the Court of Justice accepted for the first time public-public cooperation outside the concept of using jointly controlled in-house entities according to the *Teckal* doctrine. In this case, four administrative districts of Lower Saxony concluded a contract in 1995 with Stadtreinigung Hamburg (the City of Hamburg Cleansing Department) relating to the disposal of their waste in a new incineration facility which was operated by a private entity. The Commission contended that this contract should have been put out to tender. However, the Court concluded that the Procurement Directive (the former Directive 92/50/EEC) did not apply. It stressed that Union law does not require contracting authorities to use any particular legal form in order to jointly carry out their public service tasks. The Court appears to have relied on many individual circumstances which were relevant to this particular case in order to arrive at its conclusion, without explaining, however, the underlying principles.

The Court of Justice upheld its line of reasoning and clarified its view in its subsequent ruling in *Ordine degli Ingegneri della Provincia di Lecce*[46] which relates to a cooperation agreement concerning research activities in relation to earthquake security measures for buildings between a hospital and a university. In the preliminary ruling, the Court referred to and confirmed the principles established for public-public cooperation in the *Stadtreinigung Hamburg* judgment. In relation to the specific case referred to it, the Court had strong doubts as to whether the examination of earthquake security measures could be regarded as a common public task that has to be performed by both cooperation partners. Furthermore, in what could be seen as a further clarification of the *Stadtreinigung Hamburg* judgment, it ruled that the contract in question must not bring about an advantage for private undertakings compared to a competitor (as would be the case if, for example, the university engaged private entities for the performance of the contract).[47]

Article 12(4) of the new Directive 2014/24/EU codifies an exemption for a non-institutionalised cooperation between public authorities on the basis of the *Stadtreinigung Hamburg* ruling, which was also the model for the corresponding exemption in Article 2(3)(a) of the ECB procurement rules.

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[45] Article 2(3)(a) of the ECB procurement rules and Article 12(4) of Directive 2014/24/EU.

[46] Case C-159/11 *Ordine degli Ingegneri della Provincia di Lecce*, ECLI:EU:C:2012:817.

[47] Ibid, para. 38.

7.4.1 Performance of a public task

In order to be exempt from the ECB procurement rules, the cooperation agreement must serve the fulfilment of public tasks between the ECB and NCBs, other Union institutions and bodies, international organisations or public authorities. This first prerequisite enshrines the basic principle of the *Stadtreinigung Hamburg* doctrine, which requires cooperation in the performance of a task that is public in nature. This appears to mean that the authorities must be entrusted with a function for public interest reasons, rather than one that is commercial in nature, and intend to collaborate in the exercise of that function.[48]

Recital 33 of Directive 2014/24/EU provides some more clarity on the interpretation of this condition, although it does not make clear the nature of the required contribution. Hence, it appears that the previous case-law will largely remain relevant for interpreting the provision.[49] Accordingly, the cooperation may, for example, cover all types of activities related to the performance of services and responsibilities assigned to or assumed by the co-operating authorities, such as mandatory or voluntary tasks of local or regional authorities or services conferred upon specific bodies by public law.[50] Furthermore, the services provided by the different participating authorities do not necessarily have to be identical; they might also be complementary. The cooperation should be based on a cooperative concept, but it is not required that all participating authorities have to assume the performance of main contractual obligations, as long as there are commitments to contribute towards the cooperative performance of the public service in question. This implies some kind of active participation. What can be deduced from both *Stadtreinigung Hamburg* and *Ordine degli Ingegneri della Provincia di Lecce* is that there must be some form of genuine cooperation between the parties, as opposed to a situation in which one contracting authority simply procures a service from another.

Recital 33 clarifies that the individual contribution can be different for each participating authority. It does not indicate, however, whether actual participation is required by each authority in undertaking the task concerned. It could be argued, that it is not sufficient merely for some of the parties to guarantee, or simply provide, a market for the services that will entail benefits of economies of scale.[51] This seems to be the view of the Commission's (now outdated) staff working paper.[52] The Commission suggested that there must be "real co-operation aimed at the joint performance of a common task, as opposed to a normal public contract".

[48] In *Ordine degli Ingegneri della Provincia di Lecce* (ibid), the Court of Justice considered that the *Stadtreinigung Hamburg* exemption did not apply to a consultancy arrangement between a local health authority and a university in relation to a study on the vulnerability to earthquakes of hospital buildings, because it was usually carried out by engineers or architects.

[49] See also Arrowsmith (2014), para. 6-200.

[50] In Case C-15/13 *Datenlotsen Informationssysteme*, ECLI:EU:C:2016:303, the Court of Justice held that the *Stadtreinigung Hamburg* exemption could not apply because the parties were not public authorities and Hochschul-Informations-System GmbH (HIS), a company governed by private law but owned by the Federal Republic of Germany, was not entrusted directly with the performance of a public task. Technische Universität Hamburg-Harburg (Hamburg University of Technology) gave a contract to HIS in relation to an IT-system without conducting a tender procedure.

[51] Arrowsmith (2014), para 6-192.

[52] European Commission (2011), section 3.3.1.

Accordingly, this involves participation and mutual obligations which lead to mutual synergy effects. However, the *Stadtreinigung Hamburg* case does not suggest that there is a requirement for each participating authority to perform concrete tasks. According to this doctrine, it seems to be sufficient that the parties undertake any obligations that are beneficial for the cooperation, such as an obligation to purchase that facilitates economies of scale or secures the availability of capacity (as in *Stadtreinigung Hamburg*). However, such a flexible approach is difficult to reconcile with the ruling in *Piepenbrock*[53] in which the Court of Justice indicated that the *Stadtreinigung Hamburg* doctrine would not cover an arrangement for cleaning services for office, administrative and school buildings between an association of local authorities and one of the member authorities. The Court held that the condition of cooperation in a joint task was not met, but did not provide reasons as to why that was the case. From the three court rulings (*Ordine degli Ingegneri della Provincia di Lecce*, *Piepenbrock*, *Datenlotsen Informationssysteme*) following *Stadtreinigung Hamburg* it seems that the Court of Justice is generally reluctant to accept the exemption for horizontal public cooperation in cases where the specific services being supplied could be obtained on the open market (seismology services, cleaning services and IT services).[54] This unclear legal situation for horizontal cooperation between public authorities under Union procurement law is quite unsatisfactory. It is therefore to be hoped that the Court of Justice will provide clear guidance on the requirement in the future and clarify the nature of the respective contributions by the parties to the performance of a cooperation agreement that would be exempt from public tendering.[55]

7.4.2 Considerations relating to the public interest

In addition to the condition concerning the form of cooperation, the implementation of cooperation pursuant to Article 2(3)(a) of the ECB procurement rules must be governed solely by considerations relating to the public interest, in particular the achievement of common, non-commercial objectives. This requirement corresponds to Article 12(4)(b) of Directive 2014/24/EU. Furthermore, according to Recital 33 of Directive 2014/24/EU, any financial transfers between the participating contracting authorities should be governed solely by considerations relating to the public interest. The Commission's initial proposal for Directive 2014/24/EU had included the requirement that the cooperation must not entail financial transfers other than reimbursement for actual costs, but that did not find its way into the finally adopted legislation.[56] However, since the requirement is still mentioned in the preamble of

[53] Case C-386/11 *Piepenbrock*, ECLI:EU:C:2013:385.

[54] Falle (2014), p.8.

[55] See criticism in Arrowsmith (2014), paras. 6-192 and 6-201.

[56] Article 11(4)(d) of the Commission proposal.

Directive 2014/24/EU, it will constitute an element in the assessment of whether the cooperation solely pursues public interests.[57]

An additional element to be considered is that, according to Recital 33 of Directive 2014/24/EU, no private service provider should be placed in a position of advantage vis-à-vis its competitors. This requirement was confirmed in *Ordine degli Ingegneri della Provincia di Lecce* in which the Court noted that the arrangement in question permitted external collaborators to be involved as subcontractors and may therefore bring about an advantage for a private party.[58] In *Piepenbrock*, the Court also seemed to consider that the mere possibility of an (actual or potential) involvement of a private provider was sufficient to take the arrangement outside the scope of the *Stadtreinigung Hamburg* doctrine.[59] This interpretation seems to be unreasonably strict, at least in cases where sub-contracts with private suppliers have been awarded in a competitive procedure.[60]

7.4.3 Activities condition

The third condition is that the parties perform less than 20% of the relevant activities in the cooperation on the open market. This condition is also included in Article 12(4)(b) of Directive 2014/24/EU. It is aimed at restricting distortion of competition: each contracting authority participating in the cooperation is allowed to perform – in addition to the cooperation – no more than 20% of the activities concerned in the cooperation on the open market. The contracting authority's activities on the open market are therefore restricted in volume, depending on the extent of the cooperation.

As is the case with the *Teckal* doctrine, Article 12(5) of Directive 2014/24/EU contains specific rules on how the activities condition is to be applied. It states that, in order to determine the percentage of activities performed on the open market, the average turnover or an alternative activity-based measure, such as costs incurred by the relevant contracting authority in relation to services, supplies and works for the three years preceding the contract, has to be taken into consideration.

7.4.4 Horizontal cooperation agreements for the fulfilment of public tasks within the Eurosystem/ESCB

Article 128 TFEU and Article 16 of the Statute of the ESCB entrust the Eurosystem[61] with the issuance of banknotes and provide for the exclusive right of the ECB to

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[57] Janssen (2014), p. 179. Arrowsmith (2014), para. 6-205, argues that there may still be room for interpretation and the requirement may not apply in every case; for instance, if the payment which is not based solely on costs provides an incentive for efficient performance, with any surplus to be invested in improving future performance in providing the services.

[58] Case C-159/11 *Ordine degli Ingegneri della Provincia di Lecce*, ECLI:EU:C:2012:817, para. 38.

[59] Case C-386/11 *Piepenbrock*, ECLI:EU:C:2013:385, para. 30.

[60] Arrowsmith (2014), paras 6-192 and 6-195.

[61] Article 128(1) of the Treaty on the Functioning of the European Union and Article 16 of the Statute of the European System of Central Banks and of the European Central Bank.

authorise such issuance. As stated by the Court of Justice, when an institution has been entrusted with a task, "it must be accepted, if that provision is not to be rendered wholly ineffective, that it confers on the [institution] necessarily and per se the powers which are indispensable in order to carry out that task".[62] This view is also supported by some commentators, according to whom the supply of banknotes is a task performed solely in the public interest.[63] From this perspective, the issuance of banknotes and the exclusive right to authorise such issuance necessarily includes the power to decide how the production is organised and a prerogative to decide to produce banknotes and/or to have them produced by other parties. Production of banknotes is therefore considered to be directly linked to their issuance and thus a public task.

In the past, the ECB has on several occasions concluded horizontal cooperation agreements with Eurosystem NCBs in the field of banknote production, including research and development activities. Furthermore, the EPPS Guideline, which establishes the legal framework for the production and procurement of euro banknotes,[64] includes a mandate for NCBs with in-house printing works to explore the opportunities for the creation of a non-institutionalised horizontal cooperation.[65] As with the in-house entities, the conditions to be met for such cooperation largely correspond to the ones established by case-law and enshrined in Directive 2014/24/EU.

Furthermore, the ECB has concluded cooperation agreements with Eurosystem/ESCB NCBs in relation to, for example, public tasks of the ECSB pursuant to Article 3(1) of the Statute of the ESCB, which are to define and implement the monetary policy of the Union, to conduct foreign-exchange operations, to hold and manage the official foreign reserves of the Member States, and to promote the smooth operation of payment systems.

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[62] Case C- 281/85 Germany v Commission, ECLI:EU:C:1987:351, para. 28.

[63] See Gaitanides (2010).

[64] Recital 1 of Guideline ECB/2014/44.

[65] Article 8(1)(b), ibid.

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EPCO – Coordinating joint procurements in the Eurosystem/ESCB

By Tamás Csepely-Knorr[1]

Within the European Union, the estimated total general government public procurement expenditure excluding utilities and defence was EUR 1931.5 billion in 2014,[2] while public authorities in the Union spend around 14% of their gross domestic product on the purchase of services, works and supplies annually.[3] The procurements of central banks – being independent public entities – form part of this annual expenditure, and it is essential that these procurements are conducted in an efficient and effective way. This objective led to the creation of the Eurosystem Procurement Coordination Office (EPCO), an organisation coordinating the joint procurement of the Union's central banks. This paper introduces the steps leading to the creation of EPCO and the applicable legal framework for EPCO procurements, and presents the latest changes adopted by the ECB's Governing Council on EPCO effective from January 2016 allowing also non-ESCB institutions to participate in EPCO's activities.

1 The steps towards establishing EPCO

EPCO was created in 2008 by Decision ECB/2008/17 of the European Central Bank,[4] although the preparation and assessment of joint Eurosystem procurement had started before this. In 2005, the Governing Council decided to undertake an analysis of the procurement functions throughout the Eurosystem, also taking into account the model of the Federal Reserve System. The outcome of this analysis – among other conclusions – showed that procurement practices varied widely across the Eurosystem, and therefore the identification of best practices could be very valuable for all central banks and cooperation in the field of procurement could bring certain benefits. It was also considered that such cooperation required a specific institutional environment. At the same time, certain impediments potentially limiting the possibility of Eurosystem-wide cooperation in the procurement area were also identified. Based on this analysis, the exchange of best practices in the field of procurement, the development of the necessary (IT) procurement infrastructure, and the creation of a framework for the pooling of purchasing power were proposed as the main activities to be implemented via a coordination office, that being EPCO.

