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UNIVERSITY OF KENT

Faculty of Social Sciences

Kent Law School

REGULATING AND SUPERVISING SYSTEMIC RISK IN THE EUROPEAN
UNION:

RESULTS OF THE POST-CRISIS STRUCTURAL REFORMS

Benjamin Joseph Moss

Thesis submitted for the degree of PhD in Law

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ABSTRACT

This thesis contributes new and unique perspectives on the post 2007-09 crisis reform agenda established in the European Union. The focus of the thesis will be specifically on reform of the regulatory and the supervisory framework aimed at mitigating the effects of systemic risk. The starting point will be a review of the literature on the concept of systemic risk which will demonstrate that its unpredictable nature requires a malleable regulatory response. In light of the suggested areas of concern by the pivotal 'de Larosiere report', analysis will be provided on the progress achieved so far. On the regulatory front, the systemic risk aspects of the various legislative measures introduced are assessed in terms of their relevance and potential effectiveness. The reformed supervisory framework under the new European System of Financial Supervision (ESFS) requires close scrutiny due to the transfer of power to centralised authorities. Although the reform should be considered a success in terms of reaching its objectives in a timely manner, some critiques and suggestions will be provided on how to carry the framework forward. The thesis will also argue that taking the framework to the next step may require testing the boundaries of European Treaties and its case law in relation to delegation of powers. The measured success of the new framework could however be jeopardised by the recent introduction of the first steps towards a banking union in the Eurozone. By creating a new supervisory dynamic within the EU, it will be argued that such a move raises the potential of creating a 'two speed' model of financial supervision in the EU. Additionally it risks polarising the supervisory debate between the European Central Bank and the Bank of England at the detriment of the EU.

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LIST OF ABBREVIATIONS

3L3	Lamfalussy Level 3 Committees
ABS	Asset-Backed Securities
AIF	Alternative Investment Fund
AIFM	Alternative Investments Fund Managers
AIFMD	Alternative Investments Fund Managers Directive
ASC	Advisory Scientific Committee
ATC	Advisory Technical Committee
BCBS	Basel Committee on Banking Supervision
BIS	Bank of International Settlements
BoE	Bank of England
BSC	Banking Supervision Committee
CCB	Countercyclical Capital Buffers
CDO	Collateralised Debt Obligations
CESR	Committee of European Securities Regulators
CRA	Credit Rating Agency
CRAR	Credit Rating Agencies Regulations
CRD	Capital Requirements Directive
EBA	European Banking Authority
ECB	European Central Bank
ECAI	External Credit Assessment Institution
EFC	Economic and Financial Committee
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ESA	European Supervisory Authorities
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority

ESRB	European Systemic Risk Board
ESRC	European Systemic Risk Council
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSB	Financial Stability Board
FSF	Financial Stability Forum
ICAAP	Internal Capital Adequacy Assessment Process
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
LOLR	Lender of Last Resort
MBS	Mortgage-Backed Securities
MiFID	Markets in Financial Instruments Directive
MLRO	Money Laundering Reporting Officer
NRSRO	Nationally Recognised Statistical Rating Organisation
OCR	Office of Credit Ratings
OTC	Over-the-counter
SEC	Securities and Exchange Commission
SIV	Structured Investment Vehicles
SPV	Special Purpose Vehicles
SRB	Systemic Risk Buffer
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
UCITS	Undertaking for Collective Investments in Transferable Securities
VaR	Value-at-Risk

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INTRODUCTION

The 2007-09 financial crisis has had an unprecedented effect on how the risks of globalisation are viewed. Although the interconnectedness of financial markets and some cross-border financial institutions was never in doubt, the extent to which financial contagion materialised was unexpected. Existential questions arose from a market and regulatory standpoint when financial instruments that had as their purpose the mitigation of risk turned out to be originators of risk amidst market and regulatory bewilderment.

The crisis fundamentally changed the perspective on systemic risk, not only confirming the existence of its catastrophic consequences but also its unpredictability. The contagious nature of systemic risk is traditionally portrayed by the domino effect metaphor.¹ This depicts the idea that connected financial institutions fail as a consequence of the links between them, causing a knock-on effect of successive failing institutions. However, this metaphor does not seem to adequately reflect how systemic risk materialised during the recent crisis. Although knock-on effects occurred, related events combined to create a simultaneous rather than a successive breakdown of the system. Therefore, it is better to compare the crisis situation to the chemical properties of mercury drops. Beyond its poisonous characteristics, the analogy relates the idea that drops are potential trigger events of systemic risk, where at stable temperature other drops in proximity remain separate. Once the temperature rises the drops in proximity rapidly merge to create a puddle rather than a drop, i.e., when

