EUROPEAN CENTRAL BANK

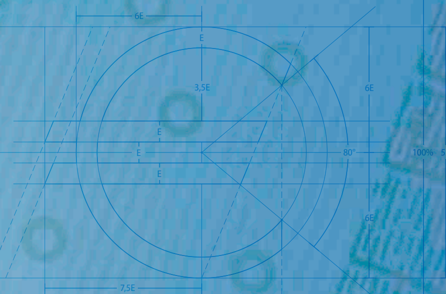
EUROSYSTEM

ECB Legal Conference 2015

From Monetary Union to Banking Union, on the way to Capital Markets Union

New opportunities for European integration

1-2 September 2015



December 2015

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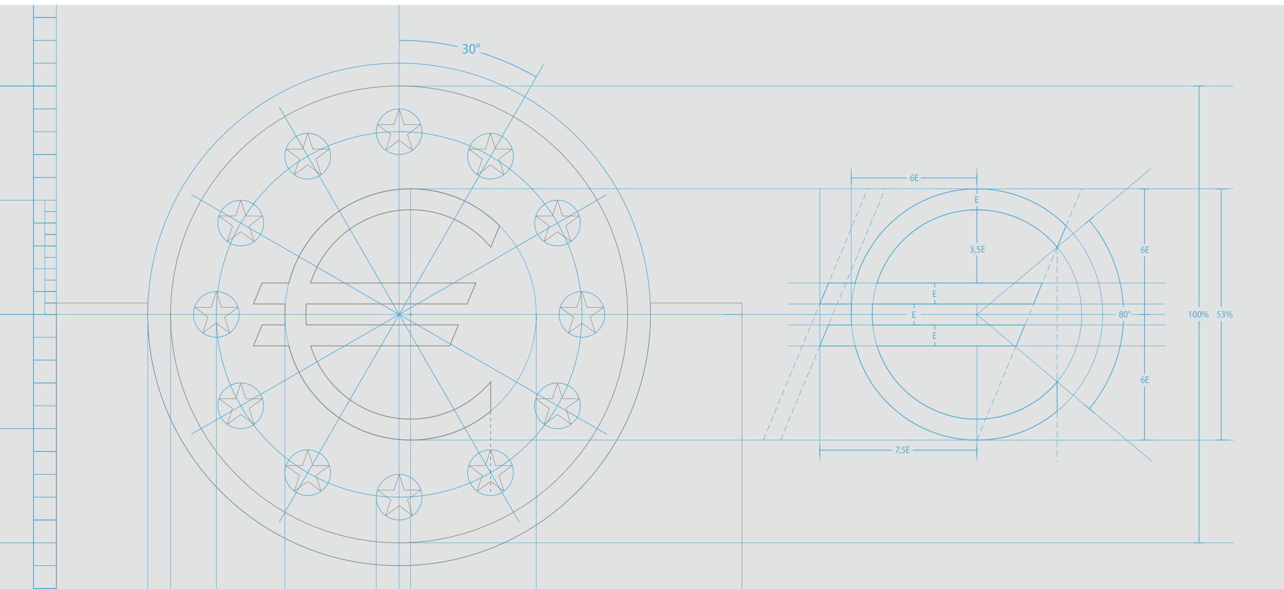

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FOREWORD

YVES MERSCH[1]

Ladies and gentlemen,

Praising the importance of law for society and the economy at the ECB's Legal Conference would be preaching to the choir. But it might be worth recalling that societies are founded on a social contract that precedes law. A common understanding of fundamental values and principles, such as democracy, the rule of law and human rights, forms the basis for enacting and enforcing the law.

Such a social contract need not be constrained to the national level; it can also exist at European level. To pay tribute to this contract, we need an effective relationship between national and EU law, which allows the integrity of the EU law system to be preserved while respecting national differences.

I will use the remainder of my introductory remarks to raise two questions highlighting some of the difficulties in this relationship:

- First, how can we overcome limits on the transfer of competences to the EU level that stem from the "constitutional identities" of Member States?

- Second, how can the relationship between national and EU law most effectively be designed, in particular to preserve the integrity of EU law as a whole?

I am raising these questions as I am optimistic that, during this conference, you will not only discuss them, but also find compelling answers and creative solutions to them.

***

Some national constitutional courts coined the term "constitutional identity" to reflect the distinction between the original, constituent power of the people and the derived, constituted power of the legislator.

The genuine intention was to preserve the nature of Member States as viable and independent political entities. Constitutional identity assumes that each Member State enjoys the right of democratic self-determination through its national parliament.

But what exactly does the right of self-determination mean in the context of membership of a political system such as the EU?

1 Member of the Executive Board, European Central Bank.

According to the Lisbon Treaty, Article 1 of the Treaty on European Union (TEU) establishes that sovereignty in the Union rests with the Member States. It formulates the concept that the Union owes its existence to the Member States by stipulating that they confer competences on the Union in order to attain common objectives. The second paragraph of Article 4 adds that national security remains the sole responsibility of the constituent states. And Article 5 TEU stipulates that the functioning of the Union shall be governed by the principles of subsidiarity and proportionality. With all these restrictions, the letter and spirit of the Lisbon Treaty clearly does not suggest that the EU should be transformed into a sovereign state called Europe.

Still, only a very radical interpretation of constitutional identity limits the ability to share sovereignty. It assumes that competences cannot be transferred to another entity without violating the original power of the people. Such an interpretation is based on the antiquated belief that the nation state is the sole locus of legitimacy.

This belief is rooted in the Westphalian model of international relations, which assumes that only the nation state has sovereignty over its territory and domestic affairs.

This model was certainly justified as a means of bringing an end to the Thirty Years' War back in 1648. Some three hundred years later, however, after two devastating wars, the need to overcome the limitations of the nation state and the dangers of a warped understanding of patriotism, i.e. nationalism, became apparent. Sharing sovereignty in key areas was a precondition to appeasing Europe.

Indeed, the European approach since then has shown that democratic states can share sovereignty in a number of policy areas without losing their statehood. In particular, the euro area has shown that like-minded states can introduce, manage and safeguard a single currency without having to merge into one overarching federal state. The "currency beyond the state" (Hoeksma) has revealed as false the widespread belief that a monetary union without a (fully fledged) state was not viable. Last but not least, the EU has developed an identity as a union of citizens and Member States, establishing a model of transnational democracy with an elected parliament and an independent Court of Justice[2]. Indeed, EU citizens have ample reason to say – as the incoming President of the European Court of Justice (ECJ), Koen Lenaerts once phrased it: *Civis Europaeus sum*[3].

***

However, not all policy areas are the same in this context. There is a broad consensus that the design and implementation of monetary policy should be

2 "EU & EMU: Beyond the 2005-2014 Crises Decade", Hoeksma, J., Duisenberg School of Finance (DSF) Policy Paper Series, No 51, April 2015.

3 "'Civis Europaeus Sum': from the Cross-border Link to the Status of Citizen of the Union", in *Constitutionalising the EU judicial system*, Lenaerts, K., Cardonnel, Rosas & Wahl, Oxford, 2012.

taken away from the political arena to protect citizens' purchasing power from the short-term temptations and pressures of the election cycle. Monetary policy should, therefore, be transferred to an independent institution, which is, however, accountable to the European Parliament.

Fiscal policy, by contrast, is quite different. It is the core competence of parliaments. Taxation, for instance, mirrors the people's preferences regarding the supply of public goods and their willingness to finance them. It therefore needs a much higher degree of democratic legitimacy and parliamentary control.

Regarding economics, the "Five Presidents' Report" rightly points to preconditions for a euro area-wide fiscal stabilisation function, namely a significant degree of economic convergence and financial integration[4]. Likewise, in the political sphere, any supranational fiscal authority – particularly if equipped with budgetary powers – would clearly need a degree of democratic legitimacy and actual parliamentary control. A college with powers delegated from intergovernmental forums would hardly satisfy these requirements.

In this respect, it made sense, in the absence of a supranational fiscal layer and given the urgent nature of the crisis, for the European Stability Mechanism to be established as an intergovernmental institution (i.e. effective and efficient) which, for tasks such as payments, still requires the prior consent of national parliaments (i.e. control). In the longer run, however, the intergovernmental approach is a dead end.

***

This reasoning in no way supports those championing a national or constitutional identity. Rather, it illustrates the need for different approaches to the respective policy areas, especially as the concept of constitutional identity has not only hampered deeper integration but risks winding back earlier achievements. National courts have repeatedly referred to constitutional identity to disapply EU law. More recently, following a referral to the ECJ, a national court suggested that it may declare the ECJ's interpretation of EU law incompatible with the relevant Member State's constitutional identity.

If national courts claim the right to defend national sovereign prerogatives over and above the decisions of their democratically elected representatives, the *legal* doctrine of "constitutional identity" morphs into a *political* question. There is a risk that sovereignty becomes an ideological category. Such "sovereignism" could further undermine European integration.

I share the concern recently expressed in an opinion of an Advocate General of the ECJ, who said that it seems an "impossible task to preserve this Union, as we know it today, if it is to be made subject to an absolute reservation, ill-defined

4 "Completing Europe's Economic and Monetary Union", a report prepared by J.-C. Juncker, in close cooperation with D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz, 22 June 2015.

and virtually at the discretion of each of the Member States, which takes the form of a category described as 'constitutional identity'." [5]

In addition, since its inception the ECJ has affirmed in historical judgments such as *Van Gend and Loos* v *Administratie der Belastingen*[6], *Costa* v *E.N.E.L.*[7] and *Internationale Handelsgesellschaft mbH* v *Einfuhr- und Vorratsstelle für Getreide und Futtermittel*[8] the principle that EU law cannot be overridden by national legal provisions, as this would call into question the legal basis of the EU itself. The principle of supremacy of European law is thus perhaps the ECJ's single most important contribution to the European integration process.

By necessity, such a European legal order means that the application of European law follows common standards throughout the EU. Some discretion in transposing EU law into national legal provisions ensures that legislators can take national differences into consideration.

However, national discretion should neither result in negative spill-overs that affect other Member States, nor undermine agreed common standards. This particularly applies if EU institutions and bodies act on the basis of national law. For instance, despite being designed as a federal institution, the Single Resolution Board has to implement its resolution schemes based on national law. Likewise, the ECB resorts to national legal provisions when performing some of its supervisory tasks. EU institutions are obliged to interpret their mandate in a uniform manner across Member States. This prerogative must not be constrained by national legal provisions.

However, Member States have started to transpose into binding national law supervisory practices that were followed in their jurisdictions prior to supervision being conferred on the ECB. If this approach sets a precedent, the ECB's independence could be undermined by constraining the supervisor's capacity to act coherently and consistently across jurisdictions.

***

Let me conclude.

While legal doctrine is important and necessary, it needs to be free of ideological interference and must not be used for purposes that go beyond its legal nature.

Defending national sovereign prerogatives can easily lead to "sovereignism", its ideological cousin, which inevitably clashes with any attempt at further European integration. This may undermine the application of EU law, leaving the EU

5 Opinion of the Advocate General Cruz Villalón in *Peter Gauweiler and Others* v *Deutscher Bundestag*, C-62/14, ECLI:EU:C:2015:7, paragraph 59.
6 Case 26/62, *Van Gend en Loos* v *Administratie der* Belastingen, ECLI:EU:C:1963:1.
7 Case 6/64, *Flaminio Costa v E.N.E.L.*, ECLI:EU:C:1964:66.
8 Case 11/70, *Internationale Handelsgesellschaft mbH v. Einfuhr- und Vorratsstelle für Getreide und Futtermittel*, ECLI:EU:C:1970:114.

legal order in a subordinate position. Ultimately, this could result in a failure to complete the European integration process.

Nevertheless, we need to take into account that some policy areas do need a higher degree of democratic legitimacy and parliamentary control than others. Responsibility for budgets, taxation and fiscal policy cannot simply be transferred to unelected technocrats. In the long term, a European finance minister who is controlled by a parliament in the same constituency remains on the agenda.

Any institutional step forward in the meantime needs to take into account the evolution of the Commission. Currently it already has a higher degree of democratic legitimacy compared to various intergovernmental gatherings. Still, the Commission increasingly experiences tensions between its ever-more political orientation and its role as guardian of the Treaty.

All in all, the transition of the EU from an international organisation to a European democracy has proceeded faster than most eurosceptics have predicted; likewise, the quality of this democracy still needs more improvement than many euro enthusiasts tend to assume (Hoeksma).

I am convinced we can overcome the narrow-minded interpretation of the nation state and continue to strive for a European *Union* that is worthy of the name. I am sure that, in this spirit, the ECB Legal Conference can contribute to the search for new opportunities for European integration.

PANEL I

LEGAL REFORM OF SECURITISATION IN EUROPE

THE ECB'S PERSPECTIVE ON ABS MARKETS

ULRICH BINDSEIL[1]

It may come as a surprise to some that a prestigious legal conference such as this one is opened by a panel discussing current legal and regulatory developments of the asset-backed securities (ABSs) market in Europe, which is certainly a rather specific and applied topic. It shows that the ECB attaches a very high importance to it. Let me devote my introduction to explain again why this is the case.

ABSs AS EUROSYSTEM COLLATERAL

The most practical ECB perspective on ABSs stems from the fact that the Eurosystem has accepted ABSs as collateral in Eurosystem credit operations since 1999. The ECB regards ABSs as a sound and relevant asset class that deserves to be part of the set of eligible Eurosystem collateral. The nominal value of Eurosystem eligible ABSs stood at EUR 292 billion in 2004, peaked at around EUR 1290 billion in 2009 and 2010, and has since declined again to around EUR 600 billion. The usage ratio of ABSs, i.e. the actual volume of ABSs posted with the Eurosystem as collateral, divided by eligible amounts, has exceeded that of other asset classes, and has been consistently above 30% since 2008. It is noteworthy that the share of ABSs used by the counterparty (group) *that has also originated the ABS* has been considerable most of the time. This was also relevant in the context of the ECB's experience with the need to liquidate ABSs submitted as collateral by Lehman Brothers and the Icelandic banks, which defaulted in September 2008. Initially, the Eurosystem had to establish provisions totalling EUR 5.7 billion in view of the difficulty of assessing the true post-counterparty default values of these idiosyncratic ABSs in the middle of an acute financial crisis that had also to do with this asset class (see ECB, 2009). In the end, no losses occurred in the liquidation of the collateral, but recovery of claims took considerable time and effort (see for example Deutsche Bundesbank, 2013). This episode of course also shaped the ECB in its view on ABSs, including the importance of simplicity, standardisation, liquidity, credit quality and the desirability of a market placement of ABSs. ABSs that are submitted by counterparties different from the originator are in principle preferable from the ECB perspective for two reasons: (1) they have passed the test of actual marketability, which supports the perception of credit quality, transparency and liquidity; on a related note, marketability should also be understood as a precondition for the transfer of securitised credit risks to other sectors, thereby contributing overall to financial stability; (2) despite the fact that eligible ABSs and their pools of underlying assets are safely bankruptcy remote, the credit quality and liquidity of ABSs will be somewhat correlated with the state of their originating entity, in particular because the originator generally remains 'involved' in the securitisation transaction, e.g. when taking the role

1 Director General Market Operations, European Central Bank. I wish to thank Mark Büssing-Lörks for comments.

of the servicer. If the originating entity is in trouble or defaults, it is also more likely that the ABS that it once originated will suffer. Therefore, the ECB would like over time to see improvements in the ABS market so that the share of ABSs submitted by counterparties which are *not* linked to the originator increases further.

It may be noted that the ECB changed the eligibility criteria for ABSs a number of times during the financial crisis, reflecting the role of ABSs in the crisis, its own experience, and the general approach in updating the collateral framework over time (see e.g. ECB, 2013, in particular Box 1 and the annex listing all changes made). In any case, the use of ABSs (as well as of other financial instruments) as collateral during the financial crisis should be regarded as a key element that supported the Eurosystem's lender-of-last function during the crisis, which was essential to overcoming the crisis and allowing solvent but liquidity-stressed banks to continue operating and providing credit to the real economy. In this sense, ABSs were a very important positive element of the sound and secure implementation of the lender of last resort role of the Eurosystem and the eventual restoration of financial stability.

ABSs AS AN ASSET CLASS WITHIN THE EUROSYSTEM'S EXPANDED ASSET PURCHASE PROGRAMME (EAPP)

The motivation behind the EAPP is to provide for more monetary accommodation in a situation of low inflation rates and largely exhausted *conventional* monetary policies (According to ECB, 2015a: 'Asset purchases provide monetary stimulus to the economy in a context where key ECB interest rates are at their lower bound. They further ease monetary and financial conditions, making access to finance cheaper for firms and households. This tends to support investment and consumption, and ultimately contributes to a return of inflation rates towards 2%.'). Actual ABS purchases have played a relatively minor role in the total volume of securities purchases in the EAPP, contributing around 2.5% of total purchases (around EUR 1.5 billion per month out of a total of EUR 60 billion). Some have wondered why ABSs have been included at all in view of these relatively low volumes. Two main reasons may be given:

– Support of the ABS market in general: including ABSs in the EAPP sends a signal from the ECB to markets of its belief that this asset class is an important and sound one.

– Preference for having private assets as part of the EAPP. While the EAPP could in principle also achieve its target volume exclusively with public sector assets, the ECB attached importance to aiming at a relevant representation of privately-issued securities. First, this links the programme closer to the funding of the real economy, which strengthens the effectiveness of the programme (for a given volume). Secondly, the ECB aims as a matter of principle at avoiding an ex ante favourable treatment of public sector issues, also in view of the relevant EU treaty provisions on monetary financing.

In ECB (2015c), the ECB signalled its preferences in relation to certain features of ABSs and their underlying assets for the purposes of its purchase programme (the ABS Purchase Programme, ABSPP). This aimed at helping originators and the ECB's external asset managers to focus their efforts, and thereby to make purchases more efficient, which should eventually support purchase volumes and direct markets (pending also the specification of qualifying securities currently undertaken by other relevant authorities – see below).

The euro area bank lending survey for the first quarter of 2015 (ECB 2015b) elaborates on the impact of the ECB's EAPP. Participating euro area banks provided qualitative feedback, reporting an overall improvement of their financial situation over the past six months and expecting this improvement to continue over the next six months. Nearly half of the euro area banks see a positive impact of the ABSPP on their market financing conditions, in particular for their financing via covered bonds and unsecured bank bonds, but also for ABSs (feedback provided by those banks with ABS business, namely about 50% of the euro area banks in the Bank Lending Survey sample).

ABSs AND PRICE STABILITY

According to Article 2 of the Statute of the ESCB, the primary objective of the ECB is to maintain price stability. Moreover, without prejudice to the objective of price stability, the ECB must support the general economic policies in the Union and act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

As explained in more detail in Bank of England and ECB (2014), ABSs can contribute to financial and economic efficiency and stability in a number of ways. As a funding tool, ABSs can support a well-diversified funding base of originators. ABSs can also facilitate asset-liability maturity-matching and can enable banks to access a broader range of investors, also by tailoring different tranches of an ABS to investors' risk appetite and preferences. Credit risk transfer away from the banking sector can be beneficial to the real economy, the banking sector and both monetary and financial stability. Risk transfer can free up bank capital, supporting the ability of banks to extend new credit to the real economy. ABSs may provide long-term investors, such as insurance companies and pension funds, with a broader pool of assets that are low-risk from a credit perspective.

Taking a strict monetary policy perspective, an efficient capital market and banking system contributes to an efficient transmission of monetary policy. What does this mean? The central bank controls short term interest rates as its conventional operational target of monetary policy. It does not control directly the funding costs of the real economy. If the spread between the two is volatile across time because of financial instability, this reduces the ability of the central bank to steer precisely its ultimate target (as the transmission mechanism will be unstable and less predictable). Moreover, in a low-growth and low-inflation environment and exhausted conventional monetary policies (blocked at the zero lower bound), reducing the spread between the short-term interest rate and the

actual funding costs of the economy becomes an essential element of preventing deflation. In such a situation the efficiency and stability of the financial system becomes decisive for the very core of the central bank's responsibility, namely the achievement of price stability. This is the world in which the ECB is currently operating. Therefore, supporting the functioning of the ABS market in the euro area is directly motivated also by the core objective of the ECB to achieve price stability (see also Mersch, 2014).

WHAT ARE THE PROBLEMS STILL HAMPERING THE ABS MARKET?

When discussing the current attempts of regulatory adjustment to contribute to the revival of ABS markets, we should start with a diagnosis.

First, the planned high levels of capital charges under Basel III and Solvency II[2] seemed to considerably overshoot if assessed against the actual historical loss rate of European ABSs. Moreover, they made ABS investments of banks and insurance companies unattractive, narrowing down the investor base to non-regulated entities. Even though some rethinking on the regulatory side has taken place and capital charges have been reduced somewhat, most regulated entities still regard the level of capital charges as prohibitive. Also on the side of originating banks, achieving capital relief through securitisation has been made difficult. Capital charges for banks and insurance companies when investing into non-senior tranches are even higher, which makes the placement of such tranches expensive (again due to the reduced investor base). Therefore, this core feature of securitisation – capital relief – is not effective for a significant part of ABSs currently issued in the euro area. Instead, these ABSs are issued as funding tools, and *de facto* only synthetic ABSs are potentially open to achieving capital relief.

Secondly, further difficulties may arise from a lack of standardisation and transparency, or because ABSs tend to be considered generally as more complex assets by investors. While for standard and large-scale categories of ABSs, such as Dutch or UK residential mortgage-backed securities (RMBSs), this is less of an issue, it is clear that for other jurisdictions and other underlying asset classes, investors may be reluctant to build up the necessary knowledge to be confident investing in them.

Thirdly, the current low interest rate environment and excess liquidity in the euro area may make securitisation, with its relatively high fixed origination costs, in many cases uncompetitive when compared with other funding sources of euro area banks (including the Eurosystem's targeted longer-term refinancing operations, TLTROs).

The development of 'qualifying securitisations' for a better capital (and generally regulatory) treatment addresses the first two issues. Crucial questions arising

2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

in relation to such a concept are: (i) Will the improvement of the regulatory treatment of qualifying securitisations be sufficient to make them a suitable asset class for regulated entities? (ii) Will it be ensured that qualifying securitisations will go beyond those standard ABSs that already benefit from a well-functioning market, thanks to sufficient non-regulated investors (e.g. Dutch RMBSs, German auto loans, etc.)? (iii) How can it be ensured that non-qualifying ABSs will not be stigmatised by being excluded, in view of the desirability of also supporting the functioning of primary and secondary markets for non-standard ABSs? (iv) How can one achieve, to the greatest possible extent, clarity about the criteria to be achieved, and who will determine if a particular ABS represented by an International Securities Identification Number (ISIN) qualifies or not (i.e. will the regulatory framework itself be 'simple and transparent')? Finding the best answers to these and some other non-trivial questions will determine the success of the current initiatives, and will be crucial to the future of ABSs in the euro area, which as I explained above is important to the ECB. The four panellists of this session are highly qualified to provide us with an insight into the current issues with regard to the finalisation of the concept and treatment of 'simple, transparent and standardised' securitisations.

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CAPITAL MARKETS UNION: SECURITISATION PROPOSALS COME CLOSER BUT RISK MISSING THE MARK

NICOLE RHODES[1]

As expected, on 30 September 2015, the European Commission published its Capital Markets Union (**CMU**) action plan and certain corresponding materials. The action plan follows on from earlier consultations and describes in high-level terms the various steps to be taken with respect to the creation of a single market for capital in Europe.

Certain workstreams under the CMU are described to be short-term priorities, meaning that they are targeted for immediate action. Such priorities include reviving the securitisation markets in Europe and, in keeping with this, the Commission published its much-anticipated legislative proposals for harmonising the current regulatory regime and for establishing a new framework for simple, transparent and standardised (**STS**) securitisations. Notwithstanding that the announcements are warmly welcomed in general and represent an improvement on previous consultations and recent leaked drafts, aspects of the published proposals risk missing the mark.

The legislative proposals are now going through the EU political negotiation process prior to final adoption, which could take a year or more. Important follow-up work will also be required in connection with the treatment of STS securitisations under Solvency II and the liquidity coverage ratio (**LCR**). In any event, stakeholders will want to focus closely on the proposals sooner rather than later, with a view to identifying key areas of focus for continuing advocacy and engagement efforts. Given the current state of the securitisation markets in Europe in general, much hangs in the balance in terms of getting the new regime right. Based on the published proposals, it appears that the right targets have been identified but, in order to be successful in reviving the markets, the EU authorities need to sharpen their aim and strengthen their arrows.

This article provides an overview of the securitisation proposals and highlights certain key points to note.

Legislative proposal basics and follow-up work

As noted above, the legislative proposals provide for the harmonisation and revision of the current EU regulatory framework for securitisation. In form, the proposals are comprised of two draft regulations.

1 Consultant Counsel, Allen & Overy, London.

Broadly, the first regulation (**STS regulation**) proposes to establish certain harmonised rules for all securitisations and to create common foundation criteria for identifying STS securitisations. The second regulation (**CRR amendment regulation**) proposes to amend the Capital Requirements Regulation (**CRR**) to implement (with key adjustments) the revised securitisation framework adopted by the Basel Committee in December 2014 and to provide for recalibrated regulatory capital treatment under the implemented framework for STS securitisation positions that satisfy certain additional credit risk-related requirements in line with recent recommendations from the European Banking Authority (**EBA**).

The proposals make it clear that full implementation of the CMU-securitisation workstream requires steps to be taken in addition to those contemplated by the two draft regulations published to start. The proposals expressly refer to amendments to other legal acts in due course. In particular, it is intended that certain existing legislative provisions (including existing regulatory technical standards relating to risk retention and disclosure requirements) will be repealed or amended once the STS regulation is agreed and adopted.

Moreover, the proposals indicate that amendments will be put forward in due course to make the Level 2B securitisation requirements in the LCR delegated act consistent with the STS foundation criteria, although it is not clear based on the published materials that general changes will be made providing for better or more flexible treatment of asset-backed securities under the LCR (in particular, market participants have called for an adjustment to the disproportionate haircuts applied to securitisations). It is also intended that changes will be made to the provisions which apply under the Solvency II Directive regime (including to the Type 1 securitisation provisions) to ensure consistency with the STS foundation criteria and to provide for a (much needed) recalibration of the treatment of STS securitisation positions for insurers. In this regard, the published materials suggest that the intended methodology will result in "a significant reduction of the capital charges for non-senior tranches of STS securitisations" but further details are not provided. While the Commission notes that it is intended that the new calibrations in the banking sector (via the CRR amendments) and the insurance sector (via the Solvency II amendments) will apply from the same date, it is not clear that the changes to be made to the LCR will be done on the same timeline.

The application date of the revised regime is not known but it seems unlikely to be before late 2016. This means that the treatment of asset-backed securities under Solvency II (which insurers must fully comply with from the start of 2016) and the LCR (which starts to apply from 1 October 2015) will remain unchanged for a material period of time, and in the case of the LCR, this could be an even longer period. This timing is cause for significant concern and it is not clear that the support signals provided by the publication of the legislative proposals will be enough in themselves to stop the exit of further participants from the market over the coming period, particularly once full compliance is required under Solvency II.

In addition to these timing concerns, it is not clear at this point what the proposed recalibration under Solvency II will look like and, as noted above, whether material changes in treatment will be made under the LCR for STS securitisations. As a result, the benefits of satisfying the STS securitisation criteria remain largely uncertain except under the CRR.

STS REGULATION

As noted above, the STS regulation includes proposals to establish certain harmonised rules for all securitisations and to create common foundation criteria for identifying STS securitisations. The regulation also includes provisions relating to supervision and enforcement and provides for certain related amendments to other legal acts, including the EU Market Infrastructure Regulation (**EMIR**).

HARMONISED RULES FOR ALL SECURITISATIONS

In response to the fact that the securitisation risk retention, due diligence and disclosure requirements implemented in the EU to date do not fully line up in all respects, the STS regulation includes provisions which recast and streamline these requirements and certain corresponding definitions. The definitions (including the CRR definition of securitisation and related guidance in recital 50) are carried over broadly intact; however, amendments are proposed to be made to the retention, due diligence and disclosure requirements. While harmonising initiatives are helpful in principle, certain questions and concerns arise under the proposals as drafted.

One of the areas of key focus under the recast requirements is scope of application and the treatment of existing transactions given that retrospective application of requirements to such transactions is highly problematic. The recast requirements are stated to apply in general in respect of transactions entered into on or after the date of entry into force of the STS regulation, reflecting what is understood to be a high-level policy intention to apply the recast regime in respect of new transactions and to maintain the existing regime for legacy arrangements. That said, there are certain qualifications to the general application approach which result in unhelpful uncertainty.

In particular, the recast investor due diligence requirements are proposed to apply in respect of both new and existing transactions and such requirements refer to pre-investment verification of compliance with the recast retention and disclosure requirements. This suggests that investors may be unable to satisfy their due diligence obligations in respect of existing transactions where the relevant retention and disclosure arrangements are not fully compliant with the new regime as adopted, although it is not clear that this is the outcome intended by the Commission. Based on our understanding of the general policy intention with respect to application, it is hoped that the technical deficiencies in the current drafting may be easily fixed.

DUE DILIGENCE

Under the proposals, the existing investor due diligence requirements applicable under the CRR, Alternative Investment Fund Managers Directive (**AIFMD**) and the Solvency II Directive would be repealed and replaced with common requirements for new and existing transactions. These common requirements would be applicable to a range of EU regulated institutional investors including banks, investment firms, insurers, AIFMs, UCITS management companies, certain internally managed UCITS and institutions for occupational retirement provision (IORPs).

As under the current regime, the recast requirements would require relevant investors to undertake certain assessments prior to investing in a securitisation position and on an ongoing basis. Amongst other things, prior to investing, an investor would need to verify that an eligible entity has retained an interest in accordance with the recast retention requirements (discussed below) and that the relevant entities make available the required information under the recast disclosure requirements (also discussed below). While the explanatory memorandum published with the STS regulation suggests that the revised due diligence obligations should operate such that investors will "in a simple manner be able to check" whether these matters are met, the drafting of the relevant operative provisions in the proposals does not make it clear that the required verification exercise does not need to go beyond checking disclosures.

The proposals would also require investors in respect of STS securitisations (discussed below) to carry out a due diligence assessment prior to investing with respect to whether the securitisation meets the STS requirements. On this front, the provisions in the proposals state that investors may place "appropriate reliance" on the STS notification and related information disclosed by the originator, sponsor and issuer on compliance with the criteria. While it is not clear what will be regarded to be appropriate reliance in these circumstances and how much work an investor will need to do, it is helpful that the proposals expressly indicate that investors may rely on the STS notification and other information to be provided. It appears that at least some additional work will be necessary as the draft recitals to the STS regulation indicate that "it is essential that investors make their own assessment … [and] take responsibility for their investment decisions…". Market participants had expressed concerns that the imposition of onerous STS assessment obligations on investors would discourage, rather than encourage, securitisation investment activities and the question of what "appropriate reliance" means is likely to be a key area of focus.

More generally, it should be noted that the proposals reflect certain improvements and clarifications to the due diligence obligations as compared to the existing regime. In particular, the requirements under the proposals are cut down and significantly streamlined. For example, the matters to be analysed and recorded prior to investing are reduced in general and certain unclear items under the current regime would be removed (including required checks relating to the reputation and loss experience of originators and sponsors in earlier securitisations and the methodology on which the valuation of the collateral is based).

In addition, existing due diligence requirements applied to AIFMs and insurers requiring an assessment of various qualitative matters related to the originator or sponsor are significantly pared down, with only a verification requirement relating to the originator's credit granting policies and systems remaining and the disapplication of this requirement in circumstances where the originator is a bank or CRR regulated investment firm. Market participants have long questioned the rationale for, and feasibility of, investors properly undertaking the qualitative assessment exercise required under the current regime in the context of asset-backed transactions and so the proposed changes in this regard are positive.

Less helpfully, there is no reference in the proposals to corresponding regulatory technical standards to specify in greater detail aspects of the due diligence requirements. The reasoning for this is not clear given that key guidance currently applies under the existing regime for the purposes of bank, investment firm and AIFM investors and this guidance would remain helpful if made available under the proposed recast requirements. If appropriate guidance is not carried over under the new regime, this may give rise to new compliance uncertainty, which would seem unlikely to encourage investment and inspire confidence as intended.

RISK RETENTION

Under the proposals, the current risk retention requirements applicable under the CRR, AIFMD and the Solvency II Directive would be repealed and replaced in part by revised common requirements for new transactions.

Key aspects of the recast retention requirements are consistent with the current regime. For example, no changes are provided for with respect to the required interest level of 5%, the restriction on transferring or hedging the retained interest or the available holding options (although helpfully the proposals make it clear that the seller's share holding option is available for revolving pool securitisations in general regardless of the nature of the underlying assets).

Notwithstanding these key areas of consistency, the proposals do provide for certain substantive changes. These changes relate to two matters – namely, application approach and eligible retainers – and pick up on recommendations made by the EBA in its December 2014 report.

In particular, the proposals revisit the current "indirect" (i.e. investor focused) application approach of the EU retention regime by imposing a new direct obligation to retain on the originator, sponsor or original lender. While the move to a direct application approach was expected, it was hoped that the proposed requirements would make it clear that the new obligations would only arise in respect of relevant entities *involved* in the securitisation (as this is not a given for all entities which may be regarded to be an originator or original lender). Unfortunately, the proposals do not include clarifying wording in this regard.

It should be noted that, notwithstanding the move to a direct application approach, EU regulated investors would not be "off the hook" with respect to retention compliance. As noted above, the proposals provide that such investors

would continue to be subject to related due diligence provisions requiring them to "verify" that the originator, sponsor or original lender retains the required interest in accordance with the retention requirements in the STS regulation and to check the disclosures made in this regard.

The corresponding explanatory memorandum also indicates that the current indirect application approach would continue to apply in certain circumstances. In acknowledgement of the jurisdictional considerations raised by a direct application approach, the indirect approach would apply where none of the originator, sponsor or original lender is EU established. In addition, express provision is made for the current requirements to continue to apply to relevant investors in the context of transactions entered into prior to the date of entry into force of the STS regulation (although, as noted above, as a respect of deficiencies in the drafting, satisfaction of the investor due diligence obligations would appear to require investors to assess the compliance of such arrangements under the new regime, which would be problematic).

The retention requirement applicable to the originator, sponsor or original lender indicates that "where the originator, sponsor or original lender have not agreed between them who will retain the material net economic interest, the originator shall retain…". While further consideration is required, issues are not expected to arise in general under this wording. This is because eligible entities will be minded to identify the retaining party and significant incentives for this to occur will continue to apply, including indirectly via the recast investor due diligence requirements. However, the additional wording seems odd in general and if adopted may give rise to some confusion as the concept of greater responsibility for retention amongst retainers is new, as is the concept of formally agreeing amongst retainers who should hold the interest.

More significantly, in addition to the application approach differences described above, the proposals differ from the existing regime in that they include a new restriction on originators. The proposed restriction seeks to address concerns identified by the EBA that, under the CRR definition of originator, it is possible for third party equity investors to establish an "originator SSPE" solely to act as retainer in a securitisation. Under the proposed restriction, an entity established or operated "for the sole purpose of securitising exposures" would not be an originator for retention purposes. This wording represents an improvement over wording included in previous leaked drafts, which referred to a "primary purpose" test and raised issues relating to uncertainty. The revised "sole purpose" wording included in the proposals is much less likely to create confusion with respect to the compliance position of retainers and more workable in general in that it should not unintentionally capture legitimate uses of the originator route.

Interestingly, the explanatory memorandum to the STS regulation includes some discussion of the "sole purpose" restriction (relevant extract below), which suggests that the policy intention behind the proposed new restriction is perhaps more nuanced than a literal reading would suggest. Market participants will want to bear this in mind when assessing any adopted sole purpose restriction, although, strictly speaking, statements included in the explanatory memorandum

would not be operative provisions under the coming new regime. It is worth noting that the approach pursued in the proposals largely follows the substance of comments submitted to the Commission by Allen & Overy and four other major law firms operating in the CLO market.

> *This proposal also takes into account the EBA recommendation to close a potential loophole in the implementation of the risk retention regime whereby the requirements could be circumvented by an extensive interpretation of the originator definition. To this aim, it is specified that for the purposes of Article 4 an entity established as a dedicated shelf for the sole purpose of securitising exposures and without a broad business purpose cannot be considered as an originator. For instance, the entity retaining the economic interest has to have the capacity to meet a payment obligation from resources not related to the exposures being securitised.*

Also with respect to eligible retainers, it is worth noting that notwithstanding calls from market participants for adjustments to the sponsor definition to create sufficient flexibility for the full range of MiFID investment firms and (in circumstances where the indirect application approach remains applicable) firms not established in Europe, the sponsor definition in the proposals remains the same, essentially carrying over the current CRR definition. More helpfully, however, amendments are proposed to be made to the provision which permits retention on a consolidated basis in circumstances involving entities included within the same group from a prudential supervision perspective. Whereas the current regime only permits retention on this basis where the arrangement involves the securitisation of assets from "several" relevant entities within the group, the recast requirements would accommodate more usual scenarios involving the securitisation of assets from "one or more" relevant entities within the group.

Given the importance of the regulatory technical standards which apply under the current retention regime to making sense of the requirements, a key question under the recast framework relates to whether the existing guidance will be carried over and, if so, whether there will be any delays or gaps in this regard. The proposals seek to address these questions by expressly providing for the development by the EBA (in cooperation with the other European Supervisory Authorities) of draft regulatory technical standards on the retention requirements within six months of the date of entry into force of the STS regulation and provision is made for the existing standards to be carried over under the new regime until the new standards are made. While these provisions are helpful on some level, it appears that new transactions would be subject to two retention compliance standards (i.e. the existing technical standards and then the new technical standards, which may be different in certain respects). Additionally, is not clear that the new standards will cover all of the areas addressed by the current guidance. In particular, the list of items to be addressed does not refer to scenarios involving multiple originators or sponsors and the flexibility for the retention requirement to be met by a single entity where certain conditions are met, which is a key part of the current standards which needs to be carried over under the new regime.

Having been through two prior rounds of extensive consultation relating to retention guidance in the EU since the requirements were first introduced, it is hoped that the next round under the STS regulation is able to build on previously agreed positions rather than starting from scratch.

DISCLOSURE

Under the legislative proposals, the current disclosure requirements applicable under article 409 of the CRR and article 8b of the Credit Rating Agency Regulation would be repealed and replaced by a single set of requirements for new transactions. It is not entirely clear but it appears that article 8b would continue to apply in respect of relevant legacy transactions, being public securitisations backed by certain asset types and involving securities issued on or after 26 January 2015, including provisions applicable under the corresponding regulatory technical standards indicating that no reporting action is required to be taken in respect of such transactions until the start of 2017.

While it is helpful that the recast requirements would seem to be intended to apply in respect of new transactions only (unlike under previous leaked drafts), there are other application and scope related concerns under the proposals. In particular, the recast requirements would appear to apply in respect of all securitisations regardless of the nature of the underlying assets subject to the development of disclosure templates. There is no carve-out for private and/or bilateral transactions (unlike under the article 8b regime). Express references in the new requirements to ABCP operate only to require more frequent reporting for these arrangements (e.g. to require loan-level information and standardised investor reporting on a monthly rather than a quarterly basis), rather than providing for relief or greater flexibility as market participants have repeatedly indicated is necessary. Notwithstanding this, the explanatory memorandum notes that in making any disclosure templates for ABCP, "there is a need to find the right balance between the level of detail and the proportionality of the disclosure requirements", which suggests that further work is to be done.

In general, the recast requirements included in the legislative proposals are modelled closely on the technical standards which apply under article 8b and similar wording is used. In keeping with this, the requirements refer to a joint disclosure obligation on the originator, sponsor and securitisation special purpose entity (**SSPE**) to make available certain information as a matter of course and with specified frequency (including loan-level data and certain other information similar to that required under the Bank of England transparency requirements) and to provide certain event-based reporting if the transaction is not otherwise subject to the ongoing disclosure obligations under the EU market abuse regime.

That said, there are a number of important differences between article 8b and the recast requirements. For example, it appears that full public disclosure may not be required under the proposals and, as expected, the concept of disclosure through a website established by the European Securities and Markets Authority (**ESMA**) seems to have been dropped (at least for the purpose of compliance with the recast requirements). In this regard, the provisions refer to disclosure of

the relevant information to competent authorities and holders of a securitisation position only and for this to be done via a website which satisfies certain conditions (the European Datawarehouse is referred to by way of example in the explanatory memorandum). Given the matters to be verified by institutional investors prior to investing under the due diligence requirements (discussed above) and the considerations which may arise in cases involving selective disclosures to certain entities only, it is likely that information would need to be made available to both prospective and existing investors in practice.

While the move away from full public disclosure appears to be an attempt to address certain concerns previously identified by market participants with respect to the application of disclosure requirements to private and/or bilateral transactions, the recast requirements would not resolve the full range of confidentiality and commercial sensitivity issues raised by the application of loan-level and other standardised reporting requirements to these transactions. Market participants have worked hard to date to highlight the issues in this regard and the real disincentives to securitise created by the application of non-principles based disclosure requirements to private and/or bilateral transactions. It is not clear what is intended to come of ESMA's work under article 8b to define private and/or bilateral transactions and to identify an appropriate disclosure and reporting standard for these arrangements.

Lastly, it should be noted that questions arise with respect to the templates to be used for loan-level reporting under the recast requirements. Provision is made for corresponding regulatory technical standards to be made to specify the information required to be disclosed by the originator, sponsor and SSPE, including standardised templates. While use of the European Central Bank templates as permitted under article 8b would be acceptable until the new technical standards are finalised, it is not clear that consistent disclosures will be acceptable in the longer term. Given that key matters relating to article 8b and the acceptable compliance standards thereunder (including the standardised templates to be used for reporting purposes) were only agreed and confirmed by the EU authorities last year, it is rather discouraging to think that this may need to be debated again in the context of the STS regulation.

COMMON FOUNDATION CRITERIA FOR IDENTIFYING STS SECURITISATIONS

Significantly, the STS regulation also includes proposals to create common foundation criteria for identifying STS securitisations. In particular, the regulation includes proposals for the criteria for true sale "long-term" and "short-term" securitisations. For these purposes, short-term securitisation is intended to mean ABCP programmes and underlying transactions. The proposals do not include criteria for synthetic securitisations but the explanatory memorandum indicates that the Commission will reflect further on these arrangements and possibly seek to develop standards in the future.

The introduction of proposals to create common foundation criteria for STS securitisations is supported by market participants in general. A harmonised

standard is preferable to the piecemeal approach which European authorities seemed at risk of pursuing given the overlapping but slightly different standards adopted under the Solvency II Directive and the LCR. More generally, this work is strongly supported given that the STS initiative represents an opportunity for more balanced EU regulatory treatment for certain securitisations. If structured properly, the hope is that the new framework will make securitisation more attractive for both issuers and investors. As a result, the STS framework is a key pillar of the CMU-securitisation workstream related to reviving the securitisation markets.

While the foundation criteria included in the proposals are improved in certain respects from those included in recent related consultation materials, aspects of such criteria remain unclear and/or disproportionately onerous. The proposed standards do not reflect certain key comments raised by market participants. It was already understood based on previous consultations that the criteria were (unfortunately) likely to exclude CMBS, managed CLOs and synthetic transactions in general but the worry is that a much wider range of other common securitisation arrangements may also be (possibly unintentionally) excluded and/or that the position of these other arrangements may not be sufficiently certain. Heightened concerns arise under the proposals in respect of existing transactions as well given that the criteria would require certain non-market standard provisions to be included in the transaction documents and it may not be possible to build these provisions into existing arrangements, particularly term deals. In addition, notwithstanding that it appears to be intended that existing transactions should remain subject to the current retention regime and current disclosure requirements (rather than the recast requirements) a technical adjustment is not made to reflect this in the STS criteria.

Based on early reviews of the proposals, it appears that issues persist under the proposed criteria for long-term securitisations with respect to (i) the restriction on defaulted assets and assets involving credit-impaired obligors given uncertainty under the proposed definitions for these purposes and the lack of provision for adjustment based on the nature of the specific credit involved, (ii) the required standards with respect to borrower creditworthiness assessments which do not reflect the simplicity, transparency and/or level of standardisation of a transaction and instead go to credit quality, (iii) the requirement for certain transfer perfection events that do not reflect existing transaction terms and (iv) requirements for the information required under the recast disclosure requirements (discussed above) to be available (in final or draft form) prior to pricing.

While it is helpful that the legislative proposals include provisions relating to ABCP in keeping with the EBA's recommendations on STS earlier this year and fix previous known issues in such recommendations, there are certain remaining concerns under the draft criteria. In particular, greater flexibility provided under the ABCP underlying transactions criteria with respect to the maturity of underlying assets represents an improvement (moving from a one-year limit to a requirement referring to a remaining weighted average life of two years and a residual maturity for individual underlying assets of not longer than three years), but probably not a full fix and other key issues have not been

addressed. For example, through the cross-application of certain long-term securitisation criteria, extensive disclosure requirements (including loan-level reporting and data on static and dynamic historical default and loss performance for substantially similar assets) would apply in respect of underlying transactions, which would be problematic.

Under the ABCP programme level criteria, consistent with comments provided previously by market participants, concerns arise given that all transactions within an ABCP programme would be required to satisfy the STS requirements for underlying transactions, that call options and extension clauses would be restricted and, once again, that extensive disclosure obligations would apply. Unless fixed, the issues on the ABCP side risk the establishment of a regime for short-term securitisations that does not work in practice. An effective exclusion of ABCP arrangements from the STS framework would compromise the success of the initiative in general, as a meaningful portion of the market would be outside scope and likely to reduce further in size.

Leaving aside the criteria themselves, it should be noted that the identification of common foundation criteria for STS securitisations also gives rise to the key issue of compliance verification: that is, who should determine, and take responsibility for, whether or not a transaction is compliant with the criteria for STS. This issue has been subject to extensive discussion and debate in Europe, with a range of views being put forward. The available options in this regard refer to the involvement of regulatory authorities (through the labelling of transactions or the licensing of entities to provide such a label) or independent third parties (such as the Prime Collateralised Securities (PCS) initiative), as well as so-called "self-attestation" by originators and corresponding due diligence by investors. For most market participants, the priority with respect to verification has been to ensure that the pursued process is practical, efficient and certain for both originators and investors. Many consider that this process is most likely to be successfully achieved through the appointment by the authorities of one or more third parties to issue certifications with a corresponding (but manageable) due diligence obligation on investors.

As expected, the Commission has not formally endorsed third-party involvement in the verification process and has instead indicated that self-attestation combined with appropriate due diligence should be required. No restriction is put on assistance from third parties behind the scenes, but the proposals make it clear that responsibility for determinations would sit with originators, sponsors and SSPEs and, to a lesser extent, investors. Unfortunately, no provision is made for guidance on the criteria (through technical standards or some kind of Q&A tool), which may make it difficult for market participants to comfortably take views on points of interpretation as questions arise.

Under the legislative proposals, where the STS designation is sought to be used in respect of a transaction, the originator, sponsor and SSPE would be required to jointly declare that the relevant transaction meets the STS requirements and to provide notification of this to ESMA and the relevant competent authority. Notifications would be published on ESMA's website and would be accessible

to market participants. In turn, institutional investors would need to assess whether a transaction meets the STS requirements as part of their due diligence obligations, although, as noted above, "appropriate reliance" could be placed on the STS notification provided to ESMA by the originator, sponsor and SSPE. The originator, sponsor and SSPE would be required to designate amongst themselves one entity to act as the first point of contact for investors and competent authorities, although all three entities would remain responsible for the notified information.

It is perhaps not surprising that the Commission has opted not to pursue a verification option based on formal involvement by the regulatory authorities and/or an independent third-party entity given previous indications from the authorities that they had concerns with these options given perceived moral hazard and external overreliance issues. The selected self-attestation option also raises questions, however, particularly given persisting concerns that the criteria are not sufficiently clear in a number of respects. It remains to be seen whether originators and sponsors would be sufficiently comfortable attesting that transactions are compliant with the requirements based on the proposals given the uncertainty with respect to various requirements. In addition, questions arise under the proposals in respect of the emphasis placed on SSPEs in the process (i.e. the requirement for such entities to participate in the joint declaration) given that such entities may not be established such that they can efficiently make an independent assessment in this regard.

Lastly, it should be noted that the sanctions proposed to potentially apply in the event of breach of the requirements (discussed below) may dissuade market participants from pursuing the STS designation in respect of their transactions and accepting responsibility in this regard. The consequences of "getting it wrong" are significant and arguably disproportionate.

SUPERVISION AND ENFORCEMENT

The draft STS regulation includes various provisions relating to supervision and enforcement. In particular, provisions are included with respect to designating the competent authorities to ensure compliance by relevant entities, with power being provided for Member States to designate one or more competent authorities for unregulated entities. Provisions are also included to specify the supervisory, investigatory and sanctioning powers held by such authorities.

With respect to sanctions, the legislative proposals refer to various actions which may be taken by authorities in respect of originators, sponsors, original lenders and SSPEs for breach of the risk retention, disclosure and STS notification-related requirements. Amongst other things, the relevant provisions refer to the right of Member States to impose criminal sanctions and possible administrative sanctions, including fines of at least EUR 5 million or, in the case of legal persons, up to 10% of total annual turnover. Express provision is made for the application of sanctions to members of the management body of relevant entities and "to other individuals who under national law are responsible for infringement".

The specified sanctions raise concerns given that areas of uncertainty exist under the legislative proposals, meaning that the compliance position may not be clear in a number of cases under the risk retention, disclosure and/or STS notification requirements. Given that possible criminal sanctions and other seemingly very harsh consequences may arise as a result of a breach, originators and sponsors may be effectively discouraged from using securitisation, particularly when taking into account that similar requirements and consequences do not arise in connection with the use of other funding tools and products such as covered bonds. Moreover, as the benefits of STS securitisation treatment remain unclear in part (e.g. under Solvency II and the LCR), it may be difficult for market participants to conclude that risks of possible non-compliance in connection with use of the STS designation are outweighed.

While the legislative proposals refer to and identify the relevant competent authorities in respect of investors for purposes of the due diligence requirements, the specific sanctions which may be applied in respect of these entities are not clear. If the usual powers of relevant competent authorities are to apply, then a key question will be whether these powers could extend to the application of increased capital charges in respect of positions where relevant and whether investors could be required to dispose of positions (particularly in a "fire-sale" scenario).

In acknowledgement of the fact that different competent authorities may have jurisdiction and power to assess the compliance position under the various requirements and may come to different conclusions in this regard, the STS regulation includes provisions intended to facilitate cooperation and exchange of information with respect to infringements. Amongst other things, the provisions provide for the settlement of disagreements between competent authorities by the joint committee of the European Supervisory Authorities if necessary and for the development of corresponding technical standards to specify required cooperation procedures. While it is helpful that the need for coordination and a backstop settlement process is acknowledged in the proposals, the process as proposed seems unlikely to provide for timely resolution, meaning that liquidity issues may arise in circumstances where any single relevant competent authority questions the compliance position of a transaction under any of the requirements.

MISCELLANEOUS AMENDMENTS TO OTHER LEGAL ACTS

As a final matter, the STS regulation provides for certain amendments to other legal acts. While a number of these amendments are of a tidying-up or consistency nature, certain changes provided for with respect to EMIR are worth noting.

Under the relevant provisions, adjusted application of the clearing and collateral posting requirements under EMIR is contemplated in the case of swaps entered into by securitisation vehicles in connection with a securitisation (and also for swaps entered into by covered bond entities in connection with a covered bond) where certain conditions are met. Market participants have long made the case for relief from the clearing and collateral posting requirements for securitisation swaps (and covered bond swaps, which was accepted and expressly provided for in EMIR).

While it is positive that the STS regulation includes provision for relief, it appears that under each of the clearing and margin requirements this would only be available in the case of swaps entered into in connection with STS securitisations and not for securitisation swaps more generally. This limitation seems misguided given that the rationale for greater flexibility in the case of usual structured finance swaps (i.e. that the swap counterparty is already sufficiently protected given that it is a secured creditor in respect of the issuing entity and has the full benefit of the security provided on a senior basis) applies across the board and not just in the case of STS securitisations. While the STS framework provides an appropriate basis for preferential treatment in certain contexts, swaps regulation is less conducive to this. It is hoped that this point may be made through the advocacy process in connection with the STS regulation and that broader relief will be provided.

CRR AMENDMENT REGULATION

As noted above, the proposals also include a regulation focused on amending the CRR to implement the revised securitisation framework adopted by the Basel Committee and to provide for recalibrated regulatory capital treatment under the implemented framework for certain STS securitisation positions. Provision is made for transitional application of the revised regime in respect of existing positions.

With respect to the implementation of the revised securitisation framework, the CRR amendment regulation provides for an important adjustment to the Basel Committee's standards. By way of background, the Basel framework imposes a set hierarchy of calculation approaches which broadly requires a firm to use a specified Internal Ratings Based Approach (**SEC-IRBA**) or, if the firm is unable to use that approach, to use a specified External Ratings Based Approach (**SEC-ERBA**) if permitted by the authorities in the relevant jurisdiction or, if the SEC-ERBA is not feasible, to use a specified Standardised Approach (**SEC-SA**). As the names suggest, the SEC-IRBA and the SEC-SA are formula-based approaches whereas the SEC-ERBA is an approach based on external credit assessments provided by credit rating agencies. Concerns have been raised by European market participants about this hierarchy given that EU banks are unlikely to be able to use the SEC-IRBA in respect of non-own name transactions due to the asset data required for the main pool capital input (KIRB), meaning that such banks would be required to use the SEC-ERBA. External ratings-based approaches for calculating securitisation regulatory capital requirements have been criticised by market participants in general and the SEC-ERBA gives rise to heightened issues in Europe given the effective rating caps linked to sovereign rating levels applied by the rating agencies.

Helpfully, in response to these concerns, the CRR amendment regulation would permit firms to deviate from the approaches hierarchy in certain circumstances. In particular, institutions would be permitted to use the SEC-SA approach instead of the SEC-ERBA in relation to a securitisation "where the risk-weighted exposure amounts resulting from the application of the SEC-ERBA is not commensurate to the credit risk embedded in the exposures underlying the

securitisation" and subject to notice being provided to the competent authority. This flexibility represents a significant improvement in the legislative proposals as compared to recent leaked documents. That said, it is not entirely clear how much flexibility is intended to be available under the provision and what will be considered sufficiently non-commensurate treatment in this regard.

With respect to the recalibrated treatment for certain STS securitisations, the legislative proposals largely follow the recommendations put forward by the EBA in July 2015. In keeping with this, the proposals would require satisfaction of the STS foundation criteria and also certain additional "building block" requirements. For example, for securitisation positions other than those relating to an ABCP programme, the additional requirements refer to, amongst other things, the assets having been originated in accordance with specified sound credit granting criteria, an asset size restriction, a maximum 100% LTV restriction for residential mortgage loan-backed transactions and the assets meeting certain credit risk-related requirements at the time of inclusion in the securitisation.

Also in line with the EBA's recommendations, it is proposed that positions in STS securitisations satisfying these additional requirements should benefit from better regulatory capital treatment through adjustments to the parameters under each of the SEC-IRBA and SEC-SA approaches, modifications to the applicable risk weights under the look-up table for the SEC-ERBA approach and a lower risk weight floor of 10% for senior positions. The adjustments which apply under the formula-based approaches are regarded by market participants to be particularly helpful and, as a result, the flexibility proposed to be provided for deviation from the approaches hierarchy (meaning that firms may not be required to use the SEC-ERBA and can instead use the formula-based approach of the SEC-SA in the circumstances described above) is likely to be regarded by market participants as one of the highlights in the legislative proposals.

Further consideration of the detailed provisions included in the CRR amendment regulation will be required over the coming period to identify any technical issues.

NEXT STEPS

The legislative proposals on the STS regulation and the CRR amendment regulation have been submitted to the European Parliament and Council. As noted above, the proposals are not law at this point and remain subject to political discussion and debate through the usual EU legislative procedure. This procedure is unlikely to be concluded before the third quarter of 2016 at the earliest.

Given that the proposals have been put forward in the form of European regulations, no corresponding national measures would be required in member states to implement the measures. That said, as noted above, the proposals expressly refer to the making of various corresponding acts, including technical standards to further specify the retention, disclosure and STS notification requirements. In addition, full implementation of the CMU action plan item related to reviving the securitisation markets will require certain follow-up actions, including amendments to Solvency II and the LCR.

While there has been some talk of the EU authorities trying to "fast-track" the legislative proposals, it is not clear that this will be possible in practice. As highlighted in this article, the proposals are welcomed in general and represent an improvement on previous positions but further work is required to land a bullseye. Timely action is required to address the current issues facing portions of the European securitisation markets but this should not come at the cost of compromising the success of the revised regime.

This article is for general guidance only and does not constitute definitive advice.

THE REVIVAL OF THE SECURITISATION MARKET

CHRISTIAN MOOR[1]

ROLE OF SECURITISATION

A well-functioning securitisation market is very important for the EU as it helps to fund economic growth and makes the financial system more robust by: (a) opening an alternative funding channel; and (b) realising credit risk transfer and hence risk sharing between different parties in the financial system.

The first benefit is particularly relevant for the EU economy, where the current bank-growth nexus is such that close to 85% of European financing is provided by banks, leaving the economy with little alternative to bank credit in order to fund growth.

The second benefit is particularly helpful in relation to the current deleveraging and de-risking processes in which EU banks have engaged. Securitisation facilitates those processes without triggering a significant contraction of the real economy.

The European securitisation market has been in decline since the beginning of the global financial crisis. A number of different factors have, in my opinion, played a role in shaping this development in recent years, including some crucial regulatory and non-regulatory determinants, such as: (a) the post-crisis stigma attached to the whole securitisation market by investors, regulators and politicians; (b) the macro-economic environment impact that has unfolded since the financial crisis, in some jurisdictions; (c) the role of alternative funding instruments available to institutions in the EU, particularly the availability of low-cost central bank money and covered bonds; (d) the tightening of credit rating agencies' rating methodologies; (e) the limited investor base in securitisation following the implosion of the structured investment vehicles (SIVs); and, last but not least, (f) the uncertainty of effects from numerous regulatory initiatives, both at the EU and global level, impacting directly or indirectly on the incentives to securitise and/or invest in securitisations.

However, the important role securitisation can play for banks and the economy as a whole has been recognised at a global level. In April 2014, the G20 Finance Ministers and Central Bank Governors agreed to examine ways to enhance the capacity of financial markets to channel more long-term finance, also to small and medium-sized enterprises (SMEs). To reach this objective, the G20 has launched a specific working group tasked with carrying out work to rebuild confidence in securitisation for infrastructure financing purposes.

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At EU level, the revival of the securitisation market has now become one of the key priorities. The European Commission confirmed its commitment to enhance the efficiency of the EU securitisation framework as part of a more comprehensive project for the establishment of a Capital Markets Union in order to set adequate conditions to aid the return to a sustainable growth and job creation path.

DEVELOPMENT OF A HIGH QUALITY SECURITISATION PRODUCT

In January 2014 the European Commission asked the advice of the European Banking Authority (EBA) to assess whether a 'high quality' securitisation instrument could be developed. In this process the EBA was requested to identify which characteristics would be the most appropriate to achieve 'simple, standard and transparent' securitisation products, having particular regard to: (i) categories of underlying assets; (ii) structural elements; and (iii) transparency features. Furthermore the EBA was requested to assess, from a prudential perspective, if there is merit in providing a different regulatory framework.

Since then, various different initiatives have taken place, both in Europe and at a global level, to explore more broadly the conditions for reviving a market deeply stigmatised by the negative events related to the financial crisis.

As an initial response, the EBA published in October 2014 a discussion paper on simple, standard and transparent securitisations, inviting its stakeholders to provide their input and views.

In the discussion paper, the EBA acknowledged the wide spectrum of risks that can be embedded in securitisation processes, as well as the different historical performance of securitisation determined by these risks and concluded that the one-size-fits-all regulatory approach to securitisation is no longer appropriate. The discussion paper provided the EBA's preliminary views on defining three pillars with criteria on: simplicity; standardisation; and transparency. These, together with criteria on the credit quality of the securitised assets, should shape a new class of securitisation products that are prudentially sound and may hence become subject to specific regulatory recognition.

On 18 February 2015, the Commission launched a specific consultation on the establishment of an EU framework for simple, transparent and standardised securitisations. This consultation represented an important step forward towards delivering a new EU securitisation framework in order to:

- revive markets on a more sustainable basis, so that simple, transparent and standardised securitisations can act as an effective funding channel to the economy;

- allow for efficient and effective risk transfer to a broad set of institutional investors as well as banks;

– allow securitisation to function as an effective funding mechanism for some non-bank organisations as well; and

– protect investors and manage systemic risk.

On the basis of these objectives, the consultation looked at securitisation markets from a holistic perspective, i.e. it covers all financial sectors with a view to enhancing cross-sectoral harmonisation. The scope is much wider than only looking into prudential regulatory issues.

Furthermore, the consultation document included questions referring to issues on securitisations in general and questions focusing on 'qualifying' securitisations specifically. The main issues addressed were:

– the identification of the criteria for qualifying securitisations according to a 'building blocks' approach, i.e. through the identification of foundation criteria (applicable to all securitisations) and additional criteria in relation to the specific sector and/or prudential objective concerned;

– a review the risk retention requirements;

– further harmonisation of disclosure obligations for issuers and originators;

– development of venues for the trading/issuing of securitisation instruments;

– capital requirements for qualifying securitisations for banks (and investment firms) and insurance companies;

– the introduction of adjustments in other EU regulatory frameworks to help other financial entities to invest in qualifying securitisations;

– the identification of possible elements for a more harmonised EU securitisation framework, including standardisation of certain aspects of the securitisation structure;

– the adequacy of the existing framework for the capital treatment of banks' exposures to securitisation transactions and the possible implementation of the new Basel Committee on Banking Supervision's revised securitisation framework; and

– measures to further develop SME securitisations, including further standardisation of underlying assets and loan-level data.

The consultation document aimed at gathering information and views from stakeholders on the impact of initiatives already adopted in the area of Solvency II[2]

2 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

for insurers and the LCR[3] for banks and the possible initiatives to make the EU legal framework better suited to build and support sustainable and stable securitisation markets.

On 7 July 2015, the EBA published the full text of its advice to the European Commission on a framework for qualifying securitisation. The EBA advice on securitisation lays down a series of criteria to identify simple, standard and transparent term securitisation and asset-backed commercial paper transactions and recommended lower capital charges than those envisaged by the 2014 Basel securitisation framework for qualifying securitisations to reflect their relative lower risk, while always keeping regulatory capital within the perimeters of a prudential surcharge. The EBA opinion specified the conditions under which transactions could qualify for differentiated treatment within this new international framework.

The EBA explicitly left synthetic transactions outside the scope of its advice on simple, transparent and standardised (STS) securitisations due to the lack, at that time, of a sound and shared basis of knowledge on the synthetic market practice, market evolution and market performance. This was also due to the private/bilateral and bespoke nature of the synthetic securitisation market. The EBA has started engaging in the collection of evidence from major stakeholders of synthetic securitisations and expects to provide its advice on this topic by year-end 2015 to the European Commission.

On 30 September 2015, the Commission published its Capital Markets Union (CMU) action plan. The action plan is a follow-up from earlier consultations and describes in general terms the various steps to be taken with respect to the creation of a single market for capital in Europe. On securitisation, the Commission published new legislative proposals for harmonising the current regulatory regime and for establishing a new framework for STS securitisations.

The first proposed regulation (the proposed STS Regulation)[4] proposes to establish harmonised rules for all securitisations and to create common basic criteria for identifying STS securitisations. The second proposed regulation (the proposed CRR Amendment Regulation)[5] proposes to amend the Capital Requirements Regulation (CRR)[6] to implement (with key adjustments) the revised securitisation framework adopted by the Basel Committee in December 2014 and

3 Commission Delegated Regulation (EU) No 2015/61 of 10 October 2014 to supplement Regulation (EU) 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (OJ L 11, 17.1.2015, p. 1).

4 Proposal for a regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 (COM(2015) 472 final).

5 Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (COM(2015) 473 final).

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).

to provide for recalibrated regulatory capital treatment under the implemented framework for STS securitisation positions that satisfy additional credit risk-related requirements in line with recent recommendations from the EBA.

The legislative proposals will have to go through the EU political negotiation process prior to final adoption, which is expected by June 2016. Following adoption, serious follow-up work will be required in connection with delegated acts (LCR[7], Solvency II[8]), technical standards, guidelines, implementation studies and reports, in order to ensure a well-functioning securitisation market.

SECURITISATION RETENTION RULES

Securitisation markets before the crisis were affected by what are termed 'misaligned incentives' or 'conflicts of interest'. These refer to situations where some participants in the securitisation chain have incentives to engage in behaviour which may further their own interests, but is not in the interests of – and may even be detrimental to – others in the securitisation chain or the efficient functioning of the market. These misalignments and conflicts are generally thought to have contributed to the loss of investor confidence in securitisation products. They are also seen as a barrier to the recovery of this market.

The G20 Leaders' statement from the Pittsburgh Summit in September 2009 recommended that securitisation sponsors or originators retain part of the credit risk of the underlying assets in order to induce a stronger alignment of the interests of the issuers of securitisations and the final investors. Furthermore, IOSCO, in its September 2009 report, 'Unregulated Financial Markets and Products', recommended that consideration be given to requiring originators and/or sponsors to retain a long-term economic exposure to securitisations in order to align interests appropriately in the securitisation value chain. IOSCO recommended specifically that the introduction of any retention requirement needed to be tailored carefully to align interests appropriately and suggested a number of principles to assist regulators in considering retention requirement approaches for their jurisdictions.

In addition, IOSCO also recommended in its report, 'Global Developments in Securitization Regulation', of November 2012, that 'all jurisdictions should evaluate and formulate approaches to aligning incentives of investors and securitisers in the securitisation value chain, including where appropriate, through mandating retention of risk in securitisation products'.

In response to the concerns raised by the crisis, retention rules were put in place in January 2011, through Article 122a of the Capital Requirements Directive (CRD II)[9] which allows investor institutions to assume exposure to

7 Delegated Regulation (EU) No 2015/61.
8 Delegated Regulation (EU) 2015/35.
9 Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (OJ L 302, 17.11.2009, p. 97).

a securitisation only if the originator, sponsor, or original lender has explicitly disclosed to the institution that it will retain, on an ongoing basis, a material net economic interest of no less than 5%.

In 2014, the EBA received a Call for Advice from the European Commission, requesting technical advice on the appropriateness of the rules provided for in the CRR in the light of recent internal developments in this area. In particular the EBA was asked to take into account the IOSCO paper 'Global Developments in Securitisation Regulation', published in November 2012, in which it recommends that regulators consider exempting collateralised loan obligations (CLOs) from the risk retention requirements.

Overall the EBA concluded that the current retention framework is functioning well and has a positive impact on the EU securitisation market as a whole. It has helped to de-stigmatise securitisation products and to create a more transparent securitisation market post crisis.

Following the assessment, in December 2014 the EBA published a report with a number of recommendations to enhance the current rules, including amongst others:

i) implementation of a direct approach of retention – the EBA believes that implementing a complementary direct approach which places the retention requirement obligation directly on originators, sponsors and original lenders will reduce compliance costs and improve legal certainty for investors, thereby encouraging new securitisation investors to invest;

ii) no exception from the retention rules – the EBA believes that there are sufficient ways of complying with the retention rule; therefore, the EBA does not recommend allowing for any further exemptions and/or exceptions. However, the EBA does recommend further assessing the possibility of introducing an 'exceptional circumstances' provision whereby under certain circumstances (such as the insolvency of the retainer), the retainer could be changed during the life of a securitisation transaction to ensure that the retainer is always the most appropriate entity to which the interests of the investors should be aligned;

iii) no alternative mechanisms to achieve the alignment of interest - while alternative mechanisms such as performance-based fee arrangements commonly used in managed CLOs are considered helpful as a complement to risk retention requirements, the EBA does not believe that there is sufficient evidence supporting the use of these alternative mechanisms as a substitute or demonstrating that they are equivalent to the current retention options; and

iv) no introduction of other forms of retention – the EBA assessed the possibility of including an 'L-shape' form of retention through a combination of the vertical slice-holding option and the first loss tranche-holding option. The combination of horizontal and vertical risk retention may mitigate some of

the costs related to the first loss option. Furthermore the 'L-shaped' option as an alternative form of retention has the potential to lower funding costs, which could be beneficial for different types of transactions that do not fit neatly into the traditional model of securitisation such as some managed CLO transactions. However, providing greater choice with an additional form of retention has its drawbacks: by giving originators and sponsors the choice of how to retain risk, their chosen 'L-shape' form of retention may not be as effective in aligning interests and mitigating risks for investors. It may also complicate the implementation of risk retention as well as investors' processes for due diligence and the ongoing measurement of compliance due to the wider choice that originators, original lenders and sponsors would enjoy.

As such the EBA believes no other form should be considered at this time.

v) Potential loopholes – the EBA has identified some practices that raise concerns. It emerges that some transactions are structured so as to meet the legal requirements of the CRR but actually do not always meet the 'spirit' of the CRR and do not align the interests of the most appropriate party to retain (originator, original lender or sponsor) with the interests of the investors.

In particular this can (but is definitely not the only loophole to) arise due to the wide scope of the definition of 'originator' in the CRR. As a result of the wide scope of the 'originator' definition, it is possible to establish, for example, an 'originator securitisation special purpose entity (SSPE)' with third-party equity investors solely for the purpose of creating an 'originator' that meets the legal definition of the CRR and which will become the retainer in a securitisation.

For example, an 'originator SSPE' is established solely for the purpose of buying a third party's exposures and securitises the exposures within one day. The EBA considers these types of structures as non-compliant with the 'spirit' of the retention requirements.

The EBA praises the European Commission for taking on board the main recommendation on risk retention in its proposals on securitisation published on 30 September 2015.

SYNTHETIC SECURITISATION AND CREDIT RISK TRANSFER

Synthetic securitisation transfers the credit risk of a portfolio of exposures by means of a credit protection agreement, without transferring the ownership of the securitised exposures. The securitised exposures remain on the balance sheet of the originator and become reference credits of the credit protection agreement. The originator of the exposures is the protection buyer, whereas the guarantor or counterparty in the credit derivative is the protection seller.

Article 242(11) of the CRR provides a definition of synthetic securitisation: 'synthetic securitisation means a securitisation where the transfer of risk is

achieved by the use of credit derivatives or guarantees, and the exposures being securitised remain exposures of the originator institution.'

While synthetic securitisation and 'true sale' (i.e. traditional) securitisation may not fundamentally differ in terms of the nature of the underlying assets, the credit risk tranching and the capital (waterfall) structures, they use two different ways of transferring credit risk from the originator to the investor. While traditional securitisation realises that transfer by means of transferring the actual underlying exposures and their ownership to an SSPE, synthetic securitisation realises the risk transfer by means of a credit protection contract between the originator and the investor, leaving the underlying exposures within the ownership of the originator and on its balance sheet. In synthetic securitisation, therefore, the actual extent of risk transfer is a function of not only the capital structure and potential mechanisms of support from the originator, as is the case in traditional securitisation, but also the features of the credit protection contract about which originator and investor agree and the creditworthiness of the originator's counterparty in that contract.

Financial guarantors (in the case of financial guarantees) or swap counterparties (in the case of credit derivatives) agree to compensate the losses suffered by the owner of the reference assets if a credit event (e.g. a payment default) occurs in relation to those assets. In return, the owner of the reference assets agrees to pay the financial guarantor or the swap counterparty a premium based on the perceived probability of credit events occurring in relation to the reference assets. As a result the financial guarantor or the swap counterparty gain exposure to the credit risk attached to the reference assets without title or any rights in these assets passing to them.

Synthetic securitisation can be structured in many different ways, depending on various factors; a major distinction arises with respect to the objectives of the transaction, whereby two main types of synthetic securitisations can be identified: 'balance sheet' synthetic transactions and 'arbitrage' synthetic transactions.

In balance sheet transactions the originating credit institution uses financial guarantees or credit derivatives to transfer to third parties the credit risk of a specified pool of assets that it holds on its balance sheet and that, in the vast majority of cases, it has originated. The third parties to which the credit risk is transferred include insurance companies, other credit institutions as well as unregulated entities.

From an originator perspective, credit risk management and the related regulatory capital relief are the main objectives of balance sheet synthetic transactions. As part of the credit risk management originators engage in synthetic securitisation, inter alia, to manage their large exposure positions and concentration risk. Originators often transfer the junior (first and/or second loss) element of the portfolio's credit risk and retain a senior tranche of the same portfolio. Unlike 'true sale' securitisation, synthetic securitisation does not provide the originator with funding.

Originators may be incentivised to use synthetic rather than 'true sale' securitisation due to the greater flexibility of the synthetic mechanism, which tends to be cheaper and quicker to arrange and allows the originator to side-step the legal, confidentiality-related and operational difficulties that can be incurred in a true sale transaction when effecting the transfer of ownership of the underlying exposures. It should be kept in mind that a special purpose entity is never required for the segregation of the securitised exposures in synthetic transactions; in addition, whereas some funded synthetic transactions set up a special purpose vehicle (SPV) for the issuance of notes (i.e. credit-linked notes), an SPV is not required at all within unfunded synthetic transactions. For these reasons market participants consider synthetic securitisation structures less burdensome and costly from an administrative perspective, as well as less risky from a legal and operational point of view.

Counterparty credit risk potentially arising in the credit protection contract is the only complex structural element that is specific to the synthetic credit risk transfer mechanism.

From a prudential/supervisory view, a key aspect to be considered is the amount of credit risk that is effectively transferred to third parties and whether the regulatory capital relief claimed by the originator is commensurate with, and correctly reflects, that transfer. In the CRR this is dealt with by the 'significant risk transfer' (SRT) rules in Article 244 as well as by the related EBA guidelines[10].

In addition to the SRT issue, it should be kept in mind that synthetic securitisation introduces leverage into the originator's balance sheet. The leverage ratio regulation, introduced with the CRR, is meant to address and mitigate the risk of excessive leverage, including the component of that risk that stems from synthetic securitisation.

The main objective of arbitrage synthetic securitisation (mainly collateralised debt obligations, CDOs – also called collateralised synthetic obligations, CSOs) is one of arbitraging between the (higher) spread received on underlying lower credit quality debt or products indices (such as ITRX, CMBX, ABX) and the (lower) spread paid on the resulting structured and credit-enhanced CDO note. They usually embed extra features such as leverage or foreign currency pay-outs. Arbitrage synthetic securitisations are usually investor- and/or asset manager-driven and are structured to achieve a desired portfolio profile in terms

10 In July 2014, the EBA published guidelines on significant risk transfer for securitisation transactions. The guidelines provide a transparent framework for supervisors, banks and investors for the assessment of significant risk transfer for securitisation transactions and should ensure a more consistent approach across the EU in this area of supervision. These guidelines are in particular helpful in relation to the current deleveraging and de-risking processes in which EU banks have engaged. As mentioned before, credit risk transfer via securitisation facilitates those processes without triggering an excessive contraction of the real economy. The guidelines specify which criteria supervisors should use to assess whether a credit risk transfer is justified, and which requirements institutions should meet to facilitate this assessment. The proposed guidelines seek through these two objectives to ensure that the reduction in capital requirements achieved by banks via the securitisation framework is justified by the transfer of credit risk to third parties.

of the seniority, rating and return desired by investors. Credit institutions usually arrange these transactions after being approached by investors, who choose most conditions, such as names to be included in the portfolio, the tranche subordination and the tranche size.

In some of these transactions credit institutions are not involved as originators, i.e. they do not own the reference exposures, nor are they involved as investors. They are rather hired by asset managers or investors to arrange and tailor-make the transactions. The interest at stake for the arranging credit institution is represented by administration fees. The substantial credit and market risk are borne by the protection buyer and the protection seller that the arranger finds on the market. However, in order to maximise the bespoke and investor-oriented nature of synthetic CDOs, starting from 2003 the market has seen the expansion of the so-called single-tranche synthetic CDOs, whereby an arranger credit institution only sells to an investor a bespoke CDO tranche, typically a mezzanine tranche. The credit institution in this case becomes the credit protection buyer (direct counterparty) in the credit default swap (CDS) contract it is selling to the investor, and hence becomes exposed to the risk of volatility of credit spreads in the portfolio of reference credits (market risk) and to the risk of default of the reference credits. In theory the arranger credit institution should hedge the risks it assumes by becoming the direct counterparty of the mezzanine investor, in particular by selling credit protection (CDSs) on the market, typically by a multiple of the mezzanine tranche's notional (to make sure that leverage is taken into account) and making sure that the positions are dynamically adjusted due to the volatility of reference credit spreads. Historically, though, the structuring of single-tranche synthetic CDOs has instead left credit institutions with substantial open counterparty positions that have led to losses.

In addition, arbitrage synthetic transactions can be managed transactions, i.e. transactions where a portfolio manager is appointed to 'actively' manage the collateral underlying the synthetic CDO. By contrast, balance sheet deals are non-managed transactions and their performance exclusively depends on the performance of the securitised exposures.

The EBA has started engaging in the collection of evidence from major stakeholders of synthetic securitisations, resulting in preliminary evidence on the following issues:

– transactions structured to make profits on assets and liabilities yields (arbitrage synthetics) performed materially worse than synthetics used to transfer the credit risk of loans originated by issuers themselves (balance sheet synthetics);

– synthetics used for off-balance sheet transfer seem to perform equally to or better than 'true sale' securitisation;

– investors buying the transferred risk are mostly non-banks (insurers, pension funds, hedge funds, specialised funds and supranationals/sovereigns); and

– banks mostly enter the market as pure originators and mainly engage in synthetic transactions to obtain capital relief on the retained portions of risk.

The EBA is currently focusing for its advice to the European Commission on the 'originator' role that banks play in the synthetic market and on the capital treatment to be provided for by the CRR of the risk that these banks retain. It is also looking at which criteria of the true sale STS framework need to be amended to ensure a safe and SRT-compatible retention of risk by originator banks, as well as which criteria need to be added in order to mitigate the risks of the credit risk transfer by synthetic securitisations.

As mentioned above the EBA expects to provide its advice on synthetic securitisation by year-end 2015 to the European Commission.

FINAL NOTE

On a final note, it is my firm belief that securitisation should play an important role in the financial system both as a funding and credit risk transfer tool and as a useful piece in the puzzle to solve the sovereign and banking crisis in the EU. It is therefore important that over the next two to three years this tool is implemented in order to achieve this goal.

PANEL 2

EMERGENCY LIQUIDITY ASSISTANCE BETWEEN MONETARY POLICY AND SUPERVISION: NATIONAL CENTRAL BANK OR EUROSYSTEM TASK?

Chiara Zilioli

INTRODUCTION

CHIARA ZILIOLI[1]

During the financial crisis, central banks around the world have provided emergency liquidity assistance (ELA) in amounts and at a frequency never seen before, both to the financial markets via non-conventional measures, and to individual credit institutions, in order to preserve financial stability and thereby also maintain monetary stability. It has become evident that the ELA function of a central bank is, in a crisis, an essential instrument to avoid contagion, supporting the actions of the other authorities having responsibilities for financial stability: only a central bank can act quickly enough to "bridge the liquidity gap", either overcoming the problem or at least enabling the competent resolution authorities to intervene immediately after.

The topic of ELA has therefore come into the spotlight: we have assisted to a move from the traditional "constructive ambiguity" approach, according to which, to avoid moral hazard, the capacity of a central bank to provide liquidity to solvent but illiquid institutions should not even be mentioned, to a more transparent approach[2] and to open discussions of this issue.

However, several issues relating to the concept of ELA itself and its functioning are still the subject of debate, while the scope of ELA is still evolving.

This is why today's panel on ELA is highly topical.

Three issues in particular warrant further legal analysis and will, among others, be discussed in our panel.

First: the fact that the ELA function can only be performed by a central bank, as it is related to its functions of carrying out monetary policy and money creation[3], is not really up for debate. No other authority would have the capacity to commit very high, potentially unlimited, amounts of money in a very short time. However, whether ELA to individual banks is more closely linked to monetary policy, similarly to the liquidity support provided to the financial markets through non-conventional measures, or whether ELA has the main objective of contributing to achieving financial stability, and in that case what the implications for central bank independence and inter-institutional relations with the authorities having

1 Director General Legal Services, European Central Bank. The views expressed herein are those of the author and do not necessarily represent those of the ECB.

2 As an example, see details of the ECB's ELA procedures, at https://www.ecb.europa.eu/mopo/ela/html/index.en.html; and the data of the Bank of England's provision of ELA in 2008-2009, at http://www.bankofengland.co.uk/publications/Documents/news/2012/cr1plenderleith.pdf

3 See Luis Garicano and Rosa Lastra, 'Towards a new Architecture for Financial Stability: Seven Principles', Journal of International Economic Law, Vol. 13, No. 3, September 2010, pp. 597-621: "Only the ultimate supplier of money can provide the necessary stabilizing function in a nationwide scramble for liquidity, as the financial crisis has amply evidenced…".

primary competence to maintain financial stability are, is the first issue which will be tackled today, as it is still open to debate.

In reality, ELA is a crisis-management measure, located in-between the monetary policy and the financial stability functions of a central bank. Its objective is to avoid an institution slipping into an insolvency situation because of a liquidity gap, creating a domino effect resulting in many insolvencies. This would have a serious impact on financial stability and thereby also on monetary stability. Given the links and interaction between financial stability and monetary stability, it is not easy to classify ELA under the monetary (exclusive) competence or the financial stability (shared) competence of a central bank alone. The distinction between broad-based liquidity provision and loans to individual banks also comes into the analysis here[4].

In addition, while the central bank is the sole holder of the monetary power, the responsibility for maintaining financial stability is shared with a number of other authorities (in Europe, both at national and EU levels)[5]. This brings the challenge of coordinating with them, but also of preserving the independence of the decision of a central bank about whether to provide ELA. In Europe, it must be clearly stated that the fact that ELA is an instrument through which the central bank contributes to the work of the competent authorities in achieving financial stability does not impinge on the independence of the ECB: indeed, a decision on ELA is to be taken completely independently by the ECB and cannot be expected, or requested, by the competent authorities, as this would be in direct conflict with Article 130 of the Treaty on the Functioning of the European Union (TFEU).

In the context of coordination with the competent authorities, the relationship with supervisory authorities is particularly important, since ELA can be provided to illiquid but solvent institutions, and it is the responsibility of the supervisor to attest that the institution is solvent (even though the borderline between illiquid and insolvent is particularly delicate, as it depends on whether the institution is a "going concern" or a "gone concern"). Another key relationship is with the resolution authority, since this is the authority that needs to intervene as soon as illiquidity appears to have become insolvency. Paul Fisher will expand on this in his contribution.

4 Xiangmin Liu, in his presentation, considers this distinction to be unimportant, as long as the intervention is undertaken with the goal of containing financial contagion.

5 In the financial stability area, in recent years in the EU we have seen a number of institutional developments in the direction of further harmonisation and institutional Europeanisation: (i) the SSM Regulation, which conferred supervisory tasks on the ECB; (ii) the Single Resolution Fund and the European Stability Mechanism providing direct and indirect bank recapitalisation tools, as a result of which the fiscal backstop for bank recapitalisation and resolution will be progressively centralised at the European level and the responsibility of individual Member States will be reduced; and (iii) the Bank Recovery and Resolution Directive and Single Resolution Mechanism rules relating to recovery and resolution, which will provide a comprehensive framework with which to address situations of distressed credit institutions.

Secondly, the question of the limits of the scope of ELA in today's integrated financial markets arises. Should ELA be provided only to banks, or has broadening its scope to cover non-banks become, in view of the risks for the stability of the financial system if illiquid non-banks lack access to central bank ELA, a requirement? How should we deal with the difficulties that a central bank can face in identifying whether it is appropriate to grant ELA in a specific situation, in particular as regards assessing whether the non-bank is illiquid or insolvent, lacking knowledge of the financial situation of the non-bank?

In principle, none of the central banks which we are looking at today are prohibited by law from extending ELA to non-banks. Since provision of ELA is a discretionary power of the central bank, the assessment of whether the requirements are fulfilled is left to the central bank itself.

The UK Discount Window Facility (DWF) is generally available on demand to banks, broker-dealers, and central counterparties, and in 2014 Mark Carney stated that non-banks should also have access to Bank of England facilities.

As regards the ECB, the second indent of Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank refers to credit operations with 'other market participants': it does not exclude non-banks. Even though at the moment financial institutions other than banks are not counterparties to Eurosystem monetary policy operations, this is not prohibited and one could still imagine that the ECB might decide to extend ELA to non-banks if, for example, it is necessary for the functioning of the monetary policy transmission mechanism. It is worth mentioning, however, that although under the ELA procedures ELA is technically available to "financial institutions", to our knowledge no ELA has been granted by any of the Eurosystem central banks to non-banks.

In the United States, section 13(3) of the Federal Reserve Act permitted the Fed to lend to non-banks "in unusual and exigent circumstances". During the crisis, the Fed relied on its §13(3) authority to provide individual loans and general market liquidity to non-banks. The Dodd-Frank Act amended §13(3) to impose restrictions on the Fed's power as lender of last resort (LOLR) to non-banks: Hal Scott and Tom Baxter will talk to us about that.

Finally, in 2005, the People's Bank of China provided extensive ELA to securities firms and to the Securities Investors Protection Fund.

Therefore, all four central banks have the power to extend ELA to non-banks, even when they do not supervise all the non-banks to which they could lend.

The question becomes one of risk management and scope of competence: on the one hand, it is important to be able to receive appropriate information on the solvency of the non-banks, either from a supervisor or by other appropriate means; on the other hand, it is important that the central bank's action has sufficient links with its monetary policy and financial stability duties, in order to ensure that the central bank is acting within the limits of its powers.

Thirdly, in the specific case of Europe, in particular after the competence to supervise banks was transferred to the EU level and assigned to the ECB, the question of whether ELA can still be considered as a national function to be performed by the national central banks (that now have neither monetary policy nor supervisory competence) deserves attention. If ELA is currently an ECB task, the next question, at least for significant banks, is what is the legal basis for the ECB exercising ELA competence at EU level.

As a brief introduction to this issue, which Christos Gortsos will develop further in his presentation, I would like to mention that the task of providing ELA is not explicitly conferred on the ECB by the Treaty because, at the time of drafting the Maastricht Treaty, to avoid moral hazard no central bank was explicitly assigned the task of providing ELA. At the same time, ELA is universally considered to be a function of a central bank - and there is no doubt that the ECB is a fully-fledged central bank. The ECB has been conferred the exclusive competence to conduct the monetary policy of the euro area. An implied power of such competence is the power to grant, at the discretion of the central bank, ELA support. Moreover, during the crisis, the strong similarity between the nature of ELA to individual institutions and that of the other elements of LOLR which are part of the Eurosystem's standard and non-standard monetary policy measures targeting specific liquidity problems became evident. In addition, it must be mentioned that, in particular in cases where ELA is provided to a significant part of the banking system of certain countries, ELA is an instrument that can be used to prevent impairment of the monetary policy transmission mechanism. These arguments support the statement that the power to provide ELA falls within the scope of the monetary policy competence attributed to the ECB.

However, even if the power to grant ELA is to be exercised at Eurosystem level, this does not mean that the national central banks (NCBs) will no longer be involved: on the basis of the decentralised implementation of monetary policy, counterparties have access to Eurosystem liquidity through the relevant NCB. The role of NCBs in the implementation of ELA will remain crucial, as they will be involved in, for example, the initial request for ELA, the analysis of the causes and severity of the liquidity problem, any additional contractual arrangements, the assessment of collateral, valuation and risk control measures, the preparation of potential funding plans, and discussions on solutions to the requesting bank's liquidity problems.

We are lucky to have on this panel some of the key experts on ELA issues, from both practice and academia, and from all across the world. While Christos Gortsos will focus his analysis on the ECB and the euro area, Hal Scott will undertake a comparative analysis of the ELA powers granted to the Federal Reserve, the Bank of England and the ECB. Tom Baxter and Paul Fisher will comment on these papers and Xiangmin Liu will focus on the Chinese situation. We also have in the audience some other top experts on ELA, such as Rosa Maria Lastra and René Smits. This is a wonderful basis for a great discussion.

LAST RESORT LENDING TO SOLVENT CREDIT INSTITUTIONS IN THE EURO AREA BEFORE AND AFTER THE ESTABLISHMENT OF THE SINGLE SUPERVISORY MECHANISM (SSM)

CHRISTOS V. GORTSOS[1]

1 INTRODUCTORY REMARKS

On 1 January 1999, upon the launch of the European Economic and Monetary Union (**EMU**), a debate opened as to which central bank would operate as lender of last resort to solvent credit institutions in the euro area: the European Central Bank (**ECB**), or the national central banks (**NCBs**) which are members of the Eurosystem. This dilemma was solved with the entry into operation of an emergency liquidity assistance mechanism.

Based on the (doubtful in the author's opinion) premise that there is no sufficient legal basis for the ECB to exercise such a power and having recourse to **Article 14.4 of the Statute** of the European System of Central Banks (**ESCB**) and of the ECB, the NCBs were entrusted with last resort lending, unless the ECB Governing Council found that this would interfere with the objectives and tasks of the ESCB. In relevant communications issued in 2013 and 2014, the ECB published the procedural rules governing the provision of emergency liquidity assistance. These communications are not legally binding texts, but they form the basis for a correct understanding of a mechanism.

Dealing with this issue, this paper is divided into three (3) main sections:

(i) **Section 2** provides a global overview of last resort lending to solvent credit institutions in the euro area, placing particular emphasis on the emergency liquidity assistance mechanism.

(ii) **Section 3** gives a detailed description of the content of the ECB's 2014 communication.

(iii) Finally, **Section 4** contains the author's proposal for a revision of the applicable mechanism, under the catalytic impact of the establishment and entry into operation, as from 4 November 2014, of the Single Supervisory Mechanism in the euro area.

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2 LAST RESORT LENDING TO CREDIT INSTITUTIONS IN THE EURO AREA: A COMPREHENSIVE OVERVIEW

2.1 INTRODUCTORY REMARKS

As just mentioned, when the Eurosystem became fully operational in the EU on 1 January 1999, a question was raised as to who the lender of last resort would be for *individual solvent credit institutions*[2] *established*[3] *in the euro area*[4] if they were to face an exceptional liquidity shortage. Given that neither the Treaty on establishing the European Community (**TEC**)[5] nor the Statute of the ESCB and of the ECB (**Statute**)[6] contained any explicit provisions on last resort lending (and there are also no relevant provisions in the Treaty on the Functioning of the European Union (**TFEU**), in force since 2009),[7] two alternative, diametrically opposed views have been put forward: according to the "decentralised approach", this power should belong to NCBs in the euro area, while according to the "centralised approach", the ECB should be the competent authority, assisted by the NCBs.[8] With regard to this issue the following should be pointed out:

2 The definition of the term "credit institution" is set out in Article 4(1), point (1), of **Regulation (EU) No 575/2013** of the European Parliament and of the Council (OJ L 176, 27.6.2013, pp. 1-337, also known as Capital Requirements Regulation (**CRR**)).

3 In accordance with the provisions of European banking law, a credit institution is deemed to be established in a Member State of the euro area (and, in general, of the EU) which has authorised its operations through its competent supervisory authorities throughout the EU. This member state is called "home Member State" (**CRR**, Article 4(1), point (43)).

4 It is taken for granted that in the Member States with a derogation (**TFEU,** Articles 139-144 and Statute, Articles 42-47), including the United Kingdom and Denmark pursuant to clauses for an opt-out from the monetary union (**Protocols (No 15)** and **(No 16)**, OJ C 326, 26.10.2012, pp. 284-287), the relevant power stayed with their NCBs. Although the matter of ensuring the stability of the banking system concerns the single market as a whole, the question of whether the ECB may act as lender of last resort only concerns the euro area (see **Schoenmaker (2000)**, p. 215).

5 OJ C 321, 29.12.2006, pp. 37-186.

6 This statute was included in **Protocol (No 18)** annexed to the TEC (OJ C 321, 29.12.2006, pp. 256-280), currently **Protocol (No 4)** annexed to the Treaty on the European Union and the Treaty on the Functioning of the European Union (OJ C 326, 26.10.2012, pp. 230-250).

7 OJ C 326, 26.10.2012, pp. 47-200.

8 For an overview of these alternative approaches see **Smits (1997)**, pp. 269-271, **Schoenmaker (1997)**, **Bini Smaghi (2000), Lastra (2000)**, **Padoa-Schioppa (2000)**, **Prati and Schinasi (2000)**, **Schoenmaker (2000)**, and **Lastra and Louis (2013)**, pp. 88-91.

(a) In accordance with the (predominant) traditional approach,[9] last resort lending[10] means the provision (usually exclusively) by the central bank of liquidity to individual solvent[11] credit institutions in exceptional circumstances and on a temporary basis.[12] This power is associated with the functions of central banks given the synergies existing between the provision of liquidity to the banking system, safeguarding the stability of payments systems, and ensuring the stability of the financial system.[13] In this sense, the close relationship between the monetary and financial systems is highlighted.[14]

The terms for exercising the power of central banks to act as lenders of last resort are not usually set out explicitly in statutory, legislative or regulatory

9 This approach is based on the seminal work by **Bagehot**, written back in 1873 (which **Tucker** calls the "classic" Bagehot view, see **(2014)**, p. 16). For more details on the other three alternative approaches (the "free banking school", the "Richmond Fed view" and the "New York view"), see *ibid*., pp. 16-19. For a historical analysis of the role of central banks as lenders of last resort, see **Gorton and Metrick (2013)** and **Bordo (2014)**. For a more detailed account of divergences in the efficiency of last resort lending depending on the structure of the financial system, see the extremely interesting (and quite technical) paper by **Fecht and Tyrell (2004)**.

10 It should be remarked that the same term is also used for the provision of financial support to independent states faced with the financing of public expenditure and public debt refinancing problems. This role is assumed on an international level, by the International Monetary Fund, and on an EU level, by the European Stability Mechanism (**ESM**). Of particular interest in this context is the paper by **Winkler (2014)**, which examines the question of whether the ECB's non-standard monetary policy measures render it a quasi-lender of last resort for euro area Member States. **Domanski, Moessner and Nelson (2014)** use the term "emergency liquidity assistance" (ELA) as equivalent to the term "last resort lending", and indeed to describe all forms of central bank intervention at times of liquidity crisis. The term "ELA" can also be found in Section 2.2 of this study, as it is the standard term used for last resort lending in the euro area.

11 See **Guttentag and Herring (1987)**, pp. 163-165, and **Tucker (2014)**, pp. 19-23. In any event, there are past examples of last resort lending to insolvent credit institutions as well, depending on a central bank's evaluation of the probability of risk for a generalised crisis producing a domino effect across the entire banking system. **Guttentag and Herring (1987**, p. 164) cite relevant examples.

12 Consequently, such liquidity is not provided to the banking system as a whole, as in the case of monetary policy operations. As to whether last resort lending should also be provided to financial undertakings other than credit institutions, see **Tucker (2014)**, pp. 27-28. This question was particularly relevant in the case of the US investment bank *Lehman Brothers* (which was not a credit institution) in September 2008, when the Federal Reserve declined to act as a lender of last resort given that it lacked the statutory authority to do so. See indicatively **Posner (2010)**, pp. 63-67.

13 See **European Central Bank (2007)**, pp. 80-81, and **Central Bank Governance Group (2011)**. As a result, last resort lending is incorporated in the instruments used to safeguard the stability of the banking system. For an overview of the components of this "bank safety net", see **Guttentag and Herring (1986)**, **Demirgüç-Kunt and Huizinga (1999)**, and **Gortsos (2012)**, pp. 90-106.

14 At times of liquidity crisis, as an alternative to the "central bank money solution" (central banks acting as lenders of last resort), there are three other options: financing of a troubled credit institution through coordinated actions of the private banking sector ("private money solution"), intervention of administrative authorities as market-makers of last resort, and non-standard monetary policy measures taken by a central bank (in this case, for the banking system as a whole). See **Padoa-Schioppa (2000)**, pp. 24-26, **Tucker (2014)**, pp. 28-32, **Borio and Disyatat (2009)**, and **Lenza, Pill and Reichlin (2010)**.

provisions.[15] *This is attributed to the fact that, according to the principle of "constructive ambiguity", the central bank must have the highest discretion possible when intervening in the capacity of lender of last resort, in order to be in a position to appropriately weigh the risks and act accordingly to each case.*[16]

(b) In the event of a generalised crisis in the euro area which would affect the liquidity position of every credit institution operating in the euro area, the theory is unanimous on arguing that an ECB intervention should be performed by means of monetary policy operations, including *in extremis* non-standard ones too.[17] This is what happened in reality during the recent (2007-2009) international financial crisis[18] but also during the ongoing fiscal crisis in the euro area.[19]

(c) Apart from the fact that last resort lending should, in principle, only be provided to solvent credit institutions, lending to insolvent credit institutions also stumbles on the provisions regarding the (in principle) prohibition of state aid[20] under **Articles 107-108 TFEU**.[21] Furthermore, lending to credit institutions may not go against the provisions of **Article 123 TFEU** which prohibit monetary government financing.[22]

15 A different issue is related with the fact that certain central banks have a statutory authority to act as lenders of last resort. In any event, this is not the case with the ECB (see Section 4 below).

16 According to **Herring and Littan (1995)**, pp. 126-131, the "constructive ambiguity" policy has significant negative side-effects, as it leads in reality to unequal treatment of large (usually systemically important) and small credit institutions. For a detailed overview of this issue, and notably whether constructive ambiguity is necessary or not ("explicit last resort lending function"), see **Guttentag and Herring (1987)**, pp. 167-172.

17 See indicatively **Padoa-Schioppa (2000)**, p. 28, **Lastra (2000)**, p. 205, and **Schoenmaker (2000)**, pp. 218-219.

18 For more details on non-standard monetary policy operations used by central banks during this crisis, see **Borio and Disyatat (2009), Lenza, Pill and Reichlin (2010)**, **European Central Bank (2010)**, and **Domanski, Moessner and Nelson (2014)**, pp. 48-61.

19 See **European Central Bank (2014a)**, pp. 21-23, **European Parliament (2014)**, and **European Central Bank (2015)**.

20 See **Smits (1997)**, pp. 270-271, and **Lastra (2000)**, pp. 207-208.

21 On the compliance of last resort lending with EU state aid rules, see **Lastra (2015)**, pp. 380-382.

22 **European Central Bank (2007)**, p. 80. In this case, monetary government financing may be affected indirectly if the credit institution uses the liquidity provided to buy government securities. Indirect monetary financing may also be affected if a credit institution is insolvent, given that the central bank enters in such a case into government activities (which it is in any event not allowed to undertake), releasing the government from any expenditure incurred as a result of capital injections to the credit institution.

2.2 THE EMERGENCY LIQUIDITY ASSISTANCE ("ELA") MECHANISM

(a) On the occasion of the onset in 2010 of the ongoing fiscal crisis in the euro area[23] and its negative impact on the banking system of several Member States, last resort lending to credit institutions established in euro area member states was repeatedly activated: in the 2010-2013 period, in turn by Ireland, Greece, and Cyprus, in 2014, by Portugal, and lately (2015) again by Greece. This mechanism is called Emergency Liquidity Assistance (**ELA**), and it is activated by NCB-members of the Eurosystem rather than the ECB.[24]

(b) The procedural arrangements governing the provision of such liquidity had already been laid down on 1 January 1999, although they were not made public.[25] On 17 October 2013, however, the ECB's Governing Council (**GC**) decided to make them public by issuing a relevant communication.[26]

On 19 February 2014, the ECB's GC approved certain, technical, specifications on the procedures described above. The content of the ECB's communication, which is analysed below (under 3), also includes these technical specifications (**ECB communication (2014)**).[27] It should be pointed out, however, that this communication does not constitute a legal act of the ECB, and it is not legally binding, but merely registers the ECB's procedural practices.[28]

The procedures referred to in this communication relate to the actions necessitated by the ECB's GC, and data to be provided to, in order for it to be in a position to assess, pursuant to **Article 14.4 of the Statute**, whether the provision of emergency liquidity by NCBs to individual credit institutions interferes with the objectives and tasks of the Eurosystem. This Article provides the following: *"National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB."*[29]

23 The author prefers the term "fiscal crisis" over the more commonly used term "debt crisis", as he is of the view that this crisis is based on the fact that the euro area Member States exceeded the reference values laid down in the TFEU **(Article 126)** and in **Protocol (No 12)** annexed to the Treaties with regard to the ratio of the (planned or actual) government deficit to gross domestic product at market prices (3%). Of course, in certain Member States, led by Greece, this crisis has also evolved into a debt crisis (for more details on this, see **Kazakos (2014)**). For an evaluation of the causes of this crisis, see indicatively **Athanassiou (2011)**, **Caminal (2012)**, **Avgouleas and Arner (2013)**, **de Grauwe (2013)**, and **Hadjiemmanuil (2015)**, pp. 6-10.

24 For a brief presentation and critical evaluation of ELA, see also **Papadia (2014)**.

25 The sole reference of the ECB to the ELA mechanism until the issuance of this communication in 2013 can be found in **European Central Bank (2007)**.

26 This communication is available at: http://www.ecb.europa.eu/pub/pdf/other/elaprocedures.el.pdf.

27 **European Central Bank (2014b)**.

28 On the ECB's legal acts, see **Smits (1997)**, pp. 102-106, **Scheller (2006)**, pp. 68-70, and **Louis (2009)**, pp. 200-211.

29 This Article is analysed in **Smits (1997)**, pp. 99-101.

3 THE CONTENT OF THE ECB'S ELA COMMUNICATION (2014): A DETAILED PRESENTATION

3.1 DEFINITION OF THE TERM "EMERGENCY LIQUIDITY ASSISTANCE"

(a) Credit institutions established in euro area Member States may draw liquidity from central banks in two (2) alternative ways: either, as a rule, in the context of monetary policy operations,[30] or, in exceptional circumstances, via the emergency liquidity assistance.[31] The **ECB communication (2014)** provides that emergency liquidity assistance (ELA) means the provision by a NCB-member of the Eurosystem to a solvent "financial institution" or a "group of solvent financial institutions" faced with temporary liquidity problems of central bank money, and/or any other form of assistance which may result in an increase in central bank money.[32]

Solvency is assessed by the authority competent for microprudential supervision. As of 4 November 2014, the competent authority for the euro area is either the ECB itself, (mainly) for "significant" credit institutions, or the national competent authorities,[33] for "less significant" credit institutions.[34]

(b) The provision of such assistance is not considered to be part of the single monetary policy in the euro area.[35] In both cases, the central bank provides liquidity to the banking system, but in the case of monetary policy actions the objective is not to ensure the stability of the financial system but (primarily or secondarily) to maintain price stability;[36] the liquidity granted is not of an emergency nature, rather it is permanent, and the liquidity is provided to the banking system as a whole rather than to individual credit institutions.

Of course, the provision of emergency liquidity assistance has an impact on total liquidity in an economy, but the ECB has the ability to sterilise this impact through appropriate monetary policy operations:[37] *"the impact of an ELA intervention on aggregate liquidity conditions in the euro area can be managed*

30 On the Eurosystem's monetary policy operations, see **European Central Bank (2011)**, pp. 93-115, **European Central Bank (2014)**, pp. 18-30, and the ECB's website on the latest developments on the Eurosystem's monetary policy (http://www.ecb.europa.eu/mopo/html/index.en.html).

31 **ECB communication (2014)**, first paragraph.

32 **ECB communication (2014)**, second paragraph, first sentence. It is noted that the terms "credit institutions" and "financial institutions" are used alternately and not in a consistent manner. This is not compatible with the provisions of European banking law (CRR), according to which financial institutions are defined as precluding credit institutions.

33 The definition of the term "competent authority" is provided in Article 4(1), point (40) **CRR**.

34 See below, **under 4.1 (b)**.

35 **ECB communication (2014)**, second paragraph, first sentence, *in finem*.

36 For a look into the differences between these two key objectives of central banks, see **Central Bank Governance Group (2009)**, pp. 21-28.

37 By means of a "sterilised intervention", central banks conduct appropriate open market operations (which are a key instrument for the implementation of monetary policy) in order to ensure that the provision of emergency liquidity assistance does not have an impact on the monetary basis and money supply, and does not affect its monetary policy strategy.

in a manner consistent with the maintenance of the appropriate single monetary policy stance."[38]

(c) Despite the fact that the ECB's communication makes no specific reference to this, the provision of liquidity assistance should, in principle, be made on a temporary basis, in order on the one hand to justify its "emergency" nature and, on the other hand, not to put into question the credit institution's solvency.

3.2 ALLOCATION OF TASKS BETWEEN THE NATIONAL CENTRAL BANKS AND THE ECB

(a) Emergency liquidity assistance is provided under the responsibility of the interested NCB.[39] As a result:

(i) The provision of such assistance is at the sole discretion of NCBs, on condition of course that the ECB has not prohibited it (see below, under point (b)). It is indicatively provided for that: *"A credit institution cannot (...) assume automatic access to central bank liquidity. As a central banking function, the provision of ELA is within the discretion of the national central bank, which will consider the relevant factors that may justify the access to this lending of last resort. Specifically, the provision of ELA may be justified to prevent or mitigate potential systemic effects on financial institutions, including repercussions for market infrastructure such as the disruption of payment and settlement systems."*[40] Hence, it is not the ECB itself that provides emergency liquidity assistance. The dilemma about the lender of last resort in the euro area is hence resolved (at least thus far[41]).

(ii) The interested NCB incurs the cost and risks that may arise from the provision of such emergency liquidity assistance.[42] In practice, this means that relevant funds appear on its balance sheet[43] and any relevant losses are debited to its financial results.

In any event, pursuant to Article 26.3 of its Statute*, the ECB's Executive Board draws up, for analytical and operational purposes, a consolidated balance sheet of the ESCB, comprising those assets and liabilities of the NCBs that fall*

38 **European Central Bank (2007)**, p. 81.
39 **ECB communication (2014)**, second paragraph, second sentence. Accoding to an ECB communication on ELA of 16 September 2015, the GC decided that NCBs may from that date communicate publicly about the provision of ELA to the credit institutions in their country if they deem it necessary. This communication is available at: http://www.ecb.europa.eu/press/pr/date/ 2015/html/pr150916.en. html.
40 **European Central Bank (2007)**, p. 80.
41 See also below, **under 4.2**.
42 **ECB communication (2014)**, second paragraph, third sentence.
43 It is common practice that a NCB borrows its funds from other NCBs within the Eurosystem.

within the ESCB.[44] *In addition, on the legal basis (nainly) of* Article 26.4 of its Statute*, the ECB adopted* Guideline ECB/2010/20 *"on the legal framework for accounting and financial reporting in the European System of Central Banks",*[45] *requiring the elaboration of a consolidated balance sheet of the ESCB. From 2015 the consolidated balance sheet of the Eurosystem will be published together with the ECB's Annual Accounts. In this Eurosystem's consolidated balance sheet, ELA features on the assets side under item 6 entitled "Other claims on euro area credit institutions".*

(b) However, on the basis of Article 14.4 of the Statute, the GC is authorised to prevent emergency liquidity assistance operations if it deems that such operations "interfere with the objectives and tasks of the ESCB".