[1] Legal Officer, Eurosystem Procurement Coordination Office (EPCO).

[2] Public Procurement Indicators 2014 – DG-GROW G4 – Innovative and e-Procurement (February 2, 2016) available at http://ec.europa.eu/DocsRoom/documents/15421/

[3] Available at http://ec.europa.eu/growth/single-market/public-procurement_de

[4] Decision ECB/2008/17 of the European Central Bank of 17 November 2008 laying down the framework for joint Eurosystem procurement (OJ L 319, 29.11.2008, p. 76).

Based on this assessment in 2007 the Governing Council approved the mandate of EPCO.[5] Decision ECB/2008/17 also records the Governing Council's decision regarding the selection of the central bank that would host EPCO. In December 2007, the Governing Council mandated the Banque centrale du Luxembourg (BCL) as the designated hosting central bank of EPCO for the period from 2008 to 2012, approved EPCO's budget for 2008, and invited all euro area and non-euro area central banks to participate in the exchange of best practices in the area of public procurement as a prerequisite for participating in pooled procurements.

Since the initial assessment of potential joint Eurosystem procurement presented some potential legal obstacles, it was suggested that an ECB legal instrument should be adopted to formalise the framework for joint Eurosystem procurement, to overcome some of the potential restrictions that could derive from national laws and to facilitate the central banks' participation in joint Eurosystem tender procedures. This proposal led to the adoption of Decision ECB/2008/17, which lays down the basic framework, main goals and functioning of EPCO.

2 Decision ECB/2008/17

Decision ECB/2008/17 was adopted by the Governing Council in November 2008 and became effective as of 1 December 2008. It contains definitions of the basic terms used (in Article 1), the scope of application (Article 2), EPCO's tasks and organisational provisions (Article 3), the provisions on the joint tender procedures (Article 4) and the possibility for non-euro area central banks to participate in EPCO's activities (Article 5), which are detailed in this section.

Article 2(1) of the Decision establishes the legal framework for the joint procurement of goods and services by the central banks *which are necessary for the performance of Eurosystem tasks*. This reference to "Eurosystem tasks" is the result of certain national (procurement) laws, which did not, at the time of adoption of the Decision, allow for participation in tender procedures governed by a foreign law unless the derogation was justified by a rule of law prevailing over national law. However, since the organisational power of the Governing Council was understood to be limited to Eurosystem/ESCB tasks, derogation from national procurement law would have been difficult to justify for the procurement of goods and services unrelated to the performance of Eurosystem/ESCB tasks. This is the reason why EPCO joint procurements are limited to goods and services necessary for the performance of Eurosystem tasks.

[5] Which included the facilitation of the adoption of best practices, developing the (IT) infrastructure to enable the pooling of purchasing power and the coordination of the Eurosystem procurement agenda.

2.1 Participating EPCO members (2008-2015) and voluntary participation

Under Article 1(c) of Decision ECB/2008/17 participation in EPCO's activities is open to the ECB and the euro area national central banks. However, Article 5 of the Decision also allows non-euro area central banks to participate in EPCO's activities under the same conditions as those applying to euro area national central banks. Thus all Union central banks may participate in EPCO's activities under the same conditions.

A central bank may participate in EPCO's activities upon the invitation of the Governing Council. Since all central banks were invited to participate in EPCO in 2007, the discussions about participating in EPCO start on an operational level between the central bank wishing to join and EPCO and are finalised between the applying central bank and the EPCO Steering Committee. Once a central bank's interest is confirmed, the Governing Council takes note of this and welcomes the central bank in question among the EPCO members.

EPCO currently has 20 members, comprising 16 euro area national central banks and the ECB, as well as three non-euro area national central banks. Participation is open to any other Union national central bank, and the recent amendment of Decision ECB/2008/17 effective as of 12 January 2016 also enlarged the potential list of EPCO participants, which is further detailed in Section 3 below.

Article 2(2) of Decision ECB/2008/17 provides for the principle of *voluntary participation* in EPCO and in any EPCO joint procedure. This principle provides the necessary flexibility for the central banks to decide whether they would like to join this form of cooperation, and if so in which of EPCO's procedures they wish to participate. Obviously, the more EPCO procedures are joined by a central bank and the more purchases are executed via the EPCO framework agreements, the higher the financial and administrative benefits that central bank obtains from EPCO.

It is interesting to note that voluntary participation is also broadly applied by the central purchasing bodies established in the Member States, where such participation is generally conditional on the contracting authorities' decisions. Thus EPCO's voluntary participation concept also follows the general approach of the central purchasing bodies within the Union.

2.2 Main EPCO tasks and the supervision of EPCO

Article 3(1) of Decision ECB/2008/17 provides for EPCO's activities, focusing on the *adoption of best practices*, the *development* of the (IT) *procurement infrastructure*, and the *identification of potential cases for joint procurements* as defined by the Governing Council. Furthermore, EPCO shall create and update its annual *procurement plan*, establish the *common requirements* for joint procedures, and *support* the central banks in *joint tender procedures* and in *procurements* related to the common *ESCB projects* if so requested by the leading central bank.

As is apparent from the above list, EPCO's activities primarily follow the tasks already identified when EPCO was established in 2008, complemented by tasks supporting joint procurement procedures. These tasks were reorganised as part of the recent amendment to Decision ECB/2008/17, which is detailed in Section 3 below.

EPCO's governance is performed by the supervisory organs of the hosting central bank and those of the Eurosystem (i.e. the EPCO Steering Committee, the ECB Executive Board and the ECB's Governing Council).

The *hosting central bank* may adopt rules on the internal organisation and administration of EPCO, such as a code of conduct, in consultation with the EPCO Steering Committee. The control and audit rules of the hosting central bank are also applicable to EPCO, and therefore it is subject to the audit activities of the hosting central bank's audit department.

The *Internal Auditors Committee* exercises control over EPCO's activities in accordance with common principles and methodologies as defined in the ESCB audit policy.

The *EPCO Steering Committee* is responsible for steering EPCO's activities. It is entitled to provide input on EPCO's organisational rules (as adopted by the hosting central bank), budget proposal and annual report. The EPCO Steering Committee is also involved in the adoption of the EPCO procurement plan and it conducted an effectiveness and efficiency evaluation of EPCO's activities five years after EPCO's establishment (on the outcome of this last task see Section 3 below).

Finally, the approval of EPCO's procurement plan, the initiation of joint procedures, the choosing of the leading central bank for an EPCO joint procedure, the approval of EPCO's budget and the decision on EPCO's financing model, as well as the approval of EPCO's annual report is preserved for the *Governing Council*.

Although this is not mentioned in Decision ECB/2008/17, EPCO maintains a *network of procurement experts* consisting of high-level procurement experts working in EPCO central banks. The purpose of this is to provide a forum for the regular exchange of information among the central banks, to discuss issues of common interest, as well as to regularly report and promote EPCO's activities to its stakeholders, and to receive the central banks' data on upcoming procurement projects as essential input in preparing future EPCO procurement plans. This forum constitutes a bridge between EPCO and the central banks, and provides for an expert in EPCO central banks as a single point of contact for all EPCO activities.

2.3 EPCO procurements

Article 4(1) of Decision ECB/2008/17 provides that EPCO joint procedures are necessary if (i) it is reasonable to expect that the joint procurement of goods and services would result in *more advantageous purchase conditions* in accordance with the principles of cost-efficiency and effectiveness, or if (ii) the central banks need to

adopt *harmonised requirements and standards* in respect of such goods and/or services. The first option for joint procurements refers to cases where direct/indirect benefits could be achieved through pooling the purchasing power of EPCO members (e.g. the area of IT/market rating data providers). The second option refers to procurement cases where the requirements need to be harmonised (like the area of banknote-related items). As already indicated in the previous section, the Governing Council is responsible for initiating tender procedures based on any of the above two grounds.

EPCO procedures are carried out by a *leading central bank*, an institution nominated for every joint procurement procedure, which is responsible for conducting the joint tender procedure on its own behalf and for the benefit of the other participating EPCO members. The role of the leading central bank is already proposed to be taken by one of the EPCO central banks at the time of the preparation of the EPCO procurement plan. The hosting central bank may also act as default leading central bank. The Governing Council decides on these matters through the approval of the procurement plan prepared by EPCO, and upon consulting the EPCO Steering Committee and the ECB's Executive Board.

2.4 Applicable law and language regime for EPCO joint procurements

The procurement rules applicable for an EPCO joint procedure are the provisions applicable to the leading central bank. Thus EPCO could be considered a permanent organisation with varying rules due to the fact that joint procedures are executed according to the provisions of the leading central bank’s legislative framework.

Article 4(6) of Decision ECB/2008/17 stipulates that the leading central bank shall carry out the joint procedure in the language(s) laid down in the procurement plan. This provision is designed to support the possibility of executing joint tender procedures in a language other than their official language as discussed below in Section 2.5.2.

2.5 Possible restrictions under national law on cross-border joint procurement

Certain national laws included provisions which could have hindered the participation in tender procedures carried out by other contracting authorities (located in other Union Member States). The following examples demonstrate provisions that existed in central banks’ national procurement legislation in 2007 which needed to be considered when establishing EPCO.

2.5.1 Potential restrictions under national law related to the applicable law in cross-border procurement

The first set of restrictions relates to the procurement rules applicable for a procurement procedure. Whereas the central banks apply their national procurement rules when procuring on their own, it was not obvious whether they could join the tenders of other Member States. Most of these restrictions were already considered when drafting Decision ECB/2008/17. However, others were only imposed after the adoption of Directive 2014/24/EU of the European Parliament and of the Council.[6]

One of the national procurement rules did not allow the contracting authorities to participate in joint tender procedures which were governed by the law of a different Member State. The procurement regulations applicable allowed for procurement of goods and services through a central purchasing body but only if the central purchasing body applied the respective national provisions, thus the use of a foreign purchasing body was not provided for by the national legislature. On the other hand, these institutions did not identify issues with leading joint tender procedures – since then their own national law was applied – or with pure coordination-type cooperation in the area of procurement, whereby the EPCO members were only coordinating their procurement specifications and procedures but every central bank then concluded a separate agreement under its national law.

Two central banks indicated that there were no legal impediments for their participation in a tender procedure governed by the law of a different Member State provided that the goods and services to be procured were related to the performance of Eurosystem/ESCB tasks. The reason for this limitation was that the national procurement law did not allow for participation in a tender procedure if it was governed by a foreign law unless the derogation was justified by a rule of law which prevailed over national law.

2.5.2 Language restrictions

The publication of tenders in a particular language may enhance or limit the number of tenderers in a procurement procedure. Whereas use of the most commonly known languages throughout the Union may allow for vendor competition, the use of other languages may limit the number of offers received. Therefore, it was imperative from the beginning of EPCO's functioning to assess the languages in which the central banks could publish the tender documents, as well as accept and evaluate the offers received.

Some central banks had already indicated in 2007 that based on their national law regimes, if they were to take the lead in a joint procedure then they would carry out a joint tender procedure in English only or in English and their official language,

6 Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC (OJ L 94, 28.3.2014, p. 65).

thereby providing the possibility for all interested European suppliers to participate in such tenders.

Others emphasised that if their institution were to take the lead, the tender documentation would need to be prepared in their official language and the tenderers would need to submit their tenders in that language. This requirement would not exclude the use of English, in addition to the official language, but the authentic version of the documents would be the one in the official language.

Only one central bank indicated that if it were to take the lead, it would be required by national law to prepare the authentic version of the tender documentation in its official language (an abstract of the notice could be drafted in one or more of the official languages of the Union) but the notice may allow applicants and candidates to submit an application/tender also in English.

From an operational perspective EPCO generally aims to publish and conduct its procurement procedures in English (and in the official language in parallel if required by national law) in order to make the tenders accessible to the broadest possible number of applicants within the Union. The fact that the contract notices for the different tenders are published in the Official Journal of the European Union – via Tenders Electronic Daily – in all official languages of the Union (at least an excerpt) is an element that also facilitates access by interested companies within the Union.

2.5.3 Participation of representatives of other institutions in the tender evaluation

While the tender specifications are prepared based on the joint needs of the institutions participating in the tender, the evaluation of the tenders is the responsibility of the leading central bank. However, the participation of representatives from other central banks in the evaluation process could be of interest for business or operational reasons (e.g. use of a particular expertise). Therefore, when EPCO was established it was also necessary to assess the possibility of a representative from another central bank, and not the leading one, participating in the tender evaluation.

Although all central banks confirmed that there were no impediments for the participation of representatives from other central banks in the *technical evaluation* of the tenders, the situation was different regarding the participation of representatives from other central banks in the *decision-making process*. While some central banks did not see any legal impediments to such participation, other central banks emphasised that if their central bank were to take the lead, decisions with legal effects vis-à-vis the tenderers would need to be taken by their respective central bank staff in charge of the procedure. Therefore, the representatives from other central banks could only participate in an advisory capacity.

3 The new EPCO mandate and framework

Article 3(7) of Decision ECB/2008/17 (prior to its amendment in 2016) required the EPCO Steering Committee to conduct an effectiveness and efficiency evaluation of EPCO's activities in order for the Governing Council to decide whether a new selection procedure for choosing a new hosting central bank would be necessary. The initial mandate of EPCO lasted until the end of 2014. The outcome of this assessment showed that exchanging best practices was highly beneficial, as was the infrastructure in place, and it supported the reinforcement of EPCO's activities as they relate to the coordination and implementation of joint procurements.