¹ M Brunnermeier and M Oehmke, 'Bubbles, Financial Crises, and Systemic Risk' (NBER Working Paper No 18398, September 2012)

pressure is felt in the market, the connections between the events creates a crisis rather than separate isolated events. This pooling of all the issues which caused the crisis can be portrayed by this mercurial effect. Taking the correlation further, just as mercury is an excellent amalgam for more valuable metals, such as gold, silver and iron, systemic risk not only affects those drops that pool quickly to create a puddle but also attracts quality assets at the same time. In terms of regulatory response, this means that measures need to be taken on several fronts to avoid the merging of events rather than intervening in the link of a domino effect.

It can be argued that, to an extent, regulatory intervention was partly to blame for aggravating the effects of the crisis; most notably, via the excessive use of credit ratings as an indicator of safety.² However, some causes of the crisis, such as the lack of transparency of certain financial instruments and inadequate capital requirements, simply cannot be resolved by limiting regulatory intervention. In addition, the general political consensus points towards the enhancement of regulatory and supervisory frameworks as a concerted response to the crisis.³

Concerted measures are particularly relevant at European Union (EU) level as the crisis demonstrated that the state of its regulatory and supervisory framework 'remains seriously fragmented'.⁴ In theory, a correction at EU level should be easier than on the wider international scene as there is a fundamental accord amongst Member States to

² G Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation' (1996) 16(1) *Cato Journal* 17; M Flannery 'Prudential Regulation for Banks' in *Financial Stability in a Changing Environment* (St Martin's Press 1995) 281, 318.

³ G20, 'G20 Leaders statement' G20 Summit, Pittsburgh, 2009) para 13
<<http://www.g20.utoronto.ca/2009/2009communique0925.html>> accessed 20 April 2014.

⁴ High-Level Group on Financial Supervision in the EU, 'Report' (Jacques de Larosière (chair), DG Internal Market, Brussels, 25 February 2009) (de Larosière report).

work towards a more stable Union under the Treaties.⁵ However, achieving consensus on the level of appropriate harmonisation of financial regulation in the EU has been difficult. There are national sensitivities to be taken into account, in particular in jurisdictions such as the UK with financial sectors representing a significant part of their economy. There has also been an aversion to the idea of a federal EU, which a centralised supervisor might represent. Despite this, reform is necessary on the content of the regulations and on the supervisory framework in order to give the financial services industry in the EU the platform it needs to pursue its business in a safe and stable way.

This thesis aims to critically analyse the law and major policy developments of the EU which are relevant for the regulation and supervision of systemic risk as at 31 December 2013. The post-crisis reform agenda is an opportunity to introduce measures that might have met political resistance in different circumstances due to national sensitivities and lack of urgency. The swing of the 'regulatory pendulum',⁶ which describes the eagerness to introduce new regulatory measures in the aftermath of a crisis, seems to have been taken full advantage of in the EU. The new measures re-launched with vigour the idea of a single rulebook for financial services in the EU based on maximum harmonisation and uniformity. Due to the inability to pinpoint systemic risk as a single legislative topic, the mitigation of systemic risk has materialised in various legislative provisions. The provisions have met different levels of political resistance due to their varying levels of complexity and relevance to national sensitivities. However, it appears that significant progress has been made in a short

⁵ Treaty of Lisbon amending the Treaty on European Union (TEU) and the Treaty Establishing the European Community (TFEU) [2007] OJ C306/1.

⁶ John C Coffee, 'The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetrated' (2012) 97 Cornell Law Review 1019.

timeframe by tackling issues that have concrete or apparent systemic risk features. There is a commonality to these measures in relation to the constant pursuit of more transparency. By removing the opacity of financial instruments and financial institution balance sheets, the access to information from a supervisory perspective is facilitated. In this respect, effective regulatory protection depends heavily on innovative supervisory strategies. Restructuring the way financial services are supervised in the EU has also formed part of the reform agenda with the overarching principle that systemic risk requires macro-prudential supervision. This is far more sensitive from a political perspective as the crux of the discussion surrounds delegation of powers. The Lamfalussy regime was put place in 2001 and introduced the Level 3 Committees (3L3), which were the advisory committees that reported to the Commission.⁷ These committees were seen as ineffective as they did not achieve their goal of more consistent application of the rules at Member State level. Therefore, they were seen as unlikely to survive the crisis in their initial guise.⁸ In order to render the committees effective, a significant shift in powers was necessary that would equip them with the necessary authority to monitor and enforce the rules on the books. This occurred as suggested by the de Larosière report in the form of the new European System for Financial Supervision (ESFS). Four bodies comprise the ESFS, three of them evolved from the 3L3 Committees and these became the three European Supervisory Authorities (ESAs).⁹ In addition, there is the European Systemic Risk Board (ESRB). The

⁷ Alexandre Lamfalussy and others, 'Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets' (presented to the ECOFIN Council, Brussels, 9 November 2000) <http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/initial-report-wise-men_en.pdf> accessed 20 June 2014.