The Eurosystem's objectives are laid down in Article 127(1) TFEU*, its primary objective being the maintenance of price stability. Its tasks are divided into the "basic tasks" (which are laid down in* Article 127(2) TFEU*), "other tasks" (featuring in various other articles of the* TFEU *(*Article 127(5) *regarding the ESCB's contribution to ensuring the stability of the financial system*[46]*) and* Article 128 *regarding the right to authorise the issue of euro banknotes within the Union), and in the Statute's articles (i.e.,* Article 5 *on the compilation of statistical data), and the "specific tasks" set out in* Article 127(6) TFEU.[47]

In this case, the GC decides with a qualified majority of two thirds (2/3) of the votes.[48] In order to do so, however, the GC must be informed of emergency liquidity assistance operations in a timely manner in order to adequately assess whether such interference is given.[49]

(c) The relevant procedures, laid down for the first time in 1999,[50] are aimed at adequately ensuring the performance of the GC's role pursuant to **Article 14.4 of the Statute**,[51] and are governed by two principles:[52] they are binding for all NCBs,[53] and their adequacy is reviewed at regular intervals (potentially leading to their revision).

44 This Article also applies to Member States with a derogation (under **Articles 42.1 and 42.4** of the Statute), including Denmark and the United Kingdom, and does not only concern the Eurosystem.

45 OJ L 35, 9.2.2011, pp. 31-68.

46 See also below, **under 4.2.3**.

47 On all these tasks see **Smits (1997)**, pp. 193-221 and 355-360, **Hadjiemmanuil (2006)**, pp. 824-825, **Louis (2009)**, pp. 152-173, and **Lastra and Louis (2013)**, pp. 79-95.

48 **Decision 2003/223/EC** of the Council, meeting in the composition of the Heads of State or Government of 21 March 2003 "on an amendment to Article 10.2 of the Statute" (OJ L 83, 1.4.2003, pp. 66-68). The legal basis was Article 10.6 (currently Article 40.2) of the Statute.

49 **ECB communication (2014)**, third paragraph.

50 See above, **under 2.2 (b)**.

51 **ECB communication (2014)**, ninth paragraph, first sentence.

52 *Ibid*., ninth paragraph, second sentence.

53 In this instance, a national central bank is not acting as an integral part of the ESCB, pursuant to **Article 14.3 of the Statute**, given that Article 14.4 precludes such an eventuality.

3.3 THE PROCEDURAL ARRANGEMENTS

(a) As a rule, NCBs must inform the ECB of the details of any ELA operation, at the latest, within two (2) business days after the operation was carried out. This information needs to include, at least, the following nine (9) elements:

(i) The counterparty to which ELA has been or will be provided.

(ii) The value date and maturity date of ELA that has been or will be provided.

(iii) The volume of ELA that has been or will be provided.

(iv) The currency in which ELA has been or will be provided (thus far provided exclusively in euro).

(v) The collateral and/or guarantees against which ELA has been or will be provided, including the valuation of, and any haircuts applied to, the collateral provided, and where applicable, details on the guarantee provided and the terms of any contractual safeguards. [54]

(vi) The "interest rate to be paid" by the counterparty[55] on ELA that has been or will be provided.[56]

(vii) The specific reason(s) for which ELA has been or will be provided (i.e. margin calls or, mainly, deposit outflows).[57]

54 This is fully consistent with theory (see on this **Tucker (2014)**, pp. 26-27). As a rule, collateral provided in such cases by counterparty credit institutions includes assets (securities) that are not eligible, given their low credit rating, in the context of open market operations (as part of a central bank's conduct of monetary policy). Although ELA is granted at particularly high rates or against elevated levels of collateral, it is worth pointing out that, in the first stages of the fiscal crisis in the euro area, demand for emergency liquidity assistance was so strong that credit institutions exposed to (not only) liquidity risk were often not in a position to provide collateral of sufficient quality. A case in point is the Central Bank of Ireland, which granted short-term emergency loans to such institutions guaranteed by itself. On this, see **Sinn and Wollmershäuser (2011)**.

55 This wording is not precise, since interest rates are set and it is the interest that is paid.

56 According to theory, last resort lending should be provided at a rate higher than that of monetary policy operations (see on this **Tucker (2014)**, pp. 23-24, directly citing **Bagehot (1873)**). The reasoning behind this is based on the premise that this rate should be of a punitive nature and, thus, act in a way to discourage credit institutions. But in reality it is mainly to do with the preceding remark about the (lower) quality of the collateral provided, which is not eligible for any other use (not only in a priori assessments).

57 Deposit outflows, even if they do not reach excessive levels (bank run-panic), are by definition the main legal basis. Liquidity problems may also ensue from a crisis in the interbank market rendering it impossible to raise capital on this market (a case in point is the interbank market crisis in 2008 as a result of the recent (2007-2009) international financial crisis), or the inability to service debt instruments issued by a credit institution as they fall due, mainly if this form of funding (on capital markets) is rather substantial (such as, e.g., in the case of Ireland and Spain, also during the recent (2007-2009) international financial crisis). For more on the funding (or liability) liquidity risk and various relevant measurement, management and microprudential regulation measures, see **Basel Committee on Banking Supervision (2008)**.

(viii) The prudential supervisor's assessment, over the short and medium term, of the liquidity position and solvency of the institution receiving the ELA, including the criteria used to come to a positive conclusion with respect to solvency.

It should be noted that in a press release dated 21 March 2013,[58] *the ECB made public a GC decision on emergency liquidity assistance to credit institutions in Cyprus,*[59] *which provided that after 25 March 2013 the ELA could only be considered if an EU/IMF programme was in place ensuring the solvency of the credit institutions concerned.*[60] *This did not constitute, in the author's view, a precedent for future decisions of the ECB, given that the specificities of each individual case are always taken into account.*

(ix) Finally, where relevant, an assessment of the cross-border dimensions and/or the potential systemic implications of the situation that has made the extension of ELA necessary.[61]

(b) Ex post information has to be provided on all the above-mentioned cases, to the extent that this information has not already been provided ex ante. Any information provided needs to be updated daily, if it has changed in comparison with the previous day.

Moreover, in specific cases if this is deemed necessary, the GC can decide to request additional information from the respective NCB, in oder to broaden the information/ reporting requirements and/or make them more stringent.[62]

(c) Depending on the volume of the ELA operations envisaged for a given financial institution or given group of financial institutions, the following applies:

(i) In the event of the overall volume exceeding a threshold of €500 million, the NCB(s) involved must inform the ECB as early as possible prior to the extension of the intended assistance.

(ii) Conversely, in the event of the overall volume of the ELA operations envisaged for a given financial institution or given group of financial institutions exceeding a threshold of €2 billion, the GC must consider whether there is a risk that the ELA involved may interfere with the objectives and tasks of the Eurosystem. Upon the request of the NCB(s) concerned, however, the GC may decide to set a threshold and not to object to intended ELA operations that are below that threshold and are conducted within a prespecified short period of time (usually one to two

58 This is available at: http://www.ecb.europa.eu/press/pr/date/2013/html/pr130321.en.html.
59 For a more detailed analysis of the 2014 banking crisis in Cyprus and the activation of the ELA mechanism, see **Orphanides (2014)** and **Zenios (2014)**, pp. 8-11.
60 This was confirmed in the last paragraph of the ECB press release published on 25 March 2013 (available at: http://www.ecb.europa.eu/press/pr/date/2013/html/ pr130325.en.html).
61 **ECB communication (2014)**, fourth paragraph.
62 *Ibid*., fifth paragraph.

weeks). This threshold may refer to several financial institutions and/or several groups of financial institutions at the same time.[63]

At least three (3) business days before the GC meeting at which the request is to be considered, the NCB must provide the following information:[64]

(i) All available *ex ante* information on the elements listed under point (i) above, under the conditions set out therein. Where the threshold refers to several financial institutions or several groups of financial institutions at the same time, the information should be provided on a bank-by-bank basis.

(ii) A projection – covering, in principle, the period up to the next regular GC meeting – of the funding gap for each individual bank that is to receive ELA on the basis of two scenarios: the expected scenario, and the stress scenario.

4 A MODEST PROPOSAL FOR THE REVISION OF THE EXISTING ELA MECHANISM

4.1 THE ESTABLISHMENT OF THE SINGLE SUPERVISORY MECHANISM AS A CATALYST FOR THE ELA MECHANISM'S REVISION

(a) A major breakthrough in the institutional framework governing the operation of the European banking system was achieved with the entry into operation on 4 November 2014 of the Single Supervisory Mechanism (SSM). This mechanism was established pursuant to **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"[65] (**SSMR**), on the basis of **Article 127(6) TFEU**. The adoption of this Regulation was a significant leap in the course towards the institutionalisation of the European Banking Union (**EBU**).[66]

(b) The institutional and regulatory framework adopted under the SSMR contains six (6) main elements, which reflect specific policy choices. In this context, it was decided, inter alia, to confer specific tasks on the ECB concerning the microprudential supervision of credit institutions and certain categories of

63 *Ibid*., seventh paragraph.
64 *Ibid*., eighth paragraph.
65 OJ L 287, 29.10.2013, pp. 63-89. Its "twin" **Regulation (EU) No 1022/2013** of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 "(...) as regards the conferral of specific tasks on the European Central Bank (...)" (OJ L 287, 29.10.2013, pp. 5-14) was adopted one week later. On the provisions of this Regulation and the relationship between the ECB and the EBA see **Wymeersch (2014)**, pp. 70-72, and **Gortsos (2015a)**, pp. 66-71.
66 On the EBU and in particular on the SSM see indicatively **Alexander (2015)**, **Ferran and Babis (2013)**, **Ferrarini and Chiarella (2013)**, **Brescia Morra (2014)**, **Wymeersch (2014)**, **Binder (2015)**, **Lastra (2015)**, pp. 361-366, and in detail **Gortsos (2015a)**. For a compendium of all legal acts pertaining to the SSM (and the SRM) see **Binder and Gortsos (2015)**.

holding companies, principally those seated in euro area Member States,[67] by transferring these tasks from national competent (supervisory) authorities,[68] to determine each of the specific (supervisory) tasks conferred on the ECB,[69] and to create the SSM for the performance of the specific tasks conferred on the ECB.[70]

The ECB (assisted by national supervisory authorities within the SSM) carries out direct microprudential supervision over credit institutions that are considered "significant" on the basis of specific criteria, unless "particular circumstances" justify their supervision by national competent authorities.[71] In addition, if deemed necessary to ensure consistent application of high supervisory standards, the ECB may at any time, on its own initiative after consulting with national competent authorities or upon request by a national competent authority, decide to exercise directly itself all the relevant powers for one or more "less significant" credit institutions.[72]

4.2 A PROPOSAL FOR DIFFERENTIATION ACCORDING TO THE SIGNIFICANCE OF CREDIT INSTITUTIONS

4.2.1 The criterion

Until the entry into operation of the SSM, the question of which central bank would act as lender of last resort for solvent credit institutions in the euro area was, of course, quite complicated. This was mainly due to the fact that monetary policy, on the one hand, was (and still is) implemented at supranational level by the ECB, while microprudential banking supervision, on the other, was exclusively carried out at national level (either by NCBs or by independent administrative authorities).[73] The entry into operation of this mechanism, however, places this question on new ground. In this vein, it is appropriate to look into the scope for differentiation on the basis of the significance of credit institutions exposed to liquidity risk.[74] In particular:

(a) Less significant credit institutions, which in principle remain under the direct microprudential supervision of national competent authorities, should reasonably continue to have access to the ELA mechanism, as currently in force.

67 Upon its own initiative a Member State with a derogation (including Denmark and the United Kingdom) may request, at its own discretion, to enter into a close cooperation with the ECB in relation to the exercise by the SSM of these microprudential supervisory tasks with regard to credit institutions established in the given Member State's territory (**SSMR**, Article 7, see **Gortsos (2015a)**, pp. 183-193).
68 **SSMR**, Article 1 (see **Gortsos (2015a)**, pp. 47-49).
69 *Ibid.*, Articles 4-5 (see **Gortsos (2015a)**, pp. 140-163).
70 *Ibid.*, Article 6(1)-(3) (see **Gortsos (2015a)**, pp. 167-171).
71 *Ibid.*, Article 6(4), sub-paragraphs (b)-(e) (see **Gortsos (2015a)**, pp. 113-117 and 171-177).
72 *Ibid.*, Article 6(5), sub-paragraph (b) (see **Gortsos (2015a)**, pp. 178-183).
73 For an overview see **Gortsos (2015a)**, pp. 93-94.
74 The need for a differentiation depending on the "systemic significance at European level" of credit institutions has been pointed out in **Schoenmaker (2000)**, p. 221, with reference to **Prati and Schinasi (2000)**, well before the recent institutional developments.

(b) On the contrary, as regards significant credit institutions which are now under the direct microprudential supervision of the ECB, the eventuality of the ECB acting as a lender of last resort gains particular importance.[75]

4.2.2 The advisability of the ECB's acting as a lender of last resort for significant credit institutions

(a) As regards the *advisability* of the ECB's acting as lender of last resort for significant credit institutions, conditions have changed. The arguments in favour of this power remaining with NCBs for as long as the conduct of other policies aimed at safeguarding the stability of the European banking system is decentralised have been weakened.[76] This is not only true because their microprudential supervision has mainly (with regard to the specific tasks laid down in **Articles 4-5 SSMR**) been transferred to an EU level, but also because the same will apply to the resolution of such credit institutions, with the establishment of the Single Resolution Mechanism (**SRM**)[77] and the Single Resolution Fund (**SRF**),[78] very probably from 1 January 2016.[79]

(b) A point of concern in this context is potential conflicts of interest within the ECB arising from its function as monetary authority *and lender of last resort*, on the one hand, and banking supervisor on the other (this applies to central banks in general[80]). Apart from any burden-sharing considerations, which are outside the scope of this study,[81] it should be noted that this point of concern has been addressed in Article 25 SSMR with the creation of

75 If the proposal below was adopted, it would obviously also apply to the less significant credit institutions that the ECB decides to subject to its direct microprudential supervision, and to credit institutions in Member States which establish a close cooperation procedure with the ECB.

76 For an overview of these arguments see **Schoenmaker (2000)**, pp. 219-220.

77 This is governed by **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 (...)" (**SRMR**) (OJ L 225, 30.7.2014, pp. 1-90). The single rulebook governing resolution is laid down in **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 (...)" (**BRRD**) (OJ L 173, 12.6.2014, pp. 190-348).

78 This is governed by the **Intergovernmental Agreement (No 8457/2014)** of 21 May 2014, signed by twenty-six (26) Member States (i.e. with the exception of the United Kingdom and Sweden) "on the transfer and mutualisation of contributions to the Single Resolution Fund" (**SRF Agreement**) (its text is available at: http://register.consilium.europa.eu/doc/srv?l=EN&f=ST% 208457%202014%20INIT). On the SRM and the SRF see, by way of an indication only, **Louis (2014)**, **Alexander (2015)**, **Wiggins, Wedow and Metrick (2015)**, and **Gortsos (2015b)**, with extensive further references.

79 On the date of application of the SRMR's provisions, see Article 99 (in particular 99(2) and 99(6)).

80 See indicatively **Goodhart and Schoenmaker (1993)**.

81 On this aspect, **Lastra and Louis (2013**, pp. 90-91**)** state: *"(...) if the ECB makes losses it will be for the NCBs and, indirectly, their respective States to come and help. (...) The ECB faces a particular problem in that there is not one government but seventeen governments (note: today nineteen) standing behind and that therefore losses on LOLR loans (if the situation turns out to be of insolvency not illiquidity) will ultimately be borne by the (...) Member States under the current institutional setting. No doubt the LOLR role tests the limits of the mandate of the ECB in the pursuit of its objectives and hence the ambiguity that surrounds the provision of ELA."*

"Chinese walls" between the ECB's monetary and supervisory functions.[82] It is expected that these would also apply if the ECB were to assume the power of the lender of last resort.

(c) As a result, there are stronger arguments in favour of the ECB acting as lender of last resort for significant credit institutions short of liquidity established in euro area Member States. Such an approach is fully consistent with the fact that several components of the bank safety net, used with a view to safeguarding the stability of the European banking system, have already been "Europeanised". This applies to:

- the authorisation and the withdrawal of authorisation of credit institutions (both significant and less significant),[83]
- the macroprudential oversight of the European financial system by the European Systemic Risk Board (ESRB),[84] with regard to which specific tasks have been conferred on the ECB,[85]
- the microprudential supervision of (at least) significant credit institutions with regard to the specific tasks conferred on the ECB,[86]
- the adoption of recovery plans for and early intervention in (at least) significant credit institutions,[87]
- the recapitalisation of systemically important credit institutions directly by the ESM under the Direct Recapitalisation Instrument (DRI),[88] which was adopted by means of a unanimous Resolution of the ESM Board of Governors,[89] and governed by a detailed Guideline,[90] and

82 This article is analysed in **Gortsos (2015a)**, pp. 124-136.
83 **SSMR**, Article 4(1), point (a), with reference to Article 14.
84 **Regulation (EU) No 1092/2010** of the European Parliament and of the Council of 24 November 2010 "on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board" (OJ L 331, 15.12.2010, pp. 1-11). This is the first component of the bank safety net that has been Europeanised (since 2011) and the only one which applies throughout the EU and not merely to the euro area.
85 **Council Regulation (EU) No 1096/2010** of 17 November 2010 "conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board" (OJ L 331, 15.12.2010, pp. 162-164). The legal basis for this Regulation is the enabling clause of **Article 127(6) TFEU**, which was activated for the first time in this case. On both these Regulations, see **Ferran and Alexander (2011)**, as well as **Papathanassiou and Zarouras (2012)**.
86 See above, under **4.1.2 (b)**.
87 **SSMR**, Article 4(1), point (i).
88 This aspect has not been fully Europeanised, since recapitalisation by national governments and indirectly by the ESM are still available. On the DRI, see details in **Gortsos (2015a)**, pp. 29-32, **Hadjiemmanuil (2015)**, pp. 29-34, **Vovolinis (2015)**.
89 This Resolution is available at: http://www.esm.europa.eu/pdf/Establishment%20of%20 the%20 instrument%20for%20the%20direct%20recapitalisation%20of%20insti%20.pdf.
90 This Guideline is available at: http://www.esm.europa.eu/pdf/20141208%20 Guideline%20 on% 20Financial%20Assistance%20for%20the%20Direct%20Recapitalisation%20of%20 Institutions.pdf.

- the drawing up and adoption of resolution plans, the assessment of resolvability and the resolution of (at least) significant credit institutions (the latter, in 2016).[91]

Accordingly, the author argues that the ECB's acting as lender of last resort for significant credit institutions is one of the necessary elements of a complete EBU.[92] The same holds true for the (still pending) Europeanisation of deposit guarantee schemes,[93] and proceedings for the winding-up of credit institutions, which stumbles on the significant differences of judicial systems across Member States.[94]

Taking into account the above, the conclusion is drawn that, even within the euro area and even with regard to significant credit institutions, the bank safety net is still only partly Europeanised (for a summary, see Table 1*).*

(d) As to the sequence of potential further developments, in the author's opinion the establishment of a "European Deposit Insurance Scheme" (EDIS)[95] is not a precondition for the ECB to assume direct responsibilities with regard to ELA. Deposit guarantee schemes are activated in the (rare in the EU environment) cases where the relevant administrative authorities make the determination that a credit institution's deposits have become "unavailable",[96] leading to the withdrawal of its authorisation (by the ECB) and its winding up by national administrative or judicial authorities (without resolution).[97] Their activation is a consequence of a credit institution's insolvency.

The activation of ELA, on the other hand, is linked to credit institutions' liquidity problems. Accordingly, the two policy instruments are dealing in principle with different types of crises, which are *not necessarily* linked. Hence, the decision

91 **SRMR**, Articles 8, 10 and 14-29, respectively.

92 See **Gortsos (2015a),** p. 29, and **Brescia Morra (2014)**, citing **De Grauwe (2013)**. See also **Lastra (2015)**, p. 378, and **Lastra and Goodhart (2015)**, p. 16, arguing that there is a *"missing fourth pillar of the banking union"*.

93 Deposit guarantee schemes are governed since 3 July 2015 by **Directive 2014/49/EU** of the European Parliament and of the Council "on deposit guarantee schemes" (OJ L 173, 12.6.2014, pp. 149-178). This Directive is analysed in **Gortsos (2014)**.

94 This aspect is governed by **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, pp. 15-23), as in force. On this Directive, see **Wessels (2006)**.

95 The prospect of creating a "European Deposit Insurance Scheme" ("EDIS") is laid down in the recent (22 June 2015) study by European Commission President Jean-Claude Juncker entitled: "Completing Europe's Economic and Monetary Union", and included in the proposals on the creation of a "Financial Union" (available at: http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en. pdf.

96 **Directive 2014/49/EU**, Articles 2(1), point (8), and 3(2), second sub-paragraph (see **Gortsos (2014)**, pp. 125-126).

97 As the author states in **Gortsos (2015a)**, p. 303, with reference to **Hadjiemmanuil (2015)**, p. 23, financial stability purposes will continue, in most cases, to preclude winding up an insolvent credit institution (especially a large one) under normal insolvency proceedings, despite the fact that, in principle, both the SRMR and the BRRD highlight the "exceptional" nature of resolution actions, irrespective of the institution's size and/or interconnectedness.

to elevate ELA to the ECB level could well be taken independently from the decision to create the EDIS.

4.2.3 The feasibility of the ECB's acting as a lender of last resort for significant credit institutions

The crucial point is still the legal basis (*i.e.* the *feasibility* of the ECB's acting as lender of last resort). The argument that the ECB may not intervene as lender of last resort in the euro area for lack of an *explicit* relevant provision in the TFEU and the Statute, is contestable for the reasons stated below.

4.2.3.1 On the financial stability mandate

With regard to the ECB's financial stability mandate, the following should be noted:

(a) There is no doubt that the primary objective of the ESCB is, according to Article 127(1), first sentence TFEU, to maintain price stability.[98] It is also true that this Article does not make any explicit reference to financial stability.

(b) On the other hand, Article 127(5) TFEU governing the ESCB's contribution to ensuring the stability of the financial system has a major shortcoming, since (literally) it only refers to the division of relevant competences between the ECB (mainly submission of opinions) and the national competent (supervisory) authority.[99]

(c) Finally, **Article 127(6) TFEU**, the legal basis of both the SSM and the ECB's involvement in the macroprudential oversight of the financial system in accordance with Regulation (EU) No 1096/2010 in the context of the ESRB,[100] can also not be taken into account, since its reach is confined, as already mentioned, to the specific tasks concerning policies relating to the *(micro)prudential supervision* of credit institutions.

98 On this TFEU Article (*ex* Article 105(1) TEC) see **Smits (1997)**, pp. 184-187, and **Louis (2009)**.

99 See **Lastra and Louis (2013)**, p. 79, and **Lastra (2015)**, p. 254. On the content and scope of application of this Article (*ex* Article 105(5) TEC, carried over *verbatim* in **Article 3.3 of the Statute**), see **Smits (1997)**, pp. 338-355.

100 See above, **under 4.2.2**.

Accordingly, **Article 127 TFEU** does not provide a solid legal basis for a general financial stability mandate.[101] Nevertheless, the ECB's heavy involvement during the recent (2007-2009) international financial crisis as well as the current euro area fiscal crisis has rendered the preservation of the financial system's stability, the underlying reason for providing last resort lending and a *conditio sine qua non* for the smooth functioning of the internal market, a *de facto* major objective. It is not convincing that during these crises the ECB could act in the way it has acted, even in the absence of a clear financial stability mandate, and then resort to the lack of mandate as a justification for its inability to act as lender of last resort, given that the latter is just one aspect of the arsenal for maintaining financial stability. This line of argumentation lacks consistency.

In any case, the author notes a comment made by Lastra and Goodhart (2015*, p. 16*)*: "Is it appropriate to keep such arrangement [i.e. the current ELA] in place when de facto, only the ECB can provide emergency assistance to the institutions that it now supervises? Moreover, when no treaty amendment is needed to establish the missing fourth pillar of banking union, but merely a change in interpretation, is it practical to follow the existing practice?"*

4.2.3.2 On the appropriate instruments to be used

(a) The author supports the view that **Article 18.1, second indent, of the Statute** (even broadly interpreted[102]) may serve as a solid legal basis as regards the instruments to be used.[103] This Article reads as follows: *"In order to* achieve the objectives of the ESCB and to carry out its tasks, the ECB and the nati*onal central banks may (...) conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral"*.[104]

According to **Smits (1997)**: *"The absence of lender-of-last-resort (LOLR) support from the text of the ESCB Statute does not make the authority of the ECB*

101 *In extremis*, a legal premise for this financial stability objective, as regards the provision of last resort lending by the ECB, could potentially be found in **Article 127(1), second sentence TFEU**, according to which: *"Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union [TEU]"* (this Article (*ex* Article 105(1) TEC) is analysed in **Smits (1997)**, pp. 187-190). The *establishment of the internal market* is such an objective according to **Article 3(3), first sentence TEU**. It could then be reasonably argued that the provision of last resort lending by the ECB for the *proper functioning of the banking system*, which is an (important) segment of the internal market, can definitely contribute to the attainment of this objective, provided that the primary objective of price stability is not compromised. Nevertheless, this issue is too important to be resolved by merely resorting to legal interpretations.

102 The author highlights the extreme caution with which the ECB (just like central banks in general) accepts the performance of tasks and powers based on an expansive reading of regulatory provisions. A case in point is that **Lastra (2012)** mentions (p. 9) the recourse to Article 14.4 of the Statute as a legal basis for ELA as a result of "a restrictive reading" of the ECB's tasks by the ESCB (see also **Lastra and Goodhart (2015)**, p. 16).

103 **Lastra (2015**, p. 378**)** expresses the view that this ECB competence could also be based on the principle of subsidiarity which governs EU law (**TEU, Article 5(3)**), since amidst a crisis action by the ECB is more effective than action by NCBs.

104 For the precise content of this Article, see **Smits (1997)**, pp. 264-269 and pp. 272-273.

to grant it, or to authorise the provision of such support by NCBs, questionable. It is submitted that, under Article 18.1, second indent, the capacity of the ECB and the NCBs to act as lenders of last resort is subsumed.”[105] As a matter of fact, the conditions for application of this Article are fulfilled in the case of ELA. In particular:

(i) The provision of ELA definitely constitutes a credit operation with credit institutions.

(ii) Lending by NCBs under ELA is curently provided under adequate collateral.[106] The eligibility of the assets to be used as collateral, the valuation of, and any haircuts applied to, the collateral provided, and (where applicable) details on the guarantee to be provided and the terms of any contractual safeguards could be adapted accordingly.[107]

(b) The ECB's acting as lender of last resort in the euro area does not preclude a NCB's ability to grant emergency liquidity assistance to a significant credit institution established in its territory facing emergency liquidity shortage and to manage relevant practical issues.[108] Under the above-mentioned provision of **Article 18.1 of the Statute**, the power to conduct credit operations is held both by the ECB and by NCBs, in accordance with the principle of decentralisation.[109]

Nevertheless, in this case, the margin for NCBs to take independent action is institutionally restricted. This directly arises from **Article 18.2 of the Statute**, which stipulates that the general principles for credit operations carried out by the ESCB, "*including for the announcement of conditions under which [the ECB and the national central banks] stand ready to enter into such transactions*", must be established by the ECB.[110]

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105 **Smits (1997)**, p. 269, under I), with reference to **Louis (1995)**, p. 59. See also **Lastra (2015)**, p. 378.
106 See also above, **under 3.3 (a)(v)**.
107 This is a solid safeguard against potential conflicts of interest between the two functions of the ECB.
108 In this case, a NCB acts as an integral part of the ESCB, in accordance with **Article 14.3 of the Statute**.
109 On this principle see **Priego and Conlledo (2005)**.
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THE ROLE OF THE LENDER OF LAST RESORT: A RESPONSE TO PROFESSORS GORTSOS AND SCOTT[1]

THOMAS C. BAXTER, JR.[2] AND M. BENJAMIN SNODGRASS[3]

I INTRODUCTION

In their papers and presentations, Professors Gortsos and Scott have undertaken to identify aspects of lender of last resort (LOLR) powers that promote the goals of emergency liquidity assistance: the provision by a central bank of temporary liquidity to solvent institutions under exigent circumstances, with the aim of promoting financial stability.[4] Professor Gortsos, in his carefully researched analysis, looks at the function of the LOLR in the euro area and the overlapping (and potentially conflicting) roles of national central banks and the ECB in the provision of emergency liquidity assistance to financial institutions. He notes the centralisation of supervision of significant credit institutions at the ECB through the single supervisory mechanism (SSM), and the establishment of a single resolution mechanism and resolution fund at European level. Given this consolidation, he proposes that the ECB should become a LOLR in the euro area in order to progress toward a more complete European banking union.

While Professor Gortsos focuses on change within the euro area, Professor Scott concentrates on identifying strengths and weaknesses across LOLRs in the euro area, the United Kingdom and the United States. In a thoughtful and thought-provoking analysis, Professor Scott concludes that the LOLR in the United States, the Federal Reserve, is the weakest LOLR of the three. In particular, Professor Scott highlights changes made by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act)[5] to the Federal Reserve's ability to lend to non-banks.

1 The views expressed herein are those of the authors and do not necessarily represent those of the Federal Reserve Bank of New York or the Federal Reserve System.

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4 See, e.g., Humphrey, Thomas M., "Lender of Last Resort: The Concept in History", *Fed. Reserve Bank of Richmond Econ. Rev.*, Mar.-Apr. 1989, at 8, 8 (describing the Henry Thornton and Walter Bagehot principles of LOLR as "(1) protecting the aggregate money stock, not individual institutions, (2) letting insolvent institutions fail, (3) accommodating sound institutions only, (4) charging penalty rates, (5) requiring good collateral, and (6) preannouncing these conditions well in advance of any crisis, so that the market would know exactly what to expect"); Paul Tucker, "The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction", in *Rethinking the Lender of Last Resort*, 10, 15, Bank for Int'l Settlements ed., 2014 (interpreting Bagehot's theory of the LOLR as "stand[ing] ready to lend early and freely (ie without limit), to sound firms, against good collateral, and at rates higher than those prevailing in normal market conditions...").

5 Pub. L. No 111-203, 124 Stat. 1376 (2010).

This paper focuses first on Professor Scott's work. Not surprisingly, we do not agree that the LOLR framework in the United States is weak, and we appreciate the opportunity that Professor Scott's critique affords us to highlight the strengths of the LOLR framework in the United States. Unlike Professor Scott, we do not evaluate the United States LOLR framework on a comparative basis; instead we discuss how the LOLR framework in the United States meets US policy objectives, namely permitting unsound firms to fail while maintaining overall financial stability. This paper then turns to the question of consolidating LOLR and supervisory authority. We see the information that a supervisor may gather as being quite helpful, but not necessarily essential, to the execution of the LOLR function. More important than the combination of the LOLR function and micro-prudential supervision is, however, the pairing of the LOLR function and the financial stability mandate with which many central banks have been tasked following the financial crisis.

2 THE UNITED STATES LOLR FRAMEWORK REFLECTS THE POLICY THAT UNSOUND INSTITUTIONS SHOULD BE PERMITTED TO FAIL

Beginning in 2007, the Federal Reserve developed innovative programs to respond to the worst financial crisis since the Great Depression in the 1930s. Many of these programs were based on the authority to extend credit as set out in Section 13(3) of the Federal Reserve Act (FRA). The Dodd-Frank Act made certain statutory changes to the FRA, and Professor Scott believes that the changes made by the Dodd-Frank Act to the Section 13(3) lending authority have weakened the LOLR authority of the Federal Reserve. In our opinion, however, to view the changes to Section 13(3) as weakening the Federal Reserve's LOLR authority is to take a part of the Dodd-Frank Act out of context. As discussed below, the amendments made by the Dodd-Frank Act reflect the policy view that individual unsound firms should be permitted to fail and that it should not be necessary to conduct a public bailout of an unsound firm in order to preserve financial stability. As amended, the Federal Reserve's authority to provide liquidity to the market remains available under Section 13(3) of the FRA, and the Federal Reserve is still able to extend credit under other statutory provisions that were not changed (or were even added) by the Dodd-Frank Act. Complementing the Federal Reserve's capacity to provide market liquidity, the Dodd-Frank Act also created tools designed to permit an individual unsound firm to fail, whether under ordinary insolvency or, if necessary, under a receivership pursuant to the Dodd-Frank Act's Orderly Liquidation Authority (OLA).

A. AMENDMENTS TO SECTION 13(3) AND DEVELOPMENT OF THE ORDERLY LIQUIDATION AUTHORITY

The FRA includes a number of means by which Federal Reserve may provide credit to financial institutions, with one section in particular – Section 13(3) – being critical to the Federal Reserve's crisis-stemming activities. At the time of the crisis, before the enactment of the Dodd-Frank Act, the provisions of Section 13(3) were as follows:

"In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section [14, subdivision (d) of the FRA], to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe."[6]

During March 2008, the Federal Reserve authorised conduit loans to Bear Stearns (Bear) through JPMorgan Chase (JPMC) under Section 13(3), first to provide liquidity to delay the filing of a bankruptcy petition by Bear and subsequently to remove about $30 billion of troubled assets from Bear's balance sheet in connection with its acquisition by JPMC.[7] Later in 2008, the Federal Reserve used its authority under Section 13(3) to make loans that enabled American International Group (AIG) to avoid catastrophic bankruptcy. While authority under Section 13(3) was used with respect to specific institutions, the Federal Reserve mostly used its Section 13(3) authority to provide market liquidity:

- The Primary Dealer Credit Facility (PDCF), operational from March 2008 to February 2010, provided overnight funding to primary dealers[8] in exchange for a specified range of eligible collateral, using tri-party repo infrastructure;

- The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), operational from September 2008 to February 2010, provided funding to US depository institutions and bank holding companies to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds under certain conditions. The objective was to assist money funds holding such paper in meeting investor redemption demands and to foster liquidity in the ABCP market, and in money markets more generally;

6 12 U.S.C. § 343 (2006). Section 13(3) was added to the FRA in 1932. While the section had contained ambiguity with respect to whether restrictions applied to the collateral could be provided to secure credit from a reserve bank, that ambiguity was cleared by a 1991 amendment, see Pub. L. No 102-242 § 473 (1991). For a description of uses of Section 13(3) before the financial crisis, see Baxter, Thomas, C. Jr. and David Gross, "The Federal Reserve's Response to the Crisis", in *International Monetary and Financial Law: The Global Crisis*, pp. 293, 298-99 (Giovanoli, Mario and Devos, Diego eds., 2010).

7 ibid., pp. 300-1.

8 The primary dealers comprise bank and broker-dealer counterparties of the Federal Reserve Bank of New York that, among other things, participate in open market operations carried out by the Federal Reserve Bank of New York at the direction of the Federal Open Market Committee.

- The Commercial Paper Funding Facility (CPFF), operational from October 2008 to February 2010, provided a liquidity backstop to US issuers of commercial paper, the intention being to improve liquidity in short-term funding markets and thereby contribute to the greater availability of credit to businesses and households;

- The Money Market Investor Funding Facility (MMIFF), operational from November 2008 to October 2009, supported a private-sector initiative to provide liquidity to US money market investors;

- The Term Asset-Backed Securities Loan Facility (TALF), operational from March 2009 to June 30, 2010, supported the issuance of asset-backed securities (ABS) collateralised by loans of various types to consumers and businesses, thus helping market participants meet the credit needs of households and small businesses.

In 2010, after the financial crisis in the United States had ended, Congress amended Section 13(3) of the FRA to achieve certain specific policy objectives. Among its top priorities was to end the problem of "too big to fail" – the concern that some financial institutions were so important and interconnected that their failure could jeopardise the financial stability of the United States.[9] Congress was mindful, when it adopted the Dodd-Frank Act, that the Federal Reserve had used Section 13(3) to save certain systemically important financial institutions because it did not have the tools to fashion an orderly liquidation of those firms without catastrophic systemic consequences.[10] Congress's policy goal was to shift away from a legal framework under which regulators were left with no option other than to "rescue" an individual failing financial firm. Through the enactment of the Dodd-Frank Act, Congress sought to establish a legal framework under which the Federal Reserve was empowered "to provide needed liquidity and confidence in financial markets during times of severe distress"[11] but could allow individual unsound firms to fail.[12] This failure could occur under the United States Bankruptcy Code (aided by the Dodd-Frank Act's recovery and resolution planning requirements) or, if necessary, under the new OLA title in the Dodd-Frank Act.

9 See *Regulation and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 1-2 (2009), statement of Senator Christopher J. Dodd: "Consider for a moment the following financial institutions: Bear Stearns, Fannie and Freddie, Lehman Brothers, AIG, Washington Mutual, Wachovia, Citigroup, Bank of America. Inside of 14 months, every one of these institutions either failed or posed a risk of failing in the absence of government intervention ... Many were saved because the Government resorted to an array of loans, guarantees, and capital injections to keep these large, complex financial firms afloat."

10 See S. Rep. No. 111-176, at 6 (2010): "The Federal Reserve's emergency lending authority, under section 13(3) of the Federal Reserve Act, in the past allowed the Federal Reserve to make loans to individual entities like AIG. While such lending played an important role in ending the recent financial crisis, it also created potential moral hazard."

11 ibid., "Title XI eliminates the ability of either the Federal Reserve or the Federal Deposit Insurance Corporation to rescue an individual financial firm that is failing, while preserving the ability of both regulators to provide needed liquidity and confidence in financial markets during times of severe distress."

12 ibid., at 182: "Lending programs must be designed to provide liquidity and not to aid a failing financial company."

Accordingly, Congress amended Section 13(3) of the FRA to restrict Federal Reserve lending to a specific institution for the purpose of saving it from filing for bankruptcy (e.g., AIG) or where loan proceeds are used to take assets from a single institution to avoid a bankruptcy filing (Bear). The purpose of Congress in restricting this kind of lending was to encourage the use of bankruptcy, either under the United States Bankruptcy Code or under the new instrument, Title II of the Dodd-Frank Act. Congress did not restrict emergency lending under Section 13(3) to "any participant in any program or facility of broad-based eligibility ..."[13]. Such a program or facility must be approved in advance by the Secretary of the Treasury.[14] In connection with such a program, the Board of Governors of the Federal Reserve System must establish procedures to prohibit lending to insolvent borrowers. That said, it is important to note that a borrower "shall be considered insolvent ... if the borrower is in bankruptcy, resolution under title II ..., or any other Federal or State insolvency proceeding."[15] Further, the Board of Governors, in consultation with the Secretary of the Treasury, is required to establish policies and procedures:

"...designed to ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion."[16]

In addition, Congress required that certain reports be made to Congressional committees regarding extensions of credit[17] and, on a delay of one year following the termination of a Section 13(3) credit facility, public disclosure of extensions of credit.[18] Section 13(3), as amended, could still authorise any of the market liquidity facilities established during the financial crisis, i.e. the PDCF, AMLF, CPFF, MMIFF, or TALF.

At the same time that Congress amended Section 13(3) of the FRA, it introduced a powerful new tool: the OLA under Title II of the Dodd-Frank Act.[19] This new special resolution regime permits the Federal Deposit Insurance Corporation (FDIC) to resolve systemically important financial institutions when insolvency proceedings under the United States Bankruptcy Code would have serious adverse effects on the financial stability of the United States.[20] OLA thus provides US

13 12 U.S.C. § 343(3)(A) (2012).

14 While the Dodd-Frank Act introduced an approval process into law, there has in the past been, in the absence of a statutory requirement, close consultation and coordination with the Secretary of the Treasury during financial crises; the change to Section 13(3) thus formalizes the consultation process. In consultation with the Secretary of the Treasury, the Board of Governors of the Federal Reserve System has proposed policies and procedures required by amended Section 13(3) as amendments to Regulation A. See Board of Governors of the Federal Reserve System, Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. 615 (proposed Jan. 6, 2014).

15 12 U.S.C. § 343(3)(B)(ii)(2012).

16 ibid., § 343(3)(B)(i)

17 ibid., § 343(3)(C).

18 ibid., § 248(s).

19 See 12 U.S.C. § 5381 *et seq.* (2012).

20 ibid., § 5383(b).

regulators with an alternative to the public bailout of a single insolvent firm and promotes Congress's objective of solving the "too big to fail" problem.

Under OLA, the FDIC would be appointed as receiver for a failing or failed financial company, upon a recommendation by the Board of Governors of the Federal Reserve System and the FDIC and a determination by the Secretary of the Treasury that (i) the company is in default or danger of default, (ii) the company's failure and resolution under the United States Bankruptcy Code would have serious effects on financial stability, and (iii) resolution under OLA would avoid or mitigate those adverse effects.[21] Among the powers of the FDIC as receiver are the powers to sell the assets or operations of the company, to transfer the company's assets, liabilities, and operations to a "bridge" financial company established by the FDIC, and to impose losses on shareholders and creditors in accordance with the priorities established under OLA.[22]

Importantly, as a complement to the Federal Reserve's emergency liquidity authority with respect to solvent institutions, OLA provides the FDIC with a source of liquidity for a company that has been recapitalised pursuant to a resolution under OLA: the Orderly Liquidation Fund (OLF).[23] Under the FDIC's single-point-of-entry resolution strategy, only the top-tier US holding company would be placed in resolution, and its interests in its subsidiaries would be transferred to a bridge financial company. The FDIC, where possible, would look to private markets for sources of liquidity for the well-capitalised bridge company. If that were not possible, however, the FDIC could use the OLF, either by providing guarantees of private sector funding backed by the OLF or by providing funding directly from the OLF.[24]

Far from being weak, Section 13(3), as amended by the Dodd-Frank Act, and the new tools designed to facilitate orderly resolutions address one of the primary mischiefs that the Dodd-Frank Act was enacted to address: the concern that the unavailability of an orderly resolution mechanism could result in bailouts and moral hazard. In light of the Dodd-Frank Act, Section 13(3) lending is no longer needed to take assets off a company's balance sheet, as was the case with Bear, or to make a large loan to save a systemically important financial company, as in the case of AIG. The risk of a firm's ultimate failure is borne by its shareholders and bondholders, rather than the central bank. The Federal Reserve remains empowered, however, to provide broader-based LOLR programs like those developed during the crisis. It is therefore still able to lend, in the words of

21 ibid., § 5382. If the company or its largest subsidiary is a broker-dealer, the Securities and Exchange Commission would make a recommendation instead of the FDIC. OLA provides for a limited and expedited judicial review of the Secretary of the Treasury's determination that the company is a financial company and that it is in default or in danger of default, if the board of directors of the company does not consent to the appointment of the FDIC as receiver.

22 ibid., § 5390.

23 ibid., § 5390(n).

24 See "Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy", 78 Fed. Reg. 76614, 76616 (Dec. 18, 2013).

Bagehot, to "[t]he great majority, the majority to be protected, ... the 'sound' people."[25]

B. THE DODD-FRANK ACT DID NOT AMEND SECTIONS 10B AND 14 OF THE FRA AND IT PROVIDES FOR LIQUIDITY TO DESIGNATED FINANCIAL MARKET UTILITIES

While we have focused on Section 13(3) of the FRA, other sources of the Federal Reserve's lending authority remain substantively unchanged by the Dodd-Frank Act. Section 10B of the FRA sets out the statutory framework for lending to "depository institutions"[26] that is not restricted to emergency situations.[27] A depository institution that maintains transaction accounts or non-personal time deposits that are subject to reserve requirements is eligible to borrow under the authority of Section 10B – the so-called "discount window."[28] US branches and agencies of foreign banks that hold reserves are eligible to borrow under the same general terms and conditions that apply to domestic institutions. Rather than restricting the Federal Reserve's Section 10B lending authority, the Dodd-Frank Act expanded the Federal Reserve's Section 10B lending authority to permit it to make loans, in unusual or exigent circumstances, to "designated financial market utilities."[29] Such lending requires the Federal Reserve to consult with the Secretary of the Treasury and for the utility to show inadequate credit accommodations from other banking institutions. The Dodd-Frank Act also requires the names of all depository institutions and designated financial market utilities that borrow from the Federal Reserve and the amounts borrowed under Section 10B to be publicly disclosed eight calendar quarters after the borrowing occurs.[30]

In addition, the Dodd-Frank Act did not amend the authority of Federal Reserve banks to undertake open market operations. Under Sections 12A and 14 of the FRA, Federal Reserve banks continue to have the power to buy and sell various bonds, notes, and other obligations, including obligations that are notes or bonds of the United States or any agency of the United States, or fully guaranteed as to principal and interest by the United States or any agency of the United States, in the open market at the direction of, and under the regulations of, the Federal Open Market Committee.[31] This authority has permitted liquidity-enhancing

25 Walter Bagehot, Lombard Street: A Description of the Money Market (1897), 94, NuVision Publications, 2008.

26 The term "depository institution" is defined in the Federal Reserve's Regulation A. See 12 C.F.R. § 201.2(c). While the rule includes a variety of technical requirements, broadly speaking it refers to deposit taking institutions.

27 See 12 U.S.C. § 347b (2012).

28 Advances are limited to a term of four months, unless collateral consists of one-to-four family mortgages, and advances must be secured to the satisfaction of the lending Federal Reserve bank. Typically, and in accordance with Federal Reserve regulations, advances are made on "a very short term basis, usually overnight, as a backup source of funding ...", 12 C.F.R. § 201.4. The FRA places no legal restrictions on the types of assets that may be used to secure discount window loans and a broad array of assets may be accepted as collateral.

29 See Dodd-Frank Act § 806(b).

30 The US system balances confidentiality of lending with the overall need for transparency in the financial system.

31 See 12 U.S.C. §§ 263 & 355 (2012).

transactions with the Federal Reserve Bank of New York's primary dealers,[32] including repurchase transactions that are the functional equivalent of secured loans. Authority under Section 14 of the FRA also permits dollar liquidity swaps with foreign central banks, such as the standing swap lines that currently exist between the Federal Reserve and the Bank of Canada, the Bank of England, the Bank of Japan, the ECB and the Swiss National Bank.[33]

3 CONSOLIDATION OF LOLR AND OTHER MANDATES

Professor Gortsos argues that steps taken toward the centralization of the mandate to safeguard the banking system in the euro area warrant centralization of the LOLR function for significant credit institutions, and he highlights the centralization of supervision through the SSM. Having supervisory jurisdiction over a borrower makes for more informed central bank lending decisions, and indeed the Federal Reserve will most likely have more information at hand about the affairs of a bank over which it exercises supervisory authority than it will over financial institutions with other primary supervisors (e.g., the Federal Reserve did not supervise AIG or Bear). Supervisory authority is not, however, a prerequisite for successful action by a LOLR, as demonstrated by the successful LOLR activities executed by the Federal Reserve during the financial crisis, including the successful lending to AIG and Bear.

A pairing that is more significant than that of supervision and LOLR is that of the financial stability function and LOLR. Following the financial crisis, many central banks now have a financial stability function and, indeed, the Dodd-Frank Act expanded the Federal Reserve's financial stability mandate. The Chairman of the Board of Governors of the Federal Reserve System is a member of the Financial Stability Oversight Council (FSOC).[34] In addition, the Federal Reserve has been given macro-prudential supervisory authority over the financial activities of nonbank financial companies designated as systemically significant by the FSOC and of bank holding companies with total consolidated assets of $50 billion or more,[35] as well as authority with respect to payment, clearing, and settlement activity designated by the FSOC as systemically important.[36] As LOLR lending is a financial stability tool, it is an important component of the Federal Reserve's, or any central bank's, macro-prudential toolkit and it enhances the central bank's flexibility as it carries out its financial stability mandate. The financial stability role of the ECB has, as Professor Gortsos notes, also been expanded through the SSM. We look forward to observing how the role of the ECB in LOLR develops as it assumes its new role under the SSM.

32 See Note 8 above.
33 See 12 U.S.C. § 353.
34 See Dodd-Frank Act § 111.
35 See, e.g., ibid., §§ 161, 163 & 165.
36 See ibid., § 805.

4 CONCLUSION

The LOLR framework in the United States may not be perfect, but we must disagree with the notion that it is weak. Viewed in the context of Congress's goal of ending "too big to fail," the Congressional purpose in restricting certain forms of Section 13(3) lending becomes apparent; this is not weakness, it is strength. The Federal Reserve's ability to respond to the particulars of a financial crisis with innovative broad-based programs remains. Policy makers will no longer be faced with an unwanted binary choice between saving an unsound firm and letting it fail with catastrophic effects on US financial stability. The Federal Reserve's strong LOLR authority dovetails with its financial stability and macro-prudential supervision mandate. As the ECB assumes its new role under the SSM, it will be interesting to observe whether it acquires an LOLR role to complement its supervision of significant credit institutions.

PRACTICAL ISSUES FOR THE LENDER OF LAST RESORT

PAUL FISHER[1]

Commenting on the presentations of Hal Scott and Christos Gortsos.

The background to this panel was how the ESCB should organise its Lender of Last Resort (LOLR) functions, and Christos Gortsos cogently sets out the arguments in favour of this moving from national central banks to the ECB. I will offer some comments on practical and public policy issues which should be relevant to how LOLR functions are arranged. My views should be taken as personal and not necessarily reflecting those of the Bank of England.

As Hal Scott explains, the Bank of England has, since mid-2007, moved from a LOLR approach based entirely on constructive ambiguity, to having perhaps the most comprehensive set of pre-published liquidity facilities of any central bank. I want to draw two points from this experience. The first is to note the range of choices that one has, and the scope for change, in establishing LOLR facilities. Legal constraints – which I appreciate are especially important in the European arena – should not be felt to be an absolute limitation on what arrangements may be possible in the future. One would hope that the law could evolve to permit the best arrangements to be made.

The second point is that widening LOLR facilities requires a lot of operational change. All the major central banks proved that complicated new operations could be devised and delivered at speed during a crisis. It would, though, have been much better practice to have made the preparations beforehand. And the context for LOLR is always how it works in a crisis, not how it works in normal times.

What are the main constraints?

Philosophical: In the US there seems to be an overriding concern that central bank support for an individual institution undermines the principles of capitalism – it seems to be seen as representing the bailing out of a failed firm, almost regardless of whether the problem is one of liquidity or solvency. As Hal Scott explains, there have been consequent moves to limit Federal Reserve support to banks only, and to market-wide liquidity facilities. Whilst I share his concern at the direction of those changes – the Fed did fantastic work to support the US financial system and its economy during the crisis – I am more optimistic about what they might mean in practice. I anticipate that the Federal Reserve System will always find a way to do what they need to, in delivering their dual mandate. I will leave Tom Baxter to reply more fully to Hal's points.

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Elsewhere, the public policy imperative that we have witnessed across Europe in the past few years seems to have been to avoid bank failures, and even the failure of potentially insolvent firms. In both cases the politics is likely to be based on perceptions of what the respective electorates will accept, and we central bankers should respect this. But what I conclude from these observations is the need in the US to preserve the ability to be the LOLR when, and to whom, necessary, and in Europe perhaps to preserve the ability to not lend, when that is more appropriate.

In the UK the PRA does not seek to operate a "zero-failure" regime. Rather, it seeks to ensure that a financial firm which fails does so in a way that avoids significant disruption to the supply of critical financial services.

Interaction with monetary policy

LOLR, by expanding the central bank balance sheet, can have a marked effect on the money supply or at least on market conditions, potentially on a large scale. But during the crisis we all found ways to accommodate or mitigate those effects as necessary. So monetary policy considerations should not be a constraint as long as there is sufficient co-ordination between those setting monetary policy and those deciding on and implementing LOLR.

Practical decision making

Where should one draw the line between banks and near-banks that have similar liquidity mismatches by the nature of their business? I hear Hal's concern that the restrictions in the US will prevent lending to non-banks at a time when other central banks are moving in the opposite direction. In particular, the Bank of England has allowed central counterparties and major investment banks to be eligible for the Sterling Monetary Framework. The issue of central bank liquidity support for non-banks has yet to receive much academic study and debate – but it should, as central banks take more interest in their broadening financial stability remits. An increasing focus on what happens outside the regulated sector is certainly on the agenda in the UK and at the FSB.

How can one tell whether a firm is solvent and illiquid or is actually going bust? Often there is simply not a clear dividing line – a firm might be solvent with liquidity support and bust without it. This can occur because the values of a bank's assets will often be dependent on whether it is a going or a gone concern.

What collateral should a central bank accept and what haircuts should it set? Almost inevitably one wants to give liquidity in return for collateral that is illiquid to some degree – otherwise that collateral could be used in the market and the firm wouldn't have a liquidity problem. The haircut needs to be conservative enough to give solid protection from loss, but shouldn't be so large as to mean the assistance isn't effective. The particular importance of that is that one doesn't want to have to decide to take new classes of collateral at short notice. It is much better to have prepared, and to have, proper risk management set up in advance.

One possible approach to collateral I have heard suggested in this conference is to simply take a floating charge over a firm's balance sheet, or at least its unencumbered assets. Whilst that is always a back-stop possibility, I would warn that it can generate a lot of legal issues that could undermine its effect. For example, it could trigger default clauses in contracts or debt instruments. So use of a floating charge needs to be thought through carefully in each context – it is not easy and certainly not a panacea.

Financial risk

This is perhaps the key point I want to highlight, based on the UK's experience. If a central bank lends enough money to a firm where solvency is inherently uncertain – and it *always* is for a bank in a liquidity crisis – then however well collateralised the loan, there is a risk of losing money – public money. Especially in stressed market conditions. Fiscal authorities will therefore have a legitimate interest, however legally independent the central bank. As Hal describes, the UK has a system now which allows the BoE freedom to lend under its published facilities (which are pretty broad and have only BoE risk limits attached) but requires Treasury involvement beyond that, and specifically in any instance where there is a risk of loss to the taxpayer.

Actually reputational loss to the central bank can arise either from losing money by lending to a bust bank, or from not doing so and allowing a bank to fail. In the long run that potential reputational loss might be of as much concern as the financial consequences.

And central banks are never totally financially independent. If a central bank uses up its capital, it can continue to operate – unlike a commercial firm. But finance ministries will ultimately need to recapitalise them, i.e. any losses will eventually flow back to the fiscal authorities. One can have pre-agreed arrangements to handle that, as the ECB does. But if large losses accrue in practice, especially in a time of pressure on fiscal deficits, and taxpayers have to pay up (even temporarily) as a result of independent central bank decisions, then one should not be surprised if governments consider changing the arrangements. The US restrictions on Federal Reserve actions are perhaps an example of the potential negative reaction to bilateral support operations – and that despite the fact that the Fed is expected to make a net positive return across the various facilities it employed during the crisis. In the UK, the bailouts for HBoS and RBS beyond normal liquidity provision were clearly a decision for the finance ministry.

So some key questions to ask in deciding LOLR arrangements are:

- *Who is best placed to decide whether an individual firm needs more liquidity and has appropriate collateral?*
- *Who can take a view on solvency?*
- *Who is in the best position to assess the risk ex ante of financial loss from LOLR?*

- *How do the arrangements work to deal with realised financial loss (even temporary or perceived)? How does one best guard against the political consequences?*

- *What are the public policy pressures to bail out potentially insolvent firms (that might need to be resisted or accommodated)?*

- *How best does one coordinate to avoid the potential consequences for monetary policy?*

In each country, central bank operating systems differ, as do political arrangements, so these sorts of questions need to be addressed in specific context rather than generically.

Christos argues that the creation of the SSM is a strong argument for giving the LOLR responsibility to the ECB. I agree that it goes in that direction, but would urge caution in relying too strongly on that argument. The access to supervisory information and coordination with the supervisor is indeed an important and positive consideration. But there are also good reasons for keeping the decision making separate.

For the US there are some very difficult issues – the nature and philosophy of the political system and the fractured regulatory structure described by Hal Scott present a challenging backdrop. But the Federal Reserve is the only US institution capable of being the LOLR. The real problem, as Hal emphasises, is what it is legally and politically allowed to do and what it can actually do in practice.

In the UK there has been little philosophical debate about the BoE's LOLR powers. The debate has been largely technical and the BoE's ability to be a LOLR has actually been considerably enhanced by the changes put in place since the crisis – but always subject to finance ministry involvement if public money is at risk, as Hal explains.

For Europe, as always, the particular arrangements need to reflect the sensitivities of the EU and the euro area. It is not for me to assert how to arrange things, but the experience of ELA over the past 8 years and, as Christos argues, the advent of the SSM might have shifted the balance of the arguments somewhat in addressing the issues I have raised.

Finally, there is another dimension not mentioned in either paper. During the crisis we all found that LOLR needed to be in foreign currency as well – for example the ECB being able to lend in both £ and $ as well as euro. The solution was the introduction and use of swap lines so that – for LOLR operations – the relevant home central banks did foreign currency lending and took the risk, rather than host central banks. There are myriad interesting questions arising from that experience which deserve fuller debate. I don't have time for that in this short intervention but I do want to note that LOLR provision is no longer just a national, technical issue. The interest in international spillovers is much more acute. So international cooperation and, where possible, alignment on these matters is much more important now than it ever has been.

SOME COMMENTS ON CENTRAL BANKS' LENDER OF LAST RESORT FUNCTION IN THE POST-CRISIS WORLD

XIANGMIN LIU[1]

I GENERAL COMMENTS

Professor Scott's presentation gives a good big picture comparison of the lender of last resort (LOLR) arrangements of the three major central banks, their relative pros and cons, and he gives his own rankings of the relative strengths of the three. Professor Gortsos's paper examines the ECB's case in detail, and argues for a clear LOLR mandate for the ECB, in line with the enhanced supervisory powers over the euro area's significant banks under the SSM. While I share Professor Scott's concern over the new restrictions placed on the Fed's LOLR authority by Dodd-Frank, I caution against a simple ranking of the effectiveness of LOLR arrangements on the basis of purely textual comparisons.

In my view, any specific legal provisions of LOLR should be considered or evaluated along with other instruments in a particular central bank's toolbox. These instruments could be used together, or in any combination, to address a systemic risk or fight a significant crisis. For example, the powers of a central bank to engage in broad and unconventional open market operations in response to a severe liquidity problem or crisis, to restructure or resolve a significant bank or nonbank on an orderly basis, or to make pre-emptive strikes (using prudential measures or reorganisation tools) against systemic issues before they explode into a full-blown crisis, are all important tools. In other words, I advocate a holistic approach to LOLR and define it as one of the tools available to a central bank in utilising its balance sheet to prevent or manage a financial panic or crisis. It is often used in combination with other tools and should not be taken out of an institutional context and simply evaluated on a stand-alone basis.

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The classic view of LOLR of Thornton (1802) and Bagehot (1873) includes the following: (1) protect the money stock instead of saving individual institutions; (2) rescue solvent institutions only and let the insolvent fail; (3) penalty pricing; (4) good collateral; (5) pre-announcement. Modern economics has essentially validated the desirability of having a LOLR as a public function. Models developed by Diamond and Dybvig (1983) and Allen and Gale (2000) prove that two Nash equilibria can exist in a panic: a good one and a bad one (bank run). A public LOLR function is an effective way to prevent the bad equilibrium and to achieve the good one.

While few dispute the desirability of having a public LOLR function, and designating that function to central banks, significant controversies still exist over the details of LOLR design and practice. Specifically, there are eight issues that are still the subject of debate and further study:

1. **Moral hazard**. While moral hazard is a valid concern and should be taken seriously, especially in normal times, in practice it may also be exaggerated and used as an excuse for weak and ineffective crisis management. While it might be morally justifiable to let a stand-alone house burn to the ground to give its owner a lesson on mishandling a fire, when a fire threatens to burn down neighbourhoods and even cities, the first priority is always to put out the fire and punish the arsonists next. In a systemic financial crisis, the top priority of the LOLR should always be to put out a financial fire: to stop panics and bank runs. In a systemic crisis, management and shareholders of a distressed bank are typically wiped out, bondholders are either wiped out or forced to take significant haircuts. When economies go into crisis, political leaders may even be forced out of office. So the extent of moral hazard from a public rescue utilising the LOLR function is typically limited and, in any case, in the normal course of business, a whole system of modern prudential regulation and bank resolution procedures are in place to systemically address the moral hazard problems created by having a public safety net for banks. In addition, since LOLR traditionally emphasises its liquidity provision function as a "*last*" resort, the risk of moral hazard should be even lower since a bank is supposed to exhaust all other available means of liquidity before it becomes eligible for a central bank lifeline. Under these conditions, priority should be given to having a strong and powerful LOLR, rather than one straitjacketed by moral hazard concerns. We should bear in mind that not having a strong LOLR is a recipe for far worse consequences than moral hazard itself.

2. **Financial stability and the rescue of individual institutions**. There are essentially two competing views on this: the money view (Goodfriend and King, 1988) and the banking view. The premise of the money view is concern for moral hazard created by rescuing individual institutions. As my above comment on moral hazard makes clear, the distinction between broad-based liquidity provision and loans to individual banks is not that important, as long as it works to contain financial contagion. Goodhart (1999) argues that only discount window lending should be considered LOLR, because open market operations cannot be separated from regular monetary policy operations. How to fit the U.S. Federal Reserve's new 13(3) power neatly into the

LOLR/monetary policy (or open market operation) dichotomy is therefore a challenge. The conceptual categorisation or distinction between the two, however, is less important than ensuring a strong LOLR function that could be employed to address both market-wide and individual entity concerns, depending on what circumstances call for, or under whatever name befits a country's political conditions.

3. **Distinction between illiquidity and insolvency**. The so-called "solvency rule" as set forth by Bagehot has been upheld most consistently and even religiously. It is often used as a powerful defence against moral hazard by free market fundamentalists who typically oppose public rescue of the financial sector. The ECB, the BoE and the Fed all require a solvency test in all or part of their LOLR operations (in the Fed's case pursuant to Dodd-Frank for nonbanks). In my view, solvency determinations are inherently difficult during a panic or crisis, and a strict solvency requirement is not only difficult to implement but also unnecessary or even counterproductive during a crisis. Goodhart and many other commentators have made the same argument. If the failure of an insolvent institution could cause widespread panic and contagion, or in an extreme case, the breakdown of a significant part of the banking/financial system, should a central bank not deploy the LOLR, or whatever other tools are available to prevent that from happening? On the other extreme, a rapid decline in the market situation could quickly take a solvent institution to the verge of insolvency. If a central bank rigidly applies the solvency test, the best window for response might be missed. In addition, during a financial panic, markets can malfunction or seize up. Price signals no longer work properly and the market prices of financial assets could deviate substantially from fair value. Prices in normal condition (or prices based on fair value methods) and fire-sale prices could be worlds apart, and this could mean life or death for banks. A strict solvency test based on market prices during a crisis could be completely counter-productive as regards accomplishing a central bank's financial stability objective.

4. **Penalty pricing and good collateral**. Bagehot's reasoning behind charging penalty rates was first, this would make the lender of last resort the very last resort and second, it would encourage prompt repayment of the loan. However, in a distress scenario, penalty pricing and/or adequate collateral could effectively make LOLR unaffordable for those in the most need or it could worsen an already weak balance sheet. Also, as a matter of practice, the Fed has neither asked for collateral nor charged rates above the market in recent years. Too rigid a policy regarding rates and collateral could be counter-productive and used as excuses for inaction.

5. **Pre-announcement.** While Bagehot emphasised the benefit of *ex ante* commitment of LOLR, many central banks have intentionally not promised anything. "Constructive ambiguity" seems to be the norm.

6. **Last resort versus first resort, second resort**? In some cases, the prevention of an imminent crisis would require central banks to take pre-emptive action to aggressively address systemic weaknesses, and the boundaries between

first, second, and last resort could be blurred. For example, after the markets seized up, the Fed acted as the liquidity provider of first resort and the buyer of first resort of a wide range of market instruments, including mortgage-backed securities.

7. **Scope of eligible entities**. Given the lessons learned during the global crisis, it is obvious that an effective LOLR should cover a whole range of entities, both banks and nonbanks, in line with the growing importance and market share of nonbanks in the financial system. As originally formulated, Bagehot (1873) even argued that a LOLR should lend "it most freely … to merchants, to minor bankers, to 'this and that man', whenever the security is good." All three central banks are authorised to lend to nonbanks, with different procedural requirements and the ECB's scope of lending restricted to its supervised entities. In light of the broad mandate central banks have regarding the stability of the entire financial system and the economy, and especially in light of the rise of the shadow banking system around the world and the extraordinary role in credit intermediation played by nonbanks that are outside the traditional supervision of central banks, the scope of LOLR should be commensurately broad and should be expanded to at least cover the regulated nonbanks.

8. **Relationship between LOLR and supervisory functions**. For reasons of information, coordination and accountability, there is a strong argument for the integration of both functions within a single entity. We see increased integration in all three central banks, as outlined by the speakers. In addition to the above reasons, the key issue here is incentives. We need an incentive-compatible structure: those who have to pay to clean up the mess should be given the power of supervision to minimise the mess in the first place.

II CHINA'S EXPERIENCE

The People's Bank of China (PBOC) has unique experience of LOLR and, more broadly, the power to use its balance sheet to accomplish its legal mandates: price stability, financial stability and economic growth.

The Law of the People's Bank of China (the PBOC Law) specifies two broad policy objectives for the PBOC: the first is to conduct monetary policy (with the goal of maintaining price stability and thereby promoting economic growth) and the second is to "prevent and resolve financial risks and maintain financial stability." There are two forms of lending to financial institutions that the PBOC can employ: First, **Section 23(4)** of the PBOC Law authorises the PBOC to provide loans to commercial banks in connection with its monetary policy function. Second, **Section 32(2)** gives the PBOC supervisory power over "financial institutions, and other organisations and individuals" in connection with "operations related to special loans of the PBOC." Here the term "special loans" are loans granted by the PBOC to financial institutions for special purposes, with the prior approval of the State Council. The scope of such loans is intentionally left undefined, while the requirement for prior State Council approval is made clear. The scope is broad enough to cover any form of LOLR

lending and more. Meanwhile, **Section 30** makes clear that the PBOC can also lend to nonbank financial entities, also with prior State Council approval. The only clear reference to LOLR authority is contained in the updated **2008 PBOC mandate** promulgated by the State Council: to exercise "the function of lender of last resort, and be responsible for supervising activities of entities that utilise central bank funds in connection with financial risk resolution." How has such legal authority been used in practice?

For a long time after the founding of the People's Republic, China was a planned economy and there was no market-based financial system. Credit was allocated pursuant to principles of central planning and there was not even any separation of central banking and commercial banking. The question of LOLR, therefore, was non-existent. After reform started in the early 1980s, and especially at the beginning of the 1990s, the financial sector was rapidly liberalised and the nation's first stock market was established. A whole range of investment trust companies, securities firms and credit cooperatives emerged. Rapid financial development was not, however, accompanied by appropriate financial regulation. With macroeconomic tightening the financial risks became very obvious; the Asian financial crisis aggravated the situation. Thus started the period of financial sector risk resolution and restructuring. Between 1998 and 2002, a large number of investment trust companies, city credit cooperatives and city commercial banks were resolved or restructured. After 2002, securities firms underwent a similar process. It was during this period that the PBOC started to seriously exercise the function of LOLR to contain and resolve financial risks, and took the lead in reforming and restructuring the entire financial sector. Some examples include:

Restructuring large state-owned banks. In 1998, the government injected capital of CNY 270 billion into the four largest state-owned banks, using the proceeds from the issue of special bonds. In 1999, it set up four "bad banks" (Asset Management Companies) that took over bad assets in the amount of CNY 1.4 trillion. In 2001, a modern loan classification and financial accounting systems were introduced. The situation was stabilised for a while before it became worse given that the underlying governance of the banks had not been modernised: the banks were technically insolvent. In 2003, the PBOC initiated a four-step restructuring of the large banks, involving writing off bad loans, separating out bad assets, recapitalisation using funds from the foreign exchange reserves (USD 80 billion in total), and global IPOs (China Construction Bank in 2005, Bank of China and ICBC in 2006 and Agricultural Bank of China in 2010). As of the end of 2014, the Big Four's capital adequacy ratios were 14.53% (ICBC), 12.82% (ABC), 13.87% (BoC) and 14.87% (CCB), and the NPL ratios were in the range of 1.13% to 1.54%. Banking sector assets reached CNY 172.3 trillion, a six-fold increase from 2003. In effect, China's banking sector was reborn and it has been in solid financial shape since the restructuring, which enabled it to successfully withstand the impact of the global financial crisis.

Reform of rural credit cooperatives. Rural Credit Cooperatives (RCCs) played an important role in rural credit intermediation, but accumulated huge risks as a result of a lack of modern governance, a policy of extensive lending, and

interference from local governments. In 2003, the reform program was launched. The PBOC issued "special loans" or "special central bank bonds" to recapitalise RCCs, for up to 50% of their actual capital shortfalls. The support was conditioned by governance reforms and performance targets (NPL ratio, capital adequacy, etc.), in order to establish a positive incentive structure and prevent moral hazard. As of Q1 of 2014, the PBOC had granted CNY 171.3 billion in funding support (including special bonds of CNY 169.9 billion to 2,408 RCCs and special loans of CNY 1.4 billion). The sector turned profitable from 2004 and accumulated profits reached CNY 886.3 billion at the end of 2013.

Resolution of securities industry risks. At the end of 2004, the losses of 114 securities firms amounted to CNY 16.7 billion. More glaringly, customer funds had been seriously misused or misappropriated and showed a deficit of CNY 64 billion. 84 firms faced a liquidity shortfall of CNY 164.8 billion. A systemic crisis was imminent. In 2005, the PBOC deployed close to CNY 10 billion in special loans to securities firms, helping securities firm repay funds to millions of customers. Also in 2005, the PBOC lent CNY 22.8 billion to the newly established Securities Investors Protection Fund as its initial capital, which was fully repaid in 2011.

III CONCLUSION: A HOLISTIC APPROACH TO LOLR

First, the role of central banks in normal times and during a crisis, and at different stages of development, might differ. In times of crisis it is difficult to distinguish between insolvency and illiquidity, and concern for moral hazard becomes secondary compared to the consequences of financial market collapse. How to properly balance the need for crisis rescue and moral hazard is a challenge for all central banks. In China's case, the PBOC had to take pre-emptive measures to aggressively address systemic risks because huge amounts of financial sector risks had accumulated in the pre-reform or early-reform eras, when heavy government interference in finance was the norm, banks were not true market players, and there was no clear boundary between market and government. In addition, concern for social stability was very real. A severe financial crisis would not only have seriously damaged the real economy, but also hurt millions of households and threatened social stability. Also very importantly, we did not have a mature legal system that could handle complicated issues relating to the bankruptcy and resolution of a major financial institution. However, as the markets and the legal system mature and the financial safety net becomes stronger, China will have more room for market forces and less tolerance of moral hazard. The balance of priorities for the PBOC will also evolve accordingly. Second, the specific role of LOLR should be viewed holistically, together with other instruments available to a central bank to maintain financial stability, and the overall supervisory structure and central bank mandates – it should not be taken out of its institutional context. Third, the actual design and practice of the LOLR, like many institutions, is an evolving process – it varies with the different stages of development, market conditions, and a whole range of political, economic and social factors. A strong LOLR is key to maintaining financial stability, but its institutional form could vary slightly or significantly, based on a country's specific conditions.

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PANEL 3

THE COEXISTENCE OF NATIONAL AND EU LAW AND THE *NE BIS IN IDEM* PRINCIPLE WITH A FOCUS ON THE SUPERVISORY POWERS OF THE EUROPEAN CENTRAL BANK

EUROPEAN CENTRAL BANK
EUROSYSTEM

INTRODUCTION

PETRA SENKOVIC[1]

The third panel was devoted to discussing the interaction between EU and national law and the *ne bis in idem* principle linked to the new supervisory role of the ECB.

Since the very start, EU law – applied by national authorities, in particular the national judiciary – was a major driver of the integration efforts. As the Court of Justice noted in the Zwartveld case, *"...the judicial authorities of the Member States ... are responsible for ensuring that Community law is applied and respected in the national legal system*"[2] and clarified in the Tetrapak II case, "*the national Courts are acting as Community courts of general jurisdiction*."[3] Indeed, it is considered that every national court is "*the natural forum"* for Community law and that national courts must guarantee the full effectiveness of EU law[4].

Within the Single Supervisory Mechanism (SSM) context, the interaction between EU and national law got an additional dimension as it is now placed in the hands of the ECB. The SSM Regulation (the "SSMR")[5]provides that the ECB should apply the national law transposing EU directives and that the ECB should also apply the national legislation exercising options granted to the Member States in EU regulations[6].

This is a novel situation. First, in the past EU bodies did not apply national legislation. Their actions and powers were framed exclusively by EU law. The only exception was provided for in Article 272 TFEU for the Court of Justice of the European Union when deciding pursuant to an arbitration clause. This is however a very specific situation where the Court of Justice is using national law in its role as arbitrator for contracts concluded by or on behalf of the EU.

Second, this novelty puts the interaction between EU and national law in an entirely new perspective. The problem of articulating these two different sources of law is henceforth no longer reduced to the question of primacy and/or direct

1 Deputy Director General Legal Services, European Central Bank, *as of 15 November 2015 Secretary to the SSM Supervisory Board*.
2 Case C-2/88 *Zwartveld*, EU:C:1990:440.
3 Case T-51/89, *Tetra Pak* v *Commission*, EU:T:1990:41.
4 Case C-144/04, *Mangold*, EU:C:2005:709.
5 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).
6 Recital 34 of the SSMR provides that "*for the carrying out of its tasks and the exercise of its supervisory powers, the ECB should apply the material rules relating to the prudential supervision of credit institutions. Those rules are composed of the relevant Union law, in particular directly applicable Regulations or Directives. (...) Where the material rules relating to the prudential supervision of credit institutions are laid down in Directives, the ECB should apply the national legislation transposing those Directives. (...) the ECB should also apply the national legislation exercising such options (...)*".

applicability of EU law. As observed by the panellists, the challenge relates to the delineation between EU and national laws in relation to the implementation of EU directives and the issue of correct interpretation of national laws.

Entrusting the ECB with the application of national law was an original solution to deal with the fact that a large part of supervisory legislation remains governed by national legislation that is also highly fragmented. Originality has always been a driving force of EU law. The use of national law by the ECB should fill the gaps in the EU supervisory legislation. Moreover, it could also be argued that by entrusting the application of national law to an EU institution, the Union legislator wanted to further encourage the harmonisation process. Putting national law in the hands of the ECB could be an effective harmonisation vehicle. In the same way that the national judiciary – in line with the so-called *effet utile* doctrine – should rely on interpretations that best guarantee the practical effects of EU law, the ECB is expected to opt for an application of national legislation that maximises the level playing field within the SSM and fosters harmonisation. From this perspective, it is clear that national law cannot be applied in a way that would undermine the effectiveness and the uniformity of EU law or serve as a tool for protectionist purposes.

Given the role of fundamental rights and general principles of law in the EU, the panel also touched upon fundamental rights in the SSM context, in particular the *ne bis in idem* principle. The main objective of the panel was to reflect on the challenges of the interaction between fundamental rights, EU and national law and highlight the main challenges for the ECB as supervisor.

KEY POINTS OF THE PANEL DISCUSSION

1 INTERACTION BETWEEN EU AND NATIONAL LAW

The panel emphasised the novel fact that an EU institution will henceforth apply national law. It was noted that until now national authorities were using EU law, while the EU institutions were not applying national legislation.

First, the panel observed that, notwithstanding the broad scope of EU banking legislation, the key aspects of supervision remain governed by national law. This is true in particular for national procedural laws related to supervision as well as for national material law provisions transposing the CRD IV[7] or implementing options available to the Member States in the CRR[8].

7 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).

8 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 an damending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

Second, the panellists noted that EU and national law are two different sources of law and that their articulation in the SSM context is ambiguous. The SSM is a complex system of mixed administration where the EU and national authorities are interacting on the basis of different EU and national laws.

Third, reference was made to Article 267 TFEU (request for preliminary ruling), which provides national judges with a possibility for a request to the Court of Justice on the correct interpretation of EU law. The preliminary ruling instrument ensured uniform application of EU law and was an extremely precious tool for national judges when asked to apply EU law. The panel noted that Article 267 would not be operational regarding the interpretation of national laws. Hence, the ECB would not be able to rely on the mechanism of Article 267 or a similar tool regarding the application of national laws. While this could be seen as an important gap in the legal structure of the SSM, it should also be clarified that the ECB will be using national law as a supervisor and not as a judge. The issue may become more relevant for the Court of Justice when deciding in litigation involving the supervisory decisions of the ECB.

However, the panel was generally optimistic that most of the issues could be mitigated by further coordination and further legislative harmonisation at the EU level, which should reduce the scope for the application of national laws. In the view of the panel, the ambiguities identified could be seen as imperfections that are not unusual in a start-up phase and will most probably be gradually resolved.

2 *NE BIS IN IDEM*

The panel considered that the set-up of the SSM is not conducive to possible violations of the principle of *ne bis in idem* and fundamental rights in general.

First, regarding the competent authority, the SSMR provided for a clear division of supervisory responsibilities between the ECB and the national competent authorities (NCAs). The panellists agreed that the existing legal framework, in particular Article 6 of the SSMR and Articles 39 to 42 of the SSM Framework Regulation[9], provide an appropriate legal basis for a clear delineation of significant and less significant credit institutions and related competences of the ECB and the NCAs. Therefore, this contrasts with the situation regarding EU competition law, where the Commission and the national competition authorities also have parallel competences, which is not the case for the SSM. In the panellists' view, there is only a very limited risk of overlapping competences between the ECB and the NCAs. In this context, the panellists also cautioned against mechanic references to the EU competition law and its applicable framework. They emphasised important differences between competition and

9 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).

supervisory laws, especially the fact that a large number of supervisory measures do not involve fines.

Second, the panellists agreed that the decisions of the SSM are subject to full judicial review, as in line with Article 263 TFEU, the decisions of the ECB can be challenged before the Court of Justice of the European Union.

Third, it was observed that the SSM legal framework contained a number of safeguards regarding fundamental rights, starting with recital 63 of the SSMR, which provides that "*the ECB should respect the fundamental rights and observe the principles recognised in the Charter of Fundamental Rights of the EU*". The panel also positively assessed the SSM legal framework in the field of sanctions, which takes into account the latest case law of the European Court of Human Rights regarding the principle of separation between an investigation and the decision-making phase. Moreover, it was emphasised that a strict separation between investigative phase and daily supervision conducted by the SSM`s joint supervisory teams is essential to ensure compliance with the right of no self-incrimination. Supervisors must be free to request information from the supervised credit institutions, which should not be able to hide behind the principle of no self-incrimination. This right should however be fully operational in the investigative phase conducted by a separate and independent unit.

In the view of the panellists, the main source of concern is the existence of highly fragmented national law provisions, in particular criminal law provisions relevant for the banking sector. Two concrete examples were mentioned. In some jurisdictions, withdrawals of banking licenses were treated as sanctions, while in others this was not the case. Moreover, national law provisions related to sanctions for obstructing the work of the supervisors vary considerably. The absence of harmonisation is a source of legal uncertainty and creates an uneven level playing field. For instance, it was uncertain whether the ECB could apply higher national standards of the principle of *ne bis in idem* in all jurisdictions.

The panellists concluded that the precise articulation of EU law, national law and fundamental rights in the SSM will be a gradual process. Such approach has been characteristic for EU law and EU integration in general since its early years. In this sense one of the main statements of the Schuman Declaration that *"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements*"[10] remains a great source of inspiration and a unique goal to which supervisors, judiciary and academia can make a major contribution.

10 Schuman Declaration of 9 May 1950.

FUNDAMENTAL RIGHTS ASPECTS OF THE SINGLE SUPERVISORY MECHANISM: DIFFERENTIATED STANDARDS OF PROTECTION UNDER THE CHARTER OF FUNDAMENTAL RIGHTS OF THE EU

BASTIAAN VAN BOCKEL[1]

1 INTRODUCTION

Under the Single Supervisory Mechanism (SSM), the ECB will assume the role of European Prudential Supervisor, taking over some of the functions of national authorities where 'significant' banks are concerned. All other credit institutions in the euro area Member States will continue to be supervised by the national competent authorities (NCAs), but the ECB can decide at any time to exercise direct supervision over any one of these credit institutions in order to ensure the consistent application of high supervisory standards. The powers of the ECB are extensive, ranging from administrative powers to authorize credit institutions and assess qualifying holdings to powers concerning compliance and sanctioning. *Inter alia*, the ECB has the competence to ensure compliance with the minimum capital requirements, to safeguard the adequacy of internal capital in relation to the risk profile of a credit institution, and to enforce compliance with provisions on leverage and liquidity. The ECB may take early intervention measures where capital requirements are violated, request information from credit institutions, and conduct all necessary investigations, including on-site inspections. Finally and crucially for the subject of this contribution, the ECB may impose fines directly upon credit institutions. All the while, national supervisory authorities will play a significant role, and EU financial regulation takes shape in a joint effort between the ECB and national supervisory authorities. In the end however, the ECB alone shall be responsible for the effective and consistent functioning of the SSM.

In order to prevent any undue overlap with the contribution by Prof. Lamandini, this contribution will focus mainly on potential issues of *ne bis in idem* in the SSM. In doing so, this contribution first comments briefly on some recent developments in the case law of the Court of Justice of the European Union (CJEU) on Articles 50-53 of the Charter which co-shape the interpretation and application of the *ne bis in idem* principle in the case law of the CJEU. The constituent elements of the *ne bis in idem* principle are subsequently set out in order to identify potential questions and issues in the context of the SSM. After that, some aspects of the SSM Regulation[2] (SSMR) are discussed against this background.

1 Assistant Professor of International and European Law, Utrecht University School of Law.
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).

Actual infringement of the *ne bis in idem* principle can only be assessed on a case by case basis. The question discussed in the present contribution therefore is not whether an infringement of the *ne bis in idem* principle is *possible* under the SSM, but whether the enforcement architecture of the SSMR poses by its design, a risk of violations of *ne bis in idem* in certain types of situations. In addition, the contribution touches on the question of whether there are other risks that need to be identified. A comparison with competition law shows that although the systems of enforcement of the SSM and Regulation 1/2003[3] are comparable in spirit, the problems that present themselves in the context of the SSM differ from those found in competition law. Contrary to that of the SSMR, the enforcement architecture of Regulation 1/2003 creates a 'systemic risk' of violations of the *ne bis in idem* principle which are in practice usually avoided, amongst other things through cooperation and restraint on the part of competition authorities. The architecture of the SSMR as such is relatively '*ne bis in idem* proof', but there are caveats. Challenges may present themselves, in particular in the interaction with national criminal law. Such issues may be exacerbated by the diversity of national legislative responses to financial misconduct that have emerged during and after the last financial crisis. It is foreseeable that in some cases, aspects of situations falling within the scope of the supervisory competences of the ECB and the NCAs will also constitute criminal or tax offences under the laws of some Member States. There is some cause for concern on this point as the interaction of national criminal and tax law and EU law could potentially jeopardize the effective and consistent supervision of banks and credit institutions by the ECB and the NCAs. It should however be pointed out that these findings must remain somewhat tentative until such issues can be observed in actual cases. Before exploring some of these issues, this contribution will first provide some background by setting out the constituent elements of the *ne bis in idem* principle and by touching on some recent developments in the case law of the CJEU on the scope of Charter rights and their relation to the European Convention on Human Rights (ECHR).

The principle of *ne bis in idem* is a fundamental principle of law, which restricts the possibility of a defendant being prosecuted repeatedly on the basis of the same offence, act or facts. The principle has a long history and exists in national systems of law in different forms: as a constitutional guarantee, as a rule of criminal procedure, and as a guarantee in extradition law. In continental law traditions, a distinction is often made between the principle's role as an individual right and its function as a guarantee for legal certainty, although these two aspects are intrinsically linked. In the former sense, the principle protects the individual from abuses of the state's *ius puniendi* (right to punish). Several logically linked *rationale* can be identified in this regard. For one, the guarantee serves to safeguard the fair administration of criminal justice as the additional burdens arising out of the repeated prosecution of a subject 'include the duplicated costs of legal representation, coercive measures to the person and property, and psychological burdens associated with the extended procedures

3 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, 4.1.2003, p.1).

and the absence of finality'.[4] Another rationale is found in the requirement that a prosecution must be based on pre-existing legislation (principle of legality), which would become illusory if a defendant could be prosecuted continually for various legal aspects of the same act or facts.

2 LEGAL PROVISIONS AND JURISPRUDENTIAL DEVELOPMENTS

For the EU legal order, three main provisions must be taken into account: Article 50 of the Charter, Article 4 of Protocol No 7 to the ECHR, and Article 54 of the Schengen Convention. The latter is not intended to have any direct relevance outside of the context of national criminal law but there is a considerable body of case law on the interpretation of that provision which must nevertheless be taken into account also in other areas of EU law. Although there are differences in wording, all three provisions lay down the same legal principle. This places some logical limitations on the extent to which the CJEU can differentiate its interpretation of the *ne bis in idem* principle according to the characteristics of different policy fields. In addition to these provisions, Articles 51-53 of the Charter determine important aspects of the interpretation and application of the *ne bis in idem* principle in the EU legal order. Some recent developments in the case law on those provisions will be briefly presented below in order to provide some additional background. Article 51 of the Charter reads as follows:

> 'The provisions of this Charter are addressed to the institutions and bodies of the Union with due regard for the principle of subsidiarity and to the Member States only when they are implementing Union law.'

From the case law of the CJEU we by now know that the scope of application of the Charter is wider than it would appear from the wording of this provision. In its judgment in *Akerberg Fransson*[5], the CJEU held that the scope of the Charter coincides with that of EU law itself but goes no further than that. In the case of *Pfleger*, the CJEU confirmed in its judgment that this also covers the so-called *ERT*-type of situation in which a Member State *derogates* from EU law.[6] It is however also clear from the *Siragusa* judgment and the order in *Sindicato dos Bancários do Norte*[7] that not every connection with EU law is sufficient to trigger the application of the Charter.[8] The case of *Sindicato dos Bancários do Norte* concerned bank personnel in Portugal litigating against a nationalised bank which had significantly reduced wages as from January 2011 to comply with the national budget law providing for wage reduction in respect of all civil servants with a view to meeting the requirements of the EU Stability and Growth Pact (SGP). Even though the national legislation was adopted in order to comply with Portugal's obligations under the SGP, the CJEU ruled that

4 Such burdens form part and parcel of law enforcement, but their repetition is by definition "unfair": M. Fletcher, The problem of multiple criminal prosecutions: building an effective EU response, Yearbook of European Law (Glasgow: 2007), p. 10.

5 Case C-617/10, *Akerberg Fransson,* EU:C:2013:105.

6 C-390/12, *Pfleger,* EU:C:2014:281.

7 Case C-128/12, *Sindicato dos Bancários do Norte* v *BPN*, EU:C:2013:149.

8 Cases C-206/13 *Siragusa*, EU:C:2014:126; C-128/12 *Sindicato dos Bancários do Norte.*

it was not competent to address the questions referred to it by the Portuguese court as there was no 'implementation of EU law' in the sense of Article 51 of the Charter. Although this ruling does not perhaps sit very comfortably with the very broad rule from *Akerberg Fransson*, any other ruling would arguably have brought national cutback laws, and perhaps even national systems of taxation as such within the scope of the Charter and therefore also within the competence of the CJEU. Such would run counter to the principle of subsidiarity from Articles 6(1) TEU and 51(2) of the Charter.

For the SSM both situations in which the ECB, as well as situations in which the NCAs act applying both EU law and national law, implementing EU law, ostensibly fall within the scope of the Charter. The same holds true in situations in which options were exercised in national legislation, regardless of the extent of discretion available to the national legislature in exercising those options. Questions may arise in situations in which the ECB for instance acts under the rules of the European Stability Mechanism, although it appears likely that the Charter will also apply in those instances if only because it is the ECB that acts. In addition, although the Charter applies in such situations, the legal situation of a supervised entity in proceedings before a national court (for example in situations in which an NCA acted under the instruction of the ECB subject to Article 4(1) to 6(1) SSMR) may in practice be quite different from that in which a decision by the ECB can be challenged directly by the supervised institution before the EU courts. Large parts of the Charter remain untouched by the case law of the CJEU, so that much is left to the particular attitudes of the national judiciary in applying Charter rights and/or referring questions to the CJEU. An interesting question may present itself with regard to Article 18(5) SSMR, where it states that the ECB may require NCAs to open proceedings 'with a view to taking action in order to ensure that appropriate penalties are imposed in accordance with (…) any national legislation which confers specific powers which are currently not required by Union law'. By doing so, the ECB would arguably be bringing those national laws within the scope of EU law and therefore within that of the Charter, even though those national laws themselves are not connected to EU law in any way. To sum up: there remains a degree of uncertainty as regards the question of how 'strong' the link between national and EU law must be in order for the Charter to apply. As discussed later on in this contribution, for the SSMR a number of questions could arise in this regard in the interaction between national and EU law.

Article 52(3) of the Charter reads as follows:

> 'In so far as this Charter contains rights which correspond to rights guaranteed by the Convention for the Protection of Human Rights and Fundamental Freedoms, the meaning and scope of those rights shall be the same as those laid down by the said Convention. This provision shall not prevent Union law providing more extensive protection (…).'

The CJEU appears to interpret this 'homogeneity clause' rather restrictively, amongst other things by not confronting the question of the relationship between Charter and Convention rights directly in its judgments, and by omitting

references to the case law of the European Court of Human Rights (ECtHR) in some cases. As a result, it is at present uncertain to what extent the CJEU considers itself bound by the case law of the ECtHR in interpreting and applying Charter rights. This, combined with the CJEU's rejection of the EU accession agreement to the Convention presently raises many questions regarding the relation between the Charter and the Convention, including the question of whether the so-called *Bosphorus*[9] doctrine still 'stands'. At present, the ECHR is still formally not binding on the EU and the CJEU has carved out ample room for doctrinal maneuver, so that the ECtHR may not be persuaded to take a deferential approach as it did in *Bosphorus* in future cases. For the SSMR, this could for example prove relevant in situations in which an NCA acts under the instruction of the ECB, as such actions may at some point be scrutinized by the ECtHR under the ECHR. It must therefore, as well as in the light of the wording of Article 52(3), be assumed for the purposes of the present inquiry that the SSM is bound to the Convention and the case law of the ECtHR (at least) to an important degree, even though the ECHR is formally not binding on the EU.

Article 53 of the Charter reads as follows:

> 'Nothing in this Charter shall be interpreted as restricting or adversely affecting human rights and fundamental freedoms as recognised, in their respective fields of application, by Union law and international law and by international agreements to which the Union, the Community or all the Member States are party, including the European Convention for the Protection of Human Rights and Fundamental Freedoms, and by the Member States' constitutions.'

In the *Akerberg Fransson* and *Melloni* judgments, the Court arrived at a somewhat cryptic interpretation of this provision.[10] It was held that the Charter applies regardless of the extent to which national law is 'determined' by EU law, and therefore regardless of the degree of discretion which was available to or was exercised by the national legislator. The latter is highly relevant to the functioning of the SSM, in case national legislation is applied in which certain options were exercised. The Court added however on the basis of Article 53 of the Charter that if national law is not 'entirely determined' by EU law, higher national standards may be applied provided the 'primacy, unity and effectiveness of European Union law are not thereby compromised'. Amongst other things, this arguably implies that if an EU institution or other EU body applies national law, *implementing* EU law directly, that institution will also be bound by any relevant higher national standards of fundamental rights protection in situations in which those national laws are not 'entirely determined' by EU law. Such a situation is foreseen in Article 4(3) SSMR:

> '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

9 *Bosphorus Airways* v *Ireland*, ECtHR 30 June 2005, appl. no. 45036/98.
10 Case C-399/11, *Melloni,* EU:C:2013:107.

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.'

The ECB may therefore have to take certain national constitutional rights into account when applying national legislation. This could raise tricky questions but it may not be much of an issue in practice; it is simply not clear how exceptional such situations will prove to be.

As for the degree to which such will (or can) deviate from the standard of protection provided in the Charter, there is much uncertainty after *Akerberg Fransson* and *Melloni*. The central question we are left with is when it is that the 'primacy, unity and effectiveness' of EU law are not 'compromised', and therefore how the Court weighs the interests of the protection of fundamental rights and against that of the enforcement of material provisions of EU law.[11]

As regards the relationship between Article 50 of the Charter and Article 4P7 ECHR, those provisions cannot simply be seen as complimentary guarantees, the one applying on the EU level and the other exclusively on the national level. One reason for this is that Charter rights are backed up by requirements of EU law such as primacy, direct effect and effectiveness, whilst the legal force of Convention rights varies widely between the Member States. Another issue is found in the limited ratification of Protocol 7 to the ECHR which leaves a gap in protection which is in some, but not all cases compensated by national laws. The Charter and the Convention can therefore be seen as qualitatively different sources of rights. Because of this (and due to the fact the CJEU appears to depart somewhat from the case law of the ECtHR in a growing number of cases) the question of whether a given situation is covered by the Charter, the Convention or both matters for the outcome in individual cases, and both standards must be taken into account by the ECB and the NCAs.

3 SUBSTANCE, SCOPE AND ELEMENTS OF THE GUARANTEE

Two distinct guarantees are commonly identified in connection with the *ne bis in idem* principle: the prohibition of double *prosecution*, and the prohibition of double *punishment*. According to established case law before both the ECtHR and the CJEU, the *ne bis in idem* principle bars the bringing of any new proceedings, regardless of whether a penalty was imposed in the first proceedings, or of the manner in which that penalty was calculated (prohibition of double prosecution).[12] The prohibition of double punishment is a corollary

11 The question of whether the CJEU is taking human rights "seriously" has lingered ever since the birth of fundamental rights protection through "general principles" in the case law of the CJEU.

12 In the *Franz Fischer* judgment, the ECtHR expressly held that Article 4 of Protocol No. 7 "is not confined to the right not to be punished twice but extends to the right not to be tried twice" *Franz Fischer v. Austria*, ECtHR 29 May 2001, appl. no. 37950/97. See also: *Sergey Zolotukhin v. Russia,* ECtHR (GC) 10 February 2009, appl. no. 1493/03.

to the *ne bis in idem* principle which forms an expression of the principle of proportionality, a fundamental principle of EU law. As for the question of who can rely on the guarantee, the answer is rather straightforward: 'only those who have actually been prosecuted and have had their prosecution finally disposed of' enjoy *ne bis in idem* protection (and not any accomplices or others who were in a similar position, but were not prosecuted).[13] Two questions arise in particular, in connection with fines under the SSMR, namely whether:

i) a bank or credit institution and its employees and/or CEOs; and

ii) different entities within a single corporate structure count as separate subjects for the application of the *ne bis in idem* principle.

Although there is no case law available to confirm this, it makes sense to treat the *legal subject* and its employees and/or executives as separate culpable subjects so that a sanction imposed on a credit institution would for example not stand in the way of the subsequent prosecution of one of its CEOs.[14] Similarly, in the case of entities within a single corporate structure the rule from the competition cases is that if they 'form an economic unit in which the subsidiary has no real economic freedom', the subsidiary cannot be seen as a separate culpable subject.[15] Subsidiaries would therefore enjoy *ne bis in idem* protection after a parent company has been fined.

As regards the material scope of application of the guarantee, the ECtHR has consistently held that 'the legal characterization of the procedure under national law cannot be the sole criterion of relevance for the applicability of the principle of *non bis in idem* under Article 4 § 1 of Protocol No. 7. Otherwise, the application of this provision would be left to the discretion of the Contracting States to a degree that might lead to results incompatible with the object and purpose of the Convention.'[16] In the first paragraph, Article 4 of Protocol No. 7 refers to 'criminal proceedings', which echoes the term 'criminal charge' from Article 6 ECHR. The scope of application of Article 4 of Protocol No. 7 is accordingly determined as an autonomous concept under the Convention by reference to three criteria, commonly known as the 'Engel criteria', which were similarly adopted by the CJEU in the *Bonda* judgment.[17] The extension of the 'Engel doctrine' to the *ne bis in idem* principle has potentially far-reaching consequences for national systems of law. The n*e bis in idem* principle entails no rule of conflict or priority between different legal rules or different types of proceedings within different jurisdictions, so that the application of the *Engel* doctrine to the *ne bis in idem* principle in practice requires full procedural coordination and/or

13 Case C-467/04, *Gasparin*i, EU:C:2006:610.

14 There at present is little evidence available in case law or doctrine to substantiate this finding, so the conclusion must be that there is nothing in the spirit of the *ne bis in idem* principle or the wording of the various provisions to indicate anything else.

15 Case C-30/87, *Corinne Bodson,* EU:C:1988:225.

16 *Sergey Zolotukhin v. Russia,* ECtHR (GC) 10 February 2009, appl. no. 1493/03, para. 78.

17 *Engel and Others v. Netherlands,* ECtHR 8 June 1976, (Series A-22); CJEU Case C-489/10, *Bonda* EU:C:2012:319. In the *Bonda* judgment the CJEU gave its own rendering of the *Engel* doctrine with particular emphasis on the need to protect the own financial means of the Union.

concentration of administrative, tax and criminal proceedings. In practice, the unwanted consequences are usually mitigated through *una via* rules, or by way of the coordination of enforcement efforts through a judicial network or government database. A second problem is that this may require a level of *ne bis in idem* protection under the Charter that the CJEU may deem to be not in conformity with the requirement of effectiveness of EU law under circumstances.[18]

The Engel criteria are:

i) the legal classification of the offence under national law;

ii) the nature of the offence;

iii) the degree of severity of the penalty that the person concerned risks incurring.

The Engel doctrine leads to a presumption that the charges against a subject are 'criminal', 'a presumption (...) which can be rebutted entirely exceptionally, and only if the deprivation of liberty cannot be considered appreciably detrimental given their nature, duration or manner of execution'.[19] In applying these criteria it is the maximum potential penalty for which the relevant law provides which must be taken into account here; the sentence that was actually imposed 'cannot diminish the importance of what was initially at stake'.[20]

The first Engel criterion, the legal classification as 'criminal' under national law is of little consequence. If an offence is classified as criminal under national law it will automatically be likewise classified for the purposes of the Convention. According to the Court, the second and third Engel-criteria are 'alternative and not necessarily cumulative. This, however, does not exclude a cumulative approach where separate analysis of each criterion does not make it possible to reach a clear conclusion as to the existence of a criminal charge'.[21] In applying the second Engel criterion, the Court will amongst other things have regard to the seriousness of the conduct itself, and the manner in which the misconduct is classified in other Member States.[22]

Of interest in the context of prudential supervision is the fact that the Court examines amongst other things whether the rule at issue is of a 'general character', applicable to all citizens and therefore belonging to the realm of criminal law in the wider sense, or a disciplinary rule which specifically aims to protect the qualities and/or integrity needed for the exercise of certain professions. The more specific a rule is in terms of the persons it potentially applies to (the case law provides examples of doctors, journalists, politicians), the greater the likelihood

18 The *Akerberg Fransson* judgment has provided one example of this.
19 *Sergey Zolotukhin* v *Russia,* ECtHR (GC) 10 February 2009, appl. no. 1493/03, para. 56.
20 *Idem*.
21 *Putz v. Austria,* ECtHR, 22 February 1996, (Reports 1996, 312), para. 31; *Sergey Zolotukhin v. Russia,* ECtHR (GC) 10 February 2009, appl. no. 1493/03, para. 53.
22 In Öztürk the Court for instance held it to be sufficient that the charges brought against the subject under provisions of administrative law were part of the criminal law in many Member States.

that the Court will consider that a measure is disciplinary, rather than 'criminal' in nature. In the *Demicoli* it was held that if the subject is in a particular position (in this case: a politician), this does not remove the prosecution from the criminal sphere if the same legal provision *could*, by its nature also apply to others.[23] Similarly, in the case of *Grande Stevens*, the Court held that the Italian rules prohibiting market manipulation generally aim to safeguard the proper functioning and transparency of financial markets and to protect the confidence of the general public in the functioning of those markets.[24]

The third Engel criterion raises questions because the Court has not set a lower limit for its application, and this is perhaps necessarily so. It may be difficult for the Court to justify the setting of any particular amount of a fine as a 'minimum threshold' due to the differences in circumstances between individual cases. Because of this, the third Engel-criterion all but obliterates the second one in practice. It is something of an Achilles heel for the Engel doctrine as a whole, amongst other things because it could tempt the Court to set the threshold for a minimum 'criminal' fine ever lower in cases where it is more difficult to reach agreement on a principled stance on a particular aspect of the second Engel criterion. The case law so far shows that not only the deprivation of liberty, but even a relatively modest fine can be sufficient to bring a case within the criminal law sphere for the purposes of the Convention.[25]

The possibility of the withdrawal of a license under the SSMR potentially falls under the third Engel-criterion. In *Nilsson v. Sweden*, the Court found that the temporary suspension of a driving license belonged to the criminal law sphere in that case because the suspension was not an 'automatic' or 'immediate and foreseeable' consequence of the subject's conviction for a serious road traffic offence. Because some time passed between the time of the subject's conviction and the moment his driving license was suspended, the Court concluded that the measure must have been, at least in part, punitive in nature. It held that 'prevention and deterrence for the protection of the safety of road users could not have been the only purposes of the measure; retribution must also have been a major consideration.'[26] In the *Haarvig* case, the temporary revocation of a medical license was considered not to be of a 'criminal law nature' given that the provision in question laid down a professional standard and did not aim to punish and deter, but only to prevent further damage to the subjects' patients.[27] Similarly, minor disciplinary proceedings against lawyers merely leading to a warning have been

23 *Demicoli v. Malta* , ECtHR 27 August 1991, appl. no. 13057/87.

24 *Grande Stevens and Others* v *Italy*, ECtHR 4 March 2014, appl. no.s 18640/10, 18647/10, 18663/10, 18668/10 and 18698/10, at paras. 96 and 97. According to the Court, these market rules serve the "general interests of society" normally protected by criminal law, and therefore belong to the sphere of criminal law for the purposes of the Convention. It follows that the Court focuses on the nature of the rule at issue and on the question whether the *rule* is of a specific character rather than on the question whether the *subject* belongs to a specific group, or profession in applying the second Engel criterion.

25 The Court has consistently held that "the relative lack of seriousness of the penalty cannot divest an offence of its inherently criminal character": *Ruotsalainen v. Finland*, ECtHR 16 June 2009, appl. no. 13079/03, para. 43.

26 *Nilsson v. Sweden*, ECtHR 13 December 2005, appl. no. 73661/01.

27 *Knut Haarvig v. Norway*, ECtHR 11 dec. 2007 (admissibility), appl. No. 11187/05.

held to fall outside of the scope of the notion of 'criminal charge'. A finding of a criminal charge may be based on a combination of factors. In the *Matyjek* case, the Court considered that a ban from taking certain government positions was sufficiently serious to constitute a criminal charge, even though not accompanied by a fine or any other form of punishment.[28] The reason for this was, according to the Court, that 'the prohibition on practicing certain professions (political or legal) for a long period of time may have a very serious impact on a person, depriving him or her of the possibility of continuing professional life. (…) This sanction should thus be regarded as having at least partly punitive and deterrent character.'[29] In the context of the SSMR, the conclusion from this is that the withdrawal of authorization can under circumstances constitute a criminal charge and therefore trigger the application of the *ne bis in idem* principle in relation to other penalties under the SSMR. Whether the same holds true for the removal by the ECB of 'members from the management body of credit institutions' pursuant to Article 16(2)(m) of the SSMR is not all that certain as those member will not be 'banned' from practicing their profession like in the *Matyek* case. All the while, there is no doubt that such a decision may have a 'significant impact' on the person in question so that the observance of at least the minimum requisite procedural safeguards under the ECHR appears advisable, regardless of whether such decision is capable of activating the Engel doctrine in every case.

To round off this brief expose on the *ne bis in idem* principle: the guarantee comprises of two main elements: '*bis*' and '*idem*'. As for the former, the guarantee only bars further proceedings once the outcome of the first set of proceedings has become *final*. The guarantee does not bar the possibility of imposing several penalties on a subject (*e.g.* the revocation of license, the imposition of a fine, and/or imprisonment) on the basis of the same conduct, only as long as those penalties are imposed simultaneously or within the same set proceedings. A decision is final when it is a decision that is *irrevocable*, 'that is to say when no further ordinary remedies are available or when the parties have exhausted such remedies or have permitted the time-limit to expire without availing themselves of them'.[30]

As for the latter, the element of *idem*, it is by now established case law that the only relevant criterion for its determination is whether both sets of proceedings concerned *substantially the same facts*.[31] The circumstance that those facts may fit different legal qualifications under different administrative and criminal law provisions is irrelevant in this regard. This holds true even if the elements of those offences under the law differ substantially across different fields of law.

28 *Matyjek v. Poland*, ECtHR 30 May 2006 (admissibility), appl. No 38184/03.

29 *Ibid* para. 55.

30 *Sergey Zolotukhin v. Russia,* ECtHR (GC) 10 February 2009, appl. no. 1493/03.

31 One of the judges sitting on *Zolotukhin* case later admitted publicly that the term "substantially" was added in order to create some scope for considerations other than strictly factual ones, and expressed regret that the "door had thus been left a little open". So far however the issue hasn't proven very contentious. The '*Zolotukhin*-formula' ("substantially the same facts") appears to provide a sufficiently clear rule that squares well with national constitutional traditions in most of the Member States of the Council of Europe. Issues appear to present themselves mainly in the context of the application of the Engel doctrine to the *ne bis in idem* principle.

This is the case, for example, if the first proceedings merely concern one or more aspect of the litigious behaviour regulated under provisions of administrative law such as failure to comply with road traffic regulation or failure to control the vehicle, whereas the second proceedings under criminal law regard more serious aspects of the event, such as involuntary manslaughter or the causing of severe bodily harm. In the case of *Lucky Dev* the ECtHR held that bookkeeping fraud and the filing of an incorrect tax statement are sufficiently separate to constitute separate facts for the application of the *ne bis in idem* principle.[32] For prudential supervision this is an important judgment which will no doubt help to take the edge off *ne bis in idem* issues in case of complex financial infringements by banks and other credit institutions, which are more easily divided up into separate wrongdoing than most other criminal acts.

4 SANCTIONS AND ENFORCEMENT UNDER THE SSMR

In the light of the foregoing, three types of decision can be identified in the SSMR with potential *ne bis in idem* relevance:

- administrative pecuniary penalties (Article 18(1) of the SSMR) of up to twice the amount of profits gained or losses avoided or up to 10% of annual turnover;

- sanctions in accordance with Regulation (EC) No 2532/98[33] for 'failure to comply with ECB decisions or regulations' (Article 18(7) of the SSMR); and

- the withdrawal of authorization (Article 14(4) of the SSMR).

The removal by the ECB of members from the management body of credit institutions pursuant to Article 16(2)(m) SSMR could perhaps be added to this list, but this is arguably too uncertain in the present state of the case law on the Engel doctrine to consider further in this contribution. As regards the penalties under Article 18(1), the SSMR does not contain any *ne bis in idem* provision, or any 'hard', legal rules coordinating enforcement measures either between the ECB and the NCAs, or between national and EU law. In broad lines, the enforcement architecture of the SSM appears similar to that of Regulation 1/2003 (the procedural regulation for competition law) but there are also differences. The pecuniary sanctions are comparable to those found in competition law, both in nature and in size and there can be no doubt that the first and second types of sanctions belong to the 'sphere of criminal law' within the meaning of the Engel/Bonda doctrine. A marked difference with competition law is found in the third category of sanctions: the withdrawal of authorization. No such sanction is available under the competition rules and it warrants some further attention, in particular in combination with other sanctions. It follows from the Engel-jurisprudence discussed above that:

32 *Lucky Dev*, ECtHR 27 November 2014, appl. no. 7356/10.

33 Council Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the ECB to impose sanctions (OJ L 318, 27.11.98, p. 4).

i) the decision withdrawing a license as such is not always necessarily punitive in nature, and different circumstances may lead to different findings in individual cases;

ii) the concurrence of the withdrawal of a license and the imposition of a fine is not necessarily problematic as long as the *withdrawal of the license* (and therefore not the imposition of a fine, due to its necessarily punitive nature) forms the *immediate and foreseeable consequence* of a decision sanctioning certain conduct.