Based on this assessment, and after requesting the central banks' confirmation of commitment in participating in EPCO's activities, the Governing Council extended EPCO's mandate for the period from 2015 to 2019 and nominated the Banque centrale du Luxembourg to host EPCO for its second mandate. The newly adopted Decision (EU) 2016/21 of the European Central Bank (ECB/2015/51)[7] modified EPCO's legal framework and also permitted the possible participation of non-ESCB institutions in EPCO's activities.

The two main novelties introduced by Decision (EU) 2016/21 (ECB/2015/51), which entered into force on 12 January 2016, are the *reprioritisation* of EPCO's tasks – making the identification of potential joint procurements EPCO's first priority – and *permission for non-ESCB institutions* – including national authorities of Member States, Union institutions and bodies, or international organisations – to *participate in EPCO's activities* upon the invitation of the Governing Council. The participation conditions are established by the Governing Council.

The reprioritisation of EPCO's tasks was a result of the assessments conducted by the EPCO Steering Committee on EPCO, which considered moving the focus from the exchange of best practices and the establishment of the procurement infrastructure to joint procurement activities. By stipulating the possible involvement of non-ESCB institutions EPCO's list of potential members was enlarged, and exchanges about the potential participation of those interested institutions have started.

4 Conclusions

EPCO's role has developed through the years, having been focused on the exchange of best practices and the development of the procurement infrastructure and now moving towards the effective coordination of joint cross-border procurements. The coordination of these procurements has led to efficient and cost-effective services, acknowledged by EPCO members and the Governing Council through the establishment of EPCO's new mandate. Participation in EPCO's

7 Decision (EU) 2016/21 of the European Central Bank of 23 December 2015 amending Decision ECB/2008/17 laying down the framework for joint Eurosystem procurement (ECB/2015/51) (OJ L 6, 9.1.2016, p. 5).

activities is based on the voluntary participation concept, driving EPCO to provide competitive prices in its framework contracts for the benefit of its members. The recent enlargement of the potential EPCO members provides the possibility for non-ESCB members to join EPCO agreements, which could further enlarge the beneficiaries of EPCO agreements.

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The interaction between European Union, ECB and national laws in the context of procuring euro banknotes

By Torsten Schäfer[1]

Euro banknotes are a distinctive product: No matter from which point of view you look at them, you see something unique. Looking at them from a pecuniary point of view, you will hardly ever find a product which is produced for only a few cents but is worth up to a hundred or even a thousand times its acquisition cost. Looking at them from a security point of view, you will hardly ever find a product which is comparably well-protected by prohibitions and criminal law sanctions. Looking at them from a material point of view, you will hardly ever find a product which seems to be an everyday piece of paper but is in fact, on the one hand, a sophisticated product made from cotton and a wide range of state-of-the-art components, such as inks, foils and security threads equipped with high-tech security features, and on the other hand carries legal tender status.

Looking at them from a procurement point of view, you will hardly ever find a product that such a very limited number of highly specialised entities – the Eurosystem national central banks (NCBs) – need to obtain from such a small and legally very heterogeneous group of producers[2] and, in the background, a group of suppliers of raw materials,[3] which have to apply a wide range of very detailed provisions. This contribution aims to give an overview of the provisions governing euro banknote production, and will place particular emphasis on procurement-related issues.

1 Sources of procurement law

As explained elsewhere in this compendium, procurement law as applicable to the ECB basically relies on three legal sources: the EU Treaties, the principles of procurement and the rulings of the European Court of Justice (ECJ).[4] Yet for procurement by NCBs the situation is even more complex. Before the introduction of the euro as the single currency and the euro cash changeover, each NCB was solely responsible for obtaining its own national banknotes and each has, over time,

[1] Principal Legal Counsel, Directorate General Legal Services, the Deutsche Bundesbank. The views expressed in this contribution are those of the author and do not necessarily reflect those of the Deutsche Bundesbank.

[2] 16 high-security printing works throughout the Union have been accredited for the production of euro banknotes (section 3.2 below). Five of these printing works are part of a national central bank and five are publicly owned. Six printing works are privately owned by four companies.

[3] Among those, there are nine paper mills, some of them part of the relevant national central bank of the Eurosystem, some of them public and some private undertakings, for details, cf. Gabriel and Weiner (2016), at p. 467. In addition, there are a certain number of manufacturers of raw materials located in a Member State of the EU or the European Free Trade Association (EFTA).

[4] Koepfer, (2016). For further details on ECB procurement law, cf. von Lindeiner, (2016).

developed its own approach. While some NCBs produced banknotes themselves, others cooperated with state-owned printing works, and yet again others procured their banknotes from private printing works, either located in their own country or abroad. With the introduction of the euro, this set-up had to be reconciled with the objective of producing banknotes of only one – single – currency in accordance with common legal and technical requirements. This highly diverse structure does not only give a new meaning to the European Court of Auditor's view that "[a] *certain level of complexity is inherent in any public procurement system",*[5] it also entails that different legal requirements apply to its individual aspects. Most areas are governed by national law requirements, frequently influenced by Union law. This has been overlain with the Eurosystem's necessities. Consequently, three legal sources apply to NCBs producing or procuring euro banknotes: Union law, ECB law and national law.

2 European Union law

A source of law applicable to both the ECB and the NCBs is Union law. This means, in the first place, the Treaties, the principles of procurement and ECJ rulings, which have been addressed in detail elsewhere in this compendium.[6] However there is a clear difference between Union law as applicable to the ECB and Union law as applicable to the NCBs. In addition to these sources, the new Procurement Directive[7] applies only to the NCBs.

Directive 2014/24/EU on public procurement had to be transposed into national law by 18 April 2016. This directive and two other directives in the area of procurement law adopted at the same time[8] are meant to achieve a variety of objectives. While on the one hand improving the efficiency of procedures as well as simplifying and accelerating them, they are also meant to enhance legal certainty and to further certain policy goals,[9] notably to "o*pen up the EU's public procurement market to competition, prevent 'buy national' policies and promote the free movement of goods and services*", while at the same time boosting jobs, growth and investment.[10]

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[5] European Court of Auditors, (2015), p. 22.

[6] Koepfer (2016).

[7] Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC (OJ L 94 of 28.3.2014, p. 65).

[8] Directive 2014/23/EU of the European Parliament and of the Council of 26 February 2014 on the award of concession contracts (OJ L 94, 28.3.2014, p. 1), and Directive 2014/25/EU of the European Parliament and of the Council of 26 February 2014 on procurement by entities operating in the water, energy, transport and postal services sectors and repealing Directive 2004/17/EC (OJ L 94, 28.3.2014, p. 243).

[9] Recital 2 to Directive 2014/24/EU; European Commission, Green Paper on the modernisation of EU public procurement policy – Towards a more efficient European Procurement Market, of 27 January 2011 (COM(2011) 15 final).

[10] European Commission, (2016).

Because examining whether the EU legislator has fulfilled these ambitions would go beyond the scope of this paper,[11] the following focuses on a few amendments of particular relevance to euro banknote production,[12] i.e. amendments concerning communication, procedures, award criteria and the codification of ECJ case-law on in-house procurement. However, before addressing these issues in detail, it might be helpful to sketch the main steps and features of a typical restricted procurement procedure.

2.1 A typical procurement procedure

Procurement law offers a variety of procedures: open procedures, restricted tender procedures, negotiation procedures, competitive dialogues and innovation partnerships.[13] In general, a restricted procedure is the most appropriate one for a standard large scale production of euro banknotes.[14] At the outset of a restricted procedure, the contracting authority publishes a contract notice inviting interested parties to submit requests to participate. The contract notice also lays out the selection criteria for candidates. The contracting authority examines the requests and assesses whether a candidate fulfils the selection criteria. It then invites some or all of the qualified candidates to submit a tender and informs them of the contract award criteria. Having received the tenders, the contracting authority finally awards the contract to the candidate or the candidates which submitted the most economically advantageous tender or tenders.[15] Directive 2014/24/EU did not generally change this approach.

2.2 Electronic communication

The first sentence of Article 22(1) of Directive 2014/24/EU provides that, in procurement procedures, all communication and information exchange shall be

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[11] With these objectives, the EU legislator has been aiming at nothing less than squaring the circle. For one thing, the objective of improving, simplifying and accelerating procedures, in general, implies reducing the number of provisions. For another, enhancing legal certainty and furthering policy goals, rather requires detailed provisions clearly addressing these issues. A purely numerical comparison is striking: The previous Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts, L 134/114 of 30.4.2004, consisted of 51 recitals explaining 83 articles. Directive 2014/24/EU, however, contains 138 recitals and 94 articles. This significant accrual in numbers might be seen as implying a certain bias towards legal certainty and further policy goals as opposed to simplification and streamlining efforts.

[12] For the sake of clarity, the term “euro banknote production” as employed in this contribution merely denotes the production of “printed cotton sheets”. It does not yet embrace the creation of legal tender, i.e. the aspect of monetisation of these “cotton sheets”. Monetisation is a legally entirely distinct process independent of the rather technical production. For further details on monetisation, cf. Krauskopf, (2005), at pp. 243 – 256.

[13] See Articles 27-31 of the Procurement Directive.

[14] For other types of euro banknote production activities, this might be different. If it comes to pilot production or R&D activities, for instance, a negotiation procedure might also be appropriate.

[15] In an open procurement procedure, there is no separate invitation to submit a request to participate. Instead, the contract notice lays down all details of the contract and request interested parties to directly submit a tender. The contracting authority then examines selection and award criteria simultaneously.

performed using electronic means of communication.[16] In practice, this means that contracting authorities will use internet-based platforms for carrying out procurement procedures, requiring that the contractual documentation be up-loaded onto these platforms. Even though in the case of a restricted tender procedure only those tenderers admitted by the contracting authority may have access to this documentation, such up-loading necessarily implies that the operator of the platform could have access as well. In this context, the nature of euro banknote production is relevant. Since euro banknote production awarded by an NCB to a private law printing works is governed by civil law, all parameters for banknote production need to be laid down in the contractual documentation, including the details relating to technical specifications and security issues. Given the highly sensitive nature of such information, up-loading such details onto an internet-based platform might, consequently, be perceived as unsafe.

Hence, contracting authorities might want to contemplate applying the exemption laid down in the fourth subparagraph of Article 22(1) of Directive 2014/24/EU. This provides that contracting authorities are, under certain security-related conditions, not obliged to require electronic means of communication. Yet this provision explicitly applies to "electronic means of communication in the submission process". Thus, can this provision be invoked for the opposite direction of communicating the contracting authority's sensitive contractual documentation to the candidates? The wording suggests something different, since "*submission*" – "*processus de soumission*" or "*Einreichungsverfahren*" in the French and German language versions respectively – can only be understood as referring to the candidates' or tenderers' submission of documents to the contracting authority. It cannot be understood as referring to the contracting authority circulating the contractual documentation or other documents to the candidates.

As another possibility, contracting authorities might consider applying the first subparagraph of Article 53(1) of Directive 2014/24/EU. Regarding the electronic availability of procurement documents, this provision allows contracting authorities to take "*measures aimed at protecting the confidential nature of the information*", if they intend to impose confidentiality requirements on candidates under Article 21(2). Yet this only allows for certain security measures, it does not relieve contracting authorities from making such information available electronically. Therefore, if NCBs as contracting authorities do not want to transmit certain sensitive documents electronically, they have to come up with other ways of making such documents contractually binding, such as for example by referring to documentation available at secure websites or distributable as hard copies only. Yet, in this case, the legal assessment leaves the area of procurement law, as the question of whether these documents then become legally binding parts of the contract[17] is a question of national civil law.

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[16] Subject to the possibility for Member States to postpone this obligation, Article 90(2) of Directive 2014/24/EU (§ 81 of the German procurement Regulation).

[17] From a civil law point of view, the contracts for the production of euro banknotes as awarded by the Deutsche Bundesbank qualify as contracts for work and materials (*Werklieferungsvertrag*) under §§ 651, 631 of the German Civil code.

2.3 Procedures and time limits

The new Procurement Directive complements the catalogue of procurement procedures – open procedures, restricted procedures, negotiation procedures and competitive dialogues – by a new concept: the innovation partnership (Article 31). Given that this is targeted at "*the development of an innovative product […] and the subsequent purchase of the resulting supplies [which] cannot be met by solutions already available on the market*" (Recital 49), this might be explored as a possible avenue in the context of developing future series of euro banknotes. While this might be used for example for acquiring innovative security features for euro banknotes, it is hard to imagine the Eurosystem as a whole using an innovation partnership for the entire development of banknotes, since this might entail relinquishing control of the process to an extent larger that is politically appropriate.