⁸ N Moloney, *How to Protect Investors: Lessons from the EC and the UK* (CUP 2010).

⁹ The ESAs respect the silo approach of the 3L3 Committees namely banking, securities and markets, and insurance and occupational pensions.

ESRB's main role is to process information in order to monitor and warn about potential systemic risks at EU level. The ESRB's role and positioning within the ESFS and its proximity to the European Central Bank (ECB) remains somewhat confusing. Not only was it constituted as a soft law body, which raises legitimacy concerns, but its lack of enforcement powers and over-reliance on other institutions is problematic. On the other hand, the ESAs gain substantial powers, most notably in the form of binding decisions. Of specific interest is the direct supervisory powers that have been granted in certain circumstances. The direct supervision of credit rating agencies (CRA) by the European Securities and Markets Authority (ESMA) is particularly relevant for the purpose of this study.

The thesis will argue that the EU post-crisis regulatory reform has been a success not only in introducing considerable legislative provisions but also in making necessary structural changes to the supervisory framework. It is considered a success on the grounds that it has achieved the objectives laid down by the de Larosière report, and it did so in a timely manner. Teething issues are a natural consequence of introducing such substantial change, in particular, at institutional levels. Therefore, this thesis suggests some amendments that could carry considerable benefits in terms of functional efficiency and independence. The new measures that have been put in place must be seen as a platform on which supervisory authorities can react rapidly to the emergence of events that carry systemic importance.

However, the success might be short-lived in the light of a competing system of supervision in the form of the Single Supervisory Mechanism (SSM) which is

Eurozone¹⁰ focussed. Due to concerns regarding the single currency and the related national debt, the SSM was conceived to introduce further stability by enabling the ECB to act as a direct supervisor to those institutions which are considered to be systemically relevant. This thesis will argue that this step towards a banking union will polarise the EU between those Member States that form part of the SSM¹¹ and those that do not, chiefly the UK.

The first chapter begins with an evaluation of the concept of systemic risk. The post-crisis notion of systemic risk is still not clear-cut and will probably evolve over time. Given that it is still too early to envisage the way in which the post-crisis definition will evolve, the chapter will draw on the pre-crisis definition. To this effect it will put forward the idea that the notion of systemic risk is a malleable one that requires a flexible regulatory approach.

The second chapter aims to briefly outline the characteristics and provide a timeline of the crisis. Causality issues are beyond the scope of this thesis; therefore, the list of causes of the crisis will chiefly rely on the influential de Larosière report which constitutes the foundation of the post-crisis reform agenda.

The third chapter will provide a critical review of the regulatory measures taken in response to the materialisation of systemic risk as a cause of the crisis. Four measures stand out as being regulations implemented post-crisis which include mitigating systemic risk as part of their aim: the European Market Infrastructure Regulation¹²

¹⁰ The term Eurozone will be used throughout to describe those countries that use the Euro as national currency.

¹¹ Non-Eurozone countries may elect to come under the SSM even though they do not use the Euro as a currency.

¹² Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories [2012] OJ L201/1 (EMIR Regulation).

(EMIR), the Alternative Investment Fund Managers Directive¹³ (AIFMD), the Capital Requirements Directive IV¹⁴ (CRD IV) and the Credit Rating Agencies Regulations¹⁵ (CRA Regulations). Due to space constraints, the provisions of each of these measures will not be analysed in detail. However, the salient points for the purpose of regulating systemic risk will be extracted. The section on the CRA Regulations will be more detailed insofar as it is relevant for the purpose of understanding the potential for direct supervision by the ESAs. The adequacy of these measures will be assessed and the argument will be made that they present a suitable initial regulatory response in the light of the causes highlighted in the de Larosière report. It will further be argued that these measures form a suitable basis for the creation of a single rulebook for financial services in the EU, albeit that caution must be used not to make the rules overly-uniform.

The fourth chapter will analyse the new ESFS system and its shortcomings as well as provide a critique and suggestions on how the system can be improved. In the light of the new regulatory measures highlighted in Chapter III, a suitable supervisory regime to make these norms effective is necessary. There will be a particular focus on the ESMA and the ESRB: the former because it follows on from the discussion of direct supervision discussed regarding CRAs in the third Chapter; and the latter due to its systemic risk focus. This chapter will argue that the weaknesses of the ESRB, such as a

¹³ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, [2011] OJ L174/1 (AIFMD).