Here, the boundaries of the *Engel* doctrine and the requirement of the finality of the previous sentence as they appear from the case law of the European Court of Human Rights (ECtHR) are somewhat blurred. It is for instance not certain whether the withdrawal of a license which is per se punitive but also forms the 'immediate and foreseeable consequence' of the decision to impose a fine or another sanction is caught by the *ne bis in idem* principle, or not. From the case law of the ECtHR we know that if the revocation of a driving license automatically follows a conviction for a road traffic offence this is not problematic, but if sufficient time has passed between the initial conviction and the revocation of the license, and the latter was at least in part based on a separate assessment of the facts of the case, this provides some indication of the (partially) punitive nature of the latter decision.

From the wording of the SSMR too little can be inferred with sufficient certainty on the interaction between the procedures for adopting decisions under Articles 14 and 18 SSMR to make a full assessment on this point, although it can safely be assumed that those provisions will often prove relevant in the same situations. Similarly to Regulation 1/2003 however, the SSM Regulation purposively leaves many points to be worked out later on in more detail in practice, through delegated secondary legislation, or as is often the case in competition law through guidelines and notices. Although it is possible that the interaction between fines and decisions to withdraw a license wasn't as such considered in the drafting of the SSMR (or at least not from the perspective of *ne bis in idem*) this is therefore not necessarily a mistake or an omission. Whether such would have been necessary or better in any way is entirely up for speculation. For now, it is sufficient to point out that the interaction between these decisions can give rise of *ne bis in idem* concerns, and that the ECB is well advised to carefully coordinate the procedure leading to a decision to withdraw the license of a credit institution with the procedure leading up to the imposition of an administrative pecuniary penalty under Article 18(1) SSMR.

5 THE ENFORCEMENT ARCHITECTURE OF THE SSM: POTENTIAL ISSUES IN (DE)CENTRALIZED SANCTIONING AND ENFORCEMENT WITHIN THE SSMR

In order to get a sense of the mechanisms of enforcement and the division of tasks between the ECB and the NCAs, the considerations of the SSMR are a first point of reference. Recital 86 SSMR affirms the respect for fundamental rights and

principles and mentions the protection of personal data, the freedom to conduct a business, the right to an effective remedy and to a fair trial, but does not mention the *ne bis in idem* principle. This is perhaps somewhat unfortunate as it could convey the impression that potential problems in this connection were not duly considered in drafting the SSMR (which they were). Several other points raise interest, in particular recital 36:

> 'In order to ensure that supervisory rules and decisions are applied (…) effective, proportionate and dissuasive penalties should be imposed in case of a breach. In accordance with Article 132(3) TFEU and Council Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the European Central Bank to impose sanctions, the ECB is entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions. Moreover, in order to enable the ECB to effectively carry out its tasks relating to the enforcement of supervisory rules set out in directly applicable Union law, the ECB should be empowered to impose pecuniary penalties on credit institutions, financial holding companies and mixed financial holding companies for breaches of such rules. National authorities *should remain able to apply penalties in case of failure to comply with obligations stemming from national law transposing Union Directives* (italics added). Where the ECB considers it appropriate for the fulfillment of its tasks that a penalty is applied for such breaches, it should be able to refer the matter to national competent authorities for those purposes.'

What this illustrates is that, similarly to competition law, the division of tasks and competences between the ECB and the NCAs within the enforcement architecture of the SSM is not characterized by 'hard' legal formalism, but could be described as a system of regulated and centralized cooperation between authorities. The difference in legal terms is that the ECB is the first and foremost party responsible for the overall functioning of the system. Article 4(1) SSMR indicates that the ECB is attributed exclusive competence for prudential supervisory purposes in respect of all banks. Article 6 SSMR sets forth a delegation of prudential supervisory competences from the ECB to the NCAs in respect of less significant banks, but this does not disqualify the ECB as the main competent authority for both significant and less significant banks. Recital 36 SSMR confirms that this system does not in principle preempt parallel or consecutive enforcement efforts of the ECB and the NCAs in respect of the same or related infringements. The same follows from paragraphs 1 and 5 of Article 18 SSMR, which read as follows:

1 For the purpose of carrying out the tasks conferred on it by this Regulation, where credit institutions, financial holding companies, or mixed financial holding companies, intentionally or negligently, breach a requirement under relevant directly applicable acts of Union law in relation to which administrative pecuniary penalties shall be made available to competent authorities under the relevant Union law, the ECB may impose administrative pecuniary penalties of up to twice the amount

of the profits gained or losses avoided because of the breach where those can be determined, or up to 10 % of the total annual turnover, as defined in relevant Union law, of a legal person in the preceding business year or such other pecuniary penalties as may be provided for in relevant Union law.

5 In the cases not covered by paragraph 1 of this Article, where necessary for the purpose of carrying out the tasks conferred on it by this Regulation, the ECB may require national competent authorities to open proceedings with a view to taking action in order to ensure that appropriate penalties are imposed in accordance with the acts referred to in the first subparagraph of Article 4(3) and any relevant national legislation which confers specific powers which are currently not required by Union law. The penalties applied by national competent authorities shall be effective, proportionate and dissuasive. The first subparagraph of this paragraph shall be applicable in particular to pecuniary penalties to be imposed on credit institutions, financial holding companies or mixed financial holding companies for breaches of national law transposing relevant Directives, and to any administrative penalties or measures to be imposed on members of the management board of a credit institution, financial holding company or mixed financial holding company or any other individuals who under national law are responsible for a breach by a credit institution, financial holding company or mixed financial holding company.'

In principle, the NCAs competences are not suspended or withdrawn when the ECB acts or has acted with respect to a certain credit institution. On the one hand, the SSM is therefore more centralized in set-up when compared to the European Competition Network due to the primacy of the ECB, while on the other hand, the SSMR would appear to leave room for national authorities to act in various types situations (as evidenced amongst other things by recital 36 SSMR). The distinction between 'significant' and 'less significant' institutions as laid down in Article. 6 SSMR sets the division of tasks between the ECB and the NCAs, which coordinates their enforcement efforts. If this coordinating function is sufficient to avoid any confusion as regards who does what in practice, it should be possible to avoid any potential *ne bis in idem* situations as far as administrative pecuniary penalties under Article 18(1) SSMR are concerned. Another difference with competition law that is relevant in this respect is that penalties under the SSMR reflect the gains had by the institution from the infringement and are not somehow divided up according to the supposed harm inflicted on different national markets for the purpose of the calculation of fines by different national authorities, as is presently the case in competition enforcement practice. Under the SSMR, it is clear that the NCAs are fully competent to impose any penalties, whereas competition law is more ambiguous in that it is thought that the national authorities are only competent as far as their own national markets are concerned. For competition law this ambiguity is conducive to infringements of the *ne*

bis in idem.[34] Infringements are however in practice usually avoided through cooperation within the European Competition Network (ECN) and through enforcement restraint on the part of competition authorities.

From the foregoing it can be concluded that the SSMR appears rather '*ne bis in idem* proof' compared to competition law as far as the penalties of Article 18(1) are concerned, owing *inter alia* to the fact that the division of tasks within the SSM hinges on the distinction between significant and less significant institutions from Article 6 SSMR. Such a coordinating principle is essential because the *ne bis in idem* principle itself does not fulfill a coordinating function and merely leads to a 'system' of first come first served as is presently the case in competition law and in the Area of Freedom, Security and Justice. Although this forms an important first safeguard, the SSM Regulation itself does not *verbatim* exclude the possibility of infringements of the *ne bis in idem* principle. The experience from competition law however shows many remaining issues can in practice be solved through coordination and cooperation within a network like the SSM, and through self-restraint on the part of the authorities where necessary.

From the foregoing it should not be concluded that the lack of a formal division of tasks and competences between the members of the SSM in the SSMR doesn't raise any potential issues. Indeed, more legal clarity on this point in the SSM Regulation itself may have been preferable from a fundamental rights perspective. An issue that was already identified is that enforcement requires effective judicial remedies, which may not be equally available before national and EU courts in all types of situations: situations in which the ECB applies EU and/or national law, situations in which NCAs act under the instruction of the ECB, and situations in which the NCAs act in other situations. Such issues are however beyond the remit of this contribution to further address.

A *ne bis in idem* issue that can be identified within the SSMR is the interaction of an administrative pecuniary penalty and the withdrawal of a license. No parallel can be drawn here with competition law; it is a problem specific to the SSMR. It should be practically possible to avoid *ne bis in idem* infringements in this type of situation, but the SSMR does not provide any particular mechanism on this point so that this must be achieved through coordination of the proceedings leading up to the withdrawal of a license and the imposition of an administrative penalty, and where needed through enforcement self-restraint on the part of the ECB. Alas, there is no case law before the CJEU to turn to for guidance on this point. From the ECtHR case law discussed earlier in this contribution however it follows that the withdrawal of a license must be the immediate and foreseeable consequence of an investigation or a decision also imposing or leading up to the imposition of a penalty – which for prudential supervision is perhaps not

34 This (unwritten) "rule" in competition law is paradoxical because it relies on national (market) boundaries which competition law and EU law as a whole precisely aim to remove. This aspect of the method of decentralized fine-setting arguably reveals a deficiency in the enforcement architecture of Regulation 1/2003. The problem is at present obscured through the case law of the EU courts, in particular the *Toshiba*-judgment, in which the CJEU resuscitated the aged and languishing *Walt Wilhelm*-judgment against that judgments' own wish.

always as easy to achieve as, say, for the withdrawal of a drivers license or the suspension of a medical license. It is possible that, applying the rule from the *Jussilla* judgment, the ECtHR will show itself to be more lenient in this regard where it concerns banks and other large enterprises but there has been so far no case concerning the *ne bis in idem* principle specifically to confirm this.

A clear parallel with competition law exists only as regards sanctions for 'failure to comply with ECB decisions or regulations' (Article 18(7) SSMR). For reasons similar to those in competition law, those types of sanction will not typically give rise to *ne bis in idem* trouble. For one, each sanction requires a specific individual 'failure to comply', and a continued failure to comply can thus be divided up into different infringements by adopting a series of decisions, which is not possible in respect of infringement in connection with sanctions under Article 18(1) SSMR. Although the possibility that a single historical infringement may give rise to the possibility of sanctions of several types cannot *a priori* be excluded, competition enforcement practice shows that this is probably very rare (or at least never surfaces in competition proceedings before the EU courts) and there appears to be no reason to assume this will be any different under the SSMR.

6 POTENTIAL ISSUES IN THE INTERACTION WITH OTHER SANCTIONS AND PROCEDURES UNDER NATIONAL LAW

The SSMR doesn't as such mention national criminal laws, tax laws or national laws of any other kind. The only provision which may provide some indication on this point is Article 3(10) of Regulation (EC) No 2532/98, which reads as follows:

> 'If an infringement also relates to one or more areas outside the competence of the ESCB, the right to initiate an infringement procedure on the basis of this Regulation shall be independent of any right of a competent national authority to initiate separate procedures in relation to such areas outside the competence of the ESCB. This provision shall be *without prejudice to the application of criminal law* (italics added) and to prudential supervisory competencies in participating Member States.'

Although it is not certain whether this provision is still relevant, the spirit of its wording doesn't augur well for *ne bis in idem* issues. A variety of national legislative responses to financial misconduct emerged during and after the recent financial crisis, and a range of potential issues could be identified on this point. The complexity of the questions that may arise in this connection makes it difficult to arrive at general conclusions. It is worth pointing out that such issues only arise, as indicated earlier, if it is indeed the legal entity – the bank or other credit institution itself – that is penalized and not its CEOs or employees. This isn't equally the case in all Member States, because not every Member State recognizes the criminal law responsibility of legal persons. In situations in which a CEO or employee is prosecuted, this does not trigger *ne bis in idem* protection for the legal entity, and *vice versa*. At least, so it must be (and is generally) assumed, as there is at present no judgment from either court confirming this.

There is a difference between the Charter and the ECHR on this point. It should be recalled that such a combination of sanctions is only a potential issue of *ne bis in idem* as a matter of EU law, if *both* decisions (sanctions) fall within the scope of the Charter. Although the influence of EU law on national criminal law and therefore the extent to which the Charter applies in situations governed by national law is steadily growing, the vast majority of criminal cases are and will likely always remain outside of the scope of application of EU law and the Charter. In financial criminal law however, there is more relevant EU legislation to consider than in many other fields of criminal law. The possibility of the occurrence of a situation in which a single infringement triggers different enforcement responses by the ECB and/or an NCA as well as national prosecutors is therefore all but imaginary. In situations in which both instances of prosecution are (sufficiently) connected to EU law, this may violate Article 50 of the Charter. Direct taxation on the other hand is not harmonized at all on the EU level so that the risk of a violation of Article 50 of the Charter through the concurrence of a tax penalty and a penalty under the SSMR for the same conduct seems minimal.

Absent any link to EU law the potential for such issues in situations under national criminal or tax law to fall within the scope of Article 4P7 ECHR is very real and the legal situation is potentially more complex. There are various national *ne bis in idem* provisions that must be taken into account in addition to Article 4P7 ECHR, which (to further complicate matters) was not ratified by all Member States. If a case reaches the Strasbourg court and the situation concerns the application of EU law or national law implementing EU law without any discretion for the Member State by an NCA, or a situation in which an NCA acts under the instruction of the ECB, the *Bosphorus* doctrine may, or may no longer apply. As discussed earlier in this contribution there is little certainty on the point of how the ECtHR will now decide in a case in which national law implements EU law in the light of the developments that followed after the *Bosphorus* judgment. There is, in sum, as much cause for concern as there is legal limbo.

No lessons can be drawn from competition law here as such questions don't really present themselves in the context of competition law enforcement. Competition laws in the Member States are (supposedly) the fruit of a process of 'spontaneous harmonization', raising the question of whether the Charter applies to national competition law at all in situations not affecting trade between the Member States – although there are good grounds to assume that it does. What the SSM, competition law, and many other areas of EU law have in common is that there is scope for conflict between requirements of effective and dissuasive measures under EU law and Convention obligations for the Member States, and the *Akerberg Fransson* and *Bonda* judgments provide some clear examples.

7 CONCLUSIONS

The question raised in this contribution is not whether an infringement of the *ne bis in idem* principle is possible under SSM, but whether there is, to borrow a term, a *systemic risk*. In other words, we have looked at whether the enforcement architecture of the SSMR is conducive to violations of the *ne bis in idem* principle

in certain situations and competition law was used as a point of reference. The SSM is *prima facie* more '*ne bis in idem* proof' than Regulation 1/2003, but there are certain *caveats* which have been highlighted.

There is no provision on *ne bis in idem* in the SSM package; the SSMR itself does not preempt violations of the *ne bis in idem* principle. The same is true for Regulation 1/2003, but the actual problems for competition law are hardly comparable to those found in prudential banking supervision. One familiar *ne bis in idem* issue in competition law is that the internal market is in practice 'divided up' into national markets overlooked by national competition authorities. Because of this the architecture of EU competition law enforcement is conducive to infringements of the *ne bis in idem* principle, which are in practice prevented through coordination and cooperation within the ECN. Fines imposed by the ECB or NCAs on the other hand do not supposedly reflect the impact of an infringement on affected markets, but are determined according to the subjective gain had by a bank through the infringement. This difference in practice already works to limit the potential for *ne bis in idem* violations.

The ECB is well advised to carefully coordinate the procedure leading to a decision to withdraw the license of a credit institution with the procedure leading up to the imposition of an administrative pecuniary penalty under Article 18(1) SSMR, as these decision may give rise to *ne bis in idem* issues.

Other issues may also present themselves, in particular in the interaction:

i) with national criminal and possibly tax law, and

ii) between the withdrawal of authorization and the imposition of an administrative pecuniary penalty.

Little can be said in general with any certainty on these points because the potential for such issues will necessarily vary from one Member State to another. Such situations will not always fall within the scope of EU law – and therefore that of the Charter – due to the limited extent to which national criminal law is harmonized at the EU level. The same applies to tax law, due to the wholly unharmonized nature of direct taxation in the EU. This will however not always prevent possible violations of Article 4P7 ECHR. Although the ECHR is formally (still) not binding on the EU, such violations nevertheless deserve consideration in the context of the SSMR, for a number of reasons. One such reason is that, unlike the ECB, it must be assumed that the NCAs are bound by the ECHR in the performance of their tasks, regardless of whether they apply EU or national law. Another reason could be that the ECB may find itself in the same position when it applies national law, implementing EU law but this last point is debatable.

LIMITATIONS ON SUPERVISORY POWERS BASED UPON FUNDAMENTAL RIGHTS AND SSM DISTRIBUTION OF ENFORCEMENT COMPETENCES

MARCO LAMANDINI[1]

A FOREWORD

1. After the insightful and comprehensive presentation of Prof. Van Bockel, my first imperative is to avoid any unnecessary duplication, for a "bis in idem" would be quite ironical in the circumstances. I take thus a step back from the "ne bis in idem" and *a broader view on the coexistence of national and EU law within the Single Supervisory Mechanism (SSM) and its interplay with fundamental rights and other constitutional limitations* on supervisory powers arising out of the vertical European/national distribution of competences. In this vein, I will also touch on the "ne bis in idem", but in a wider perspective, trying to explore some of the institutional concerns associated with coexistent or alternative European and national levels within the SSM. Here, many fundamental rights are called to action (from due process and data protection, to double jeopardy and fair trial, to mention but a few), but I will mostly focus – alongside the reasoning of the European Court of Human Rights (ECtHR) *Franzo Grande Stevens* decision[2] – on fair trial and, to a lesser extent to avoid duplications, "ne bis in idem".

2. In my view, a good starting point for the discussion of the coexistence of national and EU law levels within the SSM and of its implications on the ways supervisory, administrative and punitive measures must be adopted and subject to proper judicial control to ensure consistency with overarching constitutional principles lies on four *just exemplary* but certainly problematic areas. They revolve around: a) the vertical distribution of *regulatory*

1 Chair of Company Law and Financial Law at the Alma Mater Studiorum, University of Bologna and Board of Appeal of the European Supervisory Authorities. All views are in personal capacity and do not necessarily reflect those of the institutions to which the author is affiliated. This paper is based on the findings of a wider study performed together with David Ramos Munoz and Javier Solana under the auspices of the 2015 ECB Legal Research Program, *Depicting the limits to the SSM's supervisory powers: The Role of Constitutional Mandates and of Fundamental Rights' Protection*, forthcoming (in an abridged version) in the ECB Legal Research Working Papers and (in full) in *Quaderni di Ricerca Giuridica della Banca d'Italia*. The author is deeply indebted to his co-authors and to Renzo Costi, Chiara Zilioli, Antonio Luca Riso, Petra Senkovic, Phoebus Athanassiou, Marino Perassi, Raffaele D'Ambrosio, Alessandra De Aldisio and Olina Capolino for very useful comments. Errors remain the sole responsibility of the author.

2 Applications Nos 18640/10, 18677/10, 18663/10,18668/10, 18698/10 *Grande Stevens and Others* v *Italy*, judgment of the ECtHR of 4 March 2014.

competences (Articles 4(3) and 9 of the SSM Regulation[3]); b) role of ECB guidelines, recommendations or general instructions to NCAs for the performance of supervisory tasks and the adoption of NCAs decisions; c) ECB enforcement of national legislation implementing EU law (Article 4(3) of the SSM Regulation); d) the distribution of sanctioning powers between the ECB and NCAs (Article 18 of the SSM Regulation).

ECB REGULATORY POWERS: LIMITS FROM THE CONSTITUTIONAL MANDATES AND FUNDAMENTAL RIGHTS

3. Starting from the question of the ECB's regulatory powers, I find that: (a) the constitutional distribution of competences within the SSM is likely to be more ambiguous than necessary; (b) despite the somehow clearer horizontal distribution of regulatory competences between the European Banking Authority (EBA) and the ECB, ECB supervisory powers are possibly extending beyond direct and indirect oversight to embrace also secondary regulation where Union law is conceived as incomplete and grants "competent authorities" options and discretions. This is highly consequential because the line between the regulatory competences of the ECB and national competent authorities (NCAs) is quite uncertain and this gives rise to a risk of overlaps and conflicts of attributions; (c) fair trial and other fundamental rights come into play not only in respect of the exercise of prudential supervisory tasks but also with regard to regulatory supervision.

4. To make a quite long and controversial story on this point short, it is sufficient to say that on the ECB regulatory powers in respect to the options and discretions granted to competent authorities by CRD IV[4]/CRR[5], two conflicting readings of the SSM Regulation are possible, as evidenced in the literature. Failing a say of the Court of Justice of the European Union (CJEU) so far, there are good reasons for both.

5. A first line of reasoning points out that, except for the regulations to be issued in the framework of indirect supervision under Article 6 of the SSM Regulation, Article 4(3) expressly reserves to the ECB the exclusive possibility of adopting regulations "*only to the extent* necessary to organize or specify the arrangements for the carrying out of the tasks conferred on it by this Regulation". This is read as confining the regulatory role of the ECB only in purely organizational matters. The arguments used to support this conclusion are two-fold. One *formal:* Article 9(1) extends to the ECB the

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).

4 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).

5 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 176, 27.6.2013, p. 1).

powers granted to national competent authorities "*unless otherwise provided for by this Regulation*". Article 4(3) would in fact "provide otherwise", limiting regulatory powers only to organizational matters. One s*ubstantive:* if the ECB were empowered to exercise NCAs' options, it is argued that this would be done for significant credit institutions only and "this would jeopardize the level playing field" in each Member State because the ECB and the NCA could exercise the options and discretions differently for significant and less significant credit institutions".

6. A second line of reasoning, that we are inclined to follow, suggests that Article 4(3) can be read as limiting the scope of ECB regulation where Union law (including national legislations exercising Member States options) is already a complete body of primary and secondary rules which needs only to be enforced (and here the ECB regulatory scope shall be mainly organizational, in a broad sense of the expression, though). The ECB regulatory power under Articles 132 TFEU and 34 of the ECB Statute retains however a role, *within the limits of the tasks conferred on it* and with the functional scope of implementing them (and "*to the extent necessary to it*"), where Union law is incomplete and where in particular it defers regulatory choices to competent authorities. According to this view, Article 132 TFEU and Articles 34 and 25(2) of the ECB Statute must be read in conjunction with the SSM Regulation and the interpretation of Articles 4(3) and 9 of the SSM Regulation should be done in the light of recital 34.

7. There are, to my mind, literal and legislative history arguments supporting such a conclusion.

a) Article 132 TFEU and Articles 34 and 25(2) of the ECB Statute must be read in conjunction with the SSM Regulation. The former expressly stipulate that the ECB is granted a *general* power "to make regulations *to the extent necessary to implement its tasks*". Both Treaty and Statute enabling provisions, albeit adopted when the ECB was vested only with monetary policy functions and primarily set out with a view to the monetary functions conferred upon the ECB, are also made applicable to the prudential tasks that could be extended to the ECB under Article 127(6) TFEU, as made clear by Article 25(2) of the ECB Statute. It is worth noting, moreover, that both Article 132 TFEU and Article 34 of the ECB Statute provide that, to the extent necessary to implement the tasks conferred on it, "the ECB *shall* make regulations". In this way both provisions could even suggest that the attribution of implementing regulatory powers could be an automatic effect of the conferral of the specific prudential tasks conferred on the ECB without the need for any complementary specification by the Council regulation conferring them under Article 127(6) TFEU. This would militate against any reading of the SSM Regulation conducive to an excessive limitation of the ECB implementing regulatory powers, and in particular against a restrictive interpretation of Article 4(3) suggesting a strict reading of that provision. One could object, though, that, whilst Article 132 TFEU and Article 25 of the ECB Statute make reference to these regulatory powers as part of the ECB "constitutional" endowment in the matters deferred to it, Article 127(6) specifies that "the

Council *may* confer specific tasks" and therefore that the Council, in its political discretion, could also decide to confer prudential tasks strictly confined to supervision with express exclusion of regulatory powers in respect to the same matters. In the same vein, the first period of Article 25(2) of the ECB Statute could be interpreted so as to emphasize that the conferral of the specific tasks is in any event "in accordance with any decision of the Council under Article 127(6)". However, it could also be argued to the contrary, that, in principle the TFEU is willing to confer on the ECB regulatory powers aligned with the specific supervisory tasks attributed to it under Article 127(6) due to the "to some extent illusory"[6] distinction between these two functions. Whatever the preference for the constitutional argument based on the TFEU, one should be careful, therefore, in construing the SSM Regulation in a way that would deprive the ECB of its general power to make regulations "*to the extent necessary to implement* the tasks defined in Article 25(2)".

This reading could be supported, on one count, by a better consideration of the relationship existing between paragraphs 1 and 2 of Article 4(3). It is quite apparent, indeed, that these two paragraphs are strictly related (the *incipit* of paragraph 2 makes explicit reference "to the effect" of paragraph 1) and that they cover only situations (that are the vast majority) that are already *fully regulated* by Union law (herein including national legislation implementing Directives and exercising national discretions). In this context, Article4(3) is aimed at preventing the ECB from adding additional regulatory requirements. This is true in principle, although the expression "organize or specify arrangements for the carrying out of the tasks" leaves some leeway for intervention. However, these two paragraphs do not consider in any way how the ECB could exercise its specific tasks where Union law is incomplete and in particular where Union law simply defers a regulatory role to the competent authority in order to complete the regulatory framework for supervisory purposes. In this domain, it is our understanding that the ECB can make regulations to the extent necessary to implement the specific tasks conferred on it.

This seems further confirmed by the wording of recitals 32, 34 and 45 of the SSM Regulation itself. Indeed these recitals would likely be inconsistent with a restrictive reading of the Regulation, whilst they seem to be fully aligned with the idea that the rule making power under Article 132 TFEU is still available to the ECB (recital 32), that competent authority options within the SSM shall be exercised by the ECB, making use of its general regulatory empowerment (recital 34) and that the powers that "Union law on the prudential supervision of credit supervision confers on competent authorities" should be conferred on the ECB "to the extent that those powers fall within the scope of the supervisory tasks conferred on the ECB", because "for participating Member States the ECB should be considered the competent authority and should have the powers conferred on competent authorities by Union law" (recital 45). It is good interpretative

6 Ignazio Angeloni, "Rethinking banking supervision and the SSM perspective", speech delivered at the conference on "The new financial architecture in the Eurozone", European University Institute, Fiesole, 23 April 2015, accessible at www.bankingsupervision.europa.eu/press/speeches

practice to interpret directives and regulations in the light of their recitals and to read legislative statements (albeit inserted solely within the reasoning of the legislative act) in such a way that they make sense in their context rather than in ways difficult to reconcile with the text. Indeed, the fifth period of recital 34 seems to address specifically the issue of the national options and discretions granted by the CRD IV/CRR compact and stipulates that "(CRDIV/CRR) *options should be construed as excluding options available only to competent or designated authorities*". This wording seems to suggest that, since after the entry into force of the SSM the ECB has taken over the role of competent authority in the participating Member States, the ECB also replaced the national competent authorities as sole entity within the euro area vested with the power to exercise such competent authority options. In other words, recital 34 seems to suggest that in its supervisory action the ECB, whilst still subject to *national legislative options,* should not encounter (nor pay any deference to) national discretions embedded in the CRD IV/CRR compact and qualified herein as NCAs. This is so because such options relate to prudential tasks conferred on the ECB by the SSM Regulation and for such tasks the ECB is the competent authority.

b) Legislative history, in turn, offers some useful insights. The original wording of Article 4(3) in the 2012 Commission proposal (COM(2012) 511 final) was as follows: "Subject to and in compliance with any relevant Union law rule and in particular any legislative and non-legislative act, the ECB may adopt *regulations* and recommendations and take decisions to implement or apply Union law, *to the extent necessary to carry out the tasks conferred upon it by this Regulation*". Current recital 34 was not present in the original proposal whereas current recital 32 was already contemplated as recital 26 and current recital 45 was already contemplated as recital 30. The explanatory report confirmed, at paragraph 4.1.3, the ECB regulatory competences under Article 132 TFEU. The European Parliament (EP) Committee on Constitutional Affairs opinion of 27 November 2012 (2012/0242-CNS) proposed an amendment to Article 4(3) and namely that the ECB may adopt regulations to the extent necessary to carry out the tasks conferred upon it by the Regulation "*and only where those Union acts do not deal with certain aspects necessary for the proper exercise of the ECB's tasks or do not deal with them in sufficient detail*". This proposal was adopted by the Thyssen Report tabling the amendments to the Commission proposal on behalf of the EP Committee on Economic and Monetary Affairs of 3 December 2012 (A7-0392/2012). It was only with the second round of EP amendments adopted on 22 May 2013 that the original Article 4(3) was modified and adopted in its current text and, at the same time, a new recital 26b was inserted, expressly providing that options provided for in Union law "should be construed as excluding options available only to competent or designated authorities" (as currently set out in recital 34). The intention of the drafters might have well been, thus, to state that Article 4(3) could limit the extent of the powers to make regulations conferred on the ECB because this limitation was confined to situations where Union law was complete and recital 34 clarified that, where this was not the case, as it was precisely where Union law granted competent authority options, the ECB would have exercised such options (to that end making full use of its regulatory powers).

c) A functional interpretation could also support this conclusion. Competent authority options and discretions granted by the CRD IV/CRR compact are given to the supervisory authority because of its special position and in particular taking into account the informational advantages associated with supervisory activity. This special position, within the SSM, has been transferred, at least in respect of significant banks, to the ECB and, for consistency, also the power to exercise competent authority options should follow the same principle of attribution of competence. If one accepts this conclusion, a final question arises as to whether the ECB empowerment to exercise competent authority options and discretions for participating Member States is general or confined to prudential options for significant banks only. In the latter case - that is to say, if NCAs retain the power to exercise national options and discretions in respect of non significant banks – the allocation of rule making within the SSM for the exercise of competent authorities options and discretions would be conducive, as suggested in the literature by those advocating the first reading on limited ECB regulatory powers to a disparity of requirements for significant and less significant banks, with a uniform exercise of the options limited to significant banks. This is something that, functionally, is widely believed to be quite undesirable. We note, however, that Article 4(1) stipulates that "within the framework of Article 6, the ECB shall, in accordance with paragraph 3 of this Article, be *exclusively competent* to carry out, *for prudential supervisory purposes*, the following tasks in relation to *all* credit institutions established in the participating Member States (…)". This suggests that the attribution of competence to the ECB, whilst limited to the special tasks granted for prudential supervisory purposes, is *exclusive* and extends to *all* banks. The ECB could thus qualify as "competent authority" for the purposes of the exercise of competent authority options and discretions also for less significant banks. The basic principle of ECB exclusive responsibility for the tasks conferred on it was a cornerstone of the Commission proposal and was considered as such throughout the legislative process, although, as a compromise solution in the distribution of tasks within the SSM, the Regulation provides under Article 6(4) that responsibility for the direct exercise of some of the tasks conferred on the ECB are attributed to NCAs in the spirit of the subsidiarity principle. But also within this peculiar legislative allocation of (certain) responsibilities the ECB retains, in substance, a right of final say over the prudential tasks conferred on it by the SSM Regulation also for less significant banks, as shown by the possibility granted to it to "issue regulations, guidelines or general instructions to NCAs" (Article 6(5)(a) of the SSM Regulation) and to "exercise directly itself all the relevant powers" for one or more less significant credit institutions "when necessary to ensure consistent application of high supervisory standards" (Article 6(5)(b) of the SSM Regulation). In other words, it is certainly true that the attribution of exclusive competence set out in Article 4(1) must be read in conjunction with the provisions of Article 6, which stipulates that both NCAs and the ECB exercise competences with regard to less significant institutions. We note, nonetheless, that the cooperation framework set out by Article 6 was basically tailored as a *legislative* attribution to the NCAs of the direct exercise of (most *but not all*) prudential supervisory responsibilities of the ECB with regard to less significant banks. In this way, national supervisors are

also made competent authorities to some effects, without depriving however the ECB of the role of *primary* competent authority also for less significant banks (as witnessed by Article 6(5) of the SSM Regulation). In conclusion, if one accepts that the exercise of competent authority options and discretions granted by the CRDIV/CRR compact (a) is essential for the performance of the prudential tasks conferred upon the ECB by Article 4(1) and strictly related thereto, (b) is an expression of *regulatory* supervision consistent with the ECB rule making empowerment set out in Article 132 TFEU and (c) falls therefore within the ECB remit as competent authority for directly supervised significant banks in compliance with Article 9, expressly extending to the ECB "all the powers (…) which the competent authorities shall have under the relevant Union law, unless otherwise provided for by this Regulation", this could also support the conclusion that the same holds true also for less significant banks, because the ECB is also their *primary* competent authority. In this way the functional argument militating against the balkanization of the exercise of competent authority options and discretions for significant and less significant banks would fade away. In turn, this would make the best of the wording of recital 34 of the Regulation, because it would confirm that within the SSM competent authority options and discretion are no longer the remit of national supervisors.

8. Despite our preferences, these conclusions are however still provisional and need to be validated by the CJEU. Lacking one such final say of the CJEU, it seems safe to say that the unsettled interpretation of the SSM Regulation on this point reflects a constitutional ambiguity that fatally features a *de facto* limitation on the smooth exercise of regulatory powers within the SSM with at least two likely implications relevant for the purposes of our inquiry.

a) First, *this opens uncharted territory to private litigation* to test both the ECB and national allocation of regulatory competences from a constitutional point of view and the principle of effective judicial protection enshrined in the Charter of Fundamental Rights. Supervised credit institutions could potentially use conflicts over vertical distribution of competences under the SSM Regulation to defend themselves from intrusive acts of the SSM supervisors.[7] One such situation will evidently arise where the ECB exercises a competence that it does not hold, or where the exercise of a recognised competence goes beyond its legal scope (i.e. the ECB acts *ultra vires*).

b) Second, we expect that, *from an institutional perspective, this could lead to political compromise and light-touch, cooperative solutions rather than*

7 In the event of a conflict over the vertical distribution of competences within the SSM, any action initiated by the affected credit institution would not exclude the initiation of other court proceedings. For example, if the ECB were to adopt an act under a competence thought to fall under the scope of an NCA's powers, the latter could request the relevant Member State to institute proceedings against the ECB before the CJEU pursuant to Article 263 of the TFEU, first and second paragraphs, to seek annulment of the relevant act. If an NCA were to adopt an act under a competence thought to fall under the scope of the ECB's powers, the latter could institute proceedings against the former before the relevant national courts to seek the annulment of the relevant act.

heavy-handed unilateral action or judicial claims of conflict of attributions. In the face of the uncertainties surrounding the allocation of the competent authorities options and discretions, a pragmatic and reasonable response (proportionate but still not completely safe, for it could be considered somehow elusive of the problem) could be indeed the use of ECB guidelines and recommendations to NCAs under Article 4(3) for the exercise of such options and discretions. This, in turn, makes it relevant to explore how fundamental rights protection would react to such a course of action and in particular to what extent they would have legal effects and how they would interact with the principle of effective judicial protection.

ECB GUIDELINES, RECOMMENDATIONS AND INSTRUCTIONS TO NCAS AND RIGHT TO AN EFFECTIVE JUDICIAL REMEDY

9. This takes us to our second example of the interplay between the coexistence of EU and national levels and fundamental rights, and in particular the right to an effective judicial protection. Since the ECB can adopt guidelines and recommendations subject to and in compliance with relevant Union law (Article 4(3)) and issue "[regulations], guidelines or general instructions to NCAs" for the performance of supervisory tasks and the adoption of NCAs decisions on less significant credit institutions (Article 6(5)(a) of the SSM Regulation), three questions arise that are relevant for our purposes:

a) First, do they have legal effect and are they reviewable? The General Court's decision of 4 March 2015, in Case T-496/11, *United Kingdom and Ireland* v *ECB*[8]confirmed they could, depending on the circumstances[9]. *But how often will these circumstances occur (or be held to occur)?*

b) Second, how does the right to effective judicial protection react to the strict requirements on standing to challenge and admissibility set by the CJEU in respect of acts of general application? Indeed, in such cases the act by the ECB will be subject to the legality control of the annulment decisions (pursuant to Article 263 TFEU) but, unlike decisions directly addressed by the ECB to a financial entity, the standing of the latter to challenge the act is problematic, because the act needs to be "of direct and individual concern" to the person, or, in the case of a regulatory act, "of direct concern", and to "not entail

8 Case T-4911/11 *United Kingdom and Ireland* v *ECB,* EU:T:2015:133.

9 The Court held indeed that "*case-law is intended specifically to prevent the form or designation given to an act by its author from resulting in its escaping assessment of its legality in an action for annulment, even though it in fact has legal effects". "In the light of case-law, in order to determine whether an act is capable of having legal effects and, therefore, whether an action [...] can be brought against it, it is necessary to examine its wording and context. If the act is perceived as only proposing a course of conduct and, therefore, as being similar to a mere recommendation within the meaning of Article 288 TFEU or, in the case of the ECB, Article 132(1) TFEU, it should be concluded that the act does not have legal effects that are such as to render an action for annulment brought against it admissible. On the other hand, that examination may reveal that the parties concerned will perceive the contested act as an act which they must comply with, despite the form or designation favored by its author".*

implementing measures”.[10] These provisions have been subject to a quite narrow interpretation by EU courts: ever since the *Plaumann* decision[11]the courts have granted standing to private parties only if (a) the measure affects the applicant’s legal position directly and leaves no discretion to the addressees of the measure who are entrusted with its implementation, i.e. if there is a direct link between the challenged measure and the loss or damage (direct concern[12]); and (b) the measure *“affects them by reason of certain attributes which are peculiar to them or by reason of circumstances in which they are differentiated from all other persons and by virtue of these factors distinguishes them individually just as in the case of the person addressed”*.[13] These criteria (especially the second) have resulted in the exclusion of standing of private parties in cases of EU acts not directly addressed to them in almost all cases. In its judgment in *Inuit Tapiriit Kanatami* the CJEU also provided a restrictive interpretation for the case of annulment of regulatory acts (where only “direct”, but no “individual” concern is required).[14] In practice, this poses a significant challenge, since EU Courts seem more concerned about procedural expediency and the risk of EU courts being flooded with complaints, than about the protection of due process rights. In practice this will mean that general instructions addressed to NCAs by the ECB (typically, for the supervision of less significant entities) cannot be challenged unless the supervised entity can show that it is differently affected than the other potential addressees of the measure; while, even in case of specific supervisory measures, the addressee would have to demonstrate that the instructions leave no discretion to the NCA. Even if the ECB is a bulwark of integrity, the combination of this doctrine with the SSM is a breeding ground for concern: if the ECB were to tailor its instructions, by giving them a formal degree of generality, or giving the NCA formal discretion with regard to implementation, it could well avoid the scrutiny of the CJEU pursuant to the annulment procedure. Challenges based on a purportedly unequal exercise of supervisory powers (e.g. the failure to issue similar instructions with regard to entities in a similar position) would be almost impossible in practice.[15]

c) Third, once the decision is subject to implementation by NCAs, it will be certainly subject to challenge before national courts, but can these courts be reasonably expected not to be too deferential in respect of national decisions implementing ECB directions? Certainly, if within the procedure the matter of the legality of the previous instructions by the ECB arises, domestic courts should stay the proceedings, and make a preliminary reference to the CJEU, and later decide on the basis of the CJEU decision about the legality of the

10 Article 263 TFEU para. 4.

11 Case C-25/62 *Plaumann* v *Commission,* EU:C:1963:17.

12 See e.g. Cases 41-44/70, *NV International Fruit Company* v *Commission,* EU:C:1971:53 (standing was denied on the basis that the approval of a merger by the Commission would not be a direct cause of the loss of jobs in the merged company).

13 Case C-25/62 *Plaumann v. Commission,* para 107.

14 Case C-583/11 P *Inuit Tapiriit Kanatami and others* v *European Parliament and Council,* EU:C:2013:625. The General Court has also made a similar interpretation. See Case T-96/10 *Rütgers Germany GmbH v ECHA,* :EU:T:2013:109.

15 Case T-95/98 *Gestevisión Telecinco S.A.* v *Commission* (1998) ECR II-3407, para. 58, which holds that procedures for failure to act are subject to the *Plaumann* test.

ECB measure. How episodic will it be in practice? We expect that this only viable avenue to challenge the legality of instructions by the ECB to NCAs will prove to be quite exceptional.

THE ECB AS ENFORCER OF NATIONAL LAW AND THE RIGHT TO AN EFFECTIVE JUDICIAL REMEDY

10. A third example of the problematic coexistence of national and EU law and fair trial protection is offered by Article 4(3) of the SSM Regulation. Under this Article, "the ECB shall apply (…) 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".* There is no doubt that the CJEU retains the competence for the judicial review of these ECB decisions based upon national legislation. But how does it work in practice? Two options seem to be available.

a) One possibility would be to read the provision as meaning that national law remains national law, and that the ECB only applies it as a result of a specific mandate. In that case, at least in theory, the national court could issue an authoritative interpretation of the national rule exercising the options granted by the EU directive, or even annul the national rule. It could not, however, annul the ECB acts in application of that national law, for which it would have to make a preliminary reference. The CJEU would have to validate the decision by the national court. In so doing, however, it would have to review that the annulment of the rule or the corrective interpretation issued by the national court does not overstep the boundaries of the specific choice granted by the directive to Member States, and that it does not invade the ECB's supervisory competences, an act for which a determination of the application of national law would be a necessary step.

b) Another possibility would be to read the provisions as meaning that, through the application of the ECB, national law becomes EU law. In such case the CJEU would be entitled to make the authoritative interpretation, and could well answer the preliminary reference without having to make the balancing act of all the superimposed layers of competences. However, this would strain the express language of the provision, which refers to "national law"; it would also put the CJEU in the extremely uncomfortable position of having to determine the authoritative interpretation of domestic law, something that the Court was extremely unlikely to do and careful in avoiding so far.

11. Thus, the first possibility could appear more likely, but its mind-boggling complexity makes it desirable that either the CJEU, by relaxing its *Plaumann* test in the context of banking rules, or the ECB, by relying on acts specifically directed to financial entities (or directed to NCAs, but with a content specifically addressed to a financial entity, and leaving no discretion)

provide a channel for a direct review of legality.[16] Though more cumbersome at the initial stage, it would help provide a sounder footing for ECB action, and assess the potential impact of fundamental rights of due process.

THE DISTRIBUTION OF SANCTIONING COMPETENCES

12. A final example is given by the distribution of sanctioning powers within the SSM with the three distinct competences under Article 18 of the SSM Regulation:

a) First, those of Article 18(1) for breaches of directly applicable Union law, a competence that in turn could be read either as "bifurcated" under Article 6 and granted in principle to the ECB only for significant banks (this is the prevailing view also within the ECB) or as independent from Article 6 and thus granted to the ECB for all banks. It all depends on the reading of the opening words "for the purposes of carrying out the tasks conferred on it by this Regulation";

b) Second, those of Article 18(5) for breaches "in cases not covered by paragraph 1 of Article 18", and in particular: (i) for breaches of national law transposing relevant directives and (ii) administrative penalties and measures to be imposed on members of the management board;

c) Third, those of Article 18(7), namely sanctions in accordance with Regulation (EC) 2532/98[17], in the case of a breach of ECB regulations or decisions.

I will expand on the implications of this tripartite system for fundamental rights protection below, after having briefly discussed some overarching questions on the scope of application of the instruments granting fundamental rights.

THE AMBIGUITIES IN THE SCOPE OF APPLICATION OF THE INSTRUMENTS GRANTING FUNDAMENTAL RIGHTS

13. The picture is indeed made even more complex by ambiguities in the scope of application of the instruments granting fundamental rights. Four broad questions arise.

a) To what extent do the Charter and the Convention grant equivalent rights? In principle, under Article 52(3) of the Charter, corresponding rights in the

16 In such cases, the only difficulty would be that the legality of the ECB measure would have to be evaluated in the context of the national rules that exercise the option granted by the Directives. However, the CJEU could limit itself to gathering the opinions of the courts and experts to assess the actual state of national law, and evaluate the ECB action in its light, rather than making an authoritative interpretation of that domestic law.

17 Council Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the ECB to impose sanctions (OJ L 318, 27.11.98, p. 4).

Charter should have the same meaning as in the Convention. Will it be so in practice under the CJEU case law or will differences in interpretation weaken the *effet utile* of such a principle?

b) To what extent are Member States and NCAs subject to the Charter? This is especially pressing, since both the SSM and the Single Resolution Mechanism (SRM) envisage a combination of regulatory and supervisory actions from both EU institutions (the ECB) and national institutions (NCAs and national resolution authorities (NRAs)). Article 51 states that: "The provisions of this Charter are addressed to the institutions, bodies, offices and agencies of the Union with due regard for the principle of subsidiarity and to the Member States *only when they are implementing Union law"***.** The answer seems quite clear with regard to the ECB, which is an EU institution. But are NCAs to be considered part of an institution of the Union when they are legislatively delegated under Article 6(4) of the SSM Regulation some responsibilities in the performance of micro-prudential tasks in relation to less significant credit institutions? We are inclined to believe they are not, but that they are nonetheless implementing Union law. In turn, are Member States considered to be "implementing Union law" when the distribution of legislative competences envisaged in the CRD IV/CRR compact contemplates the possibility of Member States exercising choices in the determination of certain prudential measures? Case law by the CJEU is ambiguous in this regard. In *McB* it held that the assessment of the compatibility with the Charter had to be made exclusively in relation to EU provisions (in the case, Regulation 2201/2003[18], on the recognition and enforcement of foreign judgments in matrimonial matters and matters of parental responsibility), not the national provisions (in the case, Irish law, which, according to the EU rules, was the one regulating the acquisition of custody rights), thus rejecting the possibility that, in determining custody rights, national law was "implementing EU law".[19] Similarly, in *Magatte Gueye* the CJEU required a substantive connection between national law and EU Law (the case concerned the relationship regarding Spanish substantive law on domestic violence, and

18 Council Regulation (EC) No 2201/2003 of 27 November 2003 concerning jurisdiction and the recognition and enforcement of judgements in matrimonial matters and the matter of parental responsibility, repealing Regulation (EC) No 1347/2000 (OJ L 338, 23.12.2003, p. 1).

19 The mother removed the children from Ireland to Britain after Mr McB had initiated proceedings before the Irish courts to obtain an order securing custody rights, but before the process was completed. Article 2(11)(a) of Regulation (EC) No 2201/2003 stipulated that rights of custody were to be acquired (and, thus, subject to recognition and enforcement) "by judgment or by operation of law or by an agreement having legal effect under the law of the Member State where the child was habitually resident immediately before the removal or retention". The CJEU held that Article 2(11)(a) could not be considered incompatible with the Charter or the ECHR (the case law of the ECtHR on article 8 of the ECHR was used to integrate the meaning of article 7 of the Charter on private and family life). See Case C-400/10 PPU *J. McB* v *L.E*, EU:C:2010:582.

EU decisions on the standing of victims in such context).[20] Yet, the CJEU has given ample scope to the language of Article 51 in cases where the subject matter was closer to the subject matter of our interest here (i.e. the relationship between EU and national regulatory provisions, and with enforcement provisions), and where the different provisions are more closely connected by a similar purpose (and the national interests at stake are less obvious). In *Fransson*, it considered sufficient the connection between proceedings for the imposition of administrative penalties and criminal sanctions, and the breach of (EU-regulated) VAT, plus the broad obligation of Member States to *take all legislative and administrative measures appropriate for ensuring collection of all the VAT due on its territory and for preventing evasion*, to conclude that, when pursuing domestic proceedings based on domestic law to impose penalties, State authorities were "implementing EU law".[21] The contrary opinion of the Advocate General Villalón,[22] which was not followed by the Court, has stirred up controversy,[23] but so far the Court's case law supports the understanding that States are subject to the Charter *when they apply domestic law that has the purpose of enforcing EU provisions*. The connection is even closer in the case of the SSM and SRM, where the provisions in the EU rules make reference to the recourse by domestic authorities to inspections and sanctions. The case is even stronger when NCAs apply domestic rules in the exercise of discretions granted by EU law. In *NS v Secretary of State for the Home Department* the CJEU clearly stated in its judgment that, in such instances, State authorities are subject to the Charter.[24]

c) An interesting situation could arise if the SSM and SRM happens to operate under the aegis of the European Stability Mechanism (ESM). Would the Charter apply in this context? In its judgment in *Pringle* the CJEU held that the Charter was considered inapplicable when Member States take collaborative action outside the EU legal order.[25] The question could arise, however, if a specific supervisory action (or an action with the content of intervention and resolution) is initiated as part of the package of measures indicated by the ESM (e.g. if the bailout is limited to a State's banking sector). In that case, the

20 In this case the compatibility of a mandatory stay away injunction set forth in Spanish law against offenders in crimes of violence within the family was examined in light of Council Framework decision 2001/220/JHA of 15 March 2001 on the standing of victims in criminal proceedings. The Court held that this was a matter of domestic law, and that the Council Decision did not intend to harmonize the substantive laws in respect of the forms and levels of criminal penalties. See Joined cases C-483/09 and C-1/10 *Magatte Gueye,* EU:C:2011:583.

21 Case C-617/10 *Åklagaren* v *Hans Åkerberg Fransson,* EU:C:2013:105, paras 25-27.

22 Opinion of Advocate General Cruz Villalon in Case C-617/10 *Åklagaren* v *Hans Åkerberg Fransson,*:EU:C:2012:340.

23 See e.g. the decision of the German Federal Constitutional Court 1 BvR 1215/07, Judgment of 24 April 2013, where the Court, deciding on a case about the compatibility of German counter-terrorism database with German Basic Law, stated that this was a purely internal matter, and that the distribution of competences between EU and domestic authorities had not been altered by the *Fransson* ruling. See also UK House of Commons European Scrutiny Committee *The application of the EU Charter of Fundamental Rights in the UK: a state of confusion* Forty-third Report of Session 2013–14, 43-49.

24 Joined cases C-411/10 and C-493/10 *NS* v *Secretary of State for the Home Department*, EU:C:2011:865.

25 Case C-370/12 *Thomas Pringle* v *Government of Ireland*, EU:C:2012:756.

Charter would be applicable to the ECB actions. To my mind, there would also be a strong argument to apply the Charter if, in executing the Memorandum of Understanding, the NCA concerned makes use of the collaborative structures envisaged in the SSM and SRM (e.g. the "close collaboration" with non-euro area States). However, this is a bit of uncharted territory. The CJEU was probably more concerned about the side effects that a full-blown application of EU law to the more flexible structure created with the ESM would have, but surely *Pringle* is not (nor should it be) the last word on the applicability of the EU Charter to collaborative structures outside, yet closely connected, to EU law.

d) Having addressed the question with respect to the EU Charter, it is necessary to do the same with the European Convention on Human Rights (ECHR), which poses challenges of its own. The ECHR is not formally part of EU law, though specific references are made in article 52(3) of the EU Charter, and Article 6(2) and (3) TEU. Articles 6(3) and 52(3) indicate the relevance of the ECHR for the purpose of EU law, while Article 6(2) contemplates the accession of the EU to the ECHR. A draft accession treaty was negotiated in 2013[26], but, then, the CJEU held, in 2014, that such treaty (and parts of the ECHR) was incompatible with EU law,[27] mainly because the new powers of the European Court of Human Rights (ECtHR) would impinge upon the powers of the CJEU.[28] Therefore, up to this point the ECHR does not apply, nor can the ECtHR decide, on actions by EU institutions (including the ECB). However, the ECHR applies to actions by Member States, and, in the past, the ECtHR has held that its jurisdiction to decide on a violation of Convention rights cannot be excluded solely because a State was simply giving effect to EU law.[29] Having said that, in most cases where the ECtHR had to decide on the violation of the ECHR by a State giving effect to EU law, the complaint was manifestly unfounded,[30] or Member States had been granted a wide margin of appreciation in implementing EU measures (which means that the action

26 <http://www.coe.int/t/dghl/standardsetting/hrpolicy/Accession/Meeting_reports/47_1(2013)008rev2_EN.pdf>

27 Opinion 2/13 of the Court, 18 December 2014, EU:C:2014:2454.

28 Some objections had to do with the incompatibility of Article 53 of the ECHR, which permits Member States to dispense a greater protection to fundamental rights than the ECHR does, whereas the CJEU had ruled in *Melloni* that Member States could not do that if EU law had fully harmonized the matter, and also with the absence in the draft agreement of the "mutual trust" clause in justice and home affairs, which applies in EU law. But most objections were related to the new powers the ECtHR would gain, such as the applicability of Protocol 16, which permits Member States' courts to send questions to the ECtHR, which could rule on matters of EU law (thereby circumventing the preliminary reference procedure), the implicit possibility that the ECtHR could rule on inter-State disputes (which, by article 344 TFEU are reserved to the CJEU); and the co-respondent system, where both the EU and a Member State could be sued in proceedings before the ECtHR (as, the CJEU held, the ECtHR should not have the power to allocate responsibility between them). See Opinion 2/13 of the Court, 18 December 2014.

29 Commission Decision Application 11123/84 *Tete v France* Decision of 9 December 1987; Application 17862/91 *Cantoni v France*, Decision of 11 November 1996; Application no. 45036/98 *Bosphorus Airways v Ireland* Judgment of the ECtHR of 30 June 2005.

30 E.g. Commission Decision Application no. 11123/84 *Tete v France* Decision of 9 December 1987.

could be easily attributed to the State, and not the EU).[31] This could likely be the case of national legislative options and discretions granted by the CRDIV/CRR compact. Finally, in cases where the State had little margin of discretion, so that the potential violation of the ECHR was (if such violation existed) a direct consequence of the implementation of EU law, the ECtHR was willing to grant an unprecedented breathing space to EU law and EU institutions, by *presuming* that the EU grants an equivalent level of protection to that under the Convention.[32] In its decision of *Bosphorus Airways v Ireland* the ECtHR for the first time examined the merits of a case where domestic authorities were implementing EU law without exercising discretion.[33] The ECtHR was ready to assume that the fact that the State interfered with the property (an aircraft) to comply with its obligations under EU law constituted, in itself, a legitimate interest.[34] It then established that the system of protection of fundamental rights within the EU, albeit providing for limited access to individuals, created a presumption of Convention compliance for acts by a State that gave effect to EU measures.[35] Finally the ECtHR held that the presumption had not been rebutted in the case at hand.[36] One can only emphasize that the ECtHR even failed to undertake the proportionality assessment, which it normally does, even when the interference with property rights (or fundamental rights in general) is based on a legitimate interest. This is the current context. However, it is a context in flux. If the EU accession to the ECHR is delayed, or even frustrated, the ECtHR could find that its patience has been tested too far, and adopt a less accommodating stance towards the EU.

TWO PROVISIONAL CONCLUSIONS ON EFFECTIVE JUDICIAL PROTECTION AND "NE BIS IN IDEM"

14. We can now try to draw from the foregoing two tentative conclusions on the interplay between the coexistence of EU and national law within the SSM and fundamental rights, having specific regard to the right to a fair trial and effective judicial protection and "ne bis in idem" alongside the reasoning of the ECtHR *Franzo Grande Stevens* judgment.

15. The fundamental right to a fair trial seems to require that supervisory powers "severely" (according to the *Engels* test) affecting fundamental freedoms

31 E.g. in Application no. 17862/91 *Cantoni v France*, Judgment of 11 November 1996. The ECtHR has reviewed the States' exercise of discretion when giving effect to EU law in light of Convention rights in numerous occasions. See *Van de Hurk v. the Netherlands*, judgment of 19 April 1994, Series A no. 288; *Procola v. Luxembourg*, judgment of 28 September 1995, Series A no. 326; *Cantoni* and *Hornsby*, both cited above; *Pafitis and Others v. Greece*, judgment of 26 February 1998, Reports 1998-I; *Matthews*, cited above; *S.A. Dangeville v. France*, no. 36677/97, ECHR 2002-III; and *Société Colas Est and Others v. France*, no. 37971/97, ECHR 2002-III.

32 Commission Decision Application no. 13258/87 *M & Co. v. Federal Republic of Germany* Decision of 9 January 1990.

33 Application no. 45036/98 *Bosphorus Airways v Ireland*, paras.143-148.

34 *Ibid* para. 150.

35 *Ibid* paras. 159-165.

36 *Ibid* para. 166.

are subject to effective judicial protection and possibly full jurisdiction. A parallel is often drawn in this regard with competition cases. This is right in principle, although I would also recommend a note of caution. It is worth recalling, indeed, that the CJEU found that, in competition cases, the "review of legality provided for under Article 263 TFEU, supplemented by the unlimited jurisdiction in respect of the amount of the fine, satisfies the requirements of the principle of effective judicial protection in Article 47 of the Charter of Fundamental Rights of the European Union"[37]. However, it should also be considered that in that field, fines are the major, if not the only, way entities are "severely" affected in their fundamental rights, whereas in this context many supervisory, administrative and punitive measures are highly afflictive (and possess a "coloration pénale" according to the standards of the ECtHR) and are therefore similar in their effect on the recipients to fines in the antitrust sector, thereby requiring that an effective judicial protection be duly warranted. EU courts only review, in principle, *legality*, pursuant to Article 263 TFEU, but do not have full jurisdiction (except for what is provided in application of Article 261). Moreover, there are significant complexities reflected in the effectiveness of the judicial remedy where the supervisory process under the SSM features a composite co-administration. If the decision is adopted by the NCAs in the context of a composite procedure, where both the ECB and NCAs adopt certain acts, the financial entity is only granted with certainty the action to seek annulment of the decision by the NCA (according to differentiated national standards of review), whereas the action to annul the act by the ECB is subject to the extremely restrictive *Plaumann* standard. A similar, though even more complex, scenario arises where the ECB applies national law. It is difficult to see these guarantees as meeting the requirements of effective judicial protection under Article 6 ECHR and 47 of the Charter.

16. The most desirable outcome, in my view, would be for EU courts to show that, without the need to replace judicial second guessing to complex technical assessments, they can develop a case law of acceptably robust review of administrative decisions. There are arguments to suggest that the standard of the review of the CJEU has evolved over time (the *Remia* decision[38] is often said to have marked a turning point) and that EU courts have grown bolder and more willing to elaborate the criteria of manifest error and excess of power, to grant themselves a sufficient leeway for effective and robust judicial control. They should go even further along this line.

17. In the context of fines, it is desirable that full jurisdiction be clearly in place. The reference to Council Regulation 2532/98, whose Article 5 introduced full CJEU jurisdiction for sanctions (in conformity with Article 261 TFEU), is currently somehow equivocal. In the case of penalties imposed for breach of directly applicable Union law (Article 18(1) of the SSM Regulation), sanctions

37 Koen Lenaerts, Ignace Maselis, Kathleen Gutman, "EU Procedural Law", OUP, Oxford, 2014, p. 394 and CJEU, case C-272/09 *P KME Germany V Commission*, EU:C:2011:810 and case C-199/11, *Otis,* EU:C:2012:684

38 Case C- 42/84 *Remia BV* v *Commission,* EU:C:1985:327.

shall be imposed with respect to the 2532/98 Regulation's "procedure", and "as appropriate". Only in the case of sanctions imposed for a breach of ECB regulations and decisions, sanctions *may be* imposed "in accordance with Regulation 2532/98", and SSM rules will be complementary. The same full jurisdiction is due in the review of NCAs' sanctions under Article 6 ECHR in the wake of the ECtHR *Franzo Grande Stevens* judgment.

18. Finally, the application of the "ne bis in idem". To my mind, the attribution of decision-making competences to the ECB, the system of instructions to NCAs, and the possibility to instruct on the imposition of penalties in cases where the ECB lacks the competence make the overlapping of sanctions less plausible and can be further mitigated through the development not only of a coordinated investigatory practice, but also the coordinated imposition of penalties. It remains to be seen, however, to what extent the same conduct can give rise to both administrative and criminal penalties (in *Fransson,* the CJEU confirmed its adherence to the approach by the ECtHR, and held that criminal and administrative penalties could be accumulated only provided administrative penalties were truly administrative, i.e. they did not disguise a criminal sanction in nature, a matter that it left the national court to decide), considering that criminal law is highly fragmented along national lines also in the banking sector. And deplorably so.

THE COEXISTENCE OF NATIONAL AND EU LAW AND THE *NE BIS IN IDEM* PRINCIPLE

EILÍS FERRAN[1]

GENERAL REMARKS

The original conference programme drew attention to the *ne bis in idem* principle but it is clear from the excellent papers by Professors van Bockel and Lamandini that this is but one of many questions about respect for fundamental rights raised by the Single Supervisory Mechanism (SSM). The two-level decision-making processes within the SSM, including the novel provision in Article 4(3) of the SSM Regulation[2] for the ECB to take decisions based on national legislation, make for an exceptionally complex system of shared, or mixed, administration. The two papers in this volume form a significant contribution to a slim, but growing, line of scholarship that has begun to explore these important issues.[3]

Broad concerns that have been identified in the literature include that differences in substantive or due process requirements under national laws could impinge on the equal treatment of credit institutions within the SSM, and that there may be potential lacunae in judicial protection as a result of the division of responsibilities between the ECB and the national competent authorities (NCAs). Legal uncertainties in these areas could impinge negatively on the objective of coherent and effective prudential regulation. The existence of a clear and comprehensive system of judicial protection is critical to the success of the SSM.

The "enforcement" powers that are most commonly associated with prudential supervision are powers to adjust capital requirements and to impose restrictions on the conduct of particular types of business. It is accepted that prudential

1 Professor of Company and Securities Law, University of Cambridge.
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 The literature includes: Gisbert Ter Kuile, Laura Wissink and Willem Bovenschen, 'Tailor-made Accountability within the Single Supervisory Mechanism' (2015) 52 Common Market Law Review 155, 180-187; Tomas MC Arons, 'Judicial Protection of Supervised Credit Institutions in the European Banking Union' in Danny Busch and Guido Ferrarini, *European Banking Union* (OUP, 2015); Laura Wissink, Ton Duijkersloot, Rob Widdershoven, 'Shifts in Competences between Member States and the EU in the New Supervisory System for Credit Institutions and their Consequences for Judicial Protection' (2014) 10 Utrecht Law Review 92; Andreas Witte, 'The Application of National Banking Supervision Law by the ECB: Three Parallel Modes of Executing EU Law' (2014) 21 Maastricht Journal 1; Antonio Luca Riso, 'The Power of the ECB to Impose Sanctions in the Context of the SSM' (2014) Bančni vestnik, Letnik 63, Številka 4, April 2014, 32; Sven H Schneider, 'Sanctioning by the ECB and National Authorities Within the Single Supervisory Mechanism' (2014) 25 European Journal of Business Law 18; Raffaele D'Ambrosio, 'Due Process and Safeguards of the Persons Subject to SSM Supervisory and Sanctioning Proceedings' (Quaderni di Ricerca Giuridica della Consulenza Legale, Banca d'Italia, No 74, December 2013); Stefan Loosveld, 'The ECB's Investigatory and Sanctioning Powers under the Future Single Supervisory Mechanism' (2013) 28 Journal of International Banking Law and Regulation 422.

supervisors must have a wide measure of discretion in the use of these powers. However, current trends associate credible and effective supervision with the use of a much wider range of enforcement tools, including disciplinary powers to impose financial penalties and public censures and also criminal prosecutions. Formal disciplinary sanctions can send strong signals about unacceptable behaviour and, as such, can perform an important deterrence function. More willingness within prudential supervisory policies and practices to make full use of the enforcement "pyramid" reinforces the importance of a robust system of judicial protection for supervised credit institutions and their officers and employees.

SPECIFIC CONCERNS – THE *NE BIS IN IDEM* PRINCIPLE

The papers by Professors van Bockel and Lamandini present a relatively optimistic analysis of the operation of the *ne bis in idem* principle with respect to the significant credit institutions that are under the direct supervision of the ECB.[4] The close-up examination conducted by the authors appears to confirm initial impressions that, broadly speaking, Article 18 of the SSM Regulation together with the SSM Framework Regulation,[5] Part X (in particular Article 134 thereof) set out a clear, non-overlapping distribution of sanctioning powers within the SSM. The view that in relation to the SSM the problem of overlapping sanctions is likely to be less plausible than in the competition context and can be further mitigated through co-ordination is compelling.[6]

Nevertheless there are specific points that could be problematic in practice, such as matters that sit on intersections between prudential and conduct supervision or, as in the case of money laundering, that have both integrity and prudential implications. Novel "*idem*" questions may arise as a result of enforcement actions taken by different authorities within their own domain – that is whether the material facts are sufficiently separate to avoid the application of the *ne bis in idem* principle. Professor van Bockel also raises an interesting point drawn by analogy to the competition law jurisprudence about the operation of the *ne bis in idem* principle for banking groups in relation to subsidiaries that do not operate independently; however, context may matter in this regard since the legal entity principle is well established in banking regulation and supervision. The *ne bis in idem* principle will operate, it is clear, to protect institutions that operate on an EU cross border basis both within and outside the SSM from double jeopardy. On the other hand, it will not extend to third

4 For analysis of the principle in the pre-SSM era see Francoise Lefèvre and Stefan Loosveld, "The Influence of European Law on the Powers of Financial Supervisors" (2010) 2 Journal of International Banking Law and Regulation 51.

5 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 L141, 14.5.2014, p. 1).

6 Note also Witte, n 2, who suggests that the area of state aid control shows more similarities to the SSM than Articles 101 and 102 TFEU, and that it therefore constitutes a more fertile ground to draw conclusions for procedural questions expected to arise within the SSM.

country prosecutions or punitive sanctions (but issues as to the proportionality of sanctions may be relevant in such situations).[7]

A contested issue that arises in relation to the *ne bis in idem* principle but which is also of wider significance to fundamental rights protection is the scope of penalties belonging in the criminal sphere due to the nature of the wrong or the severity of the penalty. This issue has high saliency also for the exercise of investigatory powers, which must adhere to criminal procedural standards (on matters such as protection from self-incrimination and respect for legal professional privilege) in order for information obtained to be usable for the purpose of imposing punitive penalties.[8] Questions about the correct categorization of sanctions[9] are not new but there remain significant areas of potential uncertainty. For example, the structure of the SSM Framework Regulation is to treat periodic penalty payments imposed by the ECB as provided under Article 18(7) of the SSM Regulation pursuant to Council Regulation 2532/98[10] with a view to compelling compliance as being subject to different procedural rules from those applicable to the imposition of administrative penalties.[11] The justification for this differential treatment, as Riso has noted, is that periodic penalty payments that are oriented towards ensuring compliance rather than punishment are not criminal in nature.[12] Nevertheless ambiguities in the periodic penalty payments regime,[13] which as Regulation 2532/98, as amended, makes clear can be imposed either as a punishment or with a view to forcing compliance,[14] could continue to be a source of difficulties with regard to appropriate categorization. In theory, the same could also be said of the power to withdraw a banking licence which is vested in the ECB by Article 14 of the SSM Regulation. It is possible, for example, to postulate a hypothetical scenario of the ECB seeking to withdraw the licence of a less significant bank that is also the target of disciplinary proceedings by its NCA where questions about the possible application of the *ne bis in idem* principle could arise. However, from a more practical perspective, it is to be expected that if a situation were to be so serious as to make withdrawal of a banking licence a serious possibility, all of the relevant authorities (including the ECB, the NCA, resolution authorities and the European Banking Authority) would be working very closely together to ensure a coordinated response.

7 SSM Regulation, Article 18(3).
8 Wissink et al, n 2, provide a valuable extended discussion of the fundamental rights implications of the use of SSM inspection and investigatory powers.
9 See, eg, Jose Maria Fernandez Martin and Pedro Gustavo Teixeira, 'The Imposition of Regulatory Sanctions by the European Central Bank' [2000] European Law Review 391 (discussing Council Regulation 2532/98 and the powers of the ECB as monetary authority (at that time) to impose sanctions).
10 Council Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the ECB to impose sanctions (OJ L 318, 27.11.98, p. 4).
11 SSM Framework Regulation, Part X, Title 2 (administrative penalties) and Title 3 (periodic penalty payments).
12 Riso, n 2.
13 D'Ambrosio, n 2.
14 Regulation (EC) No 2532/98, Art. 1(6), as amended by Council Regulation (EU) 2015/159 of 27 January 2015 amending Regulation (EC) No 2532/98 concerning the powers of the European Central Bank to impose sanctions (OJ L 27, 3.2.2015, P.1).

The operation of judicial review in the context of the SSM is indisputably complex. To find the answers to quite fundamental questions – which decisions can be reviewed; which court has jurisdiction; what is the scope of the review; who has standing to challenge decisions? – involves a highly technical inquiry into, amongst other things, the SSM legal framework, the state of the EU jurisprudence on judicial review and the precise nature of the ECB-NCA interface including, specifically, whether or when there is a degree of discretion at the national level as to the action to be taken. Some of this ground has been traversed to a certain extent already in the context of the ECB's sanctioning powers conferred by Council Regulation 2532/98.[15] However, legal challenges are more likely in the supervisory context than in the monetary policy domain.[16] Moreover, the truly novel feature of the SSM whereby the ECB is empowered to apply national law takes such inquiries into uncharted territory. The prevailing assumption is that the Court of Justice of the European Union (CJEU) is the proper court before which to challenge ECB action based on national law, but a plausible argument to the contrary can certainly be developed, although, if applied, its implications could be chaotic.[17]

Professor Lamandini's paper, in particular, addresses many of these issues. His findings as to potential deficiencies in judicial protection, which are also supported by the work of other scholars, must command attention. Just to pick out a few examples, the limits on standing to challenge decisions before the CJEU (which, in addition to the cases considered by Professor Lamandini, could also exclude, for example, depositors, creditors and other third parties affected by the decision by the ECB to withdraw a bank licence (and a national court could not annul the ECB's decision[18])) are troubling; so too is the uncertainty about the scope of review by the CJEU. The risk of deferential judicial review at national level, also identified by Wissink et al, in particular in the context of inspections ordered by the ECB but conducted at national level (and thus operating in two legal orders)[19] also deserves to be highlighted. A problem not yet material but that could become significant is that of ensuring that the differences in the mechanisms by which decisions become effective (by direct imposition by the ECB or indirectly via the NCA) as between institutions in the euro area and institutions in close co-operation countries do not result in unequal standards of judicial protection.

15 See Martin and Teixeira, n 8.
16 Phoebus L Athanassiou, 'Non-contractual Liability under the Single Supervisory Mechanism: Key Features and Grey Areas' (2015) Journal of International Banking Law and Regulation 382.
17 Ter Kuile et al, n 2.
18 The adverse effects of ECB decisions on third parties prompts questions about non-contractual liability, another aspect of the SSM regime where complex questions arise: see Athanassiou, n 14; Raffaele D'Ambrosio, 'The ECB and NCA liability within the Single Supervisory Mechanism' (Quaderni di Ricerca Giuridica, Banca d'Italia, No 78, January 2015).
19 Wissink et al, n 2. See also Stefaan Loosveld, 'The ECB's Investigatory and Sanctioning Powers under the Future Single Supervisory Mechanism' (2013) 28 Journal of International Banking Law and Regulation 422.

CONCLUSION

It is not ideal to be in a situation where there are well-substantiated concerns about gaps in judicial protection. There can be no disagreement that a credible supervisory system must not compromise on fundamental rights and there is certainly force in the view that further express protection – for example with respect to the right not to incriminate oneself[20] - would have been wise. The prospect of a period of working through uncertainties on a case-by-case basis, with all of the uncertainty, including the possibility of conflicting decisions, that this process is likely to involve is unsettling. If there is a flood of cases, a specialized court to deal with claims against the ECB, as suggested by Ter Kuile et al[21] and by Arons[22] could come to be seen as a gap in the institutional architecture that needs to be closed.

Yet the papers by Professors van Bockel and Lamandini in this volume, together with work by other distinguished scholars, make a significant contribution to deepening our understanding of these important issues. Academic problematization is a valuable exercise provided that, as with the papers here, it is focused on finding practical, workable solutions. The structure of the SSM is conceptually innovative. For reasons that are too well-known to require much elaboration, at the design stage there was not the luxury of time to reflect on the profound significance of the changes and to nail down in advance every single vital detail: put simply, there was an urgent need for the SSM to be established and up and running as soon as possible. A bedding-in period of "learning by doing" is thus inevitable.

20 Wissink et al, n 2.
21 Ter Kuile et al, n 2, 183.
22 Arons, n 2, 474.

COEXISTENCE OF NATIONAL AND EUROPEAN REGULATIONS WITH REGARD TO THE *NE BIS IN IDEM* PRINCIPLE

ÉDOUARD FERNANDEZ-BOLLO[1]

I would like to thank the ECB for giving a voice in this extremely important discussion to the practical point of view of a national supervisor actively involved in the construction of the banking union, in both its supervision and legal aspects. We are all of course acutely conscious in this day-to-day work that with the banking union we are giving life to a new level of European integration that raises new issues and it is thus crucial for supervision but also for the European project as a whole to be able to address them successfully. Let me also thank Mr Lamandini and Mr van Bockel for their very interesting contributions to this debate. I will just try to point out from my specific point of view where, among all the legal issues derived from the new EU supervisory framework they identified, I see the more immediate practical challenges. And indeed, as Mr van Bockel underlines, even the most similar area of EU case law, that on competition, has in fact a very different framework, so the challenges are only partially comparable.

First, following Mr Lamandini's focus on the challenging process of SSM decisions that raises many questions on competent jurisdictions and applicable laws, I think that where we have more practical uncertainties is when the ECB applies national laws, that is, when it has to apply national laws implementing CRD IV[2]. As an example, let's see the difference between a national competent authority (NCA) applying European law and the ECB applying national law.

In the first case, for instance when an NCA applies ECB "*regulations, guidelines or general instructions to NCAs*" (Article 6(5) of the SSM Regulation[3] (SSMR)), I think that these instructions may be challenged before national courts, as a necessary part of the challenging of the NCA decision implementing the general instruction. But here we have a mechanism for sorting out the differents aspects of the legal challenge, so if it is the legality of the ECB instruction itself that is challenged, a preliminary reference to the Court of Justice of the European Union (CJEU) will be a convenient way to handle the issue.

1 Secretary General, Autorité de Contrôle Prudentiel et de Résolution.
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).

But unfortunately the converse situation cannot be handled in the same way. In application of Article 4 SSMR, the ECB shall apply national legislation transposing European directives. Therefore, if such an ECB decision is challenged before the CJEU, the latter shall review national law. Actually, the EU Charter does not provide for the possibility for the CJEU to make a preliminary reference to national courts. In this context, is the CJEU entitled to refuse the application of national law, in such a case? Powers of the CJEU regarding national law review are not defined yet.

Let me add another layer of complexity: as outlined by Mr Lamandini, these powers would depend on the qualification given to national law when it is applied by the ECB - national law or EU law? This raises an important question: for instance, for the application of Article 9(1)) SSMR, which court will have a final say on that matter, that is whether a national law is or not a transpostion of an EU directive, and so on EU law? Depending on which authority has taken the decision that is challenged on these grounds, it can go to national courts - which may well think that they are competent to interpret their national law, but now given the consequences for the powers of an EU institution, this becomes a crucial question also for EU law. So I would personally hope that a preliminary reference is raised, but again the converse will not apply if the issue is raised against an ECB decision.

a. Regarding sanctioning powers, fortunately, application of the penalty regulation should not lead to such a situation. The ECB can only apply penalties for breach of directly applicable Union law (Article 18(1) SSMR). In parallel, domestic jurisdictions apply only national laws.

However, Article 18(5) specifies that

"*the ECB may require national competent authorities to open proceedings with a view to taking action in order to ensure that appropriate penalties are imposed*".

The legal value of such an ECB requirement – when it is implemented by NCAs - is not defined yet. If a domestic jurisdiction considers that it has legal effect, the said jurisdiction may ground its decision on a European regulation.

However, the European Charter opens the possibility for national courts to make a preliminary reference to the CJEU on the legal effects, interpretation and legality of ECB requirements. In this way, case-law on ECB requirements on the basis of Article 18(5) SSMR can be kept consistent.

b. Considering more specifically the *ne bis in idem* principle, I agree with Mr Lamandini that the overlapping of sanctions for breach of prudential requirements is not really plausible, as, in particular, I do not understand the regulation as empowering the ECB to ask NCAs to apply *additional sanctions*:

1. *regarding the attribution of disciplinary competences within the SSM*: the ECB is responsible for pecuniary administrative penalties for significant

credit institutions while the NCA sanctions less significant credit institutions, and all individuals responsible for a breach of the SSMR;

2. *regarding the possibility provided for by Article 18(5) to refer to the NCA for other sanctions for significant institutions*, it is my understanding that the terms "in cases not covered by paragraph 1" means that this will not mean an *additional* sanction on the same person and facts and breaches covered by the powers of the ECB;

3. *finally, regarding the attribution of competence between criminal courts and competent authorities within the SSM*: Criminal law generally does not apply to the breach of prudential requirements (as is the case in France), so the possibility to have two sanctions seems to me to be limited, but I acknowledge that this may depend on other national legislations I am not aware of.

On the first issue (*ne bis in idem* within the SSM), an NCA applying penalties to a less significant credit institution, when the said NCA requires *also* the withdrawal of the authorisation as a disciplinary measure, has to involve the ECB, the only institution empowered to pronounce the withdrawal. In such a case, the ECB takes the required decision further to the procedure provided for in Articles 80 and following of Regulation n° 468-2014 of the ECB establishing the framework for cooperation within the Single Supervisory Mechanism. This Regulation provides that the withdrawal procedure can be initiated by the NCA. In addition, it does not qualify the withdrawal of authorisation as an administrative sanction (but of course the European Convention on Human Rights, for instance, does not hesitate to make its own qualification of a criminal sanction). Therefore, it is possible to consider that, in such a case, there is no duplication of prosecutions between the NCA and the ECB. Still, it should be confirmed by case law. And of course it would be prudent for all supervisors not to try to pursue both an administrative proceeding that can lead to an administrative measure that risks being qualified as a "sanction", and an administrative pecuniary penalty for the same person, facts and breach. Let me note indeed that prior to the SSMR we had in France, following the Dubus Case[4], two different procedures for withdrawal of the authorisation, one as a sanction and another as a purely administrative measure (for instance when the legal entity has ceased to exist), but this can no longer be the case now that the ECB is the sole competent authority.

On the second issue, my interpretation of Article 18(5) grounded not only on its opening words but also on the examples given in the second subparagraph, leads me to strongly believe that it aims at capturing situations where the ECB has not powers conferred directly, so that there is no risk to have for the same person, for the same facts and breaches one proceeding leading to a pecuniary penalty by the ECB and another proceeding leading to another administrative penalty imposed by the NCA.

On the final issue, which is more hypothetical (*ne bis in idem* between an NCA and criminal courts), if an entity were prosecuted before the criminal courts of a

4 *Dubus SA* v *France*, appl. no. 5242/04 ECtHR 11 June 2009.

Member State participating in the SSM for a breach of prudential requirements, there would be a risk of overlapping sanctions implying the application of the *ne bis in idem* principle. Although the European Convention on Human Rights cannot be directly applied by the CJEU, national authorities (NCAs and courts) of countries that have ratified the Convention apply it.

However, in such a case, the *ne bis in idem* principle would not automatically prohibit the duplication of proceedings between criminal courts and NCAs in the SSM. Actually, with a moderate interpretation of the principle – that is currently applied in France - the *ne bis in idem* principle does not prevent the same facts by the same person being challenged before two different kinds of jurisdictions, under different sets of rules, namely:

– before criminal courts, being ordinary jurisdictions;

– before NCA and Supreme administrative courts, being administrative jurisdictions.

This moderate interpretation of the *ne bis in idem* principle was given by the Conseil Constitutionnel in its decision dated March 18 2015 (N°2014-453/454, Further to a "priority preliminary rulings on constitutionality" – QPC). The Conseil Constitutionnel outlines that - when the same facts by the same person are challenged before two different kinds of jurisdictions, under different sets of rules – the possibility to duplicate prosecutions is not contrary to the principle of strict necessity and proportionality of penalties with which the *ne bis in idem* principle is associated.

However, in the case in question, the Conseil Constitutionnel deemed that the penalties associated with the offence of insider dealing and insider misconduct cannot be considered to differ in nature depending upon the application of different bodies of rules before the relevant court (before the AMF Sanctions Commission and Paris Court of Appeal for insider misconduct and before criminal courts for insider dealing). Therefore, the Conseil considered that the duplication of prosecution in this specific case was contrary to the French constitution.

c. On the scope of legal protection for credit institutions, I underline two points: while it is absolutely necessary to clearly differentiate supervision proper, which is based on a continuous flow of information from the supervised entity to the supervisor, from a criminal prosecution enquiry, when it comes to the procedure of sanctioning it is also essential to afford a high standard of protection, given the possible consequences of sanctions. Therefore, I agree fully with Mr Lamandini's conclusion that EU courts in the field of sanctions shall exercise full jurisdiction. Let me just point out that one of the key elements of the European Court of Human Rights decision against the supervisory sanction in the Dubus case was the absence of full jurisdiction in the judicial review of supervisory sanctions provided for at that point of time by French law.

PANEL 4

BANKING SUPERVISORS' POWERS

CENTRAL BANK
EUROPEAN CENTRAL

BANKING SUPERVISORS' POWERS: INTRODUCTORY NOTE

DANIÈLE NOUY[1]

Ladies and gentlemen,

It is an appropriate time to reflect more thoroughly on the powers of banking supervisors, and I trust that the work of today's panel could make a substantive contribution to such reflection. I was thus very happy to be invited to chair this panel and the discussion.

THE QUESTIONS RAISED BY THE PRESENTERS

Both presenters in this panel refer to the existence of "market limits" to the discretion of supervisors. An interesting point to examine, from a theoretical perspective, is how these market limits would exert their effects when interests of different market players (e.g. creditors and shareholders) conflict with each other.

A peculiarity of the European context is also that, from a factual perspective, many of these interests are entrenched national interests, and the divide between interests has tended to correspond to the divide between Member States.

In this context, the European Central Bank (ECB) stands as a long-established and credible supranational authority that is accountable to the European Parliament. Its far-reaching independence shields it from specific national agendas, constraints and pressures. In addition to ensuring a sound monetary policy, since November 2014 the ECB has also been entrusted with directly supervising the most important banks in the euro area. In order to avoid conflicts of interest between monetary policy and banking supervision, a separation regime within the ECB was established. This regime ensures that each function is executed in accordance with its objectives. The current framework not only shields the Single Supervisory Mechanism (SSM) from undue external influence but also allows it to benefit from the synergies with the traditional monetary policy function, as highlighted in the presentation of Professor Lastra.

Based on the classification proposed by Professor Lastra, one may argue that, when performing its tasks, the supervisor acts as "agent" of different "principals": shareholders in the authorisation phase and creditors in the crisis management phase. This analysis leads to a series of questions which are relevant for the fulfilment of the supervisory function, as follows. Which interest should prevail in day to day supervision? What is the role of sanctions in this context? If a conflict of interest is hidden behind different principals, should these tasks be better separated?

1 Chair of the Supervisory Board, European Central Bank.

The extent of supervisors' powers generally results in interference in business decisions aimed at reducing risks. How great can this interference be, considering in particular the basic assumption that a bank, as an undertaking, is interested in making a profit? Dr Psaroudakis refers in this respect to a possible different paradigm based on setting clear objectives and on sanctioning non-compliance. The risks of this model and the likelihood of its material implementation deserve further analysis. For example, adopting this paradigm would lead us to wonder whether supervisors should not be considered, at least to a large extent, as agents acting on behalf of creditors, and whether it would be possible, in this case, to internalise this representation of interests within the corporate structure of banks.

These questions are not at all disconnected from a legal analysis of supervisory actions. Both presenters refer indeed to the judicial scrutiny of supervisors' decisions. The scope and depth of the judicial review of the Court of Justice on ECB decisions relating to the use of supervisory powers necessarily relates to the understanding of these questions. And the scope of such judicial review has in turn an impact on the use of ECB discretion.

AN EXAMPLE OF THE ECB EXPERIENCE WITH SUPERVISORY POWERS: THE SREP DECISIONS

The presenters will have the opportunity to propose their answers to the questions which I briefly mentioned. I would, however, like to take some more time to analyse the practical relevance of these questions in view of the brief experience of the ECB as a supervisor.

One of the first major exercises of the ECB after the conferral of its supervisory tasks was to conduct a comprehensive assessment of significant credit institutions. Since then, one of the ECB's major responsibilities has been the implementation of the "Supervisory Review and Evaluation Process" (SREP), which is the annual supervisory assessment of banks. The SREP results in the determination of the individual capital level to be met by each bank in the following year, including in particular the setting of bank-specific requirements under Pillar 2 of Basel III.

In contrast to Pillar 1 regulatory capital, which is mainly based on quantitative calculations, Pillar 2 capital is based more on the supervisors' judgement of the bank's risk management and governance as well as other qualitative considerations. By necessity, these qualitative considerations go along with a certain margin of discretion on the part of the supervisor, which is indispensable for the supervisors in fulfilling their tasks.

More recently we have been striving to unify the methodology underlying the SREP. For this purpose, we have closely liaised with the 19 national competent authorities (NCAs). We started by identifying common denominators and existing divergences and then pinpointed best practices, guiding our final outcome. The improvement in consistency with respect to the level of capital requirements across the board can be regarded as a major result of this process. We are convinced that in the long run this will help with anticipating supervisory actions as well as capital trajectories.

The SREP methodology is only one of the steps taken by the ECB in its work towards defining the boundaries of its discretion in carrying out its supervisory tasks. Another important achievement is the manual for supervision containing detailed information on how the ECB will conduct supervision across the SSM. However, the harmonisation of supervisory practices in the SSM also requires a harmonised interpretation of the applicable legal framework in the field of prudential regulation (the Capital Requirements Directive/Capital Requirements Regulation (CRDIV/CRR) package)[2]. This is especially true where some discretion remains for national competent authorities or Member States to decide on the concrete implementation of this legal framework.

Some provisions exist in the legal framework which allow Member States or competent authorities to choose whether and how to apply different prudential treatments to banks: we refer to these provisions as options and national discretions (ONDs). Neither the Directive nor the Regulation define the rationale of such provisions or require Member States to converge. This leads to a full and unconstrained discretion within the boundaries specified by the legislation. Moreover, our aim of achieving a high level of prudence and comparability for SSM actions as well as a level playing field is clearly hampered by a strong presence of ONDs in the legal framework.

The ECB has identified over 150 such ONDs, covering not only the progressive phasing-in of new supervisory treatment and definitions but also more permanent exemptions from general rules. The ECB, as the competent authority within the SSM in close collaboration with the NCAs, the European Banking Authority and the European Commission, has started to identify, assess and, where possible, address the fragmentation and level playing field issues caused by the diverging implementation of such ONDs. Our objective of harmonised banking supervision can only be achieved by a harmonised approach, which requires the development of a single treatment of all ONDs in the SSM. Despite our efforts, in a few cases harmonisation with the necessary level of rigour has not been possible so far. The national transposition of rules established by EU directives may indeed lead to heterogeneous standards in the SSM. Since the ECB has no authority to harmonise such national provisions transposing directives, we may only enter into a dialogue with national legislators, encouraging them to reflect in good faith the objectives of the directives. They must be aware of the fact that every national exception that is not fully transparent creates an obstacle to the efficient conduct of the supervisors' tasks and also curbs investor confidence. In the long run, it is therefore of the utmost importance for the successful operation of the SSM that

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) 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).

the single rulebook really lives up to its name and becomes a fully harmonised regulatory framework.

THE LIABILITY OF SUPERVISORS

In spite of all the efforts to harmonise and define the scope of discretion for the supervisors in order to ensure both consistency across institutions and supervision tailored to banks' specific circumstances, supervisors have to enjoy a certain room for manoeuvre. Applying discretion in deciding on supervisory matters reflects the supervisors' need to counterbalance a multiplicity of interests. A supervisory decision may not only be expected to take into account major public interests protected by EU and national legislators, such as preserving the sound management of credit institutions and, particularly, the overall stability of the financial system. Supervisors may also need to safeguard the interests of other stakeholders, such as the rights of depositors, investors and creditors. This variety of interests affects the exercising of discretion on the part of the supervisors.

The so-called supervisors' dilemma, i.e. the manifold and often conflicting interests supervisors have to counterbalance, must also be taken into account when it comes to legal protection, when courts are ruling on the exercise of supervisors' powers or a potential transgression relating to their room for manoeuvre. In this context, the ECB as an institution of the European Union is subject to the EU liability regime provided for in the EU treaties. Nonetheless, this liability regime should more clearly spell out the limitations of the ECB's liability, to counter the risk of excessive claims against the ECB which may hinder the overall effectiveness of ECB supervisory action. The legal protection of supervisors is a clear international benchmark, as highlighted by the fact that it ranks second in the list of the Basel Committee's Core Principles for Effective Banking Supervision. This principle indeed clearly states that laws should provide protection for the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith, and the supervisor and its staff should be adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.

CONCLUDING REMARKS

Before leaving the floor to the panellists, I would like to call the attention of the audience to the main reason why we need an effective system of banking supervision. The reason is this. It is indispensable for a sustainable recovery and for economic growth to have a sound banking system which operates efficiently during all phases of the economic cycle. This, in turn, is key for the revitalisation of the European project.

For this reason – after a long period of deregulation and after the crisis started in 2008 – governments around the world decided to strengthen regulation and supervision. At the same time, the ultimate objective of such reform has not

changed since the 1930s: supervisors need to ensure the resilience of the banking sector and to ensure that the banking sector provides the economy and society at large with key banking services, even under severe stress. At present, we are busy establishing common methodologies, a joint culture and a shared reputation, which will ensure that we have the right instruments and incentives to effectively pursue this delicate mission for Europe.

REFLECTIONS ON BANKING UNION, LENDER OF LAST RESORT AND SUPERVISORY DISCRETION[1]

ROSA M. LASTRA[2]

INTRODUCTION

The process of monetary integration in Europe was a long and protracted journey that started gathering force with the worldwide shift to a system of flexible exchange rates following the entry into force of the Second Amendment of the IMF Articles of Agreement in 1978, which sanctioned de iure the de facto abandonment of the par value regime. The contemporaneous establishment in 1978-79 of the European Monetary System, following the agreement by Valéry Giscard d'Estaing and Helmut Schmidt, was also a response to international developments, namely the collapse of an external anchor of monetary stability. It took a bit over two decades to finally sign the Maastricht Treaty in 1992. In contrast to monetary union, European Banking Union was a much quicker process (though the intellectual foundations for single supervision were advocated by some from the very start of EMU) that was made possible by the political consensus that surrounded the need to provide European supervision and crisis management of euro area credit institutions lest the euro area would disintegrate. The urgency with which the plan was conceived and executed was rooted in the vicious link between bank debt and sovereign debt that engulfed several euro area Member States in 2012.

Banking Union consists of three pillars. While the first pillar, "single supervision", has already been completed with the establishment of the Single Supervisory Mechanism (SSM), the second pillar, "single resolution", with the Single Resolution Mechanism (SRM) – aligned with the EU Bank Recovery and Resolution Directive (BRRD) – and a Single Resolution Fund, is still in the process of being implemented. The third pillar, "common deposit protection", is yet to be constructed. Furthermore, a fourth missing pillar, namely the lender of last resort function or emergency liquidity assistance, requires further clarification.

The paper deals with this missing pillar and also provides some reflections on the challenges for the ECB with the establishment of the Single Supervisory Mechanism: (1) the overlapping nature of its functions: monetary policy, liquidity assistance, micro-prudential supervision, macro-prudential policy

1 This contribution draws heavily upon "Lender of Last Resort and Banking Union", Chapter 6 in *European Banking Union. Prospects and Challenges* (ed. By Juan E. Castañeda, David G. Mayes and Geoffrey Wood) Routledge, 2015, pp. 109 – 128 (ISBN 978-1-315-69546-4). I would like to thank Chiara Zilioli and Danièle Nouy for helpful comments on an earlier version of this contribution, as it was presented at the ECB conference on 1 September 2015.

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(shared with national authorities/councils for financial stability and the European Systemic Risk Board) and early intervention (prelude to resolution); (2) the need for consistency and coordination amongst different competent authorities; (3) the exercise of supervisory discretion; and (4) the difficult balancing act between the objective of price stability (which has been defined and quantified) and the rediscovered objective of financial stability.

CHALLENGES FOR THE ECB WITH THE ADVENT OF BANKING UNION[3]

The ECB is no longer just a price stability-oriented monetary authority. With the advent of Banking Union, the ECB has become the key micro-supervisory authority in the euro area and it has also been granted some macro-prudential powers in the pursuit of financial stability.

A price stability-oriented independent central bank was a basic tenet in the early 1990s, supported by economic theory and empirical evidence which became embedded in the Maastricht Treaty and widely accepted in the developed and developing world. This explains why price stability is unambiguously mentioned in Article 127(1) TFEU as the primary objective of the ESCB while the tenuous reference to financial stability in Article 127(5) TFEU indicates the hesitant tone of the treaty drafters in giving this goal equal footing to the goal of price stability ("The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system"). The enabling clause advocated by Tommaso Padoa-Schioppa auspiciously found its way into the final text of the Treaty – Article 127(6), thus providing a Treaty basis for the SSM. Times have changed after the crisis and though in practice the primary objective of central banking has become financial stability (also for the ECB) (Buiter, 2015),[4] the Treaty remains unaltered.

Functionally, when it was created, the ECB resembled the "Bundesbank model" of one agency (the central bank), one primary objective (price stability) and one main instrument (monetary policy), in line with the Tinbergen rule. This relative simplicity (one goal, one instrument, one authority) in the pursuit of monetary stability contrasts with the multiplicity and complexity that characterize the pursuit of financial stability and the conduct of central banking in the aftermath of the global financial crisis.

3 This section draws heavily on the Report on "The Interaction between Monetary Policy and Bank Regulation" co-written by Charles Goodhart and myself for the European Parliament, available at the dedicated section (Economic Policies) of ECON website: http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html (tab heading: 2015). Monetary policy has entered uncharted territory following the great financial crisis. While prior to the crisis it had broadly converged toward one with a price stability (inflation) target and a short-term interest rate as a policy tool, there is now a second variant of monetary policy, which involves varying both the size, and perhaps, the composition of a central bank's balance sheet, with implications for monetary policy and also for financial stability.

4 See Willem H. Buiter at http://willembuiter.com/sintra.pdf

Financial stability co-exists with other goals (such as price stability, growth, employment, consumer protection); there are multiple instruments to achieve this goal (supervision, regulation, lender of last resort/ELA, resolution and crisis management, monetary policy, fiscal policy etc.) and the central bank shares responsibility for maintaining financial stability with other authorities at different levels of governance (national, European and international).[5] Financial stability (systemic risk control) is a goal that transcends geographic boundaries and institutional mandates. But the very definition of financial stability remains a matter of controversy.

The Dodd-Frank Act 2010 in the United States reinforced the financial stability mandate of the Federal Reserve System (the overriding objective) and the law governing the Bank of England in the United Kingdom has also been revised to reflect the twin mandate of monetary stability and financial stability. At the EU level, while the hierarchy of objectives remains (price stability reigns supreme in the Treaty), the mandate of the ECB has been substantially expanded via secondary legislation (the SSM Regulation and ensuing normative) into the field of prudential supervision.

Since November 2014, the ECB is the key supervisory authority for credit institutions in the euro area. The Basel Core Principle No. 1 reminds us that the primary objective of banking supervision is to promote the safety and soundness of banks and the banking system. If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective and do not conflict with it.

The ECB has also some macro-prudential powers, according to Article 5 of the SSM Regulation. And the ECB is also involved in the pre-insolvency phase in resolution. Early intervention (in the context of the SSM Regulation) comprises actions taken before the threshold conditions for resolution are met, and before the institution is insolvent or likely to become insolvent. The boundaries between supervision at the "end of the supervisory spectrum", early intervention/PCA, recovery and resolution are not always clear. Given its role as micro-prudential supervisor with powers for early intervention, the ECB is likely to play a major

5 The Financial Stability Oversight Council (FSOC) in the United States is a good example of the multiple authorities involved in the pursuit of financial stability. The FSOC is made up of ten voting members under the chairmanship of the Secretary of the Treasury (the other nine member are the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chair of the SEC, the Chair of the Commodity Future Trading Commission, the Chair of FDIC, the Chair of the Federal Housing Finance Agency, the chair of the National Credit Union Administration, and an independent member with insurance expertise) and five non-voting members.

role in the commencement of resolution proceedings.[6] This imposes an additional challenge.

Supervision and crisis management are part of a seamless process that requires timely communication and coordination between the competent authorities as well as judgment in the exercise of discretion. Supervision is also a thankless task, prone to litigation. Indeed, while judicial review of monetary policy measures might be limited, the same cannot be said with regard to the review of supervisory decisions (actions or omissions). The limits of the ECB's authority in the pursuit of financial stability remain open, considering also the interconnection between banking markets and other markets (sovereign debt, derivative, etc.) and the designation of systemically important financial institutions. The role of law and judicial review in the demarcation of such limits also needs further clarification.

The financial architecture of Europe is now rather complex both jurisdictionally and structurally. The jurisdictional domain of the ESAs and ESRB is the whole EU/single market, while the jurisdictional domain of the SSM is restricted to the euro area and those countries that adopt close cooperation agreements with the ECB. The structure of supervision is now divided between centralized powers in banking and decentralization and segmentation in other areas of the financial sector. This will require the ECB/SSM to cooperate very closely with national securities and insurance regulators.

A REVISIONIST ACCOUNT OF LENDER OF LAST RESORT[7]

The decision to serve as lender of last resort can be taken either to support a single bank suffering from a liquidity crisis (individual bank liquidity) or to preserve the stability of the banking system as a whole, by supplying extra reserves to all banks suffering from large cash withdrawals (market liquidity). An individual bank problem can, however, quickly convert into a system problem, if a sudden collapse of confidence in one bank spreads by contagion to other banks.

6 According to Article 4.1 (i) of the SSM Regulation, the ECB is empowered: "To carry out supervisory tasks in relation to recovery plans, and early intervention where a credit institution or group in relation to which the ECB is the consolidating supervisor, does not meet or is likely to breach the applicable prudential requirements, and, only in the cases explicitly stipulated by relevant Union law for competent authorities, structural changes required from credit institutions to prevent financial stress or failure, excluding any resolution powers."

7 This section of the chapter draws heavily on chapters 2 and 4 of Rosa Lastra, *International Financial and Monetary Law*, second edition, Oxford University Press, Oxford, 2015.

LOLR therefore comes in two forms. The first form is the traditional Thornton-Bagehot[8] "LOLR model" of collateralised lines of credit to individual illiquid but solvent[9] banks;[10] the second form is the provision of "market liquidity assistance" via ordinary open market operations and via extraordinary or unconventional measures.

Under the Thornton-Bagehot model, the following principles apply: (1) the central bank should prevent temporarily illiquid but solvent banks from failing – this type of lending is by nature short-term; (2) the central bank should be able to lend as much as is necessary (only the ultimate supplier of high-powered money has this ability), but charge a high rate of interest (a penalty rate as interpreted by some commentators);[11] (3) the central bank should accommodate anyone with good collateral, valued at pre-panic prices;[12] (4) the central bank should make its readiness to lend clear in advance. The central bank's LOLR role is discretionary, not mandatory.

The central bank assesses not only whether the situation is of illiquidity or insolvency, but also whether the failure of an institution can trigger by contagion the failure of other institutions. It is difficult to calculate ex ante how far a crisis can extend. Market sentiment is often hard to predict and, sometimes, irrational, which renders any rational prediction meaningless. The dynamic of a panic

8 The theoretical foundations of the lender of last resort doctrine were first set by Thornton in 1802 and then by Bagehot in 1873, who further elaborated and refined them. See Henry Thornton, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* (Fairfield, NJ: AM Kelley, 1991, originally published in 1802); Walter Bagehot, *Lombard Street. A Description of the Money Market* (New York: Wiley, 1999, originally published in 1873). Recent studies of the work of Thornton and Bagehot on the LOLR are found in Thomas M Humphrey, "The Classical Concept of the Lender of Last Resort" (1975) 61 (1) *Federal Reserve Bank of Richmond Economic Review* 2; Michael D Bordo, "Alternative Views and Historical Experience" (1990) 76 (1) Federal Reserve Bank of Richmond Economic Review 18.

9 Though the issue of solvency is often inserted here, Geoffrey Wood reminded me in private correspondence that Hawtrey (*The Art of Central Banking,* Frank Cass & Co. 1932, 1st edition) had pointed out it is not easy quickly to determine solvency, and not necessary either so long as acceptable collateral is offered. See also Geoffrey Wood, "The Lender of Last Resort Reconsidered", *Journal of Financial Services Research* 18: 2/3 2000, pp. 203-227 (Kluwer Academic Publishers).

10 See Rosa Lastra "Lender of Last Resort, an International Perspective", *International and Comparative Law Quarterly*, ICLQ, Volume 48, 1999, April 1999, pp. 340-361; and Lastra and Andrew Campbell, "Revisiting the Lender of Last Resort", *Banking and Finance Law Review,* Vol. 24, No. 3, June 2009.

11 Charles Goodhart contends that Bagehot's proposal that LOLR lending be at "high" rates is incorrectly translated into "penalty" rates. See Charles Goodhart, "Myths about the Lender of Last Resort" (1999) 2(3) *International Finance* 339. Several authors have suggested a rate lower than the market rate. Goodhart argues that the cost of the initial [borrowing] tranche should be kept very low to avoid the stigma problem associated with borrowing from the central bank. See, Charles Goodhart, *The Regulatory Response to the Financial Crisis*, (Cheltenham UK: Edward Elgar, 2009), 71. Also see, R. Repullo, "Who Should Act as a Lender of Last Resort? An Incomplete Contract Model" (2000) 32 (3) *Journal of Money, Credit and Banking*, 580-605 and available at ftp://ftp.cemfi.es/pdf/papers/repullo/Liquidity%202005.pdf, and J.C. Rochet, *Why there are so many banking crises? (*Princeton: Princeton University Press, 2008), 89.

12 The traditional lender of last resort practice, that the institution receiving assistance should provide "good" collateral, has been the subject of much debate and criticism during the global financial crisis due to the widening range of acceptable collateral.

is typically self-fulfilling. Indeed, it is the consideration of market sentiment that prompted Thornton back in 1802 to suggest that providing liquidity to the market (lending on security) was the best way of containing a panic. Bagehot and Thornton contend that the LOLR responsibility is to the market, to the entire financial system and not to specific institutions.

WHY LOLR LINKS MONETARY POLICY, MACRO-PRUDENTIAL POLICY AND MICRO-PRUDENTIAL SUPERVISION

The nature of the lender of last resort role involves different aspects:

(a) The discount rate at which the central bank lends to all authorized institutions, acting in its capacity as lender of last resort, is an instrument of monetary policy. Only the ultimate supplier of high-powered money can provide the necessary stabilizing function in a nationwide scramble for liquidity. The central bank can and does provide market liquidity via open market operations and via other non-conventional instruments.

(b) The lender of last resort is part of the financial stability function of the central bank. The central bank via the lender of last resort provides assistance to a bank (or banks) suffering from a liquidity crisis. The immediacy of the availability of central bank assistance (the central bank being the ultimate supplier of high-powered money) makes the LOLR a particularly suitable first line of defense in a crisis. This "immediacy" contrasts with the "time framework" of some other crisis management instruments. Neither deposit insurance nor resolution and bank insolvency proceedings can achieve this. By their very nature they are lengthy and complicated processes which take into account the interests of many stakeholders and are subject to greater legal constraints.[13] The second important feature of this LOLR assistance is the unlimited capacity of the central bank to provide liquidity, either to the market in general or to individual banks as needed. Central banks provide liquidity, not capital.

(c) The lender of last resort is a service provided by the central bank in its capacity as bankers' bank.

As I wrote in an article with Luis Garicano in 2010[14]: "The lender of last resort function can only be undertaken by a central bank. The involvement of central banks in financial stability originates in their role as monopolist suppliers of fiat money and in their role as bankers' bank. Only the ultimate supplier of money can provide the necessary stabilizing function in a nationwide scramble for liquidity, as the financial crisis has amply evidenced, with conventional and

13 Government guarantees are the other obvious means of immediate support and were widely used in the global financial crisis.

14 Luis Garicano and Rosa Lastra, "Towards a new Architecture for Financial Stability: Seven Principles", *Journal of International Economic Law,* Vol. 13, No. 3, September 2010, pp. 597-621.

non-conventional monetary policy operations (quantitative easing and others). This is a clear lesson of the crisis in the United Kingdom, where the problems of Northern Rock caught the Bank of England by surprise: having timely information is particularly crucial during financial crises and the best way to ensure access is to have daily supervision by the central bank, as the literature has noted."[15] Assistance on a rainy day requires surveillance on a sunny day.

While the Fed and the Bank of England have emphasized the complementarity[16] between monetary policy, macro-prudential policy, lender of last resort and micro-prudential supervision, the ECB on the other hand has highlighted the separation between monetary policy and banking supervision in a Decision of 17 September 2014, in accordance with Article 25(2) of the SSM Regulation.[17] However, the reality of central banking is one of complementarity of functions, which explains why they are placed under the same roof; if one wants to have the functions truly separate, then assign them to different entities.[18]

LOLR/ELA links monetary policy and supervision. Only the ultimate supplier of money can provide the necessary stabilizing function in a nationwide scramble for liquidity, as the financial crisis amply demonstrated, with conventional and non-conventional monetary policy measures.

> "Monetary policy not only affects inflation rates, but the price (and thus the amount) of risk-taking. An excessively accommodating Federal Reserve convinced actors that they would be saved from their folly (the famous 'Greenspan put') and led to excessive risk-taking. Thus, those in charge of monetary policy need to know the amount of risk and instability in the system. Moreover, the absence of stable prices harms the stability of

15 See Charles Goodhart and Dirk Schoenmaker "Institutional Separation between Supervisory and Monetary Agencies" and Charles Goodhart, "Price Stability and Financial Fragility" both in Charles Goodhart (ed.), *The Central Bank and the Financial System* (Basingstoke: MacMillan Press, 1993). Joseph G. Haubrich, "Combining Bank Supervision and Monetary Policy", Federal Reserve Bank of Cleveland Economic Commentary, November 1996. Clive B. Briault and Richard K. Abrams and Michael W. Taylor. Joe Peek, Eric S. Rosengren, and Geoffrey M. B. Tootell "Is Bank Supervision Central to Central Banking?", 114 (2) *Quarterly Journal of Economics* (1999), at 629-53.

16 The Fed conceives of its monetary policy as having been largely grafted onto its stabilization and supervisory functions, and regards such functions as a prerequisite and complement of its monetary policy responsibilities. In the United Kingdom, the Bank of England launched its One Bank – One Mission strategic plan in March 2015 stressing the links between the 3Ms: Monetary policy, macro-prudential and micro-prudential supervision.

17 Article 25 (2) SSM Regulation: "The ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. The tasks conferred on the ECB by this Regulation shall neither interfere with, nor be determined by, its tasks relating to monetary policy. The tasks conferred on the ECB by this Regulation shall moreover not interfere with its tasks in relation to the ESRB or any other tasks."

18 On the subject of separation between monetary policy and supervision the seminal article by Charles Goodhart and Dirk Schoenmaker, "Should the Functions of Monetary Policy and Banking Supervision be Separated?" (1995) Oxford University Papers, Vol. 47, No. 4, 539-560, summarizes the pros and cons.

the financial system, while financial fragility in turn, negatively affects monetary stability."[19]

Conflicts of interest between monetary policy and banking supervision are of course possible, but there are ways to solve or mitigate them. The SSM Regulation establishes a mediation panel to deal with such conflicts.[20]

LENDER OF LAST RESORT AND THE 2007-2009 FINANCIAL CRISIS

Unprecedented emergency liquidity assistance has been a defining and evolving feature of the responses to the global financial crisis since 2007. Central banks around the world operated as lenders of last resort, market-makers of last resort and, at times, as lender of primary resort or lenders of only resort.