However, concerning the details of procedural rules, the new Procurement Directive enhanced legibility by consolidating the main rules for each procedure in a separate provision. For example, Article 27 now outlines the open procedure and Article 28 describes the restricted procedure – both also providing for the time limits applicable to each step. In the previous Procurement Directive 2004/18/EC,[18] the individual aspects of procedures were rather scattered over a number of provisions. Certain aspects were grouped thematically, e.g. in Article 38 laying down the time limits applicable to the individual steps of each procedure in one provision. Moreover, the new Directive has shortened these time limits. Previously, the time limit for the receipt of tenders in an open procedure was a minimum of 52 days from the date on which the contract notice was sent which has now been shortened to 35 days. For restricted procedures, the time limit for the receipt of requests to participate has been shortened from 37 to 30 days from the day on which the contract notice or the invitation to confirm interest, as the case may be, was sent, and the time limit for the receipt of tenders has been shortened from 40 to 30 days.[19]

2.4 Award criteria

Article 53(1) of the previous Procurement Directive provided for two possible award criteria. Contracting authorities could choose either the "*most economically advantageous tender*" or "*the lowest price only*". Article 67(1) of the new Procurement Directive now provides for one award criterion only by requiring that the contract be awarded based on "*the most economically advantageous tender*". Yet Article 67(2) further defines this notion and stipulates that the most economically advantageous tender shall be identified on the basis of the price or cost, using a cost-effectiveness approach. It may include the best price-quality ratio. At the end of the day, this means that the Directive aims at implementing the "best price-quality ratio", see Recital 89, which however, also allows for an award based on the lowest price only. This is explained in the first paragraph of Recital 90, but also follows from

[18] Footnote 12.

[19] In cases of urgency, all these time limits can be reduced even further.

the fact that, firstly, the last subparagraph of Article 67(2) allows Member States to exclude the lowest price as sole award criterion and, secondly, the first paragraph of Article 67(5) refers to the contracting authority identifying the most economically advantageous tender on the basis of price alone.

Yet when applying the lowest price as the sole award criterion, contracting authorities still have to take the relevant ECJ case-law into consideration, which requires that the lowest price may only be used as the sole award criterion if this neither hinders free competition nor prevents the best tender being accepted.[20] Consequently, the lowest price may only be chosen if other award criteria are either unsuitable or not necessary to compare tenders.[21] Contracts for the production of euro banknotes are standardised at least as far as the actual product is concerned. In this respect, there is basically no room for deviating technical specifications or other conditions for the execution. Consequently, criteria other than price are neither necessary nor appropriate. NCBs can continue to apply the lowest price as the sole award criterion.

2.5 Codification of ECJ case-law on in-house procurement

As indicated above,[22] not all of the printing works producing euro banknotes are privately owned. Five are part of an NCB and five are publicly owned. ECJ case-law has long established that contracting authorities are not obliged to procure goods from third parties. Instead, they may rely on their own means to obtain the products they require. This does not only apply to pure in-house purchases, such as an NCB awarding its printing department with the printing of banknotes. The ECJ also ascertained in its *Teckal* judgement[23] that such in-house transactions may be carried out without a procurement procedure even where the contractor is a person legally distinct from the contracting authority, if two conditions are met.

Firstly, the contracting authority must exercise over the person concerned a control which is similar to that which it exercises over its own departments – the control criterion. Secondly, at the same time, that person carries out the essential part of its activities with the controlling local authority or authorities – the essentiality criterion. Either condition is rather unclear and requires interpretation: What is "*control similar to that which it exercises over its own departments*"? What is the "*essential part of the activities*"? For the sake of legal clarity, the European legislator has, therefore, codified and clarified the case-law as established by *Teckal* and subsequent judgements in Article 12 of the Procurement Directive. For example, Article 12(1) of the Procurement Directive[24] does not only define the control criterion in detail, paragraph (b) thereof now also clarifies the essentiality criterion as requiring that "*more than 80% of the activities of the controlled legal person are carried out in the performance of tasks entrusted to it by the controlling contracting authority or by*

[20] Case C-247/02 Sintesi, EU: C:2004:593, para. 40.

[21] Wiedemann (2016), § 127 at para. 29.

[22] Footnote 2.

[23] Case C-107/98 Teckal srl, EU:C:1999:562, para. 50.

[24] For a particular view on the transposition into German law, Hofmann, (2016), at pp. 190 – 191.

other legal persons controlled by that contracting authority". Further details on this subject have been addressed elsewhere in this compendium[25] and it will not therefore be pursued further here.

3 ECB law

The second source of law is ECB law. In the area of banknotes, ECB law governs a wide range of issues covering the entire life-span of euro banknotes, i.e. production, issuance, use and the protection and withdrawal. The legal acts applicable to the production of euro banknotes can be categorised according to their scope of application, and one can distinguish between rules concerning organisation, participation and production.

3.1 Organisation

In the area of rules for the organisation of euro banknote production, the Governing Council adopted new rules in November 2014[26] and created the Eurosystem Production and Procurement System (EPPS). The EPPS replaced the Single Eurosystem Tender Procedure (SETP), which provided for centralised procurement of euro banknotes by the NCBs or the ECB acting on behalf of the NCBs (Article 6(1) of Guideline ECB/2004/18).[27] Under Article 6(2) of this Guideline "*NCBs that have an in-house printing works and NCBs using public printing works*" were free to opt-out from the SETP. At the outset, the Governing Council envisaged the SETP to start on 1 January 2012, but postponed this date initially to 1 January 2014[28] and then for an indefinite period.[29] Finally, when establishing the EPPS, the Governing Council repealed Guideline ECB/2004/18.

3.1.1 In-house group NCBs

Like the SETP Guideline, the EPPS Guideline sets up a model distinguishing between two groups of NCBs: tendering group NCBs and in-house group NCBs. Contrary to the previous approach, the EPPS Guideline's focus is the in-house group. In this respect, the Guideline envisages cooperation among these NCBs (Article 7), ultimately striving at establishing a separate legal person or non-institutionalised horizontal cooperation for jointly fulfilling public tasks (Article 8).

[25] See Kopefer, 2016, Müller-Wrede, (2016), pp. 292 – 302 and Lahann, (2010), pp. 41 – 77.

[26] Guideline (EU) 2015/280 of the European Central Bank of 13 November 2014 on the establishment of the Eurosystem Production and Procurement System (ECB/2014/44) (OJ L 47, 20.2.2015, p. 29).

[27] Guideline ECB/2004/18 of the European Central Bank of 16 September 2004 on the procurement of euro banknotes (OJ L 320, 21.10.2004, p. 21).

[28] Guideline ECB/2011/3 of the European Central Bank of 18 March 2011 amending Guideline ECB/2004/18 on the procurement of euro banknotes (OJ L 86, 1.4.2011, p. 77).

[29] Guideline EZB/2013/49 of the European Central Bank of 18 December 2013 amending Guideline ECB/2004/18 on the procurement of euro banknotes (OJ L 32, 1.2.2014, p. 36).

The EPPS Guideline's core procurement-related rule for in-house group NCBs, however, is contained in Article 6(2), which provides that these NCBs "*shall ensure that their in-house printing works do not participate in any tender procedures for the production of euro banknotes organised and carried out within the Union and do not accept orders for the production of euro banknotes from third parties outside the in-house group NCBs*". The ECJ has held that EU procurement law does not "*preclude a Member State from providing for further exclusionary measures designed to ensure observance of the principles of equal treatment of tenderers and of transparency, provided that such measures do not go beyond what is necessary to achieve that objective*".[30] In the absence of such exclusionary measures tenderers may only be excluded in individual cases, invoking for example the principles laid down in Article 69 of the Procurement Directive on abnormally low tenders. However, Article 6(2) of the EPPS Guideline does not actually provide for an exclusion of tenderers, instead it postulates self-restraint and merely reflects the abovementioned limitations for in-house production:[31] These rules in effect stop in-house printing works from participating in other NCBs' tender procedures, because they would otherwise run the risk of losing their in-house privilege: if they were awarded a contract with another contracting authority, they would probably no longer carry out the essential part of their printing activities with their controlling NCB as required by the ECJ.[32]

3.1.2 Tendering group NCBs

Tendering group NCBs are described as a "*group of NCBs which procure their euro banknotes*" (Recital 4 to Guideline ECB/2014/44), while Article 3 thereof provides "*NCBs that do not have in-house printing works shall be part of the tendering group*". They have to acquire their banknote needs on the market, from private printing works. For these NCBs, the EPPS Guideline further specifies their obligations under applicable procurement law.

Firstly, Article 4(1) of the EPPS Guideline recalls that NCBs "*shall carry out tender procedures individually or jointly with other tendering group NCBs in accordance with applicable procurement rules*". Yet NCBs are contracting authorities as defined by Article 2(1)(1) of the Procurement Directive.[33] As such, they are obliged to apply public procurement law. This does not necessarily mean that they also are obliged to carry out procurement procedures, since it may be possible that NCBs are, under

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[30] Case C-213/07 Michaniki, EU:C:2008:731, para. 47. The ECJ examined a pre-predecessor of the current Procurement Directive, Council Directive 93/37/EEC of 14 June 1993 concerning the coordination of procedures for the award of public works contracts (OJ L 199, 9.8.1993, p. 54).

[31] At the time of drafting this provision, the involved parties could only assess its legality in the light of the ECJ's Teckal doctrine (see footnote 24), since the Procurement Directive had not yet been adopted. However, given that this Directive codifies this case-law without substantially changing it, the initial assessment still holds true.

[32] Gabriel and Voll, (2015), at p. 268, however perceive Article 6(2) of the EPPS Guideline rather as an "indirect prohibition to participate".

[33] "'*Contracting authorities' means the State, regional or local authorities, bodies governed by public law or associations formed by one or more such authorities or one or more such bodies governed by public law.*"

national procurement law, exempt from carrying out such procedures. In such cases, an obligation to carry out procurement procedures would follow from Article 4(1) of the EPPS Guideline. In all other cases, this provision is little more than declaratory.[34] However, in all cases, it calls upon NCBs to carry out such procedures "*individually or jointly with other tendering group NCBs*", thus acknowledging that certain NCBs cooperate in the procurement of euro banknotes, such as eight NCBs, headed by De Nederlandsche Bank as the Joint European Tender (JET)[35] and, more recently, the Deutsche Bundesbank, Latvijas banka and Lietuvos bankas.[36]

Secondly, NCBs "*shall divide tenders into several lots and multiple lots should not be awarded to the same tenderer*" (Article 4(2) of the EPPS Guideline). This provision complements and curtails Article 46 of the Procurement Directive.[37] While the first subparagraph of Article 46(1) of the Procurement Directive stipulates that contracting authorities may award a contract in the form of separate lots, the second subparagraph of Article 46(2) allows contracting authorities to limit the number of lots that may be awarded to one tenderer. Article 4(2) of the EPPS Guideline removes this freedom and makes such splitting into, and limitation of, lots mandatory. Both of the requirements under Article 4(2) foster competition. However, splitting contracts into lots can be a necessity in the area of banknote production, given the number of banknotes produced annually. For example, 8 billion banknotes were produced in 2013,[38] roughly 8.5 billion in 2012[39] and 6 billion in 2011.[40]

Thirdly, public printing works may only participate in tender procedures if they have implemented the arm's length principle, Article 4(3) of the EPPS Guideline.[41] In a nutshell, public printing works are defined as printing works over which public authorities may directly or indirectly exercise a dominant influence, further details are laid down in Article 1(4) of the EPPS Guideline. The arm's length principle requires that, firstly, these printing works are fully separated from [its public authority's accounts and secondly, that their euro banknote printing activities are fully separated financially from their other activities. This is meant to exclude that direct or indirect state aid, which is incompatible with the Treaty, is provided. Furthermore, the public printing works must reimburse its public authority for the costs of all administrative and organisational support that it receives. In summary, the arm's length principle prohibits public printing works from cross-financing their euro banknote printing

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[34] To the contrary, Prieß and Hölzl, (2011), at p. 70, refer to the secrecy provision of Article 14 of Directive 2004/18/EC and argue that NCBs are not only exempt from the obligation to carry out procurement procedures, they also claim that this provision prohibits NCBs from carrying out such procedures.

[35] Central Bank of Cyprus, Eesti Pank, Suomen Pankki – Finlands Bank, Banque centrale du Luxembourg, Central Bank of Malta, Banka Slovenije and Národná banka Slovenska, see De Nederlandsche Bank, (2010), p. 123 and Gabriel and Weiner (2016), pp. 466 - 467.

[36] See Section 5.1.

[37] In this context, it should be noted that the Procurement Directive applicable at the time of entry into force of the EPPS Guideline did not contain comparable provisions on lots; it merely acknowledged the possibility of splitting contracts into lots in the rules on the methods for calculating the value of public contracts (see Articles 8 and 9 of Directive 2004/18/EC). German procurement law, however, provided for such obligation, Müller-Wrede, [(2014), § 2 EG, para. 4.

[38] European Central Bank, (2013), p. 103.

[39] European Central Bank, (2012), p. 97.

[40] European Central Bank, (2011), p. 97.

[41] For further details see Gabriel and Voll (2015), p. 267.

activities with proceeds gained in other areas such as, for example, passport production. An independent external audit firm must annually check and certify compliance with the arm's length principle.

Finally, the Guideline acknowledges that tendering NCBs generally have leeway when drawing up their tendering and contractual documentation and requires them to “seek to align their tendering requirements including eligibility criteria”, which is meant to ensure a level playing field (Article 5 of the EPPS Guideline).[42]

3.2 Participation

In the area of participation rules, Decision ECB/2013/54[43] is the main legal act. This Decision consolidates the previous “three pillar accreditation system for euro banknote manufacturers”,[44] consisting of three “sectoral” decisions each covering a specific aspect of euro banknote production: Decision ECB/2008/3,[45] Decision ECB/2010/22 of 25 November 2010 on the quality accreditation procedure for manufacturers of euro banknotes,[46] and Decision ECB/2011/8 of 21 June 2011 on the environmental and health and safety accreditation procedures for the production of euro banknotes.[47]

In a nutshell, under this Decision, undertakings wishing to be involved in the production of euro banknotes require an ECB accreditation or a provisional ECB accreditation. Before the ECB takes a decision on whether or not to accredit a manufacturer, inspection teams examine the candidate manufacturer and in particular assess their conformity with the ECB requirements in the three areas which were previously been covered by separate decisions: security requirements, quality requirements and environmental and health and safety requirements.