Furthermore, since the extraordinary provision of liquidity assistance amply benefitted financial institutions that were not commercial banks, it is fitting to conclude that today central banks are the "financiers' banks" and not simply the "bankers' banks".

The financial crisis has changed our understanding of central banking, emergency liquidity assistance and systemic risk.

The expansion of central bank liquidity operations during the crisis turned what ought to be extraordinary into "ordinary", ordinary in the sense that with the crisis central banks often became the lender of primary or only resort, and at times market-makers of last resort. Rather than discouraging its use, the central bank has been keen to encourage various types of LOLR operations, whatever qualification one wishes to attribute to them: ordinary or extraordinary. Furthermore, the contours between the domain of monetary policy and the domain of emergency liquidity assistance became increasingly blurred.

In the United Kingdom the Bank of England launched the Special Liquidity Scheme (SLS)[21] in April 2008, to deal with the failure of the interbank markets to return to normality by injecting liquidity to the banks in the United Kingdom, on a temporary basis. Funding was offered on a longer-term basis in the euro area

19 See Luis Garicano and Rosa M Lastra, "Towards a new Architecture for Financial Stability: Seven Principles", *Journal of International Economic Law,* Vol. 13, No. 3, September 2010, p. 610. "Of course, extracting synergies never comes without organizational costs. One key problem with combining tasks has to do with the difficulty in providing adequate incentives and measurement on the stability task."

20 Article 25 (5) of the SSM Regulation: "With a view to ensuring separation between monetary policy and supervisory tasks, the ECB shall create a mediation panel. This panel shall resolve differences of views expressed by the competent authorities of participating Member States concerned regarding an objection of the Governing Council to a draft decision by the Supervisory Board." According to Article 32 (1) of the SSM Regulation, the European Commission is due to evaluate by the end of 2015 the effectiveness of the separation between supervisory and monetary policy functions within the ECB.

21 Bank of England News Release 21/4/08.

through the LTROs[22] (long-term refinancing operations) and in the United States via the TAF (Term Auction Facility).[23] The ECB in response to the sovereign debt crisis in some euro area Member States purchased assets through its Securities Markets Programme[24] (to restore the monetary transmission mechanism), which was later to be replaced by the Outright Monetary Transactions[25] and provided ample liquidity to the banking system.

The US Federal Reserve System embarked on a massive programme of emergency liquidity assistance during the financial crisis.[26] To the traditional discount window lending (DWL) for depository institutions and open market operations (OMOs), a number of facilities and programme were added. The expanding list of facilities was characterized by the widening range of acceptable collateral, the lengthening of the term of the loan and the ability to reach non-depository financial institutions (such as Bear Stearns, the investment bank, and AIG, the insurance company).

For example, in October 2008, the Fed opened the commercial paper funding facility; in November 2008 the Fed announced the Term Asset-Backed Securities Lending Facility (TALF), with a longer duration than any previous facility, at least one year and available to all US persons. Many of these facilities had broad eligibility and were often characterized by the widening range of acceptable collateral and the lengthening of the term of the lending.

The crisis substantially expanded the extraordinary liquidity assistance provided by the Fed. The *Emergency and Economic Stabilization Act* (EESA) enacted in 2008 highlighted some systemic risk situations where LOLR assistance could be justified.[27]The legal basis invoked since March 2008 in the United States to justify the establishment of new facilities and the extension of emergency liquidity assistance to non-bank financial institutions was Section 13(3) of the Federal Reserve Act (an authority which has been curtailed by the Dodd Frank Act 2010). It is also worth recalling that in September 2008, following the collapse of Lehman Brothers, some US financial firms such as Goldman Sachs[28] and Morgan Stanley[29] became bank holding companies in order to benefit from the Fed's liquidity facilities. Section 13(3) ("Discounts for Individuals, Partnerships, and Corporations") read as follows [before the Dodd Frank Act amendment]:

22 http://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html. For an analysis of these measures see Rosa Lastra, "The Evolution of the European Central Bank", *Fordham International Law Journal*, Vol. 35, Special Issue, Spring 2012, "From Maastricht to Lisbon: the Evolution of European Union Institutions and Law", pp. 1260-1281.

23 http://www.federalreserve.gov/newsevents/reform_taf.htm.

24 Decision of the European Central Bank (ECB/2010/5) of 14 May 2010 establishing a Securities Markets Programme, published in OJ L 124/8 on 20 May 2010

25 They were announced on 2 August 2012 and the technical details were published on 6 September 2012, available at http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.This programme has neither been formally adopted nor used to this day.

26 See http://www.newyorkfed.org/markets/Forms_of_Fed_Lending.pdf.

27 Emergency Economic Stabilization Act of 2008, Pub L No 110–343 (2008).

28 http://www.goldmansachs.com/media-relations/press-releases/archived/2008/bank-holding-co.html.

29 https://www.morganstanley.com/about/press/articles/6933.html.

‘In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act ‘, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: Provided, that before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal Reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe’. [30]

Interestingly, the authority to provide lender-of-last-resort assistance under Section 13(3) of the Federal Reserve Act has been curtailed significantly by the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.[31] The Dodd–Frank Act 2010 requires that any emergency lending programme and facilities authorized by the Federal Reserve under Section 13(3) of the Federal Reserve Act must have “broad-based eligibility” and must be approved by the Secretary of the Treasury.[32] Thus, the Fed cannot engage in rescues of individual firms (i.e., cannot use this authority for the “purpose” of assisting a “single and specific company”). This represents a significant restriction on the prior authority that the Fed used in 2008 in the cases of AIG and Bear Stearns.

Mark Carney, Governor of the Bank of England, in his Mansion House speech on 12 June 2014, stated that non-banks should also have access to the Bank of England’s facilities.[33]

30 Christian Johnson has conducted an analysis of the extensive use of this provision during the crisis, in a paper entitled “Exigent and Unusual Circumstances” presented at the Hart Conference in London (2009), submitted to European Business Organization Law Review. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1584731.

31 Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub L No 111–203 (2010), commonly referred to as the Dodd-Frank Act 2010 or simply Dodd-Frank.

32 See http://www.federalreserve.gov/aboutthefed/section13.htm. A programme or facility that is structured to remove assets from the balance sheet of a single/specific company or that is established to assist a single/specific company avoid bankruptcy, resolution or insolvency proceeding will not be considered a programme or facility with broad-based eligibility. The Dodd-Frank Act 2010 requests the Federal Reserve to give immediate notice and periodic reports to Congress regarding any Section 13(3) facility and also to disclose information concerning the participants and the amount of individual transactions in all credit facilities under Section 13(3) and borrowers or counterparties in discount window and open market transactions. See Bank for International Settlements, “Central Bank Governance and Financial Stability” (Report by a Study Group, May 2011), available at http://www.bis.org/publ/othp14.pdf. See also http://www.federalreserve.gov/monetarypolicy/clbs-appendix-c-201203.htm and <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

33 See Speech by Mark Carney (p.10), available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech736.pdf.

THE QUESTION OF AMBIGUITY

Can ambiguity ever be constructive? In my opinion, ambiguity is seldom (if ever at all) constructive. There is a need to be clear about the responsibility for lender of last resort before any crisis arises. There is also a need to be clear about the procedures, about the way things will work out and about which institutions can apply for ELA. Then, of course, the very provision of assistance should remain at the discretion of the authorities. It is this discretionary element – this uncertainty about whether or not the emergency liquidity assistance will be provided – that reduces the moral hazard incentives inherent in any support operation. But there should not be any doubt about who is in charge and how the assistance will be provided. The law ought to be clear about these issues. I quite like the term "constructive certainty" coined by Tom Huertas in the context of resolution.[34]

What is true is that the existence of a public "safety net" creates moral hazard, that is, a set of incentives for the protected to behave differently—irresponsibly, carelessly, or less conservatively—simply because of the existence of protection. Lending to insolvent institutions increases the potential for moral hazard.[35]

LENDER OF LAST RESORT IN THE CONTEXT OF BANKING UNION[36]

The central bank provides liquidity. Then it is up to the government to provide capital (recapitalization of troubled entities – bail-out programmes). The problem in Europe is that while we do have an European Central Bank (ECB) which can provide such liquidity, we do not have a sufficiently credible fiscal backstop since fiscal policy remains decentralized and the Member States are competent (albeit subject to increasing coordination, conditionality and stringent rules).

34 See Thomas Huertas. "A Resolvable Bank", paper presented at a conference on "Managing and Financing European Bank Resolution" held at the LSE on 24 March 2014. On constructive ambiguity see *inter alia*, Xavier Freixas, "Optimal Bail Out Policy, Conditionality and Constructive Ambiguity" (1999) Working Paper No. 400, available at SSRN, http://ssrn.com/abstract=199054; Vinogradov Dmitri, "Deconstructive Effects of Constructive Ambiguity in Risky Times" (2010), available at www.ecb.int and Sylvester Eijffinger and Rob Nijskens, "A Dynamic Analysis of Bail Outs and Constructive Ambiguity" (2012), CEPR W.P., at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2118439.

35 The operational aspects of the LOLR functions are affected by problems of asymmetric information, namely moral hazard and adverse selection. See George Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism", *The Quarterly Journal of Economics*, Volume 84, Issue 3, pp. 488-500, 1970.

36 This section of the chapter draws heavily on Chapter 10 of Lastra, *International Financial and Monetary Law*, second edition, Oxford University Press, Oxford, 2015. See also chapter 7 for the non-conventional responses by the ECB to the Crisis and Lastra, "Banking Union and Single Market: Conflict or Companionship?" *Fordham International Law Journal*, Vol. 36, No. 5, 2013, pp. 1189-1223, for a consideration of how banking union fits within the single market in financial services. For a short account of banking union see "European Banking Union", by Rosa Lastra, Bernd Krauskopf, Christos Gortsos and René Smits, MOCOMILA report to the ILA meeting in Washington D.C., April 2014, available at http://www.ila-hq.org/en/committees/index.cfm/cid/22.

A limited fiscal backstop in Europe is provided via the European Stability Mechanism,[37] modeled upon the IMF (but with more limited funding, since it has a lending capacity of EUR 500 billion, backed up by an authorized capital of 700 billion[38]). The Pringle ruling confirmed the legality of the ESM in 2012.[39] On 10 June 2014, euro-area Member States reached a political understanding on the operational framework of the ESM direct recapitalization instrument.[40]

In the United States, while the Federal Reserve System provided ample liquidity assistance (both market liquidity and individual liquidity assistance), the Treasury provided the necessary capital with the TARP (Troubled Asset Relief Programme).

THE PILLARS OF BANKING UNION

Banking union is based upon three pillars.[41] The first pillar is "single supervision", with the establishment of the Single Supervisory Mechanism (SSM) based upon Article 127(6) TFEU. "Single supervision" in the context of banking union means European supervision (conferred upon the ECB) for credit institutions of euro-area Member States and of non-euro area EU Member States that choose to become part of the SSM. The second pillar is "single resolution", with a Single Resolution Mechanism (SRM) – which should be aligned with the EU Bank

37 The European Stability Mechanism Treaty, concluded in Brussels on 2 February 2012, entered into force on 27 September 2012. The ESM was inaugurated on 8 October 2012 following the ratification by all the euro area Member States.

38 The ESM raises funds by issuing money market instruments and medium and long-term debt with maturities of up to 30 years, which are backed by a paid-in capital of EUR 80 billion and the irrevocable and unconditional obligation of ESM Member States to provide their contribution to ESM's authorized capital stock

39 Case C370/12, reference for a preliminary ruling under Article 267 TFEU from the Supreme Court (Ireland), made by decision of 31 July 2012, received at the Court on 3 August 2012, in the proceedings Thomas Pringle v Government of Ireland. http://curia.europa.eu/juris/document/document.jsf?text=&docid=130381&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=37623 Pringle v. Ir., [2012] IESC 47, para. 5 (S.C.) (Ir.), available at, http://www.courts.ie/__80256F2B00356A6B.nsf/0/E7504392B159245080257A4C00517D6A?Open&Highlight=0,pringle,~language_en~.

40 http://www.euroarea.europa.eu/media/533095/20140610-eurogroup-president-direct-recapitalisation.pdf Following the relevant national procedures and the formal adoption by the ESM Board of Governors, the instrument is expected to be added to the toolkit of the ESM. Once operational, it is expected that the instrument may be activated in case a bank fails to attract sufficient capital from private sources and if the ESM Member concerned is unable to recapitalize it, including through the instrument of indirect recapitalization of the ESM. For a transitional period until 31 December 2015, a bail-in of 8% of all liabilities will be a precondition for using the instrument, as well as the use of the resources available in the ESM Member's national resolution fund. From 1 January 2016, bail-in in line with the rules of the Bank Recovery and Resolution Directive will be required. The financial assistance will be provided in accordance with EU State aid rules and the ESM Member will be asked to invest alongside the ESM.

41 Underpinning these three pillars is the concept of a common supervisory rule book, laying down uniform terms for the authorization and withdrawal of credit institutions, for the conduct of micro-prudential supervision over credit institutions, for the resolution of non-viable credit institutions and for the operation of deposit guarantee schemes.

Recovery and Resolution Directive (BRRD)[42] – and a Single Resolution Fund. The legal basis for the second pillar is Article 114 of TFEU. The third pillar is "common deposit protection".[43] (In principle 127(6) could also provide a legal basis for deposit insurance if we understand (as I do) supervision in a broad sense as a process with four stages from authorization to crisis management). This third pillar has been discussed in terms of principles and "high-level politics" though there are political and legal discussions going on as to the feasibility of different options, and the European Commission published a proposal for a euro-area wide deposit insurance scheme (EDIS) for bank deposits, in a Communication published on 24 November 2015.[44]

THE MISSING PILLAR OF BANKING UNION: LOLR

Though LOLR is not included as a pillar of the current banking union plan, in my opinion it is clearly the fourth "missing pillar". LOLR is the first line of defence in a crisis. Central banks provide liquidity when no other sources of liquidity are readily available (or at least are not available at "'reasonable market prices").

LOLR comes – as discussed above – in two forms: market liquidity assistance and individual liquidity assistance. The ECB has clear competence – a competence which it has exercised widely – when it comes to the first form, while – due to its own restrictive interpretation of Article 14.4 of the ESCB Statute – it does not so far have competence with regard to the latter. The risks and costs arising from such provision are incurred by the relevant National Central Bank (NCB), though a number of procedures – reiterated in a resolution of the Governing Council of 17 October 2013 – ought to be followed. This subject, however, has always triggered much controversy.[45]

42 The BRRD was published in the OJ in June 2014. See 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, 12.06.2014, p. 190–348. See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0190.01.ENG

43 The rationale for a common deposit insurance scheme is clear: with perfect capital mobility, in order to prevent a flight of deposits from troubled countries to countries perceived to be "safe", one needs to convince ordinary citizens that a euro in a bank account in one euro area Member State is worth the same and is as secure as a euro in a bank account in another euro area Member State. This is a real challenge, as the experience in Cyprus evidenced.

44 http://ec.europa.eu/finance/general-policy/banking-union/european-deposit-insurance-scheme/index_en.htm#151124

45 See, *inter alia*, Charles Goodhart (ed.), *Which Lender of Last Resort for Europe* (London: Central Banking Publications, 2000), Jeroen Kremers, Dirk Schoenmaker, and Peter J Wierts (eds.), *Financial Supervision in Europe* (Cheltenham: Edward Elgar Publishing, 2001), chs. 4 and 5, Tommasso Padoa-Schioppa, *Regulating Finance* (Oxford: Oxford University Press, 2004) chs. 7 and 8, and Xavier Freixas, "Crisis Management in Europe" in Jeroen Kremer, Dirk Schoenmaker, and Peter Wierts (eds.), *Financial Supervision in Europe* (Cheltenham: Edward Elgar, 2003) 110. For a critique of the ECB's interpretation of its powers in respect of ELA, see René Smits, European supervisors in the credit crisis: issues of competence and competition, chapter 15 in Mario Giovanoli and Diego Devos (eds.), International Monetary and Financial Law – The Global Crisis, Oxford 2010, at 310-311.

Granting the ECB a clear LOLR mandate does not require a Treaty change. There is sufficient legal basis in Article 127 TFEU, Article 18 of the ESCB Statute and the principle of subsidiarity. The ECB is already competent to provide liquidity assistance to "financially sound" banks. ELA/LOLR links monetary policy and supervision [thus the complementarity between monetary policy, supervision and liquidity assistance]. All is needed is a reinterpretation of Article 14.4 of the ESCB Statute in the light of new circumstances (Banking Union). At the very least such an interpretation is required for significant institutions.

Since the SSM became operational on 4 November 2014, the ECB should formally be the ultimate provider of liquidity in the euro area, both in cases of market liquidity and in cases of individual liquidity assistance, as a necessary consequence of the transfer of supervisory powers from the national to the European level.[46] The National Competent Authority (NCA) is neither the monetary policy authority nor the supervisor. The only advantage of continuing with the current interpretation is that any eventual loss is not shared (yet it would have an impact on the whole euro area).

The ECB has been always competent to act as LOLR if the crisis originates in the payments system, according to Article 127(2) TFEU, which states that the European System of Central Banks (ESCB) is entrusted with the "smooth operation of payment systems". The ECB is also competent in the case of a general liquidity dry-up to provide market liquidity according to Article 18 of the ESCB Statute, and the ECB has amply used this competence during the crisis, even leading to legal questioning of whether it has exceeded its mandate.

But it is the "traditional" understanding of LOLR assistance à la Bagehot/Thornton, that is, collateralized lines of credit to an individual financial institution which becomes illiquid, but not necessarily insolvent, and whose illiquidity threatens to spread to other institutions and to other markets (the problem of contagion). Though the ECB is competent to provide liquidity assistance to "financially sound" banks,[47] the provision of collateralized loans to troubled illiquid but solvent banks is understood to remain a national competence because it has not been specifically transferred.[48]

In 1998, the ESCB adopted a restrictive reading of the ECB competences, concluding that the provision of lender of last resort assistance to specific illiquid individual institutions was a national task of the National Central Banks (NCBs) in line with Article 14.4 of the ESCB Statute (a provision which allows NCBs to

46 Notwithstanding the ECB Decision of 18 October 2013 on ELA (Emergency Liquidity Assistance), available at http://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf, which assigns "responsibility for the provision of ELA" to the "NCB(s) concerned", further specifying that "This means that any cost of, and the risks arising from, the provision of ELA are incurred by the relevant NCB".

47 See ECB http://www.ecb.europa.eu/pub/pdf/other/gendoc2008en.pdf, 2008, p. 11

48 René Smits has always held a different opinion, regarding this LOLR responsibility as an exclusive EU competence. See René Smits, "The role of the ESCB in Banking Supervision", *Legal Aspects of the European System of Central Banks, Liber Amicorum Paolo Zamboni Garavelli* (Frankfurt: European Central Bank, 2005) n 32.

perform non-ESCB tasks on their own responsibility and liability).[49] Therefore, the classic collateralized lines of credit to individual institutions remain the responsibility of the NCBs, at their own cost, but with the fiat of the ECB. This interpretation is somewhat awkward, though it has been reaffirmed in 2013.[50]

When prudential supervision was at the national level, it was perhaps logical to assume that the national authorities had the adequate expertise and information to assess the problems of banks within their jurisdictions (assistance on a rainy day – supervision on a sunny day). But now that supervision is European, the ECB should be at all effects lender of last resort for all those institutions it now supervises. ELA in all forms should be an ECB competence, in accordance with Article and 18 of the ESCB Statute, Article 127 of TFEU and the principle of subsidiarity.

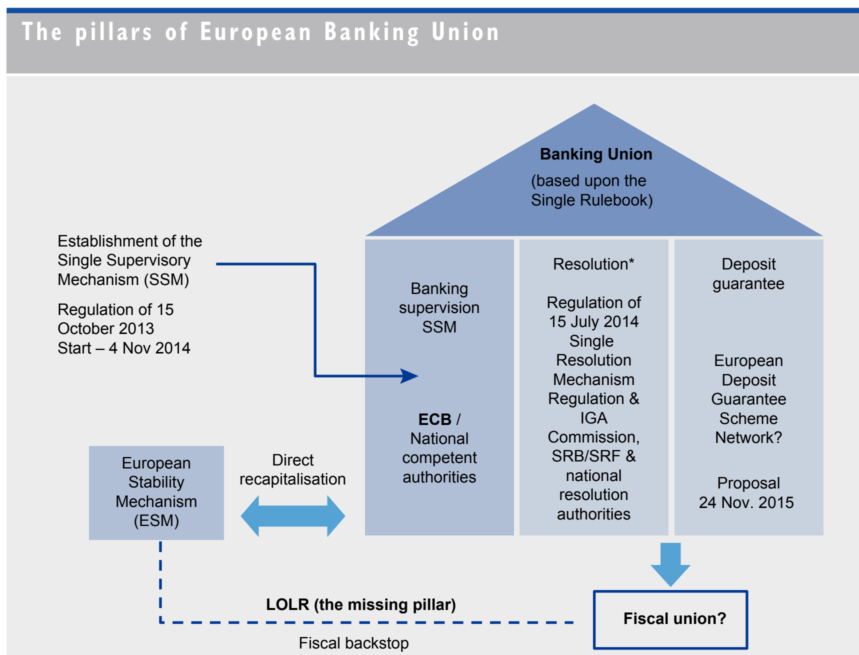
49 Article 14.4 reads as follows: "National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB". The ECB can assess whether a given LOLR operation by a NCB interferes with monetary policy and, if so, either prohibit it or subject it to conditions. To this effect, the ECB has some internal rules (MoU) requiring ex ante notification to the Governing Council of such LOLR operation (Article 14.4). I thank Antonio Sainz de Vicuña for observations on this point. The following is an excerpt from the ECB Annual Report 1999 (p. 98): "The institutional framework for financial stability in the EU and in the euro area is based on national competence and international cooperation…. Co-ordination mechanisms are primarily called for within the Eurosystem. This is the case for emergency liquidity assistance (ELA), which embraces the support given by central banks in exceptional circumstances and on a case-by-case basis to temporarily illiquid institutions and markets…. If and when appropriate, the necessary mechanisms to tackle a financial crisis are in place. The main guiding principle is that the competent NCB takes the decision concerning the provision of ELA to an institution operating in its jurisdiction. This would take place under the responsibility and at the cost of the NCB in question. (…) The agreement on ELA is internal to the Eurosystem and does not affect the existing arrangements between central banks and supervisors at the national level or bilateral or multilateral co-operation among supervisors and between the latter and the Eurosystem."

50 See ELA Decision by the ECB of 18 October 2013, available at http://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf. ELA means the provision by a Eurosystem national central bank (NCB) of (a) central-bank money and/or (b) any other assistance that may lead to an increase in central-bank money to a solvent financial institution, or group of solvent financial institutions, that is facing temporary liquidity problems, without such operation being part of the single monetary policy. Responsibility for the provision of ELA lies with the NCB(s) concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB. NCBs must inform the ECB within two days of an ELA operation, with details of the counterparties involved, the value of the operation, the haircuts and collateral applied and the rate of interest paid on the funds. A limit of EUR 500 million in ELA assistance can be provided to a given financial institution or group of institutions before the NCB(s) involved must inform the ECB as early as possible prior to the extension of the intended assistance. If the overall volume of ELA operations passes EUR 2 billion for a given central bank, the Governing Council considers whether there is a risk that the ELA involved may interfere with the objectives and tasks of the Eurosystem. Upon the request of the NCB(s) concerned, the Governing Council may then decide to set a threshold and not to object to intended ELA operations that are below that threshold and conducted within a pre-specified short period of time.

Indeed, even before banking union, Article 18 provided a perfectly valid legal basis for the ECB to provide the two forms of ELA/LOLR. And according to Article 5(3) TEU (principle of subsidiarity): ‘In areas which do not fall within its exclusive competence, the Union shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.’

In a crisis action by the ECB is more effective than action by a NCB or national authority. National supervisory authorities do not have the ability, authority, or inclination to deal effectively with externalities with cross-border effects. The ECB is able to better judge the risk of contagion.

The pillars of European Banking Union



FISCAL ASSISTANCE AND STATE AID RULES

The problem with having the ECB as LOLR is, of course, the “fiscal backstop”, when the institution receiving the assistance is no longer illiquid but insolvent.

Goodhart points out, “a central bank can create liquidity, but it cannot provide for new injections of equity capital. Only the fiscal authority can do that.” [51] The central bank should not lend over an extended period of time, committing

51 See Charles Goodhart, Foreword to the book by Tommasso Padoa-Schioppa, *Regulating Finance* (Oxford: Oxford University Press, 2004) xvii.

taxpayers' money, without the explicit approval of the fiscal authority.[52] Any extended lending becomes the responsibility of the fiscal authority.

In practice, the central bank and the Treasury/Ministry of Finance (MoF) need to work together in the case of a support operation. This can be arranged at the national level relatively easily. The problem at the EU level – as the recent financial crisis amply demonstrated – is that the relevant fiscal authorities are by definition national. Indeed, while the Bank of England is ultimately backed by the fiscal resources of the UK Treasury (though it must comply with the EU rules on state aid and the prohibition of monetary financing) and the Federal Reserve System is ultimately backed by the fiscal resources of the US Treasury, the ECB does not yet have a European fiscal counterpart.[53]

The ECB is therefore sui generis because of the "fiscal constraint" and the EU Treaty provisions (in particular Article 123 and Article 125).[54] The ECB did indeed provide hugely expanded liquidity operations during the crisis[55] and made ample use of the considerable set of operational tools at its disposal to handle a liquidity crisis.[56] The problem is that what constitutes "ordinary" liquidity assistance as opposed to "emergency"/LOLR liquidity assistance becomes blurred during a crisis, since the drying of the inter-bank market gives the central bank a primary role in the provision of liquidity.[57]

A further twist is provided by the need to comply with the EU rules on state aid. Because an inherent subsidy exists whenever the central bank lends to an insolvent institution, under the EU rules on state aid, the granting of emergency aid to

52 In the EU the prohibition of monetisation of government debt, also known as "monetary financing" in accordance with the provisions of Article 123 TFEU applies.

53 Alexandre Lamfalussy remarked in an interview with *The Guardian* on 16 August 2003: "The great weakness of EMU is the E. The M part is institutionally well organized. We have a solid framework. We don't have that for economic policy."

54 This cast some legal doubts on the OMT programme (for the referral by the German Constitutional Court to the ECJ of the legality of the OMT decision see http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg14-009en.html, February 2014) and also raised concerns about QE (quantitative easing) programmes to stimulate the euro-area economy. Article 123 TFEU only forbids the ESCB from giving credit to or purchasing sovereign debt directly from EU Member States; there is no ban on purchases of government bonds on the secondary markets, which the ECB has been doing since May 2010, when it began buying the government debt of Greece.

55 For a summary of significant liquidity provision measures adopted during the crisis, see http://www.ecb.int/press/key/date/2009/html/sp090220.en.html. As regards the Outright Monetary Transactions, see the Press Release on the technical features of the OMT at http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html. For unconventional ECB monetary policies, see also https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1528.pdf.

56 ECB open market operations are described in chapter 3 of "The Implementation of Monetary Policy in the Euro Area", European Central Bank, November 2008, available at http://www.ecb.europa.eu/pub/pdf/other/gendoc2008en.pdf.

57 In his comments to this chapter David Mayes noted: "If the ECB makes a mistake and its loans are not repaid by a counterparty then it takes the risk on its balance sheet. If the ECB becomes under-capitalized then it will be recapitalized by the Member States according to the capital key. For market lending there are general collateral rules – but in any case most of this would be on NCB balance sheets. The problem is with a cross-border bank whose exposure is very different from the capital key but still involves more than one Member State."

banking institutions can be considered illegal in some cases. The Luxembourg Court of Justice recognized in a ground-breaking decision, the *Züchner* case, that EU competition rules are also applicable to the banking sector.[58]

On 5 December 2007, the EU Commission in its approval of the rescue aid package for Northern Rock concluded "that the emergency liquidity assistance provided by the Bank of England on 14 September 2007, which was secured by sufficient collateral and was interest-bearing, did not constitute state aid".[59] The Commission Communication of 13 October 2008 further reiterated this point:[60] In establishing a single market in financial services, it is important that the Treaty's state aid rules are applied consistently and equally to the banking sector, though with a regard to the peculiarities and sensitivities of the financial markets.[61]

In August 2013 the Commission published another Communication extending the "crisis rules" for banks.[62] According to paragraph 53 of this August 2013 communication: "Liquidity support and guarantees on liabilities temporarily

58 See Case 172/80 *Züchner v Bayerische Vereinsbank* [1981] ECR 2021.

59 Available at, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1859&format=HTML&aged=1&language=EN&guiLanguage=en. "However, the guarantee on deposits granted by the Treasury on 17th September, as well as the measures granted on 9th October, which provided further liquidity and guarantees to Northern Rock and were secured by a Treasury indemnity, do constitute state aid." On 17 March 2008, six months after the first state aid measures ("rescue aid") took place, the UK authorities submitted to the Commission a restructuring plan. The Commission then launched an in-depth investigation into this "restructuring aid". See http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/489.

60 Official Journal C 270, 25.10.2008, paragraph 51: "[T]he Commission considers for instance that activities of central banks related to monetary policy, such as open market operations and standing facilities, are not caught by the State aid rules. Dedicated support to a specific financial institution may also be found not to constitute aid in specific circumstances. The Commission considers that the provision of central banks' funds to the financial institution in such a case may be found not to constitute aid when a number of conditions are met, such as: the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package; the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value; the central bank charges a penal interest rate to the beneficiary; the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State."

61 From the beginning of the global financial crisis in the autumn of 2008 to December 2010, the Commission issued four communications which provided detailed guidance on the criteria for the compatibility of State support to financial institutions with the requirements of Article 107 (3) (b) of TFEU: (1) Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (Banking Communication); (2) Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (Recapitalisation Communication); (3) Communication from the Commission on the treatment of impaired assets in the Community banking sector (Impaired Assets Communication) and (4) Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (Restructuring Communication). See http://ec.europa.eu/competition/state_aid/legislation/temporary.html.

62 Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ("Banking Communication"), 2013/C 216/01, available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730(01).

stabilise the liability side of a bank's balance sheet. Therefore, unlike recapitalisation or impaired asset measures which in principle must be preceded by the notification of a restructuring plan by the Member State concerned and approval by the Commission before they can be granted, the Commission can accept that Member States notify guarantees and liquidity support to be granted after approval on a temporary basis as rescue aid before a restructuring plan is approved."

And paragraph 62 further clarifies: "The ordinary activities of central banks related to monetary policy, such as open market operations and standing facilities, do not fall within the scope of the State aid rules. Dedicated support to a specific credit institution (commonly referred to as 'emergency liquidity assistance') may constitute aid unless the following cumulative conditions are met:

(a) the credit institution is temporarily illiquid but solvent at the moment of the liquidity provision and is not part of a larger aid package;

(b) the facility is fully secured by collateral to which appropriate haircuts are applied, in function of its quality and market value;

(c) the central bank charges a penal interest rate to the beneficiary;

(d) the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State."

It is rather interesting that the Thornton-Bagehot doctrinal principles find their way into a legal text.

Paragraph 63 of this 2013 Communication further specifies that: "interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit guarantee schemes do not constitute state aid."

CONCLUDING OBSERVATIONS

Much has been written during the crisis about the Treaty constraints within which the ECB operates. The Greek drama[63], however, reminds us that there are limits as to how much central banks can do with the tools at their disposal – monetary policy and emergency liquidity assistance – to deal with the causes and effects of a crisis in the absence of fiscal and structural reforms.

63 The "extend and pretend policies" when it comes to sovereign debt "management" (restructuring) cannot hide a few uncomfortable truths. The ECB may have to take losses. Memories of the LDC crisis in the 1980s and the lost decade in Latin America cast a long shadow on the current situation in some euro-area Member States – it took years for the Brady Plan to replace the misguided Baker Plan. Where you draw the dividing line for loss-sharing arrangements and who provides what sort of support are key issues yet to be solved.

This paper has considered the missing pillar of banking union, namely lender of last resort and the issues of supervisory discretion.

As regards market liquidity the ECB has provided ample support beyond normal operations in part because the politicians could not agree on anyone else doing it (eventually the ESM was established – limited fiscal backstop – following a number of temporary facilities), in part because the ECB committed to do everything it could within the limits of its mandate (often stretching such mandate via creative interpretation albeit in conformity with the law/Treaty requirements) to avoid the collapse of the euro.

In terms of individual liquidity assistance, the ECB's own restrictive interpretation of Article 14.4 of the ESCB Statute (a provision which allows NCBs to perform non-ESCB tasks on their own responsibility and liability) is a stumbling block in the road to the fourth pillar of banking union. Such interpretation of Article 14.4 is somewhat awkward and clouded with uncertainty, since the ECB can provide some forms of ELA (open market operations and discount policies, for example) but not others (classic collateralised lines to individual institutions, which remain the responsibility of the national central banks, at their own cost, but with the fiat of the ECB). Article 18 of the ESCB Statute in combination with Article 127 TFEU provided a perfectly valid legal basis for the ECB to provide the two forms of ELA/LOLR. The case for a more expansive interpretation of Article 14.4 has been reinforced with Banking Union: assistance in a rainy day, supervision on a sunny day, …

In the United States, federalisation of liquidity assistance and supervision took place in 1913 with the establishment of the Federal Reserve System.[64] With the advent of banking union, the ECB should be the ultimate provider of liquidity in the euro area, both in cases of market liquidity and in cases of individual liquidity assistance. This is a necessary consequence of the transfer of supervisory powers to the ECB.

64 In the United States, federalisation of bank insolvency (today resolution) and deposit insurance took place in 1933 with the establishment of the FDIC. In the same way as in supervision we went from Lamfalussy to De Larosière to SSM (the Single Supervisory Mechanism), when it comes to resolution, the Single Resolution Mechanism (SRM) is only a first step in the way towards the design of an adequate resolution framework.

THE BOUNDARIES OF BANKING SUPERVISION: BUSINESS JUDGEMENTS AND PRUDENTIAL OVERSIGHT

GEORGIOS PSAROUDAKIS[1]

I INTRODUCTION: THE SUPERVISOR'S POWERS IN CONTEMPORARY LAW

The purpose of this analysis is to offer some thoughts towards justifying and delineating the interference of supervisors in the business activities of supervised credit institutions. The emergence of broad supervisory powers in the context of the reforms that were implemented as a response to the recent crisis calls for such a discussion. These new powers are vested both in prudential supervisors (macro-prudential supervisors are now also included) and, nowadays, in resolution authorities, which, beyond applying resolution tools, may also exercise significant influence on credit institutions during their normal operations. For the sake of simplicity, reference below will generally be to supervision, but this will often also include such powers of the resolution authorities.

While the most obvious task of prudential supervisors is to quantify capital requirements (and, similarly, the most visible task of resolution authorities in their everyday operation may become the determination of the MREL of Article 45 BRRD), this is not to say that they do not have, or that they should not have, influence on material business decisions (or, rather, other material decisions too, given that the structuring of corporate financing itself between equity and debt is a fundamental decision of this kind). As to the factual question as to whether such influence exists in current law, even the determination of capital needs (in particular the needs based on a supervisory review and evaluation in accordance with Article 104 CRD IV and coming on top of the CRR requirements) is influenced by an assessment of business decisions (in particular concerning the provision of credit) and their risks, and may indirectly favour or disfavour decisions of that kind. Furthermore, supervisors may influence material decisions by using the powers granted to them by CRD IV, in particular by Article 104 (e.g. requirements for divestment, reduction of risks etc.), as well as by the BRRD, in which context it would be worth referring to the early intervention measures in Articles 27-30, and also to the power to address or remove impediments to resolvability in Articles 17-18. The latter power allows the authorities to require, among other things, the limitation of risks and activities on the basis of a forward-looking analysis of how a potential crisis in the bank could be dealt with.

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As regards the deontological question as to whether such influence should exist, it should first be recalled that the burden of persuasion lies with the supervisor, as economic liberty is the norm and intervention is only admissible as a proportionate restriction to it. It will be shown below that circumstances justifying such intervention do indeed exist. Furthermore, it may be a superficially tempting view to see the supervisor (or, even, the law directly) as only setting targets, in particular *capital* targets, and then waiting for results to be delivered by the supervised entities, without intervening in the process of producing such results. However, while this argument might have an intuitive appeal as a supposedly "liberal" method of supervision, it would not be advisable to follow it. Indeed, this method would, ultimately, lead to disproportionate results, as targets would either be achieved, in which case no further issue would arise anyway, or would not be achieved, in which case the supervisor would have little choice but to impose sanctions, if appropriate, or even withdraw the license. Seen from this point of view, interference in business decisions is a way for a dialogue to emerge between the supervisor and the supervised bank, and for less burdensome decisions (rather than heavy-handed *ex post* measures alone) to be taken by the former.

Finally, it is remarkable that the supervisory powers mentioned here are of a suppressive rather than a formative nature. The supervisor does not positively shape the policies of the bank, but rather restricts the choices available to it. These powers often include, for example, a requirement for divestment, but not a requirement for further investment in some area. In effect the supervisor is acting as a veto player; the influence exercised may still be very significant.

II THE JUSTIFICATION OF THE SUPERVISOR'S POWERS

1 *"Banks are special": from* service public *to systemic stability*

The banking sector is obviously subjected to heavier regulation than most other fields of business activity. This demands an explanation, in which the discussion of the *service public* that banks perform[2] becomes relevant. The emphasis at the start of this discussion was mostly on the provision of credit, and the idea of the *service public* was used to explain the possible liability of banks relating to their decisions on granting or refusing credit.

One might object that many (or even all) other economic activities are significant for socio-economic life (which is why they exist in the first place), that a market economy is a process of discovery,[3] in which highlighting the importance of one or another activity in principle has no meaning, and, therefore, that for a particular business activity, qualifying as a *service public* does not carry much explanatory value. And yet such objections would be rather dogmatic, as this

2 See, to this effect, CA Paris JCP 1968 II 15518 obs. Stoufflet; R Houin, RTD com, 165 (1964).

3 As argued famously by Hayek, *Freiburger Studien*, Mohr Siebeck, Tübingen, 249 *et seq*. (1969).

older discussion on the *service public* does grasp the particular significance of banking, namely that it provides essential liquidity and allows money to perform its fundamental functions as a medium of exchange and a store of value. Banks are also the intermediaries *par excellence* in our economy: by borrowing short from depositors and lending long to businesses and households, they transform maturity and direct available capital to where it can be put to productive use.

However, this older discussion also needs to be enriched with an explanation as to why individual banks are significant. On the basis of general competition law doctrine, it would be tempting to suggest that, following a bank failure, more efficient competitors survive and even that resources in the banking sector are directed where they may be more efficiently used, thus maximising consumer welfare. And yet, such an analysis, in the context of banking, while not completely out of place given that competition must indeed be safeguarded in this area too, would leave significant issues ignored.

The particularity of banking is that these competitors are also interconnected with each other to a degree that is unknown in other sectors of the economy. The failure of a bank may bring significant damage to its competitors both through the interbank market and the payment systems, and due to the erosion of depositor confidence in banks generally – given that depositors do not differentiate adequately among the banks – which raises the spectre of a bank run.[4]

In this sense, a contemporary variation of the *service public* concept for banks is that, first, they collectively provide a uniquely essential service to the rest of the economy and, second, the proper functioning of each individual bank is closely related to the proper functioning of the whole sector, due to the possibility of contagion. This provides an adequate explanation for the extraordinary public interest in promoting the smooth functioning of each bank, or the smooth handling of its failure. Banks themselves are interested in avoiding contagion, and there have been instances of collective bank action to avoid or mitigate problems arising from the failure of a single market participant. However, the stability of the banking sector is a “public good” and its “production” by a number of private parties faces the collective action problem.[5] Without public intervention this good would be “under-produced”, in other words banks left alone would care less for systemic stability than necessary.

Due to this public interest a deposit guarantee system (and now on top of that, at least in Europe, a system of resolution financing arrangements) is in place, although it must be noted that this is financed not by the general budget, but

4 See, among others, Attinger, ‘Crisis Management and Bank Resolution: Quo Vadis, Europe?’ *ECB Legal Working Paper Series No. 13*, Dec. 2011, available at< http://www.ecb.int/pub/pdf/scplps/ecblwp13.pdf> 7-8; Gordon/Müller, 28 *Yale J. on Reg. 151, 160* (2011); Psaroudakis ‘Das Recht der Bankenrestrukturierung in Zeiten der Wirtschaftskrise’ in: Hopt/Tzouganatos (ed.), *Das Europäische Wirtschaftsrecht vor neuen Aufforderungen*, Mohr Siebeck, Tübingen, 72-73 (2014); Schillig, *EBLR 751, 755* (2013); U. Schneider, *ZRP*, 119-120 (2009); Sepe, *Emory L.J 327, 346-7* (2012); *Van Der Weide/Kini 41 B.C.L. Rev 195, 202*-3 (2000).

5 Wohlmannstetter, in: Hopt/Wohlmannstetter (eds.), *Handbuch Corporate Governance von Banken,* Beck Munich, 56 (2011).

rather by levies. Even so, "insurance" which is imposed by law, and thus applied without further ado, goes beyond what is known in other sectors of the economy. Another consequence of the same public interest is the "lender of last resort" function of the central bank, albeit with the qualification that it is used to deal with liquidity, rather than solvency, problems. Still, this brings about the possibility that banks externalise credit risk to the State.[6]

Furthermore, there seems to be, at least to some extent, a (mostly) implicit fiscal backstop for losses that might bring about existential risks for the banking sector. Its exact extent and prerequisites are not determinable in advance, and neither should they be. But it may not be ignored either, and it is also present in the context of the Banking Union. Even the BRRD, which famously purports to break the adverse feedback loop between bank losses and state budgets by means of bailouts, does not fully exclude bailouts, as Article 44(7) allows for alternative funding sources to contribute to the cost of resolution in lieu of the bail-in of uncovered deposits. The ESM Direct Recapitalisation Instrument (DRI) should be thought of in the same vein. Against this backdrop, it is only reasonable that the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism is closely connected in time (or somewhat precedes) the development of a Single Resolution Fund (to be mutualised gradually) and the availability of the DRI. The Europeanisation of financial support facilities comes together with the Europeanisation of supervision.

However, this should come at a cost; in other words, submission to supervision is the consideration paid by the banks for the public contribution to systemic stability.[7] Insurance brings about moral hazard,[8] and insurers always adopt measures against it: supervision is well understood in this manner.[9]

2 *Supervising instead of mandating disclosure?*

A typical approach in many areas of regulation is that the law should only mandate disclosure and allow the interested parties to protect their own interests on the basis of such disclosure. This approach is supposed to be less paternalistic than substantive regulation in the sense that it allows private parties to develop their own business choices without external restrictions. It is also informed by mistrust of the omnipotent regulator who would stand in the way of certain contracts that private parties would be willing to make. The objection here is that it is cognitively impossible for the regulator to be aware of, and process, all information needed to analyse a complex system of interactions among market participants, in order to

6 On the justification of prudential supervision as a tool to minimize the central bank's risk of loss see Cappucci, *9 Va. L. & Bus. Rev 1, 7* (2014); Salerno, *JIBLR 30, 315, 319-320* (2015).

7 cf. Wohlmannstetter, No 5, p. 56.

8 Indeed, in the context of lending of last resort, it is discretionary precisely in order for moral hazard to be restrained: see, among others, Campbell/Lastra, *24 BFLR, 453* text at No 29-30. However, this is neither a full solution in this particular case nor applicable to other instances of state support for the banking system.

9 Posner, *Economic analysis of law*, *7th edn.,* Wolters Kluwer, Boston-Austin, 485 (2007); Van Der Weide/Kini, *41 B.C.L. Rev. 205*.

allow some contracts and disallow others.[10] A radical version of this view is that there should not even be mandatory disclosure, but rather parties should be left to their own initiative in order to protect themselves. A more moderate version, which seems to dominate the discussion in many fields of law, is the so-called "information paradigm", according to which the law should indeed mandate disclosure, but other than that let the parties decide what kind of transactions they enter into.[11] For instance, the recent criticism of the Short Selling Regulation, which includes outright bans on certain transactions, was based on this paradigm.[12]

However, while this is indeed an appropriate starting point for discussion in a market economy, there are two significant counterarguments to the information paradigm that call for such issues to be revisited. First, attention should be paid to the so-called "information overload".[13] Ever expanding mandatory disclosure may end up in laundry lists of information which are not read, let alone taken seriously. Naturally, this also depends on whether the addressee of disclosure is a consumer or not, but it has been suggested that even market professionals[14] are not immune to tendencies such as "groupthink"[15] that disclosure hardly alleviates. The paradigm of a rational market participant that collects and processes all available information and then makes decisions on that basis has been undermined by behavioural economics.

Second, it may even be individually rational for market participants to ignore disclosure that has been made to them. This is the case when disclosure on the same matters is addressed to a large number of market participants. Each one of them is not interested in bearing the costs of following and analysing the information thus made available, as each one's personal stake does not justify the cost, though it would be in their collective interest for such information to be analysed. Thus, it is not just information as such that is a public good, but also its processing. A "collective action problem" emerges and public good is not produced in an adequate quantity or, as applies in the present case, information is under-processed.

Finally, a further issue in banking is the typically huge disparity of power among the contracting parties, which makes it even more difficult for depositors, in particular, to protect themselves. Though this issue is typically brought up in the context of conduct of business regulation, it is relevant here too, as it justifies the need for the supervisor to intervene in lieu of private parties contracting with the bank.

10 The classic analysis in this field has been offered by Hayek*, 35 Am. Econ. Rev. 519* (1945). For an application to prudential regulation (particularly with regard to systemic risk) see Cappucci*, 9 Va. L. & Bus. Rev.,* p. 15 *et seq.*, who ultimately supports a "cautious, fact-based, incremental approach".

11 In the more specific discussion on banking regulation, this corresponds to the so-called "private empowerment" approach, as mentioned by Wohlmannstetter, No 5, 55.

12 cf. Möschel *, 129, 132-2* (2009); Payne*, EBOR 413, 436* (2012).

13 See in particular *Möllers/Kernchen* ZGR *1* (2011).

14 See on their behaviour *Schwarcz, 97 Geo. L.J. 219*; Schwarcz*, Wis. L. Rev. 818-9* (2012); Anabtawi/Schwarcz, *86 Notre Dame L. Rev. 1349, 1370* (2011).

15 cf., among others, Pistor 'On the Theoretical Foundations for Regulating Financial Markets' *Columbia Law School Public Law & Legal Theory Working Paper Group 12-304*, available at <http://ssrn.com/abstract=2113675> 60.

Therefore, mandatory disclosure is not always adequate, and is not adequate here. Banking regulation correctly goes beyond that and develops material rules. The unavoidable inadequacy of knowledge on the part of the supervisor means that regulation is imperfect but, given the market failures mentioned, does not prove that a pure "information paradigm" with no substantive rules would be preferable. Correspondingly, banks are not merely required to report their equity or liquidity; they are required to adhere to minimum levels of equity or liquidity. They do not merely need to report their governance; they need to follow governance rules established by law.[16]

3 *The balance of power between shareholders and supervisor*

Corporations operate on the basis of the "shareholder value" principle. This is what the management has to maximise, though it may appear in variations, in particular short or long-term value, and pure or enlightened[17] shareholder value. The reason for this is that shareholders are the residual claimants to the corporation's income. They do not have any fixed claims against it; they do not receive anything if nothing is left after satisfying creditors, while on the other hand they receive all the upside of significant profits that allow for large dividends to be paid after fully satisfying creditors. They bear the entrepreneurial risk and must also receive the corresponding reward.[18] As the downside and the upside of the corporation's performance are reflected primarily in their own income, it is their value that serves as the criterion for such performance.

Now, this does not mean that debtholders are powerless. First, their contracts with the corporation may contain terms, in particular covenants, that allow them to exercise influence on major business decisions (e.g. further leveraging, asset substitution – i.e. replace safer investments with riskier ones[19]– or extraordinary distributions).[20] Still, as covenants do not cover everything, among other things due to the inherent incompleteness of contracting,[21] there is some, albeit

16 A significant example here is the regulation of management remuneration, which is not limited to transparency under Article 450 CRR, but also (and more significantly) includes substantive rules, as explained in the text below, at III.1.

17 On this concept see among others Ho*, 36 J. Corp. L. 61* (2010).

18 As a typical expression of this difference between shareholders and creditors see *Commissioner v O.P.P. Holding Corp,* 76 F.2d 11, 12 (2d Cir. 1935): "The shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives."

19 Green/Talmor, *10 J. Banking & Fin. 391* (1986); McCoy, *47 Case. W. L. Rev. 1, 3*(1996).

20 These covenants may also be understood as decisions by shareholders to partially contract away their primacy and to bind the corporation to some particular behaviour, in which creditors are interested: see Tung 57, *Emory L.J. 809, 855-7* (2008).

21 cf. McDaniel, *13 J. Corp. L. 205, 237-8* (1988); but see also Hurst/MacGuinnes, *10 J.L. & Com.*, 198-9.

inconclusive, discussion, about a doctrine of "fairness" to bondholders,[22] which suggests that at least manifest attempts to expropriate them are unlawful; this discussion would fit in the broader concept of "enlightened shareholder value". In other words, shareholder primacy may be justified in principle, but it also brings about agency costs of debt,[23] which the above-mentioned methods purport to restrict.[24]

However, shareholders do not actually own the corporation, nor is there something unalterably special about their relationship to it. The corporation has famously been described as a nexus of contracts,[25] in which shareholders elect the managing body not because they are "owners",[26] but rather because they are the residual claimants and have the most appropriate incentives in electing and monitoring the performance of managers.[27] Once the corporation enters into the vicinity of insolvency, this analysis of shareholder primacy (which may already have been somewhat qualified) applies no more, because shareholders are no longer the residual claimants, as explained below. Therefore, amendments to the balance of power within the nexus, and in particular the loss of or restrictions on shareholders' influence, are legitimate.

Indeed, by the time insolvency approaches shareholders have probably lost their investment, which provides them with perverse incentives, as long as they still control the company and can direct the management's decisions. In particular, shareholders, who are in any case generally more inclined than creditors to assume risks, now have nothing more to lose, while they would benefit if a long-shot attempt to rescue the company – e.g. by embarking on a costly business venture with a very low probability of a positive outcome – happened to succeed; that cost would, at this stage, be borne by creditors in practice.[28]

In relation to this, it has been suggested that management may sometimes alleviate the shareholders-debtholders conflict, as managers make an undiversified investment in the corporation due to their employment, and are thus more risk averse than shareholders (even though they manage "other people's money").[29]

22 McDaniel*, 13 J. Corp. L, 265 et seq.;* McDaniel*, 41 Bus. Law, 413, 442 et seq,* (1986); Mitchell*, 65 NYU L. Rev. 1165, 1186 et seq.* (1990). For criticism against this proposal, referring among other things to the uncertainty brought about by *ex post* judicial control (which does not, however, apply to prudential supervision, as it is contemporaneous with the supervised activity), see Hurst/MacGuinsess *10 J.L. & Com. 187, 200-206* (1991); Tung, 57, *Emory L.J. 847* et *seq.*, and cf. Harvey, 65 *St. Johns L. Rev. 1023, 1039-40* (1991). See also *Katz v Oak Indus., Inc.* 508 A.2d 873, 879 (Del.Ch. 1986); *Trenwick Am. Litig. Trust v Ernst & Young, LLP* 906 A.2d 168, 199 (Del.Ch. 2006), denying fiduciary duties to creditors in Delaware corporate law.
23 As per the classic analysis by Jensen/Meckling, *3 J. Fin. Econ. 305* (1976).
24 McDaniel, *13 J. Corp. L. 234-8.*
25 See the famous analysis of Coase*, 4 Economica 386, 390 et seq.* (1936) and also (among others) Easterbrook, *63 Tex. L. Rev.,* 1984*,* 1-2; Schäfer/Ott, *Handbuch der ökonomischen Analyse des Zivilrechts* (4. Aufl. de Gruyter, Berlin et al. 2005), 643-4.
26 Jensen/Meckling, *3 J. Fin. Econ. 305, 310-1* (1976); Fama*, 88 J. Pol. Econ. 288, 289-290* (1980).
27 Sepe, *Emory L.J. 360-1*(2012).
28 Van Der Weide/Kini, *41 B.C.L. Rev. 215*.
29 Hu/Westbrook, *107 Col. L. Rev. 1321, 1351* (2007); Sepe, *Emory L. Rev. 356*, (2012)*,* Triantis/Daniels, 83 *Cal. L. Rev. 1073, 1077* (1995).

Indeed, it has been proposed that aligning bank management's interests with those of shareholders by means of management remuneration (in particular stock options) should be avoided, in order to reduce management's willingness to assume high risks.[30] However, in the vicinity of insolvency this possible divergence between shareholders and managers evaporates, as managers have nothing more to lose either and may favour inappropriately risky projects.

Therefore, as the company's financial situation deteriorates, it is those ranking above shareholders, i.e. creditors (junior, or more probably senior, if the situation is such that not even junior creditors have much hope of saving their investment) that have an interest in avoiding further damage and protecting the company's already sad balance sheet from getting worse. In the parlance used above, it is now creditors that have become the residual claimants to the company's income, which is why the company should now begin to be managed in their interest, i.e. their interest to receive as much as possible from its liquidation or reorganisation in bankruptcy or in a pre-bankruptcy procedure.[31]

Thus, the management's duties change in the vicinity of insolvency and are directed to the protection of the creditors' interest.[32] This is expressed in rules imposing liability on directors (and shadow directors) for failing to take this change in their duties into account: Notice should be taken, to name three prominent examples, of the rule on wrongful trading (Section 214 of Insolvency Act 1986) in English law, the *action en comblement du passif* (Article L. 651-2 du Code de commerce) in French law, and on the *Insolvenzverschleppung* (§ 15a InsO) in German law.

These considerations apply to banks as well.[33] Indeed, they are particularly relevant in the case of banks (so that doubts as to the appropriateness of extra-contractual creditor protection in general corporate law may be overcome), as this is by its nature (i.e. due to the importance of deposits in the balance sheet) a highly leveraged industry. Furthermore, it should be recalled that the supervisor

30 Bebchuk/Spamann, *98 Geo. L.J., 247, 262* (2010). This is all the more interesting coming from proponents of greater shareholder influence on corporations in general.

31 *Production Resources Group LLC v NCT Group, Inc* 863 A.2d 772, 790 (Del.Ch. 2004); *Official Comm. of Unsecured Creditors of Hechinger Inv. Co. of Del., Inc. ex rel. Hechinger Inv. Co. of Del., Inc. v Fleet Retail Fin. Group* 274 B.R. 71, 89 (D.Del. 2002).

32 See in particular the classic analysis by Chancellor Allen in *Credit Lyonnais Bank Nederland, N.V. v Pathe Communications Corp.* 1991 WL 277613 at 33-34 (Del.Ch.). See also *West Marcia Safetywear Ltd v Dodd* [1988] BCLC 250 (CA); Davies, *Introduction to Company Law* (OUP, Oxford 2002) 265; Keay, *JBL,* 2002, 379, 385. For a radical criticism of this "shift of duty" doctrine cf. Hu/Westbrook, *107 Col. L. Rev. 1364 et seq.*, who argue that the shift is incompatible with corporate governance, and that the solution is the initiation of bankruptcy and the use of bankruptcy governance. However, the shift in duties within corporate governance is a method of dealing with the failure of corporate governance in the pre-bankruptcy stage, as explained in the text; this failure cannot be discussed away.

33 …and they are consistent with findings that greater shareholder influence has led to the assumption of higher risks by the banks, as well as to worse performance during the recent financial crisis: see Anginer *et al.*, *Corporate Governance and Bank Insolvency Risk. International Evidence*, available at http://ssrn.com/abstract=2491490, (2014); Beltratti/ Stulz, *105 J. Fin. Econ.* 1 (2012); *Laeven/Levine* 93 J. Fin. Econ. 259 (2009).

aims to protect the public interest in the proper functioning of the banking system, which is tantamount to the proper functioning of the banks' contracts with their creditors, in particular their depositors. This is not the same thing as saying that supervision protects the individual interest of such bank creditors, which is not required by European law according to the *Peter Paul* judgment of the ECJ.[34] Indeed, the proper functioning of the bank's contracts with third parties is a good to be protected not as a matter of each party's interest, but rather as a matter of the banking system's contribution to general welfare.

On the other hand, regulation of banks clearly does not aim at protecting bank shareholders (and, more broadly, capital providers). There is no reason why the choice to invest in a bank should be treated differently from investment in other corporations, and thus no reason why such investors should benefit from the efforts of the supervisor. Indeed, shareholders generally accept a higher level of risk-taking than the prudential supervisor would favour; thus, the convergence of interests between the supervisor and creditors does not (and could not) apply with regard to shareholders too.[35]

Given that supervision aims at the bank being managed in a manner that fosters the smooth functioning of its contracts with creditors, but does not protect shareholders, the transition from shareholder primacy to creditor primacy, which takes place at the vicinity of insolvency, is very relevant as to the interference of the supervisor. Actually, since much of the criticism of the "shift of duties" concept in general corporate law is inspired by the difficulty of applying this complicated doctrine to *ex post* liability-related controversies in litigation, it is remarkable that this concept is used here to explain a different (and arguably more workable) consequence, i.e. the gradually greater interference of the supervisor in business decisions. At the vicinity of insolvency the bank must start being managed in the interest of creditors, and correspondingly the supervisor must assume a much more active role. The counterargument referring to the primacy of shareholders, as residual claimants, and of the management elected by them does not apply anymore; actually, it is turned on its head, as shareholders must not be allowed to act according to their perverse incentives in this situation.

Therefore, the interference of the supervisor in the business decisions of the bank may be legitimised by reference and comparison to the need for protection of creditors; a bank in which creditors do not suffer damage is also a bank that operates appropriately, as required by the general interest in a robust banking sector. Against this backdrop, it needs to be taken into account that bank creditors (mainly depositors) are weak, dispersed – indeed much more so than

34 C-222/02 [2004] ECR I-9425 at [33-47].

35 Garten, 57 *Fordham L. Rev. 501, 551, 569* (1989). See also the criticism of post-financial crisis reforms empowering shareholders by Bruner*, 36 Seattle U. L. Rev.,* 527 at part. III.B. (2013).

in any other corporation[36] – and disorganised;[37] it is thus impossible for them to protect themselves with covenants. In addition, they may even lack an interest in doing so, as they are protected to a very significant extent by the deposit guarantee (and now, at least in Europe, also by the resolution) fund; this has been described as the moral hazard brought about by deposit insurance (as is inherent in any kind of insurance).[38]

On the other hand, it is precisely depositors whose interest has to be protected as an aspect of the proper functioning of the financial system. Creditors (e.g. junior bondholders[39]), who are not covered by any kind of insurance and may be less disorganised and more sophisticated, are not in the same position as depositors. Thus, any measures of self-protection that they may adopt are not adequate. Finally, while shareholders generally have an incentive to offer protection to creditors, in order to reduce the cost of debt, this incentive does not exist in the circumstances described above,[40] as creditors, and in particular depositors, are not (adequately) interested in or in a position to influence bank governance.

The supervisor is therefore at all times called on to offer a functional substitute for the covenants that the creditors of the bank (and in particular its depositors) do not conclude;[41] in the same vein, the supervisor acts for the benefit of the deposit guarantee/resolution fund. Indeed, it has been suggested that even the business judgement rule regarding the limits of judicial interference in management decisions is curtailed in banking.[42] This applies all the more to the interference of the prudential supervisor, which is of a different nature (as it involves in particular *ex ante* restrictions rather than *ex post* liability), and may include matters that courts would not touch upon, because it protects third parties rather than shareholders

36 Ironically, it is banks themselves as (particularly large and powerful) creditors that are thought to act as "delegated monitors" (see on this discussion Tung 57, *Emory L.J. 836-9*) benefiting other creditors in the process. Obviously this (in any case dependent on a third party as co-creditor, whose interests are however not necessarily the same: see No 37) method of protection is unavailable in the case of the bank itself as debtor.

37 cf. the differentiation made by Lipson, 50 *UCLA L. Rev. 1189, 1249-51* (2003), among different kinds of corporate creditors (on the basis of "volition, cognition and exit"), suggesting that a fiduciary duty may not be owed to all of them in the same manner. Depositors are the kind of creditors that need protection even according to such a view; exit is only ostensibly easy for them, as a collective attempt to exit would destroy the bank and destabilise the rest of the sector.

38 McCoy, *47 Case W. L. Rev. 14-15*; Sepe, *Emory L.J. 377-8*, (2012); Van Der Weide/Kini, *41 B.C.L. Rev. 205-6, 217.*

39 But cf. Van Der Weide/Kini, *41 B.C.L. Rev., 222 et seq.*, who suggest that a subordinated debt program could function as a market-oriented complement to government regulation of banks. This approach is not accepted here, for the reasons explained in the text (and see also Tung 57, *Emory L.J. 830-3*, on the internal divisions of creditors and the divergence of interests among them); in any case, the authors present it as a complement to, rather than a substitute for, government regulation, and they acknowledge and discuss objections.

40 cf. Sepe, *Emory L.J. 378* (2012).

41 cf. Garten 57, *Fordham L. Rev. 543-5*; Sepe, *Emory L.J. 384*, (2012), proposing a "contractarian approach" to banking regulation. See for another formulation of the same point Van Der Weide/Kini, *41 B.C.L. Rev.* 208: "The regulatory scheme places government in the position that debt[holder]s typically occupy in the system of corporate governance."

42 *FDIC v Bober* (2002) WL 1929486 at 2 (SDNY). cf. McCoy 47, *Case W. L. Rev.* 48 *et seq.*, referring to civil suits filed by US federal supervisory agencies.

wishing to impose liability on the shareholder-elected directors, and also because the supervisor has the technical expertise that a judge lacks.

Even more importantly, the supervisor is called on to assume a much more active role once the bank is in the vicinity of insolvency, in which case the importance of the interest of creditors, which functions as a benchmark for the supervisor's own degree of interference, rises sharply. In this sense, the balance of power between shareholders and supervisor reflects the balance known from general corporate law between shareholders and debtholders, as well as the shifts in that balance due to the condition of the company.

III THE LIMITS OF THE SUPERVISOR'S POWERS

There is no panacea for delineating the supervisor's powers of interference in the workings of the bank, as this a very fact-sensitive matter. However, it is both possible and advisable to develop a set of indicators which could help, in a consistent manner, to determine the extent of permissible interference. Such a set of indicators constitute what is known as a *bewegliches System*.[43] Therefore, none of them is decisive on its own, while on the other hand they may either be combined or one of them may speak so strongly for or against the permissibility of interference in some cases that it compensates for the lack of others, or overrules others. This is obviously not a quantitative approach, which would be easy to apply, but it does justice to the complexity of the question and it offers a framework of analysis.

1 *The subject-matter of the supervisor's interference*

Two broad areas of potential supervisor interference in the workings of the bank may be identified: procedural or governance decisions on the one hand, material or business decisions on the other. It is arguable that the former area is regulated more heavily than the latter.

This supervision of procedure refers to the fundamental decision-making structure of the bank, i.e. its corporate governance.[44] It builds on general principles of corporate governance, applying in particular to the shareholding structure of the bank, to the development of proper compliance and financial and operational control systems (Article 88(1) CRD IV), as well as to the composition of the management body and the functioning of senior management; the latter includes the rules on remuneration (Article 92-96, 104(1)(g) CRD IV), which are a typical example of trying to influence material decisions indirectly, by focusing on a healthy incentive structure. However, bank governance goes beyond general corporate governance in a number of ways. In particular, the requirements for

43 This goes back to the classic analysis by Wilburg*: Entwicklung eines beweglichen Systems im bürgerlichen Recht* (Graz 1950).

44 On contemporary prudential requirements to bank corporate governance see, in the context of the Banking Union, Binder: "Banking Union and the Governance of Credit Institutions: A Legal Perspective", *SAFE Working Paper 96/2015*, available at <http://ssrn.com/abstract=2591817> 19-20.

compliance and risk management reach further than in general, as risk is an inherent part of the banking business, and compliance is much more complicated, precisely because of the complex rules that a bank has to follow. Moreover, the regulation of governance goes beyond the structure itself and reaches the qualifications of those populating this structure. Lastly, while general corporate governance is often soft law and follows the "comply or explain" method, bank governance is imposed by hard law, including sanctions for violations.

This is not self-evident. One might construct an argument, as a matter of economic liberty, to the effect that a bank, as an independent legal entity, should be left to govern itself as it seems fit. However, this path is not followed in current law. Rather, the aforementioned argument is turned on its head, and the approach seems to be that it is a *less* intrusive kind of interference, albeit with no less efficacy, to impose the "appropriate" governance structure on banks, and expect, in principle, that this governance will produce the proper results.[45] The idea seems to be that good governance allows the free discovery process for good results to unfold. Furthermore, the wide reach of bank governance rules, as compared to general corporate governance, should also be attributed to the fact that the former is, even more importantly, debt governance as well,[46] while the latter is basically equity governance. Debt governance is inherently more complicated and more intrusive, as it has to balance the influence that shareholders unavoidably have on management due to their right to elect the directors.

There is indeed something to be said for enhanced interference of the supervisor in the field of governance. Beyond the above-mentioned idea that supervising governance is a procedural way of contributing to good results (i.e., in the present context, of taking into appropriate account the interest of creditors), this is an area that allows for relatively bright-line rules, whose application is predictable and controllable. Thus, in general, interference in governance may be less intrusive than similar interference in material business decisions. This is clearly the case when it comes to governance structures: the supervisor should be able to examine these in detail and require full compliance.[47]

Some qualification may be required for assessments of qualifying holdings (Article 22 CRD IV), as well as the decisions relating to the composition of the management body (Article 91 CRD IV). These have been categorised here as governance decisions, which is accurate to the extent that they are based on an assessment of qualifications and background. However, it should also be borne in mind that persons may also stand as proxies for policy choices. To the extent that the supervisor's objection to a assessed person's background is not based on some *stricto sensu* wrongdoing or lack of qualifications but rather on a disapproval of his or her policies, then this objection is not impermissible, but

45 cf. more generally on this method of regulation Binder, *ZGR 745, 764-5* (2007).

46 cf. Wohlmannstetter, No 5, 53-54, as well as Chiu, *JBL 611, 627-633*, (2014) who suggests that holders of bail-inable liabilities should have some participation in bank governance, e.g. at the board of risk committee.

47 More interference in governance does not mean, on the other hand, that a single model of bank governance is imposed by the supervisor. National discrepancies in corporate law and practice are reflected in bank governance and allow for divergences: cf. Binder, No 44, 19-20.

it should be dealt with as a business-related decision, which raises the threshold for its justification.

A qualification in the opposite direction is also useful. Material business decisions are looked into in more detail when they are prone to give rise to conflicts of interest, as well as when systemic considerations become relevant. As regards conflicts of interest, this is actually a reflection of the higher risk that internal bank governance may fail in such situations, so that the supervisor assumes the role of the watchdog, which may otherwise be missing. The early adoption in the Single Supervisory Mechanism of Recommendation ECB/2015/2 on dividend distribution policies may be examined from this point of view.

As regards systemic considerations, these relate, first, to macro-prudential regulation, such as the introduction of counter-cyclical capital buffers (Article 130 CRD IV), systemic risk buffers (Article 133 CRD IV),[48] or borrower-based lending limits (LTV, LTI etc.)[49] that may be applied by national legislation. Since these measures are driven by the need to influence the market as a whole,[50] the "public good" character of supervision becomes particularly clear. Single banks and their management are not even supposed to be guided by the interest of the market as a whole (or at best they should take it into account indirectly, to the extent that it influences their own bank, again subject to collective action issues), so it is reasonable that they would not apply any measures of this kind on their own. This suggests that macro-prudential supervision may, in principle, intrude quite significantly into material business decisions (e.g. by establishing loan to value or loan to income ratios), indeed even more so than micro-prudential supervision, because here the divergence between the goal of supervision and the private interest of the bank is quite large.

The point about systemic considerations potentially justifying more intrusive supervision relates, second, to the work of resolution authorities. Given that such work purports to limit the social cost of bank failure, for example by removing impediments to resolvability, it is, in this case too, informed by the need to protect the market as a whole, going beyond the individual bank. A divergence in objectives between the public authority and the bank itself emerges here too, signifying that the former may interfere with decisions that might be reasonable from an "individualistic" point of view.

Lastly, it is interesting to note that this procedural method (in the sense that procedures rather than policies are imposed) may appear in both prudential supervision and the supervision of business conduct. An example, which refers to a particular national legal order, but is not insignificant given its subject-

48 See Tarullo*, 31 Yale J. on Reg. 505, 512-3* (2014) on macro-prudential capital requirements being informed by the social cost of a potential failure, in other words the cost to third parties rather than the bank's own stakeholders.

49 This last category is naturally not unrelated to micro-prudential supervision on credit risk (cf. Joosen, *25 JIBLR 493, 499* (2010), though the point here is that macro-prudential concerns may lead to further limitations.

50 In the words of Lastra, *International Financial and Monetary Law* (2nd edn., Oxford 2015) at 3.15, this is "the oversight of the forest" as opposed to the individual trees.

matter, is the regulation of NPL management in Greece. On the one hand, BoG Executive Committee Decision 42/30.5.2014, which is a prudential measure, determines the required internal governance as concerns dealing with NPLs. On the other hand, the Code of Conduct for NPL management (BoG Credit and Insurance Committee Decision 116/1/25.8.2014) refers to the business conduct of banks in the same area, i.e. to the procedure, according to which banks are to interact with borrowers, without, however, imposing on them obligations relating to the material content of NPL management. It is not suggested here that these measures are adequate to deal comprehensively with such difficult issues; material obligations, not least stemming from general private law, are certainly significant. What is suggested here is that the prudential regulator (and sometimes even the business conduct regulator) may tend to resort more easily to procedural rules, and that this is informed by a view that process is ultimately also substance.

2 *The condition of the credit institution*

It has already been explained that the supervisor provides the functional substitute for creditor-protection mechanisms that are unavailable to bank depositors, not because supervision operates in the individual interest of each depositor, but rather because a proper level of protection of depositors is a matter of public interest. The protection of bank creditors, in particular depositors, informs banking supervision in general, regardless of the bank's condition; the above-mentioned example of Recommendation ECB/2015/2 on dividend distribution policies is relevant here too, as these policies are a classic field of conflict between shareholders and debtholders.[51]

However, it has already been explained that this justification for the supervisor's interference in the bank's business assumes further prominence, and even urgency, when the bank enters the vicinity of insolvency, in which case it is basically run in the interest of creditors, while the interest of shareholders gradually fades into the background. This is ultimately the climax of debt governance in banks.

A further question refers to the meaning of this "vicinity of insolvency" in the context of banks.[52] It is remarkable that the revocation of the licence and/or the application of resolution tools (Article 18 CRD IV and Article 32 BRRD) do not require an insolvency in the sense known in general insolvency law, i.e. do not require the suspension of payments. The failure or likely failure of a bank is an "earlier" situation than such a suspension of payments. Among other things, it is remarkable that a bank is deemed to be failing or likely to fail when its capital is irreparably inadequate as regards the capital requirements imposed under

51 See e.g. Hurst/MacGuinness, *10 J.L. & Com.* 195. cf. also Smith. *98 Mich. L. Rev. 214, 223-4* (1999), explaining that the fundamental conflict between shareholders and creditors exists in principle at all times, as the related decisions on the assumption of risks may be made at all times.

52 The concept is in any case difficult in general corporate law too, as evidenced by the (somewhat overstated) remark on "metaphysical boundaries" in *Production Resources Group LLC v NCT Group, Inc.* 863 A.2d 790.

CRR/CRD IV, even if positive, which means that the bank still has a positive net asset value, in other words that its shares still have some positive value. It is also remarkable that, while in general law a likely insolvency tends to be a reason only for debtors themselves, and not for creditors, to request the start of insolvency proceedings, the likely failure of a bank not only comes earlier as a conceptual matter, but is also a reason for the authorities to take measures, which are thus independent from any initiative on the part of the bank itself.

One might try to argue that, since the consequences of bank failure or likely failure are produced at an earlier stage than is the case in general insolvency law, there is no independent room for a "vicinity of insolvency" here, as this vicinity will in practice be a stage of likely failure, leading to even harsher measures in any case. However, such an argument would not grasp the issue. If the trigger for insolvency proceedings is moved "forward", as it were, then the vicinity of insolvency (used here in the sense of a situation that gradually requires the adoption of measures limiting the sovereignty of shareholders) should also be moved forward, for three reasons.

First, if insolvency proceedings start at an "earlier" stage, there is a reason for this. The particular importance of banks discussed above calls for such a precaution, which should also apply to earlier stages, assuming the form of a more active involvement on the part of the supervisor. Second, shareholders do lose control of the bank when insolvency proceedings are triggered, whichever precise trigger is determined by law; when the trigger comes closer at an earlier stage, the problem of perverse incentives emerges at an even earlier one. Lastly, it should be recalled that the intervention of the supervisor is not necessarily expressed as the removal of the management elected by shareholders. Milder measures are also very relevant in this discussion, and may be applied at a stage in which shareholders still have something to lose, and so should still influence the management of the corporation.

Indeed, this analysis is consistent with current law and provides a good basis for its understanding. It is thus significant that the application of the supervisory powers of Article 104 CRD IV (and Article 16 SSMR) is connected with Articles 97 and 102, and thus with risk exposures and a failure, or likely failure, to comply with the CRR/CRD IV requirements. In other words, they are connected with early indicators of a crisis. But the escalation of the supervisory response, as a companion (and, hopefully, a cure) to the deterioration of the bank's situation, is most evident in the early intervention measures that the competent authority may adopt on the basis of Articles 27-30 BRRD. Based on indicators of an ever approaching failure or likely failure in accordance with Article 27(1), these measures range from a dialogue with the corporate organs of the bank, which still keep the initiative of responding to the crisis, to requirements of significant strategic and operational changes imposed by the authority, and ultimately to the removal of the management and the appointment of a temporary administrator.

The conclusion is that regulation may, and must, become much more intrusive in a bank that enters the vicinity of insolvency, which in the case of banks should be understood as the ever approaching vicinity of the situation that

leads to a withdrawal of its licence. There is no single point in time at which all consequences of this vicinity are produced. This is rather a process comprising gradually more intrusive measures.

Therefore, the justification for the above-mentioned intrusive measures is to be found in the analysis of the bank as a corporation and thus a nexus of contracts, and in the gradual erosion of the shareholders' position in this nexus as failure approaches. This allows the supervisor, acting not for the individual benefit but still in lieu of creditors, to intervene, as the case would be in general corporate law.

3 *The size and systemic significance of the credit institution*

No discussion on banking regulation is complete nowadays if it does not contain a reference to the "too big to fail" issue. The larger, the more interconnected with other financial institutions, in other words the more systemically significant a bank is, the more likely it is that it will need to be resolved if gets into distress, at a significant cost for the resolution fund, or even for the budget, if such a bailout happens to be decided. In other words, the credit institution that becomes systemically significant, or rather *more* significant (as all banks are of potential systemic importance under some circumstances), externalises a part of the cost for its operation to the resolution fund (and possibly the budget). This is a potential source of moral hazard, which again calls for more intrusive regulation, as a method for the bank to re-internalise this cost, by enhancing its own loss-absorbing capacity or by contributing to the fund that may be called to assume much of the burden of a potential failure.

One expression of this idea is to be found in the capital buffers for G-SIIs and O-SIIs (Article 131 CRD IV), while another is the risk-adjusted calculation of the institutions' contribution to the resolution fund (Article 103(7) BRRD), which leads to higher contributions for institutions of particular systemic importance. Even requirements that do not seem, on the face of it, to differentiate on the basis of size or systemic importance, may in practice burden the larger institutions significantly more. For instance, implementing the recovery plan, as potentially required according to Article 27(1)(a) BRRD, may be exponentially more complicated in the case of a systemically important institution, due the complexity of its structure and, correspondingly, of the measures that will need to be applied.

These instances of additional burden to the larger and/or systemically more important credit institutions may be taken to express a wider principle of somewhat heavier regulation of such institutions. This is the milder alternative to proposals that have been floated on a preventive break-up of the "too big to fail" institutions.[53] Furthermore, to the extent that the market participants may perceive such institutions to be safer, because of an implicit guarantee that they will always be rescued, if needed, then heavier regulation is both a method for

53 See e.g. Zimmer/Rengier, *ZWeR*, 2010, 105.

this implicit guarantee not to come without a cost,[54] and a way to restore some competitive balance (as it would presumably restrict some aggressive business practices).

IV CONCLUSION

It has been established that regulatory intervention in the business decisions of a credit institution is not unacceptable, as it is mandated by the need to preserve the public interest in the proper functioning of the banking system, by the inadequacy of disclosure alone, and by the lack, in practice, of private law options that could be applied by creditors in order to balance the dominant influence of shareholders.

As concerns the limits of such intervention, no attempt is made here to develop a full system of permissible interventions that would directly answer any related question. That would not be realistic. However, it is possible to build a system of factors that favour the admissibility of intervention. Supervisors and, ultimately, courts may develop clusters of cases on the basis of such factors, which could gradually allow for a consistent and quite predictable practice to develop, also taking into account developments in legislation and practice. It is therefore submitted here that it is easier to interfere in governance than in material decisions (except for decisions involving conflicts of interest or systemic considerations), in the vicinity of insolvency than in normal times, and in systemically significant institutions than in smaller or in any case less important ones.

54 cf. Wohlmannstetter, No 5, 56.

THE IMPACT OF THE NEW RESOLUTION REGIME ON "BANKING AS USUAL"

STEFANO CAPPIELLO[1]

1 INTRODUCTION

Traditionally, the extent and limits of the authorities' powers over banking activity have been analysed by discussing the scope of the business judgment decision area, and to what extent supervisors can progressively adopt a more intrusive approach as the conditions of a bank deteriorates.

In the following discussion I will adopt a complementary viewpoint, and focus my remarks on the new resolution regime, showing how the latter opens up new perspectives regarding the interplay between supervision and resolution, and prompts new questions on the impact that resolution authorities will have on banking at the going concern stage ("banking as usual" or BAU).

2 RESOLUTION AS A "PARADIGM SHIFT"

The starting point, and the backbone, of these remarks is that the new international resolution regime has brought about a "paradigm shift" in the way banking supervision had been theoretically conceived, and carried out in practice, up until the financial crisis.

Before the crisis, the main target of the prudential rules was to reduce the *probability of default* of banks. The crisis showed that this approach was missing a fundamental point and needed to be overhauled. The G20 at the 2009 Pittsburgh Summit clearly identified the "too big to fail" problem and the effect of the connected moral hazard not only as one of the key drivers that led to the crisis, but also as one of the main legacies of the bail-outs which took place during the crisis. Hence the conclusion that looking at the probability of default alone would no longer be sufficient. Under the aegis of the Financial Stability Board (FSB), the prudential framework had to be accompanied by a new complementary framework, whose purpose would be to look also at the *impact of failure*, with the aim of reducing the *social costs of failure*, i.e. the negative externalities stemming from the *disorderly* failure of banks. This is, in a nutshell, the ultimate purpose of the new resolution framework, which pursues this goal by forcing banks to *internalise* these negative externalities *ex ante*, at the going concern stage, through planning for an orderly failure. To understand the difference between how these two sets of frameworks and tools operate, we should note how "size" is considered differently when seen from these two different viewpoints. From the perspective of probability of default, size might be considered a means to

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diversify risk, while, at the same time, from the viewpoint of the impact of failure it could turn out to be a clear source of negative externalities if not accompanied by appropriate planning for orderly resolution.

However, one should not overlook the fact that reducing the social costs of default in turn decreases the probability of default, by promoting stronger market discipline and tackling moral hazard. Therefore, if on the one hand these two (prudential and resolution) frameworks pursue two distinct goals, on the other hand they need to be seen as two complementary and interlinked means of getting to the same end result. As mentioned at the beginning of this paragraph, reinforcing market discipline and tackling moral hazard are the original drivers behind the new resolution regime promoted by the G20.

We are, therefore, witnessing an intentional consequence when we realise that this new institutional architecture is going to deliver a "Copernican revolution" reaching well beyond the way banking is supervised. It is, in fact, also affecting the way banking business is carried out, and the way investors and markets look at it. By way of example, let us simply consider the impact that these new rules are having on the way the liability-side composition of the banks is analysed and priced in by investors and market gatekeepers, as well as the effect that these rules have on the structure of incentives for shareholders, whether incumbent or potential, and debtholders (e.g. the incentive to carry out "liability management exercises"). However, let us narrow down our attention to the topic defined by the title of this contribution, i.e. the impact of the new resolution regime on carrying out "banking as usual".

3 THE IMPLICATIONS FOR THE IDENTIFICATION OF THE PERIMETER OF THE BUSINESS JUDGMENT AREA BY SUPERVISORY AUTHORITIES AS WELL AS RESOLUTION AUTHORITIES.

Consistent with the ultimate goal of inducing banks to internalise *ex ante* the social costs of their possible failure, the new resolution regime provides the resolution authorities with tasks and powers that may have a substantial impact on BAU.

Article 17(5) of the Banking Recovery and Resolution Directive (BRRD)[2], as further specified by the guidelines issued by the European Banking Authority on 19 December 2014, assigns to the resolution authorities a wide range of powers to remove *ex ante* the impediments to the banks' resolvability which emerge in the resolution planning stage. These powers can be grouped under three main

2 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 Text with EEA relevance (OJ L 173, 12.6.2014, p. 190–348). For the Single Resolution Mechanism, see Article 10(11) of Regulation (EU) No 806/2014.

headings: structural measures concerning the organisational, legal and business structure of an institution; financial measures relating to its assets and liabilities, and products; and additional information requirements. When applying these measures, the resolution authorities must ensure they are "proportionate, suitable and necessary", as specified in the guidelines. This means that the authorities will have to take into account, on the one hand, the costs and benefits generated by the threat to financial stability and, on the other hand, the impact of the measures on the concerned bank (proportionality). Likewise they will have to assess the ability of the measure to overcome the identified obstacle (suitability), and the lack of less intrusive measures to achieve an equivalent result (necessity). Process-wise, in line with the principle of proportionality, these measures will be imposed only if those proposed by the bank itself are considered to be insufficient, at the end of an iterative process between the resolution authority and the bank. As a first step, the bank is required to propose possible measures to address the impediments identified by the resolution authorities. If the proposed measures do not effectively reduce or remove these impediments, the resolution authorities can require alternative measures as a next stage.

Another clear example of how resolution authorities' decisions have a substantial impact on the way banking is carried out during the going concern stage is the decision regarding the quantity, allocation and composition of the minimum requirement for eligible liabilities (MREL). Pursuant to Article 45 of the BRRD and the related technical standards, resolution authorities will have to determine the MREL requirement for each bank, according to a number of criteria which are set out in the Article and the related technical standards. It is self-evident that such decisions might have a substantial impact on the funding mix for the banks concerned.

These two sets of incisive powers raise important questions for legal academia and practice as concerns the perimeter of the business judgment area in such a new world. It is obvious that these questions cannot be investigated here in a comprehensive manner given the limits assigned to these brief remarks. I will, therefore, limit myself to drawing attention to two issues which seem to me more relevant to the supervisory perspective adopted in this volume, sharing some preliminary and necessarily incomplete notes as food for thought to be explored further.

The first issue is whether the criteria and constraints which have traditionally governed (and limited) supervisory measures in relation to the need to preserve the business judgment area, should also apply to the exercise of the resolution authorities' powers. The second is the kind of interplay that there should be, and that there will be, between the supervisory and early intervention measures that fall within the remit of the supervisory authorities, and those that pertain to the resolution authorities.

3.1 ARE THE CRITERIA AND CONSTRAINTS FOR THE RESOLUTION AUTHORITIES DIFFERENT FROM THOSE WHICH APPLY TO THE SUPERVISORY AUTHORITIES?

On the first question, among the two criteria ("proximity to failure" and "financial stability") which Georgios Psaroudakis thoroughly and properly identifies in his paper in this volume as the elements which justify the increasing intrusiveness of the supervisory authorities on BAU, I think it is important to clarify that "proximity to failure" does not, and cannot, play the same role in the resolution planning framework. As described at the start, the task assigned to resolution authorities is to ensure the possibility of banks' orderly failure. This needs to be ensured even in those cases where default seems to be a remote event. Hence "proximity to failure" cannot operate as one of the guiding criteria or limits to the powers of the resolution authorities. As long as financial stability can be threatened by a banking failure, the low probability of default cannot *per se* rule out the possibility of intervention by the resolution authorities.

On the other hand, resolution authorities will share with supervisory authorities the financial stability driver, i.e. the need to prevent negative externalities as a consequence of banking failure, as a common polar star. Indeed, financial stability could be seen as one of the common threads that keep supervision and resolution together, and should steer their course of action in the same direction. This obviously does not mean ignoring that in practical terms there could be different interpretations of what financial stability means and requires in specific cases. I will turn to this aspect in a moment.

Finally, as already happens in the supervisory area, the proportionality principle will be another common criterion which will shape the nature and direction of the initiatives of the resolution authorities in the years to come. As is already the case for supervisory authorities, resolution authorities will also have to prove that the constraints that they impose on the business judgment of the banks are "suitable, proportionate, and necessary" to achieving the underlying goals, within the meaning described previously.

3.2 THE NEED TO ENSURE A CONTINUUM BETWEEN SUPERVISION AND RESOLUTION

These initial remarks on the guiding criteria which supervisory and resolution authorities have in common allows me to move on to, and conclude with, the second question, on the interplay between supervisory powers and resolution planning powers. As I have explained, consistency between these two sets of powers is a paramount objective which must be achieved by the supervisory and resolution authorities. The BRRD and the guidelines and technical standards specifying its content repeatedly underline the duty of these authorities to consult each other and coordinate their actions and powers in order to build a continuum between supervisory and resolution actions. The European legislator has already clearly cast this need for consistency as a cornerstone of the BRRD. This is evident when we look, for example, at the various provisions of the BRRD which require close interaction between recovery and resolution plans, as well

as between early intervention measures and the decision to trigger resolution and subsequent developments, or the criteria to set the MREL and those governing the capital requirements.

Consistency between the actions of the supervisory authority and those of the resolution authority is therefore destined to become another fundamental criterion, and at the same time a limit, for the exercise of their discretionary powers, as it will be likely to become a benchmark to assess the "suitability, proportionality and necessity" of the respective actions of both authorities. Supervisory measures should not turn out to be an obstacle to resolvability and resolution planning measures, in as much as the latter should be consistent with the former, if one wants to preserve the paramount objective of ensuring financial stability. Moreover, any clash and contradiction between the course of action of the two authorities could be considered as an argument to legally challenge their actions and qualify them as an improper invasion of the business judgment area. From this perspective one might conclude that such consistency will become, in concrete cases, an additional criterion for identifying and defining the perimeter of the business judgment area as regards the authorities' scope of action.

More generally, I would say that this need for consistency between the two set of rules and actions is a distinctive element of the new order, which also should be carefully considered in possible legislative developments. I refer in particular to the current discussion on the legislative initiatives which would grant supervisory authorities the power to impose structural constraints on banks. Also in this case it is self-evident, in light of what has been said so far, why such measures should be assessed and considered by resolution authorities, given their impact on the resolvability of the banks.

4 CONCLUSION

As noted in the introduction, the discussion of the limits of the discretionary powers of supervisors over banks has traditionally been conducted by framing it within a bi-lateral relationship, with the banks (and their management, shareholders and investors) on the one hand, and the supervisors on the other. I hope I have managed to raise sufficient arguments and questions to build a case for introducing a new element into this picture: the resolution framework and the resolution authorities. I think that to be aware of the distinct roles and the mutual impact of supervisory authorities and resolution authorities is a perspective which will provide interesting theoretical and practical insights for such a discussion.

PANEL 5

BURDEN-SHARING AND RESOLUTION

ADEQUATE LOSS-ABSORBING AND RECAPITALISATION CAPACITY OF G-SIBs IN RESOLUTION

EVA HÜPKES[1]

The commitment by the G20 and the Financial Stability Board (FSB) to make reforms to address 'too-big-to-fail' has led to important changes in the ways systemically important financial institutions (SIFIs) are regulated and resolved. In 2011 the G20 endorsed the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions ('Key Attributes')[2]. This marked the beginning of a transition to a new paradigm for dealing with distressed and insolvent financial institutions. The Key Attributes set out the powers and tools that authorities should have to resolve a financial firm in a manner that minimises systemic disruption and allocates the financial costs of failure not to the public, but rather to the firm's shareholders and creditors.

THE KEY ATTRIBUTES – A NEW PARADIGM FOR DEALING WITH DISTRESSED AND INSOLVENT FINANCIAL INSTITUTIONS

Resolution differs fundamentally from standard bankruptcy and insolvency processes. Bankruptcy is a court-administered process that is focused on legal entities. It works for individual companies, but it is messy and disruptive if applied to complex group structures with hundreds of financially and operationally interconnected entities located in multiple jurisdictions. Resolution is controlled by administrative rather than judicial authorities. It also pays greater heed to the systemic consequences of financial failure by seeking to ensure that critical functions continue to be performed by a recapitalised institution, a newly established bridge institution, or otherwise by market participants. Importantly, resolution relies on *ex ante* resolution planning. It assumes that home and key host authorities have *ex ante* identified the entity or entities within a financial group (termed the 'resolution entity/entities') to which resolution tools will be applied under their preferred resolution strategy. The goal is to limit resolution processes to one (in a 'single point of entry' (SPE) strategy) or a few entities (in a 'multiple point of entry' (MPE) strategy) and thereby avoid the cross-border difficulties of legal entity-based approaches.

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2 The FSB adopted the '*Key Attributes*' at its Plenary meeting in October 2011. The G20 Heads of States and Government subsequently endorsed the '*Key Attributes*' at the Cannes Summit in November 2011 as "a new international standard for resolution regimes." On 15 October 2014, the FSB adopted additional guidance that elaborates on specific Key Attibutes relating to information sharing for resolution purposes and sector-specific guidance that sets out how the *Key Attributes* should apply to insurers, financial market infrastructures (FMIs) and the protection of client assets in resolution. See http://www.financialstabilityboard.org/2014/10/r_141015/

BAIL-IN TO ACHIEVE A CREDITOR-FINANCED RECAPITALISATION

One of the objectives of the G20 and the FSB is to avoid the use of fiscal resources when dealing with financial crises. Apart from being deeply unpopular with the electorate, the use of public money can create moral hazard and, where the banking system is large, lead to questions about the sustainability of public debt.

The Key Attributes therefore envisage the write-down or conversion into equity of debt issued by the financial institution ('bail-in') as a means of financing resolution. Bail-in provides resources from within a financial group to finance the continued performance of vital economic functions or to achieve an orderly wind-down over time. Unlike the bail-outs of the past using public money, bail-in does not rely on outside resources, apart from temporary liquidity support. In addition, unlike the mergers and asset sales that have traditionally been used to deal with failing banks, it does not need to lead to more concentration.

Bail-in may take the form of either (i) a 'direct bail-in', i.e. the write-down and/or exchange of a legal entity's unsecured debt for equity in the same legal entity, without closing the legal entity; or (ii) an 'indirect bail-in' or 'bridge bail-in', i.e. the exchange of a legal entity's unsecured debt for equity in a newly established bridge institution to which all or a portion of the first legal entity's assets have been transferred.

A NEW STANDARD ON TOTAL LOSS-ABSORBING CAPACITY FOR G-SIBs

To achieve the bail-in objectives of effective recapitalisation and to make resolution credible, sufficient loss-absorbency needs to be built into the capital and liability structure of all global systemically important banks (G-SIBs)[3] so that their material operations can be maintained. To ensure that this is the case, the FSB has adopted a new international standard on total loss-absorbing capacity (hereinafter the 'TLAC standard').[4]

The TLAC standard consists of: (i) a set of principles that elaborate on the premise set out in the September 2013 report on *Progress and Next Steps Towards "Ending Too-Big-To-Fail" (TBTF)*[5] that there must be sufficient loss-absorbing and recapitalisation capacity available in resolution to implement an orderly resolution that minimises impacts on financial stability, ensures the continuity of critical functions, and avoids exposing public funds to loss; and (ii) a term sheet that implements these principles. The TLAC standard sets out minimum requirements for TLAC-eligible instruments and liabilities that G-SIBs must issue. Such TLAC-eligible liabilities should provide for loss-absorption and recapitalisation capacity that can be relied on in resolution. As such, it constitutes an important part of the overall FSB/G20 policy framework to address TBTF.

3 http://www.financialstabilityboard.org/2015/11/2015-update-of-list-of-global-systemically-important-banks-g-sibs/for the 2015 list of G-SIBs.

4 See Principles on Loss Absorbing and Recapitalisation Capacity of G-SIBs in Resolution Total Loss Absorbing Capacity (TLAC) Term Sheet, November 2015 at http://www.financialstabilityboard.org/2015/11/tlac-press-release/.

5 See http://www.financialstabilityboard.org/2013/09/r_130902/.

The FSB standard specifies the types of instruments that can count as TLAC, as well as those that cannot. Short-term liabilities may be susceptible to runs as the firm approaches the point of entry into resolution. For this reason, they do not qualify as TLAC even though such liabilities may be bailed-in in the course of a resolution. Also, liabilities such as deposits, payment-related liabilities and derivatives do not qualify as TLAC, since any write-down or conversion of these liabilities could interfere with the critical economic functions that the firm performs, could be operationally difficult or could pose wider financial stability risks.

Capital that counts towards satisfying minimum regulatory capital requirements may also count towards satisfying the minimum TLAC requirement provided it meets the core features and eligibility criteria for TLAC set out in the term sheet. To be TLAC-eligible instruments must be issued by the resolution entity, be paid in and unsecured and not be subject to set-off or netting rights that would undermine their loss-absorbing capacity in resolution. They must have a minimum remaining contractual maturity of at least one year or be perpetual (no maturity date); not be redeemable by the holder (i.e. not contain an exercisable put) prior to maturity; and not be funded directly or indirectly by the resolution entity or a related party of the resolution entity, except where the relevant home and host authorities in the Crisis Management Group (CMG) agree that it is consistent with the resolution strategy. A phaseout applies to certain regulatory capital instruments that do not meet all of the TLAC-eligibility criteria. As such, regulatory capital instruments that are not directly issued by the resolution entity can only be used to meet minimum TLAC until 31 December 2021. An exception applies to: (i) Common Equity Tier 1 (CET1) regulatory capital issued by subsidiaries forming part of the resolution entity's resolution group to the extent that this is recognised as CET1 for the consolidated resolution entity under the Basel III framework; and (ii) regulatory capital instruments issued by cooperative banks or financial institutions affiliated to them that have in place an institutional protection scheme or other cooperative mutual solidarity system that protects the solvency and liquidity of the affiliated cooperative banks and institutions.

The TLAC standard provides for a two-stage phase-in, which is different for G-SIBs headquartered in advanced economies and those in emerging market economies (EMEs). Firms headquartered in advanced economies that have been designated by the FSB as G-SIBs before the end of 2015 and continue to be so designated thereafter must meet the minimum TLAC requirements of at least 16% of Basel III risk-weighted assets (RWA) and 6% of the Basel III leverage ratio exposure (LRE) denominator from 1 January 2019. From 1 January 2022, such firms must meet the minimum TLAC requirements of at least 18% RWA and 6.75% of the Basel III leverage ratio denominator.

G-SIBs headquartered in EMEs will be required to meet the 16% RWA and 6% LRE minimum TLAC requirement no later than 1 January 2025, and the 18% RWA and 6.75% LRE minimum TLAC requirement no later than 1 January 2028. This conformance period could be accelerated if, in the next five years, the size of the corporate debt market reaches 55% of the relevant emerging market economy's GDP. The FSB will monitor implementation of the TLAC standard and will undertake a review of it by the end of 2019.

The EU and the United States have issued rules that pursue the same objectives as TLAC. In the EU, the Bank Recovery and Resolution Directive (BRRD) requires banks to have enough liabilities that are eligible for bail-in and meet at all times a minimum requirement for own funds and eligible liabilities (MREL). Unlike TLAC, MREL applies not just to G-SIBs but to all banks in the EU. It is set on a case-by-case basis for each bank. G-SIBs headquartered in the EU are expected to meet MREL consistent with the TLAC standard.

In the United States, the Federal Reserve has issued a proposed rule that would impose a TLAC requirement and a separate long-term debt requirement on top-tier US bank holding companies identified by the Federal Reserve as systemically important bank holding companies and on US intermediate holding companies with at least USD 50 billion in US assets[6].

TLAC IN THE CREDITOR HIERARCHY

Authorities need to be able to write down or convert TLAC with legal certainty. This requires clarity about the creditor hierarchy within a firm's liability structure and about how, when and by whom such powers will be exercised.

TLAC should absorb losses ahead of (operational) instruments and liabilities that are directly linked to critical functions provided by a G-SIB. This means that TLAC should in principle be subordinated to such liabilities in the creditor hierarchy to avoid the risk of legal challenge based on the 'no creditor worse off than in liquidation' principle that could arise from a differential treatment of liabilities that rank *pari passu*. The FSB standard therefore permits only a portion of otherwise TLAC-eligible liabilities that rank *pari passu* with operational liabilities to count as TLAC (unless the amount of *pari passu* operational liabilities as specified in the standard is less than 5% of the entity's TLAC), subject to the condition that it does not give rise to a material risk of legal challenge or have an adverse impact on resolvability.

ALLOCATION OF TLAC ACROSS A G-SIB

TLAC must be available in amounts that are sufficient to foster market confidence that each G-SIB has sufficient resources in resolution to absorb losses and recapitalise those parts of the firm that perform economic functions, even if some TLAC is consumed prior to entry into resolution.

TLAC needs to be available in sufficient amounts to those entities within the group that provide or support the provision of the firm's vital economic

6 See Federal Reserve System, 12 CFR Parts 217 and 252 Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies. See http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20151030a1.pdf.

functions. The location of TLAC will depend on the resolution strategy. An SPE resolution strategy assumes that bail-in of TLAC available at the level of the parent company, which can be either an operating or a non-operating holding company, will generate sufficient loss-absorbing and recapitalisation capacity to support all material subsidiaries with critical operations so that they remain going-concern. An MPE strategy assumes that there are two or more points of entry into resolution, at the level of the parent, at sub-holding entities and/or operational subsidiaries. TLAC therefore needs to be available in sufficient amounts at those entities.

TLAC may be located directly in the entity that provides or supports the provision of vital economic functions and is in need of recapitalisation. Alternatively – and this is the assumption underlying an SPE strategy – it may be located at the parent entity. In the SPE scenario, TLAC must be transferred from the parent to the material subsidiaries or sub-groups suffering the losses. To ensure that this will be the case in particular in a cross-border context, the TLAC standard requires pre-positioning of a certain amount of 'internal TLAC' at foreign subsidiaries. This means that the subsidiary would hold on its balance sheet liabilities issued to the parent or resolution entity. These liabilities (referred to as 'internal TLAC') should be subject to write-down and/or conversion into equity in the subsidiary ahead of third-party creditors of the subsidiary. Conversion would upstream loss to the parent. The equity created through conversion would be held by the recapitalised parent holding or newly established bridge institution.

CROSS-BORDER COOPERATION

Location of loss-absorbing resources matters, particularly in a cross-border context. In an SPE resolution strategy, host authorities will want to be confident that a foreign parent will support local subsidiaries. They will want to have assurances that there is adequate loss-absorbing and recapitalisation capacity available to the local subsidiaries even if the parent itself enters resolution. Home authorities will want to have assurances that host authorities will cooperate and support the implementation of an agreed strategy, and will not precipitate local action that could threaten the chances of achieving an orderly resolution.

To support cross-border cooperation, the FSB requires subsidiaries or groups of subsidiaries outside of the home jurisdiction that are not themselves resolution entities and that are deemed material based on criteria set out in the TLAC standard to pre-position internal TLAC on their balance sheet so that it can be bailed-in to recapitalise the subsidiaries without imposing losses on third-party creditors of the subsidiary and without there being a need to place the subsidiary into resolution. Under the FSB standard, each material sub-group must maintain internal TLAC of 75% to 90% of the external minimum TLAC requirement that would apply to the material sub-group if it were a resolution group, as calculated by the host authority. The actual minimum internal TLAC requirement within that range should be determined by the host authority of the material sub-group in consultation with the home authority.

Internal TLAC needs to be designed so that it can absorb subsidiaries' losses and recapitalise them while they are kept open and operating or are being reorganised in a manner that assures the continued performance of critical functions. The write-down or conversion of internal TLAC should therefore not require the subsidiary to enter into resolution. In principle, the bail-in of internal TLAC should be triggered on the basis of the local supervisor's judgement about the subsidiary's safety and soundness, but with the consent of the home authority of the parent resolution entity. The bail-in trigger will need to achieve a balance between home and host interests. Whereas host authorities will be concerned about maintaining domestic financial stability, home authorities may be concerned about early triggers that could drain the parent's resources that are also needed to support other domestic and foreign subsidiaries and branches.

EX ANTE TRANSPARENCY AROUND THE ALLOCATION OF LOSS

As noted above, an important shift in paradigm relates to resolution planning which determines *ex ante* how the burden of the costs of failure will be shared. It determines who will take losses and in what order. It presupposes a resolution regime that is consistent with the FSB Key Attributes and operational and financial structures that support the implementation of a preferred resolution strategy. Firm structures may need to be adjusted or simplified to accord with the strategy. Market participants will expect disclosure about the order in which capital and liability instruments of a firm's individual legal entities are exposed to the risk of loss. They will want to know where they rank in the creditor hierarchy and how thick the TLAC buffer is that protects them from loss. They will also need to understand the legal structure of the group to appreciate the structural subordination of TLAC resources. TLAC holders will require information to assess the risk and consequences of a bail-in. The Basel Committee on Banking Supervision is developing a disclosure framework to support consistent disclosures around TLAC positions.

CONCLUSION

Adequate loss-absorbing capacity in resolution is a necessary but, taken alone, insufficient condition for successful resolution. Other important conditions relate to effective cross-border recognition, in particular with regard to bail-in and temporary stays of early termination rights, to access to sufficient amounts of liquidity in resolution, and to arrangements that support operational continuity. Finally, bail-in is not the end of the resolution process. It is only the beginning. The restructuring that follows will need to address the causes of the failure through changes in the management and governance of the firm, and through the sale or wind-down of certain businesses or legal entities, to ensure that the business model is viable. If effectively and consistently implemented, TLAC combined with effective resolution regimes and policies should provide a robust foundation for achieving orderly resolution.

BAIL-IN AND THE TWO DIMENSIONS OF BURDEN-SHARING

ANNA GARDELLA[1]

1 THE TWO DIMENSIONS OF BURDEN-SHARING

The financial crisis has brought to the fore the absence of credible threats to discourage moral hazard and opportunistic behaviors, among other things because of the lack of an (effective) crisis management framework that could remove the implied State guarantee as the only available remedy. The size, interconnectedness and complexity of Global Systemically Important Banks ("G-SIBs") had the effect of underscoring reliance on public financing, on the assumption that these institutions simply were too big to fail (TBTF). The consequences of this self-fulfilling promise are well known: the State stepped in, leaving taxpayers to foot the bill. Member States and the EU regime were unprepared to cope with the cross-border banking crisis, since the large-scale consolidation of banking groups that took place in the years before the crisis had not been paralleled by the set-up of a crisis management framework. Home States are not inclined to disburse financing to rescue depositors or activities abroad. The solution to transnational crises has therefore been financial subsidization along national lines, thus proving the traditional view that banks are "international in life and national in death"[2].

As a reaction to the crisis, the re-regulation process has focused on the reinforcement of prudential requirements with a view to increasing banks' resilience as well as to solving the TBTF problem, so as to make the orderly resolution of large banks possible[3]. These aspects of the regulatory landscape had not received extensive attention in the past and prompted policymakers to place resolution issues at the top of the agenda.

This paper is specifically concerned with burden-sharing as a key aspect of the resolution regime's overall feasibility and credibility as an alternative to State bail-outs. For this purpose, it will explore the double aspect of burden-sharing: (i) the "vertical dimension", relating to the setting of an appropriate dividing line between private and public financing of resolution costs and (ii) the "horizontal dimension", relating to the setting-out of an EU-wide resolution framework and

1 Legal Expert, European Banking Authority. PhD, University of Milan, LLM Harvard Law School; JD University of Genoa. Senior Lecturer, Catholic University of Milan (on leave). The views expressed in this paper do not necessarily reflect those of the EBA.
2 The quotation is attributed to Mervyn King and Charles Goodhart.
3 In addition to the documents elaborated by standard-setting bodies, in particular the Financial Stability Board and by the Basel Committee on Banking Supervision, see Rosa Lastra, "Systemic risk, SIFIs and financial stability" (2011) 6 Capital Markets Law Journal 197; Panagiotis K. Staikouras, "Universal Banks, Universal Crises? Disentangling Myths from Realities in Quest of a New Regulatory and Supervisory Landscape" (2011) 11 JCLS 139.

international cooperation, tackling *ex ante* the issue of loss allocation across the jurisdictions concerned by the bank in financial distress. Both dimensions will be explored with a view to underscoring their interconnection within the EU financial and economic environment.

The definition of the vertical dimension of burden-sharing has undisputedly been a major political concern and a priority of the regulatory agenda for redressing the political and economic inadmissibility of bail-outs. The regulation of the horizontal dimension of burden-sharing is less intuitive but no less compelling from an internal-market and financial-stability perspective, having regard to the cross-border banking groups operating in the EU. The need to couple cross-border bank supervision with cross-border crisis management, so as to ensure that banks' life as well as death are international, is equally significant. This paper will investigate burden-sharing through the lense of bail-in, in as much as the resolution tool that best enshrines the policy response to State rescues. The paper will first underscore the conceptual framework and the underlying policy rationale of bail-in (paragraph 2); it will then analyze the "vertical dimension" of burden-sharing, focusing on the dividing line between private and public financing of resolution costs, as well as on the determination of the loss-absorption sequence within private resources (paragraphs 3.1-3.5). Attention will then be directed at the cross-border aspects of resolution with a view to underscoring the interaction of bail-in with the horizontal dimension of burden-sharing (paragraphs 4.1-4.5).

2 BAIL-IN: CONCEPTUAL FRAMEWORK

As a reaction to the massive State bank rescues, policymakers and regulators have committed to remedy the socialization of costs of TBTF banks that has shifted the financial burden onto taxpayers. The conceptual inadmissibility of such an approach has been illustrated at length by scholars and does not need to be further analyzed here, save for the basic policy consideration that bail-outs reinforce banks' moral hazard and the implied State guarantee rather than deter excessive risk-taking. When enforced, the State guarantee has a negative fiscal impact and taxpayers are called upon to remedy business failures. By contrast, the new resolution framework, whose key principles have been elaborated at the international level by the Financial Stability Board[4] and implemented in the Union by Directive 2014/59/EU, establishing a framework for the recovery and resolution of credit institutions and investment firms (Bank Recovery and

4 Key Attributes for Effective Resolution Regimes for Financial Institutions ("KA"), approved by the G-20 in October 2011, and updated in October 2014; available at http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf On the reform of bank crisis management, see Rosa Lastra (ed.), *Cross-border bank insolvency* (OUP 2011); for some critical remarks see Christos Hadjemmanuil "Special Resolution Regimes for Banking Institutions: Objectives and Limitations" (LSE Law, Society and Economy Working Papers 21/2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2336872; Jens-Hinrich Binder, "Resolution: Concepts, Requirements and Tools", (2014) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2499613

Resolution Directive – "BRRD"), aims at an orderly resolution of TBTF banks without, to the maximum extent possible, any fiscal impact.

The bail-in tool implements these policy concerns by imposing the internalization of bank losses that, in the new regime, have to be sustained by shareholders and creditors, rather than by the State, i.e. by taxpayers[5]. Even though the possibility of State intervention is not completely ruled out, it is meant to be residual, whilst loss absorption is imposed by the resolution authority on shareholders and creditors in accordance with a pre-established loss-absorbing sequence set out in the Directive and the pecking order provided by national law.

One might claim that conceptually it is nothing new, since it corresponds to the basic principle according to which he who causes a damage bears the costs. This applies also to large-scale disasters: for instance in environmental law it is enshrined in the "polluter pays" principle. When this concept is applied to bank failures, the threat of ex post compensation through the writedown and conversion of own funds and eligible liabilities is intended to work as an ex ante governance tool, deterring excessively risky conducts and incentivizing virtuous behaviors, both within the financial institution and outside of it, via creditors' monitoring. In this respect, although framed as a resolution tool, bail-in is not just remedial in nature but is meant to achieve ex ante beneficial effects. Despite the fact that bail-in shares the same rationale as other existing legal remedies, its implementing complexities underscore its innovative character. It should be noted that by virtue of the bail-in tool, the write down affects not only shareholders but also creditors, who bear a significant burden of monitoring the debtor's creditworthiness. The same conclusion is true when the bail-in tool is compared with reorganization measures that are typical of ordinary insolvency or restructuring and work-out frameworks, providing for the voluntary haircut of creditors' claims. Unlike such ordinary regimes, the application of the bail-in tool means the haircut is not voluntarily undertaken by the creditors but is imposed by the resolution authority on the assumption that it is best placed to achieve the resolution objectives. These are not limited to the maximization of private interests such as the recovery of creditors' claims like in ordinary insolvency or restructuring proceedings, but include public goals such as the maintenance of financial stability, the continuity of critical functions, as well as the protection of public finances and covered depositors. The tool – as a means to achieve the resolution objectives – is therefore very ambitious.

3.1 THE VERTICAL DIMENSION

Having outlined the underlying conceptual framework of the bail-in tool, this part of the paper intends to investigate the public/private divide of resolution financing with a view to emphasizing the role played by the State-aid framework

5 Anna Gardella, "Bail-in and the Financing of Resolution within the SRM Framework" in Danny Busch and Guido Ferrarini (eds.), *The European Banking Union*, OUP 2015, n. 11.24; Antonio Capizzi, Stefano Cappiello, Prime considerazioni sullo strumento del bail-in: la conversione forzosa di debito in capital, Working Paper, available at http://www.orizzontideldirittocommerciale.it/media/24571/cappiello_s._-_capizzi_a._def._30.01.14.pdf ; Christos Hadjemmanuil in this volume.

in setting such a dividing line and in making sure that it is not crossed. This part will also touch upon a second aspect of the vertical dimension, namely the role played by EU law and national law respectively in the identification of the private resources that will bear the resolution costs within the perimeter determined by the dividing line traced by the EU legislator.

3.2 THE PERIMETER OF THE VERTICAL DIMENSION

The starting point of the analysis is that public financing is not a resolution measure, quite the opposite: the need for State aid is a trigger for resolution, since it means that the institution is considered "failing or likely to fail" (Article 32(4), letter (d), BRRD), with the exception of those specific circumstances set out in that provision, where the granting of State aid is considered consistent with the resolution regime but is still subject to State-aid clearance[6]. When a financial institution is placed in resolution by the resolution authority upon the assessment that the conditions for resolution are met, private resources, notably own funds and eligible liabilities, are the primary form of resolution financing and resorting to public financing is envisaged as a secondary and residual option that can be exercised only after the use of private resources. The same is true when the financial institution reaches the point of non-viability, where, regardless of meeting the conditions for resolution, the authority decides to write down and convert relevant capital instruments or other instruments of ownership with a view to restoring the bank's viability (Article 59 BRRD). Use of public funds is prevented, as it would be in breach of the EU State-aid framework.

Within the range of private resources, all liabilities of an institution or entity may be bailed-in, following the loss-absorbing sequence set out in Article 48 BRRD and in accordance with the pecking order provided by national insolvency law. In principle all liabilities are eligible for bail-in, but this rule bears exceptions directly set out in Article 44 (2) and (3) of the BRRD, to be interpreted restrictively. What has not been harmonized by EU law is the pecking order of claims in insolvency, which is still under the competence of national law. This is therefore an economic policy margin left to Member States, which are entitled to determine which creditors are directly and immediately exposed to bail-in and in all likelihood will bear the bank's losses, and which are more bail-in remote by virtue of their seniority in the insolvency ranking.

The scope of action of the bail-in tool is therefore delimited at the top end by the prohibition of the use of public financing and the State-aid regime, and at the bottom end by the protection to be afforded to certain categories of creditors that are entitled to statutory exemptions from bail-in, as well as by the loss-absorption sequence laid down in the BRRD and the pecking order set out by national law. What lies between these two ends is in principle bail-inable and contributes to the financing of resolution costs. This general framework is completed by

6 Article 18 (4), letter (d), (i) to (iii), corresponding to Article 32 (4), letter (d), (i) to (iii), BRRD. The conditions when an institution is considered failing or likely to fail are further specified in EBA Guidelines adopted pursuant to Article 32 (6) (EBA/GL/2015/07 of 26 May 2015) available at www.eba.europa.eu.

the overarching "no creditor worse off" ("NCWO") principle, providing that creditors cannot incur greater losses than they would have sustained had the institution been subject to normal insolvency procedure rather than resolution. This principle informs the whole resolution process and needs to be respected by the resolution authority when taking action[7].

3.3 STATE-AID FRAMEWORK AS GUARDIAN OF BURDEN-SHARING

The above elements outline the vertical dimension of the EU burden-sharing approach for resolution financing, which builds up and goes beyond the line taken by the European Commission in the various State-aid Communications adopted during the financial crisis and in particular in the Commission Banking Communication on the application of State-aid rules to support measures in favor of banks in the context of the financial crisis ("Banking Communication")[8]. With a view to harmonizing the burden-sharing approaches developed by Member States in the course of the crisis – approaches that have impacted creditors differently –, the Banking Communication marked a step forward in the Commission's practice[9]. The EU burden-sharing approach is now enshrined in the BRRD, a hard law instrument, representing a significant difference from the previous practice in terms of legal sources. The interaction between the resolution and the State-aid framework needs to be explored with a view to assessing the internal consistency of EU law as well as coming to a clear understanding of the procedure to be followed by the resolution authorities[10]. To this end the analysis will move from the resolution regime in as much as the ordinary framework for orderly bank resolution, envisaging recourse to State aid as an exceptional measure. This methodology is also imposed by the clarification in the BRRD of the exact perimeter of the private/public divide for resolution financing in qualitative as well as quantitative terms. This is also aimed at better understanding the scope left for public contribution, the circumstances when it can be granted, and at what point in the loss-absorbing waterfall.

According to Regulation (EU) No 806/2014, establishing the framework of the Single Resolution Mechanism and of the Single Resolution Fund ("SRM Regulation")[11], resort to the single resolution fund ("SRF") is conditional upon the prior exhaustion of the institution's internal loss-absorbing capacity and State-aid clearance. The BRRD/SRM Regulation framework in particular provides that the

7 See Anna Gardella, "Bail-in" (nt. 5).

8 In OJ C 216, 30.7. 2013, 1.

9 On the Commission's State-aid practice in the financial sector in the course of the crisis, see Ignazio Angeloni and Niall Lenihan, "Competition and State-aid rules in the time of Banking Union", in Ester Faia, Andreas Hackethal, Michael Heliassos, Katja Langenbucher (eds.), *Financial Regulation: A Transatlantic Perspective* (Cambridge University Press 2015), 89; Damien M.B. Gerard, "Managing The Financial Crisis In Europe: The Role of EU State Aid Law Enforcement", in Jacques Derenne, Massimo Merola, José Rivas (eds.), *Competition Law at Times of Economic Crisis – In Need for Adjustment?* (Bruylant 2013), 231.

10 Stefano Micossi, Ginevra Bruzzone, Miriam Cassella, "Bail-in Provisions in State Aid and Resolution Procedures: Are they consistent with systemic stability?" CEPS Policy Briefs, 21 May 2014, available at http://www.ceps.eu/book/bail-provisions-state-aid-and-resolution-procedures-are-they-consistent-systemic-stability.

11 Article 24 (7), SRM Regulation.

following two conditions must be met: (i) the internal loss-absorbing capacity must have reached an amount of not less than 8% of the institution's total liabilities – based on the valuation carried out pursuant to Article 20 SRM Regulation – via the writedown or conversion of capital instruments and eligible liabilities; and (ii) the contribution of the SRF must not exceed 5% of total liabilities including own funds of the institution under resolution. In extraordinary circumstances it is envisaged that further funding may be sought through alternative funding resources after (i) the SRF's contribution has reached the limit of 5% of the total liabilities; (ii) all unsecured, non-preferred liabilities other than eligible deposits have been written down or converted in full[12].

It is disputable whether the writedown or conversion of capital instruments and eligible liabilities for an amount equal to 8% of total liabilities is a necessary and sufficient condition for accessing the SRF, or whether the threshold should be increased where liabilities in excess of 8% of the total losses are available for bail-in in the institution. The latter approach is suggested by the literal wording of recital (80) SRM Regulation, which provides that 8% of the institution's total losses is "the *minimum* amount of bail-in", and of Article 27 (7) SRM Regulation, according to which the SRF may intervene only where "a contribution to loss absorption and recapitalization equal to an amount *not less* than 8% of the total liabilities including own funds has been made by shareholders and holders of capital instrument and other eligible liabilities"[13]. It is questionable whether this amount is at the same time the floor and the cap or whether it should be understood just as the floor. A systematic interpretation of the relevant provisions suggests that while the EU resolution regime is unambiguous in requiring the bail-in of all unsecured creditors, including senior creditors but excluding preferred liabilities, as a precondition for seeking alternative funding resources pursuant to Article 27 (9), SRM Regulation, after the SRF has been accessed, it does not set forth such a precondition for accessing the SRF which could be based on the more relaxed requirement of the absorption of (only) 8% of total liabilities. The reverse side of this reasoning, however, could entail characterizing access to the SRF (which the bank in resolution has contributed to) as a legitimate expectation of the institution, provided the minimum requirements are met, i.e. the satisfaction of the required loss absorption and the Commission's approval on the basis of the restructuring plan to restore the bank's viability[14].

3.4 SYSTEMIC CRISIS AND EXTRAORDINARY PUBLIC FINANCIAL SUPPORT

It is now time to consider whether the framework outlined in the previous paragraph works for idiosyncratic and systemic shocks alike. In the latter scenario there is an inherent risk of contagion requiring alternative strategies in

12 Article 27 (9), SRM Regulation; Article 44 (7), BRRD.

13 Emphasis added.

14 The scope of bail-in and the connected aspect of the size of resolution funds have been the object of political negotiations between the European Parliament and the Council within the Trialogue, see Commission Staff Document, Bail-in tool: a comparative analysis of the institutions' approaches, 18 October 2013, available at http://www.thetimes.co.uk/tto/multimedia/archive/00477/EC_BAIL-IN_-_compar_477750a.pdf, accessed on 22 November 2014.

order to restore financial stability, including the application of public support measures[15]. Consistently with the resolution objectives, State aid is meant to be an exceptional option.

Government financial stabilization tools ("GFSTs"), such as the public equity support and the temporary public ownership tool, are expressly envisaged by Article 56 BRRD. The BRRD is careful in making it a last-resort option subject to the prior assessment and exploitation of "the other resolution tools to the maximum extent practicable whilst maintaining financial stability"[16] and to meeting the resolution objectives set out in Article 31 (2) BRRD. The granting of such measures is also conditional upon the fulfillment of the requirements set out in Article 32 (1), 37 (10) and 56 (3) and (4), letters (a) to (c) BRRD, and to the State-aid framework. The circumstances and the phase within the loss-absorption waterfall where Member States may be entitled to apply GFSTs are worth considering. Paragraph (10) of Article 37, relating to the general principles of resolution tools, provides that "*in the very extraordinary situation of systemic crisis*[17]" the resolution authority may seek funding for resolution from alternative financing resources through the use of GFSTs, provided that the shareholders and creditors of the institution have made a contribution equal to 8% of the total liabilities including own funds of the institution and the GFST is approved under the State-aid framework. This provision makes clear that the GFST is not a resolution tool and that being conditional on the prior absorption of 8% of total liabilities – including own funds – by shareholders and creditors, it is subsequent to the application of the resolution tools. To put it in other words, it may step in only as an alternative to the use of resolution financing arrangements. This marks a difference from the State aid envisaged in Article 32 (4), letter (d), points (i) to (iii) BRRD[18], which does not require the application of any resolution tool prior to the State's intervention, given that in such case the provision of State aid is independent and outside the resolution procedure. The comparison between Article 27 (9) SRM Regulation – relating to extraordinary public financial support measures – and Article 37 BRRD – relating to the GFST – shows that conditions for the adoption of the latter are less stringent in terms of private contributions, but limited to cases of systemic crisis.

An element of uncertainty is represented by the misalignment of the SRM Regulation with the BRRD, given the lack of reference to the GFST in the

15 See the critical remarks by Charles Goodhart and Emilios Avgouleas, "A Critical Evaluation of Bail-ins as Bank Recapitalization Mechanisms" (CEPR, Discussion Paper 10065, July 2014) http://ssrn.com/abstract=2478647, questioning in general the adequacy of the bail-in tool in systemic as opposed to idiosyncratic crises.

16 Article 56 (3), BRRD. See also Article 31 (2), letter (c), BRRD and recital (45), BRRD, which reads "Save as expressly specified in this Directive, the resolution tools should be applied before any public-sector injection of capital or equivalent extraordinary public financial support to an institution. This, however, should not impede the use of funds from the deposit guarantee schemes or resolution funds in order to absorb losses that would have otherwise been suffered by covered depositors or discretionarily excluded creditors. In that respect, the use of extraordinary public financial support, resolution funds or deposit guarantee schemes to assist in the resolution of failing institutions should comply with the relevant State-aid provisions".

17 Emphasis added.

18 Equivalent to Article 18 (4), letter (d), points (i) to (iii), SRMR.

former. This gap raises the question of the underlying rationale for, and the consequences of such lack of reference, in particular whether it is a deliberate political choice aimed at reducing reliance on State aid.

Public support measures are not excluded by the SRM Regulation regime and are expressly envisaged by Article 19 (1) SRM Regulation, including the possibility that resolution schemes involve State aid in accordance with Article 107 (1) TFEU. The SRM Regulation, though, has failed to reproduce the possibility to apply directly for alternative funding measures after the absorption of 8% of total losses.

Reference to GFSTs might have been deemed inappropriate in a supranational context like the Banking Union, where provision of domestic support arguably runs counter to the level playing field to be achieved through the common supervisor and resolution authority[19]. Similarly, the inclusion of GSFTs could have had the effect of discouraging the contribution to the SRF. Also worth noting is the lack of cross-reference to the support of the European Stabilization Mechanism ("ESM")[20], which – pursuant to the Eurogroup guidance of 20 June 2013[21] – established a direct bank recapitalization instrument. The fact that at the time of approval of the BRRD such direct recapitalization instrument ("ESM DRI") had not yet been approved may have contributed to the wording's ambiguity. The political agreement reached within the Eurogroup on 10 June 2014 announcing the approval of the ESM DRI, which was subsequently implemented in December 2014[22], may shed some light but leaves other issues open[23]. Besides the fact that the GFSTs are not provided for in the SRM Regulation, it should be noted that the actual scope for the application of the ESM DRI remains unclear, having regard to the strict requirements laid down in the ESM implementing Guidelines[24]. These provide that such financing line is meant to come into question only when: (i) the bank fails to attract sufficient capital from private sources; (ii) the financial institution has systemic relevance or poses financial stability risks to the euro area as a whole or to the Member State concerned; (iii) the financing has to be requested by the Member State concerned, which

19 Also worthy of consideration is the principle set out in Article 6 (6) SRMR, calling on the SRB, the Commission and the Council not to require member States "to provide extraordinary public financial support nor impinge on the budgetary sovereignty and fiscal responsibilities of the Member State".

20 Established among the euro area Member States by Treaty of 2 February 2012, the text is available at www.esm.europa.eu

21 Eurogroup, *ESM direct recapitalization instrument* (Statement, 20 June 2013), available at http://www.eurozone.europa.eu/media/436873/20130621-ESM-direct-recaps-main-features.pdf. The ESM DRI may be included within the ESM instruments pursuant to Article 19 of the Treaty establishing the ESM, entrusting the Board of Governors with amending existing financial assistance instruments.

22 The Eurogroup political statement is available at http://www.eurozone.europa.eu/media/533095/20140610-eurogroup-president-direct-recapitalisation.pdf; as to the ESM DRI, information is available at www.esm.europa.eu

23 Silvia Merler, *Comfortably numb: ESM direct recapitalization – too late to solve the current crisis, too little to deter future crises* (Bruegel), available at http://www.bruegel.org/nc/blog/detail/article/1369-comfortably-numb-esm-direct-recapitalization/.

24 ESM Guidelines on Financial Assistance for Direct Recapitalization of Institutions the ESM DRI of 8 December 2014, available at www.esm.europa.eu

has to be unable to autonomously provide financial assistance without adverse effect on its fiscal sustainability even via the ESM loan for recapitalization to institutions; (iv) the assistance is necessary for the stability of the euro area as a whole or of its Member States. The Guidelines clearly specify that the exhaustion of the waterfall set out in the SRM Regulation is a precondition for access to the ESM DRI. This implies that the ESM may come into play only after (i) a contribution to loss absorption and recapitalization equal to 8% of total liabilities has been made; (ii) the SRF has contributed to up to 5% of total liabilities and (iii) all unsecured non-preferred liabilities, other than eligible deposits, have been written down and converted in full.

3.5 THE NOTION OF STATE AID AND CONDITIONS FOR ACCESS

It is worth further considering the notion of State aid in the resolution context and the kind of resources it affects. In particular, it is worth noting that both the Banking Communication and Article 19 of the SRM Regulation consider the financing provided by financing arrangements like the SRF, subject to State-aid scrutiny. Regardless of the private origin of its financial resources, consisting of bank levies, what matters for the application of the State-aid regime is the compulsory character of the contribution, which can be assimilated to a tax, the imputation to a public authority of the decision of its use and the economic advantage brought to the beneficiary or any other undertaking[25]. Along the same lines, the supranational management of the funding[26] does not affect the public character of the support measures and their inclusion within State-aid control. Only the money disbursed by the national Deposit Guarantee Schemes ("DGSs") in accordance with the function of depositors' payout, as provided by Directive 2014/49/EU[27], does not amount to State aid[28]. The same is generally true also as regards the provision of emergency liquidity assistance ("ELA") by central banks which, in the Commission's view "may constitute State aid pursuant to the State-aid framework" unless certain conditions are met. These are the terms under which ELA is commonly disbursed, such as standard collateralization and application of the interest rate, allowing the conclusion that ELA is normally

25 See Article 19 (3) SRM Regulation, providing for the SRB to notify the Commission in case the resolution scheme provides for the use of the SRF. On the notion of State aid in case non-public resources are at stake, see CJ, case 173/73 *Italy v Commission* [1974] ECR 709, para. 16.

26 Including of the European Stabilization Mechanism in case of direct recapitalization.

27 Directive of the European Parliament and of the Council on deposit guarantee schemes, in OJ L 173, 12 June 2014, 49.

28 Banking Communication, para. 63, where reference is made to CJ, case C-460/07, Puffer [2009] ECR 3251, para. 70. The rationale of the exclusion being that whilst the advantage conferred by State aid to the recipients must be selective, this is "not the case of a measure which, although conferring an advantage on its recipient, is justified by the nature or general scheme of the system of which it is part". In contrast, when DGSs participate in the resolution of the bank, for instance to support the transfer of the depositors' book, they are considered falling within the State-aid framework, see *Danish Winding-up scheme*, Decision SA N 407/2010 of 30 September 2010.

outside the scope of the Commission's State-aid control[29]. Differently, State guarantees ancillary to liquidity facilities granted by the central bank or securing newly issued liabilities or public precautionary recapitalization, even when compatible with the resolution regime, are subject to State-aid control under Article 107 (3), letter (b), TFEU[30].

Access to State aid, including to the SRF, is therefore subject to a "double-tier" assessment involving the interaction between the resolution and the State-aid framework, where the first set of compatibility rules is laid down in the resolution regime and the loss-absorbing sequence envisaged therein. Only when this first test is passed does the EU State-aid compliance assessment come into play. In providing clearance, the Commission will scrutinize consistency with both the SRM Regulation and the State aid regime.

3.6 ELIGIBLE LIABILITIES: EU HARMONIZATION AND NATIONAL LAW

Within the vertical dimension of burden-sharing, the determination of the private resources that will actually bear the losses is the outcome of the combination of the choices of the EU and of the national legislator. EU law levels the playing field by harmonizing the notion of eligible liabilities, in particular by expressly indicating those excluded from this definition and therefore from the general principle that all liabilities are in principle bail-inable. The purpose of harmonization is to avoid regulatory arbitrage and opportunistic behaviors in the crafting of the contract in order to find a safe harbor from the reach of the resolution authority's write down and conversion powers. The same policy reasons underpin the BRRD approach not to distinguish between liabilities subject to the law of an EU Member State and of a non-EU Member State, providing that the latter are also eligible for bail-in. This is a compelled anti-elusive solution in light of the extensive party autonomy provided by Article 3 of Regulation (EU) No 593/2008 on the law applicable to contractual obligations[31], allowing for the selection of any law, not just the law of a Member State, to govern the contract regardless of any geographical connection, except for the safeguard of mandatory rules. True, it also raises practical implementing difficulties linked to the extraterritorial exercise of executive powers, prompting the legislator to take a pragmatic approach by providing for mandatory contractual recognition of bail-in, unless a binding agreement is in force with that third country whose law governs the contract or the resolution authority determines that those liabilities can be subject to write down or conversion pursuant to the law of such third country[32].

29 See recital (41) BRRD; for an interpretation and explanation of the conditions under which ELA constitutes State aid and the applicable competition regime, see Banking Communication, para. 62. For criticism of the Commission's approach, see Ignazio Angeloni and Niall Lenihan (nt. 9); in literature see also Georgios Psaroudakis, "State Aids, Central Banks and the Financial Crisis" (2012) ECFR 194.

30 Article 32 (4), letter (d), points (i) to (iii), BRRD.

31 Helmut Heiss, "Party Autonomy' in Franco Ferrari and Stefan Leible (eds.), *Rome I Regulation. The Law Applicable to Contractual Obligations in Europe* (Sellier 2009) 1; Anna Gardella, "Articolo 3" in Francesco Salerno and Pietro Franzina (eds.), *Commentario al Regolamento Roma I*, in (2009) Le Nuove Leggi Civili Commentate 611.

32 On contractual recognition of bail-in, see Anna Gardella, "Bail-in" (nt. 5) n. 11.44.

Statutory exceptions include liabilities, governed by the law of a Member State or of a third country, owed to specific typologies of creditors[33]. These are: (i) secured creditors[34], on the assumption that the total wipe-out of contractual protections would jeopardize legal certainty and business reliability; (ii) "protected" or weaker creditors, such as covered depositors, liabilities to employees or liabilities arising from the holding of clients assets or money to the extent they are protected by national insolvency law; (iii) entities that are significant for the preservation of financial stability, such as liabilities owed to institutions – with the exception of intra-group liabilities – with original maturity of less than seven days, given the intrinsic adverse effect of bail-in on the unsecured interbank market. Along the same lines, liabilities owed to settlement and payments systems with remaining maturity of less than seven days are also excluded from bail-in as well as liabilities due to deposit guarantee schemes arising out of contributions. Lastly, (iv) liabilities owed to tax and social security authorities are also outside the scope of bail-in under national law.

In addition to the statutory exemptions provided by Article 44 (2) BRRD, the EU regime provides for a uniform set of liabilities that may be exempted from bail-in by the resolution authority on a case-by-case basis in exceptional circumstances (Article 44 (3) BRRD). Resorting to this exclusion as an exception from the general rule of bail-in should be interpreted restrictively and should be carefully assessed by the resolution authority, duly taking into account the potential negative externalities deriving from either inclusion or exclusion of such liabilities from bail-in. The application of that provision is therefore subject to certain restrictions by the SRM Regulation. It should be limited to the occurrence of exceptional circumstances where the bail-in of certain liabilities would impair: (i) the swift and effective resolution action; (ii) the continuity of critical functions; (iii) financial stability, by giving rise to widespread contagion that would severely disrupt the functioning of financial markets, including of market infrastructures; or would (iv) increase the amount of losses that would be borne by the other creditors[35]. The authority's exercise of discretion therefore depends on the circumstances and the necessity of the exclusion to achieve the resolution objectives, while it does not purport to create additional exemptions that are not expressly listed in the BRRD. These elements are going to be further clarified by the Commission in a Delegated Regulation to be adopted pursuant to Article 44 (11) BRRD[36].

The resolution authority's choice to exclude some eligible liabilities from the application of bail-in is not neutral from a burden-sharing perspective, in terms of both the vertical and the horizontal dimensions: discretionary exclusions might impact the haircut imposed on the other creditors, including potentially impairing the principle of non-discrimination and the integrity of the internal market, or

33 Article 27 (3), letters (a)-(g), SRM Regulation, corresponding to Article 44 (2), BRRD.

34 It is worth noting that the part of the liability exceeding the coverage of the security is subject to bail-in, see Article 44 (2), third sub-paragraph, BRRD.

35 See Article 27 (5), letters (a)-(d).

36 To fulfill its mandate, the Commission has requested from the EBA a Technical Advice on the delegated act on the circumstances when the exclusion from the bail-in tool are necessary; this was rendered on 6 March 2015 (EBA/Op/2015/07), available at www.eba.europa.eu

the SRF's contribution to the costs of resolution pursuant to Article 101(1) (f) BRRD, thus interfering with the State-aid framework. For this reason, where the resolution authority intends to exclude certain liabilities from bail-in, it has to notify the draft decision to the Commission, which is entitled to "prohibit or require amendments to the proposed exclusion […] in order to protect the integrity of the internal market" and without prejudice to the EU State-aid framework[37].

The policy reasons underlying the EU approach of rule/exception on eligible liabilities are clear as to the pursued goal of discouraging regulatory arbitrage and opportunistic behaviors. A counter-argument that might be raised from a regulatory perspective, is that such an approach gives rise to normative over-inclusiveness, bringing along practical difficulties both in the ordinary business activity and in the implementing phase of resolution. Although the claim has to be given consideration, it is mitigated by the statutory and the discretionary exemptions. Legal interpretation and actual practice will shed additional light on the notion of eligible liabilities and the related exemptions, thus providing useful data for assessing the calibration of the relevant provisions.

Other aspects, such as quantitative requirements or the "proximity" to bail-in of the various 'bail-inable' liabilities, have not been (fully) harmonized by the EU legislator; discretion has rather been left to (i) the resolution authorities and (ii) the implementing law of each Member State.

As regards the quantitative aspect, the EU regime provides that the resolution authorities should determine the minimum requirements of own funds and eligible liabilities ("MRELs") to be met at all times by the institution in order to enable its orderly resolution without exposing taxpayers to losses. The amount of MRELs is not provided by the BRRD and the EBA has been mandated to specify the criteria for its determination in the regulatory technical standard to be developed pursuant to Article 45 (2) BRRD. Considering the financial impact on the institutions, this is undisputedly a politically sensitive matter, so much so that the mandate conferred on the EBA is focused on the elaboration of *criteria* for the determination of the minimum amount, rather than the determination of the minimum amount itself. Parallel to the work carried out by the EBA, the Financial Stability Board launched a consultation on the Total Loss-Absorbing Capacity ("TLAC") for Global Systemically Important Insurers (G-SIIs)[38]; this closed in February 2015. The TLAC standard and its timelines will be finalized by the time of the G20 Summit in November 2015.

As regards the EU regime, Article 12 of the SRM Regulation provides that the MREL is determined by the Single Resolution Board ("SRB") in consultation with the supervisory authority, including the ECB, with a view to ensuring the

37 Article 18 (7), eighth sub-paragraph, SRM Regulation, replicating Article 44 (12), BRRD.

38 Financial Stability Board, Consultative Document on Adequacy of loss-absorbing capacity of globally systemic banks in resolution, of 10 November 2014, available at http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf. After submission of this paper, the FSB has finalized its standard on 9 November 2015 relating to the Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution, available at www.financialstabilityboard.org

effectiveness of the bail-in tool. This consists of the ability to absorb losses to a level necessary to restore the entity's CET1 ratio and the conditions for authorization and to continue to carry out the activities for which it is authorized as well as to sustain sufficient market confidence in the institution[39]. The MREL must be "calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institutions". Where the resolution plan envisages the potential exclusion of liabilities or of a class of liabilities from bail-in pursuant to Article 27 (5) SRM Regulation, it is provided that the MREL has to be reached taking into account other eligible liabilities of the institution, having regard to the need that the losses are absorbed to the required level[40]. In this fashion the MREL discipline caters for the need of resolution plans to lay down credible and feasible resolution strategies that can be easily and swiftly implemented, taking into account in particular the need to discourage a depositors' bank run and to maintain financial stability.

Another element impacting the application of the bail-in tool is the ranking of liabilities in insolvency, a matter left to national law and not harmonized at the EU level. The sequence of writedown and conversion set out in Article 48 BRRD expressly provides that when bail-in of CET1, AT1 and T2 instruments does not reach the necessary amount determined pursuant to Article 47 (3) BRRD, the resolution authority has to write down and convert to the extent necessary firstly subordinated debt and thereafter the other eligible liabilities in accordance with the hierarchy of claims in normal insolvency proceedings. This implies that bail-in of eligible liabilities after the writedown and conversion of shares or other instruments of ownership and relevant capital instruments partly depends on the policy choices enshrined in the national insolvency law. Not surprisingly, certain Member States have taken the opportunity to amend the existing ranking with a view to influencing the bail-in waterfall. Worthy of notice is the German law on the adaptation of the resolution mechanism to the SRM (*Abwicklungsmechanismusgesetz*); this provides for statutory subordination of certain senior unsecured debt instruments issued by the financial institution, which will rank junior to other liabilities such as interbank deposits, corporate deposits, money market instruments, certain claims under derivative transactions and structured notes with derivative-linked features. The purpose of that regulatory choice is to make bail-in easier and resolution action more effective and credible, by focusing the bail-in power on the holders of such instruments and making the writedown and conversion of operational liabilities more remote. At the same time, this approach is meant to restrict contagion potential. In as much as introducing regulatory mechanisms to help remove the implied State guarantee, the German approach is a welcome solution that should prompt discussion at the EU level as to the opportunity to harmonize this part of the resolution action with a view to avoiding the fragmentation of the internal market for such debt instruments[41].

39 Article 12 (6), SRM Regulation. The need to sustain market confidence arguably includes, in addition to the restoration of CET1, also of capital buffers, see Article 3 (7) of the EBA Consultation Paper on draft regulatory technical standards on minimum requirements for own funds and eligible liabilities (EBA/CP/2014/41), available at www.eba.europa.eu.

40 Article 12 (6), second sub-paragraph, SRM Regulation.

41 See ECB Opinion on the draft German law of 2 September 2015 (CON/2015/31), para. 3.4.

The Italian law implementing the BRRD has also taken the opportunity to amend the ranking waterfall but for policy reasons partly different from the German law. The Italian law has created a new super-priority ranking for eligible deposits above €100,000 held by depositors other than those covered by Article 108 BRRD, thus making the possibility of them being bailed-in more remote[42]. The immediate policy goal pursued by the Italian legislator is therefore the protection of uninsured deposits, including those held by corporate clients, that do not match the requirements set out in Article 108 BRRD.

4.1 THE HORIZONTAL DIMENSION

The horizontal dimension of burden-sharing is typical of cross-border banking groups and is concerned with the jurisdictional allocation of the resolution costs. In the pre-BRRD context, experience shows that cross-border crisis management is a history of cooperation failures, ultimately leading to the public recapitalization of group entities along national borders regardless of the group business and operational model[43]. The presumption that national supervisors favor national champions and domestic interests versus foreign interests is hardly rebuttable. The widespread ring-fencing practices adopted by national authorities during the crisis confirm such a view, including the bias in favor of the protection of local creditors and of domestic financial stability. In the bail-out scenario, where public financing is at stake, international cooperation envisaging the taking into account of other countries' interests is very unlikely to succeed. The universalist approach laid down in Directive 2001/24/EC on the reorganization and winding-up of financial institutions ("Winding-up Directive"), which is centered on the home-State jurisdiction, has shown its shortcomings, among others, in the absence of a strong cooperation network with the authorities of the other Member States concerned and in the reluctance of the home authority to deal with issues outside its territory[44]. Undisputedly, principle-agent constraints between the authority and the State, as well as the obligation to pursue national interests, play a decisive role in cooperation failures. Sovereignty implies that no payment should be made for other States, unless financial stability or other compelling interests outweigh the costs of the intervention[45]. The same rationale underpins a part of the recent decision of the LG München of 8 May 2015 given in the Heta asset resolution case[46]. The court rejected the characterization of the Austrian special provisions on resolution of Hypo Alpe Adria purporting to protect Austrian national interests such as public finances, as mandatory rules ex

42 See D.lgs n. 181/2015, the law implementing the BRRD and amending the Testo Unico Bancario, Article 91(1) bis, lett. (a). This provides the new waterfall that is articulated as follows: (1) covered deposits, deposit guarantee schemes subrogating to the rights and obligations of covered depositors; (2) the part of deposits of individuals and SMEs eligible deposits exceeding €100,000 that fall within the scope of Article 108 BRRD; (3) the other deposits at the bank that therefore rank senior to the other unsecured creditors.

43 Charles Goodhart and Dirk Schoenmaker, "Burden sharing in a banking crisis in Europe", LSE Financial Market Group, Special Paper Series n. 164, March 2006.

44 See Anna Gardella, "Cross-border bank insolvency: private international law and State-aid rules" (2009) European banking and financial law journal (Euredia) 127.

45 Federico Lupo-Pasini, "International Coordination in Cross-Border Banks Bail-ins: Problems and Prospects" Eur Bus Org Law Rev (2015) 203.

46 On file with the author.

Article 9 (3) of Regulation (EU) No 593/2008 and therefore refused to give them cross-border effect on claims governed by German law (and German creditors), thus preventing the application of a haircut.

In the changed context of the bail-in scenario, it can be argued that international cooperation still remains critical to the success of an orderly resolution but has arguably more chances of succeeding because it is a process embodied in hard law, ie the BRRD, which envisages different phases including the draw up of group resolution plans and (ideally) the achievement of joint decisions in the course of such preparation so to build a common strategy and consensus. An important variable, however, is represented by the location of the holders of eligible liabilities, which might trigger protectionist/discriminatory behaviors amounting to cooperation failures. This part of the paper therefore intends to explore the interaction between bail-in and burden-sharing from the perspective of the allocation of resolution costs between the jurisdictions where the banking groups operate[47].

4.2 THE ARCHITECTURE OF THE HORIZONTAL DIMENSION IN THE EU REGIME

In light of the above remarks, it is worth exploring if and how the EU framework has remedied the inadequacies of the pre-existing regime. To remove any misunderstanding of quick and easy solutions, no mathematical formula is provided as regards the burden allocation among the jurisdictions concerned, and rightly so. This is something that cannot be done ex ante by statute without regard to the specificities of the financial institution and of the circumstances. Rather, the EU regime moves along two main directions relating to planning and in the implementation phase: firstly, it mirrors the FSB Key Attributes and lays down the two resolution strategies providing the blueprint for orderly resolution of cross-border banking groups; secondly it provides for the international administrative cooperation and institutional setting to ensure that the preferred resolution strategy is successfully implemented[48]. As it will be explained below, such institutional setting is more advanced among the EU area Member States where the Single Resolution Mechanism with the SRB at its center has been established. The architecture of the horizontal dimension is completed on top, at the international level, by the coordination of legal systems ensuring cross-border recognition of resolution actions. Central to the latter aspect is the Winding-up Directive – which has not been repealed by the BRRD and the SRM Regulation – providing the umbrella framework to ensure effectiveness of resolution actions. Critical to the design of the horizontal dimension as regards the coordination of the legal system is also the allocation of adjudicatory jurisdiction and the law applicable to the disputes, taking into account the high litigation rate connected to resolution actions and the potential impact on resolution costs.

47 Simon Gleeson, "Bank resolution and bail-ins in the context of bank groups", Law and Financial Markets Review (2012) 61.

48 On the interaction of resolution financing and cooperation, see Seraina Gruenenwald, "Inducing Cooperation Through the Back Door? The Case of Cross-Border Bank Resolution", available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2151789

4.3 RESOLUTION STRATEGIES: SPE AND MPE

The allocation of the resolution burden within a cross-border group is determined in the preparation phase through the choice of the resolution strategy to be outlined in the resolution plan[49]. This shall be implemented in the resolution phase, unless, taking into account the circumstances, the authorities assess that resolution objectives could be more effectively achieved through other resolution actions (Article 91 (6) BRRD). Along the lines of the FSB Key Attributes, the BRRD identifies two resolution strategies: the Single Point of Entry ("SPE") and the Multiple Point of Entry ("MPE").

The SPE is centered on the ultimate parent holding company and purports to direct the resolution action at that level without (supposedly) involving the lower levels of the corporate structure. One way of making it effective, is to locate eligible liabilities at the HoldCo level, so as to enable resolution without affecting the operations of the subsidiaries (OpCos). This entails an upstream of the losses to the parent level and close scrutiny of the group's liabilities structure with a view to ensuring that externally issued, easy to bail-in liabilities are available. The SPE strategy could be appropriate for highly interconnected and centralized managed banking groups. The success of the strategy, however, relies, among other things, on the availability of sufficient eligible liabilities at the top level, the upstream of losses from the subsidiaries, the recapitalization of the distressed subsidiary and the ability to maintain critical functions. In as much as is directed only at one level of the corporate chain, this resolution strategy could restrict, though not exclude, cross-border aspects of resolution. The location of creditors and the law applicable to the bail-inable liabilities are all elements to be taken into account and that may affect the reach of the resolution authority's action. From a jurisdictional perspective, the SPE strategy is reminiscent of the universalist approach, since the focus is on the home State, even though, should resolution extend to the subsidiaries the resolution authority of the latter would be empowered to take the relevant decisions.

The MPE strategy takes a fragmented "territorial" approach, envisaging resolution actions to be taken in respect of subsidiaries in different jurisdictions. This strategy is more appropriate for less integrated banking groups without a centralized operational organization, the entity of which can therefore be independently resolved. In light of these reasons and of the lesser integration of the banking group, this strategy is arguably less prone to triggering contagion.

Impediments to the implementation of the preferred resolution strategy have to be addressed at the planning stage by the resolution authority. A potential issue to a credible and feasible plan may be represented by the presence of a large amount of liabilities governed by a third-country law. Whilst the BRRD does not exclude them from the MREL, the resolution authority must be satisfied that they can be easily bailed-in, for instance because they include the contractual recognition

49 Jens-Hinrich Binder, "Resolution planning and Structural Bank Reform within the Banking Union", SAFE Working Paper Series, SAFE Working Paper No. 81 (2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2540038

clause. Should this not be the case, it could be argued that the resolution authority could address the issue by limiting the amount of debt issued under a third-country law, as part of its remit to address and remove impediments to resolution.

As specifically regards the implementation of the SPE, potential obstacles to the feasibility and credibility of the strategy may arise from the corporate structure of the banking group, in particular in those jurisdictions where there is no holding company at the parent level where externally issued eligible liabilities are expected to be concentrated. In such cases there is a risk that senior unsecured creditors like a bank's bondholders would rank equally with other senior unsecured creditors that should also be bailed-in to comply with the *pari passu* principle, making the implementation of the resolution strategy without negative spill-overs and contagion effects more difficult. These considerations actually underpin the German approach to MRELs and the introduction of statutory subordination, which is supposed to work as a functional equivalent in order to make bail-in easier. As underscored by the ECB Opinion on the draft law, however, some aspects might be worth additional consideration including the impact on the market (price and volume effects) and the cross-border and potential conflict-of-laws issues.

4.4 INTERNATIONAL ADMINISTRATIVE AND INSTITUTIONAL COOPERATION

To revert past records of cooperation failures and of lack of burden-sharing policy at the international level, the EU regime has significantly focused on laying down a framework of international administrative cooperation between the relevant resolution authorities[50]. This approach has been further stepped up by the establishment of the SRM as the second Pillar of the Banking Union, moving from cooperation networks to institutionalized cooperation. Both modalities co-exist in the EU regime, depending on the geographical location of the group entities. So long as they are exclusively concentrated in the euro area, cooperation is governed by the SRM Regulation; where the group is established in both the euro area and the non-euro area jurisdictions, or entirely in non-euro area jurisdictions, cooperation takes place in resolution colleges. To the list of cooperation modalities, Crisis Management Groups should be added for those financial groups established also in non-EU countries.

The institutionalized cooperation with the SRM framework is the strongest existing model for cross-border resolution that, similarly to the SSM, revolves around the relationships between a centralized authority – the SRB – and the national resolution authorities. In a nutshell, decisions are taken at the EU level according to a more or less complex procedure, depending on whether the decision relates to the preparatory phase, such as the approval of the resolution

50 Jens-Hinrich Binder, "Cross-border coordination of bank resolution in the EU: all problems resolved?" (2015) available at www.ssrn.com; Anna Gardella, "Aspetti cross-border della risoluzione", forthcoming in Anna Gardella, Antonella Sciarrone Alibrandi, *La disciplina europea delle crisi bancarie* (Giuffré 2015). On cross-border cooperation in the context of recovery plans, see Valia SG Babis, "European Bank Recovery and Resolution Directive: Recovery Proceedings for Cross-Border Groups" Eur Bus Law Rev (2014), 459.

plan, or to the execution phase, such as the adoption of the resolution scheme[51]. The decisions relating to the preparatory phase involve the SRB in its executive session composition, including the Chair and the four full-time members of the Board mentioned in Article 43 (1) (b) of the SRM Regulation, and the representative of the national resolution authorities concerned. The procedure for the adoption of the resolution scheme in the resolution phase provides for additional steps, in particular for the scrutiny of the Commission, empowered with raising objections and requesting amendments binding upon the SRB, and the potential involvement of the Council should the Commission propose to object to the meeting of the public interest as one of the conditions for resolution or to object to or approve a material modification of the amount of the contribution of the SRF (Article 18 (7) SRM Regulation). Once the decision is taken at the EU level, national resolution authorities are in charge of their implementation at the national level and will receive instructions from the SRB. Notwithstanding decision-making complexities, this is the most advanced form of cooperation, taking into account that the joint decision-making process is compulsory and that national resolution authorities cannot decide independently. This scenario is expressly excluded from the SRM framework where, should no consensus be reached within the SRB executive session between the Chair, the four Board members and the representatives of the resolution authorities concerned, it is provided that the Chair and the four Board members take the relevant decision by simple majority (Article 55 SRM Regulation).

Resolution colleges are the network cooperation modality envisaged by the BRRD, borrowing on the supervisory colleges set out in Directive 2013/36/EU ("CRD IV"), to be set up by the group-level resolution authority for those institutions established both in participating and non-participating Member States or exclusively in more than one non-participating State. Resolution colleges provide the relevant resolution authorities with a forum for meeting and discussion of resolution-related issues. The BRRD framework provides for various joint decisions to be taken within the college between the resolution authorities as regards group resolution, in particular the assessment of resolvability, the preferred resolution strategy, MRELs and the group resolution plan. Unlike the SRM framework, should resolution authorities not agree on a joint decision, a significant role is entrusted to the EBA to act as mediator among the authorities concerned. Such mediation may take the form of conciliation (Article 31 (c) of Regulation 1093/2010/EU establishing the EBA), where the EBA acts as a facilitator and is aimed at reaching an agreement between the authorities concerned, or as a binding mediation in accordance with Article 19 of Regulation (EU) No 1093/2010, whereby the EBA's decision concluding the procedure is binding upon the authorities. The system, however, is not as solid as it would be desirable and has scope for improvement in order to strengthen EU cooperation.

51 Danny Busch, "Governance of the Single Resolution Mechanism", in Danny Busch and Guido Ferrarini, *The European Banking Union* (OUP 2015), Chapter 13; Eddy Wymeersch, "Banking Union: Aspects of the Single Supervisory Mechanism and the Single Resolution Mechanism Compared", ECGI Law Working Paper No. 290/2015; Mauro Grande, "Il Meccanismo di risoluzione unico: aspetti istituzionali e operativi", forthcoming in Anna Gardella and Antonella Sciarrone Alibrandi nt. above.

Firstly the EBA's mediation role, both binding and non-binding, may be carried out by the EBA only upon request of one of the authorities involved and not on its own initiative; secondly, certain matters are excluded from the reach of EBA binding mediation in particular in light of fiscal budget constraints, binding mediation cannot be conducted in order to reach a joint decision on the group resolution scheme, with the consequence that if no agreement is reached via the EBA conciliation, resolution authorities are in principle free to act independently. To avoid major adverse consequences, in these circumstances the BRRD requires that "resolution authorities shall cooperate closely within the resolution college with a view to achieving a coordinated resolution strategy for all affected group entities" (Article 92 (7)).

4.5 LEGAL COORDINATION AND RECOGNITION OF RESOLUTION ACTIONS

The third element shaping the architecture of the horizontal dimension of burden-sharing is legal coordination and recognition of resolution actions which posits on top of the two previous pillars with a view to ensuring cross-border effectiveness and enforcement of resolution decisions.

This element builds on the Winding-up Directive, which has been amended by Article 117 of the BRRD in order to include the resolution tools and the exercise of resolution powers within the definition of the reorganization measures laid down in Article 2 of that Directive. As a consequence, the adoption of resolution actions and the exercise of resolution powers will be covered by mutual recognition and will be "fully effective in accordance with the legislation of [the home] Member State throughout the Community without any further formalities" (Article 3, second sub-paragraph of the Winding-up Directive).

This framework is further completed and cooperation strengthened by the setting up of additional coordination requirements, in particular as regards resolution actions entailing transfers. For this purpose, the BRRD provides for support obligations, assistance and isolation from external legal interference (Article 66 (1)-(3)). Member States other than that of the resolution authority have to ensure that the transfer of shares, assets or rights that are located in that Member State or under the law of which the transfer ordered by the home resolution authority must be carried out, has effect in or under the law of that State. In the same spirit of coordination, it is also provided that Member States shall provide all reasonable assistance to the resolution authority of the other Member State to ensure that the transfer is effective under the applicable national law. Lastly, the BRRD isolates the resolution action taken by the resolution authority entailing transfers from potential impediments, such as prevention, challenges or setting aside by the concerned shareholders, creditors and third parties, on the basis of the law where the assets are located or the law governing such assets. Paragraph (6) of the same provision goes even further by expressly providing that the right of (a) "shareholders, creditors and third parties to challenge, by way of appeal pursuant to Article 85, a transfer of shares, other instruments of ownership assets, rights or liabilities"; as well as the right of (b) creditors "to challenge, by

way of appeal pursuant to Article 85, the reduction of the principal amount, or the conversion, of an instrument or liability" has to be determined in accordance with the law of the home resolution authority.

The relationship between the automatic effect of resolution tools and exercise of resolution powers in accordance with the definition of resolution measures set out in the amended Winding-up Directive and the specific provisions laid down in Article 66 BRRD may be worth further consideration in light of recent case law. In *Goldman Sachs v. Novo Banco*[52], relating to the recognition of acts taken by the Bank of Portugal in the course of the resolution of Banco Espirito Santo, the High Court took a restrictive reading of mutual recognition of resolution decisions whose consistency with the Winding-up Directive may be disputable. It is not fully clear from the decision whether this approach is due to the specific circumstances of the case, prompting to focus only on Article 66 BRRD, or whether it will set a judicial precedent.

52 [2015] EWHC 2371 (Comm).

BANK STAKEHOLDERS' MANDATORY CONTRIBUTION TO RESOLUTION FINANCING: PRINCIPLE AND AMBIGUITIES OF BAIL-IN

CHRISTOS HADJIEMMANUIL[1]

1 BANK RESOLUTION POLICY IN THE WAKE OF THE GLOBAL FINANCIAL CRISIS

The establishment of special resolution regimes ("SRRs") for banking institutions constitutes a central plank of the post-crisis regulatory agenda.[2] In sharp contrast to the past, when most countries lacked specialized legal frameworks, or even clearly defined principles, for handling the failure of banking institutions, current regulatory thinking is premised on the belief that a state's ability to respond to failures of large and/or systemically important banks in an effective and orderly manner depends on the availability of special legal tools and procedures. These must be able to ensure continuity in the performance of failed banks' critical financial intermediation functions: that is, to preserve those operations and transactions whose interruption could have negative repercussions for the wider financial system or the real economy ("open bank" resolution).

Up till now, this objective was typically attained by means of state-financed bailouts; these prevented the collapse of troubled banks, thus preserving operating continuity and avoiding contagion and systemic crises. Bailouts, however, transfer the costs of failure from the failed banks' immediate stakeholders (and more specifically, its liability holders, including depositors, and possibly equity holders too) to the taxpayer. This has major implications for the banking market's incentive structure. In particular, if, based on past experience or governmental declarations of intent, banks' liability holders are convinced that, in the event of bank failure, the state will come to the rescue, they will tend to discount the risk of default on their claims and will, accordingly, relax their monitoring efforts. For the same reason, the wider market for loanable funds will fail to properly and fully incorporate in interest rates and bond prices perceived differences in individual banks' risk profiles. Instead, a bank's relative funding costs will tend to depend on the likelihood that it will be bailed out if in trouble. This leads to the well-known "too-big-to-fail" ("TBTF") problem, whereby large banks (which due to their size and systemic importance are almost certain to be supported by

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2 See Christos Hadjiemmanuil, "Special Resolution Regimes for Banking Institutions: Objectives and Limitations", in Wolf-Georg Ringe and Peter M Huber (eds), *Legal Challenges in the Global Financial Crisis: Bail-Outs, the Euro and Regulation* (Oxford & Portland, Oregon: Hart Publishing, 2014), at 214–217; Thomas F Huertas, *Safe to Fail: How Resolution Will Revolutionise Banking* (Basingstoke & New York: Palgrave Macmillan, 2014).

the state) gain a significant competitive advantage in terms of financing costs in comparison to smaller banks (as to which the extension of support is not assured).[3] In the manner described above, traditional bank crisis management practices, which relied implicitly on discretionary bailouts of failed banks, resulted in inappropriate incentives, implicit subsidies to risk-taking by banks and distortions to competition. They also generated major fiscal risks, since bailouts often require enormous amounts of funding. Indeed, the recent crises in a number of euro-area crises, including Ireland, Spain and Cyprus, have shown that the fiscal costs of bailouts may be prohibitive, with deleterious consequences, both for the state (whose own fiscal sustainability can be undermined by its implicit commitment to stand behind the domestic banking sector) and for the banks themselves (whose survival in times of systemic crisis may come to depend precisely on the existence of a credible state guarantee).

The need to restore market discipline, avoid moral hazard in the banking field and protect the state's fiscal position points to the second facet of recent SRRs, namely, their insistence that the financial burden of resolution actions should fall to the maximum extent possible on the private sector, that is on the failed banks' own stakeholders or, if this not possible, on the banking industry as a whole, in the form of contributions by industry-funded deposit insurance schemes and/or resolution funds. In contrast, the state's contribution to resolution financing, and the attendant exposure of taxpayers to the risk of loss, should be kept at a strict minimum, with fiscal resources being available only as an ultimate "backstop", or last resort, in totally exceptional cases.

Thus, the SRRs that various countries have enacted following the Global Financial Crisis[4] are characterized by this dual concern: how to organize resolution in an orderly and predictable way so as to avoid systemic disruption, without, however, shifting the costs of failure to taxpayers. Sharing common understandings on the ways in which these objectives can be pursued, the national SRRs display many technical similarities.[5] To a large extent, they build on global standards,

3 For a review of the literature on TBTF, see Philip E Strahan , "Too Big to Fail: Causes, Consequences, and Policy Responses", (2013) 5 *Annual Review of Financial Economics* 43–61.

4 Starting in the UK, with the Banking Act 2009; and Germany, with Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz) vom 9. Dezember 2010, BGBl. 2010, I, 1900. For a brief description of the German statute in English, see Barbara Jeanne Attinger, "Crisis Management and Bank Resolution: Quo Vadis, Europe?", *ECB Legal Working Paper* No 13 (December 2011), 28–34.

5 Many technical aspects of post-crisis SRRs have their origins in earlier American resolution policy; Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), PL 102-242, 105 Stat 2236. But this does not apply to the financing aspects of resolution and, more specifically, to bail-in, which constitute drastic policy innovations.

developed by the Basel Committee on Banking Supervision ("BCBS")[6] and, primarily, by the Financial Stability Board ("FSB").[7]

2 EUROPE'S NEW BANK RESOLUTION REGIME: THE BRRD

In the European Union, a harmonized framework for the recovery and resolution of weak or failed banks was proposed in 2012 and finally adopted in 2014 in the form of the Bank Recovery and Resolution Directive ("BRRD").[8] The BRRD is already in force, although the full effect of Europe's new SRR will only be sensed from 1 January 2016 onwards.[9]

In so far as credit institutions, investment firms and entities belonging to banking groups are concerned,[10] the BRRD pre-empts the application of general corporate insolvency law or replaces pre-existing national systems of special bank insolvency law. Based on a purely administrative approach, it largely excludes courts from the resolution process, which are instead entrusted to administrative resolution authorities. These are vested with a wide array of powers[11] and a set

6 The BCBS had developed common resolution concepts and principles as early as 2002; BCBS, "Supervisory Guidance on Dealing with Weak Banks: Report of the Task Force on Dealing with Weak Banks" (March 2002), www.bis.org/publ/bcbs88.pdf, esp. section 6. See now BCBS, "Guidelines for Identifying and Dealing with Weak Banks" (July 2015), http://www.bis.org/bcbs/publ/d330.pdf, esp. section 7. Following the crisis, it took up additional work on the coordinated treatment of bank insolvencies with cross-border implications. This led to the publication of a list of ten recommendations, which, beyond the need for cross-national cooperation, also call for convergence of the underlying national resolution regimes and approaches; BCBS, "Report and Recommendations of the Cross-Border Bank Resolution Group" (March 2010), http://www.bis.org/publ/bcbs169.pdf; and BCBS, "Resolution Policies and Frameworks – Progress So Far" (July 2011), http://www.bis.org/publ/bcbs200.pdf.

7 FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (October 2011), www.financialstabilityboard.org/publications/r_111104cc.pdf; revised version (15 October 2014) http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf. These were part of a set of policy measures intended to ensure the resolvability of the world's largest financial institutions, the so-called "global systemically important financial institutions" ("G-SIFIs"), in a manner that puts an end to bailouts and the TBTF problem. Beyond their immediate concern with G-SIFIs, however, they serve as a global standard for regional and national SRRs. The "Key Attributes" have been endorsed by political leaders at the G20 level; G20, "Cannes Summit Final Declaration: Building Our Common Future: Renewed Collective Action for the Benefit of All" (4 November 2011), https://g20.org/wp-content/uploads/2014/12/Declaration_eng_Cannes.pdf, paras 28–29.

8 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 2014 L173/190.

9 The period for national transposition of the BRRD expired at the end of 2014 (although many Member States failed to meet the deadline). However, Member States were given discretion to postpone the entry into force of provisions implementing the BRRD's norms on the bail-in tool, which will be the focus of the present discussion, until 1 January 2016 at the latest. BRRD, Art 130(1).

10 The resolution regime's scope of application *ratione personae* is defined in BRRD, Art 1(1).

11 BRRD, Arts 59–72.

of very potent resolution "tools",[12] or statutorily defined resolution techniques, hitherto unknown in most European countries.

It is worth noting the BRRD also incorporates formally in the resolution regime the recapitalization of failed banks with public funds. In particular, it authorizes, in limited cases (to use the directive's wording, in the "very extraordinary situation" of a systemic crisis[13]) and under strict conditions, the extension by national governments of two forms of public financial assistance[14]: the public equity support tool, whereby the state injects capital into the failed bank[15]; and the temporary public ownership tool, whereby the state nationalizes the failed bank.[16] In this manner, the BRRD brings within the picture and regulates through binding legal provisions the conditions for bank bailouts – a type of governmental action which up till now took place on a fully *ad hoc* basis, subject only to the need to respect European state-aid norms.[17]

The BRRD's tools and procedures will be applied in a decentralized manner, with individual countries retaining responsibility for the resolution of their domestic banks, in accordance with the well-established principle of home-country control. For this purpose, each Member State must appoint a resolution authority to carry on resolution actions in accordance with the domestic implementing legislation. This means that the "common" SRR is subject to important national discretions (including in relation to the critical issue of the precise order of priority of claimants in a credit institution's insolvency). Within the narrower geographical confines of the euro area and its Banking Union, however, the resolution process will be unified to a much greater extent as a result of the establishment of a Single Resolution Mechanism (SRM),[18] which entails a common decision-making framework for the main resolution actions, with a supranational body, the Single Resolution Board (SRB) serving as the central resolution authority.[19]

12 BRRD, Arts 37–55.
13 BRRD, Art 37(10).
14 Arts 37(10) and 56–58. In addition to these "government stabilization tools", which may be employed in support of failed banks, the BRRD also authorizes the extension of "extraordinary public financial support" in various forms (including by way of recapitalization with public funds) to solvent banks, if this appears necessary in order to prevent or contain a wider financial crisis; but in this case the support may only be extended to solvent banks and should be of a "precautionary and temporary" nature. BRRD, Art 32(4)(d).
15 BRRD, Art 57.
16 BRRD, Art 58.
17 The applicability of the Union's state-aid framework to bank bailouts was recognized unambiguously in Commission Decision 95/547/EC of 26 July 1995 giving conditional approval to the aid granted by France to the bank Crédit Lyonnais, OJ 1995 L308/92.
18 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 2014 L225/1 ("SRM Regulation").
19 The SRM is supported by common financial arrangements in the form of a Single Resolution Fund (SRF) (but not by common deposit guarantee arrangements, since the system of separate national deposit-guarantee schemes continues). However, the SRM does not lead to full unification of the resolution process, since the euro area's national resolution authorities retain certain responsibilities within the system, while the implementation of resolution action continues to be conducted in accordance with the national legal provisions applicable to each bank by reason of its nationality.

The BRRD enumerates four resolution tools, which the resolution authorities must be able to utilize separately or in combination: the sale of business tool, the bridge institution tool, the asset separation tool and, last but not least, the so-called "bail-in" tool.[20] The sale of business tool permits the forcible transfer to a third-party acquirer, by way of a sale conducted on commercial terms, either of the ownership of the failing bank's legal person or of its ongoing business in whole or in part (including assets and rights as well as liabilities).[21] The transfer is decided by the resolution authority without obtaining the consent of the failing bank's existing shareholders or any other stakeholder, and without complying with any procedural requirements under company or securities law,[22] thus avoiding delays and, most importantly, strategic behavior on the part of the old stakeholders, who might otherwise withhold their consent as a means of exerting pressure for an alternative offer that would be more advantageous to themselves. Where an appropriate acquirer cannot be found immediately, the bridge institution tool[23] enables the resolution authority to transfer ownership either over the failing bank itself or of the whole or part of its business to a special institution operating under the resolution authority's own control, so as to ensure continuity of operation and maintain critical functions pending a final retransfer of the bank or its assets to the private sector. Whenever either of these tools is used to transfer only part of the failed bank's business (as will often be the case), the old legal person with its residual estate must be wound up by way of normal insolvency proceedings.[24] As for the asset separation tool,[25] this can be used only jointly with (and effectively, in support of) another resolution tool. The asset separation tool is designed to avoid an immediate forced sale of the failed bank's portfolio of impaired assets, which may cause grave further losses; instead, the substandard portfolio is transferred to an asset management vehicle, which will seek to maximize its overall liquidation value through an orderly realization or collection process (which may include the runoff of the portfolio).

The BRRD's fourth and final resolution tool, the bail-in tool,[26] empowers the resolution authorities to force a failing or failed bank's immediate stakeholders (specifically, its shareholders and certain, but not all, creditors) to contribute to the financial cost of resolution through a writedown or conversion of their claims

20 BRRD, Art 37(3)–(5).
21 BRRD, Arts 38–39.
22 BRRD, Art 38(1), second subpara.
23 BRRD, Arts 40–41.
24 BRRD, Art 37(6).
25 BRRD, Art 42.
26 BRRD, Arts 43–55. For early legal commentary on bail-in (including the provisions of the draft and final BRRD), see: Simon Gleeson, "Legal Aspects of Bank Bail-Ins", *LSE Financial Markets Group Special Paper* No. 205 (January 2012); Seraina Neva Grünewald, *The Resolution of Cross-Border Banking Crises in the European Union: A Legal Study from the Perspective of Burden Sharing* (Alphen aan den Rijn: Wolters Kluwer, 2014), at 42–45; Dirk H. Bliesener, "Legal Problems of Bail-ins under the EU's Proposed Recovery and Resolution Directive", Andreas Dombret and Patrick S. Kenadjian (eds), *The Bank Recovery and Resolution Directive: Europe's Solution for "Too Big To Fail"?* (Berlin & Boston: De Gruyter, 2013), 189–227; Patrick S. Kenadjian, "CoCos and Bail-Ins", in Dombret and Kenadjian, op. cit., 229–257; and Bart P.M. Joosen, "Bail In Mechanisms in the Bank Recover and Resolution Directive", paper presented at the Netherlands Association for Comparative and International Insolvency Law Annual Conference (6 November 2014), http://ssrn.com/abstract=2511886.

against the bank. Bail-in is thus designed to provide an innovative and drastic response to the problem of resolution financing. At the same time, it is meant to strengthen market discipline by abolishing the public subsidy that banks' stakeholders enjoyed in the past as a result of bailouts.[27]

Beyond the BRRD, a full appreciation of bail-in and its precise role in European resolution policy would require an examination of three other European legal instruments, namely, the Commission's communication of 2013 on state-aid measures in support of banks,[28] and, in so far as the Banking Union is concerned, the SRM Regulation[29] and the ESM's DRI Guideline.[30] These instruments set relevant parameters, in particular with regard to the interrelationship between bail-in and the potential financing contributions of industry-funded resolution funds, on the one hand, and of states in the form of the government financial stabilization tools envisaged by the BRRD, on the other hand. They are of little relevance, however, for the topics of the present discussion, which is not intended to provide a detailed presentation of the provisions of European law affecting bail-in.[31]

For the same reason, the discussion will also eschew, among other things, any analysis of the formidable technical difficulties that the application of bail-in in relation to domestic and, especially, cross-border banking groups might involve – a particularly significant issue, since almost all systemically important banks are organized as groups of companies rather than as single-entity credit institutions.[32] It will, instead, be restricted to highlighting certain general aspects of the new tool, namely:

27 Other provisions of the BRRD seek to restore discipline by expelling the key decision-makers of the failed bank from its surviving part or successor entity. Thus, the commencement of resolution actions triggers the removal of the old board of directors and senior managers, unless their retention is considered necessary for the achievement of the resolution objectives; and the resolution authorities can exercise control over the institution under resolution with all the powers of its shareholders and management body: BRRD, Arts 34(1 (c) and 63(1)(b).

28 During the Global Financial Crisis, the requirement for prior approval of the state-aid element inherent in any bailout turned the Commission's Directorate-General for Competition into the key arbiter of national bank-rescue programmes. It also led to the adoption by the Commission of a series of communications, setting out its general policy for the evaluation of proposed state-aid measures relating to the banking sector. The matter is currently governed by the seventh such communication, which was issued in July 2013. "Communication from the Commission on the application from 1 August 2013 of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication')" (2013/C 216/01), OJ 2013 C216/1.

29 In particular, SRM Regulation, Arts 12, 17, 18(6), 20, 22(2), 27 and 76(1).

30 ESM, "Guideline on Financial Assistance for the Direct Recapitalisation of Institutions" (8 December 2014).

31 On the relationship between the BRRD and the other three instruments, see René Smits, "Is My Money Safe at European Banks? Reflections on the 'Bail-In' Provisions in Recent EU Legal Texts", (2014) 9 *Capital Markets Law Journal* 137–156; and Stefano Micossi, Ginevra Bruzzone and Miriam Cassella, "Bail-in Provisions in State Aid and Resolution Procedures: Are They Consistent with Systemic Stability?", *CEPS Policy Brief* No 318 (21 May 2014).

32 See Federico Lupo-Pasini and Ross P. Buckle, "International Coordination in Cross-Border Bank Bail-ins: Problems and Prospects", (2015) 16 *European Business Organization Law Review* 203–226.

– the underlying philosophy of bail-in and its relation to standard theories of insolvency law (section 3);

– the limited and potentially discretionary scope of bail-in as operationalized in the BRRD (section 4);

– the tension between the bail-in tool and the protection of stakeholders' rights in accordance with general principles of insolvency law (section 5); and

– the implausibility of the claim that bail-in will relegate discretionary bank bailouts to the ash heap of history, as some people seem to think (section 6).

3 BAIL-IN FROM AN INSOLVENCY-LAW PERSPECTIVE

Up to a certain point, the introduction of special norms of bank insolvency law can be justified on merely technical grounds. In other words, even if one assumes that bank insolvency shares the same objectives and principles with the general system of corporate insolvency, the unique characteristics of banking institutions arguably necessitate different procedural solutions.[33] Thus, the collective proceedings of general corporate insolvency may be unsuitable for the handling of bank failures due to their exceedingly long time frame and procedural strictures. Moreover, being court-based, they do not provide opportunities for cross-border coordination, as necessary for handling effectively the failure of an international bank. And they certainly render redundant the prior planning of recovery and resolution actions on the part of regulators, since there can be no certainty that, following failure, the insolvency court will give effect to their plans.[34] From this angle, an SRR can be seen as a superior means of achieving in the banking field the usual objectives of insolvency law, such as ensuring an orderly approach and and/or maximizing the value of the insolvent estate for the benefit of existing creditors.

According to the dominant theory of insolvency law, the creditors' bargain theory,[35] the institutions of insolvency provide a solution to collective action

33 See, e.g. Eva Hüpkes, "Insolvency: Why a Special Regime for Banks?", in IMF Legal Department, *Current Developments in Monetary and Financial Law*, Vol 3 (Washington, DC: International Monetary Fund, 2005); Tobias MC Asser, *Legal Aspects of Regulatory Treatment of Banks in Distress* (Washington, D.C.: IMF, 2001), 94–118, 155–166; and IMF and World Bank, "An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency" (17 April 2009), 18–19.

34 Paul Tucker, "The Resolution of Financial Institutions without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations", paper presented at the European Summer Symposium in Economic Theory, Gerzensee, Switzerland (3 July 2014), http://www.cepr.org/sites/default/files/events/papers/6708_TUCKER%20Essay.pdf, at 4–5.

35 Thomas H Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain", (1982) 91 *Yale Law Journal* 857; Douglas G Baird and Thomas H Jackson, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy", (1984) 51 *University of Chicago Law Review* 97–130; Thomas H Jackson, *Logic and Limits of Bankruptcy* (Cambridge, Mass.: Harvard University Press, 1986). See also the contributions in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge: Cambridge University Press, 1996), esp. Pt II.

problems, which are inherent in the creditors' attempts to realize the common pool of assets of the insolvent estate. The collective proceedings seek, in particular, to prevent a value-destroying race for the assets between the individual creditors. The same logic applies to certain closely related pre-insolvency procedures for the reorganization of distressed enterprises through the restructuring of their obligations (such as voluntary schemes of arrangement) when these can achieve restructuring on the basis of (super)majority voting, thus overriding opportunistic holding-out by particular creditors.

Of course, SRRs do not abandon the objective of estate-value maximization, which in many cases is achieved more effectively through going-concern reorganization of the existing legal person and, when this does not work, through its orderly liquidation, which may involve the separation and sale of its viable parts as operating units. This, indeed, is one purpose of "open-bank" resolution. Techniques of open-bank resolution essentially identical to those set out in the BRRD – that is, "purchase and assumption" ("P&A") transactions analogous to the sale of business tool, bridge banks and "bad banks", which in in the BRRD go under the "asset separation" moniker – have been used for some time in the US and to a lesser extent elsewhere, including with a view to maximizing value by avoiding piecemeal liquidation and preserving the failed banks' franchise value. The maximization of the failed bank's estate value may also serve to contain the losses of the relevant deposit insurer, who may thus choose to support financially the open-bank solution as the "least costly" alternative. But these considerations are still compatible with the basic understandings of general corporate insolvency and its orientation towards the protection of private rights and interests.

This, however, is not the whole story. SRRs – at least those of recent vintage, such as the BRRD – are not confined to offering technically superior solutions to the problems of insolvency law. They have much wider, public objectives, which shift drastically the focus from the balancing of stakeholders' interests to the systemic implications of bank failure (that is, on an externality). Thus, as we have seen, their primary objectives are the protection of financial stability and the uninterrupted provision of critical credit and payment services to the economy.[36] Significantly, to achieve these objectives, SRRs are willing to bypass or disregard basic assumptions and limitations of the general insolvency system. This tendency is more pronounced in the case of the bail-in tool than of the BRRD's other resolution tools. The latter take for granted the funding structure of the failed bank and respect the form of the various stakeholders' claims. In contrast, the way in which bail-in operates marks a rather decisive departure from private law's common assumptions regarding the respective roles of shareholders and debtholders in a distressed business enterprise. In this sense, bail-in has unusual, and very interesting, implications from the viewpoint of private rights and their articulation in insolvency law.

Keeping a loss-making bank, with potentially negative net worth, going will typically require an injection of new funds. As already discussed (section 1), traditionally this could be achieved only voluntarily or by means of a publicly financed bailout; but the Global Financial Crisis has proven conclusively that

36 cf BRRD, Art 31(2).

bank bailouts, in addition to their other defects, can have disastrous fiscal consequences. As a result, the search for alternative solutions to the problem of resolution financing has become a top policy concern.

The bail-in tool responds to this concern in a novel and ambitious way.[37] It seeks to return the failed bank, or its surviving part, to full solvency and financial viability[38] without recourse to outside funding. For this purpose, it combines in a distinctive mix three distinct ideas: the internalization of the costs of failure by stakeholders; the mandatory aspect of liquidation; and the drastic financial restructuring of the distressed enterprise. All of these can be found in general corporate insolvency law and/or pre-insolvency reorganization proceedings, but the second and the third do not normally coalesce.

The mandatory writedown or conversion of claims could be interpreted as a method for allocating to the failed bank's existing stakeholders past losses, despite the fact that the bank has escaped liquidation. From this perspective, bail-in would signify banking's renewed subjection to normal budgetary constraints and market discipline.

Seen as a form of reorganization proceedings, however, the mandatory character of bail-in has another function. It is designed to resolve the problem arising from the strategic behavior of stakeholders of failed banks (the shareholders, debtholders and, less directly, the directors, who can control corporate actions) as against the state, representing the taxpayers and the economy at large. When the stakeholders can reasonably expect that the state will be forced, or simply inclined, to provide support for reasons of systemic stability (or even for other reasons, e.g. political), they have an incentive to hold out, vetoing (or obstructing procedurally, if in control of the proceedings) the proposed reorganization plans, up to the point where they receive some benefit which improves their position substantially. The stakeholders become effective veto players who seek to gain a rent from the public in return for their consent; they thus manage to externalize their losses, occasionally in full, through a complete bailout.[39] Bail-in, being administration-based and mandatory, removes the veto power of stakeholders.

37 On the general case for bail-in and the specification of preconditions for its successful application, see Jianping Zhou, Virginia Rutledge, Wouter Bossu, Marc Dobler, Nadege Jassaud and Michael Moore, "From Bail-out to Bail-in: Mandatory Debt and Restructuring of Systemic Financial Institutions", *IMF Staff Discussion Note* No. SDN/12/03 (24 April 2012). For a rather sceptical approach, see Emilios Avgouleas and Charles Goodhart, "Critical Reflections on Bank Bail-ins", (2015) 1 *Journal of Financial Regulation* 3–29.

38 Evidently, in order to survive as an operating entity, in addition to its financial restructuring, the failed bank will also need to take steps to correct flaws in its organization and business practices, so as to avoid a repetition of past mistakes and a reversion to its previous loss-making condition. Accordingly, the BRRD provides that, when bail-in leads to the old legal person's recapitalization, it must draw up (within one month) and, following official approval, implement a suitable business reorganization plan. The resolution authority may appoint one or more persons for this purpose. The reorganization plan must be compatible with the restructuring plan submitted by the institution to the Commission for state-aid purposes. BRRD, Arts 51–52.

39 See Rolef de Weijs, "Too Big to Fail as a Game of Chicken with the State: What Insolvency Law Theory Has to Say About TBTF and Vice Versa", (2013) 14 *European Business Organization Law Review* 201–224.

Holding out is no longer possible – at least, not in a direct, procedural sense. There is no possibility for strategic behavior. Thus, bail-in allocates losses authoritatively to the stakeholders and impedes the externalization of burdens to taxpayers. In this way, it simultaneously serves two purposes: the protection of fiscal interests; and the restoration of market discipline.

Less commonly discussed is the fact that bail-in seeks to provide a solution to a problem unconnected to the bailout debate, namely, the sufficiency of the reorganization exercise. For a failed bank to survive as a viable entity, the absorption of past losses is not sufficient. To retain the confidence of the market and be able to resume normal business activity, it must further display a relatively high level of capitalization. This will also be necessary in order to meet the regulatory requirements. For this reason, bail-in is not limited to the absorption of past losses, but is also applied to recapitalize forcibly the institution, marshalling for this purpose liability holders' resources which are converted into equity. Note that such conversion may provide the only means of rebalancing the books and raising new private capital in the adverse environment of a systemic crisis, when external demand for new issues of capital instruments may be exceptionally weak. Bail-in is thus functionally equivalent to a US-style prepackaged bankruptcy, through which the lawful continuation of the banking business becomes possible following financial restructuring, thus avoiding a value-destructing piecemeal liquidation. The difference is that bail-in is externally mandated and does not require the majority consent of the classes of liability holders affected thereby. It is an effective method for avoiding the technical constraints of general company and insolvency law; but to the extent that it ignores the normal principles of insolvency law, it is bound up with issues regarding the protection of private rights (a point discussed in section 5).

The contribution of shareholders and eligible liability holders can be achieved either through a writedown of their claims or through the conversion of claims or debt instruments into equity either in the existing legal entity or in a bridge bank. Technically, in the BRRD's scheme the authorities' power to write down or convert capital instruments (meaning equity and any other instruments included in the definition of own funds,[40] some of which may be issued in the form of debt claims, e.g. perpetual and subordinated bonds) is treated separately[41] from the bail-in tool, that is, the power to write down or convert into equity the bank's liabilities.[42] But this is only due to the fact that the former power, though not the latter, can also be exercised by the resolution authorities without formally placing the ailing bank in resolution[43] – effectively, as an alternative, pre-insolvency intervention. Otherwise, however, it is almost impossible to treat the power to write down or convert capital instruments separately from bail-in, and "bail-in" will be used in the present discussion as a short form for the exercise of either power.

40 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 2013 L176/1 ("CRR"), Arts 25–91.

41 BRRD, Arts 59–62.

42 BRRD, Arts 43–55.

43 BRRD, Art 59(1).

It is envisaged that the bail-in tool will play a prominent role in future resolution actions. Any external contribution to the financing of resolution actions, whether this is ultimately borne by the private sector or by the state, should follow bail-in, in accordance with a prescriptive financing cascade. Specifically, under the BRRD's resolution regime:

- Whenever a bank fails, the possibility of liquidation (a procedure which does not raise the external financing issue) must first be considered. The BRRD emphasizes the "exceptional" character of resolution actions: an insolvent bank should normally be wound up by way of normal insolvency proceedings; it should be maintained as a going concern through the exercise of resolution powers and the application of resolution tools only if this appears advisable for financial stability purposes.[44]

- If winding-up is inadvisable for reasons of systemic stability, the failed bank's resolution (involving its continuation as a going concern, whether as a whole or in part, and whether by retaining the old legal entity, through a merger with another entity or through a bridge bank) must be financed to the extent possible from private sources, both internal (existing stakeholders of the bank) and external (willing acquirers and/or investors of new capital).

- In particular, existing stakeholders – namely, shareholders, junior creditors and, depending on the circumstances, even senior creditors and depositors with deposits in excess of the guaranteed amount of € 100,000 – are required to contribute to the absorption of past losses, as well as to the recapitalization of the open bank to a level sufficient to satisfy its minimum conditions for authorization, through the writedown of their equity and debt claims and/or the conversion of debt claims into equity (application of the bail-in tool).[45] The extent of writedown or conversion of claims will depend on the circumstances, but for each category of creditor included in the bail-in an upper limit is set by the principle that "no creditor shall incur greater losses than would have been incurred if the [bank …] had been wound up under normal insolvency proceedings" ("no creditor worse off" or "NCWO" principle).[46]

- In this context, the relevant national deposit guarantee scheme ("DGS") (a mechanism funded through levies on the banking industry, thus also a "private" source in a restricted sense) may be required to contribute to the financing of a member bank's resolution. However, its participation to open-bank resolution financing is limited to the amounts that it would be required to pay out to covered depositors, if the bank in question had been wound up under normal insolvency proceedings.[47] Thus, the NCWO principle applies to the DGS's participation in a similar manner as to creditors whose claims are included in the bail-in.

44 BRRD, rec (45)–(46).
45 BRRD, Arts 43(2)–(3), 44(1)–(3), 46–50.
46 BRRD, Arts 34(1)(g) and 74–75.
47 BRRD, Art 109.

- If the contributions of private parties are not enough, the appropriate national resolution fund or, for the countries of the Banking Union, the SRM's Single Resolution Fund (once more, a mechanism which is funded by the banking industry, therefore from a financing perspective as "private" as the DGS) can make a contribution, subject to strict conditions and up to a specific limit. Thus, the relevant resolution fund can only step in after a contribution amounting to no less than 8% of total liabilities (that is, liabilities including own funds) has been made by stakeholders other than covered depositors by way of bail-in.[48] In addition, the intervention is limited to medium-term financing of no more than 5% of total liabilities.[49]

- If a bank remains undercapitalized even after all the aforementioned sources of resolution financing have been exhausted (either because they were depleted, or because the limits on their contribution were reached), but its continuation as a going concern appears imperative for reasons of systemic stability, recapitalization with public funds (whether national or pan-European) may be considered.

While the resolution authorities have discretion to select the most appropriate method of resolution and to apply any of the resolution tools set out, the BRRD does not afford discretion as to the application of the burden-sharing cascade.[50] Accordingly, assuming that the legal prescriptions will be applied faithfully *ex post*, especially at a time of crisis, the cascade shifts the bulk of the burden from the taxpayer to the banks themselves, along with their investors and creditors.

4 AMBIGUITIES AND DISCRETIONARY ELEMENTS OF BAIL-IN IN THE BRRD

The principle of bail-in in the BRRD – just like the overall burden-sharing cascade – appears to be highly prescriptive, but the reality may prove to be more nuanced. Much may come to depend on the specific circumstances of each case. This is a typical characteristic of the BRRD and other recent SRRs, whose very detailed legal frameworks are not necessarily intended to establish hard rules or prescribe with precision the final outcomes of resolution actions, but to structure discretion and standardize the procedural framework by establishing the decision-making order and relevant considerations for official actions, while leaving substantial room to the relevant official decision-makers for *ex post* variation of the substantive choices.

Thus, the modalities of the bail-in tool in the BRRD set significant limits to its scope. They also introduce significant discretionary elements, which place in question its automaticity and uniformity of application. Of special interest in

48 BRRD, Arts 37(10)(a), 44(5)(a) and 44(8)(a); SRM Regulation, Art 27(7)(a). The 8% minimum ratio cannot include reductions in own funds reflecting historical losses, if these had been made prior to the bank's valuation for the purposes of the resolution process.
49 BRRD, Arts 44(5)(b) and 44(7).
50 This also applies to the resolution actions of the Banking Union's SRM.

this context are: the order of priority of claims in bail-in (that is, the sequence of writedown and conversion of various instruments); the exclusion from bail-in of certain liabilities, sometimes in general terms, but on other occasions on a discretionary, *ex post* basis; and the method of protection of the economic rights of a failed bank's existing stakeholders.

To start with, the sequence of writedown and/or conversion of claims in bail-in[51] largely respects the order of priority in insolvency (that is, follows the reverse order, moving from more junior to more senior instruments). Thus, capital instruments and eligible liabilities may be written down or converted in the following order:

– writedown of Common Equity Tier 1 items (including shares which have been issued as a result of the conversion of contingent convertible bonds, or 'CoCos', in accordance with their contractual terms, with such conversion taking place prior to the writedown);

– reduction through writedown or conversion of the principal amount of Additional Tier 1 instruments "to the extent required and to the extent of their capacity";

– reduction of the principal amount of Tier 2 instruments "to the extent required and to the extent of their capacity";

– reduction to the extent required of principal amount of subordinated debt that does not count as Additional Tier 1 or Tier 2 capital; and finally,

– reduction to the extent required of the principal amount of, or outstanding amount payable in respect of, the rest of eligible liabilities, in accordance with the hierarchy of claims in normal insolvency proceedings, including the new preferred rankings[52] of DGS-covered and non-covered retail deposits.

Within each class, losses must be allocated equally, by reducing the principal amount *pro rata*.[53] Resolution authorities may apply different rates of conversion of debt to equity to different classes of capital instruments and liabilities. However, the conversion rates must be set so as to provide appropriate compensation to the affected creditor; and in any event, the conversion rate applicable to senior liabilities must be higher than that applicable to subordinated liabilities.[54] The provisions also require that one class of liabilities may not be converted as long as another class that is subordinated to it remains substantially unconverted into equity or not written down.[55] Interestingly, however, the relevant qualification is "substantially", rather than "completely", as one should expect in accordance with the absolute priority rule of insolvency law. To increase certainty and

51 BRRD, Art 48(1).
52 BRRD, Art 108.
53 BRRD, Art 48(2).
54 BRRD, Art 50.
55 BRRD, Art 48(5).

uniformity of application, the European Banking Authority (EBA) is empowered to issue guidelines on certain aspects of the process, including the treatment of capital instruments and the setting of rates of conversion of debt instruments into equity.[56]

Importantly, of a failed bank's liabilities, not all are bail-inable. Certain critical provisions of the BRRD[57] exclude for bail-in, and thus protect from the normal course of loss absorption in accordance with the insolvency rankings, broad classes of liabilities. The BRRD mandates the exclusion of particular types of liability categorically. Other liabilities, whose contractual or transactional nature is not specified in the directive, may be exempted from bail-in on a discretionary basis *ex post*, that is, at the time of resolution, by the relevant resolution authority.

The BRRD-mandated exclusions[58] of Art 44(2) include:

– DGS-covered deposits;

– all secured liabilities, including covered bonds;

– client assets or client money, including assets or money held on behalf of undertakings for collective investments in transferable securities (UCITS) or alternative investment funds (AIFs), but only if these clients are protected under national insolvency law;

– liabilities arising by virtue of a fiduciary relationship, but only if the beneficiary is protected under national insolvency or civil law;

– interbank liabilities, excluding claims of entities within the same group, with an original maturity of less than seven days;

– claims to trading systems and their operators arising from the participation in such systems with a remaining maturity of less than seven days;

– claims of employees in relation to accrued salary, pension benefits or other fixed remuneration;

– claims of commercial or trade creditors arising from the provision to the bank of goods or services that are critical to the daily functioning of its operations;

56 BRRD, Arts 47(6), 48(6), 50(4). See currently the following EBA documents: "Consultation Paper: Draft Guidelines on the Treatment of Shareholders in Bail-in or the Write-Down and Conversion of Capital Instruments" (EBA/CP/2014/40), 11 November 2014); "Consultation Paper: Draft Guidelines on the Rate of Conversion of Debt to Equity in Bail-in" (EBA/CP/2014/39, 11 November 2014); and "Consultation Paper: Draft Guidelines Concerning the Interrelationship between the BRRD Sequence of Writedown and Conversion and CRR/CRD IV" (EBA/CP/2014/29, 1 October 2014), clarifying the interrelationship between the sequence in which liabilities should be written down or converted and the structure of own fund instruments in the CRR.

57 BRRD, Art 44(2)–(3).

58 BRRD, Art 44(2).

– tax and social security liabilities, if these are preferred under national law; and

– liabilities resulting from contributions to deposit guarantee schemes.

To these mandatory exclusions may be added certain discretionary ones. Thus, in so-called "exceptional circumstances", the national resolution authorities may decide to exclude totally or partially certain liabilities from bail-in if:

– it is not possible to bail-in such liabilities within a reasonable time notwithstanding the good-faith efforts of the resolution authority,

– the exclusion is strictly necessary and proportionate to achieve the continuity of the bank's critical functions and core business lines,

– "the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium-sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy", or

– bail-in of such liabilities would be value-destroying, thus imposing even higher losses on other creditors.[59]

In the event of a discretionary exclusion on such grounds, the level of writedown or conversion applied to other eligible liabilities may be increased, subject to the NCWO safeguard.[60]

It should be noted that it is precisely because of exclusions (whether mandatory or discretionary) that a need for external resolution financing may arise. The exclusions deplete the pool of resources available for loss absorption and recapitalization, while leaving an increased volume of liabilities behind. If all capital instruments and liabilities were fully subject to bail-in in accordance to their ranking, there would never be a need for external financing, because the pool of liabilities would be allowed to disappear to the degree necessary for ensuring a full absorption and internalization of losses. Liability holders would be treated in roughly the same way as in a normal liquidation. At the limit, old shareholders would be totally eliminated, while the former liability holders would be left, in strict accordance with their order of priority, with claims over a residual pool of assets – the equivalent of the dividend that they would receive in insolvency, albeit in non-monetized form. Of course, so robust an approach would be inconsistent with the public objectives of resolution. In a sufficiently deep insolvency, the old deposit-taking intermediary would have effectively disappeared. And resolution might have taken place in an orderly manner, but it could not achieve its stabilization and financial continuity objectives. In this

59 BRRD, Art 44(3).
60 BRRD, Art 44(3), second subpara.

sense, the protection of a large volume of claims is both a limit to bail-in and a condition for the successful completion of the resolution process.

Still, the fact of the matter is that exclusions reduce the potency of bail-in as a solution to the problem of resolution financing. They can leave a funding gap, which necessitates the intervention, first of the relevant resolution fund, and then of the state. The BRRD seeks to constrain reliance on these external, public sources of financing by insisting on bail-in of 8% of total liabilities, including own funds, before these other sources of funding can be called upon to contribute.

Even worse, discretionary exclusions of a potentially wide range of liabilities can turn bail-in into a largely optional tool, whose use and scope depends on the *ex post* evaluation of prevailing conditions in the financial and real economy. To constrain the discretion of national resolution authorities in this regard, the Commission is empowered to adopt delegated acts specifying the circumstances when exclusion is necessary on such grounds.[61] Moreover, a discretionary exclusion requires prior notification to the Commission and, if it leads to a funding gap that will need to be filled by the relevant resolution fund, may be opposed by the latter.[62] And the state-aid framework provides additional safeguards. However, the main issue is not one of national abuse of the system of discretionary exclusions, but the time-inconsistency of resolution policies. This affects the Commission as much as the national resolution authorities. Accordingly, the existence of discretions takes away the automaticity of bail-in and turns its applicability into an open question (to which we will return in section 6).

As for the mandatory exclusions of specified classes of liabilities, this is bound to lead to strategic behavior on the part of credit institutions and their liability holders, thus opening an important new chapter in the history of bank funding and regulatory dynamics. In particular, banks could seek to alleviate the burden by financing themselves to a much greater extent with non-bail-inable instruments. The mandatory presence of a sufficient volume of bail-inable liabilities in banks' balance sheets is thus a prerequisite for the successful operation of bail-in.[63] For this purpose, the BRRD introduces a minimum requirement for own funds and eligible liabilities ("MREL").[64] The MREL obliges credit institutions to meet, at all times, a minimum amount of own funds and eligible liabilities expressed as a percentage of their total liabilities and own funds. The MREL will be set separately for each credit institution, always in view of certain general criteria,

61 BRRD, Art 44(11). See currently EBA, "Technical Advice on the Delegated Acts on the Circumstances When Exclusions from the Bail-in Tool Are Necessary" (1 EBA/Op/2015/07, 6 March 2015).
62 BRRD, Art 44(12).
63 At the global level, the problem is addressed by the FSB's proposal for a "total loss-absorbing capacity", or "TLAC", requirement. FSB, "Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution: Consultative Document" (10 November 2014).
64 BRRD, Art 45.

which do not include, however, a numerical minimum level or default indicator.[65] In combination, the exclusion of certain types of liabilities and the MREL may lead to a bifurcated liability structure, with banks seeking to confine the issuance of bail-inable liabilities to the level necessary for meeting their specific MREL, while for the rest they prefer to finance their activities with non-bail-inable instruments.

A converse problem concerns the possibility that a high concentration of bail-inable instruments issued by a particular bank in the hands of another entity (such as a bank, financial institution, shadow bank or institutional investor) might lead to the collapse of that entity due to losses from holding the instruments, should the issuing bank fail, thus providing a channel of contagion. In order to ensure resolvability by way of bail-in without thereby engendering contagion, resolution authorities are authorized to limit the extent to which other institutions within the scope of the resolution regime, which do not belong to the same group, can hold the bail-inable liabilities of a particular institution or group.[66]

5 BAIL-IN AND STAKEHOLDERS' RIGHTS

In SSRs generally, and the BRRD specifically, the public interest (including in the stabilization of the financial system and the minimization of taxpayers' exposure to direct loss or mere financial risk) can trump the stakeholders' interests, especially by overriding their legitimate expectation to receive individually the maximum possible recovery rate. The bail-in tool, in particular, raises issues of equal treatment and protection of property rights, which go to the heart of private law and, in particular, the general principles of insolvency. At a limit, the tension between discretionary but mandatory bail-in and the private rights of stakeholders may raise questions relating to the violation by the state of fundamental rights of the stakeholders.[67] At a more prosaic level, however, the application of bail-in entails unavoidably substantive conflicts with legitimate private interests of the stakeholders affected thereby, as the latter are reflected in the principles and objectives of general insolvency law, including the absolute priority rule, which requires strict respect for the order of priorities, the principle of *pari passu* satisfaction within the same class, and the expectation that

65 BRRD, Art 45(2) and (6). The criteria are operationalized with the help of a regulatory technical standard ("RTS"), whose final draft has already been issued by the EBA: "EBA Final Draft Regulatory Technical Standards on Criteria for Determining the Minimum Requirement for Own Funds and Eligible Liabilities under Directive 2014/59/EU" (EBA/RTS/2015/05, 3 July 2015).

66 BRRD, Art 44(2), fifth subpara.

67 On potential tensions between bail-in and the right to property as enshrined in the ECHR, see Anna Gardella, "Bail-in and the Financing of Resolution within the SRM Framework", in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford: Oxford University Press, 2015), paras 11.24–11.32.

insolvency proceedings must ensure the maximization of payouts to stakeholders, always according to their rank.[68]

Of course, the general principles of resolution emphasize that shareholders bear first losses, adding that creditors bear losses after the shareholders in accordance with their order of priority, but recognize that this principle is bent in various cases where the Directive provides otherwise.[69] Moreover, the directive requires the "equitable", not equal, treatment of creditors of the same class; even this is subject to exceptions.[70]

The exclusion of many categories of liabilities is a significant source of tension between bail-in and private rights. In particular, the exclusions result in more lenient treatment of the liabilities covered thereby in comparison to the non-excluded ("eligible") liabilities of the same insolvency rank! This consideration applies with particular force to the *ex post* discretionary exclusion of certain liabilities. By nature, the exclusion of certain claims worsens the position of those left behind in a reduced pool of bail-inable liabilities. This violates both the *pari passu* principle and the recovery maximization objective of insolvency law. This consideration applies with lesser force to the mandatory exclusions. These may be seen as a pre-publicized modification of the order of priorities, which, having been promulgated in the form of legal provisions of general applicability, determines the private investors' decision-making horizon and defines in a stable way the content of their contractual rights.[71] In the special case of deposits, the BRRD reprioritizes the relevant claims in a direct and legally unexceptionable way, by introducing new mandatory preferences in favor of DGS-covered deposits, followed by non-covered deposits from natural persons and micro, small and medium-sized enterprises.[72]

Another tension relates to the ambiguity of the provisions governing the extent of inclusion in bail-in and relative treatment of various classes of claims.[73] The whole tenor of the provisions suggests that more senior claims can be written down or converted before junior ones have been extinguished completely, as the absolute priority rule would require. (Conversely, the provisions require a severe dilution of existing shareholders when bail-in is applied to a bank with positive

68 Such conflicts are a general trait of SRRs, due to their departure from normal insolvency norms and purely mandatory and administration-based character. See Eva Hüpkes, "Special Bank Resolution and Shareholders' Rights: Balancing Competing Interests", (2009) 17 *Journal of Financial Regulation and Compliance* 277–301. But they acquire a particularly virulent form in the case of bail-in.

69 BRRD, Art 34(1)(a)–(b).

70 BRRD, Art 34(1)(f).

71 This argument is reinforced by the obligation imposed, for reasons of legal certainty, on banks to incorporate in the contractual terms of bail-inable instruments issued under the law of a third country a term whereby the holder of the instruments recognizes the bindingness of a potential decision of the resolution authorities subjecting the instruments to bail-in. BRRD, Art 55; and EBA, "Final Report: Draft Regulatory Technical Standards on the Contractual Recognition of Write-Down and Conversion Powers under Article 55(3) of Directive 2014/59/EU" (EBA/RTS/2015/06, 3 July 2015).

72 BRRD, Art 108.

73 BRRD, Arts 48–50. See also the relevant EBA guidelines, note 56.

net worth.[74] Since this may not be necessary on financial grounds, the relevant provision introduces a punitive element in an otherwise technical approach to burden-sharing.)

The fact that resolution can take place at a point when the bank is still solvent aggravates in a very serious way the tension between bail-in and private rights. The trigger for resolution in the BRRD is that the institution is "failing or likely to fail", and the failure cannot be avoided by resorting to alternative private sector measures or supervisory action (such as early intervention measures or the pre-resolution writedown or conversion of relevant capital instruments) which could prevent the failure within a reasonable timeframe.[75] When these conditions apply, resolution action may be taken if this is necessary in the public interest.[76] However, "failing or likely to fail" does not mean only actual or impending balance-sheet insolvency or inability to pay debts as they fall due, in harmony with the usual criteria insolvency law. It may also include vaguely defined situations raising the need for public financial support as well as, and more critically, situations involving the actual or impending infringement by the bank of its regulatory requirements for continuing authorization, including the depletion of a significant amount of own funds due to operating losses.[77] The criteria are rather fluid and imprecise, but they certainly mean that the trigger for resolution can be crossed at a point well before the bank has reached the financial state of negative net worth (economic insolvency). Unfortunately, the BRRD does not include a specific numerical indicator of critical undercapitalization, to serve as a clear quantitative trigger. In any event, the early trigger raises further concerns regarding the treatment of liability holders (who at this stage may legitimately expect to get what they are due under the terms of their contracts) as well as equity holders (whose interest in the bank continues to have positive value).

The power to write down capital instruments can also be exercised as a corrective action, that is, without placing the bank in resolution.[78] In this case there is an alternative test, namely, that the institution (or its group) is no longer "viable".[79] This is also set out in imprecise terms, but effectively overlaps with the trigger for resolution in the proper sense. But on this occasion too, the trigger can be pulled at a point when the institution is not insolvent.

The resolution regime seeks to alleviate concerns relating to bank stakeholders' private rights by introducing the NCWO principle,[80] according to which "no creditor shall incur greater losses than would have been incurred if the institution . . . had been wound up under normal insolvency proceedings".[81]

74 BRRD, Art 47(1).
75 BRRD, Art 32(1).
76 BRRD, Art 32(1)(c) and (5).
77 BRRD, Art 32(4) and (6). See also EBA, "Final Report: Guidelines on the Interpretation of the Different Circumstances When an Institution Shall Be Considered as Failing or Likely to Fail under Article 32(6) of Directive 2014/59/EU" (EBA/GL/2015/07, 26 May 2015).
78 BRRD, Art 59(1)(a).
79 BRRD, Art 59(3)–(4).
80 For detailed analysis, see Karl-Philipp Wojcik, "Significance and Limits of the 'No Creditor Worse Off' Principle for an Effective Bail-in", in the present volume.
81 BRRD, Art 34(1)(g).

Shareholders are not explicitly mentioned, but their financial interests are also at stake and should be considered. The assumption appears to be that resolution will tend to increase a failed bank's total value to a considerable extent, so that, even though certain stakeholders may receive less than a full share of the difference, they will still be left better off than under the alternative scenario of insolvent liquidation. Accordingly, despite the fact the principle of equal treatment among the relevant class is not honored in full, such stakeholders cannot be said to suffer actual harm as a result of its violation!

The NCWO principle applies to partial transfers under the other resolution tools as well as to bail-in.[82] It requires, in particular, resolution authorities to ensure, on the basis of a valuation by an independent person, not only that the conditions for resolution (or, where applicable, a pre-resolution writedown of capital instruments) exist, but also that the proposed resolution actions are appropriate and that bail-in is applied only to the necessary extent.[83] In addition to this prior valuation, another independent valuation must take place following the implementation of the chosen resolution action, in order to establish whether the treatment of shareholders and bailed-in creditors in resolution was different from what it would have been in the counterfactual comparative scenario of the bank's liquidation.[84] If the treatment proves to have been worse than in liquidation, there is a right to compensation (or "safeguard"), whereby the creditors' or shareholders' excess losses are covered by the relevant resolution fund.[85] It may be asked why it should be the resolution fund which owes the compensation, but this is not the main concern.

The fundamental ambiguity of the NCWO principle relates to the basis of comparison.[86] The BRRD mandates that the treatment of stakeholders in resolution should be compared with the liquidation value of the bank at the time of the resolution decision, rather than its value following restructuring.[87] The valuation must assume that no resolution actions would take place and that no extraordinary public financial support would be extended.[88] Worse, although this is not clearly stated, the implicit operating assumption would appear to be that the valuation must be conducted on a gone-concern and forced-sale basis (rather than on a

82 NCWO is a general principle governing resolution and the application of resolution tools, in accordance with BRRD, Art 34(1).

83 BRRD, Arts 36 and 46. See also the relevant draft RTSs issued by the EBA: "Consultation Paper: Draft Regulatory Technical Standards on Valuation under Directive 2014/59/EU" (EBA/CP/2014/38, 7 November 2014); "Consultation Paper: Draft Regulatory Technical Standards on the Valuation of Derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)" (EBA/CP/2015/10, 13 May 2015); and "Final Report: Draft Regulatory Technical Standards on Independent Valuers under Article 36(14) of Directive 2014/59/EU" (EBA/RTS/2015/07, 6 July 2015).

84 BRRD, Art 74.

85 BRRD, Art 75.

86 See Phoebus Athanassiou, "Valuation in Resolution and the 'No-Creditor-Worse-Off-Principle'", (2014) 29 *Butterworths Journal of International Banking and Financial Law* 16–20; and George Jacobs and David Mitchell, "The No-Creditor-Worse-Off Principle from a Valuation Perspective: Standing in the Shoes of a Hypothetical Liquidator", (2014) 29 *Butterworths Journal of International Banking and Financial Law* 233–235.

87 BRRD, Art 74(2).

88 BRRD, Art 74(3).

going-concern or open-bank reorganization basis, since this is explicitly excluded, or even a longer-term orderly liquidation basis, potentially including the managed run-off of the asset portfolio)! The question is whether this is in all cases an appropriate valuation approach. Furthermore, the evaluation is bound to depend on macroeconomic assumptions and changing market conditions. The problem of the potentially inappropriate comparator is accentuated when the bank has been placed in resolution before reaching the point of balance-sheet insolvency.

6 AN END TO BAILOUTS?

Regardless of the tensions discussed above, bail-in is bound to affect the banking industry's incentive structure. However, one may doubt whether bail-in and, more generally, the new, structured approach to resolution, will mark the end of TBTF and/or bank bailouts using taxpayers' money.[89] Bailouts may become more rare than in the past, but there will still be concrete situations when they will appear to constitute the best available solution. Exactly as in the past, this is likely to be the case primarily with regard to large failures and systemic crises.

Even general corporate insolvency law will tend to vacillate between an *ex ante* insistence on strict enforcement and a more lenient *ex post* perspective.[90] *Ex ante,* the law may emphasize the principles of hard budgetary constraints and strict enforcement of claims, because these optimize debtors' incentives and reinforce market discipline. *Ex post*, however, things are seen in a different light. Due to the long time delays, informational asymmetries and high administrative and transactional costs of the liquidation process, the termination of an insolvent enterprise will frequently appear more costly and inefficient, and thus value-destroying, when compared with the alternative of its continuation as a going concern following some sort of debt restructuring. Thus, real insolvency actions tend to relax *ex post* the budgetary constraints and to treat debtor enterprises more leniently than what would be necessary in order to eliminate moral hazard. The same shift in perspectives applies with a vengeance to bank failures – not to mention system-wide banking crises, when the incentives for forbearance are almost insurmountable! This is due to the overriding consideration that bank closures can cause exceptionally strong negative external effects. Of course, the resulting softening of the theoretically applicable norms creates moral hazard; but, all in all, the immediate external costs of strict enforcement may be so high (especially in the context of a systemic crisis),[91] that even a benevolent public

89 For economic theoretical support for bail-in, see Peter Klimek, Sebastian Poledna, J. Doyne Farmer and Stefan Thurner, "To Bail-out or to Bail-in? Answers from an Agent-Based Model", (2015) 50 *Journal of Economic Dynamics & Control* 144–154. For empirical evidence (in the form of retrospective calculation of bail-in's potential impact on the euro area's banking crises), see Thomas Conlon and John Cotter, "Anatomy of a Bail-in", (2014) 15 *Journal of Financial Stability* 257–263; Clara Galliani and Stefano Zedda, "Will the Bail-in Break the Vicious Circle Between Banks and their Sovereign?", (2015) 45 *Computational Economics* 597–614.

90 cf Matej Marinč and Razvan Vlahu, *The Economics of Bank Bankruptcy Law* (Berlin and Heidelberg: Springer, 2012), ch 2.

91 See Luc Laeven, "Banking Crises: A Review", (2011) 3 *Annual Review of Financial Economics* 17–40, at 23–28.

decision-maker may consider it preferable to relax the supervisory standards, and even to use public moneys for a costly bailout.

The policy trade-off between immediate stabilization and longer-term incentives is unlikely to disappear simply because of the new resolution principles. To strictly enforce the regulatory covenants, or to tolerate slippages and even provide support to failing banks, thereby fuelling moral hazard, is a perennial dilemma of banking policy, which we cannot simply wish away.

Moreover, it is not true that the interests of taxpayers are in all cases harmed by bailouts. It is notoriously difficult to evaluate the costs of bailouts. The immediate price tag for recapitalizing the failed banks does not tell the whole story. There are indirect costs (such as the long-term cost of reduced market discipline, or the distortions resulting from the state-financed validation of substandard past financial claims and the retention of high levels of leverage in the economy), but also substantial indirect benefits (from the financial and macroeconomic stabilizing effect), which cannot be measured with accuracy. Even in terms of direct outlays, the magnitude of the subsidy to the banking sector, as well as the taxpayers' estimated losses, will depend on the macroeconomic environment. They will be higher precisely at the point when the economy is weak and system-wide difficulties are in evidence – that is, precisely at the point at which the social costs of allowing a bank to fail will also rise. It is not uncommon for the sign of the taxpayers' investment in banks to be reversed over time, as the macroeconomic environment improves, with the potential loss from the state's participation in bank recapitalization efforts eventually turning into substantial gains, as the economy improves and the value of the recapitalized banks increases.[92]

Time inconsistency may, more specifically, affect the actual application of the BRRD's bail-in instrument. The resolution approach in the BRRD is largely premised on the assumption that banks fail individually, one at a time. In reality, bank failures (including failures of systemically important banks) tend to occur in a context of wider economic distress. In this environment, resolvability and bail-in cannot of themselves preserve systemic stability. They can certainly render more practicable the rapid recognition and write-off of bad debts, thus facilitating immediate deleveraging. But this can hardly be achieved without second-order harmful effects. In particular, it is unrealistic to believe that, in a systemic crisis, bail-in can take place at a scale sufficient to absorb the losses and/or cover the recapitalization needs of all troubled banks simultaneously and without very serious negative side-effects. In this scenario, alternative private sources of financing will also be scarce: new private money will be no more forthcoming than it was during the recent crisis. Similar considerations apply to the individual

92 See Mathias Dewatripont, "European Banking: Bailout, Bail-in and State Aid Control", (2014) 34 *International Journal of Industrial Organization* 37–43.

failure of any of the system's largest banks.[93] In such circumstances, a publicly financed bailout continues to provide a valid policy alternative, because, even if it remains technically feasible, it may appear highly undesirable.

In short, bail-in evidently improves the overall policy mix, especially if the MREL is taken into consideration: it increases banks' financial buffers in normal times and the resources available for resolution financing at the point of failure; it introduces new restructuring possibilities by simultaneously achieving some deleveraging and recapitalization; and it precludes strategic behavior on the part of the banks' stakeholders, thus enabling resolution officials to pursue more effectively the optimal resolution actions. *Ex post*, however, full bail-in may often prove to be unsuitable. This is why in the relevant provisions the apparent automaticity of bail-in is watered down by allowing discretionary exemptions for particular classes of liabilities.[94]

As for bail-in's impact on market discipline, it should be observed that the latter depends less on the internal legal articulation of the formal resolution regime and more on predictions about the state's future response to a crisis. If the assumption is that bailouts are unlikely to disappear completely, bail-in may lead to generally reduced, and possibly less linear, *ex ante* values for the bailout subsidy, that is, to higher, and more properly priced, funding costs for banks,[95] but not to a full correction.[96] Moreover, the likelihood of a bailout, and with it the estimated value of the subsidy, will be neither the same for all banks, nor immutable over time, but will be likely to increase with a bank's size and, primarily, with the deteriorating macro-environment. And in any event, market discipline will continue not to apply to the various categories of protected ("excluded") creditors.

Taken by itself, then, bail-in may have a limited practical effect, leaving the general tendency of the old incentive structure largely unaffected. It may reduce substantially the likelihood of bailouts in the case of medium and small banks,

93 In the Banking Union, the total pre-funded resources of the relevant DGSs and the SRF may eventually suffice for the resolution of even the largest systemically important banks, but only if these fail one-by-one, at discrete points in time. But they will be clearly insufficient for a system-wide bank recapitalization exercise. This is why the need for a publicly financed bailout cannot be ruled out. See Christos Hadjiemmanuil, "Bank Resolution Financing in the Banking Union", London School of Economics, *LSE Law, Society and Economy Working Paper* No 6/2015 (2015), http://ssrn.com/abstract=2575372, 35–38.

94 BRRD, Art 43(3).

95 On the implication of the introduction of the bail-in tool for banks' cost of funding, see Benoît Coeuré, "The Implications of Bail-in Rules for Bank Activity and Stability", at the conference on "Financing the Recovery after the Crisis – The Roles of Bank Profitability, Stability and Regulation", Bocconi University, Milan (30 September 2013).