[42] The EPPS Guideline has been criticised as falling short of preventing a systemic failure. Gabriel and Weiner (2016) at p. 467 welcome the distinction between private and public printing works and notably the obligation for the latter to comply with the arm’s length principle. Yet they argue that this approach should be extended to the entire banknote production process. According to them, paper mills are subcontractors of printing works. Consequently, public paper mills should also be required to comply with the arm’s length principle. Moreover, just like in-house printing works, in-house paper mills should also be excluded from participating in tenders of tendering group NCBs which, consequently, means that printing works using in-house paper mills as (perceived) subcontractors should be excluded from participation in such tender procedures as well. Since discussing this issue in detail would go beyond the scope of this contribution, it might suffice to point out that this conclusion is based on a wrong assumption. According to Gabriel and Weiner, paper mills are printing works’ subcontractors. Yet according to German case-law, this is explicitly not the case. Both the Vergabekammer des Bundes (German Federal Procurement Board; decision of 27 August 2010, VK 2 − 80/10) and the Oberlandesgericht (Higher Regional Court,) Düsseldorf; order of 27 October 2010, VII-Verg 47/10, para. 39) have clarified that paper mills are not subcontractors as referred to in Article 25 of the previous Procurement Directive.

[43] Decision ECB/2013/54 of the European Central Bank of 20 December 2013 on the accreditation procedures for manufacturers of euro secure items and euro items and amending Decision ECB/2008/3 (OJ L 57, 27.2.2014, p. 29).

[44] Karshev, (2015), on the current version and Gabriel and Voll (2015) at p. 265 on the previously applicable decisions.

[45] Decision ECB/2008/3 of the European Central Bank of 15 May 2008 on security accreditation procedures for manufacturers of euro secure items for euro banknotes (OJ L 140, 30.5.2008, p. 26).

[46] Decision ECB/2010/22 of the European Central Bank of 25 November 2010 on the quality accreditation procedure for manufacturers of euro banknotes (OJ L 330, 15.12.2010, p. 14).

[47] Decision ECB/2011/8 of the European Central Bank of 21 June 2011 on the environmental and health and safety accreditation procedures for the production of euro banknotes (OJ L 176, 5.7.2011, p. 52).

3.3 Production

The third area of ECB law governs the actual production of euro banknotes. While this is, in terms of pages, probably the largest area of euro banknote-related legislation, most of these rules are of a highly technical nature. Yet from a legal point of view, they are only of limited interest for the purposes of this paper. In addition to purely technical rules, these rules cater for the need to establish which NCB is actually responsible for which part of the production. To this end, the Governing Council, in 2001, established the so-called decentralised production scenario with pooling. Under this scenario, production is shared among NCBs, and each NCB only produces or procures one or a few denominations, which are then shared with the other NCBs.[48]

As to the technical rules for the production of euro banknotes, Decision ECB/2013/10[49] lays down the basic features, such as the denominations, dimensions and general design issues.[50] According to Article 1 of this Decision, euro banknotes include the denominations 5 euro to 500[51] euro. They bear illustrations of gateways and windows on the front and bridges on the back reflecting the theme "*Ages and styles of Europe*". They are typical of artistic periods, but do not depict existing edifices. In addition, Article 2(2) lays out the main design elements including the symbol of the Union, the © symbol and the signature of the ECB President. Concerning the name of the currency and the initials of the ECB, this provision distinguishes between the first and the second series, taking into account that the number of Member States, and thus of official languages[52] as well as alphabets[53] used, increased significantly since the time of the introduction of the euro as the single currency.

48 See, for example, the ECB Annual Report 2013, p. 103.

49 Decision ECB/2013/10 of the European Central Bank of 19 April 2013 on the denominations, specifications, reproduction, exchange and withdrawal of euro banknotes (OJ L 118, 30.4.2013, p. 37).

50 For further details regarding the preceding Decision ECB/2003/4 of the European central Bank of 20 March 2003 on the denominations, specifications, reproduction, exchange and withdrawal of euro banknotes (OJ L 78,25.3.2003, p. 19), (See Freimuth, (2012), Article 128, at para. 17 et seq.

51 The ECB decided in May 2016 to discontinue the production of 500 euro banknotes. The issuance of this denomination is envisaged to cease around end-2018. Thus, the second series of euro banknotes – the "Europa series" – will not contain this denomination. However, in its press release of 4 May 2016, the ECB declared that this banknote "*will remain legal tender and can therefore continue to be used as a means of payment and store of value*". Moreover, the ECB announced that it "*can be exchanged at the national central banks of the Eurosystem for an unlimited period of time*", *production and issuance of €500 banknote*" [There was only one press release on 4 May 2016 covering both aspect.], ECB, (2016). Against this background, the reference to a 500 euro banknote needs to be maintained in Article 1 of the Decision.

52 The first series of euro banknotes uses five official language variants (BCE, ECB, EZB, EKT and EKP); the second series applies nine official language variants (BCE, ECB, ЕЦБ, EZB, EKP, EKT, EKB, BĊE and EBC).

53 The first series uses the Roman and Greek alphabets, while the second series also uses the Cyrillic alphabet.

4 National law

The third source of procurement law is national law. As mentioned above, the Procurement Directive required transposition into national law by 18 April 2016.[54] The German legislator, for example, seized this opportunity and overhauled the entire German legislation on procurement law and adopted a set of legal acts, commonly referred to as the 2016 procurement law reform. In this exercise, the legislator has thoroughly revised each relevant legal act.

4.1 Set-up

At the outset, it should be recalled that by virtue of Article 4, the Procurement Directive only applies to procurement with a value above certain thresholds. For public supply and service contracts awarded by central government authorities – such as NCBs – point (b) of Article 4 of Directive 2014/24/EU sets that threshold at EUR 134 000 (net of VAT).[55] Against this background, German procurement law distinguishes between contracts below the thresholds on the one hand and contracts above the thresholds on the other hand, the Procurement Directive is only relevant for the latter.

4.1.1 Procurement below the thresholds

Given that contracts for the procurement of euro banknotes generally exceed the threshold of EUR 135 000, the rules that apply to procurement below the thresholds need not detain us here. This area is governed mainly by national budgetary law.[56] According to § 30 of the Act on Budgetary Principles for the Federation and the Länder (Part States) and § 50 of the Federal Budget Code,[57] contracts may, as a rule, only be concluded following a public tender procedure. Detailed rules are set out in the Ordinance on Construction Works – Part 2 and in the Ordinance on Supply of Goods and Services Ordinance on Construction Works. In general, these provisions, although not as detailed, follow principles similar to those of the Procurement Directive, and, generally, require an open or a restricted tender procedure.

[54] For a general overview of the new structure, see von Wietersheim, (2016), pp. 269 – 278.

[55] In the meantime, this has been raised to EUR 135 000 (Commission Delegated Regulation (EU) 2015/2170 of 24 November 2015, OJ L 307, 25.11.2015, p. 5. An overview of the thresholds applicable to other cases can be found in Neun and Otting, (2016), p. 487.

[56] Yet the ECJ has recently again confirmed that for contracts with a value below the thresholds (and thus not subject to the (previous) Procurement Directive), in the case of cross-border interest, the fundamental rules and general principles of the Treaty, "*in particular the principles of equal treatment and of non-discrimination and the consequent obligation of transparency*" apply, case C-278/14 SC Enterprise Focused Solutions SRL, EU:C:2015:228, para 4, furthermore case C-425/14 Impresa Edilux Srl, EU:C:2015:721, para. 21.

[57] Similar rules are laid down for the individual *Länder* in their regional laws.

4.1.2 Procurement above the thresholds

Above the thresholds, the so-called cascade principle, based on a multi-layered approach, applies, even though the legislator has used the procurement law reform to slightly dilute the cascaded approach.[58] At the top level, there is the *Gesetz gegen Wettbewerbsbeschränkungen* (Competition Act). Parts I to III of the Competition Act cover "traditional" competition law issues such as restraints of competition (part I), competition authorities (part II) and certain procedural and legal protection issues in the context of court proceedings (part III). Part IV regulates procurement law, containing the basic rules for public procurement and the rules for a review procedure.

By the procurement law reform, certain issues which had previously been provided for at lower levels are now regulated at the top national level, i.e. in the Competition Act. This concerns, in principle, the general principles of procurement law and the basic procedural rules including the rules for an exclusion of tenderers. In addition, there are, for the first time codified rules on the amendment of contracts.

On the second level, the Procurement Regulation lays down additional details for supplies, services and works, and provides for procurement procedures, addressing the minutiae of open procedures, restricted procedures, negotiation procedures, competitive dialogues and innovation partnerships.

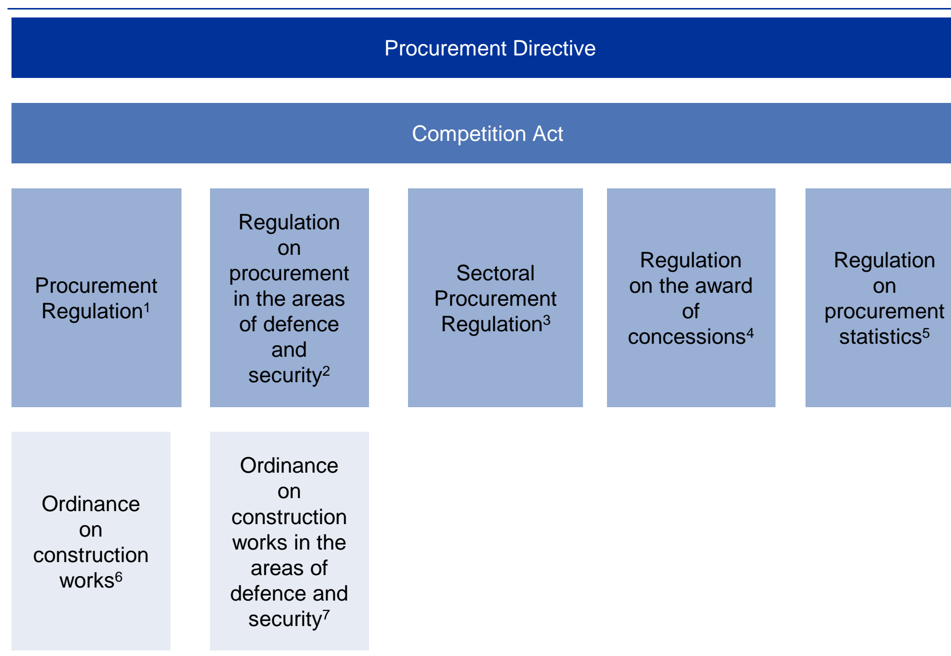
The third national level is no longer relevant for the procurement of euro banknotes or supplies in general. Up until the entry-into-force of the 2016 procurement law reform, the Ordinance on Supply of Goods and Service[59] applied at this third level. Such third-level ordinance has only been maintained for the procurement of construction works. In this latter area, however, the scope previously covered by the Ordinance on Supply of Goods and Service has been lifted up to the second national level and is now covered by the Procurement Regulation itself, thereby enhancing the status of these provisions. The cascade principle is depicted in Figure 1.

[58] Knauff, (2016), p. 195, refers to the remaining cascading elements as "artificial ruins".

[59] Vergabe- und Vertragsordnung für Leistungen – VOL/A 2009.

Figure 1

Cascade principle of German procurement law



1) Vergabeverordnung – VgV
2) Vergabeverordnung Verteidigung und Sicherheit – VSVgV
3) Sektorenverordnung – SektVO
4) Konzessionsvergabeverordnung – KonzVgV
5) Vergabestatistikverordnung – VergStatVO
6) Vergabe- und Vertragsordnung für Bauleistungen Teil A, Part 2 – VOB/A EU
7) Vergabe- und Vertragsordnung für Bauleistungen Teil A, Part 3 – VOB/A VS

When adopting the 2016 procurement law reform, the German legislator not only transposed the Procurement Directive, but also enacted further improvements. In particular, the previous Procurement Directive[60] did not provide for any kind of supremacy or hierarchy between the open and the restricted procedure; neither does the current Procurement Directive 2014/24/EU. Prior to the procurement law reform, national German law, however, provided for such a distinction: According to the first sentence of § 101(7) of the Competition Act (previous version), contracting authorities had to apply open procedures, unless they could invoke specific reasons for applying another type of procedure.[61] Contracting authorities could inter alia apply a restricted procedure, if the performance, due to its nature, could only be carried out by a limited number of undertakings.[62] Given that only 16 ECB-accredited printing works can produce euro banknotes, contracting authorities such as the Deutsche Bundesbank could invoke this exemption and carry out a restricted tender procedure.[63] This reasoning, however, had to be included in its procurement documentation in order to avoid subjecting the procurement procedure to the risk of

60 Footnote 12.

61 Concerning the supply of goods and services, the conditions for opting for procedures other than the open procedure were laid down in the first sentence of § 3 EG(1) VOL/A 2009. These conditions, however, did not have a basis in Union law, cf. Kulartz, (2009), § 101, para. 64. The second sentence of Article 28 of the previous Procurement Directive mentions rather the open and restricted procedures without any differentiation: *"…by applying the open or restricted procedure*".

62 § 3 EG(2) VOL/A 2009.