96 Strahan, "Too Big to Fail ...", note 3, at 56–57, observes that markets price the specific risk of large financial firms more now than before the Global Financial Crisis; this is an indication that market perceptions of the probability of bailouts have changed (possibly also due to the insistence of recent legislative instruments on orderly resolution and bail-in). A similar conclusion is reached by Oana Toader, "Quantifying and Explaining Implicit Public Guarantees for European Banks", (2015) 41 *International Review of Financial Analysis* 136–147, who nonetheless also points to another partial explanation, namely, the fiscal weakness of several European governments, which reduces the value of the implicit state guarantee to the liability holders of domestic banks.

but only to a lesser extent the value of the TBTF subsidy. If so, rather than removing the comparative advantage from size, it would tend to entrench it. To cancel the TBTF subsidy, the enactment of bail-in-focused resolution policies is not enough, because such policies are neither time-consistent, nor sufficiently uniform in their application and effects. For this purpose, regulatory measures which penalize size in normal times, such as structural regulations and prudential requirements whose intensity increases with size, would be necessary.

LEGAL CONSTRAINTS ON RESOLUTION MEASURES AND THE APPLICATION OF THE BAIL-IN TOOL UNDER BRRD AND SRMR

AXEL KUNDE[1]

The new EU resolution framework for banks, codified by the BRRD, provides resolution authorities with far-reaching powers to interfere with the rights of the shareholders and creditors of a failing bank. One of the requirements is that taking such actions is expected to result in an outcome that is deemed socially superior to the winding up of the relevant entity under normal insolvency proceedings: the "public interest test" requires that taking resolution actions must be necessary and proportionate to achieving the resolution objectives, and that normal insolvency proceedings would not meet these objectives to the same extent. Under the Single Resolution Mechanism (SRM) which has been created to establish uniform rules and procedures for the resolution of banks established within the Banking Union, the Board exercises the resolution powers through instructing the relevant national resolution authorities. However, since the resolution tools, the resolution objectives, and the conditions for resolution including the public interest test, are identical for the BRRD and the SRMR (Article 18.5 SRMR and Article 32.5 BRRD), there is no need to make a distinction for the purpose of the discussion that follows.

The resolution objectives, which must be observed universally, can be interpreted as an initial set of constraints in the sense that they limit the set of sensible resolution measures. These are:

a) ensuring the continuity of the banks' critical functions,

b) protecting financial stability and avoiding contagion,

c) protecting public funds,

d) protecting retail depositors and retail investors, and

e) protecting client funds and client assets.

An additional constraint is that the resolution actions should seek to minimise the cost of resolution and avoid destruction of value unless this is necessary to achieve the resolution objectives (Article 14.2 SRMR and Article 31.2 BRRD).

Interference with shareholders' and creditors' rights is limited by certain general principles governing resolution and a number of safeguards that protect certain contractual arrangements between the entity in resolution and its counterparties.

1 Head of Unit Resolution Planning and Decisions, Single Resolution Board.

These provide additional sets of legal constraints. The principles governing resolution include, inter alia, (i) that the shareholders of the entity under resolution bear losses first, (ii) that creditors bear losses after shareholders in accordance with the order of priority of their claims, and (iii) the "no-creditor-worse-off principle" (NCWO, Article 15.1 SRMR and Article 34.1 BRRD).

The NCWO principle applies universally, irrespective of the resolution measures taken, and requires that no creditor shall incur greater losses than would have been incurred if the entity under resolution had been wound up under normal insolvency proceedings. While the NCWO principle is worded only in terms of creditor rights, it also applies to shareholders in the sense that shareholders, too, are entitled to a compensation payment by the resolution financing arrangement (the SRF in the euro area) should an *ex post* valuation determine that they had been treated worse in resolution than they would have been in a hypothetical counterfactual insolvency scenario (Article 76.1 SRMR and Article 101.1 BRRD).

Borrowing terminology from economic theory, an allocation of resources is defined to be efficient if it is not possible to redistribute the available resources in a way that makes at least one person better off without making at least one other person worse off. In this sense, including the NCWO principle as a constraint on the outcome of resolution measures implies a) the assumption that normal insolvency proceedings may not deliver an efficient outcome and, more importantly, b) that resolution authorities are able to deliver a better outcome for the shareholders and creditors of a failing bank. Importantly, it is not sufficient for resolution authorities to deliver net benefits for the shareholders and creditors in aggregate terms: they must be able to deliver these benefits in a way that protects specific types of creditors as prescribed by the resolution objectives, i.e. retail depositors and other clients. Since these protected clients and counterparties are expected to bear little or no losses, resolution authorities must redistribute losses to the non-protected creditors only, while at the same time observing the constraint that the non-protected creditors must not be made worse off than they would be in the case of an insolvency. Meeting all of these constraints is only possible if application of the resolution tools and powers does, in fact, generate a net benefit of a specific minimum size. This minimum size differs from bank to bank and will depend to some extent on the relative size of the banks' liabilities as regards protected and non-protected creditors: the larger the fraction of liabilities with protected clients, the more challenging it will be to make the non-protected creditors bear all the losses – in resolution – without making them worse off than in the case of insolvency.

The need to create value in order to satisfy the resolution objectives and the NCWO principle at the same time is sometimes portrayed as a specific challenge for applying the bail-in tool. It is, in fact, a challenge for all resolution strategies. However, it may be more pressing when applying the bail-in tool because this requires resolution authorities to quantify and crystallise losses quickly, and to allocate them to shareholders and creditors as part of the resolution decision. The additional constraints that apply to the bail-in tool are also more explicit in terms of which counterparties must be protected.

ADDITIONAL CONSTRAINTS WHEN APPLYING THE BAIL-IN TOOL

One of the conditions for taking resolution action is that a private sector solution must not be available, i.e. that the existing shareholders are unable or unwilling to recapitalise the bank, that there is no willing buyer for the failing bank, and that negotiations with creditors about a voluntary haircut or conversion of claims into ownership rights have failed. Applying the bail-in tool allows the resolution authority to effect a forced on-balance-sheet recapitalisation within existing legal entities, if appropriate.

When applying the bail-in tool to creditors' claims, i.e. the liabilities of the entity or group in resolution, resolution authorities have only very limited discretion: *A priori*, the BRRD and the SRMR identify a set of liabilities that are generally excluded from bail-in (Article 27.3 SRMR and Article 44.2 BRRD). Since some of the excluded liabilities may not benefit from a preferred status in the creditor hierarchy under national insolvency laws, a risk for violations of the NCWO principle arises. Examples of excluded liabilities include certain short-term liabilities to other financial institutions and financial market infrastructures, employees, credit or trade creditors.

Under both BRRD and SRMR, all non-excluded liabilities are defined as *eligible liabilities,* and excluding eligible liabilities from bail-in is only possible under exceptional circumstances. Hence, eligible liabilities are generally "bail-inable". Further exclusions from bail-in are only possible under exceptional circumstances (Article 27.5 and Article 44.3, BRRD) which essentially require that bailing-in the relevant liabilities is either impossible or that their exclusion is *strictly necessary and proportionate* in order to meet the resolution objectives.

When applying the bail-in tool, resolution authorities must observe the creditor hierarchy according to national insolvency law (Article 17.1 SRMR) as well as the pari passu principle, i.e. that creditors of the same class must be treated in an equitable manner (Article 15.1(f) SRMR). Hence, if the claims of subordinated creditors are insufficient to cover all losses and to recapitalise an entity, the claims of all ordinary creditors that relate to eligible liabilities must be bailed-in to the same extent. Doing this could involve a number of well-known operational and conceptual challenges.

As already argued more generally, the overall amount of losses does not change depending on the way they are allocated. If some liabilities are fully or partially excluded, it may be necessary for the claims of equally ranking creditors to be written down or converted into equity to a greater extent. Provided exceptional circumstances prevail, such redistribution of the burden between creditors of equal ranking is permissible under the BRRD and the SRMR, but only if this does not violate the NCWO principle. Conversely, it follows that in the absence of exceptional circumstances, the general rule is that all eligible liabilities must be bailed-in on a pro rata basis, in accordance with the creditor hierarchy under national insolvency law.

In summary, the primary driver for taking resolution measures is the public interest in achieving the resolution objectives, in particular protecting financial stability. However, this must be achieved in a way that also protects the private interests of the failing entities' shareholders and creditors. Since some types of creditors are protected in resolution but are not protected from bearing losses in insolvency, the resolution measures must be appropriate for preserving a higher value than that which would be achieved in liquidation. This difference in value could be allocated to protected creditors only, without violating the NCWO principle. When applying the bail-in tool, additional constraints need to be observed: some bank liabilities are *ex lege* excluded from bail-in; other liabilities may need to be excluded to meet the resolution goals. In addition, not all eligible liabilities are equally suitable for the partial write-down or conversion – from a practical, operational perspective – which would be required under the *pari passu* principle. Given these constraints, it could become necessary – under the "resolvability assessment" process – to require banks to change the structure of their liabilities in order to allow the bail-in tool to work effectively without giving rise to substantial NCWO risk. This is also necessary in order to reduce the risk of legal challenges which, if successful, would give rise to compensation claims against the Single Resolution Fund.

THE SIGNIFICANCE AND LIMITS OF THE "NO CREDITOR WORSE OFF" PRINCIPLE FOR AN EFFECTIVE BAIL-IN

KARL-PHILIPP WOJCIK[1]

The Bank Recovery and Resolution Directive[2] (BRRD) introduced bail-in as a new power for resolution authorities in dealing with banks which are failing or likely to fail.[3] To be applied at the latest as of 1 January 2016, bail-in describes the power of resolution authorities to cancel shares and to write down or to convert the liabilities of a failing bank. Bail-in imposes losses incurred by a failing bank on its shareholders and on certain creditors. It is one of the instruments through which the EU Council and Parliament, as the European co-legislators, have sought to sever the ties between banks and sovereigns. At the same time, bail-in aims at restoring market discipline by reducing the implicit state guarantee from which banks have benefitted, and for which the number of bank bail-outs and the huge amount of state resources employed to this end during the last financial crisis provide evidence.[4]

Economic research has shown that if national authorities had been able to apply bail-in during the financial crisis, it would not have been necessary to tap governments' budgets to such a great extent.[5] This research was undertaken retrospectively and it was – and could only be – carried out on an abstract basis. Whether in real life the application of the bail-in rules will achieve all the objectives which the European co-legislators intend to achieve with it, only a real-life case can demonstrate. Obviously, any real-life bail-in will trigger specific legal and economic results and will be embedded in specific legal as well as micro- and macro-economic circumstances. It is my view that these will determine, to a large extent, whether bail-in will achieve its goals, i.e. whether bail-in will be effective.

1 Member of the European Commission's Legal Service. The views expressed in this contribution, which slightly adapts and updates the author's oral presentation at the conference, are solely those of the author. They do not bind the European Commission.

2 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 Text with EEA relevance (OJ L 173, 12.6.2014, p. 190–348).

3 Regulation 806/2014 on a Single Resolution Mechanism (SRM-Regulation) contains in parallel provisions on bail-in identical in substance to those laid down in the BRRD. In the following, therefore, only the BRRD will be mentioned.

4 According to data published by the European Commission, state aid for the financial sector in the EU amounting to, in total, EUR 5.76 trillion was approved by the European Commission between 2008 and 1 October 2014. http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html.

5 Conlon/Cotter, Anatomy of a Bail-In (March 26, 2014), *Journal of Financial Stability*, Vol. 15, 2014, http://ssrn.com/abstract=2294100, p. 14.

This contribution cannot analyse all the conditions for an effective bail-in:[6] my intention is to highlight the role of the "no creditor worse off" principle as one element determining the effectiveness of a bail-in.

A EFFECTIVENESS OF BAIL-INS

The effectiveness of a bail-in will depend on whether its application is predictable for the markets and whether it is legally robust. Bail-in is predictable if creditors understand sufficiently in advance whether and to what extent their claims could be bailed-in. It is legally robust if its result is permanent, taking into account the risk of subsequent changes to the bail-in result following legal challenges. Both aspects are linked. The resolution principle of "no creditor worse off" is one of the measures to address these aspects.[7]

1 THE "NO CREDITOR WORSE OFF" PRINCIPLE

According to Article 34(1)(g) BRRD "no creditor shall incur greater losses than would have been incurred if a bank had been wound up under normal insolvency proceedings". That means that no creditor (and no shareholder) must be worse off economically after a bail-in compared to his or her treatment under normal insolvency proceedings.

In order to attain the result prescribed by the "no creditor worse off" principle, the resolution authorities will need to establish, when they are cancelling shares, or writing down or converting liabilities[8] of the bank which is failing or likely to fail, a hierarchy of claims under normal insolvency proceedings. The resolution authorities will then apply the bail-in to the shares and liabilities in the reverse order of this hierarchy of claims. For instance, under normal insolvency proceedings shareholders receive the proceeds of the liquidation of assets usually only once all other claims against the bank have been satisfied. Equity is therefore ranked lowest in insolvency proceedings. Correspondingly, in resolution, shares are cancelled first through a bail-in, in order to absorb losses. For creditor claims analogous considerations apply.

2 SIGNIFICANCE OF THE "NO CREDITOR WORSE OFF" PRINCIPLE TO ENSURE THE EFFECTIVENESS OF BAIL-INS

How does the "no creditor worse off" principle contribute to the effectiveness of bail-ins? The answer to this question is two-fold:

a) Significance for the predictability of a bail-in

The "no creditor worse off" principle uses the treatment of shareholders and creditors under normal insolvency proceedings as a benchmark from which

6 A comprehensive and detailed analysis of the conditions for the effectiveness of bail-in as well as its legal and economic consequences can be found in an article by the author in the Common Market Law Review on "Bail-in in the Banking Union" which is forthcoming.

7 The BRRD distinguishes "resolution objectives" (Article 31 BRRD) and "resolution principles" (Article 34 BRRD) which are fundamental when applying resolution tools or exercising resolution powers.

8 On the scope of bail-inable liabilities see Article 44 BRRD.

the treatment of shareholders and creditors in a bail-in can be deduced. Hence, the "no creditor worse off" principle should give creditors a fair idea of their treatment in a bail-in. This enhances predictability.

b) Significance for the legal robustness of a bail-in, namely its importance for the compatibility of a bail-in with the right to property

The "no creditor worse off" principle contributes to making the legal result of a bail-in permanent. Obviously, the "no creditor worse off" principle cannot exclude that a bail-in, involving cancellation, write down or conversion, will be challenged in court and that the bail-in result could therefore be subsequently changed. In fact, litigation may be expected challenging the resolution authorities' decision on a bail-in, since a bail-in will have important legal and economic consequences for affected shareholders and creditors.[9] No legislator can exclude through a legal provision that a legal challenge could be brought against a bail-in. This would be against the fundamental right to an effective remedy as enshrined in Article 47 of the EU Charter of Fundamental Rights (ChFR). However, given the time constraints for any resolution, the BRRD has reduced the scope for the *ex ante* legal review of resolution decisions in favor of an *ex post* review focusing on compensation.[10] The "no creditor worse off" principle can specifically contribute to the co-legislators' intention to reduce litigation risk and subsequent changes to the bail-in result, namely by being a means to rebut any applicant's claim that the bail-in decision has infringed their fundamental right to property. Let me briefly explain how:

The cancellation of shares, the write down of claims or their conversion into equity fundamentally alters or suppresses the protected property positions enjoyed by shareholders or creditors. A bail-in therefore interferes with the fundamental right to property which is laid down in Article 17 of the EU Charter of Fundamental Rights and Article 1 of Protocol 1 of the European Convention on Human Rights, as interpreted by the case law of the European Court of Human Rights.[11]

To be legal, the limitation must be provided for by law, respect the essence of the right and comply with the principle of proportionality.[12] In the case of interference

9 Goodhart/Avgouleas, "A Critical Evaluation of Bail-ins as Bank Recapitalisation Mechanisms*", CEPS*, July 2014, p. 26, 36.

10 Measures to limit the scope of *ex ante* judicial review are laid down in Article 85 BRRD. They comprise, inter alia, the requirement to provide for an expeditious *ex ante* judicial review of crisis management measures, that appeals do not entail any automatic suspension of the effects of the challenged decision, that decisions by resolution authorities are immediately enforceable and that, in principle, the annulment of a decision of a resolution authority shall not affect any subsequent administrative acts or transactions concluded by the resolution authority concerned, that were based on the annulled decision.

11 See for instance ECHR, Sporrong and Lönnroth v. Sweden, ECLI:CE:ECHR:1982:0923, paragraph 61. According to the case law of the ECHR, shares in a company and claims resulting from debt instruments constitute property rights, ECHR, Sovtransavto Holding v. Ukraine, ECLI:CE:ECHR:2002:0725, paragraph 92 and Fomin ea v. Russian Federation, ECLI:CE:ECHR:2013:0226, paragraph 25.

12 ECHR, Grainger and others v. United Kingdom, ECLI:CE:ECHR:2012:0710, paragraph 35.

which takes the form of expropriation a compensation payment reasonably related to fair value is, in principle, foreseen.[13]

The two main goals pursued by bail-ins, namely fiscal protection and financial stability, are legitimate public interests recognised by the case law of the European Court of Human Rights.[14]

It is here where the importance of the "no creditor worse off" principle becomes apparent – as a limit to how far the interference with the right to property may go and thus being a measure guaranteeing the proportionality of a bail-in:

If shares were worth nothing, since in insolvency proceedings the shareholder would not have received anything from the liquidation of the bank's assets, then the cancellation of their shares through bail-in does not put them in a worse position.

If creditors' claims have only been partially satisfied in normal insolvency proceedings, a write down or conversion limited to the hypothetical loss does not put those creditors in a worse position.

If, however, a shareholder or a creditor was, after a bail-in, in an economically worse position, the bail-in would be disproportionate.

To avoid this outcome, the BRRD introduces two important features which underpin the general compatibility of bail-ins with the right to property by giving effect to the "no creditor worse off" principle:

(i) According to Article 74 BRRD, an independent valuer should carry out a valuation after the application of a bail-in. The independent valuer should establish if there is a difference between the treatment of shareholders or creditors in the bail-in compared to their treatment under normal insolvency proceedings.[15]

(ii) If there is a negative difference, the shareholder or creditor can claim financial compensation directly from the resolution financing arrangement, be it – as the case may be – the national financing arrangement or the Single Resolution Fund. The existence of such a claim is foreseen in Article 75 BRRD.

The "no creditor worse off" principle, together with the other safeguards, contributes to the justification of bail-in as compatible with the fundamental right to property as enshrined in Article 17 ChFR and Article 1 of Protocol 1 of the European Convention on Human Rights. By doing this the "no creditor worse off" principle makes it much less likely that persons affected by a bail-in will

13 ECHR, Jahn and others v. Germany, ECLI:CE:ECHR:2005:0630, paragraph 117.
14 ECHR, Grainger and others v. United Kingdom, ECLI:CE:ECHR:2012:0710, paragraph 42.
15 This valuation is to be distinguished from the valuation of assets and liabilities of the failing bank to be carried out pursuant to Article 36 BRRD before the application of any resolution measure.

be able to successfully challenge it. Thus, the "no creditor worse off" principle contributes to making the bail-in result permanent.

3 LIMITS OF THE "NO CREDITOR WORSE OFF" PRINCIPLE

While the "no creditor worse off" principle is an essential element contributing to the effectiveness of bail-ins, it currently has some inherent limits. To illustrate these limits, I will select two issues of legal and practical importance:

a) Comparison with a hypothetical situation

To establish the treatment which shareholders and creditors would have received had the bank been wound up under normal insolvency proceedings, a comparison needs to be made with a hypothetical situation.

Whoever wants to, or needs to, carry out that comparison (for instance investors, resolution authorities, a court) will need to simulate the outcome of hypothetical insolvency proceedings. It is obvious that such a simulation will be based on a number of assumptions: national insolvency proceedings usually take time; their outcome depends on the application of specific national rules by courts, and the courts have to decide on the basis of whether or not specific moves were made by creditors. As a consequence, the comparison with a hypothetical situation involves uncertainty which is not beneficial to the effectiveness of a bail-in.

b) The lack of comprehensive harmonisation of insolvency law in the EU

The EU currently lacks a comprehensive harmonisation of insolvency law. For credit institutions, EU law harmonises provisions on jurisdiction, recognition and applicable law in the area of insolvency law through the instrument of Directive 2001/24/EC[16] (Winding-Up Directive). In contrast, important parts of substantive insolvency law, namely the order of priority of claims, is not harmonised in the EU.

There is, however, one exception. Article 108 BRRD prescribes that in insolvency proceedings, covered deposits (i.e. in principle deposits of up to EUR 100.000) and Deposit Guarantee Schemes subrogating to the rights and obligations of covered depositors in insolvency, will have to rank higher than deposits from individuals and SMEs which exceed EUR 100.000, and higher than deposits which would be eligible deposits from natural persons, micro, small and medium-sized enterprises had they not been made through branches located outside the EU of banks established within the EU. Both types of deposits, however, have to rank higher than other unsecured, non-preferred claims.

Apart from the Winding-Up Directive and the "depositor preference" laid down in Article 108 BRRD, there is no comprehensive harmonisation of insolvency law in the EU. As a consequence, Member States may, within the limits set by the Treaty and other secondary law, freely regulate in this area.

16 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, pp. 15–23).

For bail-in, the lack of harmonisation creates some complex challenges:

Firstly, any application of bail-in and the "no creditor worse off" principle presupposes that the applicable national insolvency law is correctly determined. The applicable national insolvency law is, as a general rule, the law of the home Member State of the bank in resolution.[17] However, there is no rule without an exception. Thus, in specific circumstances other legal orders may be applicable to specific legal aspects of the insolvency proceedings in addition to the law of the home Member State.[18]

Secondly, with 28 EU Member States, there are potentially 28 different rankings of claims in insolvency proceedings, depending on where the failing bank is established. Any investor that needs to know the relevant ranking to predict the treatment in bail-in, needs to identify and assess 28 potentially divergent legal orders. Moreover, he or she needs to take into account that these laws may change over time.

Lastly, the lack of harmonisation might contribute to a fragmentation of the internal market with respect to investments in banks. In order give an incentive to creditors to provide debt capital to banks established in a given Member State, that Member State might give, in its national insolvency law, a more senior statutory ranking of that claim than usually afforded in other Member States' insolvency laws. This would at the same time reduce the probability that such claims are bailed-in.

B CONCLUSION

The "no creditor worse off" principle is fundamental to ensure the effectiveness of bail-in in the EU. It enhances the predictability and the legal robustness of a bail-in result. However, it is important to be aware of the limits of the "no creditor worse off" principle for facilitating the effectiveness of bail-ins. One such limit is the uncertainty which results from the fact that in order to apply the "no creditor worse off" principle a comparison with a hypothetical insolvency procedure has to be made. Another limit stems from the fact that currently there is almost no harmonisation of national insolvency laws in the EU. As regards this lack of harmonisation, it should be noted that on 30 September 2015 the Commission announced, in its Action Plan on Building a Capital Markets Union, that it will make a legislative proposal on business insolvency by the end of 2016.[19] It is to be hoped that the ensuing legislative procedure will result in a legal text which will end this important lacuna.

17 Article 10 of the Winding-Up Directive.
18 See, for instance, the list of exceptions in Articles 20-33 of the Winding-Up Directive. On the interpretation of the exception of Article 30 of the Winding-Up Directive EFTA Court, LBI, E-28/13.
19 COM(2015)468 final, p. 25, 30.

KEYNOTE SPEECH – HOW POLITICAL ARE THE INSTITUTIONS OF ECONOMIC AND MONETARY UNION?

THE CASES OF THE EUROPEAN CENTRAL BANK AND THE EUROPEAN COMMISSION[1]

MARTIN SELMAYR[2]

I INTRODUCTION

Ladies and gentlemen,

Thanks a lot for inviting me to conclude the first day of your deliberations at the ECB Legal Conference with a dinner speech. In view of the current context, I want to speak about a subject that has been very topical since the euro was created. I want to address the question of how political are the institutions of our Economic and Monetary Union. I want to address the political or non-political role of the European Central Bank (ECB) – where I started my European career in 1998 as a young lawyer – and of the European Commission, the institution for which I work today. For me, the Commission and the ECB are institutional cousins and therefore worth comparing, as they are often in a similar position when confronted with the reproach of being too political.

The tension between rules and discretion and more generally between law and politics, is inherent in the architecture of Europe's Economic and Monetary Union (EMU).[3] The euro is, and has always been, a political project, seen as the most advanced stage of European integration and a driver of further steps towards an ever closer Union. At the same time, the EU Treaties entrust the management of the money supply in the euro area to the ECB, which is designed to be an institution remote from politics, with a very far-reaching independence legally

1 This keynote speech was held at the dinner of the ECB Legal Conference, 1 September 2015.

2 Professor Dr Martin Selmayr is Head of Cabinet of Commission President Jean-Claude-Juncker. The views held in this paper, which is a revised transcript of the dinner speech, are exclusively those of the author. They do not necessarily reflect the official views of the European Commission. The paper is at the same time a tribute to the Legal Service of the ECB, where the author had his first employment contract in 1998 and where he learnt to apply and develop European law in practice. He remains indebted to his former colleagues at the ECB and for what they taught him, notably to Dr Chiara Zilioli, today Director-General of the ECB's Legal Service.

3 See for example the debate in the 1990s on the rigidity or flexibility of the convergence criteria, Selmayr, Die Europäische Währungsunion zwischen Politik und Recht, Europäische Zeitschrift für Wirtschaftsrecht 1998, p. 101 et seq.; or on the appointment of the President of the European Central Bank, see Selmayr, Der Präsident der Europäischen Zentralbank zwischen Politik und Recht, in: Meng/Ress/Stein (Eds.), Europäische Integration und Globalisierung, 2011, p. 513, notably p. 538 et seq., p. 541 et seq.

entrenched in the EU Treaties (see Articles 130 and 282(3), third and fourth sentence TFEU). The European Commission, which has a key responsibility in applying and developing EMU's economic and fiscal rules as well as its broader legal framework, is required to be "completely independent" under the EU Treaties (see Article 17(3), third subparagraph, first sentence TEU).

As a result of this tension, the question of the political nature of decisions made by the ECB or the European Commission is regularly on the agenda and particularly heated when these two independent European institutions make decisions considered to be controversial. While for some, the ECB and the Commission are too independent, too technocratic, too apolitical and therefore somewhat alien elements in a democratic system – this criticism is often heard in France and Italy and more recently in Greece –, others – notably here in Germany as well as in the Netherlands – believe that both the ECB and the Commission have become too political during the first years of EMU. The decisive roles played respectively by the ECB throughout the financial and sovereign debt crisis since 2007 and by the Commission in the recent "Grexit" crisis of summer 2015 have made this debate increasingly relevant.

Both institutions came under intense verbal attacks during this debate. As regards the ECB, the Opinion of Advocate-General Pedro Cruz Villalón delivered on 14 January 2015 in the *Gauweiler* case concerning the ECB's Outright Monetary Transactions (OMT) is symptomatic.[4] While the Advocate-General in essence confirmed the legality of the OMT decision – under which the ECB would make secondary market purchases of sovereign bonds of countries which agreed to a programme under the financial assistance mechanisms of the euro area[5] –, he made this finding conditional. Legally, OMT could only be qualified as a monetary policy instrument if the ECB stayed outside the management of the programme in programme countries. In the view of the Advocate-General, the ECB would otherwise be in a problematic dual role: the ECB would on the one hand buy government bonds in the markets in order to stabilise a programme country, and at the same time the ECB would be involved – as part of the so-called "troika" of Commission, ECB and IMF – in designing, adopting and regularly monitoring the relevant programme in a not only significant but decisive manner. The Advocate-General made clear that this dual role of the ECB would represent a conflict of

4 Case C-62/14, Peter Gauweiler and Others v Deutscher Bundestag, Opinion of 14 January 2015, EU:C:2015:7, paragraphs 142-151. See also Thiele, Die EZB als fiskal- und wirtschaftspolitischer Akteur? Zur Abgrenzung der Geld- von der Fiskal- und Wirtschaftspolitik, Europäische Zeitschrift für Wirtschaftsrecht 2014, p. 694 et seq.

5 These are today the European Financial Stabilisation Mechanism (EFSM), based on Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p. 1); and the European Stability Mechanism (ESM), based on the ESM Treaty among the euro area countries. The European Financial Stability Facility (EFSF), created in 2010, no longer provides further financial assistance. The final EFSF assistance programme (for Greece) expired on 30 June 2015.

interest.[6] The ECB therefore should detach itself from the programme design and implementation and instead only be indirectly involved. The ECB could certainly be kept informed about what is going on in a programme country and even be consulted on the development and implementation of a programme. But if the ECB took a more decisive role in a programme which OMTs are supposed to support, OMTs would no longer be monetary policy but amount to economic policy-making.[7] It was perhaps as a result of these findings of Advocate-General Cruz Villalón that the ECB took, during the first semester of 2015, a back seat in the often conflictual negotiations with Greece on a possible third programme and left the front seat to the Commission.[8] "We are just a junior partner in these negotiations", we in the Commission often heard our ECB cousins say during this period.

But also the Commission recently came under strong verbal attacks for its political role. At the end of July, when we were just finishing the negotiations on the third programme for Greece, suddenly we were reading in German newspapers that the German Minister for Finance was criticising the Commission for having become too political.[9] A political Commission would not be able to just apply the law independently as it should. The Commission would be in a conflict of interest, as the repeated, direct negotiations between Commission President Jean-Claude Juncker and the Greek Prime Minister Alexis Tsipras, as well as the very generous Commission assessment of the French budget, showed. To avoid conflicts of interest, the Commission's responsibilities as guardian of the EU Treaties should be separated from its increasingly political activities. Notably, the Commission should no longer be in charge of applying the Stability and Growth Pact or EU competition law. Independent authorities modelled on

6 Paragraph 145: "[T]the fact that the ECB plays an active part throughout the course of financial assistance programmes may make the OMT programme, inasmuch as it is unilaterally linked to those programmes, into something more than a monetary policy measure. Unilaterally making the purchase of government bonds subject to compliance with conditions when those conditions have been set by a third party is not the same as doing so when the 'third party' is not really a third party. In those circumstances, the purchase of debt securities subject to conditions may become another instrument for enforcing the conditions of the financial assistance programmes. The mere fact that the purchase may be perceived in that way – as an instrument which serves macroeconomic conditionality – may be sufficient in its impact to detract from or even distort the monetary policy objectives that the OMT programme pursues."

7 Paragraph 150: "[U]nder no circumstances would it be possible for the ECB, in a situation in which a programme such as OMT is under way, to continue to take part in the monitoring of the financial assistance programme to which the Member State is subject when, at the same time, that State is the recipient of substantial assistance from the ECB on the secondary government bond market. Accordingly, it is my view that this functional distance between the two programmes must be maintained if the OMT programme is to retain its character of a monetary policy measure, aimed exclusively at restoring the monetary policy transmission channels." Para 151: "I consider that the OMT programme is to be regarded as a monetary policy measure, provided that the ECB refrains – once the time has come to put that programme into effect – from any direct involvement in the financial assistance programmes of the ESM or the EFSF."

8 See Zydra, Süddeutsche Zeitung, 20 January 2015, p. 4: "EZB: Nur Helfer, nicht Macher"; Financial Times, 6 February 2015, p. 8: "The ECB is right to take a back seat on Greece".

9 Frankfurter Allgemeine Zeitung, 30 July 2015, p. 15: "Schäuble will EU-Kommission entmachten"; and the commentary by Mussler in Frankfurter Allgemeine Zeitung, 1 August 2015, p. 17: "Der Doppelhut der EU-Kommission".

the German Federal Cartel Office would represent a more credible alternative to the Commission.

It is remarkable: within just six months, the two key institutions of our Economic and Monetary Union, the ECB and the Commission, had gone too far in the perspective of some observers, had become too political and were both considered to be in a conflict of interest. The conclusion of the critics is: we have to limit the mandate of these two institutions to ensure that they only do what they are supposed to do. As this is a rather far-reaching conclusion, going right to the heart of the institutional architecture of EMU, I would like to assess in more detail whether the criticism of the ECB and the Commission is really justified.

2 IS THE ECB (TOO) POLITICAL?

When the design of the ECB, as laid down in the Treaty of Maastricht, was studied and academically explored in the 1990s, it was broadly applauded for being depoliticised. It was very much in the mainstream of the 1990s to welcome that there was now an apolitical supranational organisation that would be in charge of our money and of price stability. Some even considered the ECB, in line with neoliberal mainstream thinking, a fourth branch of government. This led some to describe the ECB, in deliberate provocation, as a "new Community"[10], in view of its far-reaching independence and unprecedented insulation from national as well as European day-to-day politics.

Is the ECB really non-political? Let us start to answer this question by doing what lawyers do: looking at the Treaty. According to Article 127(2), first indent TFEU, the key responsibility of the ECB is monetary *policy*. Yes, it says policy in the Treaty. Policy means making choices: between keeping interest rates low, or increasing them; between purchasing more or fewer securities; between intervening in the foreign exchange markets or abstaining from such interventions.

The ECB is thus in charge of a policy, of defining and implementing it. To do so, the ECB is entrusted with strong independence, as can be seen from Articles 130 and 282(3), third and fourth sentence TFEU. This raises the question of legitimacy: from where does the ECB get its legitimacy to independently design, adopt and implement monetary policy? Monetary policy may be seen as a rather limited policy area, but at the same time, it is a policy the conduct of which may have far-reaching consequences for the well-being of the more than 300 million citizens living in the euro area.

10 Zilioli and Selmayr, The Law of the European Central Bank, Oxford 2001, notably Chapter 1: What is the European Central Bank, p. 29 et seq. For a comprehensive view on the debate this view triggered and an update of the legal and doctrinal situation as it stands today under the Treaty of Lisbon, see Selmayr, Das Recht der Europäischen Währungsunion, in: Müller-Graff (Ed.), Europäisches Wirtschaftsordnungsrecht, § 23, p. 1508 et seq.

The answer to this question is: from the EU Treaties. The ECB derives its legitimacy from its creation by the Treaties and from the mandate given to it by these Treaties. The way the Treaties have created the ECB shows that it does not have to rely in its day-to-day operations on the democratic process, as a government would have to. Under the Treaties, the ECB is not accountable for its day-to-day decisions directly to the European Parliament, the Council, nor to national Parliaments. Instead, it can decide on monetary policy without needing the approval of any other institution. In addition, neither the European Parliament nor the Council nor the Commission nor a Member State can remove members of the ECB's decision-making bodies. Only the Court of Justice has the power to do this (see Articles 11.4, 14.2, second subparagraph of the Statute of the European System of Central Banks and of the ECB).

As long as the ECB stays within its mandate, it thus has the legitimacy to make policy and to make policy choices. And the ECB's mandate, as defined by the Treaties, is a bit broader than some of my German compatriots often say. The ECB's mandate is not limited to guaranteeing price stability only, even though price stability is the ECB's primary objective. The mandate of the ECB also allows and requires[11] the ECB to support the general economic policies in the Union as secondary objective. On the basis of this broad legal mandate, the ECB can define and implement monetary policy.

ECB President Mario Draghi put all this very wisely in several letters and statements: the ECB is a rules-based institution. It is not a political institution.[12] I do not think that the second sentence follows from the first, namely that the ECB is not a political institution *because* it is a rules-based institution. Because there are other rules-based institutions that are more political, as we will see in a few minutes with the example of the Commission. But the ECB is rules-based and in addition deliberately – outside the field of monetary policy – non-political.

The reason for this is simple: the ECB is entrusted by the EU Treaties with the responsibility for monetary policy and it is in this field that it has independent expertise which distinguishes it from all other institutions.[13] The same does not hold true for other policy areas where the ECB has no mandate and no expertise. The ECB is thus an independent *specialised* organisation that has a mandate to make policy within its field of legal competence and expertise, which is mainly monetary policy (and more recently policies related to financial stability), but not other fields of policy.

Where do we see this in practice? During the "Grexit" crisis before the summer, the ECB was on several occasions faced with the need to decide whether to cut

11 On the ECB's duty to support the general economic policies in the Union, see Selmayr, Das Recht der Europäischen Währungsunion, in: Müller-Graff (Ed.), Europäisches Wirtschaftsordnungsrecht, § 23, p. 1482 et seq.

12 See, for example, ECB press conference of 5 March 2015, answer to a journalist.

13 A good indicator for this is Article 283(2), second subparagraph TFEU, where it says that the members of the Executive Board of the ECB are chosen by the European Council "from among persons of recognised standing and professional experience in monetary or banking matters".

off Emergency Liquidity Assistance (ELA) to Greece. This was notably the case at the end of June and at the beginning of July, when the second programme for Greece expired and a new programme appeared very difficult to agree, in view of the negative outcome of the Greek referendum on the conditionality negotiated with the "troika" and the subsequent hardening positions of many creditor countries.

As the ECB was a rules-based institution, so the narrative of some observers went, the ECB was obliged to cut off ELA; because legally, the ECB is only allowed to accept that ELA is granted to temporarily illiquid, but solvent institutions, while the growing possibility of a "Grexit" made the solvency of Greek credit institutions an increasingly questionable assumption.[14]

On the other hand: an ECB decision to cut off ELA would have been a decision that would have meant *de facto* forcing Greece out of the euro – which in itself would have been a very political decision.[15]

The ECB decided not to do this, but froze ELA at the level where it was at the end of June.[16]

This shows exactly what Mario Draghi said: the ECB is a rules-based institution; it sticks to the rules but it is not political in the sense that it could decide to throw a Member State out of the euro. For such a decision, the ECB has no mandate. For such a decision, the ECB would need at least the full backing from the governments of the euro area countries; if at all, only those who have the right to allow a Member State to join the euro can be said to be allowed to decide on the continued membership of a euro area country. And even this option is highly doubtful. Because under the EU Treaties, membership of the euro is irreversible (see Article 140(3) TFEU).[17]

One can therefore say that at the end of June and in July 2015, the ECB even behaved in a rules-based manner vis-à-vis Greece – as euro membership is legally irreversible. This is inherent in the mandate of the ECB: a mandate given to it by the Treaties and which the ECB is not allowed to interpret in a way that would make membership of the euro reversible. When the ECB decided not to cut off ELA for Greece, it therefore complied with its mandate.[18] What may have

14 See, for example, Frankfurter Allgemeine Zeitung, 26 June 2015, p. 25: "Weidmann verurteilt Ela-Notkredite an Griechenland".
15 See Financial Times, 18 February 2015, p. 2: "ECB weighs pulling plug on Greek banks"; Financial Times, 24 June 2015, p. 4: "ECB tries to avoid having any blood on its hands"; Financial Times, 7 July 2015, p. 2: "Draghi tries to avoid role of executioner"; Financial Times, 13 July 2015, p. 2. "Draghi faces anxious wait and see if he must decide Athens's fate".
16 ECB press release of 28 June 2015: "ELA to Greek banks maintained at its current level".
17 On the irreversibility of the euro, see Selmayr, Das Recht der Europäischen Währungsunion, in: Müller-Graff (Ed.), Europäisches Wirtschaftsordnungsrecht, § 23, p. 1490 et seq.
18 This question is currently sub judice, as the Greek company Alcimos Consulting has brought an action for annulment against the ECB decision to freeze ELA for Greek banks: see Case T-368/15, *Alcimos Consulting v European Central Bank*. A request for an injunction was denied by the General Court.

appeared to be a political decision was thus a very rules-based manner of sticking to the Treaties and not going beyond the legal mandate of the ECB.

3 IS THE COMMISSION (TOO) POLITICAL?

Let us now turn to the European Commission, the cousin of the ECB. Cousins are often a little bit similar but still very different. We saw that the ECB is political within its monetary policy mandate, but is apolitical beyond this mandate, as it does not make policy decisions in areas other than monetary policy. How political is the Commission compared to its cousin in Frankfurt?

The Commission has three roles, according to Walter Hallstein, the first President of the Commission. First of all, the Commission is supposed to be the *motor of European integration* and it fulfils this role notably by being the initiator of new legislation or new international agreements. Secondly, the European Commission is the *guardian of the EU Treaties*. It has a legal and executive function because it can start infringement proceedings against a Member State. It is not the judge in such cases; this is the Court of Justice. The Commission is, if you like, the attorney-general of legal supervision in the EU, a kind of "Rechtsaufsicht" over the Member State, and it has this role as central guardian of the Treaties chiefly to avoid that, at some point, Member States go to court against each other. Thirdly, the Commission is the broker, an *honest broker*, in negotiations on legislation and on international agreements.

In all these three roles, the Commission is entirely political. Because politics means making choices. The Commission, as motor of integration, makes choices when it decides to propose this or that piece of new legislation; or to start this or that Treaty negotiation. For example, the Commission made an important political choice earlier this year when proposing ambitious new measures to address the refugee crisis; we prioritised refugee-related proposals over other proposals.

As guardian of the Treaties, the Commission is political because the Commission has the discretion as to whether or not to start infringement proceedings. We also have the right to choose to start infringement proceedings a bit sooner or a bit later. We can like or not like the German car toll, but the decision to go against the German car toll right after its adoption is a political decision of the Commission College on which Commissioners could vote – if needed – by simple majority. It is a political decision, in the making of which the Commission weighs different priorities and options.

Also in its role as honest broker, the Commission makes political choices. The Commission can decide to prefer an amendment to legislation introduced by Council over an amendment voted by Parliament. We may also decide that we oppose an amendment proposed by a majority of Member States' representatives in Council; in such a case, where the Commission decides to say no, the

Commission's position can only be overruled by unanimity in Council.[19] The Commission thus has an important influence over the legislative process at Union level; and in exercising its influence, it makes policy choices. It makes policy.

So the Commission has an entirely political role in all its three functions, as motor of European integration, guardian of the Treaties and honest broker. But what is the legitimacy of the Commission to make such policy decisions? The Commission's legitimacy is different to the one of the ECB, but also a bit similar. What is similar is that the Commission also derives its mandate from the EU Treaties. The Commission is a creation of the Treaties, like the ECB.

However, the Commission's legitimacy goes further. The Commission is, in its respective composition, a creation of the politics of the time. Because its President is elected by the European Parliament; the Members of the European Commission are approved by the European Parliament; and the European Council gives the whole Commission its blessing, first in the nomination proposal and then when appointing the Commission in its final composition. This is the political process, which applies every five years, in order to get a new Commission into office. The Commission can also be removed from office by a motion of censure, a vote of non-confidence by the European Parliament (see Article 234 TFEU). This is not possible in the case of the ECB.

The Commission is thus closely linked to and closely controlled by the political process at EU level. This is also why the independence of the Commission is different in scope from the independence of the ECB. The ECB has been granted its independence both towards the EU institutions and towards the Member States; it thus enjoys both vertical and horizontal independence. The Commission's independence is more limited. The Commission is only independent vis-à-vis the Member States, and thus vertically, but not horizontally vis-à-vis the Parliament or the Council. We are part of the political process at EU level. The Commission is thus by design of the Treaties a political institution, and this for the whole of its mandate – a mandate which is significantly broader than the specialised monetary policy mandate of the ECB, as it encompasses all policy areas listed in the EU Treaties.

Now to the alleged conflict of interest of the political Commission. The current Commission, which has been in office since 1 November 2014 and is presided over by President Juncker, is, in the words of the new President, a "highly political" Commission.[20] He announced this on the day when he was elected President by the European Parliament. What did he mean by that? He meant a Commission that is ready, in this time of crisis – and the Commission President considers us to be in times of multiple crisis – to rise to the big challenges of our time and to show political leadership, not only technocratic excellence. The big challenge which is currently at the forefront of the Commission's work

19 See Article 293(1) TFEU.

20 Juncker, A New Start for Europe, Opening Statement in the European Parliament Plenary Session of 15 July 2014: "The Commission is political. And I want it to be more political. Indeed, it will be highly political."

is migration – one of the big issues that President Juncker mentioned already in July 2014 as a key priority for his Commission – and the Commission brought several very ambitious initiatives to the table, which all call for a new combination of solidarity and responsibility in refugee, asylum and border management matters. A further important challenge for the Juncker Commission was to avoid Greece having to leave the euro area; and another big challenge continues to be ensuring that Britain remains comfortable with staying in our Union, thus avoiding a "Brexit" that would be very harmful both for the Union and for Britain.

President Juncker felt that he has a special legitimacy for tackling these challenges in a new and more political way. Because he came into office via a new democratic process – via the famous "Spitzenkandidaten" or lead candidate process.[21] This process results directly from Article 17(7) TEU, as worded by the Lisbon Treaty with the purpose of strengthening the link between the outcome of the European Parliament elections and the choice of the leadership of the executive branch of the European Union, following the principles of parliamentary democracy. President Juncker is the first President of the Commission who campaigned as lead candidate across Europe during the European Parliament election campaign; whose party became the strongest political group in this election; and who got the support of a very broad cross-partisan majority in the Parliament who wanted to see him appointed as first democratically elected Commission President.[22] And from this process, he takes the legitimacy to lead a political Commission.

What does it mean for the Commission to have this new legitimacy, this new democratic mandate? What does it mean in practice to be a political Commission on this basis? I would like to mention three examples where you can see this very clearly.

First of all, the new Commission decided that we have to *prioritise the Commission's agenda*. The Commission, as a political institution, cannot and should not do everything. A technocracy can do everything because it can technically prepare and adopt every initiative that the Commission machinery produces in normal times, which is around 5,000 initiatives per year. President Juncker felt that this is not something his Commission should do, as he did not get the impression during his election campaign that citizens wanted a continuation of

21 See Commission Recommendation 2013/142/EU of 12 March 2013 on enhancing the democratic and efficient conduct of the elections to the European Parliament (OJ L 79, 21.3.2013, p. 29), notably point 3: "European and national political parties should make known, ahead of the elections to the European Parliament, the candidate for the function of the President of the European Commission they support and the candidate's programme." See also recital 17: "If European political parties and national parties make known the candidates for President of the Commission they support, and the candidate's programme, in the context of the elections to the European Parliament, this would make concrete and visible the link between the individual vote of a citizen of the Union for a political party in the European elections and the candidate for President of the Commission supported by that party. This should increase the legitimacy of the President of the Commission, the accountability of the Commission to the European Parliament and the European electorate and, more generally, increase the democratic legitimacy of the whole decision-making process in the Union."

22 On this, see Peñalver García/Priestley, The Making of a European President, 2015.

business as usual. And he has got a lot of support for this more focused approach in his Commission. The new Commission is already very political in its composition: we have four former Prime Ministers serving in the Juncker Commission; 80% of the Members of the Commission previously served as members of a national government, many as Finance or Foreign Ministers and thus in a democratically accountable position. They all agreed with President Juncker: we don't now need a situation in which the Commission does 5,000 things; we have to do ten things and we have to get them right. And this is what this Commission is working on, on the basis of the Political Guidelines issued by President Juncker before the beginning of the mandate[23] and detailed mission letters addressed by the President to each Vice-President and Commissioner.

A second example where you can see the new political Commission at work, is the *new macroeconomic policy orientation of the Juncker Commission*. This is of course controversial. If you decide on a macroeconomic policy orientation, this is always controversial. Some are a bit more Keynesian, some a bit more neoclassical. The Commission just decided to expand our policy options and policy objectives in our macroeconomic policy: not only fiscal responsibility which remains necessary; not only structural reforms which are indispensable in a number of Member States; but also investment, on which we need a new focus, both with regard to public and private investment. To expand the macroeconomic policy orientation of the Commission to include investment was a key political decision. Mario Draghi had already prepared the ground in his Jackson Hole speech and the Commission drew inspiration from this and put it in place in the form of a €315 billion investment plan for Europe which was adopted by Parliament and Council in record time. In addition, the Commission inserted a bit of flexibility in the application of the Stability and Growth Pact. I know that not everyone in the ECB is a fan of this; but the Commission did no more than use the flexibility that is already built into the rules of the Pact. We did not change the rules. There is an investment clause in the Stability and Growth Pact and there is a structural reform clause in the Pact, and the College of Commissioners decided to operationalise them. That was certainly political. Political is always controversial, but it is something that now also allows the Commission to apply the principle of equality of treatment to all Member States; our approach is now standardised by means of a policy, and not a case-by-case approach that too often in the past was more beneficial for bigger Member States than for smaller ones. The flexibility that we identified in the Pact will be applied not only to one or two Member States, but to all Member States equally and under the same conditions.

A third point where you can see the political Commission at work – probably most directly – was the *"Grexit" crisis*. This crisis was one of the defining moments of the European Union. And it almost went wrong. We had some observers of this crisis who said that the Commission was very much involved and was even too much involved. They said the Commission invested too much political capital in order to make sure that Greece stayed in the euro. And they did not like it that President Juncker and his team worked day and night to keep

23 Juncker, Political Guidelines, 15 July 2014, available at: http://ec.europa.eu/priorities/docs/pg_en.pdf.

Greece in the euro – which was his explicit and publicly declared objective.[24] Some even said: the Commission should stay out of such a process. They said that the Commission is not a creditor of Greece – these are the national Finance Ministers –, and that therefore the Commission had nothing to do with saving or stabilising Greece; this would not be the Commission's job.

However, if you read the Treaties, the Commission has a duty to promote the general interest of the European Union (see Article 17(1), first sentence TEU). Keeping a Member State within the single currency, one of the key achievements of European integration, is certainly part of the common interest and thus part of the general policy mandate of the Commission. In addition, the Commission has a specific mandate given to it by the ESM Treaty. Under Article 13 of the ESM Treaty, following a request by a euro area Member State for a financial assistance programme (so-called "stability support"), the Commission is entrusted with the task of negotiating with this Member State and to do so on behalf of the ESM, in liaison with the ECB and wherever possible, together with the IMF. And Greece wanted a programme, also under Prime Minister Tsipras. Our Greek partners said it continuously and so we negotiated and negotiated. These negotiations were not always a good experience but they were the Commission's job – a job explicitly entrusted to the Commission by all 19 euro area Member States in the ESM Treaty.

The ESM Treaty says that "the Commission" should conduct the negotiations with a programme country. Now a very relevant question is: who exactly is the Commission? Some Finance Ministers probably thought it would be fine if Commission experts conducted the negotiations, but this should not concern the political level of the Commission, which had better not interfere with the work of the Commission officials. President Juncker disagreed with this view; he believes that the 35,000 people in the Commission should not, must not and cannot work in isolation from the political process; one cannot divide the Commission into a purely technocratic Commission and a political Commission leadership, as in the end, the College of Commissioners is and remains responsible for all acts or omissions in the name of the Commission.[25] That is why President Juncker introduced new internal working methods when the negotiations with Greece started during his term. He requested that during the decisive weeks of the crisis, every morning, the key Commission negotiators with Greece had to be in his office. He then asked them: "What are you doing? You are working as an important part of the troika and what are you doing there? You are preparing

24 On the discussion of the Commission's role in the "Grexit" crisis, see Juncker, Authorised State of the Union Address 2015: Time for Honesty, Unity and Solidarity, Strasbourg, 9 September 2015: "As long as Member States have not amended the Treaties, I believe the Commission and all other EU institutions have a clear mandate and duty to do everything possible to preserve the integrity of the euro area."

25 See Juncker, Time for Action, Statement in the European Parliament Plenary Session ahead of the vote on the College of Commissioners, 22 October 2014: "In July, I promised to put together a political Commission. I told you that the next Commission would be political, that it would be highly political. It was, so to speak, an ecumenical wish expressed by many of you. The Commission is not just a troop of anonymous high officials. The directors-general, all highly competent, have to obey their Commissioners and not the other way round."

very political decisions here and I want to know what you are doing and what the choices are." And in the evening, the Commission negotiators had to come back to his office and explain what they had been doing during the day in the negotiations. Some would say that this is political interference. These were Commission experts. But was it not the right thing, to make sure that the boss of the institution knows what Commission experts are doing in his name and in the name of the whole Commission? Is this not what one would expect from the leadership of each organisation? So the Commission's role was perhaps understood in a bit more political and proactive way, perhaps too political for some peoples' taste, but it was certainly in line with the mandate of the Commission under the EU Treaties and under the ESM Treaty. Because neither EU law nor ESM law divide the Commission into an expert technocracy and a political Commission at the top, as such a division would be artificial and against all the principles of a good, efficient and hence unified administration.[26]

For President Juncker, a key principle in these negotiations with Greece was to stick to the legal assumption that the euro is irreversible and that membership of the euro is irreversible. This is what the Treaties say. Therefore, President Juncker said repeatedly: "I cannot start these negotiations by saying it is an option that Greece leaves the euro. As someone who has taken an oath on the Treaties, I cannot say that. I will do everything to keep my oath on the Treaties. Of course I cannot save Greece's membership in the euro alone. But I will do everything in my legal and political powers to contribute to this objective. For me, Grexit is not an option". Some told him that he should not say that and that this exposed him to blackmail by Prime Minister Tsipras. But is this not a bit like saying "I will never throw a nuclear bomb first"? Is this opening yourselves up to blackmail, or is this not rather a reasonable policy choice – as you are thinking of the tremendous further damage that could be caused if you were to throw the bomb first?

I would like to mention three examples of moments during the negotiations towards the third Greek programme where you can see the political intervention of the leadership of the Commission, notably by President Juncker himself, who made sure throughout the process that the College of Commissioners discussed these matters once a week.

The first one: there was an agreement among the euro area creditors that Greece had to *increase Value Added Tax (VAT)* on all goods and services – to 23% as a rule, with a lower VAT rate of 13% for selected products. When looking at the overall situation, President Juncker saw that some pharmaceutical products and medicines had become substantially more expensive over the years of the crisis

26 See Juncker, Authorised State of the Union Address 2015: Time for Honesty, Unity and Solidarity, Strasbourg, 9 September 2015: "Where the Treaties talk about the Commission, I read this as meaning the Commission as an institution that is politically led by the President and the College of Commissioners. This is why I did not leave the talks with Greece to the Commission bureaucracy alone, in spite of their great expertise and the hard work they are doing. But I spoke personally to our experts regularly, often several times per day, to orient them or to adjust their work. I also ensured that every week, the situation of the negotiations in Greece was discussed at length and very politically in the meetings of the College."

and that today, 30% of the Greek population no longer had health coverage. Therefore President Juncker said "no" to increasing VAT on medicines and asked his negotiators to find another way to pay for that within the context of the programme. If the Greek governments found another way to compensate for keeping VAT on medicines lower, we should accept that. In the negotiations, he explored possible options with Prime Minister Tsipras and his negotiators. And in the end, President Juncker insisted that the Greek government financed the shortfall by cutting military expenditure instead, knowing that Greece is in relative terms one of the biggest spenders on military expenditure in Europe. This was a very political choice and not a technocratic decision. It was a common-sense decision and it also took into account the social impact of measures and not only the economic and fiscal impact.[27]

A second political moment in the negotiations concerned the assessment of the *sustainability of the Greek debt*. A painful subject, notably in Germany. Is the debt of Greece sustainable? There are two methods to approach this. The traditional method is that you look at the debt to GDP ratio. If it is above 90%, 120%, 130%, then debt is no longer sustainable. Is this really right? The debt of the US and the debt of Japan would then surely not be sustainable. You do not have to be an economist or a fiscal expert to understand that this is not right. To understand whether debt is really sustainable over time, you also have to look at the structure of the debt. It has to do with the financing over time. And President Juncker looked at the structure of the Greek debt and remembered: in 2012, the Eurogroup had extended the maturities of Greek debt. The first repayments on the Greek debt to the EFSF, the Greek loan facility, are only due in 2023. The interest on Greek debt is only 1%. Is this not also something that should count when assessing debt sustainability? Don't we have to look at what a country has to pay per year, to know what the gross financing needs of this country really are? This approach changed the narrative in the negotiations and convinced the other institutions in the troika, notably the IMF, and also the euro area creditors. It was a political process and the Commission initially did not have many allies. It took political courage to go against the doctrine. But otherwise, we also could have entrusted the decision on debt sustainability to Eurostat, the independent European statistical office which, on the basis of the figures alone, would have had to say that at some point the debt is not sustainable as it exceeds a certain numerical value. Instead, the Commission believed that this matter required a political assessment and President Juncker brought this political assessment into the negotiations.[28]

A last example, which was very relevant for the ECB, notably for the ECB's summer holidays this year. This was the question of the *bridge financing for*

27 Further details on this can be found in the Commission's Assessment of the Social Impact of the new Stability Support Programme for Greece, SWD(2015) 162 final, 19 August 2015.

28 See the debt sustainability assessment of the institutions, available at http://ec.europa.eu/economy_finance/assistance_eu_ms/greek_loan_facility/pdf/debt_sustainability_analysis_en.pdf, where it says: "However, focusing exclusively on the debt-to-GDP level does not allow capturing the structure of debt and is not accounting entirely for the measures taken by the European financial support. This aspect can be better assessed by the gross financing needs of a country, which captures its payment structure over time."

Greece. In the middle of the negotiations over 12 to 13 July, in the early morning hours, the third Greek programme was finally agreed by the Heads of State or Government of the euro area, all of them sitting on the 80th floor of the Justus Lipsius building in Brussels. Most people were very tired, no one looked fresh. But "what happens after this summit?", we in the Commission team asked ourselves. The Euro Summit had only decided to *start* the negotiations for a new ESM programme for Greece of up to €86 billion and it had given the Commission (in liaison with the ECB and together with the IMF) until mid-August to conclude these negotiations. However, on 20 July Greece had to pay around €7 billion to the ECB on a maturing Greek government bond. What would happen then, with the final programme negotiations still pending and no new programme money yet available for Greece? Many euro area leaders said: "This is not our problem; this is the ECB's problem". President Juncker said: "Wait a second. This is a big issue: a country defaulting on its central bank, on our common central bank, is a big issue, we cannot just let this happen". But everybody left the room, nobody – except ECB President Draghi – was interested in this seemingly technical question. Already on the next day, after only a few hours' sleep, President Juncker proposed a solution to this problem. It was very controversial; Britain did not like it as it meant reactivating the European Financial Stability Mechanism of 2010[29] which – at least Britain had thought – had been dormant forever since 2011. But it still existed and still had an untapped financing capacity of €12.5 billion. In the end, it took three days to overcome the British opposition, to elaborate guarantees for non-euro area Member States (following the Commission's suggestion[30], they were exempted from all liabilities resulting from this bridge financing) and to get support from all 28 Member States.[31] This bridge financing in the end allowed Greece to pay the ECB fully on 20 July.[32] This was not a small technical exercise. It meant avoiding that a "Grexit" happened by accident; that we had a "Graccident" because Greece was not honouring its financing obligations vis-à-vis the ECB – because even though the ECB is not a political institution and even though it did not want to pull the plug on Greece, I fear that if Greece had not paid the ECB back on 20 July, we would today have only 18 members in the euro area.

29 Regulation (EU) No 407/2010.

30 Already on 14 July, when making its bridge financing proposal, the Commission had communicated the following to the Council secretariat: "It is clear for us that non-euro Member States (in particular one) will need some further reassurances to be willing to accept an EFSM-based solution. One solution already discussed would be to foresee that the euro area Member States commit formally to indemnify the non-euro Member States, for the case that Greece would not pay back the loan to the EFSM and the EU budget would suffer losses. A similar arrangement was put in place in the context of the setting up of the Single Resolution Fund in 2013. Euro area Member States committed (in that case via an intergovernmental agreement), to indemnify the non-euro States, in case the EU budget would be called on to rescue banks in euro area Member States. A similar solution could be explored here."

31 As a result, the EFSM Regulation was changed: see Council Regulation (EU) 2015/1360 of 4 August 2015 amending Regulation (EU) No 407/2010 establishing a European financial stabilisation mechanism (OJ L 210, 7.8.2015, p. 1).

32 See Financial Times, 17 July 2015, p. 1: "Athens wins lifeline as Draghi stands by Greece's place in euro. Plans for €7bn bridging finance to avert default".

4 CONCLUSION

I come to the end: the Court of Justice did not take over Advocate-General Cruz Villalón's view on the alleged conflict of interest of the ECB. The Court decided not to address the question at all in its final judgement in the *Gauweiler* case, which was delivered on 16 June 2015. The ECB can therefore feel relatively safe: you are not too political for our Court and legally, you are not in a conflict of interest when participating in the implementation of the third Greek programme or another programme while standing ready to activate your OMT decision. The political discussion on the politics of the ECB in programme design and implementation may continue, but at least, critics cannot rely on the authority of the Court of Justice. Even though the ECB may consider whether a more prudent, cautious role in the management of such programmes is not wise. But this is now a matter of political choice for the ECB, not a legal imperative.

Will the broader public, will political opinion follow the German Finance Ministry's criticism of the "too political" Commission? The jury is still out on this, but I do not believe that the Commission should be too afraid of this debate. From its inception, the Commission has been there to be the scapegoat for Member States when something is controversial – Walter Hallstein knew this already. This is politics, too. And sometimes the Commission has to choose to do the right thing even though it triggers a lot of opposition. The Commission invested a lot of political capital in keeping Greece in the euro, because the Commission's political leadership felt it was the right thing to do. The Commission is investing a lot of political capital in managing the refugee crisis – because the President of the Commission and his College believe it is the right thing to do. And the Commission will continue to do its utmost to prevent "Brexit". Because we do not see it as part of our mandate to let the Union disintegrate; but rather to strengthen the forces that keep our Union together. This is a political choice and it will not always make the Commission popular. But for those who disagree with the Commission's political choice, there is a moment when they can express their preference for another political course: during the next European Parliament elections in 2019.

How does the general public so far assess the allegedly too-political role of the ECB and of the Commission? We have no comprehensive scientific evidence on this yet, but at least a very recent opinion poll conducted here in Germany.[33] This August, the German public was asked: who has the strongest influence on the political direction of Europe? The ECB, the Commission, or Germany? The result is interesting: the Germans consider the ECB to have most influence, with 39%. The Commission comes second with 36%, and Germany last with 34%. For the ECB and the Commission, the two cousins of our Economic and Monetary Union, this is not such a bad result. Congratulations notably to the ECB. I personally must say that as a citizen, I am often glad that the ECB understands and uses its mandate, within the limits of EU law, in a proactive, and thus political way.

And on this note, I wish you now a good dinner and interesting discussions.

33 Poll by Deutsche Welle with infratest-dimap, accessible at: http://www.dw.com/de/dw-umfrage-ezb-hat-gro%C3%9Fen-einfluss-in-europa/a-18649650.

PANEL 6

DIFFERENTIATED INTEGRATION IN THE EUROPEAN UNION: THE EUROPEAN CENTRAL BANK BETWEEN THE EURO AREA, THE SINGLE SUPERVISORY MECHANISM AND THE EUROPEAN UNION

INTRODUCTION

FRANK MOSS[1]

Ladies and gentlemen, I am very pleased at having been accorded the role of chairperson of a panel at this ECB Legal Conference. This is the first, and at the same time penultimate, panel of the second day of the conference, coming after a very rich day of five panel discussions, which underscores what Ms Zilioli has just observed, namely that this conference has already witnessed many interesting interactions. The common theme of today's two panels could be described under the heading of the scope for differentiation in the degree of integration of economic and financial policies in the EU, whereby the panel after this one will focus on real economic aspects whereas the current one will dwell on financial stability aspects.

In the wake of the global financial crisis and the euro area sovereign debt crisis, the EU in general, and the euro area in particular, have been making big efforts to foster financial stability in Europe. The Euro Area Summit statement of 26 October 2011 even referred to unprecedented steps having been taken over the preceding three years, both in the EU as such and within the euro area, to combat the effects of the worldwide financial crisis. Three days previously, the European Council had noted the intention of the Heads of State or Government of the euro area to reflect on a further strengthening of economic convergence within the euro area, on improving fiscal discipline and on deepening economic union. This reflection would be crystallised in a report by the President of the European Council, in close collaboration with the President of the European Commission, the President of the Eurogroup and the President of the ECB, i.e. a Four Presidents' Report. At the same time, the European Council agreed on the need for coherence of the activities of the euro area and the EU, in full respect of the integrity of the EU as a whole.

On 29 June 2012, the European Council welcomed the statement of the Euro Area Summit of that same day, which referred to proposals to be developed by the European Commission on the basis of Article 127(6) TFEU for an effective Single Supervisory Mechanism (SSM) that would aim at breaking the vicious circle between banks and sovereigns. On the same occasion, the European Council adopted a Compact for Growth and Jobs which explicitly acknowledged that financial stability is a prerequisite for growth and that the first version of the Four Presidents' Report, presented at its meeting, sketched out important ideas in that respect. It went on to observe that 'these are areas where the Member States sharing a single currency, and others willing to join the effort, want to go further in their efforts to coordinate and integrate their financial, fiscal and economic policies within the European Union framework, fully respecting the integrity of the Single Market and of the European Union as a whole'.

1 Director General International and European Relations, European Central Bank.

When the final version of the Four Presidents' Report was presented in December 2012, the European Council acknowledged that the SSM constituted a major qualitative step forward towards a more integrated financial framework. At the same time, it observed that the process of completing economic and monetary union (EMU) would build on the EU's institutional and legal framework. It would be open and transparent towards Member States not using the single currency. All of this testifies to the awareness of Europe's leaders that differentiated integration, in particular in the financial sphere, might create tensions between those EU Member States that are part of the euro area and others that are not or are not yet ready to enter into this undertaking of a monetary union.

In his introductory words to today's session of this legal conference just a moment ago, President Draghi referred to two priority areas highlighted in the Five Presidents' Report, the recent follow-up to the Four Presidents' Report, for ensuring a well-functioning monetary union: first, completing banking union; secondly, advancing with capital markets union. It deserves to be underlined once more that these three unions are, at least for the foreseeable future, intended to serve three different compositions of the European Union: a monetary union for those, currently nineteen, countries that have adopted the euro as their national currency; a banking union for those same nineteen euro area countries plus any other EU member countries that would like to join; and a capital markets union for all twenty-eight EU Member States. In other words, geographically differentiated approaches to financial integration, which could from one vantage point be seen as complicating the process of arriving at a more perfect union, as President Draghi has just coined it, but which from another vantage point could be regarded as a pragmatic means of facilitating progress towards such a more perfect union.

To avoid complications, European leaders have persistently stressed that the progress being made towards deepening EMU must involve all. Hence, the discussion of the Four Presidents' Report, its successor, and many other discussions held regarding a deepening of EMU or the strengthening of the governance of the euro area have all taken place at EU level. At the same time, the EU Treaty itself embodies the acknowledgement that differentiated integration in the financial and economic fields is a reality in the EU. Indeed, not only does the EU Treaty contain specific provisions that apply to member countries of the euro area only, it also specifies the conduct of a convergence assessment exercise, the very nature of which is to assess differences in the degree of economic and financial alignment across EU Member States that warrant a differentiated pace for acceding to the monetary union. Likewise, even though Article 142 TFEU calls for each Member State with a derogation to treat its exchange rate policy as a matter of common interest, this same article as well as other Treaty articles make reference to the exchange rate mechanism of the European Monetary System, which is an arrangement that eminently differentiates between EU Member States. Another obvious case of the Treaty providing for a differentiated pace of integration concerns the procedure for enhanced cooperation outlined in Articles 326-334 TFEU.

As a matter of fact, the ECB itself is a reflection of this differentiated approach to integration in the monetary and financial domain. First and foremost, the ECB is the central bank of the euro area, with two decision-making bodies: its Executive Board and Governing Council, which assume responsibility for the conduct of the euro area's monetary policy. Given this responsibility for the single monetary and exchange rate policy of the euro area, the ECB also naturally fulfils a core role in the organisation of the exchange rate relationships between the euro area and those non-euro area EU Member States that have agreed to participate in the exchange rate mechanism of the European Monetary System. Secondly, the ECB incorporates the Supervisory Board which carries out the banking supervisory tasks of the SSM, comprising all participating Member States, which per definition are those whose currency is the euro, but which can also include EU Member States that do not have the euro as their national currency but whose national competent authority for banking supervision has engaged in close cooperation with the SSM. Thirdly, the ECB provides a platform for dialogue and cooperation among the central banks of all EU Member States in the format of the General Council of the ECB, which also has some limited decision-making powers. And, finally, the ECB hosts the platform for exchanges of views among the central banks and the micro and macro-prudential authorities of all EU Member States in the constellation of the European Systemic Risk Board, which has no formal decision-making powers. In sum, the ECB itself is a living example of how to handle under one and the same roof differentiated forms of financial integration within Europe.

So it is possible, also from a legal point of view, given the status of the ECB as an EU institution, to provide for differentiated forms of integration in the financial domain. That does not answer the question, however, whether differentiated integration in the financial sphere of the European Union is going to help or hinder the process of a deeper union, or whether it can promote or delay that process. As I mentioned just a moment ago, there can be very different vantage points in relation to the legal scope for differentiated financial integration. As an economist, the matter seems rather straightforward: the deeper the degree of economic and monetary union, the stronger the case for a free movement of factors of production to buffer asymmetric shocks to this union. In other words, if the euro area does not comprise the entire EU membership, it makes economic sense for the euro area members to engage in deeper financial integration, in terms of banking as well as capital markets union. Of course, the real world is more complex than textbook economics and, to the extent that one conceives the European Union as already being some kind of political union, the legal framework underpinning this political union becomes both key and complicated at the same time.

I can therefore fully understand that, from a legal perspective, matters can look very different. To cover the different legal vantage points, I am in the fortunate position of being able to introduce to you a diverse group of panel members. It consists of three presenters and two discussants, all of whom are in my view very well-suited to shed light on the matter from its various angles. Given the differences in their background, age and affiliation, I am looking forward to a very interesting exchange of views, following which we should have some

remaining time to interact with the audience. That obviously assumes that I will not disappoint in my role as chair in disciplining each speaker to stay within the time limits allocated. I will therefore also not spend much time on introducing every one of the speakers, whose current occupation is mentioned in the conference programme. Suffice it to say that they come from two institutional domains. The three presenters – Roberto Cisotta, Frédéric Allemand and Ann-Katrin Pötter – are all currently affiliated to an academic institution, but each of them has had some work experience at an EU institution; as a matter of fact, the first two spent some time inter alia at the ECB. The two discussants – Hubert Legal and Savvas Papasavvas – are both affiliated with an EU institution: the Council and the Court of Justice of the EU, respectively.

Having had the opportunity to preview the contributions from the three presenters, I can affirm that a diversity of views will be exposed in a thought-provoking manner that will undoubtedly trigger interesting reactions from the discussants as well as follow-up questions from the audience. In a nutshell, and without any intention whatsoever to pre-empt part of the presentations – which would indeed be a reckless undertaking for a simple economist at a high-level legal conference – I would merely like to point out that, from an ECB perspective, three interesting themes are likely to be addressed: first, the concept of the financial stability of the euro area as a whole and how it relates to the EU Treaty framework and the functioning of the internal market; secondly, the emergence of differentiated arrangements to foster financial stability in Europe, built also on different legal bases, both inside and outside the EU legal framework, and how to keep this differentiation in check; and, thirdly, the different roles played by the ECB as an EU institution in contributing to securing financial stability in the EU.

I have spoken for too long already. In order not to lose my credibility as a time-considerate chair, let me therefore immediately give the floor to the three presenters, followed by the two discussants, before opening up the session to the audience.

FINANCIAL STABILITY AND THE RECONSTRUCTION OF THE EU LEGAL ORDER IN THE AFTERMATH OF THE CRISIS

ROBERTO CISOTTA[1]

ABSTRACT

This paper examines the role plaid in the context of the responses offered by the EU to the financial crisis by the concept of 'financial stability of the euro area as a whole'. It emerges as a value and as an objective of the national and EU legal orders, and it is argued it can provide a guiding principle for national and EU bodies and institutions and as a coherence factor from an interpretative point of view.

I INTRODUCTION

This paper aims at formulating a new theoretical reconstruction apt to offer a better understanding of the interplay between the various differentiated *circles* of cooperation created, on different legal bases – inside and outside the EU legal order – to tackle the financial crisis up to the present time. In particular, I will try to clarify how the coexistence between those *circles* and the internal market can be arranged.

The analysis starts from an understanding of the new legal institutional and financial framework set up to cope with the economic crisis as a legal apparatus based on the protection of the 'financial stability of the euro area as a whole'. This is only apparently an obvious and neutral starting point. Both the EU institutions and its Member States have taken the preservation of the financial stability of the monetary area as their pole star throughout the crisis[2]. On top of that, taking it as the cornerstone of the latest evolution of EU law, and namely economic and monetary union (EMU) law, constitutes an interpretative option which has relevant consequences on the evaluation of the actions and new powers of pre-existent and newly established institutions, organs and bodies, and, ultimately, on the reconstruction of the EU legal system. It will be argued that the latter has welcomed the 'financial stability of the euro area as a whole'

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2 Since the beginning of the crisis, the safeguard of the financial stability of the EU and in particular of the euro area has been at the core of the concerns in particular of the Member States whose currency is the euro and, as it will be outlined, this lies with the fact that the ultimate responsibility for the financial stability of the euro area is in their hands – and not of the EU; see Statement by the Heads of State or Government of the European Union, Brussels, 11 February 2010, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/112856.pdf.

as a new objective, and this enables the EU institutions to take new actions – i.e. adopt legislation and other acts, establish regulatory and supervisory (especially over national economic policy decisions) systems and, in particular as regards the ECB, carry out market operations partly under new and different conditions.

The evolution triggered by the crisis has probably accelerated an already ongoing process regarding in particular the euro area. In formal terms, this process can be clarified as the *incremental clarification and concretisation* of the latitude and consistency of EU's competence in economic policy *vis-à-vis* the EU Member States whose currency is the euro. In fact, as will be recalled in Section 2, the limits and the nature of EU's competence in this field are not fully clarified by primary law, which leaves room for manoeuvre to Member States and institutions for its concrete definition.

The existing literature has extensively dealt with the *special* legal features of the solutions and mechanisms set up by the EU and its Member States to react to the crisis and to create a sounder financial system able to withstand financial bad weather[3]. It seems that the time has come to formulate a tentative theoretical reconstruction – allowing a new practical approach, too – for the understanding and management of the new complex legal framework. This paper tries to shed some light on the systematic implications of the appearance of the concept of the 'financial stability of the euro area as a whole', especially in terms of impact on the internal market functioning.

2 THE EU'S COMPETENCES IN EMU AND THE PROBLEM OF THE PRESERVATION OF THE FINANCIAL STABILITY OF THE MONETARY AREA

Article 5(1) TFEU recognises that economic policy is, in substance, a matter pertaining to the national level. The text of the provision reads as follows:

'The Member States shall coordinate *their* economic policies within the Union.'[4]

Such wording leaves little space to the EU and the relative powers do not seem to fall in any of the three established categories of competences, listed in other provisions (Articles 3, 4 and 6 TFEU). This is confirmed by Article 2 TFEU, where economic policy coordination is mentioned separately from the *ordinary* groups of competences[5].

3 See, amongst many others, Viterbo and Cisotta (2010), pp. 961-994; Louis (2011), pp. 353 et seq.; Adamski (2012); Smits (2012), pp. 827 et seq.; Viterbo and Cisotta (2012), pp. 325 et seq.; Tosato (2012), pp. 681 et seq.; Adinolfi and Vellano (2013); Chiti and Teixeira (2013), pp. 683 et seq.; De Streel (2013), pp. 336 et seq.; Martinico (2013), p. 3 et seq.; Smits (2015), p. 1135 et seq.

4 Emphasis added.

5 See Dougan (2008), pp. 655-6.

However, Article 5(1) TFEU also states that

'[s]pecific provisions shall apply to those Member States whose currency is the euro.'

Chapter IV of Title VIII of the Third Part of the TFEU is entitled 'Provisions Specific to Member States whose Currency is the Euro': thus, it may be wondered whether the provisions included in Chapter IV contain the legal bases for reinforced coordination for euro area Member States. It cannot be excluded that other primary law provisions may also be considered as 'specific' ones which apply to euro area Member States allowing them to take actions implementing the 'special' powers of the EU in economic policy as regards such States. Nevertheless, from a systematic point of view, the title of Chapter IV cannot be due just to organisational reasons in the context of Title VIII – i.e. to distinguish those provisions that apply only to euro area Member States from all the others, addressed also to the Member States which have still not joined the monetary area. In fact, there are some other clauses in different provisions in Title VIII specifically dedicated to the functioning of the monetary area (for instance as regards voting rules, sanctions in the context of the *excessive deficit procedure*, etc.: see Article 139 TFEU). It seems nonetheless clear, from the aim of provisions in Chapter IV and also on the basis of the praxis that emerged during the crisis – see the next Section –, that that Chapter contains at least the most important of such 'specific' legal bases. Resorting to those bases, the powers that can be conferred upon the institutions of the EU may go beyond the mere coordination of national economic policies and may entail more significant and intrusive actions for the EU in the field.

In this paper it is assumed that, in the field of economic policy, and at least as far as Member States whose currency is the euro are concerned, the competences of the Union can grow to the detriment of those of Member States, as is the case in the fields where competences are shared between Member States and the EU (listed in Article 4 TFEU). It will be demonstrated in paragraph 2.2 that the Court of Justice of the EU has implicitly made the same assumption.

2.1 PRIMARY LAW PROVISIONS SPECIFIC TO EURO AREA MEMBER STATES: THE PRAXIS DURING THE CRISIS

The praxis of the actions undertaken by the EU institutions in the course of the crisis endorses the proposed interpretation as regards the competences of the EU in the field of economic policy. In this respect, Article 136 TFEU is the most significant provision of Chapter IV and since the beginning of the crisis it has been used as a legal basis for a series of acts concerning euro area Member States with a view to providing what can be considered closer coordination in the field of economic policy.

This is the original text of Article 136 TFEU (without the third paragraph, which was added in 2011 – see next paragraph):

'1. In order to ensure the proper functioning of economic and monetary union, and in accordance with the relevant provisions of the Treaties, the Council

shall, in accordance with the relevant procedure from among those referred to in Articles 121 and 126, with the exception of the procedure set out in Article 126(14), adopt measures specific to those Member States whose currency is the euro:

(a) to strengthen the coordination and surveillance of their budgetary discipline;

(b) to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance.

2. For those measures set out in paragraph 1, only members of the Council representing Member States whose currency is the euro shall take part in the vote.

A qualified majority of the said members shall be defined in accordance with Article 238(3)(a).'

Since the spring of 2010, when the first Greek crisis erupted, Article 136 TFEU has been interpreted extensively and used for a variety of purposes. First, it has been used to adopt acts incorporating the conditionality clauses for Member States receiving financial aid. Secondly, decisions on the existence of excessive deficits for euro area Member States have thereafter been adopted on the basis of Articles 126(6) and (13) and 136 TFEU. Article 136 TFEU plays an important role also in those groups of measures referred to as *six pack*[6] and *two pack*[7]; in order to entrust the EU institutions with new and more intrusive powers as regards the euro area, recourse to Article 136 TFEU is deemed necessary.

2.2 THE AMENDMENT OF ARTICLE 136 TFEU: AN INTERPRETATION CONSISTENT WITH THE OBJECTIVE OF SAFEGUARDING THE FINANCIAL STABILITY OF THE EURO AREA AS A WHOLE

Article 136 TFEU has throughout been at the centre of the action: it has in fact been the object of an amendment and the analysis of such intervention is especially relevant for our purposes. A third paragraph was added to the provision in question by European Council Decision 2011/199/EU of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro[8]. This act was intended to explicitly allow euro area Member States to establish a permanent stability mechanism[9]. The reasons that led the

6 See OJ L 306, 23.11.2011, pp. 1-47.
7 See OJ L 140, 27.5.2013, pp 1-23.
8 OJ L 91, 6.4.2011, p. 1.
9 It is not relevant here to make reference to the financial assistance mechanisms existing before the amendment to Article 136 TFEU. See Viterbo and Cisotta (2010), pp. 980-988; Viterbo and Cisotta (2012), p. 333-334, 335-341; Viterbo (2012); De Witte (2011) p. 1 et seq.; Louis (2012b), pp. 284 et seq.; De Gregorio Merino (2012), p. 1613 et seq.; Martucci (2012), pp. 664 et seq.

Member States to introduce such an amendment are quite complex, but can be summarised by saying that an explicit endorsement in primary EU law was felt to be needed so that Article 125 TFEU (the *no bail-out* clause) was not infringed by a permanent financial assistance mechanism for euro area Member States.

For our purposes, just a few remarks seem opportune to clarify the legal questions underlying this choice[10]. The *no bail-out* clause – and, with different addressees and/or under different perspectives, Articles 123 and 124 TFEU – is intended to oblige each Member State that is part of the monetary area to bear sole responsibility for its financial commitments[11]. Otherwise, as is well known, incentives to moral hazard would be created, as Member States might conduct prudent fiscal policies relying on the support of other Member States, or of the Union (or the ECB or the banking system), which would sooner or later be provided to *rescue* the monetary area in the event of financial turmoil. If such objective, pursued by Article 125 TFEU, is clear, it has to be recalled that when EU Member States started to be hit by the crisis, the problem arose as to whether a kind of financial assistance could be given to the Member States with the worst financial problems without infringing the *no bail-out* clause. In essence, the response was in the affirmative, but without any undertaking of financial obligations of the rescued Member State by the other Member States. Therefore, the whole operation should have constituted, in essence, issuance of new debt for the rescued State. Moreover, such loans have been granted under 'strict conditionality', i.e. with the rescued Member State undertaking very serious obligations concerning the conduct of its fiscal policy.

These arguments have been severely criticised by the authors who maintain that the *Maastricht design* must be interpreted restrictively, i.e. not allowing any substantial circumvention of the fiscal discipline rules[12]. However, the interpretation followed by the EU institutions and the Member States, generous as it may be, can hardly be considered at odds with primary law. It is difficult to overcome the formal argument that Article 125 prohibits operations that relieve the debtor Member State of a direct assumption of its financial commitments, but not other forms of financial aid.

Let us now turn back to the Treaty amendment. This is the new third paragraph of Article 136 TFEU, added by Decision 2011/199/EU:[13]

'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.'

10 On this issue in general see Athanassiou (2011), pp. 558 et seq.; Palmstorfer (2012), pp. 771 et seq.
11 See Louis (2010), p. 978.
12 See Ruffert (2011), p. 1785 ss.
13 OJ L 91, 6.4.2011, p. 1.

Therefore, the new stability mechanism can be activated only 'if indispensable to safeguard the stability of the euro area as a whole' and any required financial assistance 'will be made subject to strict conditionality' (similar statements are contained in Decision 2011/199/EU). These limitations are clearly aimed at maintaining the rigour of the fiscal discipline for euro area Member States and at avoiding moral hazard. One cannot escape from noting that they are the same limitations recognised, under the praxis developed before the Treaty amendment, for the interventions carried out on an *ad hoc* basis or under non-permanent mechanisms. *Du reste*, there are no indicators in primary law that should lead one to consider differently financial assistance provided in one of such forms from others.

As stated by the European Commission Opinion on the draft European Council Decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro[14], and by ECB Opinion CON/2011/24 on a draft European Council Decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro[15], the new third paragraph of Article 136 TFEU just *clarifies*[16] that the kind of financial assistance possible under the permanent stability mechanism which was to be established was compatible with the *no-bail out clause*. Given that the limitations were the same as those recognised for the other financial assistance interventions carried out before the Treaty amendment, it can be said that the legitimacy of the latter has been indirectly endorsed *ex post* by those statements of the Commission and the ECB. The same can be said for the Court of Justice, which had the chance to express its view on this matter in the *Pringle* case[17], where it reviewed the validity of Decision 2011/199/EU and was called upon to interpret a series of primary law provisions.

It seems clear that the *authorisation* contained in the new third paragraph of Article 136 TFEU concerns action to be carried out by Member States of the euro area (and it was intended to clarify the compatibility of such action with the *no bail-out* clause). Therefore, as regards this matter, the new paragraph of

14 Brussels, 15.02.2011, COM(2011) 70 final.

15 OJ C 140, 11.5.2011, p. 8.

16 In the words of the Commission, the amendment '*confirms* that the legal framework of the Union does not prevent those Member States from establishing a permanent stability mechanism enabling them to obtain any necessary financial assistance': paragraph 6 of the European Commission Opinion, emphasis added. Paragraph 5 of ECB Opinion CON/2011/24 states that the new third paragraph of Article 136 TFEU 'helps to explain, and thereby confirms, the scope of Article 125 TFEU with respect to safeguarding the financial stability of the euro area as a whole, i.e. the activation of temporary financial assistance is in principle compatible with Article 125 TFEU provided that it is indispensable for such safeguarding and subject to strict conditions', which is possible under Article 125 TFEU.

17 See the judgment in Case C-370/12, *Thomas Pringle v Government of Ireland, Ireland and The Attorney General*, ECLI:EU:C:2012:756, paragraphs 129-147. This judgment raises several issues which are not dealt with here; in the literature, see, amongst others, Thym and Wendel (2012), pp. 733 et seq.; Borger (2013), pp. 113 et seq.; De Witte and Beukers (2013), pp. 805 et seq.; Adam and Mena Parras (2013), pp. 848 et seq.; Beck (2013), pp. 635 et seq.; Craig (2013), pp. 3 et seq.

Article 136 TFEU does not confer any power upon the EU and the competence for the *ultimate action* to *rescue* the euro area rests with the Member States, as confirmed, once more, in *Pringle*[18]. Nevertheless the Court of Justice, again in *Pringle*, has not precluded recourse to Article 352 TFEU for the establishment of a permanent mechanism: it has confined itself to noting that such solution has not been adopted by the EU institutions[19]. This passage appears significant. By stating that, in principle, Article 352 TFEU could be used, the Court of Justice is accepting that a shift in competence from the Member States to the EU may take place as regards the preservation of the financial stability of the euro area as a whole: as resort to Article 352 can be justified only by the existence of an objective to be pursued by the EU, the referred statement implies that such an objective might, in the future, pertain to the Union. Therefore, the assumption (made in Section 2) that competences in economic policy can undergo the same dynamics of shared competences also seems to have been made by the Luxembourg judges.

The elements emerging from the presented praxis constitute the starting point for an understanding of the meaning and of the systematic role of the concept of financial stability of the euro area as a whole. Before trying to outline other important elements which will help to complete the picture, we should try to answer a last question concerning the new text of Article 136 TFEU. Such text, as seen, refers to the 'stability of the euro area as a whole'. It may be questioned whether the absence of the adjective 'financial' implies that non-economic elements can come into play when the existence of the prerequisites for providing financial assistance is evaluated. Recitals 2 and 4 to European Council Decision 2011/199 would lead one to consider that the 'stability of the euro area as a whole' has to be intended primarily as 'financial stability', but it is probably not by chance that the adjective 'financial' has been omitted in the new third paragraph. It is difficult to isolate merely financial aspects, just cutting off political considerations. The two aspects are often intertwined and the reactions of the markets – which in theory should be amongst the most relevant aspects to be considered – can be caused by misinterpretation and/or under- or overreaction to the situation of the Member State concerned.

The Court of Justice has provided an element which would be relevant in such contexts: the financial stability of the euro area and that of its Member States are

18 See Case C-370/12, *Pringle*, paragraphs 68, 72 and 184.

19 See Case C-370/12, *Pringle*, paragraph 67. It should be recalled that the European Parliament in its resolution on the draft European Council Decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, approved on 23 March 2011, had called for the adoption of an act under Article 352 TFEU to establish a permanent mechanism.
The permanent stability mechanism authorised by Article 136 TFEU was eventually set up by the *Treaty establishing the European Stability Mechanism* (ESM Treaty), http://europa.eu/rapid/press-release_DOC-12-3_en.htm.

closely connected and it can be inferred that no Member State belonging to the monetary area is isolated enough, that its financial situation can worsen without repercussions on the stability of the area as a whole[20].

3 BUILDING THE 'FINANCIAL STABILITY OF THE EURO AREA AS A WHOLE' AS A LEGAL CONCEPT

It is not easy to define what is financial stability, and it is even more difficult to establish when a risk to financial stability should be deemed serious enough and, therefore, an intervention of the Member States of the euro area – now via the permanent stability mechanism envisaged by Article 136 TFEU – could be considered possible.

As we shall see, monitoring financial stability is becoming increasingly important for central bankers and for the ECB in particular. Therefore, the ECB has also come across the problem of defining financial stability, as emerges from the following passage:

'Capturing the complex notion of financial stability is not straightforward; the ECB defines it as a condition in which the financial system – intermediaries, markets and market infrastructures – can withstand shocks without major disruption in financial intermediation and in the effective allocation of savings to productive investment'[21].

For our purposes, we can assume that financial stability is a condition in which the different actors of the financial system, as well as its institutions and infrastructures ('intermediaries, markets and market infrastructures') are able to absorb shocks without 'major disruption' in the performance of their tasks ('financial intermediation and in the effective allocation of savings to productive investment'). However, some other elements also need to be outlined.

In the first place, what may seem obvious is that in Article 136 TFEU financial stability refers essentially to the public finances of one or more euro area Member States. However, the relationship between sovereign debt and financial stability of the private sector has always been evident and it has constituted one of the most problematic issues throughout the crisis. To what extent *private financial stability* should be considered separate from *public financial stability* from an economic point of view is not relevant here, but it has to be borne in mind that the aspects related to the stability of private entities constitute an important element for the reconstruction of the concept of 'financial stability' under Article 136 TFEU. This aspect is confirmed by the ECB definition of financial stability reported above, where no distinction is made as to the nature – public or private – of the subjects or financial instruments considered[22].

20 See Case C-370/12, *Pringle*, paragraph 142.
21 See European Central Bank, *Financial Stability Review*, May 2014, p. 8.
22 See also Juncker, Tusk, Dijsselbloem, Draghi, Schulz (2015), p. 12.

In the second place, it is useful to make reference to how the financial stability of the euro area as a whole has been considered in the context of a national legal order: given that its preservation belongs to national competences, it is quite natural that this has been a matter also for national judges[23]. A case decided by the Estonian Supreme Court appears representative: the safeguarding of the financial stability of the euro area as a whole was considered as a *value* which can provide grounds to limit some constitutional prerogatives, in particular of the national Parliament[24]. The issue concerned Article 4(4) of the ESM Treaty, which allows decisions to be taken with a 85% majority (instead of the unanimity vote that is prescribed as a general rule) in case of urgent financial assistance requests. Hence, even with a negative vote of its representative (amounting to less than the blocking minority of 15%), Estonia could find itself bound by a decision of the majority and by the consequent financial commitments.

The Estonian judges recognised that '[f]inancial stability is related to significant constitutional values': Estonia has put its financial stability in common with the other euro area Member States, therefore the stability of the euro area as a whole has become a national constitutional value[25].

It is clear that this judgment regards only Estonia, but it is remarkable as the financial stability of the euro area – considered by the Estonian Supreme Court no longer to be separable from the national financial stability[26] – comes into play with other values of the same rank and the Estonian judges took the view that corresponding advantages overcome the disadvantage of the risk relating to Article 4(4) of the ESM Treaty. In this judgment, the financial stability of the euro area as a whole *in its national legal dimension* shows one of its possible faces.

In the third place, one should have a fresh look at the *EU law dimension* of the financial stability of the euro area as a whole – which exists, despite the dominant competences of the Member States in the field. The Cypriot case appears here especially emblematic: the safeguarding of financial stability has been recognised by the Commission as a valid justification for temporary restrictive measures to freedom of circulation of capital put in place by Cyprus in 2013 to cope with serious financial risks[27]. Reproducing a very well known framework in EU law, the Commission has recognised that some public policy objectives may justify restrictions to the fundamental freedoms granted under EU law also in cases different from those explicitly provided for by primary law. While the legitimate source for such recognition was the case-law of the Court of Justice, here it has come from the Commission itself, giving rise to a praxis which is very

23 For some interesting insights on the role of constitutional courts, as developed over the decades and in particular in the context of the crisis, see Sciarra and Nicastro, 2015; see also the essays in Ringe and Huber, 2014.

24 See Estonian Supreme Court *En banc*, Constitutional Judgment 3-4-1-6-12, 12 July 2012, translation in English: http://www.riigikohus.ee/?id=1347&print=1.

25 See Ginter (2013), p. 345 et seq.

26 This position seems in line with the perspective of the Court of Justice: see *supra*, footnote 20 and corresponding text.

27 See *Statement by the European Commission on the capital controls imposed by the Republic of Cyprus*, http://europa.eu/rapid/press-release_IP-13-298_en.htm?locale=en. On the Cypriot crisis see Cisotta (2013).

interesting for our purposes (and which may be endorsed by the Court of Justice in the future).

In this case the financial stability of a single (small) euro area Member State was at stake. However – as already recognised by the Court of Justice and the Estonian Supreme Court – it would have been difficult to consider that financial risks affecting just that Member State of the euro area could have been irrelevant and innocuous for the stability of the monetary union as a whole.

In the fourth place, and again in the context of EU law, the financial stability of the euro area as a whole should be considered in a broader perspective. According to some legal scholars, the safeguarding of the 'financial stability of the euro area as a whole' seems now to amount to a new objective of the EU, in particular in the context of the EMU[28]. In addition to the objectives set by Article 119 TFEU, i.e. price stability and prudent fiscal policies, the institutions should now also pursue the objective of safeguarding financial stability.

Whether and to what extent preserving financial stability is an objective compatible with the other two laid down in Article 119 TFEU is a matter essentially pertaining to economic analysis and cannot be verified here; moreover, interpreting those two objectives rests substantially in the discretion of the EU institutions. What can be said is that sudden and/or continuous changes of them would call into question their credibility (towards third parties and in particular the international markets). At least in the long run, this might dangerously put at risk the chances to pursue effectively all the objectives (including financial stability).

Nonetheless, whether or not the objective in question is in an ancillary position to those explicitly set by primary law, it would still be mandatory for EU institutions to take it into account. First of all, the praxis shows that a number of pieces of EU law take account – although indirectly, as one may say – of financial stability. The objective of the measures adopted to respond to the crisis is not just to keep public expenditure under control, but to set up efficient mechanisms which correct in a timely manner imprudent fiscal behaviour, thus avoiding financial disruption and reducing contagion risks throughout the monetary union. In other and more formal terms, the shift in competences from the Member States to the EU in the field of economic policy has concerned action apt to attain the safeguarding of the financial stability of the euro area as a whole[29].

28 See in particular De Gregorio Merino (2013), p. 1629; Tuori and Tuori (2014), pp. 132-133; Cisotta (2015), pp. 80-82.

29 For some remarks on the critical issue of the choice of a State to cede its powers as regards economic stability in general, see Lupo Pasini, 2013, p. 211 et seq. The emergence of the objective of safeguarding financial stability is evident also for the financial supervision framework set up over the last few years: see *The High Level Group on Financial Supervision – Report (De Larosière Report)*, Brussels, 25 February 2009; on the framework established as a follow up to the work of the high level group, see Louis, 2010b, pp. 645 et seq.; Alexander, 2011, pp. 229 et seq.; Merlin, 2011, pp. 17 et seq.

Secondly, even if such objective had to be classified only as a national one – which in any event seems impossible given the current state of evolution of EU law –, it would stem from the principle of loyal cooperation that the EU should not make it more difficult for Member States to achieve it[30], and, on top of that, should cooperate with national authorities for the preservation of financial stability of the euro area as a whole.

What seems undisputable is that financial stability has different aspects and at least some of them cannot be considered outside the reach (and the responsibility) of the EU[31]. For instance, financial stability is not irrelevant in the context of the activity of the ECB: one may think about the Financial Stability Review, regularly carried out since 2004, as well as the new tasks with which the ECB has been entrusted in the context of the establishment of a banking union, where the safeguarding of financial stability is preeminent (see also Article 127(5) TFEU).

3.1 THE 'FINANCIAL STABILITY OF THE EURO AREA AS A WHOLE' AND ECONOMIC AND MONETARY POLICIES

The hypotheses exposed will now be verified in the light of the case-law of the Court of Justice. It seems especially important to draw attention to the consequences of the results that will emerge as regards the activity of the ECB.

First, it should be recalled that, in addition to pursuing the primary objective of price stability, the ECB and the ESCB have to support the general policies of the EU (see Article 127(1) TFEU). Inasmuch as the financial stability of the euro area as a whole can be considered an objective of the EU, the ECB should help to pursue it, although as a *second-tier objective* after price stability. Second, the Court of Justice has recognised that the ECB and the ESCB, in conducting the monetary policy of the EU, should take care of the transmission mechanism of the 'impulses' they give in the performance of that task. Ensuring proper transmission mechanisms pertains to the primary objective of maintaining price stability. To clarify the point, it seems worth quoting the relevant passages from the recent judgment in the *Gauweiler* case.

'The ability of the ESCB to influence price developments by means of its monetary policy decisions in fact depends, to a great extent, on the transmission of the 'impulses' which the ESCB sends out across the money market to the various sectors of the economy. Consequently, if the monetary policy transmission mechanism is disrupted, that is likely to render the ESCB's decisions ineffective in a part of the euro area and, accordingly, to undermine the singleness of monetary policy. Moreover, since disruption of the transmission mechanism undermines the effectiveness of the measures adopted by the ESCB, that necessarily affects the ESCB's ability to guarantee price stability. Accordingly, measures that are

30 See Article 5 TEU. Loyal cooperation is owed not only by national authorities, but by EU institutions too: see Case C-2/88, *Zwartveld and Others*, EU:C:1990:440, paragraph 17.

31 See also European Commission, *A blueprint for a deep and genuine economic and monetary union – Launching a European Debate*, COM/2012/777 final.

intended to preserve that transmission mechanism may be regarded as pertaining to the primary objective laid down in Article 127(1) TFEU.

The fact that a programme such as that announced in the press release might also be capable of contributing to *the stability of the euro area, which is a matter of economic policy* (…), does not call that assessment into question.

Indeed, a monetary policy measure cannot be treated as equivalent to an economic policy measure merely because it may have indirect effects on the stability of the euro area (…).'[32]

The Court of Justice has thus maintained that a monetary policy measure cannot become an economic policy one 'merely because' it may indirectly have some effects on the (financial) stability of the euro area. The Luxembourg judges have thus preferred to take a 'purist' approach as regards the qualification of a measure as pertaining to the economic or monetary policy[33] – keeping only the second category within the remit of the ECB and of the ESCB –, but they have apparently chosen to consider *irrelevant* its 'indirect effects'. Such effects, on the contrary, may well be taken into consideration by (economic or monetary) policy makers when they set their objectives and choose the measures to be adopted in their toolkit. In fact, shortly after the reported passages, the Court of Justice has stated – with a more precise reference to the government bond-buying programme at issue in the *Gauweiler* judgment – that such indirect effects may constitute a way to support the general policies of the EU as an ulterior objective to price stability, to be primarily pursued by the monetary policy measure at issue (thus allowing the ECB and the ESCB to abide by Article 127(1) TFEU)[34].

What is extremely relevant is that the Court of Justice has, incidentally, affirmed that 'the stability of the euro area (...) is a matter of economic policy'. Despite avoiding the word 'objective', which would have engaged the CJEU in an interpretative effort that was not necessary in the case in question, the Luxembourg judges showed their awareness of the crucial role of financial stability in the ambit of economic policy.

With reference to the division of competences between the EU and the Member States, one may wonder whether the Court of Justice was hinting at economic policy as an essentially national competence, just coordinated at the EU level (see Articles 2 and 5(1) TFEU, and *supra*, Section 2). The exposed analysis, with the highlighted shift in competence from the Member States of the euro area to the EU in the field of economic policy, precisely regarding the pursuit of the safeguard of the financial stability of the euro area as a whole, should lead to a

32 Judgment in Case C-62/14, *Gauweiler v Deutscher Bundestag*, EU:C:2015:400, paragraphs 50-52, emphasis added; see also the judgment in Case C-370/12, *Pringle*, paragraph 56.

33 However, the same action can be classified as an economic or monetary policy measure depending on the subject which carries it out and the objectives pursued: see Case C-62/14, *Gauweiler*, paragraphs 63-64.

34 Case C-62/14, *Gauweiler*, paragraphs 58-59 and 61.

different solution: the Court is referring to a matter of economic policy which is increasingly falling, although not completely,[35] within the competence of the EU.

It can be also noted that the Court of Justice has used the expression 'stability of the euro area' without the adjective 'financial', like in Article 136(3) TFEU. The same observations already made with reference to Article 136 TFEU apply, and here they are confirmed by the link established with economic policy.

4 AN ATTEMPT TO ASSESS THE LEGAL SIGNIFICANCE AND USEFULNESS OF THE CONCEPT OF 'FINANCIAL STABILITY OF THE EURO AREA AS A WHOLE' WITH REGARD TO THE TENSIONS ARISING BETWEEN NEW AND DIFFERENTIATED LEGAL FRAMEWORKS (IN PARTICULAR THE BANKING UNION) AND INTERNAL MARKET LAW

The coexistence with the internal market of the several differentiated *circles* of cooperation established by various measures adopted to tackle the crisis has to be investigated; it will be argued that the concept of financial stability of the euro area as a whole can, explicitly or implicitly, play a role in preventing or solving possible clashes. To this end, it has to be borne in mind that such concept has been already used with reference to the internal market functioning, and in particular for providing grounds to justify a restriction to the fundamental freedoms (see *supra*, Section 3).

Here the new framework for establishing a banking union in the EU will be the object of the analysis, with special reference to the tasks of the ECB. Two critical points emerge immediately. First, the role given to the ECB in the context of the establishment of a banking union could be in some way in contrast with the performance of its primary task, which is to maintain price stability. In fact, the ECB, involved in particular as part of the Single Supervisory Mechanism (SSM) in the new supervisory system, should in that capacity pursue the safeguard of financial stability (of the euro area) and it has been shown that the relationship of this objective with price stability might be problematic (see *supra*, Section 3)[36]. Besides, a new differentiation is being introduced, as not all EU Member States take part in the banking union and thus not all market players will receive the same normative treatment and are subject to the same supervisory and regulatory

35 In this respect, it is remarkable that the Court of Justice has made reference to economic policy actions (namely government bond-buying) undertaken by the ESM, i.e. an entity which works outside the framework of EU law and is under control of the Member States of the euro area: see Case C-62/14, *Gauweiler*, paragraph 63, and Case C-370/12, *Pringle*, paragraph 60. At the same time, in *Pringle* the Court of Justice did not close the door to a possible incremental attraction of competences by the EU in this domain (see *supra*, paragraph 2.2), which, leaves, as explained, space for an increasing role of the EU in the safeguarding of financial stability.

36 See also Lastra (2013), p. 1208; Di Marco (2013), p. 556.

system[37]: this circumstance inevitably causes tensions with internal market law and namely with the existing single financial market.

More precisely, the realisation of the banking union requires: the establishment of a single banking supervisory structure, led by a single organism, which ensures uniform conditions on the market; the establishment of a single authority for bank insolvency, ensuring orderly restructurings; and a single deposit guarantee scheme, with a view to avoiding bank runs and uncontrolled liquidity movements in the euro area[38].

The conceptualisation of the safeguarding of the financial stability of the euro area as a whole emerging from the illustrated praxis and from the presented elaboration can shed some light on the understanding of the legal mandate and activity of the European and national institutions involved.

Two elements in particular should be taken into account from the outset.

Firstly, it has to be borne in mind that – in the words of Lastra –

'[f]inancial stability is a key goal for national, European and international authorities. To achieve this goal the authorities have a variety of instruments at their disposal: regulation, supervision (micro and macro), lender of last resort, recovery and resolution tools, orderly insolvency and others.'[39]

Therefore, working for the establishment of a banking union implies that the specificities of the related tasks have to be taken into consideration: the primary objective of the preservation of the financial stability (of the euro area as a whole) and the variety of specific instruments which can be used to achieve this objective.

37 When performing their monetary policy tasks, the ECB and the ESCB are not under an obligation only to adopt measures of a general character; they can take into account the specificities of a certain Member State and tailor their intervention in relation to it by adopting *selective* measures; in fact, market conditions are usually different in each Member State of the monetary union (as regards in particular sovereign bonds) and interest rates vary as well; therefore, sometimes monetary policy may suffer from uneven transmission maybe only in some of the Member States whose currency is the euro: see Case C-62/14, *Gauweiler*, paragraph 55. This approach recognises the importance of the singleness of monetary policy; in the context of the banking union, legal fragmentation might be due to a presumably temporary form of differentiated integration – and therefore a consequence of political choices –, as well as an unwanted outcome of market and legal conditions. Where possible, the ECB should be allowed to take a differentiated approach in this context, too (as to the justification of possible ruptures in the singleness of the internal market, see above in the main text).

38 See European Council, *Towards a Genuine Economic and Monetary Union* (May 2012), http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf; European Commission, *A blueprint for a deep and genuine economic and monetary union – Launching a European Debate*, COM/2012/777 final; European Commission, *A Roadmap towards a Banking Union*, COM (2012) 510 final; in the legal doctrine see, amongst others: Louis (2012a), pp. 289 et seq.; Di Marco (2013), pp. 549 et seq.; Alexander (2013), pp. 81 et seq.; Lastra (2013), pp. 1190 et seq.

39 Lastra (2013), p. 1217.

Secondly, with specific regard to the ECB, the goal of safeguarding the financial stability of the euro area as a whole cannot be, as is well known, its primary objective, but could just be pursued as a second-tier objective after maintaining price stability (see *supra*, paragraph 3.1). Nevertheless, this privilege for price stability is prescribed by Article 127(1) as regards the conduct of monetary policy, but should not be followed in the context of the establishment of a banking union and namely of supervision activities. This stems also from a systematic interpretation of Article 127(6) TFEU, which allows the conferral upon the ECB of banking supervision tasks – in fact it has been used as a legal basis –, but does not impose that the supremacy of price stability spills over to the supervisory function, i.e. to activities which do not pertain to monetary policy. Nor does Article 127(1) TFEU itself. Furthermore, the exposed analysis shows that the preservation of financial stability of the euro area as a whole has reinforced its standing as an objective of the EU.

However, the legal framework is complicated, *inter alia*, by the fact that – once more in the words of Lastra –

'[t]he advent of macro prudential supervision has further reinforced the link between monetary stability and financial stability.'[40]

Macro-prudential supervision rests in the hands of the ESRB, hence increasing the overlap of objectives and functions within the constellation of institutions and organs involved in the banking union project (but the mandate of the ESRB also goes beyond the boundaries of that project). In its turn, the ECB is called on, on the one hand, to make its contribution to that project and to the efforts to safeguard the financial stability of the euro area as a whole, and, on the other, to work to set conditions which, although apparently disconnected from its usual business and maybe even in contrast with its primary objective, will also ensure monetary stability and thus, in the end, facilitate the transmission of monetary policy 'impulses'.

What is even more interesting is that the preservation of the financial stability of the euro area as a whole could play a role in the management of the criticisms arising out of the subdivisions of the EU created under the frameworks of the SSM and the Single Resolution Mechanism (SRM)[41]. Not all issues can obviously be dealt with here, but it will be useful to sketch the basic principles that stem from the imperative to safeguard the financial stability of the euro area as a whole.

First, on the basis of the case of the capital controls imposed by the Cypriot authorities in 2013 (see *supra*, Section 3), restrictions on fundamental freedoms can be justified on the basis of the need to safeguard the financial stability of

40 Lastra (2013), p. 1217.

41 For another example of tensions between activities of the ECB and internal market law, see the judgment of the General Court in Case T-496/11 *United Kingdom v ECB*, EU:T:2015:133 (the applications in Cases T-45/12 and T-93/13, concerning similar issues, have been withdrawn).

the euro area as a whole. In the *classical* cases regarding fundamental freedoms, restrictions are imposed by, or come out as an effect of, national legislative or administrative measures adopted by authorities of Member States in the exercise of their powers under national law. In our cases, restrictions could be caused by acts or behaviour of national or European organs or institutions acting under the framework of banking union law, thus applying or implementing EU law. The reader will be now well acquainted with the fact that the EU justifies a share of competences as far as financial stability is concerned. Therefore, the potential clashes arise within the EU legal order itself. The contrast would actually be between freedoms of circulation or competition law principles and the safeguarding of the financial stability of the euro area as a whole. This may give the financial stability of the euro area as a whole an advantage: born in the realm of national competences, having now penetrated into the EU legal order and linked in that context to the first rank objective of the realisation of EMU, this goal would not represent a national protectionist tendency. On the contrary, the banking union ultimately serves internal market functioning[42].

Secondly, once entered in the chess game of internal market law, the financial stability of the euro area as a whole, even as an EU law – and not merely national law – objective, should play in such a way as to respect the rules of that game. When striking a balance between exigencies related to the application of provisions on freedoms of movement and possible exceptions, the Court of Justice looks favourably upon freedoms of movement and interprets exceptions restrictively. Despite the referred *benevolentia* from which the preservation of the financial stability of the euro area as a whole may benefit, restrictions should certainly respect the proportionality principle. For instance, it might be necessary to demonstrate – when defending a piece of legislation or another act which establishes a difference in treatment between (market players of) banking union Member States and other EU Member States – that without such act the financial stability of the euro area as a whole would be less well defended, or, ultimately, put at risk. Useful indicators would be: the special conditions and features recognised by primary law and by the legislators (technical expertise, independence, accountability) which place the entrusted entity in a better position to perform the particular task at issue; demonstrable systemic importance of the tasks performed or of the supervised/regulated entities in question; existence of financial linkages of the supervised/regulated entities in question with other public and private subjects, or the special exposure to certain risks emerging from evidence collected by national or European supervisors. However, to respect the proportionality principle, the restriction (and the consequent market distortion) at issue should be strictly limited to the achievement of the objective pursued. In that connection, as is well known, the principle of subsidiarity can also come into play. This would be the case in particular when the conferral to the EU level of a certain function regarding supervision, or resolution, or other (previously exercised by national authorities) powers is contested.

Thirdly, when technical evaluations – for instance the qualification of an entity of systemic importance – are called into question, it is foreseeable that the

42 See Lastra (2013), p. 1221.

EU institutions and organs involved in the framework of the banking union, and especially the ECB, would be granted a broad discretion in technical appreciations, largely subtracted to the scrutiny of the EU judges. To this end, one can invoke, by analogy, the *Gauweiler* case, where this free space of appreciation has been recognised (in the context of the proportionality test) to the ECB when performing its monetary policy tasks: the Court of Justice has recognised that, once the reasons of the contested act have been correctly and sufficiently stated, so that the *basic* scrutiny of the judges can be exercised, and this statement is not vitiated by a manifest error of assessment, the act survives a legality review[43].

Fourthly, competition rules, including both antitrust and State aid law, are part of internal market law in the EU legal system and issues of compatibility between banking union law and such rules may arise, too. Some of the arguments put forward as concerns the application of freedoms of movement rules could be invoked, *mutatis mutandis*, to advocate a somewhat limited application of competition rules, too. As far as State aid rules are concerned[44], resort to exceptions to the general prohibition provided for in Article 107 TFEU may be granted, on the grounds that certain measures – although amounting to aid – are aimed at safeguarding the financial stability of the euro area as a whole. In certain situations, the existence of a general scheme, based also on EU law, to provide financial support to banks or financial institutions – e.g. in recapitalisations – may be qualified as an aid regime. What is more, in competition law the framework for the banking union will have to coexist with the powers of the Commission in competition law enforcement.

Finally, the existence of complex regulatory frameworks established by the EU legislator has been sometimes been regarded with a certain deference by the Court of Justice. However, it would be risky to formulate legal arguments that solicit this type of attitude, which would, in any event, be an indirect acknowledgement of the importance and of the high ranking of the financial stability of the euro area as a whole in the EU legal order.

5 THE FINANCIAL STABILITY OF THE EURO AREA AS A WHOLE AND OTHER (THAN ARTICLE 136 TFEU) LEGAL BASES

As a final step of the present enquiry, it will be verified whether the preservation of the financial stability of the euro area as a whole (or maybe of financial stability of the EU in general) is apt – explicitly or implicitly – to allow the use of legal bases other than Article 136 TFEU, in particular Articles 114 or 352 TFEU, for the adoption of legislation aimed at promoting closer coordination and market integration at various levels.

As regards Article 352 TFEU, there must be an objective the EU has to attain and a lack of powers to establish actions accordingly. The Court of Justice

43 See Case C-62/14, *Gauweiler*, paragraphs 68-80.

44 On this issue, see Quigley and Ackermann in Ringe and Huber (2015), respectively pp. 131 et seq. and 149 et seq. amongst many others.

has been quite generous in acknowledging the existence of an objective in the Treaties, not requiring an explicit statement in the relevant provisions (see in particular Article 3 TEU). The exposed analysis shows that the safeguarding of the financial stability of the euro area as a whole should indeed provide an objective which requires resort to Article 352: being a non-codified objective of the EU, at least in the Treaties, there are no specific actions provided for therein to support its achievement. It can be taken as a confirmation the view taken by the Court of Justice in the *Pringle* case, where the door was left open even to the establishment of a permanent mechanism for euro area Member States on the basis of Article 352 TFEU[45].

As to Article 114 TFEU, it is linked to the objective of internal market functioning and also here the Court of Justice has demonstrated quite a generous approach. Pieces of legislation can be adopted on the basis of Article 114 TFEU where there is an actual and not merely hypothetical positive impact on internal market functioning: there might be many cases of measures aimed at safeguarding the financial stability of the euro area as a whole with at the same time the capability to enhance internal market functioning (even if in these pages the stress has been put on cases of potential contrast between internal market law and banking union rules). In the legal doctrine, the single deposit guarantee scheme has been taken as an example[46], but also the single supervisory and resolution systems, in the absence of subdivisions – due to non-participating Member States – would bring uniform rules and regulation to the market. This characteristic can, even when subdivisions still exist, allow the adoption of legislation in support of the activities of those systems. The viability of Article 114 TFEU solution in the context of the current evolution of the EMU – where the indicated conditions are met – is testified by its use in the ESRB Regulation[47].

6 CONCLUDING REMARKS

The safeguarding of the financial stability of the euro area as a whole, maybe unexpectedly, is at the core of a profound evolution of the EU legal order. From a legal point of view, the need to protect and preserve that stability lies at the intersection of different lines of the evolution of the EU legal order. In the first place, the objectives to be pursued in the context of EMU, as set by the Treaties, had already been felt as probably too rigid, especially if compared to the experience of the Federal Reserve in the USA. In the second place, the fiscal discipline system had had mixed results, undermining its credibility. At the same time, the need to enhance economic policy coordination – the weak pillar of the *Maastricht design* – had led to thinking on a closer union, not just based on discipline and negative solidarity, but also on unified resources and a full fiscal union. In the third place, driving financial markets towards integration had

45 See *supra*, footnote 19 and corresponding text.
46 See Lastra (2013), p. 1221.
47 Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (OJ L 331, 15.12.2010, p. 1).

become an imperative *per se*, and, in addition, both to exploit the potential of the single currency and to build a sounder financial system. Finally, common, clear and well framed rules were clearly necessary to complete the design. The shock of the crisis has triggered change along each of these lines. Bringing together the intertwined tensions of the private and public entities, as well as the critical points of the legal system, the concept of financial stability of the euro area as a whole has become a big issue to be dealt with and therefore its safeguarding provides a *coherence factor* of all the machinery of the potentially involved sectors and policies of the EU.

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THE ECB, THE SSM AND DIFFERENTIATED INTEGRATION: THE LEGAL TRIANGLE OF INCOMPATIBILITY?

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I INTRODUCTION

In their book *The Law of the European Central Bank*, at the beginning of the chapter on 'The European Central Bank and Differentiated Integration', Chiara Zilioli and Martin Selmayr observe that 'EMU [economic and monetary union] is the first comprehensive experiment on differentiated integration.' The two writers go on to say that 'For Community law, this situation represents a challenge.'[2] As regards the rules of law relating to the ECB, more specifically, they note that differentiation holds a much more important place there than in all the other areas of the EU's legal system, precisely because several Member States have not relinquished the right to exercise their monetary sovereignty to the Union. 'The ECB is therefore much more subject to differentiation than are the Community and its institutions […]'[3].

More than 15 years later, this analysis matters more than ever. Since the subprime crisis, the financial sector in the EU has undergone a profound transformation. There has been a rethink of the supervision, oversight and resolution of credit institutions in the direction of greater integration at the European level,[4] as recommended in the report by the de Larosière Group[5]. The year 2010 saw the setting up of the European System of Financial Supervision (ESFS), which consists, in particular, of the three micro-prudential supervision authorities[6] and a committee whose task is macro-prudential supervision, the European Systemic

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2 Zilioli, C. and Selmayr, M., *The Law of the European Central Bank*, Oxford, Portland Oregon: Hart Publishing, 2001, p. 133.
3 Ibid. p. 156.
4 Weder di Mauro, B. and Klüh, U., 'Reshaping Systemic Risk Regulation in Europe', *Brown Journal of World Affairs*, Spring/Summer 2010, Vol. XVI, No 2, p. 181.
5 The High-Level Group on Financial Supervision in the EU. De Larosière, J. (chairman), Report. Brussels, 25 February 2009.
6 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); Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48); Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

Risk Board (ESRB)[7] [8]. This is an EU body[9] without legal personality[10], which is responsible for macro-prudential oversight of the financial system within the EU[11]. It exercises its powers at the EU level, with respect to all the Member States. The ESRB does not 'have any binding powers to impose measures on Member States or national authorities'[12].

Between 2013 and 2015 a banking union has been set up to break the vicious circle between public debt and banking sector debt: the ECB's powers have been extended to cover micro-prudential supervision of euro area banks in the framework of the Single Supervisory Mechanism (SSM) – it exercises its powers directly only with respect to the 123 most significant banking groups. The resolution power of these banks was centralised and conferred on a new Single Resolution Board (SRB), an EU agency open to the representatives of the participating Member States. Bank resolution is financed in two stages, by an internal bailout and, if necessary, a private (Single Resolution Fund, SRF) then public (European Stability Mechanism, ESM) external bailout.

Both the ESRB and the SSM are based around the ECB. For this purpose, the ECB has been given new, specific tasks on the basis of Article 127(6) TFEU. The content and scope of this provision, which had not so far been used, was clarified (section 3 below). Its implementation, however, raised two sets of difficulties associated with the mismatch between the field of application of the ECB's specific tasks and that of the monetary policy. In the ESRB framework the mismatch is organic (section 4) and in the SSM framework it is operational (section 5). Before detailing theses mismatches, the special position that the ECB holds in the differentiated framework of EMU will be briefly summarised (section 2).

7 Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (the ESRB Regulation) (OJ L 331, 15.12.2010, p. 1).
8 The ESFS also includes the Joint Committee of the European Supervisory Authorities and the competent or supervisory authorities in the Member States. See Article 1(3) of the ESRB Regulation.
9 See recital 15 of the preamble to the ESRB Regulation. Stressing the varied origin of its members, the chairman of the Eurosystem's financial stability committee, Mauro Grande, describes the ESRB as an 'interinstitutional committee'. See Grande, M., 'Le comité européen du risque systémique: l'approche européenne du risque systémique', *Revue d'économie financière*, 2011/1, No 101, p. 180.
10 For an account of the discussions concerning the status of the ESRB, see Louis, J.V., 'Le Comité européen du risque systémique (CERS)', *Cahiers de droit européen*, 2010, No 5-6, pp. 652-654.
11 Article 3(1) of the ESRB Regulation.
12 Explanatory memorandum to the Commission communication on the proposal for a regulation on the ESRB, cited above, p. 5, paragraph 6.2.

2 THE SPECIAL POSITION OF THE ECB WITHIN EMU

The ECB 'falls squarely within the EU framework'[13]. Article 13(1) TEU lays down that it is one of the seven institutions forming the institutional framework of the Union. Its decision-making bodies manage the ESCB, the main purpose of which is to maintain price stability. Monetary policy is an exclusive competence of the EU only for the Member States whose currency is the euro. Member States that come under the derogation regime or have an opt-out retain their competence over monetary policy[14]. Their central banks conduct their own monetary policies[15]. The ECB is therefore 'the Euro area's central bank'[16] and not the central bank of the EU. Its functions and powers are limited by the territorial scope of the EU's monetary policy. Each of the legal acts it adopts is an integral part of EU law[17] and, in the case of a regulation or decision, 'is binding in its entirety and directly applicable in all EU countries in accordance with the Treaties'[18]. But the acts have no legal effect with respect to Member States that are not in the euro area.

Equal participation in the EU institutions by the Member States is as much a condition as a consequence of the uniform application of EU law[19]. 'Equality between the Member States of the European Union is a condition of the validity of the restrictions on their sovereignty'[20], it has been observed on this point. Conversely, ruling out the application of a substantial proportion of the common rules entails restricting the right to participate in the EU institutions. In the field of EMU, the ECB's two main decision-making bodies, the Governing Council and the Executive Board, are thus open, respectively, only to the governors of the national central banks (NCBs) of the euro area Member States and to nationals of those Member States[21].

The institutional exclusion is not, however, complete: if and as long as there are Member States with a derogation, the ECB includes a third decision-making body, the General Council[22]. Consisting of the President and Vice-President of the ECB and of all the governors of the Member States' NCBs, this body contributes to the

13 Judgment of the Court of Justice of 10 July 2003 in Case C-11/00, *Commission v European Central Bank,* EU:C:2003:395, especially paragraph 92.
14 See Article 139(2) TFEU, Article 4 of Protocol No 15 on certain provisions relating to the United Kingdom and Article 1 of Protocol No 16 on certain provisions relating to Denmark.
15 Article 42(2) of the Statute of the ESCB.
16 Recital 11 of the Commission proposal for a Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions. Brussels, 12 September 2012, COM(2012) 511 final.
17 Zilioli and Selmayr (2001), p. 165.
18 For example.
19 Order of the Court of Justice of 22 June 1965 in Case 9-65 *Acciaierie San Michele SpA (in liquidation) v High Authority* (EU:C:1965:63), p. 35.
20 Stephanou, C. A., 'Le principe d'égalité statutaire des États', in *Le droit de l'Union européenne en principes. Liber Amicorum en l'honneur de Jean Raux*. Rennes: Éditions Apogée, 2006, p. 373; also Dubos, O., 'L'Union européenne: Sphynx ou Enigme?', in *Les dynamiques du droit européen en début de siècle. Études en l'honneur de Jean-Claude Gautron*. Paris: Pédone, 2004, p. 55.
21 Article 283(1) and (2) TFEU.
22 Articles 141(1) TFEU and 44 of the Statute of the ESCB.

performance of the ECB's transitional tasks associated with maintaining Member States outside the euro area, an exhaustive list of which is set out in the TFEU and the Statute of the ESCB[23]. It has no decision-making powers. '[Its main role] is to give the countries with a derogation a voice in the ECB in matters concerning them after the start of Stage Three and to avoid potential conflicts and misgivings between 'insiders' and 'outsiders' that might prevent the final extension of EMU to the entire Community'[24]. As will be discussed in section 4, the setting up of the ESRB threw the spotlight back onto the ECB's General Council.

3 THE ACTIVATION OF ARTICLE 127(6) TFEU: A WELCOMED CLARIFICATION

EU law is '*un droit transformiste*' ('transformist law')[25]. This observation remains true when it is applied to EMU. In addition to Article 129(2) TFEU and Article 40 of the Statute of the ESCB, which lay down the simplified procedure for revising technical provisions of the Statute of the ESCB[26], Article 127(6) TFEU provides for the possibility of conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. These specific tasks are assigned by a Council regulation adopted in accordance with a special legislative procedure. The Council must act by unanimous vote of all the EU Member States' representatives, after consulting the European Parliament and the ECB.

Article 127(6) TFEU was first applied in November 2010 for the adoption of the ESRB Regulation. It was used again in October 2013 as the basis for the SSM Regulation[27].

23 Articles 141(2) TFEU and 44(3) of the Statute of the ESCB, together with Articles 43 and 46 of the Statute of the ESCB; Article 12 of the Rules of Procedure of the ECB (Decision ECB/2004/2 of 19 February 2004 adopting the Rules of Procedure of the European Central Bank (OJ L 80, 18.3.2004, p. 33)). As part of its tasks, the ESRB promotes monetary cooperation and coordination between the monetary policies of the EU's central banks, assists with the ECB's consultative function and the performance of a raft of other special tasks, and has inherited the functions assumed by the European Monetary Cooperation Fund that were discharged by the European Monetary Institute between 1994 and 1998. For a recent analysis, see Scheller, H. P., 'Artikel 141 AUEV'. In: Von der Groeben, H., Schwarze, J. and Hatje, A. (eds.), Europäisches Unionsrecht. Baden-Baden: Nomos, 2015. Volume 3: Art. 106 bis Art. 173 AUEV, pp. 1245-1249.

24 Watson, A.M., 'A Two-Speed Europe?'. In: Laurent, P.-H. and Maresceau, M. (eds.), *The State of the European Union*. London: Lynne Rienner Publishers, 1998, Vol. 4 'Deepening and Widening', p. 285.

25 Simon, D., *Le système juridique communautaire*. 3rd ed. Paris: PUF, 2001, esp. p. 101 et seq.

26 There is a special procedure for amending Article 10(2) of the Statute of the ESCB owing to the political dimension of that provision (relating to the voting arrangements in the ECB's Governing Council).

27 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).

This ‘curious’ article is well known[28]. Its formulation is restrictive and its application is strictly regulated by the Member States[29]. This is a reflection of the difficult trade-offs that had to be made during the negotiations on the Maastricht Treaty. Article 127(6) TFEU should be looked at in conjunction with Article 127(5) TFEU. In the words of the latter, the ESCB ‘shall contribute to the smooth conduct of policies pursued by the competent authorities’ as regards prudential supervision and the stability of payment systems. Article 25(1) of the Statute of the ESCB details one of the ways in which the ECB’s contribution is expressed: the performance of an advisory function. In practice, the ECB’s contribution also takes the form of participation in the negotiations on international agreements in the field of prudential supervision[30] and, since December 2004, the publication of a half-yearly report on financial stability[31].

Article 127(6) TFEU does not authorise the conferring of a new competence on the EU with respect to prudential supervision: it provides a basis for an EU competence which complements those of the Member States[32]. As to the substance, the Treaty refrains from stipulating what the ‘specific tasks’ cover[33]. However, their ‘specific’ character defines what shape they may take. They go beyond mere consultation, since the ECB is already covered for that task by Article 127(5) TFEU. They remain distinct from the basic tasks defined in Article 127(2) TFEU, otherwise they might conflict with the performance of those tasks. Ranging between these two limits, the ‘specific tasks’ may consist of centralised coordination or performance missions at ECB level[34]. How exactly they are defined will depend on the circumstances and what is required for an efficient prudential policy and the stability of the financial system. In the same way, the specific character of the tasks does not place any limit on the powers available to the ECB. If the performance of the tasks so requires, the ECB can be authorised to use its advisory powers, as well as its regulatory[35] or statistical powers, within the bounds defined by the regulation conferring the tasks in

28 Sainz de Vicuña, A., Hearing before the European Union Committee, House of Lords, London, 3 March 2009. In: House of Lords. European Union Committee. *The Future of EU financial regulation and supervision*. London: The Stationery Office Ltd, June 2009. 14th Report of Session 2008-2009. Vol. II. Evidence, p. 74.

29 Implementation is also subject to successful scrutiny as to subsidiarity. See Louis, J.-V., Memorandum. Reproduced in: House of Lords. European Union Committee. *The Future of EU financial regulation* (2009*)*, p. 229, especially paragraph 8.

30 Zilioli and Selmayr (2001), p. 211.

31 For the grounds for publishing the report, see Trichet, J.-C., ‘Foreword’. In: ECB, *Financial Stability Review*, December 2004, p. 7.

32 Constantinesco, V. and Michel, V., ‘Compétences communautaires’, *Répertoire communautaire Dalloz*, September 2002, paragraph 202.

33 The use of this vague term is in sharp contrast with the concern to exclude insurance undertakings from the scope of the tasks conferred on the ECB. There are grounds for this lack of precision, however, given the need for flexibility of action in the face of developments in financial markets and products.

34 In contrast to the wording of Article 127(5), Article 127(6) TFEU explicitly mentions the ECB as the body that can be given these specific tasks. Also Smits, R., *The European Central Bank – Institutional Aspects*, The Hague, Kluwer, 2000, p. 193.

35 On this: Martucci, F., *L’ordre économique et monétaire*. Thesis under the supervision of Professor Dominique Carreau, Université Paris I Panthéon Sorbonne, 2007, mimeograph, p. 108, especially paragraph 192.

question and without prejudice to the proper performance of its basic tasks[36]. The SSM Regulation thus confers on the ECB powers to implement banking legislation, powers of investigation and oversight[37] and powers to impose administrative sanctions[38], and allows the ECB to adopt regulations. In terms of subject matter, this regulatory power is confined to the organisation or definition of the procedures for accomplishing the tasks conferred by the SSM Regulation[39].

Lastly, the field of application of the specific tasks conferred on the ECB is not confined just to the euro area Member States: it can also cover all the EU Member States, as is the case with the ESRB Regulation and the SSM Regulation[40]. The ECB is an institution of the EU 'as a whole', in the words of recital 54 to the SSM Regulation[41]. Article 127(6) TFEU applies to all the EU Member States. Like Article 127(5), its objective is the financial stability of the EU and within the EU.

The conferring of special tasks that are performed with respect to all the Member States does not alter the composition of the two main decision-making bodies or the powers of the ECB. A political and legal disconnect then arises: the ECB is required to carry out tasks which concern all the Member States without their having appropriate representatives on its bodies; the ECB does not have the powers to perform its tasks, as its regulatory power applies only with respect to euro area Member States[42].

These two difficulties came up in the negotiations on, respectively, the ESRB Regulation of October 2010 and the SSM Regulation of November 2013.

4 THE ECB AND THE ESRB: THE ORGANIC MISMATCH

Under Article 3(1) of the ESRB Regulation, the ESRB is responsible for the macro-prudential oversight of the financial system within the Union. Its main tasks are to collect and analyse relevant financial and statistical information, monitor

36 Opinion of the ECB of 26 October 2009, CON/2009/88 (OJ C 270, 11.11.2009, p. 1), paragraph 4.
37 Article 4 of the SSM Regulation.
38 Article 18 of the SSM Regulation. Implementation required amendments to Council Regulation (EC) No 2532/98 concerning the powers of the European Central Bank to impose sanctions (OJ L 318, 27.11.98, p. 4). See Council Regulation (EU) No 2015/159 of 27 January 2015 (OJ L 27, 3 February 2015, p. 1).
39 Second subparagraph of Article 4(3). The need for regulations must, furthermore, be demonstrated by conducting the appropriate consultations.
40 The SSM is applicable in all the Member States but produces legal effects only with respect to the euro area Member States and the other Member States that have entered into a close cooperation agreement with the ECB.
41 This clarification was brought in by amendment No 308 tabled by Sven Giegold and Philippe Lamberts on behalf of the Green/EFA Group. European Parliament. Committee on Economic and Monetary Affairs. Draft report by Marianne Thyssen of 30 October 2012 on the Commission proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. Amendments 55-331. Session 2009-2014, 2014/0242(CNS), PE497.794v01-00.
42 See also House of Lords. EU Select Committee. *The Future of EU financial regulation and supervision*. London: The Stationery Office, 17 June 2009. 14th Report of Session 2008-2009. Vol. I: Report, p. 31, paragraph 105.

and assess macro-prudential risks, issue alerts, formulate recommendations, etc. The basis for the ESRB Regulation is Article 114 TFEU. The ESRB's tasks and powers cover all the EU Member States.

The ECB and the NCBs are in ongoing contact with credit institutions for the conduct of monetary policy operations. Many NCBs also perform macro-prudential supervisory tasks under national legislation[43]. The contribution of the ECB and the NCB to the ESRB's tasks in the field of macro-economic, financial and monetary policy was therefore obvious. However, Article 114 TFEU allows for the setting up of a Community body responsible for contributing to the harmonisation process[44]: it does not allow for the allocation of responsibilities to the ECB. This limitation makes it necessary to activate Article 127(6) TFEU. Conversely, that Article is too narrow a basis for the creation of an independent body[45]. ESRB governance thus relies on two texts that refer to each other: Regulation (EU) No 1096/2010 confers on the ECB tasks in support of the ESRB[46]. The ESRB Regulation, adopted a week later, established the ESRB. Its Article 4(4) defines the tasks of the ESRB Secretariat.

The particular position that the ECB should occupy in the ESRB was the subject of discussion from the outset. The de Larosière report proposed that the future 'European Systemic Risk Council [be composed] with the central banks of the ESCB': the new body would replace the banking supervision committee of the ESCB and would consist of the Vice-President of the ECB, the governors of the 27 NCBs and the representatives of the European committees responsible for micro-prudential supervision and a representative of the Commission. The chairmanship of the ESRB should go to the President of the ECB[47], having regard to that institution's expertise in prudential oversight and financial stability. That would also help to consolidate the independence of the new body[48]. Lastly, the Board's Secretariat would be provided by the ECB. The UK government feared that the interests of London would not be adequately considered by the future macro-prudential supervisory organisation if most of the members of its bodies were central bankers from the euro area Member States[49]. It proposed that the ECB should merely be an observer[50]. The requirement for unanimity for the purpose of activating Article 127(6) TFEU led the Commission to seek a point of balance between conferring a serious responsibility on the ECB in the ESRB and the representation of British interests. Nor was it in anyone's interest

43 ECB, *Report on the recent developments in supervisory structures in the EU Member States (2007-2010)*. ECB: Frankfurt am Main, 2010; also: Gluch, D., Škovranová, L. and Stenström, M., *Central Bank Involvement in Macro-Prudential Oversight*. ECB, Legal Working Paper Series, January 2013, No 14.
44 Judgment of the Court of Justice in Case C-217/04 *United Kingdom v European Parliament and Council*, EU:C:2006:279, paragraph 44.
45 Sainz de Vicuña testimony to the House of Lords (2009), p. 75.
46 Council Regulation (EU) 1096/2010 of 17 November 2010 conferring specific tasks on the European Central Bank concerning the functioning of the European Systemic Risk Board (OJ L 331, 15.12.2010, p. 162).
47 De Larosière report (2009), p. 50.
48 Louis, J.-V. (2010), p. 661.
49 'EU Proposes New Financial-Market Supervision System', *The Wall Street Journal*, 24 September 2009.
50 House of Lords. EU Select Committee report (2009), pp. 39-40, especially paragraph 141.

to marginalise the United Kingdom in the new European System of Financial Supervision, given the importance of London as a financial centre in the EU[51].

In its communication on financial supervision of May 2009, the Commission took up the proposals in the de Larosière report and took care to emphasize the requirement for balanced representation within the ESRB: 'As the chairperson [of the ERSB] comes from a central bank within the Eurosystem, it would seem appropriate that a vice-chairperson should be elected from among those Member States outside of the euro area'[52]. The proposal for a regulation establishing the ESRB tabled four months later came across as more balanced. It left open the possibility of an agreement on the post of Vice-Chair of the ESRB without explicitly writing it into the legal framework. The Chair and Vice-Chair were to be elected by and from the members of the ESRB General Board who are also members of the ECB's General Council[53]. At the same time, the legislative proposal provided for the establishment of a Steering Committee responsible for preparing the meetings of the General Board and monitoring the work of the ESRB. The Steering Committee would consist of 12 members, of whom seven could potentially be members of euro area NCBs: the Chair and Vice-Chair of the General Board, five other members of the General Board who are also members of the General Council of the ECB, a Member of the Commission, the Chairperson of the European Banking Authority (EBA), the Chair of the European Insurance and Occupational Pensions Authority (EIOPA), the Chair of the European Securities and Markets Authority (ESMA) and the President of the Economic and Financial Committee[54]. The guarantees were considered insufficient by the Member States outside the euro area, with the United Kingdom in the lead.

The version adopted by the Council in October 2010 was a compromise between the various points of view in play. The President of the ECB assumed ex officio the chair of the ESRB. This arrangement applies for the first term, which is five years. For ensuing terms, defining the appointment procedure is one of the aspects to be examined when the regulation is reviewed[55].

The ESRB Regulation created two posts of Vice-Chair. Appointment to these posts reflects distinct concerns and comes under separate procedures. Responsibility for appointing the first Vice-Chair is referred back to the ECB's

51 Ferran, E. and Babis, V., *The European Single Supervisory Mechanism. University of Cambridge*, Legal Studies Research Paper Series, No 10/2013, March 2013, p. 22.
52 Commission Communication, European financial supervision. Brussels, 27 May 2009, COM(2009) 252 final.
53 Article 5(1) of the proposal for a regulation on the ESRB.
54 Article 11 of the proposal for a regulation on the ESRB.
55 The Commission launched the review of the ESRB Regulation in the autumn of 2014. It concluded in favour of retaining the holding of the Presidency of the ECB and the chairmanship of the ESRB by the same person. See Report from the Commission to the European Parliament and the Council on the mission and organisation of the European Systemic Risk Board. Brussels, 8 August 2014, COM(2014) 508 final, section 3.2.2.; and Opinion of the ECB of 4 February 2015 on the review of the mission and organisation of the ESRB (CON/2015/4), section 1.2.

General Council: it has to make an appointment from among its members[56], 'with regard to the need for a balanced representation of Member States overall and between those whose currency is the euro and those whose currency is not the euro.'[57] This stipulation has no prescriptive value and is an invitation to be borne in mind by the members of the ECB's General Council. Any other stance would have clashed with the principle of independence that the members of the ECB's General Council enjoy[58]. The Rules of Procedure of the ESRB set out the procedure for electing the first Vice-Chair. It takes place under the responsibility of the Chair of the ESRB in his or her capacity as the President of the ECB. The members of the ECB's General Council are invited to stand for election if they wish. The vote is by secret ballot, in the interests of preserving the anonymity and neutrality of a vote for a particular person[59]. Voting is by simple majority. Legally speaking, the Vice-President of the ECB can be elected first Vice-Chair of the ESRB. In practice, Mervyn King, Governor of the Bank of England, was elected to that post on 16 December 2010 by the ECB General's Council[60]. The invitation had been heeded.

The creation of the post of second Vice-Chair[61] was in response to a request from the European Parliament, in order to guarantee that there would be a diversity of points of view in the General Board.[62] The post is held by the Chair of the Joint Committee of the European supervisory authorities (the EBA, EIOPA and ESMA).[63] This appointment is made on an annually rotating basis among the chairs of the three European authorities[64].

56 The arrangement made an alteration in responsibility as compared with the Commission's legislative proposal. The proposal provided that the appointment by and from members of the ECB's General Council should take place within the General Board of the ESRB. Curiously, the allocation of that responsibility to the ECB's General Council is not in Regulation (EU) No 1096/2010.

57 The requirement for 'balanced representation' arose out of an amendment tabled by Sylvie Goulard, the rapporteur on the document. See Amendment 39 to the draft report on the proposal for an ESRB regulation by Sylvie Goulard, on behalf of the European Parliament's Committee on Economic and Monetary Affairs. Session 2009-2014, 10 February 2010, C7-0166/2009, 2009/0140(COD), p. 26.

58 Article 130 TFEU, repeated in Article 7 of the ESCB Statute, applies to all the decision-making bodies of the ECB and their members, including the governors of the NCBs of the Member States which are not in the euro area (except the Governor of the Bank of England, since Article 130 TFEU, under Protocol No 15, does not apply to the United Kingdom).

59 The procedure remains the exception. It is also provided for with respect to the Governing Council when it has to rule on matters relating to the personal situation of members (appointment, resignation, terms of remuneration). See Rule 4(6) of the Rules of Procedure of the ECB.

60 ECB. *European Systemic Risk Board established*. Press release, 16 December 2010. Available at: http://www.ecb.europa.eu/press/pr/date/2010/html/pr101216_3.en.html

61 The creation of the post of second Vice-Chair was apparently in response to the concern to take account of micro-prudential concerns at the highest level of ESRB governance. See Dierick, F., Lennartsdotter, P. and Del Favero, P., *The ESRB at work – its role, organisation and functioning*, ESRB. Macro-prudential Commentaries, No 1, February 2012, p. 4.

62 See Explanatory statement on the draft report on the proposal for an ESRB regulation by Sylvie Goulard (2010), p. 51.

63 Article 5(3) of the ESRB Regulation.

64 Article 55(3) of Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010 and Regulation (EU) No 1095/2010.

The composition of the Steering Committee was also a sign of a rebalancing of the ESRB at the expense of representation of the central bankers. The number of members of the ESRB's General Board other than the Chair and the Vice-Chair went down from five to four. They must be elected by and from among the members of the General Board who are also members of the ECB's General Council. To avoid this reduction penalising the presence of governors of an NCB from a non-euro area Member State, the Regulation called on the General Board to make sure that there was balanced representation of Member States overall and between those whose currency is the euro and those whose currency is not the euro[65].

In addition, Article 7 of the ESRB Regulation, which deals with the impartiality – not the independence[66] – of ESRB members, goes into greater detail. ESRB members must perform their duties 'solely in the interest of the Union as a whole.' The addition of this statement is striking when it is compared with the wording of Article 17(3) TEU and Article 130 TFEU on the independence of the Commission and the ECB respectively. The reference to 'solely in the interest of the Union' was called for by the ECB in its opinion on the proposal for a regulation on the ESRB[67]. As Jean-Victor Louis points out, 'this phrase echoes the point that the ESRB must fit into a "wide EU perspective"'.[68] It was also in response to a general concern among the Member States not in the euro area that there might be a bias in the ESFS towards the specific situation of the euro area. The 'interest of the Union' must also guide the three micro-prudential oversight authorities in the performance of their tasks[69]. The requirement for impartiality is broad in its scope. It extends to all the members of the ESRB's decision-making bodies and advisory committees[70]. It covers participation in the activities of the General Board or the Steering Committee, and *all other activity* [sic] associated with the ESRB, for instance the participation of the Chair of the ESRB at meetings of the other authorities and committees of the ESFS, the holding of public consultations, communication with outside bodies, etc.

65 Article 11(1) of the ESRB Regulation.

66 In its Opinion of 26 October 2009, the ECB had proposed that the word 'independence' be added to 'impartiality' in the title of Article 7 of the proposal for a regulation. The legislature did not take up the bank's suggestion. It is true that a strict interpretation of the notion of independence could have complicated relations between the ESRB and the ECB – an interpretation which the ECB tried to put in perspective in the explanation attached to its proposal for an amendment. See ECB Opinion CON/2009/88, especially 'Amendment 6'; the ECB's amendment is also highlighted by Jean-Victor Louis (2010), p. 654. It is a matter of regret, however, that the word 'independence' was passed over, especially since the article includes a set of prohibitions or guarantees deriving from the articles relating to the independence of the Commission and of the ECB. The question of impartiality is also addressed by recital 79 of the preamble to the SSM Regulation with regard to the ECB staff involved in the prudential supervision of credit institutions.

67 ECB Opinion CON/2009/88, especially 'Amendment 6'.

68 Louis, J.-V., 'Le CERS' (2010), p. 654.

69 Last paragraph of Article 1(5) of Regulation (EU) No 1093/2010; last paragraph of Article 1(6) of Regulation (EU) No 1094/2010; and Article 1(5) of Regulation (EU) No 1095/2010.

70 The ESRB's Code of Conduct applies to all full members as well as to substitutes and alternate members. See Decision of the ESRB of 25 March 2011 adopting the Code of Conduct of the ESRB (ESRB/2011/3) (OJ C 140, 11.5.2011, p. 18).

By way of anecdote, at his hearing before the House of Lords' EU Select Committee, Antonio Sainz de Vicuña, in his personal capacity, proposed that the ECB might set up a branch office in London so that the General Board of the ESRB could hold its meetings there[71]. The idea was not taken up as such[72]. London was made the seat of the EBA.

Under Article 4(4) of the ESRB Regulation, the ESRB has a Secretariat responsible for providing high-quality [sic] analytical, statistical, logistical and administrative support. The regulation does not explicitly mention the ECB[73], but refers to it implicitly in the reference it makes to Regulation (EU) No 1096/2010 in Article 4(3). Article 2 of the ESRB Regulation supplies a non-exhaustive list of the tasks to be performed by the ECB in discharging the specific duties of the ESRB Secretariat: the preparation of the ESRB General Board meetings, the collection of statistical information, the preparation of analyses for the ESRB, support to the ESRB in its international cooperation at administrative level and general support to the work of the various ESRB bodies. Further detail is added in Rule 15 of the ESRB's Rules of Procedure[74].

There are some specific comments to be made regarding the collection of information. As we have already stated, the ESRB has no binding powers. Article 15 of the ESRB Regulation makes provision for a system of exchange of information on financial stability between the committee and the other public authorities concerned (European Supervisory Authority, ESCB, the Commission, the national supervisory authorities and national statistical authorities). This exchange is based on the principle of close cooperation between them. The ESRB may send specific requests to certain authorities, or indeed directly to the Member States. In accordance with Article 5 of Regulation (EU) No 1096/2010, the Secretariat, on behalf of the ESRB, collects all the requisite information, in accordance with Article 15 of the ESRB Regulation. To safeguard the confidentiality of the information exchanged, the reaching of agreements between the ESRB and other European and national institutions or authorities is authorised.

The ECB is in a special position in this respect. As the Secretariat of the ESRB, it collects the information necessary for the performance of the ESRB's tasks, 'on behalf of the ESRB'[75]. The ESRB Regulation lays down an obligation to exchange information upon the ESCB – not the ECB. The ECB and the NCBs must, as part of the tasks performed in the ESCB, cooperate with the ESRB and provide it with the appropriate information[76]. Article 2(b) of Regulation (EU)

71 Testimony of Sainz de Vicuña (2009), p. 75.

72 Contrary to the Commission's legislative proposal, Article 1 of the regulation adopted by the Parliament and the Council establishes Frankfurt am Main as the seat of the ESRB.

73 Recital 16 of the preamble to the ESRB Regulation also avoids making the link between the Secretariat and the ECB.

74 Decision of the ESRB of 20 January 2011 adopting the Rules of Procedure of the ESRB (ESRB/2011/11) (OJ C 58, 24.2.2011, p. 4).

75 Article 5(1) of Regulation (EU) No 1096/2010.

76 NCBs which carry out other tasks outside the ESCB framework, e.g. in relation to prudential supervision, are also required to exchange information, but in their capacity as supervisory authorities.

No 1096/2010 defines the powers conferred on the ECB for this purpose: the collection of information, including statistical information, is to be carried out in accordance with Article 5 of the Statute of the ESCB and Article 5 of the Regulation. The Commission's original proposal made no reference to the Statute of the ESCB; it was added following a request for an amendment from the ECB in its Opinion of October 2009. As the ECB says in the introductory statements of its Opinion, this addition 'will enable the Secretariat to obtain confidential data collected by the ECB/ESCB on behalf of and for the benefit of the ESRB'[77].

This being so, the motivations given by the ECB seem to us to overlook the limited scope of the ECB's statistical power. This consists of the power to collect the statistical information necessary for the performance of the Eurosystem's tasks and power to harmonise the rules and practices governing the collection, establishment and dissemination of the statistics. The ECB exercises its power with respect to all the Member States, whether or not they are participants in phase three[78]. Article 42(1) of the Statute of the ESCB does not mention Article 5 among the provisions that do not apply to non-participating States[79]. The obligations to make statistical declarations to the ECB vary however, depending on whether a Member State is or is not participating in phase three. Regulations adopted by the ECB do not confer any entitlement, nor do they impose any obligation, on non-participating Member States[80].

5 THE ECB AND THE SSM: THE OPERATIONAL MISMATCH

Having considered the advantages and drawbacks of assigning responsibility for micro-prudential supervision to the ECB, the de Larosière report of 2009 concluded against it. Among the arguments it put forward, it stressed that 'conferring responsibilities to the ECB/Eurosystem which is not responsible for the monetary policy of a number of European countries, would not resolve the issue of the need for a comprehensive, integrated system of supervision'[81]. Three years later, the shortcomings in the institutional framework for micro-prudential supervision in the EU changed the terms of the analysis and these reservations were lifted. Stabilisation of the financial system of the EU and the Member States required that micro-prudential supervision be centralised at the European level. In June 2012, the President of the Commission, José Manuel Barroso, called for the establishment of an integrated financial framework that would take the 27 Member States as its starting point. But in his view, the opt-out of some Member States from the euro area required that the appropriate financial architecture be set up: opting out must

77 ECB Opinion CON/2009/88, especially 'Amendment 11'.
78 Recital 17 to Regulation (EC) No 2533/98 concerning the collection of statistical information by the European Central Bank (OJ L 318, 27.11.1998, p. 8).
79 Article 4 of Regulation (EC) No 2533/98 does not draw any distinction between participating and non-participating Member States: 'Member States shall organise themselves in the field of statistics and shall fully cooperate with the ESCB in order to ensure the fulfilment of the obligations arising out of Article 5 of the Statute.' Following the same logic, Article 46(2) of the Statute of the ESCB lays down that the ECB's General Council must contribute to the collection of statistics.
80 Recitals 14 to 16 to Council Regulation (EC) No 2533/98.
81 De Larosière report (2009), p. 49.

be seen as the exception, not the rule[82]. Reconciling a banking union including some but not all Member States and the internal market was a source of concern. The difficulties were, nevertheless, considered to be surmountable, once the complementarity between the achievement of the banking union and the deepening of the internal market was borne in mind. In the explanatory memorandum on the legislative proposals that it put forward in September 2012, the Commission laid this down as a principle:

> 'The creation of the banking union must not compromise the unity and integrity of the single market which remains one of the greatest achievements of European integration. Indeed, the banking union rests on the completion of the programme of substantive regulatory reform underway for the single market (the "single rulebook").
>
> The single market and the banking union are thus mutually reinforcing processes. Work to strengthen the single market must continue across all existing areas covered by Commission proposals.'[83]

In October 2012 the European Council gave approval in principle to an integrated financial framework centred on the euro area and, it was stated, 'open to the extent possible to all Member States wishing to participate'[84]. It was decided to confer specific tasks on the ECB on the basis of Article 127(6) TFEU. Faced with the concerns of Member States not belonging to the euro area and not wishing to take part in the banking union – the United Kingdom in particular[85] – the European Council called for equal treatment between those Member States which take part in the SSM and those which do not, and for the institutional arrangements which would be set up to ensure non-discriminatory and effective decision-making within the single market. This requirement for a level playing field concerns the institutional arrangements within the ECB and the functioning of the EBA[86]. Alongside the adoption of the SSM Regulation in October 2013, the regulation establishing the EBA was amended[87]. The ECB has performed its tasks entirely within the SSM since 4 November 2014.

82 'President Barroso proposes banking union', News. European Commission, 26 June 2012. [Online] http://ec.europa.eu/archives/commission_2010-2014/president/news/archives/2012/06/20120626_speeches_2_en.htm.

83 Communication from the Commission, *A Roadmap towards a Banking Union*. Brussels, 12 September 2012, COM(2012) 510 final, p. 3; also on this subject: Tressels, T., 'The Banking Union and non-Euro area EU Member States'. In: Enoch, C., Everaert, L., Tressels, T. and Zhou, J. P., *From Fragmentation to Financial Integration*. Washington D.C.: IMF, 2013, p. 191.

84 *Conclusions of the European Council*. Brussels, 18-19 October 2012. EUCO 156/12, point 6.

85 Quaglia, L., *The European Union and Global Financial Regulation*. Oxford: Oxford University Press, 2014, p. 175; and for a detailed account of the discussions: Howarth, D. and Quaglia, L., 'Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks and "Completing" Economic and Monetary Union', *JCMS*, 2013, Vol. 51, pp. 114-116.

86 *Conclusions of the European Council*. Brussels (October 2012), point 8.

87 Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013 (OJ L 287, 29.10.2013, p. 5).

The SSM Regulation substitutes the ECB for the competent national authorities of the Member States for the implementation of the 'EU single rulebook'[88] and their implementing rules adopted at the level of the EU and the Member States with respect to prudential requirements, depositor protection and resolution applicable to credit institutions. The ECB performs its tasks with respect to credit institutions located in the participating Member States, i.e. the euro area Member States and in the Member States whose competent authorities have established close cooperation with the ECB[89]. When performing these specific tasks, the ECB has normative power, which is expressed in the adoption of guidelines, recommendations and decisions, or indeed regulations[90]. The ECB may also impose administrative penalties on credit institutions that, intentionally or negligently, breach a requirement under the relevant EU law[91]. The SSM Regulation recognises the ECB's direct supervisory and investigatory powers over credit institutions[92]. The supervisory power includes the right to grant or withhold a banking licence and the right to approve or reject the acquisition of a qualified shareholding in any credit institution located in a participating Member State. To finance its micro-prudential supervisory tasks, the ECB may levy an annual supervisory fee on such institutions[93].

The ECB's position within the SSM is distinct from that which it occupies in the ESRB, since it has to consider not two but three categories of legal relationships: those with the Member States in the euro area, those with the Member States outside the euro area but participating in the SSM, and those with the Member States belonging neither to the euro area nor to the SSM. Our remarks will focus on the latter two categories, as they are the complex aspects of differentiated integration for the ECB. Depending on whether the Member States participate in the SSM or not, the ECB's ties with them will be in the framework of close cooperation or ordinary cooperation.

a) *The ECB and close cooperation*

Since 4 November 2014, SSM has been fully operational and includes all the euro area Member States. The adoption of the single currency by a Member State entails its automatic integration into the SSM[94] and, where applicable, the termination of close cooperation. In accordance with the European Council's conclusions of October 2012, participation in the SSM for Member States that are not in the euro area is provided for in the form of close cooperation. The general system for this opt-in facility is defined in Article 7 of the SSM Regulation. The procedural arrangements for participation in and suspension and cessation of

88 All the regulations composing the 'single rulebook' are made available on the EBA website. See: http://www.eba.europa.eu/regulation-and-policy/single-rulebook.
89 Article 2(1) of the SSM Regulation.
90 Article 4(3) of the SSM Regulation. As regards regulations, the ECB is called upon to resort only sparingly to these for the purpose of organising or laying down the practical arrangements for the tasks assigned to it. The legislature's intention was to avoid any competition over subject matter between the ECB and the EBA.
91 Article 18 of the SSM Regulation.
92 Article 9 of the SSM Regulation.
93 Article 30 of the SSM Regulation.
94 ECB, Convergence Report 2014. Frankfurt am Main: ECB, May 2014, p. 5.

close cooperation are the subject of the Decision ECB/2014/15[95]. The way close cooperation works is described in the SSM Framework Regulation[96].

The aim of close cooperation is to accord the same treatment to Member States outside the euro area and Member States in the euro area.[97] The SSM Regulation defines all of them as ‘participating Member States’, as soon as they take part in the SSM. Close cooperation sets the framework for the performance by the ECB of its tasks as set out in Article 4(1) and (2) and Article 5 as regards all the credit institutions established on the territory of the non-euro area Member State concerned.[98] Equal treatment is something of an optical illusion, as is clear from the deliberate omission of the last paragraph of Article 4 from among those applying to a country in a close cooperation arrangement. The paragraph in question concerns the regulatory powers of the ECB. Under the Treaties, these still do not apply to the Member States that do not belong to the euro area. The SSM Regulation can do nothing to alter that. The ECB is reduced to sending instructions to the authorities of a participating Member State whose currency is not the euro. Such acts have no binding force. Hence, close cooperation tries to find, in international law, a substitute for limited territorial scope of the ECB’s regulatory powers. It results in a complicated arrangement that raises as many questions as it provides answers.

The basis for close cooperation is a request from the Member State concerned for the launching of cooperation and a decision by the ECB launching such cooperation. Legally, close cooperation can be broken down into an ‘auto-normative act’[99] by the State comprising a series of undertakings and a unilateral act by the ECB in the form of a decision published in the Official Journal, through which the ECB takes note of the State’s undertakings and confirms that it will perform its tasks with respect to the State’s credit institutions. The State undertakes quite specifically to make sure that its authorities will comply with all instructions, guidelines or requests issued by the ECB from the date of the establishment of close cooperation; and to adopt the relevant national legislation to guarantee that the legal acts adopted by the ECB under the SSM Regulation are binding and enforceable against itself[100]. In that framework, the ECB’s acts derive their binding force not from the EU legal order but from the national law governing acceptance of EU law into the internal legal order. The SSM Framework Regulation illustrates this approach: whenever the ECB wants to send a decision to an entity established in a Member State in close cooperation, it has to forward the appropriate instructions to the competent authority for it to

95 Decision ECB/2014/5 of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro (OJ L 198, 5.7.2014, p. 7).

96 Regulation ECB/2014/17 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) (OJ L 141, 14.5.2014, p. 1).

97 See, in particular, Articles 109 et seq. of the SSM Framework Regulation.

98 Article 7(1) of the SSM Regulation.

99 On the validity and scope of auto-normative State acts, see ICJ, *Nuclear tests*, ICJ Reports 1974, p. 270.

100 Article 3 of Decision ECB/2014/5.

pass the decision on to the entity concerned[101]. This contradicts the *Commission v Italy* case law of 1972[102] and introduces a legal uncertainty factor in the name of the effectiveness of ECB action.

It is interesting to see how important is the room of manoeuvre given to the ECB in the setting up of close cooperation. This is especially remarkable when compared with enhanced cooperation under Article 20 TEU: there are substantially more procedural precautions there. Authorisation to go ahead with enhanced cooperation is given by the Council, on a proposal from the Commission and following approval by the European Parliament[103]. In the case of close cooperation, the ECB receives the application for it to be set up, evaluates it and takes a decision. The other Member States, the Commission and the EBA are only notified by the Member State concerned that it has applied for cooperation[104]. Only the ECB is competent to decide whether to suspend or terminate close cooperation with a Member State that has failed to fulfil its obligations. The Member State also has the right to terminate close cooperation either because of consequences it may have for its budgetary powers or because of a difference of view with the ECB's Governing Council[105]. Termination by a Member State triggers a three-year waiting period during which it may not apply for fresh cooperation to be set up; this restriction does not apply when termination is the result of an ECB decision even if the Member State may have been accused of serious failure to live up to its obligations under the SSM. It may be wondered whether it is advisable to concentrate the responsibility for setting up and terminating close cooperation solely in the hands of the ECB, having regard to the implications of this cooperation for banking union as a whole (i.e. participation in/withdrawal from the Single Resolution Mechanism).

The entry into force of close cooperation entitles the new participating Member States to be represented on the ECB bodies established by the SSM Regulation and the supplementary legislation: the Supervisory Board[106], the Steering Committee[107], the mediation panel[108] and the Administrative Board of Review[109]. This participation in the bodies does not authorise participation in the exercise of decision-making power within the ECB. Under Article 282(2) the Governing Council and the Executive Board are the decision-making bodies of the ECB. Article 127(6) allows the legislature to confer specific tasks on the ECB: it does not allow any change to be made to the responsibilities, powers and procedures

101 See, for example, Article 113 of the SSM Framework Regulation.
102 Judgment of the Court of Justice in Case 48-71 *Commission v Italy* EU:C:1972:65, especially paragraphs 6 and 7.
103 Article 329(1) TFEU.
104 Article 7(2)(a) of the SSM Regulation.
105 Articles 7(6) to (9) of the SSM Regulation.
106 Article 26(1) of the SSM Regulation and Article 13b of the Rules of Procedure of the ECB.
107 Article 26(10) of the SSM Regulation, together with Articles 9 to 12 of the Rules of Procedure of the Supervisory Body (OJ L 182, 21.6.2014).
108 Article 25(5) of the SSM Regulation and Regulation ECB/2014/26 of 2 June 2014 concerning the establishment of a Mediation Panel and its Rules of Procedure (OJ L 179, 19.6.2014, p. 72).
109 Article 24 of the SSM Regulation, supplemented by Decision ECB/2014/16 of 14 April 2014 concerning the establishment of the Administrative Board of Review and its Operating Rules (OJ L 175, 14.6.2014, p. 47).

relating to the ECB bodies as defined in the Treaties[110]. Article 19(3) of the proposal for a regulation on the SSM laid down that the ECB's Governing Council could delegate clearly defined supervisory tasks and the corresponding decision-making power to the Supervisory Board. The SSM Regulation sets that approach aside and makes the Supervisory Board responsible for planning and performing the tasks conferred on the ECB[111]. In addition, the ECB's Rules of Procedure stipulate that '[a]ny tasks of the Supervisory Board shall be without prejudice to the competences of the ECB decision-making bodies'[112]. All decisions associated with the performance of the tasks conferred on the ECB under the SSM Regulation remain the responsibility of the Governing Council – a body from which the participating Member States that do not belong to the euro area are excluded. Furthermore, the voting system laid down to be used in the various ECB bodies by the SSM Regulation (i.e. simple majority) gives the euro area Member States special influence over the decision-making process. As has been observed, the SSM Regulation creates 'a second-class participation'[113]. This is an aspect that is viewed adversely by the Member States concerned and does not encourage them to take part in the SSM in the short term[114].

In this context, the SSM Regulation gives guarantees, especially in the decision-making process – even though it means setting up an overly complicated institutional architecture. According to recital 54 of its preamble, '[t]he ECB is an institution of the Union *as a whole*'[115] [emphasis added]. Any appropriation of the institution by a category of members in their own interests is ruled out and could, where appropriate, be grounds for an action for annulment before the Court of Justice for breach of the principle of equal treatment. A distinguishing feature of the composition of the SSM bodies which include a limited number of members must therefore be that they are fairly balanced[116]. In the words of the ECB's Mission Statement, the performance of the specific tasks in the field of micro-prudential supervision must contribute 'to the safety and soundness of the banking system and the stability of the financial system *within the EU* and each participating Member State'[117] [emphasis added].

The Regulation also lays down a special system which guarantees a right of objection to participating Member States which are not in the euro area and whose special interests, it is claimed, are not duly taken into account in the decision-making process of the SSM.

110 See the confidential legal note from the Legal Service of the Council of October 2012. Reproduced in: 'Leaked legal opinion on eurozone banking union' *Financial Times*. Brussels Blog, 18 October 2014.
111 Article 26(1) of the SSM Regulation.
112 Article 13a of the Rules of Procedure of the ECB.
113 Tröger, T., *The Single Supervisory Mechanism – Panacea or Quack Banking Regulation?* Goethe University, Center of Excellence SAFE, Working Paper Series, No 27, p. 39 et seq.
114 *Ibid.* However, the legislature calls on the Member States to call rapidly for the establishment of enhanced cooperation (see recital 42 of the preamble to the SSM Regulation).
115 Recital 54 to the SSM Regulation.
116 Article 26(10) of the SSM Regulation for the Steering Committee; Article 4(4) of Regulation ECB/2014/26 for the mediation panel; and Article 4(1) of Decision ECB/2014/16 for the Administrative Board of Review.
117 ECB, ECB Mission. Available at: https://www.ecb.europa.eu/ecb/orga/escb/ecb-mission/html/index.en.html. Source consulted on 15 July 2015.

To take one example, suppose that a participating Member State from outside the euro area disagrees with a draft decision of the Supervisory Board. Then, save for some exceptions, the draft is deemed adopted by the Governing Council at the end of a ten-day period unless it objects to it. The reasoned disagreement is forwarded to the Governing Council, which may either approve the draft decision or reject it if it sides with the arguments put forward by the Member State concerned; in either case, it must explain its decision in writing. In the event of profound disagreement, the Member State may ask the ECB to terminate the close cooperation with immediate effect[118]. No cooperation can be re-established at the request of the State until three years have passed, which makes termination a weapon to be used only in 'exceptional cases'[119], such as, one might imagine, withdrawal of the banking licence by a major national banking establishment.

To take another case, the Member State agrees with the Supervisory Board's draft decision and disagrees with the objection to the draft raised by the Governing Council. The Governing Council has 30 days to confirm its objection or withdraw it, stating its reasons. If the objection is upheld, the SSM Regulation allows the Member State to opt out: this opt-out, which cuts deep into close cooperation, means it does not have to implement the decision which may flow from a draft decision amended by the Supervisory Board[120]. The unity and effectiveness of micro-prudential supervision by the ECB may be seriously affected by it. Depending on how far the opt-out goes, the ECB may decide to suspend or terminate close cooperation; it takes account of any measures adopted by the Member State in question as a substitute for the Governing Council's decision. It is hard to see what the point of such a penalty is, as it has the effect of giving a Member State back the freedom it has already recovered by exercising the right to opt out which the SSM Regulation itself gives it!

In her study of the banking union, Eilis Ferran concludes, on the subject of this arrangement: 'This structure, and other safeguards in the SSM Regulation, appear to go as far as is legally possible to place euro and non-euro Member States on an equal footing with respect to governance arrangements and whilst the outcome is not ideal for non-euro participating Member States, it is expedient'[121]. We subscribe fully to her remarks. The abandonment by non-euro area Member States of the individual exercise of their powers in relation to micro-prudential supervision is not offset by the gain of a collective exercise of those powers at the European level. Moreover, one may well wonder how real the equal treatment guaranteed by the arrangements laid down in Article 7 of the SSM Regulation as 'mediation channels' is[122]. This situation accounts, in particular – though not

118 Article 26(8) in conjunction with Article 7(8) of the SSM Regulation; together with Article 13g(3) of the Rules of Procedure of the Supervisory Board.

119 Recital 43 of the preamble to the SSM Regulation.

120 Article 26(8) in conjunction with Article 7(7) of the SSM Regulation; together with Article 13g(4) of the Rules of Procedure of the Supervisory Board.

121 Ferran, E., *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?* University of Cambridge, Faculty of Law. Research Paper No 29/2014, August 2014, p. 17. Available at: http://ssrn.com/abstract=2426580.

122 Goyal, R. et al., *A Banking Union for the Euro Area*. IMF Staff Discussion Note, SDN/13/01, February 2013, p. 28.

exclusively – for the scant enthusiasm shown by the non-euro area Member States to participate in the SSM[123].

b) *The ECB and ordinary cooperation*

Cooperation and the exchange of information between the SSM and the competent or prudential supervisory authorities of the non-participating Member States are decisive in guaranteeing the effective supervision of transnational credit institutions. The ECB is under a number of obligations as regards cooperation and information exchange, whether within the ESRB, the EBA or the colleges of supervisors. As the EBA points out, these colleges remain of pivotal importance notwithstanding the SSM since they make it possible to share information between the SSM Member States, those not participating and the EBA, on the overall position of transnational groups; they encourage convergent approaches on applying the prudential rules to the different entities in the group; and they make it possible to coordinate supervisory operations, especially through on-the-spot checks[124].

In addition, the SSM Regulation lays down that the ECB and the competent authorities of non-participating Member States must conclude a memorandum of understanding describing in general terms how they will cooperate with one another in the performance of their supervisory tasks in relation to credit institutions. The ECB is called upon to conclude a memorandum of understanding with the competent authority of each non-participating Member State that is home to at least one global systemically important credit institution[125].

Lastly, the European legislature has deemed it necessary to review the EBA's decision-making process in order to prevent the Member States participating in the SSM from exerting excessive influence on that authority. The risk then would be that the EBA would perform its tasks in the interests of the euro area and no longer in those of the EU as a whole. This could lead to a malfunctioning of the internal market and a breach of equal treatment of the Member States[126]. There

123 For a clear and firm view on the lack of any advantage from the SSM to Member States not belonging to the euro area, see the position that the Governor of Česká národní banka, Miroslav Singer, stated at the 19th Dubrovnik Economic Conference, Dubrovnik, 13 June 2013. Available at: www.hnb.hr/dub-konf/19-konferencija/panel_singer.ppt; and for a full study of the advantages and disadvantages of participation or non-participation in the SSM, see: Ministry of Finance of the Czech Republic, in cooperation with the Ministry of Foreign Affairs, the Office of the Government and the Czech National Bank, Impact study of participation or non-participation of the Czech Republic in the Banking Union. Prague: Ministry of Finance of the Czech Republic, February 2015.

124 Article 116 of 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); Articles 8 to 10 of the SSM Framework Regulation.

125 Article 3(6) of the SSM Regulation.

126 See recital 10 of the preamble to Regulation (EU) No 1022/2013 of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 (OJ L 287, 29.10.2013, p. 5). We would point out that nearly a third of the recitals in the preamble contain a reference to equal treatment, non-discrimination or geographical balance.

is twofold protection for the interests of Member States not participating in the SSM. Firstly, decisions by the Board of Supervisors concerning allegations of a breach of EU law by a competent authority or disputes between competent authorities in cross-border situations will now be discussed and prepared by a special group of independent experts[127]. Secondly, the voting procedures in the Board of Supervisors have been amended to ensure that a decision requires a double majority in order to be adopted: a simple or qualified majority of all those voting, including at least a simple majority of the members from the competent authorities of the participating Member States, and at least a simple majority of the members from the competent authorities of the non-participating Member States[128].

6 SOME FINAL COMMENTS ON THE NEXT STEPS OF THE EUROPEAN INTEGRATION PROCESS

An editorial in the *Revue du Marché commun* in 1984 announced: 'A two-speed Europe: neither a fast track, nor the wrong road'[129]. When we look at the expedients resorted to in order to manage equal treatment as between the Member States, preserve the unity and integration of the internal market and guarantee the effectiveness of the ECB's action, we might question how valid the second half of the alternative is, 30 years after it was spoken. In *Mélanges offerts à Pierre-Henri Teitgen*, the former Secretary-General of the Commission, Emile Noël, on the question of differentiated integration, said that 'it is not a panacea but an imperfect palliative for the Communities pending more thorough reforms'[130].

A number of reforms are now being proposed and put before Europe's political leaders, including those contained in the Five Presidents' Report of June 2015. As soon as the Greek debt crisis has been dealt with, it might be a good time to get out of the rut we are in now, between the desire for enhanced integration and the weight of differentiated integration. Isn't the crisis a good spur to a rethink? By making 'a break with a past which no longer seems to supply the resources for thinking about our present' ('une rupture avec un passé qui ne fournirait plus les ressources pour penser notre présent')[131], it would give us the keys to open the way forward for our future.

127 New Article 41(1a) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council.

128 New Article 44(1) of Regulation EU (No) 1093/2010 of the European Parliament and of the Council.

129 *Revue du Marché commun*, 1984, No 278.

130 Noël, E., 'Réflexions sur le processus de décision dans le Conseil des Communautés européennes'. In *Etudes de droit des Communautés européennes. Mélanges offerts à Pierre-Henri Teitgen*. Paris: Pédone, 1984, p. 353.

131 Arendt, H., *La crise de la culture: huit exercices de pensée politique*. Paris: Gallimard, 1995, p. 382.

DEVELOPMENTS IN THE ECONOMIC AND MONETARY UNION IN THE CONTEXT OF THE EUROPEAN DEBT CRISIS: DIFFERENTIATED INTEGRATION REVISITED

ANN-KATRIN PÖTTER[1]

I INTRODUCTION

Due to dramatic economic events during the last couple of years, the Member States of the EU as well as the European Commission and the ECB were forced to act fast and to think about new ways to handle first the financial crisis and now the European debt crisis. It became clear that, to be able to overcome this crisis and its imminent dangers, new instruments and fast decision-making processes were needed. This article investigates how the European debt crisis reinforced the need for differentiated integration in the field of economic and monetary policy and what this means for the idea of a united Europe. Differentiated integration as investigated in this article is the cooperation of some but not all EU Member States within or outside the Treaties of the EU[2] in the field of European economic and monetary policy. Because of its specific focus on European economic and monetary policy, the article will only outline and discuss the forms of differentiated integration, which are relevant in this context and will refrain from presenting the wider discussion on differentiated integration.[3] The first part of this article focuses on two questions. Firstly, on the development of Economic and Monetary Union (EMU) through differentiated integration and secondly, what forms of differentiated integration are available in the field of EMU. To answer the second question, the article will go into an analysis of the requirements for differentiated integration as provided for by the Treaties and of general principles of EU law. The second part of the article will focus on the steps of differentiated integration that have been taken so far by the EU Member States to tackle the problems of the euro area with a focus on measures taken regarding economic coordination and the European Banking Union. Finally, the third part of the article will address the different integration dynamics in EMU and its impact on a unified Europe.

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2 As stated in Article 1(3) Treaty on the European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU).

3 A good overview regarding differentiated integration can be found at D. Thym, Ungleichzeitigkeit und europäisches Verfassungsrecht, 2004.

II DIFFERENTIATED INTEGRATION IN EMU

The concept of differentiated integration yields itself to different definitions. Differentiated integration in the context of this article is understood as firstly a form of cooperation between some but not all EU Member States inside and outside the EU's legal framework, and secondly a restricted applicability of this law only in the participating Member States as well as no voting rights of the non-participating Member States when adopting the law. The need for differentiated integration always appears when there are some Member States that wish to proceed with European integration and some who do not. Reasons for differing levels of commitment to further integration can be political will or economic criteria, which are not met by all Member States at that time.[4] Different ideas of how an ideal EU should look as well as the growing number of EU Member States make finding a fitting solution for everyone more and more difficult. Looking at the development of the EU it can be said that differentiated integration is an inherent part of European integration and part of the very nature of European cooperation.[5]

I THE PROCESS OF DEEPENING INTEGRATION IN AN EXPANDING EU

From its beginning, differentiated integration has played an important role in EMU.[6] Formally established by the Treaty of Maastricht in 1992[7], it allowed already then for the first exception with the so-called 'Denmark-Agreement'[8] and the special role of the UK. Both Denmark and the UK were given the right to opt out of the Monetary Union. Since then the EU has grown from six to twenty-eight Member States and the integration and harmonisation within the field of EMU has come from treating economic trends and exchange rate policies as matters of common concern, Articles 103(1) and 107(1) EEC, and to provide for cooperation between the central banks to establish the ESCB and the ECB: Articles 127 and 132 TFEU. Already at the beginning of the creation of EMU it became obvious that it would not be possible to take further steps towards European integration with all Member States (twelve at that time) and that new forms of integration were needed. Economic and monetary policy, which also includes fiscal sovereignty and national currencies, touches on some of the core characteristics of a sovereign state.[9] Not all Member States met the economic

4 Differentiated integration because of objective criteria is a peculiarity of Monetary Union, Art. 140 TFEU, D. Thym (2004) p. 28.
5 Without getting into and analysing the differences, the Schengen Agreement, the Maastricht Social Protocol and the area of freedom, security and justice can be mentioned: D. Thym (2004), pp. 267, 385.
6 J. Beutel, Differenzierende Integration in der Wirtschafts- und Währungsunion, 2006, p. 10.
7 F. Snyder, EMU – Integration and differentiation: Metaphor for European Union, p. 687, 693 in Craig/de Búrca, The Evolution of EU Law, 2011.
8 F. Snyder (2011), p. 694.
9 G. de Búrca, Differentiation within the 'Core': The Case of the Common Market, p. 133, 147 in de Búrca/Scott, Constitutional change in the EU: From Uniformity to Flexibility, 2002.

requirements to join the Monetary Union[10] and not all Member States had the political will to do so.[11] With the establishment of the euro area, EMU became one of the most important and most obvious areas of differentiated integration in the EU. While monetary policy has always been a self-contained system of integration, economic policy has been of a fuzzier nature and has been mainly evolving complementary to Monetary Union.[12] In the field of monetary policy the Member States soon transferred competences to the EU and its bodies and established in the shape of the ECB a central EU institution.[13] In contrast, economic policy was only treated as a matter of common concern and had to be coordinated within the Council.[14] Only with the Stability and Growth Pact (SGP) did Economic Union acquire a preventive and a dissuasive arm to ensure fiscal discipline in EMU.[15] With the Treaty of Lisbon[16] the Eurogroup, another actor of differentiated integration, was formally inserted in the Treaties. Established in 1997 to ensure better coordination between the Member States of the euro area it is now formally laid down in Article 137 TFEU and Protocol No 14. With the Treaty of Lisbon, differentiated integration in EMU increased and became more obvious.[17] The Member States of the euro area now meet outside of the common European institutions in the Eurogroup.[18] For the first time primary law establishes special provisions for the Member States of the euro area: Articles 136-138 TFEU. According to Article 136(1) TFEU the Council can now adopt measures specific to those Member States whose currency is the euro in order to ensure the proper functioning of EMU, while with regard to Article 136(2) TFEU only the Member States of the euro area can take part in the vote. With the Eurogroup and these Articles, new and stronger forms of coordination in the field of economic governance are now possible between the euro area Member States. Before the financial crisis, the practical importance of Article 136 TFEU was limited, but since then Article 136(1) TFEU has been used

10 On 3 May 1998, the Council stated that just eleven out of fifteen Member States met the convergence criteria (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain).

11 J. Beutel (2006), p. 20. Denmark and the UK still do not have the political will to join the euro area and Sweden, which generally would meet the convergence criteria, has a special position as it refuses to join the European exchange rate mechanism and because of the lack of independence of its national central bank.

12 K. Dyson, Economic and Monetary Union, p. 453, 464 in Jones/Menon/Weatherill, The Oxford Handbook of the European Union, 2012.

13 The ECB was founded in 1998 and it and its tasks were first mentioned in the Treaty of Maastricht. With the Treaty of Lisbon, it gained the official status of an EU institution, Article 13(1) TEU.

14 Article 99 EC, now Article 121 TFEU, F. Snyder Ibid., p. 695, 697.

15 The SGP was implemented by Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p. 1) and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2.8.1997, p. 6).

16 F. Snyder (2011), p. 687.

17 F. Snyder (2011), p. 705.

18 F. Snyder (2011), p. 705.

as a legal basis for various kinds of secondary legislation,[19] even though its legal scope still remains controversial.[20]

2 THE LEGAL FRAMEWORK OF DIFFERENTIATED INTEGRATION

In the case of EMU, differentiated integration is, with the exception of the UK and Denmark and to some extent also Sweden, based on objective reasons. All Member States except the UK and Denmark will join the Monetary Union and its level of integration as soon as they meet the objective convergence criteria.[21] For Member States with a derogation some Treaty provisions are not applicable and their voting rights for Council decisions taken under these provisions are suspended.[22] In contrast to other forms of differentiated integration, differentiated integration in EMU takes place at primary as well as secondary law level. [23] Due to the nature of EMU, differentiated integration continues at the level of secondary law because secondary law adopted in this field often distinguishes between the euro area Member States and Member States with a derogation. For the purposes of this article both levels are relevant because EMU can only be fully understood by taking into account both levels of integration and its interaction.

a) Competences of the EU in EMU

Differentiated integration in EMU is laid down in the Treaties and some legal requirements regarding the procedural and the substantial sides are stated there. In particular Articles 121, 126, 127(6), 136 and 139 TFEU can be mentioned.[24] The EU's competences regarding EMU are asymmetric: while it has exclusive competence regarding the monetary policy of the euro area Member States, Article 3(1)c TFEU, its competence regarding the economic policy of its Member States only involves taking coordination measures: Articles 2(3) and 5(1) TFEU.[25] Member States are free to adopt further measures and find other ways to act in the field of economic policy.[26]

19 As stated in Article 136(1) TFEU it has to be read together with Articles 121 and 126 TFEU. Two regulations of the so-called 'six pack' and the two regulations of the 'two pack' are based on Articles 136 and 121(6) TFEU.
20 U. Palm, Art. 136 TFEU paragraphs 1, 2, 35 in Grabitz/Hilf/Nettesheim, Das Recht der Europäischen Union: EUV/AEUV, 2014; C. Herrmann, Differentiated Integration in the Field of Economic and Monetary Policy and the Use of Semi-Extra Union Legal Instruments – The Case for Inter Se Treaty Amendments, p. 7 in De Witte/Voos/Otte, Between Flexibility and Disintegration: The State of EU law today (forthcoming).
21 Art. 140 TFEU refers to them as 'Member States with a derogation'. Tuytschaever, EMU and the Catch - 22 of EU Constitution-making, p. 173, 174 in de Búrca/Scott, Constitutional change in the EU: From Uniformity to Flexibility, 2002.
22 Article 139(2), (4) TFEU, Tuytschaever (2002), p. 174.
23 Article 3(4) TEU, Article 2(3), 3(1)c, 5(1), Article 119 et seq. TFEU.
24 The requirements mainly refer to voting modalities. These modalities are laid down in Articles 136(2) and 139(4) TFEU.
25 The legal basis for the in this context relevant legislation can be found in Articles 53, 114, 121(6), 126(14), 127(6) and 136 TFEU.
26 With regard to exclusive competences of the EU, the Member States are not allowed to take actions on their own, whether with regard to domestic policy actions or international law actions: Opinion 1/75, ECLI:EU:C:1975:145 of the ECJ.

b) General principles of EU law

General principles of EU law, which can be infringed by differentiated integration in EMU, are foremost: the principle of sincere cooperation in Article 4(3) TEU, the principle of non-discrimination and the internal market with regard to fragmentation and a distortion of competition.[27] Higher requirements need to be met regarding instruments adopted outside of the EU's legal framework.

i) The principles of sincere cooperation and non-discrimination

Article 4(3) TFEU states that the Member States and the Union 'shall, in full mutual respect, assist each other' in carrying out tasks, which flow from the Treaties and that they 'shall facilitate' the achievement of the Union's tasks and refrain from any measure, which could jeopardise the attainment of the Union's objectives. The principle of sincere cooperation[28] obliges the Member States to respect the EU's legal order's cohesiveness and unity.[29] Regarding the EU's legal cohesiveness and unity, one has to distinguish between the general applicability of EU law, as stated for example in Article 288(2) TFEU with regard to regulations, and the uniformity of the legal order.[30] Uniformity can still be accomplished, even if the measures taken under differentiated integration are not applicable in every EU Member State. With regard to universality, there is a gap between this principle and differentiated integration. However, when introducing differentiated integration in EMU in the Treaties, the Member States agreed on this objection.[31] Article 4(3) TEU also contains an order for the primacy of actions taken within the EU's legal framework in contrast to actions adopted under international law. Member States have the duty to try to act within EU law as far as the competences of the EU go before taking action under international law.[32] Furthermore, differentiated integration in EMU also has to respect the general principle of non-discrimination[33], which in a wider and more political sense includes equal conditions of competition between the Member States.[34] With regard to that also, in EMU differentiated integration must not lead to differentiation based on nationality.

ii) The internal market

Difficulties with differentiated integration can also arise with regard to the internal market if the differences lead to trade barriers. The internal market is an area with positive (Article 26 TFEU) as well as negative (Article 34 TFEU

27 Article 26(2) TFEU.

28 Violations of the principle of sincere cooperation are possible, for example, with regard to consultations within informal meetings of the Eurogroup and a vote within the Council afterwards without another consultation process despite the right of the non-euro area Member States to be part of the consultation process.

29 Risks for the Union's cohesive and unified legal framework through differentiated integration have already been stated by D. Curtin, The Constitutional Structure of the Union: A Europe of Bits and Pieces, CMLRev. 30 (1993), p. 17 et seq.

30 D. Thym (2004), p. 236.

31 D. Thym (2004), p. 238.

32 D. Thym (2004), p. 309; E. Philippart/G. Edwards, Flexibility, JCMS 37 (1999), p. 84, 104.

33 Judgment of the Court of Justice in Case C-115/08 *Land Oberoesterreich v CEZ*, EU:C:2009:660, paragraph 89.

34 B. De Witte (forthcoming), p. 48.

et seq.) integration norms.[35] It is a set of norms and policies and a first step towards a European political entity.[36] Despite the EU's task in Article 26(1) TFEU, integration in the internal market in the field of EMU is already fragmented due to differentiation at primary law level and different competences regarding the EU and euro area Member States. But even before establishing the EMU, differentiation between Member States took place in the most hallowed parts of the 'supposedly uniform and shared internal market acquis'.[37] With regard to EMU, differentiation in the internal market is temporary and will be removed as soon as the other Member States have joined the euro area. But as long as differentiation exists, measures taken within EMU have to respect the fundamental freedoms, especially with regard to the free movement of capital, as well as the above-mentioned principle of non-discrimination, to ensure that there is no competitive distortion with regard to the non-euro area Member States.[38]

c) Cooperation outside of the EU's legal framework

Another question regarding differentiated integration in EMU is the question of the legitimacy of Member States entering into inter se agreements outside the EU's legal framework.[39] There is no doubt that Member States of the EU, as an expression of a state's sovereignty, still have the power to enter into treaties and through that enter inter se agreements.[40] This power is not limited by the provisions on enhanced cooperation.[41] However, when concluding an international treaty, Member States may not disregard their duty to comply with EU law.[42] The limits on concluding inter se agreements are the areas of exclusive competences of the EU and where the Treaties impose any obligation on the Union to act.[43] Furthermore, the principle of sincere cooperation obliges the Member States not to jeopardise the functional capability of the EU and contains the obligation to act within the legal framework when possible. Regarding the question of whether it is possible to allocate duties to EU institutions when

35 The internal market as defined in Article 26(2) TFEU is a market without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties; G. de Búrca (2002), p. 136.
36 G. de Búrca (2002), p. 133.
37 G. de Búrca (2002), p. 134.
38 D. Thym (2004), p. 252.
39 The term inter se agreements is understood here as in B. De Witte, Old-fashioned Flexibility: International Agreements between Member States of the European Union, p. 31, 32 in de Búrca/Scott, Constitutional change in the EU: From Uniformity to Flexibility, 2002. It means that some but not all Member States of the EU conclude an international treaty with each other.
40 B. De Witte (2002), p. 40.
41 The provisions on enhanced cooperation in Article 20 TEU were introduced by the Treaty of Amsterdam, H. Blanke, Art. 20 TEU, para. 2 in Grabitz/Hilf/Nettesheim, Das Recht der Europäischen Union: EUV/AEUV, 2014.
42 Cf. judgment of the Court of Justice in Case C-55/00 *Gottardo v INPS*, EU:C:2002:16, paragraph 32; and judgment of the Court of Justice in Case C–370/12 *Pringle v Ireland*, EU:C:2012:756, paragraph 69.
43 Regarding the EU's exclusive competences the Member States transferred their national competence to the EU level. This also implies the conclusion of international treaties, Articles 2(1), 3(2) TFEU. Case C-22/70 *ERTA,* ECLI:EU:C:1971:32, paragraph 95; Case C–370/12 *Pringle*, paragraph 67. It should further be recalled that, under Article 3(2) TFEU the Union is to have 'exclusive competence for the conclusion of an international agreement when its conclusion may affect common rules or alter their scope', Case C–370/12 *Pringle*, paragraphs 100 et seq.

acting outside of the EU's legal framework,[44] the European Court of Justice (ECJ) decided that the Member States are entitled to do so, in areas which do not fall under the exclusive competence of the Union. In those areas they can entrust tasks to the institutions, provided that those tasks do not alter the essential character of the powers conferred on those institutions by the Treaties and do entail any power to make decisions on their own and will not commit the EU institutions.[45]

III DIFFERENTIATED INTEGRATION IN THE EUROPEAN DEBT CRISIS

When the euro crisis began in 2010, it became apparent that the legal instruments available in the Treaties were not sufficient to cope with the problems that had arisen. Since 2011, the EU and its Member States have implemented different new instruments and have changed the structure of the Economic Union to cope with emerging problems that were caused by the European debt crisis to support and adjust the existing EMU. Different areas had to be addressed to ensure financial stability. Amongst other things were the closer coordination of the Member States' economic policy and stricter surveillance of the Member States' budgetary discipline to ensure a sound and lasting management of public finances and the harmonisation of the EU's financial sector.

1 NEW FORMS OF COORDINATION IN ECONOMIC POLICY

The measures taken in the field of European economic policy aimed at strengthening the coordination of economic and budgetary policies with the European Semester and building an effective framework for preventing and correcting excessive government deficits with the SGP.[46] Besides this preventive side of the new structure of the Economic Union, changes took also place regarding the 'preserving' side for Member States who are facing financial difficulties.

a) Developments within the SGP – the 'six pack'

With modifications of the SGP the economic cooperation within the EU has been altered in many ways. New forms of cooperation and stricter surveillance have

44 The ECJ faced this question in a preliminary ruling, brought to the Court by the Irish Supreme Court, Case C–370/12 *Pringle*.

45 Case C–370/12 *Pringle*, paragraphs 158, 161.

46 Recital 9 to Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 306, 23.11.2011, p. 12).

been implemented with the so-called ‘six pack’ in 2011.[47] While three of the regulations and the directive are applicable in all EU Member States, two of the regulations are only applicable in the Member States of the euro area. The major changes include the detection, prevention and correction of macroeconomic imbalances[48] and the formal implementation of the ‘European Semester’[49]. As a further step, Council Directive 2011/85/EU contains detailed rules concerning the characteristics of the budgetary framework of the Member States to ensure stability in the EU and avoid excessive government deficits.[50] On the corrective side of the SGP, excessive government deficits should be avoided and if they occur, their correction should be further prompted.[51]

b) Economic policy coordination in the euro area

For the Member States of the euro area, Regulation (EU) No 1173/2011, Regulation (EU) No 1174/2011, Regulation (EU) No 472/2013 and Regulation (EU) No 473/2013 firstly, lead to closer surveillance and monitoring of the euro area Member States and secondly, introduce enforcement measures regarding the correction of excessive macroeconomic imbalances and budgetary surveillance.[52] All of these measures find their legal basis in Articles 136 and 121(6) TFEU.[53] With these regulations, the reporting and implementation obligations of the euro area Member States are now enforceable through the European institutions.[54] Moreover, with the introduction of the so-called reverse qualified majority voting procedure (RQMV), the imposition of sanctions becomes less difficult in most cases since they will be deemed adopted by the Council unless it decides

47 The ‘six pack’ consists of five regulations and one directive: Regulation (EU) No 1175/2011, Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 306, 23.11.2011, p. 33); Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area (OJ L 306, 23.11.2011, p. 1); Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area (OJ L 306, 23.11.2011, p. 8); Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41); Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (OJ L 306, 23.11.2011, p. 25).

48 Regulation (EU) No 1176/2011; C. Antpöhler, Emergenz der europäischen Wirtschaftsregierung – Das Six Pack als Zeichen supranationaler Leistungsfähigkeit, ZaöRV 2012, p. 353, 362 et seq.

49 With Regulation (EU) No 1175/2011 the coordination of the Member States’ economic policy has now acquired a formalised framework with the so-called ‘European Semester’. The European Semester is the EU’s annual cycle of economic policy guidance and surveillance. http://ec.europa.eu/economy_finance/economic_governance/the_european_semester/index_en.htm.

50 Article 1 of Directive 2011/85/EU; S. Pilz/H. Dittmann, Perspektiven des Stabilitäts- und Wachstumspaktes – Rechtliche und ökonomische Implikationen des Reformpakets „Economic Governance“, ZEuS 2012, p. 53, 60, 64.

51 Regulation (EU) No 1177/2011.

52 The SGP contains now sanction mechanisms for the euro area Member States regarding the preventive and the corrective sides of the SGP: Regulation (EU) No 1173/2011.

53 The question of whether Article 136 TFEU is a sufficient legal basis for this is highly controversial. For more information compare U. Palm (2014), paragraphs 1 et seq.

54 Mainly the European Commission and the Council are involved. S. Pilz/H. Dittmann (2012), p.62.

by qualified majority to reject the Commission's recommendation.[55] Regarding voting rights, the regulations determine that only euro area Member States are allowed to vote, but the rest of the Member States are able to participate in the consultations within the Council.[56] With the 'two-pack', added in 2013, economic policy coordination and the (budgetary) surveillance mechanisms in the euro area are further enhanced.[57] Through Regulation (EU) No 473/2013 measures of the SGP are complemented with regard to the monitoring of budgetary policies in the euro area and the consistency of national budgets with the economic policy guidance.[58] For Member States experiencing, or threatened with, serious difficulties with respect to their financial stability even more enhanced provisions for strengthening economic and budgetary surveillance apply.[59] Besides the two main actors, the Commission and the Council, the Eurogroup and the ECB are also involved.[60]

2 INTERNATIONAL INSTRUMENTS – THE FISCAL COMPACT AND THE ESM

Besides those measures analysed so far, a further two instruments of international law were put in place: the Fiscal Compact to improve economic cooperation and financial stability in the euro area, and the European Stability Mechanism (ESM) to provide financial stability to euro area Member States facing financial difficulties.

55 Articles 3(1) and (3) of Regulation (EU) No 1174/2011; Articles 4(2), 5(2) and 6(2) of Regulation (EU) No 1173/2011; C. Antpöhler (2012), p. 365.

56 Article 5 of Regulation (EU) No 1174/2011, Article 12 of Regulation (EU) No 1173/2011 and Article 15 of 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 L 140, 27.5.2013, p. 1).

57 Article 1 of Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (OJ L 140, 27.5.2013, p. 11).

58 Articles 1 and 6 of Regulation (EU) No 473/2013; and if an excessive deficit exists in a Member State further reporting requirements apply: Articles 4(2) and 10 of Regulation (EU) No 473/2013.

59 Article 1 of Regulation (EU) No 472/2013. The Regulation governs three types of economic surveillance: enhanced surveillance in Article 2 et seq., surveillance based on a macroeconomic adjustment program, Art. 7 et seq, and post-programme surveillance, Article 14. M. Ioannidis, EU Financial Assistance Conditionality after 'Two Pack', ZaöRV 74 (2014), p. 1, 16.

60 Articles 3(5), 5(1), 6(1) and 7(1) of Regulation (EU) No 1176/2011; with regard to Regulation (EU) No 473/2013, Member States 'shall submit' their draft budgetary plan to the Eurogroup as well as to the Commission, Article 6, and report on their national debt issuance plan to both of them, Article 8(1). Article 7(5) of Regulation (EU) No 473/2013 states that the Eurogroup 'shall discuss' opinions of the Commission on the draft budgetary plan and the budgetary situation and prospects in the euro area as a whole, where appropriate. The ECB is involved in cases of enhanced surveillance of a Member State: Articles 2(1), 3, 5, 7, and 9 of Regulation (EU) No 472/2013; Article 9(3) of Regulation (EU) No 1176/2011.

a) The Fiscal Compact

The Fiscal Compact was signed by 25 of the 28 EU Member States in 2012.[61] Due to the resistance of the UK, an amendment of the TFEU was not possible at that time and because of that the Member States agreed on concluding an international treaty outside of the EU's legal framework.[62] The Fiscal Compact can be seen as a stricter version of the SGP and includes fiscal (Title III) as well as enhanced economic coordination provisions (Title IV) for the euro area Member States. Only Title V of the treaty is automatically applicable to all signing Member States.[63] The Fiscal Compact also formally establishes Euro Summit meetings where the Heads of State or Government of the contracting parties whose currency is the euro meet, together with the President of the Commission, at least twice a year to discuss issues regarding the euro area.[64] The President of the ECB must be invited, the President of the European Parliament can be invited. With this new development an already existing form of the European Council is now formally established.[65] Article 11 of the Fiscal Compact determines that the contracting parties of the euro area discuss all major economic policy reforms that they plan to undertake ex ante, and where appropriate, coordinate them among themselves. Such coordination also includes the competent European institutions where required. The President of the Euro Summit meeting is closely connected to the President of the European Council, whose position has been strengthened thereby.[66] The Heads of State or Government of the non-euro area Member States 'shall participate' in the discussions of the Euro Summit meeting with regard to the competitiveness of the contracting parties, the architecture of the euro area in the future and, when appropriate, the implementation of the Fiscal Compact in EMU.

b) European rescue mechanisms

Whereas the abovementioned changes to the structure of the Economic Union are supposed to prevent the EU from further financial crises, the mechanisms that will now be analysed were put in place to be used in the event that a Member State, despite all preventive measures, faces financial difficulties. In 2010, the EU established the European Financial Stabilisation Mechanism (EFSM).[67] In accordance with its legal foundation, Article 122(2) TFEU, it was set up as a temporary emergency funding programme of the EU that gives financial support to every EU Member State that is in financial difficulties. It runs under the supervision of the European Commission and is accompanied by the European Financial

61 Formally the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. It has been signed by all EU Member States except the UK, the Czech Republic and Croatia.
62 P. Craig, The Stability, Cooperation and Governance Treaty: Principles, Politics and Pragmatism, European Law Review 2012, p. 231, 232.
63 The whole treaty only applies to euro area Member States while Title V applies to all signing Member States. Non-euro area Member States have the possibility to declare Title III and IV to be also applicable, Articles 1(2), 14 of the Fiscal Compact.
64 Article 12 of the Fiscal Compact.
65 A. Harratsch/C. Koenig/M. Pechstein, Europarecht, 2014, paragraph 1280.
66 Article 12(1) of the Fiscal Compact; A. Harratsch/C. Koenig/M. Pechstein (2014), paragraph 1280.
67 Established through Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p. 1). It is the only one of the (so far) three established rescue mechanisms that has its legal basis within the Treaties, but for a better overview it is analysed here.

Stability Facility (EFSF). The EFSF was also created as a temporary crisis resolution mechanism by the euro area Member States to grant financial assistance to euro area Member States in need.[68] In 2010, both mechanisms were replaced by the ESM. Both the EFSF and the ESM were founded outside the Treaties[69]: the EFSF as a limited liability company under Luxembourgish Law[70] and the ESM as an international financial institution[71]. The ESM Treaty came into force on October 2012[72] and since then its staff carries out the tasks of the EFSF. The ESM was established as the euro area's permanent rescue mechanism with the purpose of mobilising funding and providing stability support under strict conditionality to euro area Member States in financial difficulties.[73] Establishing the ESM as an international financial institution outside of the EU's legal framework was seen as legitimate since the provisions of the Treaties 'do not confer any specific power on the Union to establish a stability mechanism of the kind envisaged by Decision 2011/199'.[74] It can be understood as the euro area's last line of defence against a confidence crisis affecting the stability of the euro area and it has to be considered together with the SGP, the Fiscal Compact and the Banking Union.[75]

3 HARMONISING THE EU'S FINANCIAL SECTOR

In the European debt crisis another problem became visible: the weaknesses of the governance structure in the relations between financial institutions and governments.[76] To be able to regain financial and monetary stability, a stable banking sector was seen as an essential precondition. Because of that, the EU and

68 Since Article 2(2) of Council Regulation (EU) No 407/2010 determines that the outstanding amount of loans or credit lines to be granted to Member States under this Regulation 'shall be limited to' the margin available under the own resources ceiling for payment appropriations, the euro area Member States decided to provide assistance through a 'Special Purpose Vehicle' that would expire after three years, and neither grant loans nor establish financing programmes after 30 June 2015. G. Bianco, The New Financial Stability Mechanisms and Their (Poor) Consistency with EU Law, EUI Working Papers, Robert Schuman Centre for Advanced Studies, RSCAS 2012/44, p. 6.

69 Decision of the Representatives of the Governments of the euro area Member States meeting within the Council of the European Union, ECOFIN; Brussels 9 May 2010, http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%209614%202010%20INIT.

70 European Financial Stability Facility, société anonyme, Grand-Duché de Luxembourg, Memorial C, 8 June 2010, No 1189, 57026; G. Bianco, Ibid., p. 4 et seq.

71 Article 1 of the Treaty Establishing the European Stability Mechanism (ESM Treaty) and Article 136(3) TFEU.

72 With Germany ratifying the ESM Treaty, 90% of the total subscriptions as set out in Annex II of the ESM Treaty were reached as determined in Article 48 of the ESM Treaty, http://www.esm.europa.eu/about/index.htm.

73 Articles 1 and 3 ESM Treaty.

74 Case C-370/12 *Pringle*, paragraph 64.

75 Centralised banking supervision has been understood as a necessary precondition for enabling the ESM funding for direct bank recapitalization: recitals 4 and 5 of the ESM Treaty; E. Ferran, European Banking Union: Imperfect, but it can work, Legal Studies Research Paper Series, University of Cambridge, Paper No 30/2014, p. 2.

76 While sovereign debt crises come from failures in the political system, banking crises come from failures of risk control and a lack of prudential supervision over banks. M. Hellwig, Yes Virginia, There is a European Banking Union! But it may not make your wishes come true, Preprints of the Max Planck Institute for Research on Collective Goods, Bonn, 2014/12, p. 1, 4.

its Member States took further steps to harmonise the internal market in financial services as well as to create a new architectural structure in the field of banking supervision and banking resolution in the euro area.

a) The single rulebook

The implementation of the single rulebook was the first measure taken to establish a unified regulatory framework for the EU's financial sector. The single rulebook was established after a European Council recommendation in June 2009 as a set of legislative texts that all financial institutions in the EU have to comply with.[77] For this, the European Banking Authority (EBA), a regulatory agency of the EU and part of the European System of Financial Supervision (ESFS)[78], was assigned to develop draft technical standards, which had to be formally adopted by the European Commission.[79] The single rulebook includes prudential regulation aspects as well as a framework for the recovery and resolution of credit institutions and investment firms. Its legislative texts are the Capital Requirements Directive IV[80], the Deposit Guarantee Scheme Directive[81] and the Bank Recovery and Resolution Directive[82].[83] Because of the need to implement

77 The term 'single rulebook' was coined in 2009 by the European Council in order to refer to the aim of a unified regulatory framework for the EU's financial sector that would complete the internal market in financial services. Memo of the European Council meeting in Brussels, 10 July 2009, p. 8, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/108622.pdf.

78 The EFSF was created in 2010 after the recommendation of the de Larosière group, a group set up by the European Commission in 2008 to examine financial supervision with special attention paid to the financial crisis. Member States of the ESFS are all 28 EU Member States. P. Schammo, Differentiated Integration and the Single Supervisory Mechanism: which way forward for the European Banking Authority?, Working Paper Version: October 2014, p. 1 et seq., 7.

79 Articles 10 et seq. of 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). P. Schammo, Ibid., p. 8.

80 The Capital Requirement Directive IV, 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) implement the Basel III agreement on global standards on bank capital.

81 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (OJ L 173, 12.6.2014, p. 149).

82 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).

83 http://europa.eu/rapid/press-release_MEMO-14-244_en.htm.

these directives into national law and Member States' procedural autonomy, full harmonisation in financial services is not accomplished by the single rulebook.[84]

b) A European Banking Union

In the euro area, despite its single currency and its high level of cross-border externalities, control over financial institutions was solely national.[85] For this reason the Heads of State of the euro area decided in June 2012 that the Commission should present a proposal on the basis of Article 127(6) TFEU for a Single Supervisory Mechanism (SSM). This would involve the ECB[86] and centralise banking supervision to be able to effectively address the problems that became visible during the European debt crisis. As a result, the SSM and the Single Resolution Mechanism (SRM), which manages the resolution of banks in the euro area, were established.[87] In contrast to the single rulebook, the SSM and SRM are only applicable in the Member States of the euro area with the possibility of non-euro area Member States joining and being in close cooperation.[88] The SSM was created in accordance with Article 127(6) TFEU by a Council regulation.[89] This Regulation transferred banking supervision powers for significant credit institutions in the euro area to the ECB. With that, the ECB, as the core institution of the Monetary Union, acquired a new field of activity that now includes supervising systemic relevant banks, in cooperation with the national competent authorities (NCAs) of the euro area Member States.[90] The SRM as the euro area's single resolution mechanism applies to banks covered by the SSM and was created according to Article 114 TFEU. In addition, a Single Resolution Board (SRB), under Article 42 of Regulation (EU) No 806/2014, was created to ensure the effective and consistent functioning of the SRM together with the Council, the Commission and the national resolution

84 Even though the directives require full harmonization, which means the Member States are not allowed to impose additional requirements, unless it is allowed by the directives themselves. V. Babis, Single Rulebook for Prudential Regulation of Banks: Mission Accomplished?, Legal Studies Research Paper Series, University of Cambridge, Paper No 37/2014. p. 8.

85 M. Hellwig (2014), p. 13.

86 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

87 A third component of the European Banking Union is the recast Directive 2014/49/EU on deposit guarantee schemes.

88 Article 7 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 (OJ L 287, 29.10.2013, p. 63) and Article 4(1) of 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).

89 Council Regulation (EU) No 1024/2013 and Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013 (OJ L 287, 29.10.2013, p.5).

90 Article 6 of Council Regulation (EU) No 1024/2013; R. Wiggins et. al., European Banking Union A: The Single Supervisory Mechanism, Yale program on financial stability, case study 2014-5b-V1, November 1, 2014, p. 5. This task is also personally separated from the ECB's tasks regarding monetary policy and other tasks: Article 25(2) of Council Regulation (EU) No 1024/2013.

authorities. It is funded by a Resolution Fund,[91] which, with the approval of the European Commission and the European Parliament, 'shall be created' by an intergovernmental agreement.[92] With the establishment of the European Banking Union, the supervision of groups of banks can now take place in a uniform way and by one deciding body, with the advantage of greater consistency and a better information flow. In contrast to the other measures adopted within the EU's legal framework, differentiation in the Banking Union is not based on the objective criteria of participation in the euro area (Article 140 TFEU), but on the political will of the non-participating Member States. Both Regulations are, in conformity with Article 288(2) TFEU, binding in their entirety and directly applicable in all Member States.[93] To still achieve this differentiation the Regulations distinguish between 'participating Member States' and 'non-participating Member States'.[94] Participating Member States are automatically all Member States of the euro area and those Member States who establish close cooperation.[95] Even though the two Regulations are very participation-friendly, differentiated integration as it is used here remains difficult with regard to Article 288(2) TFEU and the idea of the internal market. With this demarcation, the instruments adopted to overcome the European debt crisis introduce yet another and maybe the most problematic form of differentiated integration in EMU.

III INTEGRATION DYNAMICS IN EMU

Besides the two opt-outs, and in that respect also Sweden, differentiated integration in EMU is meant to be time-limited: Article 140 TFEU. With one of the objectives of the European integration process to create an internal market through harmonisation and an increasing level of coordination and therefore uniform application of and compliance with EU law,[96] differentiated integration in the financial crisis touches upon one of the core principles of the idea of a united Europe.[97] But differentiated integration in the European debt crisis also has a positive connotation. The participating Member States are pushing the integration process forward in an area where European integration was rather limited. Differentiated integration gives the Member States the opportunity to pursue new integration measures even though not all EU Member States want to

91 Articles 67 et seq. of Regulation (EU) No 806/2014.

92 26 EU Member States, all except the UK and Sweden, have signed the intergovernmental 'Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund', http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%208457%202014%20INIT; M. Hellwig (2014), p. 13.

93 The legal bases of both regulations, Article 127(6) TFEU for Council Regulation (EU) No 1024/2013 and Article 114 TFEU for Regulation (EU) No 806/2014, allow to adopt general applicable secondary law.

94 Whereby the tasks conferred on the ECB are only carried out with regard to credit institutions established in the participating Member States. Articles 2(1) and 4(1) of Council Regulation (EU) No 1024/2013, Article 2(a) of Regulation (EU) No 806/2014.

95 Articles 2(1) and 7 Council Regulation (EU) No 1024/2013.

96 F. Capriglione, European Banking Union. A challenge for a more united Europe, in Law and Economics yearly review, volume 2, part 1, 2013, edited by Capriglione, Lastra, McCormick, C.Paulus, Reichlin, Sakuramoto, p. 60; G. de Búrca (2002), p. 133.

97 Uniform integration as a guiding principle is stated in recitals 2 and 4 of the preamble to the TFEU and also in Article 288(2) TFEU.

deepen the level of integration at this time. Still, the biggest risk of differentiated integration is the falling apart of the model of a united Europe and its replacement by different and looser forms of cooperation between different European Member States.[98] To prevent this, the newly adopted instruments put in place different mechanisms to interconnect the different levels and to ensure a parallel existence without apostatising the idea of a more united Europe.

1 INTEGRATION DYNAMICS IN THE EU'S ECONOMIC POLICY COORDINATION

When looking at the different measures taken in the field of economic coordination within the legal framework of the EU, the differences in the integration process between the Member States of the euro area and the non-participating Member States are not as large as one might assume. The main differences between the euro area Member States and the other EU Member States lie in closer monitoring and surveillance by the European institutions through more frequent reporting duties and, as a result of that, leading to a closer coordination of economic and budgetary policies. One novelty with regard to the euro area Member States is of course the possibility of EU institutions taking enforcement measures and imposing sanctions on euro area Member States.

2 INTEGRATION DYNAMICS OUTSIDE OF THE EU'S LEGAL FRAMEWORK

Regarding the two international treaties concluded outside of the EU's legal framework a similar picture emerges. Both instruments are very closely connected to the EU's legal framework.[99] The ESM as well as the Fiscal Compact delegate tasks to EU institutions, in particular to the European Commission, the Council, the ECB and the ECJ. The European Commission and the ECB are closely involved in the procedure to grant financial assistance to ESM Members, Article 13 ESM Treaty,[100] and in the excessive deficit procedure, Art. 5 et seq. of the Fiscal Compact. In the event of a dispute the case will be submitted to the ECJ: Article 37(3) ESM Treaty and Article 8 of the Fiscal Compact. Both Treaties are open to accession and whereas the Fiscal Compact is open to accession by any Member State of the EU, a precondition to accession to

98 Non-participating Member States run the risk of missing out on the decision-making process and because of that will not be able to influence the underlying guidelines of the policy area. This makes an opt-in at a later stage more difficult D. Thym (2004), p. 382.

99 Many references to the EU's legal framework are made in both Treaties and Article 2 of the Fiscal Compact determines its consistency with the Treaties, especially with Article 4(3) TEU. Several provisions refer to the SGP as well as to Articles 121, 126 and 136 TFEU and the provisions on enhanced cooperation (Article 326 et seq TFEU). For example Articles 3, 4, 5, 6, 10, 11 of the Fiscal Compact and recital 5 to the ESM Treaty.

100 The European Commission has already been entrusted to negotiate and sign a memorandum of understanding with one ESM Member, Greece, which was asking for financial assistance, (Article 13(3) and (4) of the ESM Treaty) in August 2015.

the ESM Treaty is membership of the euro area.[101] After being revised several times, the Fiscal Compact does not contain great differences in comparison to the secondary legislation adopted with the 'six-pack' and the 'two-pack'.[102] Foremost it strengthens and deepens pre-existing duties under EU law.[103] With the ESM Treaty as the euro area's permanent financial rescue mechanism, the situation is different because there was no such pre-existing mechanism in the EU's legal framework. Nevertheless, with the EU having no competence to create such a permanent rescue mechanism[104] and its very close interconnection with the existing EU legal framework, the setting up of a parallel and detached regime is not an impeding danger. To ensure conformity with the Treaties and especially with the coordination of the Member States' economic policies, Article 136 TFEU was amended to guarantee strict conditionality when granting any required financial assistance under the ESM.[105] Last but not least, the Fiscal Compact contains the provision that within five years the necessary steps should be taken to incorporate the substance of the Fiscal Compact into the EU's legal framework.[106] To some regard this has already taken place with the adoption of the 'six-pack', which contains analogous rules,[107] and the adoption of the 'two-pack'.[108]

3 DIFFERENTIATED INTEGRATION IN THE EU'S FINANCIAL SECTOR

The measures taken with regard to the financial sector led to a deeper level of differentiated integration between EU and euro area Member States. During the crisis it became apparent that with a single currency and a fragmented financial sector mere coordination would not be enough and that real homogenisation of the financial sector was needed.[109] With the establishment of a European Banking Union not only the coordination but also the administration has been moved to the European level and the ECB practice will set a uniform and standardised administrative practice. Integration dynamics have been secured with this new institutional structure and another level of harmonisation in the field of the

101 After a Member State has joined the euro area in accordance with Article 140 TFEU, membership of the ESM Treaty is open to them: Articles 2 and 44 of the ESM Treaty.
102 P. Craig (2012), p. 233, 235.
103 C. Herrmann, Ibid., p. 9.
104 Case C-370/12 *Pringle*, paragraph 64.
105 Article 136(3) TFEU, Case C-370/12 *Pringle*, paragraph 69. Whether this amendment was necessary or if it was rather declaratory is open to debate. Cf. Case C-370/12 *Pringle*, paragraph 72; BVerfGE 132, 195, 247 et seq.
106 With regard to the Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund, the incorporation of the substance of the Treaty within the legal framework of the EU should take place within ten years of the date of entry into force of this agreement: Article 16(2) of this agreement.
107 A good overview of these analogous rules can be found by P. Craig, Ibid., p. 235 et seq.
108 The provision on 'economic partnership programmes' in Article 5 of the Fiscal Compact is now implemented in Article 9 of Regulation (EU) No 473/2013 and the requirement of submitting a debt issuance plan was first stated in Article 6 of the Fiscal Compact and is now implemented in Article 8 of Regulation (EU) No 472/2013.
109 Different mechanisms can be found throughout the new instruments to ensure such reconnection to the EU's legal framework and to the idea of a unified Europe. F. Capriglione (2013), p. 60; recitals 2 and 5 to Council Regulation (EU) No 1024/2013.

financial sector has been reached with the ECB as the central body for an optimal integration of the banking system.[110] The coexistence of the single rulebook and the Banking Union does affect the uniformity of the internal market and the idea of a unified regulatory framework in the financial sector. This differentiation is especially unfortunate with regard to the UK and its important banking sector.[111] But even though the administrative practice of the ECB is formally restricted to the euro area, it will also influence the financial sector of the EU as a whole through the application of the single rulebook and its cooperation within the ESFS and the EBA.[112] The EU did also, with regard to the Banking Union, consider the difficulties of this differentiation for the idea of an internal market. All the measures taken refer to the internal market as a whole[113] and affirm that, to maintain and deepen the internal market, the Banking Union should also be open to non-euro area Member States.[114] Within the European actors there has been an opening up towards non-participating Member States. Since by Treaty only euro area Member States have decision-making authority within the ECB, a new decision-making process was created to enable non-euro area Member States that want to join the SSM to participate.[115] Furthermore, there was a change in the voting system within the EBA's Board of Supervisors when non-euro area Member States were worried about a loss of influence in EU decision-making fora.[116]

IV CONCLUSION

One cannot deny that the new measures adopted maintain rather than circumvent the fragmentation of the internal market. But even though these measures do not lead to complete harmonisation within the EU, they also do not bear the risk of having established a closed-up parallel system of only some EU Member States detached from the rest of the EU. All of the measures were taken to ensure an enhanced functioning of the internal market and to overcome obstacles with regard to the exercise of fundamental freedoms and to prevent distorted

110 F. Capriglione (2013), p. 45.

111 F. Capriglione (2013), p. 72 et seq.

112 Recital 30 to and Article 3(6) of Council Regulation (EU) No 1024/2013, Article 5 of Regulation (EU) No 806/2014. Non-participating Member States will interact with SSM Member States through the EBA and through the ESFS. In addition the ECB and the competent authorities of non-participating Member States 'shall conclude' a memorandum of understanding describing in general terms how they will cooperate.

113 Article 6(2) of Regulation (EU) No 806/2014, recital 30, Article 1(1) of Council Regulation (EU) No 1024/2013: 'With full regard and duty of care for the unity and integrity of the internal market based on equal treatment of credit institutions with a view to preventing regulatory arbitrage'.

114 Recital 11 to Council Regulation (EU) No 1024/2013. Close cooperation can be established between the national competent authorities of non-participating EU Member States and the ECB: Article 7 of Council Regulation (EU) No 1024/2013, Article 4(2) of Regulation (EU) No 806/2014. Other forms of cooperation are possible: Article 3 of Council Regulation (EU) No 1024/2013, Articles 10 et seq. of Regulation (EU) No 806/2014.

115 Articles 26(8) and 7(7) of Council Regulation (EU) No 1024/2013.

116 P. Schammo, Ibid., p. 3 et seq. Because of that substantial changes within the EBA took place: Regulation (EU) No 1022/2013.

competition.[117] The fragmentation the EU is facing today was already apparent when establishing EMU in the Treaties and is, at least in principle, of a temporary nature.[118] Without having more competences the EU and its Member States tried to harmonise the fragmented internal market as far as possible and bore in mind the risk of this partial harmonisation for the concept of the internal market and the EU as a whole.[119] Differentiated integration in the European debt crisis emerges as an important instrument to permit constitutional change and development. Where legally and politically possible, the EU and its Member States used uniform instruments as provided for in the Treaties to deal with the crisis. Where there was no common ground for uniform actions, they connected those instruments very closely to the existing legal framework of the EU. All parties involved seem to have been aware of the inherent risks for the European idea by setting up those new instruments and structures. Even though differentiated integration took place in a lot of different ways, it can be seen as a somehow integrative form of integration with the possibility for other Member States to catch up at a later stage. A fully harmonised EMU is still in a distant future, but the last few years have shown that there are ways for the EU and its Member States to deal with a complex crisis like the European debt crisis without jeopardising one of its basic principles – the idea of a unified Europe.[120]

117 All measures taken refer in one way or another to the proper functioning of the internal market or try to ensure the proper intertwining of the different instruments. This becomes especially clear with regard to the instruments establishing the Banking Union: recitals 10, 12, 22 to and Article 1 of Regulation (EU) No 1024/2013 and inter alia recitals 5, 12, 24, 26 to and Article 6(2) of Regulation (EU) No 806/2014.