63 Oberlandesgericht (Higher Regional Court) Düsseldorf, order of 27 October 2010, VII-Verg 47/10.

legal challenge. Following the 2016 procurement law reform, contracting authorities may apply the open or restricted procedures at their own choice; where they choose to apply one of the other types of procedure, specific reasons must be invoked under § 119(2) of the Competition Act.[64]

5 Implementation by the Deutsche Bundesbank

The Deutsche Bundesbank, being both an NCB of the Eurosystem and a contracting authority under § 99 No 2 of the German Competition Act[65] (Article 2(1)(1) of the Procurement Directive), is in a rather unique position, since, unlike a standard contracting authority, it is not only obliged to apply national procurement law, but also to implement the obligations stemming from its role as an integral part of the Eurosystem. Consequently, the Deutsche Bundesbank needs to apply all the provisions detailed in sections 2 to 4 of this contribution.

Before the introduction of the euro as the single currency, the Deutsche Bundesbank was solely responsible for the issuance of DM banknotes. Even though the Deutsche Bundesbank does not possess its own printing department, it was not obliged to carry out tender procedures for the procurement of DM banknotes, but could simply mandate two German printing works with the production of its banknote needs. As only the Deutsche Bundesbank and the two German printing works involved had access to the specifications, security features and other confidential information relating to DM banknotes, the Deutsche Bundesbank could invoke the secrecy provisions exempting contracts from the application of procurement law provided for in point (b) of Article 2(1) of Council Directive 93/36/EEC of 14 June 1993 coordinating procedures for the award of public supply contracts.[66]

This, however, changed with the introduction of the euro. All accredited euro banknote printing works had access, from that point on, to the pertinent technical information and were, thus, in a position to produce these notes, and the Deutsche Bundesbank could no longer make use of the above-mentioned secrecy exemptions. As a consequence, the Deutsche Bundesbank has developed its own approach to the procurement of euro banknotes.

5.1 Organisation

While the Deutsche Bundesbank has specialised business units in charge of procuring all required goods, services and works, it was felt that legal, political and financial aspects of the procurement of euro banknotes might warrant special treatment. Therefore, all significant decisions relating to the procurement of euro banknotes are taken by the Executive Board. Moreover, the Deutsche Bundesbank

[64] Kulartz,(2016), § 119, para. 5.

[65] For the preceding version of this provision (§ 98 No 2 of the Competition Act), this has been clarified by the German Federal Procurement Board, decision of 27 August 2010, VK 2 - 80/10.

[66] OJ L 199, 9.8.1993, p. 1.

has established a Banknote Procurement Committee, consisting of representatives of the Deutsche Bundesbank's Directorate General Cash Management, Directorate General Legal Services and the Procurement Centre. The Committee's tasks relate solely to the procurement of euro banknotes; the tasks relating to the procurement of all other goods, services and works remain within the responsibility of the Procurement Centre.

In addition, the Deutsche Bundesbank has recently concluded a cooperation agreement with Latvijas banka and Lietuovs bankas. Under this agreement, the three NCBs pool the banknote production quotas allocated to them by the Governing Council for joint procurement. To this end, the Deutsche Bundesbank regularly carries out tender procedures. As a result, even though only a single tender procedure is being carried out, each of these NCBs enters into a separate legal relationship with the printing works concerning its share in the production.[67]

5.2 The initial approach

With regard to actual procurement procedures, the Banknote Procurement Committee initially carried out one tender procedure per year, mirroring the ECB's annual allocation of production quotas. To this end, the Deutsche Bundesbank carried out restricted tender procedures, publishing an invitation for tenders in the Official Journal[68], making ECB accreditation the decisive condition for participation. As a rule, the Deutsche Bundesbank's production requirements were split into two or more lots, depending on the amount of notes to be procured. The procurement documentation provided for one award criterion only, i.e. with no more than one lot being allocated per printing work. The technical rules, such as technical specifications or security and transport rules have been made mandatory for printing works as part of the conditions for performance of the contract

5.3 The actual approach

In 2013, the Deutsche Bundesbank changed its approach and entered into a framework agreement[69] with ECB-accredited printing works for the production of euro banknotes ("framework partners"). The framework agreement in itself does not yet provide for the actual production of banknotes and does not yet stipulate the quantity of euro banknotes to be produced by the printing works concerned, but merely establishes the legal framework for the production. In this respect, the

[67] Another group of NCBs has adopted a similar approach under De Nederlandsche Bank's leadership: Under the Joint European Tender (JET), Central Bank of Cyprus, Eesti Pank, Suomen Pankki – Finlands Bank, Banque centrale du Luxembourg, Central Bank of Malta, Banka Slovenije and Národná banka Slovenska jointly procure euro banknotes, De Nederlandsche Bank, (2010), p. 123. See also Gabriel and Weiner (2015), p. 467. For further details on joint procurement, see Koepfer (2016) and Csepely-Knorr, (2016).

[68] For instance contract notice 2011/S 242-392613: http://ted.europa.eu/udl?uri=TED:NOTICE:192985-2012:TEXT:EN:HTML&src=0

[69] Contract notice 2013/S 100-171223, available at: http://ted.europa.eu/udl?uri=TED:NOTICE:428628-2013:TEXT:EN:HTML&src=0

framework agreement covers two areas. One part –the substantive part – lays down substantive rules on the modalities of the production of banknotes and largely mirrors the contractual and technical rules that applied under the Deutsche Bundesbank's initial approach.

The other part of the framework agreement – the procedural part – is an innovation. In essence, this part of the framework agreement provides for a tailor-made procurement procedure featuring "mini-competitions". Under these rules, the Deutsche Bundesbank may award a euro banknote production contract without having to initiate a fully-fledged (restricted) tender procedure involving the publication of a contract notice in the Official Journal. Instead, the Deutsche Bundesbank can call on the framework partners to submit individual offers for the production of euro banknotes according to the provisions of the substantive part. The details of this procedure have been drafted along the lines of the rules for a restricted tender procedure, in particular allowing for the splitting production requirements into lots, in principle limiting the number of lots available for each framework partner to one and making the lowest price the sole award criterion. In general, this is an approach foreseen by both the Procurement Directive and the German Competition Act. Article 33 of the Procurement Directive and § 103 of the Competition Act[70] allow for framework agreements, provided that they apply the procedures provided for in the Directive and the Competition Act, respectively. Thus, the framework agreement simplifies the procedures by laying down common requirements for all production orders. In the context of the individual order – the "mini-competition" –, only those aspects which are specific to each order need to be addressed. This both simplifies and accelerates proceedings significantly, and provides for a wider margin of flexibility when euro banknotes need to be acquired. This entails significant advantages, in particular, as regards the procurement of euro banknotes: Given that German procurement law requests contracting authorities to initiate a procurement procedure only once the contracting authority has all relevant information available and the procurement documentation has been finalised,[71] NCBs may only initiate a procurement procedure following the annual allocation of banknotes by the Governing Council. In this respect, the gain in time brought about by the accelerated procedures under its framework agreement cannot be overstated, and further research is needed to see whether the time limits laid down in the framework agreement could be shortened even further, given the acceleration of procedures under the new Procurement Directive.[72]

6 Conclusion

The rules for procurement and production of euro banknotes form a complex framework, providing for different types of legal conditions stemming from different legislators. To this end, NCBs not only have to apply specific procurement procedure

[70] Details are laid down in § 21 of the German Procurement Regulation.

[71] Principle of maturity of procurement, see Oberlandesgericht Düsseldorf, order of 26 June 2013, VII-Verg 2/13, para. 47 et seq.

[72] See Section 2.3 above.

rules, but also have to comply with a wide range of substantive provisions relating to banknote production.

In this context, the revision, in particular, of Union procurement law and, arising therefrom, of national provisions is problematic for contracting authorities, as in this area of law procurement issues on the one hand and substantive interests on the other hand have conflicting objectives: This is particularly relevant in an area as security-sensitive as euro banknote production, since tendering NCBs will have to find ways of appropriately reconciling their security and confidentiality needs with increased transparency requirements and the digitalisation of procurement procedures. It should also be pointed out that the revised Union procurement framework makes the contracting procedure easier for contracting authorities by accelerating the procedure and codifying the rules on in-house procurements.

While Union law on euro banknote production is mostly confined to procedural issues, ECB law in this area is more diverse, as it establishes both procedural and substantive requirements. While the procedural rules for tendering NCBs broadly coincide with NCBs' established procurement approaches, the emphasis of ECB law lies on substantive law, providing NCBs with a sound legal framework.

Under German procurement law, some of the previous requirements which went beyond a mere one-to-one transposition of Union requirements have been removed and the legal framework has been simplified. Furthermore, under the revised rules the Deutsche Bundesbank can continue applying its court-tested[73] approach of awarding contracts by way of mini-competitions under a framework contract.

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The EU and EMU as correlated institutions beyond the State Keynote speech

By Jaap Hoeksma[1]

Abstract

The European Union is neither a State nor an organisation of States, but may be described instead as a union of States and citizens. The political hallmark of the new polity is that it has replaced the principle of absolute sovereignty with the concept of shared or "smart" sovereignty. This paradigm shift has enabled the EU to develop a common market, an autonomous legal order and a single currency. The present stage in the evolution of the EU may be reflected in the following aphorism: "As the European Union constitutes a polity beyond the State, the euro forms a currency beyond the State".

1 Introduction

The purpose of the present essay is to demonstrate the correlation between the European Union and the Economic and Monetary Union (EMU) through the lens of a new paradigm. It seems a topical subject for this year's ESCB Legal Conference, as the participants are all in the vanguard of the philosophical debate about the question of whether it is actually possible for these institutions to exist. Traditional theorists in the field of international relations argue that sovereignty is one and indivisible. According to the prevailing Westphalian system, absolute sovereignty is an absolute requirement for States to survive. In this approach, it is unthinkable that States should share the exercise of sovereignty. Consequently, its proponents regard the EU as an anomaly. Since EMU forms an integral part of the EU, it is equally impossible for the euro to function as the single currency of the Union. At the peak of the euro area crisis, the consequences of this philosophical vacuum were highlighted in the harshest possible way. The euro was so close to the point of collapse that Chancellor Merkel issued the warning that, if the euro broke down, the EU would also fall apart.

In situations like this, philosophers can either deny reality in the name of theory or adapt their theories to the realities on the ground. Preferring the latter option, I suggest replacing the principle of absolute sovereignty with the concept of shared or "smart" sovereignty. The proposition of this essay is, in other words, to substitute the

[1] Philosopher of Law, Director of Euroknow and Creator of the Boardgame Eurocracy.

civic perspective of democracy and the rule of law for the predominant Westphalian paradigm. The theory of democratic integration, which originates from this paradigm shift, is based on the presumption that, if two or more democratic States agree to share the exercise of sovereignty in a number of fields in order to attain common goals, the organisation they establish for this purpose should function on a democratic footing as well. The new model allows the EU to evolve towards a democratic polity of States and citizens, which combines constitutional pluralism in the legal-political domain with, for the euro area members, monetary uniformity in the financial field. To rephrase this academic description in plain and simple terms: as the EU constitutes a polity beyond the State, the euro forms a currency beyond the State.

2 The organisation of international political and financial relations

2.1 The Westphalian system of international relations

The Westphalian system of international relations emerged in Europe during the 17th century in reaction to the atrocities of the religious wars, notably the Thirty Years' War in Germany. In effect, it supplanted the feudal system, known for its division of sovereignty between the ecclesiastical and the worldly powers, with the modern notion of States. The importance of this post-medieval system for today's international politics has been highlighted recently by Henry Kissinger in his book "World Order" (Kissinger 2014). It lays the foundations for the United Nations Organisation (UN) and lies at the heart of the present practice of distributing international justice. The fundamental hallmark of the Westphalian system par excellence consists in its emphasis on absolute sovereignty. This concept has an internal and an external aspect (Cooper 2003). The internal dimension of the Westphalian concept of sovereignty implies that States no longer have to recognise a higher authority like they used to do under the feudal system. The external dimension signifies that States deal with each other on an equal footing and that they refrain from interfering in each other's affairs. Since the 19th century, the main domestic consequence of this system has been that the concepts of democracy and the rule of law are, as a matter of principle, confined to a State. The most important implication for the financial domain, which has developed over the centuries, is that currencies are exclusively related to States as well (Lastra 2006). Debts incurred by States are therefore referred to as "sovereign debts". As to the relationship with the outer world, the system allows for conflicts between States to be settled by the use of force. The conduct of war forms an integral part of the Westphalian system. Notably, violation of national sovereignty constitutes a legitimate reason for war.

2.2 Kant and the pursuit of peace

In his essay "On Perpetual Peace" of 1795, the German philosopher Immanuel Kant undertook the first effort to remedy the most striking shortcoming of the Westphalian system of international relations, namely the conduct of war (Kant 1795). In his endeavour to contribute to the prevention of future wars, Kant investigated the possibilities for States to co-exist in a peaceful manner. He identified two options: States wishing to avoid war could either form a "federation of free States" or merge into a universal State. As Kant feared that a world republic might lead to a global dictatorship, he preferred the concept of a society of nations.

Although the Westphalian system served Europe rather well during the nineteenth century, leading scholars and politicians concluded after the end of the First World War that the concept of absolute sovereignty had to be reined in for the sake of peaceful co-existence between the nations and States on the "old continent". The absolute atrocities of the Second World War demonstrated that, for Europe to survive, relations between States had to be placed on a different footing. In the words of the Dutch historian Johan Huizinga, it would only be possible for the smaller States of Europe to obtain safety and security if they were integrated in a new legal order with the larger ones (Huizinga 1945).

2.3 Inventing smart sovereignty

The United Nations Organisation, the Council of Europe and the predecessors of the EU were all created in reaction to the Second World War. The absolute sovereignty of States was restrained initially by the UN Charter and by the 1948 Universal Declaration of Human Rights. Over the decades, the sovereignty of States has been further limited in favour of the protection of individual human beings by such measures as the prohibition of the act of genocide, the prevention of forcible return of refugees, the foundation of the International Criminal Court and the gradual introduction of the principle of the responsibility to protect in the first years of the 21st century (Hoeksma 2011).

The Council of Europe, founded in 1949, curbed the sovereignty of its Member States in a manner similar to, although more stringent than, the UN. The primary tasks of the Council of Europe as an intergovernmental organisation are to promote cooperation between European governments and to enhance democracy and respect for human rights at the national level. Neither the UN nor the Council of Europe questions the concept of sovereignty as such. In this respect, the six Member States of the European Coal and Steel Community (ECSC), which entered into force in 1952, chose a principally different path. Driven by their determination to prevent the renewed outbreak of war, they decided to transfer the exercise of parts of their sovereignty to a higher organisation, which they created for this purpose. Both from a practical and a theoretical point of view the new approach had huge consequences. For the first time since 1648, States voluntarily accepted the existence of a higher authority and of a higher community, within which they would be bound by decisions that could even be taken against their own will. Although they

originally did so in a limited field and for a limited period of time, the prudent Dutch author Jos Kapteyn described the practice of the ECSC in 1974 as “a revolutionary breakthrough of the classic pattern of international organisation” (Kapteyn, 1974). Or, in terms of this essay, Europeans had started their journey towards smart sovereignty.

2.4 Neither State nor union of States

The Westphalian system of international relations is so deeply rooted in our way of thinking that many practitioners and students simply take it for granted. For this reason, the debate about the future of the EU and its predecessors has been dominated from the outset by the question as to whether the EU should become a sovereign State of Europe or form a Europe of sovereign States. In hindsight, the discussion about the end goal or “*finalité politique*” of the EU may be described as the great debate between federalists and sovereignists. The 2007 Lisbon Treaty rendered this discussion obsolete, since it constructs the Union neither as a federal State nor as an organisation of States. The EU is not a State, since sovereignty in the Union rests with the Member States. According to Article 4 of the Treaty on European Union (TEU), the Union has to respect the sovereignty of its Member States. It is also impossible to define the EU as a traditional union of States because the EU has citizens, as well as a directly elected parliament, an autonomous legal order and a single currency. Actually, the novelty of the Lisbon Treaty is that it constructs the EU as a democracy without turning the Union into a State.

2.5 Monetary sovereignty

The adage that absolute sovereignty forms an absolute requirement for States to exist also underlies the organisation of international financial relations. For the markets, monetary sovereignty is as absolute as political sovereignty is for States. Indeed, the concept has developed over the centuries in the wake of its political counterpart. In medieval times, emperors were not the only authorities to raise taxes and issue coins. Counts and cities did so as well (Bakker 1996). With the transition from the Middle Ages to modernity, these rights became royal prerogatives. According to the Westphalian paradigm, which was to dominate political theory in the course of the following centuries, the absolute sovereignty of States implied absolute monetary sovereignty as well (Lastra 2006). In this template sovereign States have central banks, which issue and control national currencies. Consequently, the theory emerged that each currency must be backed by a national State. Since they have the right to raise taxes, States have “deep pockets” (Schoenmaker 2011). This prerogative enables States to loan money and contract debts. In financial terminology, debts incurred by States are referred to as “sovereign debts”.

From the financial perspective, the EU is a paradoxical entity. It possesses its own currency but is not allowed to tax its citizens. As a result of this construction, the EU has no deep pockets and is therefore unable to back the euro in times of need. This state of affairs induced the markets to conclude in 2009 that, if they were to exert a

similar pressure on the euro as they did on the pound sterling in September 1992 (Szasz 2001), the euro would also fall.

2.6 A currency without a State?

The fact that the EU remained in theoretical limbo was not only of interest to philosophers, but it also had great practical implications. The most striking consequence in the legal field was that the German Constitutional Court (*Bundesverfassungsgericht*) concluded, in its Lissabon-Urteil of 30 June 2009, that the European Parliament does not represent the citizens of the EU but rather the nationals of the Member States of the Union (Buitenweg 2016). The Court therefore condemned the Parliament to the status of a “surrogate parliament”. The verdict came at a moment in time when another symbol of the EU, the euro, had already come under attack from the markets. Shortly afterwards the banking crisis, caused by the collapse of the Lehman Brothers bank, turned into a sovereign debt crisis. In these circumstances the hedge funds and speculators, keen on the fall of the euro, had ample reason to argue that, if the European Parliament was considered a surrogate parliament by the Constitutional Court of the largest Member State, the euro might be considered a surrogate currency as well. The German verdict may have strengthened them notably in their conviction that, as currencies must be backed by States, the euro was actually a currency without a State (Padoa-Schioppa 2010). Thus, in their view, the question was not if the euro would collapse but rather on which day this momentous – and for them advantageous – event was to happen. In hindsight, it may seem curious that such diverse institutions as the German Constitutional Court and hedge funds should have been trapped in the same, outdated Westphalian paradigm. This circumstance may, however, also be indicative of the power and pervasiveness of this model of thinking.

3 Beyond Westphalia

3.1 Beyond the Westphalian system of international relations

In the field of legal philosophy, sixty years is a relatively short period of time. It is, however, long enough to acknowledge that the EU has evolved into a new kind of polity in international law with a distinct form of governance. In defiance of the Westphalian system, the EU has demonstrated that it is possible for States to share the exercise of sovereignty without losing statehood. Contrary to the belief of the financial markets, the EU has shown that States can enjoy a single currency without having to merge into a federal State. Looking forward, the Union still has to prove that it is also capable of winning the hearts and minds of its citizens. In order to succeed in this challenge, the EU should, paradoxically, come to terms with its own achievements. In addition to the construction of a new reality on the ground, the EU should also develop a new theory for its functioning. Obviously, as long as the EU perceives itself in terms of the outdated Westphalian system and continues to regard

itself as deadlocked in the debate as to whether it will become a sovereign State of Europe or a Europe of sovereign States, it will be unable to understand what is actually going on. Instead of staring at the skies in the hope of finding eternal ideas, the EU should look to the ground with a view to determining the specific qualities and hallmarks of the Union. In doing so, it will come to realise that the EU was founded in 1992, by virtue of the Maastricht Treaty, as a union of States and peoples (van Gerven 2005) and that, as a result of the Lisbon Treaty, it is currently in the process of being transformed into a union of States and citizens (Hoeksma 2016).

3.2 From peoples to citizens

One of the most contested phrases in the process of European integration consists of the first consideration of the preamble to the 1957 Treaty of Rome, in which the founding Member States have expressed their determination "to lay the foundations of an ever closer union among the peoples of Europe". Despite a German-French proposal to supplant the term "ever closer union" with "federal vocation", the Treaty on European Union marks, according to Article 1(2), "'a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as closely as possible to the citizen". Although the phrase "ever closer union" has led to heated debates and remarkable inconsistencies, the focus in this essay is on the noun "peoples". It is especially interesting in this connection that the last sentence of the first article goes on by pointing out that the task of the Union shall be "to organise (…) relations between the Member States and between their peoples". Moreover, the Maastricht Treaty also uses the term "peoples" in connection with the European Parliament. Article 137 stipulates that the Parliament shall consist of "representatives of the peoples brought together in the Community". The triple appearance of the term "peoples" in the Maastricht Treaty has led eminent scholars to conclude that the EU can thus be described as a union of States and of peoples (Timmermans 2008).

Although stern Westphalian scholars have been unable to appreciate the differences between the treaties of Maastricht and Lisbon, a fresh examination of the terms "peoples" and "citizens" reveals a significant shift in accentuation.

The first change brought about by the Lisbon Treaty is that the word "peoples" has all but disappeared as a constitutive element in the construction of the EU. While the peoples are duly referred to in the preamble of the Treaty on European Union, Article 1 TEU no longer entrusts the EU with the task of organising relations between the Member States and between their peoples. Moreover, the term has also ceased to be used in connection with the composition of the European Parliament. Whereas the previous treaties prescribed that the European Parliament should consist of "representatives of the peoples brought together in the Community", Article 10(2) TEU unambiguously states that "Citizens are directly represented at Union level in the European Parliament" (von Bogdandy 2012). As the first paragraph of the same article stipulates that the functioning of the Union shall be founded on representative democracy, it may be suggested that the Lisbon Treaty brings about a fundamental change in the nature of the European Union. While the EU has been described on

the basis of the Maastricht Treaty as a Union of States and peoples, the Lisbon Treaty constitutes a further evolution of the EU into a Union of States and citizens. This finding is corroborated by the fact that the new treaty not only uses the term “the Union and its citizens”, but also speaks of “the Union and its Member States”.

At the same time the new treaty strengthens the position of the citizens of the Union by stating in Article 6 TEU that the Charter of Fundamental Rights of the European Union has the same legal value as the two founding treaties. In doing so, the Lisbon Treaty completes the development initiated by the Court of Justice of the European Union in its famous Van Gend en Loos verdict. While the Court described the nationals of the States brought together in the Community as bearers of individual rights and obligations on the one hand and as participants in the political life of the Community on the other hand, the Lisbon Treaty finalises this process by granting full political rights to the citizens of the EU, while simultaneously recognising their civil rights through the inclusion of the Charter of Fundamental Rights in the legal framework of the EU.

3.3 The theory of democratic integration

This examination allows for the suggestion that, as the EU consists of both States and citizens, it is also in the position to substitute the civic perspective of democracy and the rule of law for the traditional Westphalian paradigm of States and diplomats. The theory of democratic integration, which originates from this paradigm shift, is based on the presumption that, if two or more democratic states agree to share the exercise of sovereignty in a number of fields with a view to attaining common goals, the organisation they establish for this purpose should function on a democratic footing too. The driving force, which triggers the process from within, lies in the concept of democratic citizenship. As Hirsch Ballin has pointed out in his recent treatise on the rights of citizens and the right to citizenship, the essence of democratic governance is that the citizens are the authors of the laws, which they themselves have to obey (Hirsch Ballin 2014). In the context of the EU as a Union of citizens and Member States, this principle implies that the citizens should not only be able to enjoy their democratic rights in their home countries but also within the framework of the Union.

The presumption of the theory of democratic integration is corroborated by the experience of the EU. In the wake of the successful experiments with the sharing of sovereignty in the fields of coal and steel and, subsequently, of the economy at large, the question arose if and how it would be possible to organise forms of democratic control over the sovereignty thus exercised. Citizens, notably farmers, were increasingly affected by the measures taken by “Brussels” in the exercise of shared sovereignty. Human rights activists, as well as artists and intellectuals, argued that they did not want to give up their democratic rights and freedoms for the sake of European integration. They rejected the de-democratisation of their nation States in the name of international cooperation.

The secrecy surrounding the 1985 Schengen agreement on the abolition of internal borders only served to raise the suspicion in legal circles that the entire endeavour was driven by the wish to keep asylum seekers out. In the ensuing debate about the democratic deficit, these citizens insisted that the EU should meet requirements of democracy and the rule of law similar to those that the Member States were required to respect. Their distrust in the manner in which the process of European integration was implemented was exemplified by the suggestion, floated after the fall of the Berlin Wall, that Schengen was to become the new European divide (van Es 1991). On a more humorous note, other critics borrowed the joke of the day from the comedian Groucho Marx, who famously said he refused to become a member of a club that would have him as a member.

3.4 Towards a democratic polity

In hindsight, it seems obvious to suggest that the best way to overcome the democratic deficit was to democratise the EU. In his inaugural lecture of 1964, Jos Kapteyn had already underlined the necessity of this endeavour by suggesting that the Communities should develop in a sound democratic direction. In his analysis the need for such an evolution became all the more pressing, as the Communities were distracting more subjects from the remit of the competences of the national parliamentary democracies (Kapteyn 1964). Trapped in the Westphalian paradigm, however, the national and the European authorities had no idea of the way in which this democratisation could be brought about. The Commission Adonnino, which was charged in 1984 with the task of bringing Europe closer to its citizens, came no further than suggesting the introduction of a European flag and the organisation of remembrance and exchange programmes for the nationals of the Member States of the Communities (Adonnino 1985). Even the establishment of EU citizenship in 1992 was not regarded by the European Council as a means for the democratisation of the Union. Instead, the new status was meant to strengthen the position of workers using the four freedoms in order to take up employment in another Member State (Cloos 1994). It was only after the Copenhagen Criteria for the accession of new Member States had been adopted that the European Council started to question the democratic credentials of the EU itself. In the end, the 1997 Treaty of Amsterdam mentioned democracy as one of the core values of the European Union per se. According to Article 1 under 8(a) of the Treaty of Amsterdam, the Union “is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law, principles which are common to the Member States”.

The ultimate and decisive push to end the exclusive predominance of the Westphalian paradigm was given by the convention responsible for the drafting of the EU Charter of Fundamental Rights. The preamble of this Charter, which was proclaimed at the Nice Summit in 2000, stated in a direct and almost self-evident manner that the European Union is based on the principles of democracy and the rule of law. According to the traditional theory, such a statement could only be made in relation to sovereign States. The Charter is the first official document in the history of the EU to include these principles in such plain and simple terms in the juridical foundation of the Union. Since the Charter was incorporated in the 2007 Lisbon

Treaty, the principles of democracy and the rule of law form an integral part of the EU's legal heritage.