118 Article 140 TFEU.

119 Also with regard to the principle of sincere cooperation, Article 4(3) TEU, and the principle of non-discrimination the measures so far do comply. Regulation (EU) No 1024/2013 and Regulation (EU) No 806/2014 both state that no action, proposal or policy of the ECB 'shall, directly or indirectly, discriminate' against any Member State or group of Member States as a venue for the provision of banking or financial services in any currency. The Fiscal Compact as an international agreement even states in its Article 2(1) its conformity with the Treaties and especially with Article 4(3) TEU. See Article 1(4) of Council Regulation (EU) No 1024/2013, Article 6(1) of Regulation (EU) No 806/2014

120 P. Craig, (2012), p. 248.

DIFFERENTIATED INTEGRATION IN THE EUROPEAN UNION AND THE DEBT CRISIS

HUBERT LEGAL[1]

Through the concept of differentiated integration, we are discussing today the institutional future of the Union in the light of the handling of the debt crisis. Potentially it has the flavour of a think-tank subject I tend to stay away from. What lies ahead for us nobody knows. But there is a pattern in recent events that does not make disdain a sufficient response. There is an interest in a deepening of the Economic and Monetary Union, which the Presidents' Report illustrates but of which the essence is as yet unclear; there is the tentative prospect of a new settlement for the United Kingdom; and there are the legislative adjustments made necessary by the generalised political background of Euroscepticism: carve-outs, unanimity votes and intergovernmentalism characterise this trend.

In institutional terms, there is no Greek problem. There is a British problem and there is a German problem. To the extent these two remain separate, we at least do not have to add to them an EU existential problem.

I am actually an admirer of the confidence – or rather the fortitude – of those who maintain that good may come out of bad and who perceive the emergence of strength and cohesion in a landscape where divisions are too strong to be honestly called 'differences'. The recent Eurogroup and summit meetings have revealed many more dividing lines than that between Member States with and without the common currency: between those with or without a high level of public debt; between virtuous monetarists and Keynesian spenders; between Northern Protestants and Mediterranean Catholics; between those who are here for the business alone and those who want political union; between those who matter and those who perceptibly don't matter quite as much. This has been exacerbated by the rough antagonism of vital negotiations in which solidarity itself became a divisive concept. Some basic precepts of the law of the Union may be weakened; yet I do not see any credible alternative than to resolidify them. To put one's trust in miracles I would not recommend, be they qualitative leaps or spiritual revelations.

Rather, some essentials should be borne in mind.

One can never say it enough. In treaty terms, there is no such thing as a euro area. There is one currency of the Union: it is the euro and except for one national exception in primary law, the potential territorial scope of its use is that of the Union as a whole, with only temporary derogations for Member States that have not yet been recognised as having met the conditions to make the circulation of the single currency possible on their territory. The single currency

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is, in its political essence, an integration tool which in turn requires that certain preconditions of homogeneity or at least of compatibility of the economies of the participating Member States are met before it comes into place and is allowed to serve its integration purpose.

We are discussing now differentiated integration. I understand this as meaning differentiated paths towards European integration. I do not believe for one single second that we might be heading, as a political objective, towards a compound of multiple schemes of specialised integration with varying participation – and no political unity. We are talking about recourse to diversified rhythms and methods, which are nothing new – not about the acceptance of a split purpose. This concept is crucial to the correct description of the state of the Union being, particularly in the financial sector, either a composition in concentric circles or an aggregation of adjacent areas. A common purpose calls for a single centre of gravity. A mere alliance of interests implies that each allied power retains its own centre. Concentric and parallel are as different as are Union and association. It is simply not the same game.

Now this is not a theoretical play on words for the Brussels windmills – this is the current political reality. In the context of the bridge financing for Greece, the Commission and the Council have jointly endorsed on 16 July a declaration stating that there is a principle that any future use of an instrument similar by nature to the European Financial Stabilisation Mechanism (EFSM)[2] (i.e. a budget-based assistance mechanism with 28 Member States concerned) will not entail any financial liability, direct or indirect, for non-euro area Member States if the purpose of using the instrument is to safeguard the financial stability of a euro area Member State. It is common knowledge that this declaration was imposed by the United Kingdom as a condition for accepting recourse to EFSM funds where the Heads had committed not to use them again for that purpose but to go the European Stability Mechanism (ESM)[3] way instead. So the UK had a very strong hand there and played it well. It remains that the implications of the accepted language are such as ought to be reflected upon. Admittedly, it may be argued that there are few instruments similar in nature to the EFSM – if any at all. So the scope of the declaration is contained. But its inspiration clearly lies in the theory of adjacent zones: it is for the members of the currency union to take care of themselves, separately or collectively, but without affecting the interests of the non-members – including by putting in place collaterals, guarantees or equivalent measures to protect such non-members from any risk that may be incurred to stabilise the situation of a member. Watertight compartments is what it means.

This in my view meets two objections. First, it is an exaggeration of the scope of the monetary union; a Member State is a Member State and whether or not it has the euro as its currency is not a decisive factor in determining the applicability of

2 The EFSM was established on the legal basis of Article 122(2) TFEU to provide financial assistance to Member States in difficulties, irrespective of whether they have the euro as their currency.

3 The ESM was established by a treaty open to the Member States whose currency is the euro. Article 136 TFEU was amended to include a reference to this treaty.

all EU solidarity mechanisms and other policies. Second, it is an invitation to limit the Union to single market issues and to deal with any further integration between interested Member States essentially through intergovernmental instruments adopted outside the treaties, as was the case with the ESM, the Fiscal Compact[4] and the agreement on the Bank Resolution Fund.

Public international law is clearly an option for deepening the Union but only under the three conditions that relevant instruments are: supplementary to the law of the Union proper; compatible with it; and destined to be incorporated in due time into the framework of the EU treaties. This is the essence of the *Pringle* judgment of the European Court of Justice[5].

Therefore this option is not a substitute for Union law and not a reason for depriving the organs of the Union of the authority to act in their core quality of policy makers for the Union in all its areas of competence, including monetary and economic policy.

This central policy-making function of the Commission in particular is why I am not a supporter of the view that its two core duties to initiate legislative proposals and to monitor the implementation of the law should be separated by a Chinese wall, as Dr Schäuble has suggested. The example of the European Central Bank, with the segregation of bank supervision activities, is sometimes offered in this respect. But the purpose of this segregation is to protect the constitutional independence of the Bank in its monetary activities – which is irrelevant to the functioning of the Commission.

To keep the Union together also means avoiding a pick-and-choose concept through which the scope of any legislative instrument would be decided on an *ad hoc* basis, leaving out those Member States that are not willing and interested. Of course there can be objective justifications to a limited territorial scope. Participation in the single currency may justify this – but only to the extent that it is relevant. That it may justify a carve-out such as the one foreseen for the Vickers national rules from the Banking Structure Regulation[6] remains to be seen. It would certainly not be compatible with our legal system to make of this a model through which the economic and financial law of the Union would have two versions: a compulsory one for the fully-fledged integrators and a soft, non-binding and lighter version for those who will not go beyond voluntary cooperation.

Distinctions are legitimate and there is no absolute requirement to apply brutally the same rule to all at whatever cost. For example, the treaties make provision for enhanced cooperation. Legislative practice also seeks to avoid creating unnecessary antagonisms by respecting the sovereignty of States in their

4 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG).

5 Case C-370/12 *Pringle v Ireland*, EU:C:2012:76.

6 Proposal for a regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions (COM/2014/043 final).

constitutional principles to the largest extent possible. But a single purpose and direction are crucial to the Union as such – which is not a provider of services offered to customer – or client – Member States.

The challenge is, by the way, not one that concerns Ecofin only. Application of solidarity to the relocation of persons seeking international protection is currently envisaged through a scheme that in principle concerns all Member States but with distribution figures that almost amount to leaving certain partners out for all practical purposes. Solidarity *à la carte* is also part of a looming 'differentiated' landscape that extends beyond the protection of the City of London as a provider of financial services and of the Bundestag's authority to make payments possible.

But, fundamentally, it should be the authority of the rule in force, our common belief in the rule of law, that keeps us durably together. This is why I am not an enthusiast either, with all respect for the pronouncements of our host President Draghi, of the idea that the Union should be more 'institution-based' and less 'rules-based', in the financial sector at least. Of course, although a lawyer, I understand that rules that are not applied do not generate confidence any more than governments that hold no interpretative power and that it would be more appropriate to keep the rules unspecific and to grant broad discretion to common institutions that will exercise it in an impartial and fair manner and restore consistency and trust. Fine. This is a federal programme with a central authority that is not even bound by specific norms. Clearly we are not there. And in my view we cannot be there any time soon because the elements of a democratic control over this central echelon are still missing, despite the existence of a European Parliament – as was explicitly stated by the Bundesverfassungsgericht[7] and further revealed by the recent handling of the Greek debt crisis.

All the same, it is somehow reassuring that there is an expressed hope that this crisis will lead us to a reinforced and possibly deeper Union. But my number one article of faith is that stability is what our institutions, collective and national, mainly need now. There is no promised land that is convincingly announced, either on the side of the *à la carte* doctrine or on that of the supranational *avant-garde*. Of course a mix of the two may give the fever of hope to some of us. My perplexity should not and will not discourage them.

Amending our treaties has somehow become part of our genes so I have no doubt we shall come to it sooner or later. For some tidying up this will certainly be in order. But to think currently exacerbated differences may lead to further institutional integration is either cultivating paradox or acting in a gambling mood. Differentiated integration is a fact of life. But, as a programme for our institutional future, integration through differentiation sounds to me like a federation of sovereign states: a meeting of words that may be a little bit too ingenious to provide a sound basis for a durable meeting of minds.

7 Judgment of 30 June 2009 of the German Constitutional Court on the ratification of the Lisbon Treaty.

PANEL 7

ENHANCED COORDINATION OF ECONOMIC POLICIES IN THE EURO AREA

EUROPEAN CENTRAL BANK
EUROSYSTEM
EUROPEAN CENTRAL
EUROSYSTEM

ENHANCING INCENTIVE-BASED AND INSURANCE-TYPE COORDINATION

ARMIN STEINBACH[1]

I INTRODUCTION

The regime governing EU Member States' fiscal and macroeconomic policies has undergone significant changes over the last few years. One key element of policy change has been the extension of the initial focus on purely fiscal parameters to a more macroeconomic approach incorporating non-fiscal aspects of national economic policies. The scope of coordination – no matter whether in soft or hard formats – has increased gradually.[2]

Future modes of coordination can be analysed by reference to two models.[3] First, the "surveillance model" corresponds to the transgression of the status quo under which Member States continue to have full fiscal competence and retain competence to conduct economic policy. In this scenario, the EU continues to be the "discipline enforcer", applying numerical fiscal rules and the existing budgetary and economic surveillance system. In contrast, the "fiscal federalism model" would imply a higher degree of centralised steering rather than surveillance. In this scenario, the EU would have the necessary resources to address structural inequalities and prevent asymmetric shocks – either through intergovernmental grants or transfers. Both the surveillance model and the fiscal model are part of the "vision" for European Monetary Union (EMU), as continually expressed by the EU institutions. Starting with the Four Presidents' report, the European Parliament's resolution on the Four Presidents' report, the Commission's Blueprint for a deep and genuine EMU, and up to the most recent Five Presidents' Report – all of these documents refer to the two models by viewing the somewhat short-term dominance of the surveillance model and the long-term goal of the fiscal federalism model.

However, despite (or maybe because of) the remarkable pace at which both substantial and institutional changes have been put in place, there are obvious frictions in Member States' views of the further development of EMU. Opinions about the allocation of competences between EU Member States are increasingly

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2 Steinbach, *Economic Policy Coordination in the Euro Area*, Routledge, 2014, pp. 72-171; Armstrong, "The New Governance of EU Fiscal Discipline", 38 *EL Rev.*, 2013, p. 601; Hinarejos, *The Euro Area Crisis in Constitutional Perspective*. OUP, 2015, pp. 15ff.; Bauer and Becker, "The Unexpected Winner of the Crisis: The European Commission's Strengthened Role in Economic Governance", 36 *Journal of European Integration*, 2014, pp. 213-222; Majone, *Rethinking the Union of Europe Post-Crisis,* CUP, 2014, pp. 199, 308; Chalmers , "The European Redistributive State and a European Law of Struggle", 18 *European Law Journal*, 2012, pp. 676-682.

3 Armstrong, *Governing Social Inclusion. Europeanization through Policy Coordination,* OUP, 2010; Hinarejos, *The Euro Area Crisis in Constitutional Perspective,* OUP, 2015, pp. 181.

diverse, reflecting not only diversity in national sentiment in the aftermath of the crisis, but general concerns about the function and future of the EU.

Given the existing reservations and obstacles to further deepening coordination mechanisms, ambitious treaty amendments appear (politically) unlikely and underscore the significance of the effective application of the existing legal framework. Against this backdrop, the pragmatic purpose of my contribution is to discuss the legal feasibility of certain elements of both the surveillance and the fiscal federalism model within current EU treaties. First, in light of the limited likelihood of major institutional developments within the EMU, the current (but not yet exploited) flexibility and scope for manoeuvre provided within the existing legal framework should be explored. In line with the dominant surveillance model, I explore incentive-based mechanisms that promote the implementation of structural reforms and public investment in Member States. Incentive-based mechanisms not only refer to the established sanction-based logic of the existing surveillance mechanisms, but also to reward-based instruments offering benefits to Member States for implementing structural reforms. Second, while pursuit of the fiscal federalism model is commonly agreed to require a substantive delegation of competences, making treaty changes indispensable, we explore the legal feasibility of certain elements of the fiscal federalism model within the current legal framework. More specifically, we shed light on insurance-type coordination mechanisms that cushion large macroeconomic shocks and that make the EMU more resilient overall. With a view to the broader trajectory of EU law, we infer some conclusions as to how coordination governance may be implemented in the short run.

II INCENTIVE-BASED COORDINATION – EXPLOITING THE SCOPE OF FISCAL AND MACROECONOMIC SURVEILLANCE

The SGP remains the key instrument of fiscal policy coordination, featuring binding rules and sanction mechanisms. In the past, application of the SGP focused on fiscal policy and compliance with numerical budget rules. In line with the trend towards broadening the surveillance focus from a purely fiscal to a more macroeconomic perspective, incentive-based tools can be extended towards promoting investment and structural reforms.

I FLEXIBILITY UNDER THE SGP IN PROMOTING INVESTMENTS

There has been much discussion as to whether and how investments could be considered in the determination of a country's fiscal stance. This refers to the "golden fiscal rule", i.e., deficits can only be used to finance investments that are to the benefit of future generations. There is empirical evidence supporting the view that during phases of budgetary consolidation public investment is reduced proportionally more than other expenditure categories in EU countries. This has led to criticism of budgetary policies enacted during the debt crisis, supposedly curtailing public investment and thereby impeding fiscal recovery.

The Commission recently moved in this direction by claiming flexibility in applying the rules of the SGP. The Commission seeks to privilege investment, unlike other public expenditures, on two grounds: First, under the preventive arm of the SGP, the Commission would (i) consider investments under certain conditions as "one-off expenditures" that would not affect the structural balance relevant to the attainment of the MTO and (ii) consider other investments as "structural reform" within the meaning of Article 5 of Regulation (EC) No 1466/97[4]. Second, in the corrective arm, the Commission will consider contributions to the European Fund for Strategic Investments (EFSI) to be a "relevant factor" in line with Article 2(3) of Regulation (EC) No 1467/97. The Commission's acknowledgment of its leeway in applying the Pact amounts to a significant deviation from previous practices. It opens the door to the "golden rule" debate and raises a number of legal questions.

a) Treatment of investments as "one-off measures"

The SGP provides that, in the assessment of the necessary fiscal adjustment under its preventive and corrective arms, the Council specifies targets that are set in structural terms. More specifically, Article 5 of Regulation (EC) No 1466/97 stipulates that when assessing the adjustment path toward the medium-term budgetary objective, the Council and the Commission shall examine "[…] if the Member State concerned pursues an appropriate annual improvement of its cyclically-adjusted budget balance, net of one-off and other temporary measures, required to meet its medium-term budgetary objective, with 0.5% of GDP as a benchmark […]." On that legal basis, the Commission views contributions to the EFSI as eligible under both the preventive and the corrective arm.

The relevant legal question at stake is whether contributions to the European investment fund (and investment spending in general) can be considered "one-off measures" within the meaning of Article 5. One-off measures have played a significant role in the history of EU fiscal surveillance and their actual budgetary impact has been far from marginal. For example, Portugal brought its nominal deficit below 3% of GDP between 2002 and 2004, for three consecutive years, through the implementation of very large one-off measures. Also, the measures typically adopted to improve fiscal balances include the sale of real assets and tax amnesties or settlements. More recently, in the course of the financial crisis, government support for the financial sector has been classified as a one-off measure across Europe.

However, the difficulty of precisely defining the nature and scope of one-off measures has not been satisfactorily addressed until today. The SGP Code of Conduct defines one-off and temporary measures as "measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position". Given the absence of an exhaustive list of one-off measures the question of definition remains highly relevant. It is agreed that the common features of one-off measures are their temporary influence

4 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1.

on the cyclically-adjusted fiscal position and their non-recurrent nature. More specifically, according to the Commission, “when deciding whether a particular measure is non-recurrent, the measure should be assessed in the context of the chain of measures of the same type. For instance, although each investment project is unique, a specific investment decision should be seen in the context of a continuity of investment decisions over time. As a rule, such measures should therefore not be considered as one-off and temporary measures, unless their size is exceptional.”[5]

Generally, the definition and the classification of one-off measures remain inherently vague and unreliable. Qualifying public investments as one-off measures therefore appears questionable. First, and from an economic perspective, requiring the non-relevance of such measures to the intertemporal budgetary situation does not permit a general assessment of public investments. Investments may have an impact on the intertemporal budget constraint. This holds irrespective of whether purely domestic investments or contributions to European investments through the EFSI are at stake. Domestic and European investments only differ to the extent to which they benefit a Member State. Also, the privileging of European over national investment not only raises a question about the reason for such discriminatory treatment of national and European investments, but it also appears incompatible with the provisions in the SGP to which the Commission refers.

Second, a comparison with the aforementioned examples of deficit-increasing “one-off measures” suggests that investment should be treated in a fundamentally different manner to those examples. While unique payments due to natural disaster or a payment fine imposed by a court occur only once in the budgetary constraint, investments typically have an intertemporal impact. Moreover, and from the perspective of the political economy, discounting EFSI payments on the deficit may induce policymakers to adapt their expenditure pattern in an undesirable fashion. If governments are aware that EFSI contributions will not be counted as a budget deficit, they may feel induced to cut their expenditure, e.g., for cross-border infrastructure, given that such investments are likely to be financed from EU and EFSI funds. This also highlights that discriminating between the fiscal treatment of national and European investments not only lacks sound legal grounds, but may also invite policymakers to engage in undesirable strategic behaviour.

This finding can be translated in traditional methods of interpretation as a way to determine the meaning of a provision, including the literal interpretation of a provision, the meaning of a provision in light of scheme and context, and the purpose, spirit and historical intention of a rule. The Commission seems to rely on a literal approach to applying Article 5 of Regulation 1466/97 by stressing that an exceptional cash payment may by definition constitute a “one-off measure”. However, as shown above, the context, purpose and historical intention of the provision militate against such an interpretation. Historically, the rule was designed to prevent biases in a country’s fiscal performance due to exceptional measures, without an effect on the structural fiscal situation. Likewise, the spirit

5 European Commission, Directorate-General for Economic and Financial Affairs, “Public Finances in EMU – 2006”, *European Economy,* No 3/2006, p. 113.

and purpose of this rule does not allow deficit-increasing measures to have an impact on the intertemporal budgetary situation; indeed, the measures are likely to be of a recurrent nature and may possibly change the expenditure pattern.

b) Investments as structural reforms

Besides its recent move to recognise contributions to EU funds as a "one-off" measure, the Commission has identified an alternative way to favour national investment under the corrective arm of the SGP. Article 5 of Regulation (EC) No 1466/97 provides that "[…] the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth […]". The Commission considers that some investments may be deemed to be equivalent to major structural reforms and may, under certain conditions, justify a temporary deviation from the Medium-Term Budgetary Objective (MTO) of the concerned Member State or from the adjustment path towards it. The (economic) purpose of this extension of the investment clause is to allow Member States to benefit from this clause when their own growth is negative and better reflect the country-specific economic situation. In this vein, the Commission's decision is economically founded on those studies that find an over-proportionate decline of public investments during phases of budgetary consolidation.

The Commission's assimilation of "public investments" and "structural reforms" is questionable. Apart from the obvious literal difference between the two terms, the Commission's own use of the concepts "investments" and "structural reforms" suggests that these terms cannot be used interchangeably as legal terms. In its 2015 Annual Report, for instance, the Commission refers to its well-established economic policy strategy resting on three pillars comprising investments, structural reforms and fiscal responsibility. According to that economic policy strategy, investments and structural reforms constitute individual pillars of EU economic policy and rest on different concepts, though they share the common goal of promoting sustainable growth.

The Commission broadly assimilates investments and structural reforms and limits eligible investments to projects co-funded by EU funds which have a positive budgetary effect within Article 5 of Regulation (EC) No 1466/97. This approach raises concerns on three grounds. First, and considering the distinct concept of investments and structural reforms, there are no grounds for the general assumption that all co-financing expenditures by Member States amount to structural reforms. Rather, a case-by-case analysis that examines to which investments the implementation of structural reforms is intrinsically tied should be made before investments qualify as structural reforms within the meaning of Article 5(1) of Regulation 1466/97. Second, the Commission gives privilege to any expenditure that is co-funded by the EU for the assessment of "structural reforms" pursuant to Article 5 of Regulation (EC) No 1466/97. This is an open discrimination against national public investments that might equally be linked to structural reforms. Such discrimination ignores the fact that economic policy-making remains within the competence of Member States. In principle, economic policy is not a competence of the EU but of Member States (Articles 4(1), 5(2) TEU). Rather, the EU's competence lies in coordination, i.e.,

in providing arrangements to facilitate the coordination of policies that remain national in nature. Member States can adopt measures in this field, as long as the competences of the Union are not infringed.

Third, there is no indication why investments co-funded by the EU should qualify as structural reforms rather than domestic investment projects. There is neither a general legal rule nor an economic rationale according to which projects promoted by EU funds could be considered fundamentally different from domestic projects, except for the fact that the latter typically imply larger cross-border spillover effects. For example, projects co-funded under the Connecting Europe Facility (CEF) do not primarily promote projects amounting to structural reforms rather than domestic projects. The CEF finances projects that fill the missing links in Europe‘s energy, transport and digital infrastructure. Even though this infrastructure may promote the completion of the internal market, there is no indication that a national infrastructure project would not serve similar goals or contribute otherwise to structural reforms in terms of reallocating resources more efficiently.

In summary, an extensive interpretation of the term "public investment" as a structural reform within the meaning of Article 5 of Regulation 1367/97 seems to overstretch the literal and contextual meaning of this provision. However, the Commission's general tendency to promote investments within the boundaries of the fiscal rules may be compatible with the relevant provision under two conditions. First, a case-by-case examination of the investments at stake must give consideration as to whether a project is linked to the implementation of structural reforms rather than generally equating public investments and structural reforms. Second, the general privilege of projects co-funded by EU funds over national investment projects appears to be untenable in light of the wording and purpose of the rules. Domestic investments should generally be treated like EU projects when considering their quality as structural reforms for the application of Article 5 of Regulation (EC) No 1466/97. Thus, while there are no legal or economic grounds for discrimination, we must concede that considering all public investments as potentially qualifying as structural reforms would imply an additional burden of examination on the Commission's side.

2 PROMOTING STRUCTURAL REFORMS UNDER THE SGP

Even though the regime governing EU Member States' fiscal and macroeconomic policies has undergone significant change over the last few years, an insufficient level of structural reforms persists. Some of these reforms are critical for the growth and sustainability of the euro area as a whole, as they imply positive externalities across countries. Recent reforms of the binding and sanction-based EU legal framework have allowed for stronger surveillance within the EU, with extended mechanisms regarding fiscal and macroeconomic surveillance. In this vein, the Commission recently adopted the stance of interpreting SGP and MIP with a view to offering leeway to incorporate the implementation of structural reforms under these procedures to the extent possible. We examine the opportunities to perform the economic surveillance with a stronger focus on the implementation of structural reforms.

a) Preventive arm

Under the preventive arm, there is an explicit reference allowing the linking of the fiscal regime under the SGP to a broader macroeconomic dimension of structural reforms. In this vein, the explicit reference to structural reforms in Article 5 thus serves as the basis to connect various economic policy coordination tools to each other.

The Commission has set out a number of principles to be followed for the structural reforms clause to be activated. They must be major in relation to their effect on growth and the sustainability of public finances; they must have a long-term positive budgetary effect, where this effect can lead to direct budgetary savings from reforms (e.g. pension reform) or through increased revenues (e.g. as a result of an increased labour force); and they require their "implementation", which is a controversial point between the Council Legal Service and the Commission. While the Commission requires the "full implementation" of the reform, it acknowledges that adopting reforms may take time and thus views the implementation of reforms as fulfilled when "the Member State presents a medium-term structural reform plan". By contrast, the Council refers to the Code of Conduct, according to which the "implementation" pursuant to Article 5 requires that "only adopted reforms should be considered".

From a contextual perspective, guidance on interpretation may be sought from practice under the financial support programmes of the EU. The pattern of conditionality and disbursement of payments offers an understanding that the favourable treatment (under EU financial assistance, the disbursement of loans) is typically granted on the basis of formalised commitments and their forward-looking implementation. Under the support programmes for Greece, for instance, before each disbursement the Commission, the ECB and the IMF staff conduct joint review missions to Greece in order to monitor compliance with the terms and conditions of the programme. The disbursement is tied to forward-looking commitments, including steps to implement these reforms fully through secondary legislation, other administrative acts and complementary reforms. Applying this functionality to the exchange of structural reforms in return for favourable treatment under Article 5 of Regulation 1466/97, one can infer that, in general, a forward-looking commitment should suffice. This implies that implementation in terms of a credible, comprehensive and detailed plan should be sufficient.

b) Corrective arm

While there is an explicit reference to structural reforms under the preventive arm in Article 5 of Regulation (EC) 1466/97, the relevant norms of the corrective arm are silent on the treatment of structural reforms. The only legal term potentially allowing the incorporation of structural reforms into the assessment under the corrective arm is laid down in Article 2 of Regulation (EC) 1467/97, which states that the Commission "[…] shall take into account all relevant factors […] in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the Member State concerned". The reference to "relevant factors" has been interpreted by the Commission as including the implementation of structural reforms set out in the European Semester. Given the

vagueness of this provision, the question is whether this interpretation remains within the boundaries of the legal text. A number of points can be put forward in the affirmative: First, the Commission enjoys wide leeway of discretion in the application of EU rules. In addition, on various occasions, the Court has confirmed that the Commission enjoys wide discretion in the assessment of economic circumstances. Second, there is no indication that interpreting structural reforms as "relevant factors" would be incompatible with the overall purpose of the excessive deficit procedure. The main purpose of the excessive deficit procedure is to ensure the prompt correction of excessive deficits, i.e. making sure that Member States return to a sustainable fiscal position. Structural reforms would have to further this goal. The Commission and other EU institutions have repeatedly underscored the relevance of structural reforms as an essential element for long-term positive budgetary development. Structural reforms are a requisite for growth as the basis for fiscal sustainability. The positive correlation between structural reforms and positive budgetary effects is also acknowledged in Article 5 of Regulation (EC) 1466/97, which explicitly refers to structural reforms that have such a positive budgetary effect. Third, and in the same vein, for the sake of consistency between the preventive and corrective arms of the SGP, the same reasoning and logic should be applied, given that both arms share the same overriding fiscal policy goals.

In summary, there is significant leeway to account for the implementation of structural reforms both in the preventive and corrective arms of the SGP. A comprehensive and detailed structural reform plan containing well-specified measures, verifiable information and credible timelines may lead to a modification of the medium-term budgetary objective. The requirements relating to the degree of implementation should not be too strict, given that there is sufficient potential for sanctions and withdrawal of the favourable treatment. Similarly, under the EDP, structural reforms may be a relevant factor when decisions are made about opening procedures and setting the deadline for the correction of the excessive deficit. Incorporation of country-specific recommendations under the European Semester, as well as the corrective action plan under the MIP, ensures consistency of the economic policy tools.

3 CONTRACTUAL AGREEMENTS PROMOTING STRUCTURAL REFORMS

The current surveillance system under the SGP works in a hierarchical sense, that is, the EU Commission leads the procedure and has the right to decide authoritatively on the structural reforms that are to be implemented. Also, the SGP incentivises through sanctions rather than rewards, as monetary or procedural penalties can be imposed in the event of non-compliance by a Member State. That would be fundamentally different if structural reforms were incentivised and incorporated by contractual agreements. Such agreements would modify the existing logic, as structural reforms would be negotiated between the parties and incentives would be set through rewarding the implementation of structural reforms. One can conceptualise such agreements in two ways: first, through agreements concluded between the EU and individual Member States, underpinned by financial support as an incentive, and second, as mutual agreements concluded between Member

States, which agree on the implementation of structural reforms in the respective country as a kind of barter trading.

a) Legal implementation of contractual agreements

Assessing the legal feasibility of contractual agreements raises questions regarding the legal nature of contractual agreements and the possible legal basis to allow for agreements sidelined by a funding facility.

The EU treaties are silent on contractual agreements between the EU and its Member States. In the absence of an explicit legal basis under primary or secondary law, which would provide for a certain competence of the EU vis-à-vis its Member States, general considerations apply in principle as to the EU's ability to enter contractual relationships. One may consider such agreements as constituting international law treaties or, based on specific secondary law, as Memoranda of Understanding.

In general, the EU can enter into international agreements according to Article 47 TEU and Article 335 TFEU. In addition, Article 216 TFEU explicitly recognises that the EU can conclude agreements with third countries and international organisations. The ability to enter into agreements with EU Member States is implicitly acknowledged by Article 50(2) TEU, according to which the EU concludes an agreement with a Member State leaving the EU. Also, any agreement between the EU and a Member State must remain within the substantial competences granted to the EU under the treaties. The conclusion of an agreement by the EU outside of the scope of the legal basis of the EU treaties would infringe the principle of conferral in Article 5 TEU.

Alternatively, the contractual relationship may be established as a Memorandum of Understanding (MoU). While the EU treaties are silent on this instrument, it has been used frequently during the crisis, rendering financial assistance to states conditional on a range of domestic economic and public administration reforms. In this way, the MoUs float between supporting intra-EU and extra-EU support mechanisms, with the European Commission and European Central Bank acting as negotiators and compliance monitors. There is some conceptual similarity between the MoUs under the ESM and the contractual agreement discussed here – both tie financial support to conditionality and largely concern the implementation of structural reforms. The conclusion of contractual agreements would therefore be provided under secondary legislation, and compliance with MoUs can be ensured by the financial assistance that is granted only if there is compliance, and withheld in the case of non-compliance.

Without the possibility of concluding contractual agreements through international treaties, contractual agreements ought to be established on the basis of secondary legislation. Depending on the design, content and objective of contractual agreements, we identify three potential legal grounds in the EU treaties, which allow for the establishment of contractual agreements.

First, agreements promoting the implementation of structural reforms generally appear connected to Article 136 TFEU as a regular norm providing for economic

policy coordination. In the past, Article 136 TFEU played a significant role in strengthening budgetary surveillance and economic coordination, giving rise to concerns about an inadmissible stretching of the boundaries of this norm. Most importantly, structural reforms agreed upon under contractual agreements are intended to ensure conformity with the broad guidelines referred to in Article 121(4) TFEU, and they reduce the risk that the proper functioning of the economic and monetary union will be jeopardised, which indicates a parallel between the structural reforms under the MIP and the contractual agreements.

This finding holds, considering the establishment of a fund intended to incentivise the implementation of contractual agreements. In *Pringle*, the Court found in relation to the ESM that "neither Article 122(2) TFEU nor any other provision of the EUT and TFEU Treaties confers a specific power on the Union to establish a permanent stability mechanism such as the ESM", which raises the question as to whether the fund attached to contractual agreements would be construed to be a stability mechanism like the ESM. Comparison with the ESM thus depends on whether contractual agreements are considered as an economic policy coordination tool or as a permanent stability mechanism. Connecting country-specific policy recommendations to incentivising payments contains elements of both economic policy conduct and financial support. But while under the ESM financial support seeks "to safeguard the financial stability of the euro area", under contractual agreements financial support aims at the implementation of structural reforms in order to promote the economic adjustment capacity of a Member State and could thus be based on Article 136 TFEU.

An alternative legal basis that is particularly relevant for the establishment for the fund attached to the contractual agreements lies in Article 175(3) TFEU. Under this norm, specific measures serving the goals of Article 174 TFEU (promotion of overall harmonious development and strengthening of its economic, social and territorial cohesion) can be adopted, including the use of the EU funds specified in Article 175(1) TFEU. Accordingly, the European Union Solidarity Fund (EUSF) was set up in response to major natural disasters and expressed European solidarity to disaster-stricken regions within Europe. Also, the European Globalisation Adjustment Fund, which provides support to people who have lost their jobs as a result of major structural changes in world trade patterns due to globalisation, was based on this provision. Hence, in light of the previous use of Article 175(3), there are ample opportunities to design and endow the contractual agreements of the fund, provided that they aim at strengthening the EU's economic, social and territorial cohesion.

Finally, and depending on the specific design of the contractual agreements, the legal basis for the establishment of a fund outside the EU budget and of an agency to implement it can be found in Article 352 TFEU. According to the flexibility clause, the EU can take appropriate measures if action by the Union should prove necessary, within the framework of the policies defined in the treaties, to attain one of the objectives set out in the treaties. In principle, establishing a fund that promotes structural reforms under Article 352 TFEU appears to be feasible if the fund serves the objectives mentioned in Article 3 TEU, notably to attain the "sustainable development of Europe based on balanced economic growth".

However, actions under the flexibility clause must observe limitations imposed by the EU treaties, i.e. they must not alter the institutional setting established by primary law. For example, Article 153(4) TFEU must be observed – this rule allows the EU to support Member States' social and labour policies, excluding any harmonisation of the laws and regulations of Member States. However, given the unanimity requirement under Article 352 TFEU, and as the Court has made clear in the *Single European Patent* case (namely that it is possible to make use of legal bases requiring unanimity through enhanced cooperation), resorting to enhanced cooperation might be the more realistic option, provided the above legal bases do not suffice given the specific design of contractual agreements.

b) Inter se agreements between Member States

As an alternative to the contractual relationship between the EU and its Member States, bi- or plurilateral agreements between Member States could be considered, without the involvement of the EU. The crisis has shown that a lack of necessary reforms in one Member State can have negative effects in others. Conversely, the adoption of structural reforms in one country has a positive spillover in others – i.e. there is a mutual interest in implementing structural reforms. Reciprocity enshrined in contractual agreements reflects the positive cross-border spillovers from the domestic deal and increases Member States' willingness to reform.[6]

More recently, *inter se* agreements between Member States reflect a general trend of intergovernmentalism. The main explanation for this trend lies in the overall strategy pursued by EU Member States in responding to the euro crisis. While a number of reforms to the architecture of EMU have been carried out in the framework of EU law, Member States have decided to act, to a large extent, outside the EU legal order, tightening budgetary constraints, establishing new mechanisms of financial stability and setting up a framework for economic adjustment for countries in fiscal trouble. This is done through international agreements, most notably the treaties establishing the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), both of which (like the stability treaty) aim at supplementing the EU law measures on the EMU. However, the limits of intergovernmentalism in managing the euro crisis effectively and legitimately have been emphasised repeatedly. It remains to be seen what role intergovernmentalism will play in post-crisis times over the coming years.

The Court noted in *Pringle* that in areas where the European Treaties do not confer a "specific competence" on the EU, Member States are generally free to act. In the areas concerned here – economic, labour, social policy (Articles 2(3), 5 TFEU) – the Treaty does not confer specific competences, as the EU is allowed to act only by coordination. More specifically, Member States enjoy full competence in the domain of economic and fiscal policy and are thus free to enter into *inter se* treaties. Regarding the prospective content of mutual agreements, general restrictions exist in relation to the EU's exclusive

6 The practical relevance of such agreements is illustrated by the ambitions recently expressed in the joint report from France and Germany on economic reforms focusing on competitiveness and investment issues.

competence to conduct currency and monetary policy (Article 3(1c) TFEU). However, if *inter se* agreements coordinating economic policy have an effect on the stability of the euro or on inflation, this would not justify the EU's exclusive competence as such an influence would constitute only the indirect consequence of the economic policy measures adopted.

Member States may even design mutual agreements by involving the EU, potentially as a broker and monitoring body for the agreement. The EU Commission would then facilitate and monitor bilateral agreements, and the CJEU may be called upon for judicial review. Guidance on the feasibility of such integration of EU institutions into *inter se* treaties can be sought from the Court's *Pringle* judgment. In that case, the ECJ set aside the concern that the involvement of EU institutions under the intergovernmental ESM Treaty was incompatible with the principle of sincere cooperation (Article 4(3) of TEU). It ruled that the attribution by the ESM Treaty of specific tasks to some EU institutions (the ECB, the Commission and the ECJ) did not violate Article 13 EUT, stressing that its case law, or specific provisions of the Treaty such as Article 273 of the TFEU, entitled Member States, "in areas which do not fall under the exclusive competence of the Union, to entrust tasks to the institutions, outside the framework of the Union, […] provided that those tasks do not alter the essential character of the powers conferred on those institutions by the EU and FEU Treaties." While this finding has been criticised as hampering the institutional design of the EU, allocating tasks to EU institutions in framing *inter se* agreements remains in line with established ECJ jurisprudence.

III IMPLEMENTING INSURANCE-BASED COORDINATION MECHANISMS

While incentive-based coordination largely follows the logic of the existing surveillance model of coordination, insurance type coordination falls, instead, into the domain of fiscal federalism. The insurance-type coordination mechanism relates to the debate about stabilisation tools counteracting asymmetric shocks within EMU. The underlying idea is that, in a monetary union, member countries do not have access to monetary policy to react to a downturn – they can only use fiscal policy. In such a situation, a fiscal equalisation scheme may provide insurance through financial transfers to countries affected by asymmetric negative shocks. Building on the fiscal capacity, an EMU-level stabilisation tool to support adjustment to asymmetric shocks, facilitating stronger economic integration and convergence and avoiding the setting up of long-term transfer flows, could become a component of a genuine EMU.

I INSURANCE MODELS

Among the multiple potential designs of insurance-based coordination, we representatively explore the legal feasibility of two concrete modes of insurance. The main difference between them is that one is permanent in nature, i.e. the setting up of a re-current flow of financial transfer based on a set of criteria. The

alternative model is shock-based, i.e. transfers occur only (and rarely) if certain thresholds reflecting an economic shock are met.

The first model is represented by an unemployment scheme, as suggested by EU Commissioner Laszlo Andor,[7] which has the following features: the unemployment insurance would replace the corresponding part of national schemes. The levels of the contribution and of the benefit should represent a relatively low common denominator among the rules of the various national schemes. The insurance would focus on short-term unemployment and would, for example, be paid only for the first six months of unemployment. Each Member State would be free to pay out a higher or longer unemployment benefit on top of this European unemployment insurance. Crucially, this basic European unemployment insurance would help EMU Member States to share part of the financial risk associated with cyclical unemployment. Every month national authorities would send the basic contribution from all their employed workers to the European fund. This model represents unconditional, permanent insurance – variations can specifically modify the eligibility criteria.

The second insurance model is distinct from the above mainly in that payments from the insurance depend on the occurrence of an economic shock. These models vary in underlying threshold criteria. Payments could be linked to the deviation of actual from natural unemployment rate, deviations from the short-term unemployment rate or the ten-year average and deviations from the average output gap. If the threshold is met, national unemployment insurance funds receive payments from the EU fund. Thus, this design of unemployment insurance is not suitable for EU-level absorption of small national shocks, but, instead, for large shocks only. Deductibles are proposed as a balancing tool, i.e. deductibles are based on actual long-term average spending on benefits for the short-term unemployed. Country premiums should be differentiated according to risk in order to ensure an approximate long-term balance between contributions and benefits for each country.

2 LEGAL BASIS

There is a discrepancy in analytical depth between the policy debate and the legal analysis of insurance models. While the discussion of macroeconomic desirability of an insurance scheme has been active for quite some time, producing a variety of different proposals, no comprehensive legal analysis has been undertaken. We now identify the legal basis on which each of the above models of insurance could be based.

a) Article 153 TFEU

In principle, the applicable legal basis for EU measures depends on the subject area in which the EU intends to become active. In the case of an unemployment scheme aimed primarily at performing a macroeconomic function as discussed here, this does not seem to be a straightforward issue, as it relates to both the

7 Andor, "Social dimension of the Economic and Monetary Union: what lessons to draw from the European elections?", *Lecture at Hertie School of Governance*, Berlin, 13 June 2014.

governance of national EU unemployment schemes and a macroeconomic instrument to smooth business cycles. Generally, in the case where the Union's legislative intention allows for more than one legal basis to be applicable, the choice of the appropriate legal basis depends on where the focus of the measure lies.

Provided the focus of the measure lies in the social policy dimension, the scheme must be in line with the EU competences set out in Article 153. According to Article 153(1) TFEU, the EU shall "support and complement the activities of the Member States". Furthermore, Article 153(2b) TFEU allows the EU to set minimum requirements by means of directives, including in the area of social security and social protection of workers (Article 153(1c)). While EU competences in social affairs have been gradually expanded in recent treaty changes, a number of hurdles limit the EU's scope of manoeuvre in implementing an EU-wide unemployment scheme.

Article 153(4) TFEU imposes a general restriction in the EU's exercise of its competences under this provision by requiring that any measure taken by the EU must not affect Member States' freedom to determine the fundamental principles of their social security systems. Such measures must not affect these systems' financial equilibrium either. Also, Article 153(2b) TFEU only allows the adoption of measures by means of directives. Again, depending on the ultimate design, it appears difficult to establish an effective anti-cyclical fiscal instrument that is intended to work following identical parameters and thresholds across the euro area by a directive that, in theory, leaves Member States room for manoeuvre in national implementation. Finally, Article 153(2b) TFEU only allows the setting of "minimum requirements" and must be interpreted in conjunction with the supporting and complementing functions referred to in Article 153(1) TFEU, which implies an overall restriction of EU harmonising activity. Any attempt to replace national unemployment schemes in their entirety must run counter to this norm. In summary, genuine unemployment insurance implemented at EU level is not likely to be grounded on Article 153 TFEU given the high degree of Member States' room for manoeuvre in the area of social security.

b) Article 122 TFEU

In order for Article 122(2) TFEU to serve as a legal basis for an insurance scheme, the entitlement to receive payments under the scheme would need to be tantamount to "severe difficulties caused by natural disasters or exceptional occurrences beyond its control". In relation to the requirement of "exceptional occurrences", there is considerable debate as to whether this term not only covers obvious cases such as social unrest or foreign policy turbulence, but also extends to solvency issues due to public debt resulting from a financial crisis. During the crisis, the controversy extended to whether the difficulties of Greece, Ireland, Portugal and Spain were caused by such occurrences. Considering the degree of flexibility granted by Article 122(2) TFEU, and considering that every situation requires a case-by-case examination, a country's own responsibility in critical circumstances can be taken into account when determining the conditionality necessarily tied to financial assistance.

The exceptional nature of the situation in which financial assistance may be granted disqualifies any scheme that establishes a permanent transfer system, irrespective of the exceptionality of the economic situation. Unemployment schemes falling within the first model described above do not meet the requirements of Article 122(2), for they simply replace recurring elements of an insurance scheme that is responsive to usual business cycle fluctuations. Variations in business cycles cannot be considered exceptional within the meaning of Article 122(2) TFEU. By contrast, shock-based adjustment mechanisms may be designed in a way that would reflect the requirements of the norm. Most importantly, both the characteristics of the criteria and the applicable threshold would need to be chosen with a view to reducing potential payments under the insurance scheme to a level that can arguably be considered as exceptional. The frequency by which support is triggered must plausibly be due to significant crisis effects. Unlike under the ESM, the exceptional impact triggering payments under the insurance scheme can be limited to the country concerned and must not necessarily be of a euro-wide dimension. By way of economic assessment, the representative character of the respective criteria to measure the severity of economic shocks (e.g. short-term unemployment, output gaps) must be determined.

This finding can also be brought into line with the Court's reasoning on the ESM in *Pringle*. The Court identified two obstacles to the use of that provision as a legal basis for an EU-based ESM. A first problem was that the ESM establishes a permanent mechanism, whereas the Court found the requirement of "exceptional occurrences" to imply assistance on an ad hoc basis only. Under the ESM, the ad hoc nature of the support was ensured through a formal decision of the Council rather than automatically triggering financial support. Similarly, the trigger of the shock adjustment mechanism could be made dependent not only on the threshold criteria, but also on a subsequent affirmative decision by the Council, accounting for the explicit ad hoc character required by the Court in *Pringle*. That such assistance is organised via a permanent (but shock-dependent) mechanism is irrelevant so long as assistance is granted in specific (emergency) instances and only for the duration of the (threat of) serious difficulties.

c) Article 125 TFEU

Any financial assistance must be assessed in respect of the no-bailout clause set out in Article 125 TFEU. In *Pringle*, the ECJ substantiated the terms of this norm by finding that this clause was "not intended to prohibit either the Union or the Member States from granting any form of financial assistance whatever to another Member State."[8] According to the ECJ, from the preparatory work of the Maastricht Treaty it emerged that "[t]he prohibition laid down in Article 125 TFEU [was designed to] ensure that the Member States remain subject to the logic of the market when they enter into financial assistance "as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy [would] diminish."[9] At the core of Article 125 TFEU, as interpreted by the Court, is encouragement to Member States to conduct sound budgetary policies, ideally

8 Case C-370/12, *Pringle*, [2012] ECR I-756, para. 130.
9 Case C-370/12, *Pringle*, [2012] ECR I-756, para. 136.

incentivised by market pressure, but under certain circumstances also through conditionality if financial support is required for the sake of financial stability.

In relation to the insurance models, given the various financial support mechanisms established in the EU legal framework in recent decades, a distinction has to be made that takes account of the purposes of the respective mechanism. Payments to Member States under the European Regional Development Fund, the European Social Fund and the Cohesion Fund have been an integral part of EU financial assistance, fostering social and economic cohesion in the EU over several decades. Similarly, the European Union Solidarity Fund enables the EU to provide effective support to Member States in its efforts to deal with the effects of a major natural disaster. Formally, such a support mechanism falls under the broad array of possible support measures under Article 125 TFEU. However, the compatibility of these financial support mechanisms with Article 125 TFEU has virtually never been questioned, even though they provide financial support, not as a repayable loan, but as a grant. Unlike the crisis financial support mechanism, the intention and effect of the other funds of the EU are fundamentally different. They aim primarily at social and economic cohesion or compensation for particular losses. These instruments do not aim at addressing the financial problems of a Member State. Likewise, payments made under an EU unemployment scheme serve preventive rather than corrective purposes, seeking to smooth business cycles rather than improving a budgetary position or reducing market pressure.

3 FISCAL CAPACITY FOR INSURANCE SCHEME

Endowing the insurance fund raises the question of EU fiscal capacity. I discuss three different options for setting up the fund: first, the use of existing funds as a nucleus of a future stabilisation fund; second, the justification of loan facility under Article 122 TFEU; and third, the financing of the fund through Member State contributions on an intergovernmental basis.

A practical scenario would be to employ the existing funding scheme to create a macroeconomic stabilisation mechanism. We have discussed above the possibility of basing the structural reforms of funding schemes on Article 175 TFEU designed as an instrument to promote economic cohesion. In this vein, the EU Five Presidents' Report proposes building on the European Fund for Strategic Investments, as a first step towards an overall stabilisation mechanism, by identifying a pool of financing sources and investment projects specific to the euro area, to be tapped into according to the business cycle. Resting on Article 175(3) TFEU and strengthening economic, social and territorial cohesion, this could be an elegant avenue to establish an insurance fund in line with the ordinary legislative procedure (based on a qualified majority) pursuant to Article 172 TFEU.

Given the (initially) limited effectiveness of the EU Structural Funds, there may be scope for a genuine EU borrowing-and-lending facility. This would require the insurance scheme to be designed as a shock-based mechanism in line with Article 122 TFEU. In principle, the Union may not raise loans within

the framework of the budget. However, there have been exceptions to this rule. Article 143(1) subpara. 2 TFEU provides that, acting on a recommendation from the Commission, the Council can grant mutual assistance where a Member State is in difficulties or is seriously threatened with difficulties as regards its balance of payments. This provision thus generally recognises a situation under which the EU may exceptionally enter into a lending operation vis-à-vis another country if a certain situation of economic distress occurs. On the basis of Articles 143 and 352 TFEU, Regulation No 332/2002 has set up a mechanism of mutual assistance for when a Member State is in "difficulties or is seriously threatened with difficulties as regards its balance of payments". Indeed, Article 143 TFEU does not define the instrument to be used for granting the mutual assistance envisaged. The application of Article 143 TFEU illustrates the leeway granted to EU institutions where the EU Treaty recognises the possibility of a financial support mechanism. More specifically, while Article 143 TFEU only recognises the requirements under which mutual assistance may be provided, it is silent on how the EU may raise the funds it provides to Member States that are in difficulty. However, this norm has been applied in a manner acknowledging that "it is for the Council to decide whether to grant a loan or appropriate financing facility, its average duration, its total amount and the amounts of the successive instalments". Thus, there is ample scope for manoeuvre for the Council to determine the appropriate method of support. This flexibility led the Council, under Articles 143 and 352 TFEU, to establish a medium-term financial assistance facility, enabling loans to be granted to Member States. However, Article 122 TFEU would need to be observed. If the insurance scheme is designed as a shock-based scheme in line with Article 122 TFEU, the EU may consider granting loans to the Member State suffering a shock. Furthermore, in light of the conditionality requirement referred to in Article 143(2) TFEU and the significance of conditionality as a requirement for financial support under Article 125 TFEU, one might impose conditionality for loans under the insurance scheme as well. In practice, this would imply that shock-induced recipient countries would be subject to conditionality, which would set out the policy measures which should be used for payments.

Considering (political) obstacles to extending the EU's scope of fiscal activities, it seems possible that an enhanced fiscal capacity could be funded more easily through direct national transfers. An implementation based on Article 136(3) TFEU does not appear feasible, as the insurance primarily aims at balancing asymmetric business cycle shocks that do not seem to be "indispensable to safeguard the stability of the euro area as a whole". However, the crisis context has given sufficient examples of how Member States might put in place a mechanism providing financial support. Establishing a fund providing the means for an insurance scheme could be made, in line with experience, with the EFSF, the temporary loan vehicle created on an intergovernmental basis. Similarly, the ESM was created as an intergovernmental fund, with Member States remaining liable funders. If an insurance scheme were based on economic policy as genuine Member State competence, there would be no conflict with competences assigned to the EU – a conflict that would prevent Member States from establishing a fund outside the EU legal framework. If Member States are allowed to act outside the EU framework, then Member States can also spend outside the EU budget. This would be different if the insurance scheme were based on Article 175 TFEU and

aimed at social and economic cohesion, as discussed above, since in that case EU competence would be involved (and would give the EU the powers to create a fund under that norm). Thus, an insurance scheme created as an economic policy instrument could generally be funded by Member States that would also regulate and govern its operational setup. Inconsistencies of such a fund with Article 125 TFEU, as in the case both of the ESM and the EFSF, can be avoided if the specific design of the scheme complies with the requirements discussed above.

IV CONCLUSION

The current "surveillance model" of European economic policy coordination is likely to persist over the next few years. In light of the lack of political impetus in pursuing deeper integration towards the "fiscal federalism model", Member States will continue to have full fiscal competence and retain competence to conduct economic policy. In this scenario, the EU continues to be the "discipline enforcer" applying a number of fiscal rules and following the existing budgetary and economic surveillance system. There is a corresponding need to exploit the existing rules in a flexible manner, allowing the European Commission and Member States to design national economic governance in a manner that deals accurately with the economic challenges at stake. This extends, *inter alia*, to addressing the persistent lack of structural reforms and the need for public investments in times of euro-wide fiscal consolidation. Beyond that, frequent calls have been made to strengthen shock absorption capacities within EMU.

The distinction between incentive-based and insurance-type coordination adopted in this analysis may reflect the two avenues for further coordination efforts. The former corresponds to the established surveillance mode, but is not confined to the existing sanction-based logic that also allows for more egalitarian and reward-based incentives through bilateral agreements. Insurance-type coordination refers to stronger resilience within the EMU through shock absorption mechanisms requiring (at least some) fiscal capacities at EU level and thus alluding to the logic of fiscal federalism. Adopting a legal perspective, this analysis has sought to highlight the room for manoeuvre offered by the current legal framework in three regards. First, the existing fiscal legal framework offers flexibility to varying degrees by taking account of investments and structural reforms under the SGP. By using the existing surveillance tools and by introducing new arrangements under the current rules, surveillance and policy options are diversified, facilitating more targeted responses to country-specific needs. While there are limitations to a more favourable treatment of investments within the SGP, there is significantly more leeway to account for the implementation of structural reforms both in the preventive and the corrective arm of the SGP. Second, there is scope for both contractual agreements between the EU and Member States, and among Member States that agree on structural reform plans, incentivised either through funding or by reciprocity of reforms. This instrument would add a reward-based mechanism to the existing sanctions-based logic without unlawfully interfering with the existing governance. Third, the legal scope for insurance schemes is narrow and establishes a number of conditions as to the design. Fully-fledged unemployment insurance schemes (even if limited

to a kind of basic insurance) are likely to overstretch the boundaries of the EU treaties. More narrowly, however, such a scheme is rather likely to be feasible if designed as a shock-based mechanism where the gravity of the economic shock must be significant. Existing EU funds could then be used as a nucleus for an extended funding scheme.

What are the implications for the further trajectory of economic policy coordination efforts within the EU? The surveillance model making use of the flexibility options described is likely to be the short-term avenue pursued by the EU institutions. In this vein, the recent Five Presidents' Report has stressed the use of existing instruments in implementing structural reforms. This may imply a stronger role of the European Semester as the forum to assess comprehensively, on a country-specific basis, the need for structural reforms, which could then be implemented under the MIP and SGP or through arrangements as discussed in this analysis. At a subsequent stage, the Five Presidents' Report proposes the introduction of a fiscal treasury. While such a far-reaching institutional novelty would certainly require treaty amendments and is realistically confined to the euro area, this analysis has sought to highlight more limited models of introducing fiscal transfers aiming at macroeconomic stabilisation, which may be easier to implement under the existing rules.

ENHANCED COORDINATION OF ECONOMIC POLICIES IN THE EURO AREA: LEGAL ANALYSIS OF SOME POSSIBLE WAYS FORWARD

JEAN-PAUL KEPPENNE[1]

While the current EU treaties do not provide a basis for a common economic policy within the euro area, it is nevertheless admitted that the current rules-based system of coordination of the economic policies of the Member States, essentially through fiscal discipline, is not sufficient. As a follow-up to the financial crisis, some new approaches have recently been tested and further steps are envisaged under the current treaty framework. One approach consists of promoting national structural reforms by using the fiscal control procedure. Other ideas focus on the building up of shock absorption mechanisms or fiscal stabilisation functions within the euro area. This paper discusses a few legal questions linked to these recent evolutions. First, it assesses the way in which the Commission tries to promote structural reforms by using the procedures of the Stability and Growth Pact (Section 1). Secondly, it tries to shed some light on the possible use of so-called "contractual instruments" to be agreed between the Union and its Member States (Section 2). Finally, looking at the (unfortunate) precedent of the financial assistance mechanisms (European Financial Stability Facility (EFSF), European Stability Mechanism (ESM)) created during the recent financial crisis, this paper argues that the new support initiatives envisaged for stabilising the euro area (shock absorption mechanisms or fiscal stabilisation functions) should not rely on financing originating from outside of the EU framework (Section 3).

1 THE USE OF THE STABILITY AND GROWTH PACT TO PROMOTE STRUCTURAL REFORMS IN THE MEMBER STATES

1.1 THE STABILITY AND GROWTH PACT[2]

As general background, it should be recalled that the conduct of the budgetary policies of the Member States is not submitted to directly applicable Treaty provisions but to a general coordination framework. The Stability and Growth Pact is the name given to all primary and secondary law provisions that regulate the monitoring by the Union Institutions of the fiscal situation of the Member States. The TFEU, especially its Articles 121 and 126, has entrusted

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2 For more details, see the Vade mecum on the Stability and Growth Pact, European Economy, Occasional Papers 151, May 2013.

the Council and the Commission with the responsibility for coordinating and monitoring the fiscal situation of the Member States, on the basis of reference values for the deficit and debt ratio (respectively 3% and 60% as contained in Protocol No 12 to the Treaties).

The implementation of these general provisions requires further specifications through secondary legislation. The legislator has therefore adopted provisions as regards the procedures to be followed and the substantive rules to be respected. These provisions pertain to, on the one hand, the preventive arm of the Pact, i.e. the prevention of excessive deficits, and, on the other hand, the corrective arm of the Pact, i.e. the correction of excessive deficits (respectively Regulations No 1466/97[3] and 1467/97[4]).

Due to the complexity of the facts to be determined and of the economic analysis to be performed, the provisions of the Pact necessarily leave a substantial margin of appreciation to the Commission and the Council. On the basis of experience and expertise, this margin of appreciation has been framed over time through the more precise and predictable parameters of the so-called "Code of Conduct" informally agreed between the Commission and the Council. Apart from the Code of Conduct, the Pact is also complemented by a number of other informal guidance documents endorsed, at political or services level, by the Council and/or the Commission (analytical papers, etc.). As part of this package of guidance documents, the Commission adopted in January 2015 an interpretative communication on "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"[5] (Flexibility Communication). This communication presents detailed new guidance on how the Commission intends to apply the existing rules of the Stability and Growth Pact to strengthen the link between structural reforms, investment and fiscal responsibility in support of jobs and growth.

1.2 THE COMMISSION'S COMMUNICATION ON THE FLEXIBILITY OF THE STABILITY AND GROWTH PACT

The Flexibility Communication does not represent new legislation but informs about the way in which the Commission interprets the relevant legislation. What it aims to do is to provide transparency about the use by the Commission of its remaining margin of appreciation. By providing this transparency (and making itself accountable in the process), the Commission commits to using its margin of appreciation in a predictable and legally sound way.

The Flexibility Communication provides clarity both on the preventive and the corrective arms of the Pact. In the Flexibility Communication, the Commission recalls that the Pact is a cornerstone of the EU's economic governance and

3 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.
4 Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.
5 Making the best use of the flexibility within the existing rules of the Stability and Growth Pact, COM(2015)12 final, 13 January 2015.

the EMU, but it also sets out under which conditions the rules forming part of the Pact may be applied in a more flexible way than they used to be. In particular, the Commission announces that, provided that a Member State implements structural reforms, it will accept a more flexible assessment of the rules of the Pact. This implies, more specifically, the following:

– Under the preventive arm of the Pact, the Commission and the Council monitor whether each Member State maintains its medium-term budgetary objective (MTO, budget balance) or, if it is not yet at its MTO, approaches it at an appropriate pace (annual improvement of 0.5% of GDP as a benchmark). Member States are allowed to deviate from this obligation in certain circumstances, in particular in order to take account of the costs linked to the implementation of major positive structural reforms they adopt. The Flexibility Communication clarifies ex ante certain categories of reforms or public investments that may justify a temporary deviation from the MTO. Under the preventive arm of the Pact, for reform measures to qualify "ex ante," or, in other words, for the "structural reform clause" to be activated and to apply (Article 5 of Regulation (EC) No 1466/97/EC), Member States are expected to present a dedicated structural reform plan providing detailed and verifiable information, as well as credible timelines for adoption and delivery. If these conditions are fulfilled, the Commission will allow for a deviation from the MTO of the Member State concerned (investment clause).

– The same holds true with respect to the corrective arm of the Pact, the so-called "Excessive Deficit Procedure" of Article 126 TFEU: for Article 2 of Regulation (EC) No 1467/97/EC to apply, the Commission will check that the same set of conditions is fulfilled when recommending a deadline for the correction of the excessive deficit or the length of any extension to that deadline. Thus the Flexibility Communication clarifies how the implementation of structural reforms may be a mitigating factor that would justify postponing the opening of the procedure or granting a longer deadline to the Member State concerned.

1.3 FROM FISCAL SURVEILLANCE TO THE PROMOTION OF STRUCTURAL REFORMS

It is interesting to note how, through the Flexibility Communication, the discipline of the Pact is used beyond fiscal surveillance, strictly speaking, to promote structural reforms within the Member States. In this regard, the Flexibility Communication could be seen as a good example of what the ECB President recently called for, i.e. a shift "from rules to institutions".[6] Previously, the fiscal discipline within the Union, especially within the euro area, was based on pre-established and agreed rules, in particular the 3% deficit and the 60% debt criteria as mentioned in Protocol No 12 to the Treaties "on the excessive deficit procedure". The crisis made clear that these numerical ceilings

6 "Stability and Prosperity in Monetary Union", opinion piece by Mario Draghi, available at: http://www.project-syndicate.org/commentary/ecb-eurozone-economic-union-by-mario-draghi-2015-1-2015-01

were not sufficient to guarantee the stability of the monetary union and that more monitoring was needed as regards the competitiveness of the national economies and the promotion of structural reforms. However, general and abstract rules cannot be used in advance in order to shape structural reforms in a particular Member State. Rather, it is a case-by-case analysis that is needed. Therefore, with the Flexibility Communication, the responsibility for deciding which structural reforms are necessary in each Member State is partially taken away from the Member States concerned, and therefore from their national parliaments, and shared with the Union institutions.

Under the appearance of budgetary monitoring, this Communication confirms the competence of the Commission, as well as the Council, to have a say as regards the structural reforms to be undertaken by the Member States. It applies to all Member States, regardless of whether they are subject to "conditionality" or not.[7] This evolution shows that, through the use of instruments of fiscal control, the EU Institutions also exercise some additional competence in order to induce Member States to apply structural reforms.

This evolution raises challenging issues of democratic accountability. It demonstrates that Member States' core powers in the economic field no longer exclusively belong to them. They are increasingly subject to the control of the Commission and of the other Member States through the Council. Emphasis should be put on the fact that the Flexibility Communication follows a commitment from the Political Guidelines for the new Commission that were presented by the candidate Jean-Claude Juncker in July 2014. It must be recalled, in this regard, that the new President of the Commission was proposed by the Council, after "taking into account the elections to the European Parliament" (Article 17(7) TEU) and then elected by the European Parliament. He was indeed elected by the European Parliament thanks to a coalition of the two biggest political parties represented in the Parliament. Thus he has more political and democratic legitimacy than the previous presidents of the Commission and embodies the willingness to have a more politically driven Commission. It is therefore neither entirely illogical nor illegitimate that the current Commission shows willingness to interpret with more activism, so to speak, the Stability Pact – and it should be recalled, for that matter, that Jean-Claude Juncker expressed his desire, while campaigning, to strike a different balance between fiscal discipline and flexibility. At the same time, it has to be recognised that, for the moment, the degree of involvement of the national parliaments and the European Parliament in the implementation of the Pact remains limited, despite the fact that they represent popular sovereignty. This bigger intrusion of the Union Institutions into the economic policy choices of the Member States probably calls for a parallel reinforcement of the role of the European Parliament in the process.

7 The conditionality refers to structural reforms to be implemented by Member States in exchange for financial assistance.

2 THE USE OF "CONTRACTUAL INSTRUMENTS" FOR THE COORDINATION OF THE ECONOMIC POLICIES OF THE MEMBER STATES: SOME LEGAL QUALIFICATION

Reference was regularly made recently to the use of "contractual instruments" to be agreed between the Union and each Member State in the framework of the coordination of the economic policies of the Member States. One can think in particular of the Commission's communication on the introduction of a competitiveness and convergence instrument.[8]

This reference to "contractual" instruments should be properly qualified. The EU legal framework does not envisage the adoption of acts of a contractual nature in the legal sense. The idea behind such vocabulary is political rather than legal. It aims to have in place measures for which there is a true sense of ownership from the Member State concerned. Legally speaking, EU law, which is characterised by being an autonomous legal order, only provides for a centralised procedure of economic coordination and surveillance, where acts (whether they be opinions, warnings, recommendations or decisions) are adopted in a unilateral fashion by the Union institutions. Within this setting, the entry into force and validity of a Union act cannot depend on further acceptance by the Member States concerned. In this vein, neither the TFEU nor secondary legislation founded on it could be the basis for the adoption of acts of a truly "contractual" nature, where the mutual consent of two parties – the Union and one of its Member States – would be required to engender rights and obligations enforceable before the Court of Justice.

What can be established, however, are legal procedures whose effects come very close to those of proper contractual arrangements, whilst respecting the scope of the competences of the Union. Under such procedures, reform programmes could be formulated by Member States and be subsequently endorsed by acts of the Union. Whereas EU legislation could define the circumstances under which reform programmes are to be formulated, as well as their basic content, they would remain an act of the Member State in question. The corresponding act by the Union would endorse the relevant programme. Nonetheless, the act of the Union would not constitute a source of obligations on Member States enforceable before the Court of Justice: rather, Member States would be bound by the acts and obligations they have given to themselves. The Union could have the power to assess whether the Member State concerned respects the commitments it has given to itself, to the effects of providing possible financial incentives (in the case of compliance) or to trigger the application of sanctions (in the case of breaches).

These kinds of procedures, consisting of the juxtaposition of two separate legal acts, a programme formulated by a Member State and a subsequent act by the Union, are already used in EU economic coordination law. This is the case of

8 Communication from the Commission to the European Parliament and the Council, Towards a deep and genuine Economic and Monetary Union – The introduction of a convergence and competitiveness instrument, COM(2013)165 final.

Regulation No 1176/2011[9] on the prevention and correction of macroeconomic imbalances, which establishes corrective action plans (that may lead at the end of the day to the application of financial sanctions for euro area Member States). This is also the case in the so-called Two-Pack, which provides for quasi-contractual economic partnership programmes[10] and macro-economic adjustment programmes for euro area Member States.[11]

3 MAIN FEATURES OF SHOCK ABSORPTION MECHANISMS OR FISCAL STABILISATION FUNCTIONS WITHIN THE EURO AREA: LESSONS TO BE DERIVED FROM THE PRECEDENT OF THE FINANCIAL ASSISTANCE INSTRUMENTS

3.1 DECOUPLING BETWEEN FUNDING DECISIONS AND DECISIONS ON CONDITIONALITY

For the elaboration of new stabilisation financial mechanisms within the euro area, useful lessons may be derived from the precedent of the financial assistance mechanisms that were put in place over the last years within the euro area (EFSF, ESM). These mechanisms typically contain two elements for dealing with Member States in financial difficulty: the provision of financial assistance, through loans, on the one hand, and the requirement for structural reforms within the beneficiary Member State ("the conditionality"), on the other hand.

From an institutional point of view, these mechanisms are characterised by a decoupling between the funding (decided directly by the Lenders, the EFSF/ESM, in an intergovernmental framework) and the conditionality (largely framed by Union law instruments, in particular the macroeconomic adjustment programme approved by the Council under the Two-Pack).

At the beginning of the crisis, in 2010, while the funding was already decided entirely through intergovernmental channels,[12] by contrast, the conditionality was not in the hands of the lending Member States alone. It is true that the conditionality was mainly prepared and negotiated behind closed doors through direct contacts between the so-called "troika" on the one hand (the Commission, the ECB and the IMF) and the authorities of the assisted Member State on

9 Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

10 See Article 9 of Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

11 See Article 7 of 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.

12 Except for the support granted by the European Financial Stability Mechanism under Council Regulation No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism.

the other hand.[13] When there was technical agreement at their level, political endorsement of the package was given by the Eurogroup, which is the informal meeting of the finance ministers of the euro area and, thereafter, formally agreed between the Member State concerned and the competent intergovernmental bodies. Nevertheless, the Memoranda of Understanding negotiated by the troika were not purely intergovernmental since they were framed by Council decisions (based on Article 136 TFEU or on the EFSM Regulation) providing the main lines of the reforms expected from the Member State under assistance. The content of the conditionality remained, therefore, within the umbrella of the Union framework, in order to guarantee its consistency with the coordination made within the Council. The so-called Six-Pack and Two-Pack have reinforced this feature by repatriating the work of the troika within the EU method, through the "economic dialogue" and a specific procedure for the preparation of macro-economic adjustment programmes, as provided for in Regulation No 472/2013.[14] As a first step, through the Six-Pack, a general economic dialogue was set up involving not only the European Parliament, the Commission and the Council but also, where appropriate, the European Council and the Eurogroup.[15] The Two-Pack that entered into force in 2013 repatriated further within the ambit of the European Union the so-called "conditionality". With these new provisions, if a euro area Member State requests financial assistance, its macroeconomic adjustment programme has to be prepared by the Member State concerned on the basis of an agreed procedure. This procedure more or less reflects past practice (in particular the intervention of the troika) but within the institutional framework of Union law. The Commission must inform the European Parliament during the preparation and implementation of the programme. Approval of the programme by the Council is also required. Exchanges of views between all parties may be organised both before the national parliaments and the European parliament.[16] The Commission's negotiating and monitoring activities are thus largely carried out within the EU context and are therefore within the scope of the EP's political control as guaranteed by the EU treaty.[17]

What are the consequences of this decoupling between the funding decisions (taken by the Lenders outside the EU framework) and the conditionality (largely framed by EU acts)? It created a difficult situation. The reality has often been that, since the funding had to be decided through a unanimous decision of the ESM Members, the conditionality also remained very much de facto within the

13 When acting as part of the troika, the Commission and the ECB only fulfil a mandate given to them by the euro area Member States; they do not act within the legal framework of the EU treaties.
14 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.
15 Regulation No 1466/97, as amended by Regulation (EU) No 1175/2011.
16 Regulation No 472/2013, Article 7.
17 The European Parliament will hold the executives, and in particular the Commission, accountable for their conduct, including in respect of surveillance. The Regulation foresees that the Parliament has to be informed, in a timely manner, of not only decision-making but also the outcomes of the economic surveillance process. The European Parliament can also organise debates in the context of an economic dialogue with other Union institutions as well as the Member State concerned.

hands of the Member States. In other words, even if the Council decisions framing the conditionality were adopted first, the real negotiation on the conditionality seemed to have taken place during the Eurogroup meetings that took stock of the negotiations on the Memoranda of Understanding. In practice, therefore, the real political decisions have continued to be taken largely by the Eurogroup/ESM, which holds the purse strings, while the involvement of the Council has been kept rather secondary.

This experience should serve as a lesson for the shock absorption mechanisms and fiscal stabilisation functions that are currently envisaged for the euro area. A situation of decoupling, with one "intergovernmental" leg and an EU leg, should be avoided. If new instruments are created within the EU framework but with funding coming from intergovernmental mechanisms (like the unfortunate precedent of the Single Resolution Fund), it is to be feared that the centre of gravity of the economic policy of the euro area could be moved further away from the EU legal framework.

3.2 DIFFERENCES BETWEEN THE COUNCIL AND THE ESM BOARD OF GOVERNORS

As a continuation of the previous section, it is worth stressing that the fact that a decision is taken by the ECOFIN Council on the basis of the Two-Pack or by the ESM Board of Governors on the basis of the ESM Treaty entails huge differences, even if the very same Finance Ministers are members of these two bodies. Indeed, a number of institutional weaknesses affect the intergovernmental decision-making procedure by contrast with the EU one.[18]

Firstly, the intergovernmental mechanisms imperil the delicate balance upon which the EU model rests. The balance between the European Parliament, the Council and the Commission serves to provide checks and balances and act as a last-instance guarantee ensuring that the EU process is the product of equilibrium or settled consensus between particular actors in order to ensure legitimacy and stability.[19] This balance is lost when finance ministers agree between themselves, without a Commission proposal and using alternative voting arrangements on fundamental questions related to redistributive policies throughout the Union. *Secondly*, and possibly more importantly, the creation or reinforcement of *permanent* intergovernmental bodies constitutes a long-term threat to the unity and homogeneity of the Union. As the ESM has been established as a permanent body, its operational budget and staff have started to grow in size and ambition. The temptation to intrude into the territories of EU competences

18 For an analysis of the consequences of the intergovernmental method in the EMU sector see Keppenne, "Institutional Report", XXVI FIDE Congress in Copenhagen, published in U. Neergaard, C. Jacqueson and J. Hartig Danielsen (eds), the Economic and Monetary Union: Constitutional and Institutional Aspects of the Economic Governance within the EU, 2014, Congress Publications Vol. 1 (Copenhagen: DJOF Publishing, 2014), pp. 179-257, esp. pp. 206-207; Ponzano, Méthode intergouvernementale ou méthode communautaire: une querelle sans intérêt?, Les brefs de Notre Europe, 23, 2011.

19 Dawson and De Witte, Constitutional balance in the EU after the euro-crisis, The Modern Law Review, 2013: 817-844, p. 829.

might grow at the same speed and *institutional rivalry* could be a danger in the near future. The functioning of the EU institutions could be affected.[20] *Thirdly*, another danger associated with the intergovernmental mechanisms is that they induce a "participation à la carte" of the Member States, with all the ensuing inconsistencies, lack of clarity, priority given to the defence of national interests, etc. The field of intergovernmental economic governance has become the place where a *multi-speed Europe* is standard practice. Most measures are restricted to a sub-group of Member States, usually euro area Member States, sometimes open for the voluntary participation of willing non-euro area Member States. This pattern has started to contaminate the whole EU framework (see the examples of the Single Supervisory Mechanism and of the Single Resolution Mechanism), thus making the enhanced cooperation mechanism de facto nearly obsolete.[21] Finally the democratic control in place in the framework of this method is not entirely satisfactory. This applies not only at the moment of adoption of new principles or setting up of new institutions but also in the day-to-day implementation of these principles and as regards the functioning of these institutions.[22] In particular the EP cannot properly control intergovernmental action while decentralised control by national parliaments is largely ineffective, except for the largest Member States.

20 See for example the impact of Eurogroup's meetings on the work of the ECOFIN Council as well as the voting commitments adopted under the Treaty on Stability Coordination and Governance for EDP decisions to be taken within the Council.

21 One has to recognise, however, that the Treaty-based enhanced cooperation mechanism, because it requires time and is open to all Member States willing to participate, is not an adequate instrument for setting up measures for the euro area. In the long term, a revision of Article 136 TFEU would be desirable in order to expand the scope of what can be set up for the euro area only. Another useful amendment would be to permit the adoption of specific measures for Member States that are close to entering the euro area.

22 de Streel, The evolution of the EU economic governance since the Treaty of Maastricht: an unfinished task, Maastricht Journal, 2013: 336-362, p. 357.

EIB MISSION

NICOLA BARR[1]

INTRODUCTION

Often, demands are made on the European Investment Bank (EIB). Given this, it is relevant to consider what the EIB is. Is it a bank or an EU body subject to the EU framework? The answer to this is both. And it is the European Union's bank which is owned by all of the EU Member States. I will further elaborate on these points below.

The task of the EIB is to promote European objectives within its institutional and legal framework. I will summarise some of the principal legal constraints on the EIB's activities and give some indications of how the EIB has contributed to the achievement of European objectives and policies, as well as describe how the nature of finance provided by the EIB has evolved and continues to evolve.

WHAT IS THE EIB?

There are four main points I would like to make in describing the nature of the EIB. The first two points, as mentioned above, are that the EIB is both an EU body and a bank and is owned by and represents the interests of all EU Member States, which is relevant when considering which particular initiatives it may undertake. In relation to this, it enjoys legal personality and financial autonomy and has its own decision-making bodies. And lastly, it is established under the Treaties.

Taking these in turn, because the EIB is at the same time an EU body and a bank, it is governed by both public governance and corporate governance principles. The EIB enjoys legal personality (Article 308 TFEU) and financial autonomy and has its own independent decision-making bodies within the Union institutional system.

The EIB's management and control structures reflect this independence and allow it to take lending decisions solely on the basis of a project's merits and to tailor borrowing in line with the best opportunities available on the financial markets. This reflects the function of the EIB as a bank.

In this respect, it is worth providing here a brief summary of the EIB's governance and decision-making structure. Firstly, as mentioned above, the shareholders of the EIB are the 28 Member States of the EU. There are three decision-making bodies: the Board of Governors, the Board of Directors and the Management Committee.

1 Director General and General Counsel, European Investment Bank.

Taking the Board of Governors first, this is made up of government members of the EU Member States and sets the guiding principles and high-level policies, and decides on capital increases and on participation in financing outside the EU. It also approves the annual accounts and appointment and remuneration of members of the other governing bodies of the EIB.

The Board of Directors is made up of non-resident members nominated by EU Member States and one by the European Commission. It approves the financing operations together with policies and operational strategy. It also oversees the activity of the Management Committee.

The Management Committee is the resident decision-making body and carries out the day-to-day management of the EIB under the authority of the President.

There is a control body, the Audit Committee, which is an independent body answerable to the Board of Governors and which is responsible for auditing the annual accounts and verifying that the EIB's activities conform to best banking practice.

It is also important to note that the European Commission and the relevant EU Member State are required to provide opinions on each financing proposal (Article 19 Statute). In the event that the European Commission is against a proposed operation (which is rare), then the unanimity of the remaining Board members is required to authorise the operation. The EU Member State in which the project is located can also veto the EIB's financing, irrespective of the opinion of the Commission and the other EU Member States. This is also extremely rare.

The EIB is the European Union's bank, owned by and representing the interests of the EU Member States. The EIB's core task is to promote European objectives within its institutional and legal framework by supporting sound investments and to contribute "to the balanced and steady development of the internal market in the interest of the Union" (Article 309 TFEU). Article 175 TFEU provides that, "The Union shall also support the achievement of these objectives [Article 174 TFEU, the strengthening of the Union's economic, social and territorial cohesion] by the action it takes through … the European Investment Bank …".

Which brings us to the last point, being that the EIB performs its functions and activities in accordance with the provisions of its Statute, which is drawn up as a Protocol (No. 5) annexed to the Treaties. The Statute forms an integral part of the Treaties and has the same legal value (Article 51 TEU), i.e. it is above domestic law.

WHAT THE EIB CAN DO AND HOW THIS HAS EVOLVED

The EIB responds pragmatically to the initiatives of the EU.

WHAT CAN'T IT DO?

The EIB is required to act within its institutional and legal framework, notably the restrictions contained in its Statute.

The EIB carries out its task by granting finance for investments. It may not fund budgets, but rather provide finance for projects. Its funds are required to be employed as rationally as possible in the interests of the Union (Article 18(1) Statute). EIB funding may be provided only where funding is not available from other sources on reasonable terms (Article 16 Statute). Interest rates must be in line with prevailing market conditions and enable the EIB to cover its expenses and risks. They may not be subsidised (Article 17 Statute).

The projects financed must be bankable. This is necessary to enable the EIB to maintain its AAA rating which allows funds to be raised on reasonable terms. This financial advantage is passed on to customers – be they public bodies, large corporations or small businesses – in line with the EIB's non-profit-maximising remit.

The projects financed must also comply with strict economic, technical, environmental and social standards.

EVOLUTION OF PROJECTS

Within the above constraints, the nature and type of EIB financing has evolved in the light of and in response to financial, economic and market developments.

One example of this is in the area of trade finance. Following the market failure experienced by Greek companies and banks in trade finance, in 2013 the EIB established the small and medium-sized enterprises (SMEs) trade finance facility (€500 million) to help re-activate credit lines in favour of Greek banks by international banks.

There are no major constraints in the EIB's Statute which would prevent it from engaging in trade finance activity provided that, in order to qualify as investments, it can be demonstrated that such activity contributes to an increase in economic productivity in general and promotes the attainment of the internal market.

WHAT THE EIB HAS DONE AND THE FUTURE

These are some statistics and examples taken from the EIB's annual activity reports to indicate how the EIB contributes to Union objectives and policies.

ANNUAL STATISTICS:

- 2013: Total disbursements (own resources) within the EU: €48.5 billion

  Total amount borrowed: €72.1 billion

- 2014: Total disbursements (own resources) within the EU: €59.3 billion

  Total amount borrowed: €61.6 billion

IN THE EU

Employment: As a result of EIB 2014 funding, we anticipate the creation of more than 150,000 new permanent jobs, with 1.8 million jobs being generated in the construction phase.

SMEs: In 2014 the EIB supported around 285,000 micro enterprises and SMEs helping sustain some 3.6 million jobs in Europe. Support to SMEs amounted to €23.3 billion, mostly through intermediated loans.

Investment and growth and restoring competitiveness: The EIB contributes to the reallocation of resources in the EU economy to growth opportunities through investments in particular sectors such as research and development, innovative start-ups and fast-growing firms needing skilled labour, venture capital (through its subsidiary the European Investment Fund, EIF), SMEs and MidCaps, information and communications technology, infrastructure and education.

IF CALLED UPON

The European Fund for Strategic Investments (EFSI) is an initiative launched jointly by the EIB Group and the European Commission to help overcome the current investment gap in the EU by mobilising private financing for strategic investments. The EFSI is a €16 billion guarantee from the EU budget, complemented by an allocation of €5 billion of the EIB's own capital. EFSI projects are subject to the normal EIB standards and governance where, with EFSI support, the EIB will provide funding for economically viable projects including projects with a higher risk profile than ordinary EIB activities. It is expected to generate around €60.8 billion of investment to bring €315 billion of total investments in the next three years.

CLOSING REMARKS

VÍTOR CONSTÂNCIO[1]

It is my pleasure to close the 2015 *ECB Legal Conference.* This year's theme *From Monetary Union to Banking Union, on the way to Capital Markets Union: new opportunities for European integration* generated thought-provoking presentations as well as rich and stimulating panel discussions. We heard different perspectives from top academics, policy-makers and high-level market participants on the most complex and pressing issues surrounding financial integration and stability in Europe. More importantly, this event demonstrates that legal doctrine is contributing to a more general debate on how to enhance and strengthen European and Monetary Union (EMU) and its institutional framework.

I will not attempt to summarise the discussions of the past two days. I will rather share some of my thoughts on the complementarities and challenges facing monetary policy, financial integration and financial stability. First, I will touch upon the need to preserve financial stability while supporting financial market integration in the capital markets union (CMU) project. Second, I will talk about the importance of macroprudential policies in a monetary union – which will be a key topic in the upcoming Capital Requirements Regulation/Capital Requirements Directive (CRR/CRDIV)[2] review. Finally, I will conclude on the institutional dimension of financial integration in Europe – namely the completion of the banking union, which is a priority in the recently published report by the Presidents of the European Commission, the European Council, the Eurogroup, the European Parliament and the ECB – the so-called Five Presidents' Report.

The discussion at this conference has shown that integrated and stable financial markets in the EU remain key for prosperity and growth in Europe. The right forms of financial integration allow us to reap the benefits of the Single Market for capital and financial services as they lead to a better allocation of capital. They also translate into more competition which leads to lower prices, more choices for individuals, better business opportunities for firms and ultimately to higher economic growth.

To reach this goal, we see the completion of the banking union as well as the creation of a CMU as a further step towards a financial union. A financial union is desirable because we need to move from a system of EU rules and guidelines

1 Vice-President, European Central Bank.
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, 27.6.2013, p. 1) and 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).

for the national level to a system of further sovereignty sharing within common institutions. Let me start with the CMU.

FINANCIAL INTEGRATION AND FINANCIAL STABILITY IN THE CMU DEBATE

In our view, a genuine CMU requires achieving a high level of financial integration in order to complete the Single Market in this area. This translates into all market participants with the same relevant characteristics facing a single set of rules, having equal access to markets and being treated equally when they are active in this market. Ultimately, the roadmap towards a true CMU warrants a single rulebook and the establishment of a single capital markets supervisor as a long-term final goal.

While we should also acknowledge that a full CMU in the true sense of the word can only be achieved in the longer term, we see within the CMU initiative the following three short-term priorities. First, revive simple and transparent securitisation, which has evidenced better performance and lower risk throughout the crisis, via an adjustment of the prudential treatment of these transactions for both banks and insurers. This would contribute to unlocking some funding for the real economy. Second, facilitate access to credit by enhancing the availability and standardisation of information, especially of small and medium-sized enterprise (SME) credit information, which is key for the functioning of capital markets. And third, further develop private placement markets aimed at providing medium to long-term finance to European mid-sized and unlisted companies.

If well designed and thoroughly implemented, CMU will strengthen private cross-border risk-sharing through the deepening integration of bond and equity markets, the latter being key shock absorbers. The reason is that holding a more geographically diversified portfolio of financial assets, including corporate bonds and equities, provides for returns that are less volatile and less correlated with domestic income.

There are three main mechanisms whereby risk-sharing can take place between member states in a political and economic area. First, countries can share risk via cross-ownership of productive assets, a mechanism facilitated by developed capital markets. Second, a system of taxes and transfers can serve as a vehicle for further income smoothing. Third, member states can smooth consumption by adjusting their asset portfolios, for example, by lending and borrowing in international credit markets.

Truly integrated capital markets in Europe would also make the resulting larger markets more resilient against the same size of shocks than before integration and strengthen private sector risk-sharing across countries.

In turn, this reduces the amount of risk-sharing that needs to be achieved through public means. Research has found that private risk-sharing through integrated

capital markets can be a more important shock absorber than public risk-sharing.[3] Sizeable cross-border holdings of debt and equity and direct cross-border exposures of banks in one jurisdiction to firms and households in another would signal that the preconditions for such risk-sharing are in place.

In addition, deep and well-diversified capital markets would enhance the functioning of our monetary policy by facilitating risk-sharing and capital flows across sectors. Well-functioning cross-border capital flows across sectors are especially relevant in a monetary union with strict budgetary rules and high debt levels, and with conventional monetary policy unable to address asymmetric shocks. The recently published Five Presidents' Report on a genuine EMU recognises that CMU is a key objective for the short term and its potential benefits for the euro area.

But financial integration also affects financial stability through a variety of channels. On the positive side, it improves market efficiency, diversification, and risk-sharing, which tend to have stabilising effects, as I just explained. However, financial integration may entail certain risks. Financial markets need to be supported by a sound legal framework and by initiatives to remove barriers that enable market forces to work. As witnessed during the crisis, financial integration may increase volatility and lead to an abrupt reversal of capital flows, as well as to contagion and cross-border transmission of financial shocks. While the progress towards more advanced and integrated financial markets cannot be and should not be seen to be contrary to the objective of financial stability, a stronger prudential framework, including both effective regulation and supervision, is essential in order to limit the ensuing potential risks to financial stability.

More concretely, the expected benefits of financial integration can only be reaped when – inter alia – the following conditions are met: (i) an Economic and Monetary Union and a Single Market complemented by stability-oriented macroeconomic policies, (ii) the enhancement of the prudential framework including progress towards establishing a "true" single EU rulebook without numerous national options and discretions, and (iii) the elimination of remaining long-standing legal barriers to financial integration by, for example, tackling conflicting national laws in areas such as taxation of financial products, insolvency and company law. These are issues that involve relevant aspects of national legal frameworks where we need important contributions from the legal community.

MACROPRUDENTIAL TOOLS IN THE CRR/CRDIV REVIEW AND BEYOND

This brings me to my second point. We are currently experiencing a shift away from bank-intermediated finance and this process will continue in the future. A broadened toolkit is therefore required. We need the ability to take decisive and intrusive macroprudential policy decisions and a framework that is sufficiently broad to capture all relevant systemic institutions and activities.

3 Asdrubali, P., Sørensen, B.E. and Yosha, O. (1996), "Channels of Interstate Risk Sharing: US 1963-1990", *Quarterly Journal of Economics*, 111(4).

In a monetary union, macroprudential policies are particularly important to deal with sectoral and regional risks that cannot be accounted for by a common monetary policy. In this regard the need for a broadened and effective macroprudential framework is an important element to safeguard financial stability.

The European Commission's review of the CRR/CRDIV will provide an opportunity to review and complement the current macroprudential toolkit for banking at the European level. This review should entail (i) broadening the toolkit for the competent authorities to include additional instruments, (ii) streamlining the process, such as notification or information procedures, and (iii) strengthening the centralised coordination mechanism in the Single Supervisory Mechanism (SSM) to increase the effectiveness of the EU macroprudential framework.

Additionally, the development of market-based financing may also lead to risks building up in this part of the economy which is typically less regulated and where information is still lacking. Therefore, the need for a common and broad macroprudential toolkit at the EU level to enable authorities to address risks which can arise from the ever growing non-bank sector is clearly warranted in the short term. This is a much more difficult task because of the lack of a common legal basis. But it is crucial that this be urgently addressed. We need to have adequate tools to deal with rising systemic risk when and where needed.

I want to clearly state that the financial regulatory reform has to be completed and extended through further efforts to contain risks in the shadow banking sector and to strengthen macroprudential policies. Believing that advanced economies face a protracted period of low growth that requires accommodative monetary policy, I see no alternative than the use of regulatory macroprudential instruments to mitigate financial instability and crises by smoothing the financial cycle. Naturally, we should be aware that taming finance is a challenging, if ever achievable task. Nevertheless, our countries have experienced long, tranquil periods without financial crises in the past, and we should now aim to return to that.

THE COMPLETION OF THE BANKING UNION

Another important step in fostering financial integration is the completion of the banking union as called for in the Five Presidents' Report. To do so, it is, first, necessary that Member States transpose the Bank Recovery and Resolution Directive (BRRD)[4] in their national laws to ensure that authorities have the right tools and appropriate legal framework for bank recovery and resolution in place.

4 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).

In addition, the ratification of the Intergovernmental Agreement is key to ensure that the Single Resolution Fund is operational in euro area Member States.

Second, it is essential that Member States deliver on their commitment to set up a so-called "bridge financing mechanism" for the Single Resolution Fund. This means a common public backstop for the Single Resolution Fund during the transition phase while the fund is being built up. The European Stability Mechanism is the natural candidate to provide such a public backstop in the transition phase but also in the steady state.

This brings me to the third important point for completing the banking union, namely a common public backstop for the Single Resolution Fund once it is fully set up and mutualised. It is important that such a backstop is fiscally neutral over the medium term, by recouping any assistance from the financial sector via ex post levies.

The fourth important point for completing the banking union is to provide it with the third pillar as envisaged from the beginning: a centralised European Deposit Insurance Scheme (EDIS) that goes beyond a simple network of national schemes. After having transferred supervision and resolution to the European level, this is the logical next step. On substance, I personally see merit in designing the EDIS along similar lines as the Single Resolution Fund, starting with national compartments which are gradually mutualised, so that in the steady state we have one single EDIS. Such a scheme will provide the same level of confidence in deposit protection throughout the banking union, leading to a truly single banking system, which is the necessary mirror image of the single currency.

I am aware that this is an ambitious project and that the timeline envisaged in the Five Presidents' Report to agree on an EDIS by mid-2017 is also ambitious. However, given that major political milestones have already been achieved with the two other pillars of the banking union, the successful accomplishment of this third pillar is within reach.

Recent events have again shown us how much still needs to be done. It is now important that policy-makers make use of the current momentum and invest in strengthening European integration. The topic of this conference could therefore not have been more on target. I am delighted that it gave us a lot of insight on how to go *from Monetary Union to Banking Union* and further *on the way to Capital Markets Union.* We lack institutions that reduce uncertainty and increase our ability to prevent and respond to crisis situations. That is why we now need to start working on the long-term changes. We need to work hard on designing the envisaged convergence process.

Let me conclude by thanking our distinguished speakers and panellists for sharing their views. I am sure that each of us will take home plenty of food for thought from the rich discussions over these two days.

EUROPEAN CENTRAL BANK
EUROSYSTEM

AFTERWORD — EUROPEAN INTEGRATION: MORE THAN AN OPPORTUNITY, A NECESSITY

MARIO DRAGHI[1]

Ladies and gentlemen,

You probably all know the quote from Shakespeare's Henry VI: "The first thing we do, let's kill all the lawyers". I expect that you also know that by putting those words in the mouth of a brutal, anarchist conspirator – Dick the Butcher – Shakespeare meant to underline the importance of the law to the stability of society. And indeed I would like here to pay homage to the work of the legal profession in facilitating the very necessary deepening of our monetary union.

Over the past four years, I have been involved in a process known as the Four Presidents' process – it now actually includes five presidents – the purpose of which is to propose a way forward for the completion of our monetary union. It is generally understood that this process deals with the need to complete monetary union with four additional dimensions of the union, which are economic, financial, fiscal, and political.

But actually, this is not strictly true. In the report we published in June, we refer indeed to economic, financial and fiscal union, but we do not talk about the establishment of a political union. We talk about the need to strengthen democratic accountability, legitimacy and institutions.

One reason for this is that we do not need to create a political union. The European Union, and a fortiori the monetary union, is already a political union.

Indeed, even before the euro came about, the creation of a truly single market was per se the establishment of a political union. I once said that a market is a fundamentally political construct, because a market does not rely only on the freedom to take part, but also on the means to protect that freedom. The proper functioning of any market depends upon the protection of property rights, the enforcement of contracts, and protection against unfair competition.

But in a single market, and even more so in a true monetary union, the unrestricted opening of borders means that no government, no national court of law can provide full protection to its citizens against their rights being infringed by counterparties or competitors operating from abroad. And for that reason, the single market requires a judiciary with jurisdiction over the whole market, which can afford equal protection to all.

But if a judiciary is to exercise power over the whole market, there has to be a legislature to write the law in the first place, and an executive to enforce the

1 President, European Central Bank.

decisions of the legislature and the judiciary. The point I am making is that the functioning of the market relies on the existence and proper functioning of the three branches of government at the level of the market, which makes it an eminently political construct.

With a monetary union, however, the question of which powers those branches of government should exercise becomes more complex than in a single market. Indeed, many of the conference sessions yesterday revolved around the level at which law should be written, and enforced, so as to ensure optimal protection of citizens – i.e. whether this should be at national or European level.

And the last two sessions of the conference revolve around the additional complication of the European level itself having different boundaries, depending on whether we are talking about the EU as a whole, the euro area, or the area covered by the SSM.

Yet this question of where sovereignty should reside is more than just legal. It is also a question of legitimacy and effectiveness.

Indeed, I believe that citizens understand, better than they are given credit for, that transfers of sovereignty to the European level do not necessarily constitute a loss of sovereignty. That such transfers can in fact allow sovereignty to be recovered, in the sense that they ensure that citizens' rights are better protected.

Consider in this context the level of support for the euro. According to the Eurobarometer survey, in the spring of this year 69% of respondents supported the single currency, which is more or less the highest level of support recorded since the creation of the euro.

What is comparatively low, by contrast, is trust in institutions. Based on the same Eurobarometer, trust in the EU, while on the rise, stands at 40%. That is not high. But it is actually higher than the level of trust Europeans have in their own national institutions, their governments, and their parliaments, which stands at only 31%.

In other words, we have a public that is generally supportive of Economic and Monetary Union but that is frustrated that the promises of EMU have not been fully delivered upon. And they have a right to be frustrated, because the European Union, and monetary union, are not yet sufficiently complete to meet the fundamental expectations of citizens, including as regards macroeconomic stability.

So the challenge we face today is to complete our union – which means to make it sufficiently coherent and consistent for it to really deliver what it was intended for.

How to complete the union is precisely what we investigated in the recent Five Presidents' report. That includes *what* policies have to be common policies to ensure a well-functioning monetary union. And it includes *how* those policies

need to be formed so as to render them effective, namely the right balance between rules and institutions. Clearly we need a broad view if we are to build a consistent union. There are nonetheless two areas that I wanted to underline as a particular priority for now – they are named explicitly in the title of your conference.

The first is completing banking union, which has been the main emphasis of our institutional reform efforts since 2012. At that time we identified three pillars of banking union, two of which were to be implemented immediately – single supervision and resolution – and one addressed later – the deposit guarantee. Now, three years on, we are "later". So we need to complete the missing element of banking union, in full and without delay.

The second priority is advancing with capital markets union – and this is an area where, perhaps more than any other, we depend on our best legal minds to produce an acceptable outcome. Be it in securities law, insolvency law or corporate governance law, capital markets union will be a minefield of legal grey areas and national exceptions. It will require tremendous effort to bring all the necessary areas into alignment and produce a genuine level playing field.

Indeed, it will ultimately be the quality of both the law and the judicial process that determines the success of this project – whether investors can assess securities on the same basis across the union, be guaranteed the same rights, and have their claims addressed in the same period of time. Otherwise, those hidden barriers that create financial fragmentation and subtly weaken the integrity of the union will remain. This is the larger context to why a capital markets union is imperative.

In sum, the way I look at ongoing opportunities in the field of European integration is very practical. It is not so much in my mind about making our union "ever closer", but more, to borrow language from the US constitutional tradition, about making it "more perfect". By this, I mean that we have to address in full the residual internal inconsistencies that contribute to making our union much less stable, and certainly much less prosperous, than it otherwise would be. This is not so much in my mind a matter of opportunities, but rather one of genuine necessity.

EUROPEAN CENTRAL BANK
EUROSYSTEM
Panel 4
Banking supervisors' powers

PROGRAMME

TUESDAY, 1 SEPTEMBER 2015

08.30 a.m. Registration

09.00 a.m. **Welcome address**
Chiara Zilioli, *Director General Legal Services, European Central Bank*

09.10 a.m. **Keynote speech: New opportunities for European integration – the role of law**
Yves Mersch, *Member of the Executive Board, European Central Bank*

09.25 a.m. **Panel 1**
Legal reform of securitisation in Europe
Chair:
Ulrich Bindseil, *Director General Market Operations, European Central Bank*

Towards a new securitisation framework in Europe

Presenter:
Ward Möhlmann, Policy Officer FISMA, European Commission

The pendulum swings: finding the balance in over/under regulating securitisation

Presenter:
Nicole Rhodes, *Consultant Counsel, Allen & Overy, London*

Discussant:
Christian Moor, *Policy Expert, Securitisation and Covered Bonds, European Banking Authority*

Discussant:
Ashley Kibblewhite, *Manager, Structured Finance, Prudential Regulation Authority, Bank of England*

Discussion

10.45 a.m. Coffee break

11.00 a.m. **Panel 2**

Emergency liquidity assistance: between monetary policy and supervision: national central bank or Eurosystem task?

Chair:
Chiara Zilioli, *Director General Legal Services, European Central Bank*

Last-resort lending to solvent credit institutions in the euro area before and after the establishment of the Single Supervisory Mechanism (SSM)

Presenter:
Christos Gortsos, Professor of International Economic Law, Panteion University of Athens

The Federal Reserve as lender of last resort: a comparison with its peers

Presenter:
Hal Scott, *Nomura Professor of International Financial Systems, Harvard University*

Discussant:
Paul Fisher, *Deputy Head of the PRA and Executive Director, Supervisory Risk and Regulatory Operations, Bank of England*

Discussant:
Thomas Baxter, *General Counsel and Executive Vice President of the Legal Group at the Federal Reserve Bank of New York*

Discussant:
Xiangmin Liu, *Deputy Director General Legal Department, People's Bank of China*

Discussion

12.30 p.m. Lunch

1.30 p.m. **Panel 3**

The coexistence of national and EU law and the ne bis in idem (double jeopardy) principle, with a focus on the supervisory powers of the European Central Bank

Chair:
Petra Senkovic, *Deputy Director General Legal Services, European Central Bank*

Fundamental rights aspects of the Single Supervisory Mechanism: differentiated standards of protection under the Charter of Fundamental Rights of the EU

Presenter:
Bastiaan van Bockel, *Assistant Professor of International and European Law, Utrecht University School of Law*

Limitations on supervisory powers based upon fundamental rights and SSM distribution of enforcement competences

Presenter:
Marco Lamandini, *Professor, Department of Sociology and Business Law, University of Bologna*

Discussant:
Eilís Ferran, *Professor of Company and Securities Law, University of Cambridge*

Discussant:
Édouard Fernandez-Bollo, *Secretary General, Autorité de Contrôle Prudentiel et de Résolution*

Discussion

2.50 p.m. Coffee break

3.05 p.m. **Panel 4**
Banking supervisors' powers
Chair:
Danièle Nouy, *Chair of the Supervisory Board, European Central Bank*

Supervisory discretion and the domain of monetary policy: challenges for the European Central Bank

Presenter:
Rosa María Lastra, *Professor of International Financial and Monetary Law, Centre for Commercial Law Studies, Queen Mary University of London*

The boundaries of banking supervision: business judgements and prudential oversight

Presenter:
Georgios Psaroudakis, *Lecturer in Commercial and Financial Law, University of Thessaloniki Faculty of Law*

Discussant:
Jonathan Overett Somnier, *Head of Legal Unit, European Banking Authority*

Discussant:
Stefano Cappiello, *Head of Unit Resolution Planning and Decisions, Single Resolution Board*

Discussion

4.25 p.m. Coffee break

4.40 p.m. **Panel 5**
Burden-sharing and resolution
Chair:
Eva Hüpkes, *Adviser on Regulatory Policy and Cooperation at the Financial Stability Board*

Bail-in and the financing of resolution within the SRM framework

Presenter:
Anna Gardella, *Legal Expert, European Banking Authority*

The private stakeholders' contribution to the bank resolution financing principle and ambiguities of bail-in

Presenter:
Christos Hadjiemmanuil, *Professor of International and European Monetary and Financial Institutions, University of Piraeus and Visiting Professor, Department of Law, London School of Economics*

Discussant:
Axel Kunde, *Head of Unit Resolution Planning and Decisions, Single Resolution Board*

Discussant:
Karl Philipp Wojcik, *Legal Adviser, Directorate General Legal Services, European Commission*

Discussion

6.00 p.m. End of day 1 of the conference

WEDNESDAY, 2 SEPTEMBER 2015

8.30 a.m. Registration

8.45 a.m. **Keynote speech: European integration: more than an opportunity, a necessity**
Mario Draghi, *President, European Central Bank*

9.00 a.m. **Panel 6**
Differentiated integration in the European Union: the European Central Bank between the euro area, the Single Supervisory Mechanism and the European Union
Chair:
Frank Moss, *Director General International and European Relations, European Central Bank*

Financial stability and the reconstruction of the EU legal order in the aftermath of the crisis

Presenter:
Roberto Cisotta, *Lecturer and Adjunct Professor, EU Law, LUMSA, University of Rome*

The European Central Bank: coping with the legal challenges of the EU increasing differentiated integration

Presenter:
Frédéric Allemand, *Coordinator of the European Integration Studies Department, Centre Virtuel de la Connaissance sur l'Europe, Luxembourg*

Differentiated integration in the financial crisis – chance or dead end?

Presenter:
Ann-Katrin Pötter, *PhD candidate, Bocconi University, Milan*

Discussant:
Hubert Legal, *Director-General Legal Services, Council of the European Union*

Discussant:
Savvas S. Papasavvas, *President of the 3rd Chamber, General Court of the European Union*

Discussion

10.30 a.m. Coffee break

10.45 a.m. **Panel 7**

Enhanced coordination of economic policies in the euro area

Chair:

Frank Smets, *Coordinator Counsel to the Executive Board, European Central Bank*

Enhancing incentive-based and insurance-type coordination

Presenter:

Armin Steinbach, *Senior Research Fellow, Max Planck Institute for Research on Collective Goods, Bonn*

EMU unemployment insurance scheme – legal feasibility

Presenter:

Alexandre De Streel, *Professor of European law, University of Namur*

Discussant:

Jean-Paul Keppenne, *Legal Adviser, Directorate General Legal Services, European Commission*

Discussant:

Nicola Barr, *Director General and General Counsel, European Investment Bank*

Discussion

12.15 p.m. **Concluding remarks**

Vítor Constâncio, *Vice-President, European Central Bank*

European Central Bank

ACKNOWLEDGEMENTS

This book is a collection of the proceedings of the ECB Legal Conference “From Monetary Union to Banking Union, on the way to Capital Markets Union: new opportunities for European integration”, hosted by the European Central Bank on 1 and 2 September 2015.

One of the main objectives of this project was to provide a forum for the free exchange of ideas between lawyers working in different fields and, in particular, between members of academia on one side, and practitioners – including representatives of the institutions – on the other.

The seven panels, which are distinctive feature of this conference, covered a wide range of topics. These included long-standing issues of EU law, such as differentiated integration and coordination of economic policies, and key areas of financial law and central banking law, such as securitisation and emergency liquidity assistance, as well as some crucial supervisory and resolution aspects of the new banking union, focusing in particular on the institutional setup and the tasks and powers of the ECB.

This approach was intended to trigger an exchange of new ideas and cross-fertilisation among the various fields of research. The desire to promote this exchange of ideas across the usual academic borders was not, however, the main reason for adopting this approach: the common thread running through the conference programme was the tasks of the ECB, the challenges it has faced in recent years, and the challenges it is likely to face in future.

The role of law in the process of European integration is fundamental, and forums like the ECB Legal Conference can make an important contribution towards achieving this goal.

Against this background, this conference has not been conceived as a one-off event, but is intended to be followed by other similar events offering further opportunities for the exchange of ideas over the coming years.

The conference and this book are also part of a more wide-ranging effort by the ECB’s Directorate General Legal Services to foster the development of a central banking legal doctrine and to encourage academic research on aspects of law of interest to the ECB.

For many years the ECB has offered its own staff members and external academics the opportunity to publish research in areas of interest to the ECB in its Legal Working Paper Series.

Another part of this effort is the Legal Research Programme, under which, since 2008, the ECB has awarded annual scholarships to foster and promote academic research in fields related to the ECB’s statutory tasks and, more generally, to EU law, central banking law, financial law and supervisory law.

The ECB attaches great importance to all of these tools in promoting transparency and accountability in its work and an effective exchange of information to the benefit of all the parties involved.

This comprehensive effort for the advancement of legal scholarship in fields relevant to the ECB would, however, not have been possible without the full support of the Executive Board, which has not only allowed the Directorate General Legal Services to pursue such activities with the highest degree of independence for the researchers involved, but has also made valuable contributions at all stages of the process.

Thus the credit for the publication of this book goes first and foremost to the Executive Board as a whole and, in particular, to Yves Mersch, in his capacity as Executive Board member responsible for Directorate General Legal Services. They have sponsored the research activities of Legal Services and given constant support throughout the devising, organising and hosting of the ECB Legal Conference.

Gratitude also needs to be expressed to those members of the Executive Board, in particular the President, Mario Draghi, the Vice-President, Vítor Constâncio, and, again, Yves Mersch, who attended the conference and gave speeches, thereby also acknowledging the importance of the event for the ECB as an institution. Special thanks also to the Chair of the Supervisory Board, Danièle Nouy, who chaired one of the panels, thereby showing the interest of the SSM in this initiative.

Thanks also go to all of the chairpersons, presenters and discussants at the conference, who enriched the panels and debates with their thought-provoking ideas, and put considerable effort into delivering their contributions for this book within a very tight timeframe.

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.

A committed team of colleagues from the Directorate General Legal Services helped to organise the practical arrangements for the Legal Conference, ensuring the smooth operation of two very intensive days: the effort, patience and willingness to help shown by all staff members who contributed to the success of this conference are gratefully acknowledged.

Frankfurt am Main, December 2015

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