3.5 Competing models of governance

Over the decades, the replacement of absolute with smart sovereignty by and between the EU Member States has resulted in the emergence of a new model of democracy. Although this European democracy is far from perfect, the EU may be described from a citizens' point of view as "a union of States and citizens, in which the citizens are entitled to participate both in the national democracies of their countries and in the common democracy of the Union".

From an architectural perspective, the differences between the Westphalian system of absolute sovereignty and the European model of smart sovereignty may be summarised as follows:

	Westphalian system of international relations	European model of integration
Sovereignty	Absolute	Smart
War	Not excluded	Materially impossible
Borders	National	External border control
Customs	National	Common
Market	National	Internal
Citizenship	National	National plus European
Currency	National currencies	Single currency
Democracy	National	National plus European
Global Stage	Irrelevant	Major player

It would thus appear that the hegemony of the Westphalian system of absolute sovereignty has been challenged by the European model of smart sovereignty. In the second decade of the third millennium there are at least two competing models of international governance. This conclusion is of great consequence for the viability and future of the EU. Whereas the traditional approach of international relations results in the construction of a Europe of sovereign States with national democracies, the European model provides the blueprint for a transnational polity of States and citizens which functions as a common democracy. While the first option is sure to lead the EU back to the 19th century, the second one contains a democratic alternative for the future.

3.6 Stabilising institutions

At this juncture, mention should be made of the contributions made to the construction of the present Union by two of its institutions, namely the EU Court of Justice and the European Central Bank.

1. Although the introduction of EU citizenship in 1992 was meant to strengthen the position of border-crossing workers in the context of the internal market, the EU CoJ and subsequent treaties have given the concept a meaning far beyond the

original intentions of the European Council. The Court of Justice confirmed the transition from the European Communities to the EU in 2001 by establishing that the citizenship of the Union was destined to be the fundamental status of the nationals of the Member States.[2] Rather than an economic organisation of States, the citizens of which enjoyed the freedom to work and reside in the other Member States, the EU constitutes – in the Court's perspective – a political entity with a distinct legal order and a common citizenship. The consequence of this approach became apparent in the case of the Columbian national Ruiz Zambrano.[3] Whereas the Court had ruled so far that Union law could only be applicable if the citizens concerned had crossed an internal border by moving from one Member State to another – the regime which was established during the period of the European Communities – it adapted its jurisprudence to the new treaties by linking the rights of EU citizens to their status as such. The Court notably established that "Article 20 TFEU precludes national measures, which have the effect of depriving citizens of the Union of the genuine enjoyment of the substance of the rights conferred by virtue of their status of citizens of the Union".

In a third seminal verdict, given in 2013, the Court answered the question with respect to the scope of EU citizenship.[4] It ruled that the fundamental rights of EU citizens are protected in all situations wherein the law of the Union is applicable. In doing so, the Court gave meaning to the notion that EU citizenship is destined to be the fundamental status of the nationals of the Member States. Thanks to the case-law of the EU CoJ, EU citizens enjoy the protection of the EU Charter of Fundamental Rights in all cases in which Union law may be applied.

2. The significant contribution of the financial institutions to the creation and maintenance of the new polity is that they have proven under pressure that the principle of sharing sovereignty cannot only be practised in the political domain, but also in the financial field. Chancellor Merkel was right in her analysis that, if the euro were to collapse, the EU would also fall apart (Merkel 2010). While the advocates of the Westphalian system insisted that the EU should either merge into a federal State or return to the concept of a free trade area in order to solve the sovereign debt crisis (Stephens 2011), the EMU and the Member States stuck to their practice of sharing a sufficient measure of sovereignty in order to maintain the euro as the single currency of the polity. In their determination to defend the currency, the Union institutions and the member countries of the euro area established themselves as the "joint sovereign" behind the euro (Hoeksma Schoenmaker 2011). From this crisis onwards, the euro is no longer a currency without a State but rather a currency beyond the State. In combination with the introduction of new instruments, notably the banking union, the Union institutions and the member countries of the euro area as

[2] Case C-184/99, Rudy Grzelczyk v Centre public d'aide sociale d'Ottignies-Louvain-la-Neuve, EU:C:2001:458.

[3] Case C-34/09, Gerardo Ruiz Zambrano v Office national de l'emploi (ONEm), EU:C:2011:124.

[4] Case C-617/10 Åklagaren v Hans Akerberg Fransson, EU:C:2013:105.

symbolised by the ECB have proven the viability of the European model of smart sovereignty. At the end of this paragraph it may therefore be concluded that, although the challenges facing the joint sovereign are still formidable (van Riet 2016), the euro may well be on its way to become the first ever stable currency beyond the State.

4 A new polity with a distinct form of governance

4.1 Improving the Union

On the eve of the celebrations of the sixtieth anniversary of the Treaty of Rome, it may be concluded that the EU has succeeded in developing a new model of governance beyond the Westphalian system of international relations. From the perspective of the Theory of Democratic Integration, the EU should now concentrate on completing the transition of the EU from a union of States and peoples to a union of States and citizens. This implies, in the first place, the introduction of transnational voting lists for the elections of the European Parliament (Article 223 TFEU). Moreover, the European Commission should adapt its policies towards the citizens, notably its communication strategy, to the new concept of the union of States and citizens. The present programmes in this field are focusing on remembrance and exchange activities, rather than on the promotion of democratic participation and education to European citizenship. Thirdly, the governance of the EMU should be embedded in the democratic structures of the EU. It is inconceivable in a true union of citizens and Member States that an informal group of ministers will continue to take decisions, which affect citizens, without democratic control at the appropriate level.

4.2 Brexit

In its present form, the EU is far from perfect. Both the euro crisis and the migration problems are, to a large extent, the result of deficiencies in the construction of the Union. Just as the EU and a number of its Member States have introduced a single currency without taking additional measures in order to defend the new asset in times of need, they have abolished internal border controls without taking appropriate measures to protect and control their external borders. Apparently, the EU has to learn its lessons the hard way. Fortunately, the Union and its Member States have finally come to realise that the abolition of border controls, under pressure from large numbers of migrants – whether refugees or job seekers – is set to increase rather than solve domestic problems.

At the same time, however, it is mistaken to blame the Union for all the wrongs and evils at home. During the Brexit campaign, the proponents of leaving the EU attributed responsibility for the migratory flows towards the UK solely to the EU. In doing so, they completely ignored the fact that the UK has no proper expulsion policy

and that Union law does not oblige Member States to grant social security benefits to unemployed workers from other EU Member States.[5,6] Leaving the EU will therefore not solve the UK's migration problems.

Ironically, the difficulties with border-crossing demonstrate once more how much European countries have come to depend on one another other and how vital it is for these States to replace the Westphalian principle of absolute sovereignty with the concept of smart sovereignty. The reason why the advocates of absolute sovereignty in Great Britain are accusing the EU of being or becoming a Hobbesian Leviathan lies in their inability to appreciate the difference between smart and absolute sovereignty (Stephens 2011). Curiously enough, their decision to leave the EU forms the ultimate proof that the Union is neither a reinvention of the Roman or Napoleonic Empires, nor a "Fourth Reich".[7]

4.3 The survival of Europe in the 21st century

Approaching its sixtieth birthday, the EU has no reason whatsoever to follow the British example of returning to the Westphalian system of international relations. On the contrary, the Union should persist in its efforts to become the first international organisation which functions on a democratic footing. Taking into account that the predecessors of the EU were founded as more or less traditional organisations of States (Forsyth 1981), considerable progress has been made. A quarter of a century after the start of this experiment, the EU may be described, from a citizens' point of view, as a "polity of States and citizens, in which the citizens are entitled to participate both in the national democracies of their countries and in the common democracy of the Union". The EU and its Member States should use the forthcoming celebrations to set themselves the goal of completing the transition from a union of States and peoples to a union of citizens and Member States. If the proposition of the theory of democratic integration is correct that the EU is currently in the process of developing from a common market to a common democracy, the next stage for the EU is to evolve into a union of democratic States, based on the rule of law, which also constitutes a law-based democracy of its own. Although it may take the EU another twenty-five years to reach this goal, in pursuing this dream it will ensure that the citizens receive a similar measure of protection and democratic participation from the Union as they enjoy in their Member States. The end goal or "*finalité politique*" of the process of European integration is not to create a new fixed form of public organisation, but to enable Europe to survive in the global competition of the 21st century and to do so in a democratic manner. At the close of this essay it may thus be concluded that, sixty years after the foundation of the EEC by virtue of the Treaty of Rome, the EU has an own and distinct model of thinking at its disposal, which may

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[5] C 333/13, Elisabeta Dano and Florin Dano v Jobcenter Leipzig, EU:C:2014:2358.

[6] WRR-Policy Brief 4, December 2014.

[7] Obviously, the inconsistency of Mr Boris Johnson, who claims in his capacity as a prominent member of the Conservative Party that he has liberated the UK from the EU, while he simultaneously participates as the UK's Foreign Minister in the meetings of the Council of Ministers, should not be rewarded by the European Commission and his fellow Ministers in the Council.

boost its self-confidence and provide guidance with respect to the further evolution of the Union.

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Concluding remarks

By Chiara Zilioli[1]

The aim of the ESCB Legal Conference 2016 has been to present legal developments, legal challenges and practical legal issues which have recently arisen and are related to the activities of the Eurosystem and of the Single Supervisory Mechanism.

The specialised nature of the conference and of the discussions held there has been underlined by the professional qualifications and expertise of the speakers, drawn from the ECB and the legal services of national central banks and of national competent authorities, as well as Union institutions and international financial institutions. The speakers have analysed the various stimulating panel topics from their different perspectives and from the perspective of their institution, and with their remarks they have opened the floor to a broad and candid discussion among the conference participants, in turn composed of central banking and financial lawyers and experts from all over the world.

The conference panels have tackled very diverse topics. Somewhat atypically, the only link among them is the fact that they are all very topical and relevant for the exercise of the tasks of the ECB. A legal debate on these topics is timely, and this is why they are the subject of the conference programme.

These diverse panels provided an insight into current challenges, in particular in relation to collateral rules, the need for a unified administrative law for Union procedures as well as to the difficult issue of how to legally approach government debt restructuring; and into future challenges, such as the development of financial technology and its potential benefits, as well as the delicate equilibrium between accountability and interdependence in the context of the attribution of new competences to the ECB.

These were two very intensive days. The panels presented an analysis of the novel legal issues from the perspective of the ECB, the Eurosystem, the competent national authorities and other European institutions and international organisation. Of particular interest are the following issues:

- Sovereign debt restructuring and the necessary elements for a restructuring mechanism; the importance, in this context, of collective action clauses and of the introduction of a dispute resolution body for sovereign default.
- The direct application of national law by a Union institution, which amounts to a new experiment in Union law;

[1] Director General Legal Services, European Central Bank.

- The different, even scattered, sources of European administrative law and the efforts towards unification to aim at a single administrative law for European procedures;
- The tension between confidentiality and transparency in the operation of monetary policy and of supervision, also in view of the public role of the European and national courts of auditors;
- The developments needed in the area of collateral to foster a capital markets union and facilitate the safe use of collateral, and the problems remaining in the enforcement area which can arise in the event of a crisis;
- The drive for efficient procedures, while keeping in mind the efficient use of ECB and national central bank resources, which is the objective of the requirement to publicly procure goods and services.
- Last but not least, and looking to the future, the role of digital currencies and of financial technology in the development of payments, with the aim of increasing efficiency and reducing costs and risks.

I myself thoroughly enjoyed all the panels. Each presentation added a different perspective; the discussion thereafter was lively and brought in a wide range of viewpoints. Also interesting was the concept of shared or “smart” sovereignty in the Union presented by the keynote speaker, who suggested that this concept should now replace the principle of absolute sovereignty of the Westphalian system. He furthermore argued that, as the Union constitutes a polity beyond the State, the euro forms a "currency beyond the State".

We are fortunate that most of the speakers have agreed to provide a written contribution, so that we can offer you, in this book, the substance of these initial discussions. Indeed, the intention is that these discussions will continue and that the analysis will be further deepened: the objective of the conference was to act as a catalyst and stimulate further thinking, and its main value is in what will be developed by the legal experts in the future.

In these last pages, some acknowledgments are due.

I would like to present these acknowledgments also on behalf of Mr Mersch and my colleagues.

First, I would like to thank all the participants for attending and for their thought-provoking interventions: to be good, a conference needs to have a highly qualified and active audience.

Secondly, I would like to warmly thank the panellists for their engaging contributions and their participation in the production of this book within a very tight timeframe, as well as the chairs who have given the right "spin" to each panel, guiding the discussions.

Thirdly, very special thanks go to the Legal Groups Team and to the team of assistants, who with great professionalism have organised and ensured the smooth

running of this conference, and to Iliyan Bakalov from the ECB Legal Services, who has been in charge of coordinating the academic input into the conference and the book.

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The authors are responsible for the accuracy of their contributions. The views expressed in the contributions are those of the authors and do not necessarily reflect those of the ECB (or of the institution of which the authors are respectively officials).

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Postal address 60640 Frankfurt am Main, Germany
Telephone +49 69 1344 0
Website www.ecb.europa.eu

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