¹⁴ 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 L176/338 and Regulation (EU) No 575/2013 of the European and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1 (CRD IV).

¹⁵ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies [2009] OJ L302/1 (CRA Regulations).

lack of independence and exposure, can be overcome with some relatively easy fixes, even though, eventually, Treaty change will be necessary if it is going to be effective in carrying out its future mandate as signalled under CRD IV.

Finally, the fifth chapter will discuss the creation of the SSM, some of its mechanisms and the problematic relationship between the ECB, the European Banking Authority (EBA) and the ESRB. Despite significant efforts to cater for the new regulatory measures on a supervisory level, as presented in chapters three and four, the sudden creation of a new supervisory authority in the form of the ECB does not sit well with the new framework. This Chapter will argue that in isolation the ECB appears to be an effective supervisor for the Eurozone although this will be to the detriment of a more fragile ESFS. Furthermore, the risk of polarisation, whereby the two most influential bodies of financial supervision in the EU stand to be the ECB and the Bank of England (BoE), risks jeopardising the interests of the Union.

In combination, these Chapters contribute to the initial assessment of the post-crisis reform measures in relation to mitigating systemic risk in the EU. Despite the considerable achievement of establishing a new framework in a relatively short timeframe and the power shift towards the new supervisory authorities, weaknesses subsist on a governance level that could eventually require Treaty changes.

CHAPTER I: CONCEPTUAL SYSTEMIC RISK ISSUES

The financial crisis of 2007-09 has often been labeled as 'systemic' due to its global nature, its diverse manifestations and the harshness of its consequences. Due to the extent of its impact, it can only be qualified as an event of rare economic severity. The large financial institutions which previously incarnated the success of global finance centres have been confronted with unprecedented difficulties; in certain cases, these have led to bankruptcy. Governments and Central Banks intervened substantially in order to reintroduce financial stability and finance their respective economies. Despite these efforts, a global recession occurred, and this was particularly damaging for those jurisdictions with the most developed finance centres.

This Chapter does not attempt to explain the reasons behind this financial crisis, nor any other past or future one. It will, however, attempt to clarify a fairly contentious concept known as systemic risk, which relates to the contagious nature of adverse events. Therefore, the global environment and interrelation within the financial sector is not a cause, but can be seen as playing a part in aggravating the crisis and degrading national economies.

Prior to the crisis, many questions regarding the substance of this notion were being debated. However, since the crisis, questions over the merits of regulating systemic risk have been replaced by questions over how to regulate systemic risk. The characteristics of the crisis and the effects of contagion on a global scale appear to constitute overwhelming evidence of the need for regulatory measures to mitigate systemic risk. Most of the literature discussing the merits of regulating systemic risk will therefore have been written pre-crisis.

The first challenge is to define the term adequately. Although the existence of systemic risk was never really doubted, some scholars were more skeptical than others on the extent to

which regulatory intervention was desirable.¹ It is then necessary to discuss which risks are truly systemic, with some supporting the idea that banking should not be deemed different to other industries, where market forces decide the fate of their existence.² It is also important to understand the pluri-dimensional aspect of the concept by considering not only institutional systemic risk but also the market and real economic effects.

I. The difficulties in defining systemic risk

Generally recognised as a rationale for financial regulation, academic discourse regarding systemic risk starts with a disagreement on the definition of the concept. In order to begin resolving this issue, it is essential to reach a consensus on the definition of this notion. This previously intangible concept has gained a basis of evidence with the crisis. Indeed, although examples of contagion were available, their extent and impact were not comparable in size to the most recent crisis. Although the crisis evidenced new origins of systemic risk, its definition remains unsettled due to its potentially unlimited scope.

The acceptance of a commonly established definition of systemic risk often goes to the core of the debate regarding its validity as a regulatory concern and its recognised consequences. The Oxford English Dictionary defines systemic as 'relating to a system as a whole'. This already creates some level of debate when discussing financial systemic risk because it is not clear which system is being referred to. Indeed, several dimensions are to be considered, such as institutional or market ones, but also the geographic considerations at local, jurisdictional or international level.

¹ G Benston was of the opinion that regulation should be limited to capital requirements. See G Benston, 'Is Government Regulation of Banks Necessary?' (2000) 18(2/3) *Journal of Financial Services Research* 185.

² G Benston and G Kaufman, 'The Appropriate Role of Bank Regulation' (1996) 106(436) *Economic Journal* 688.

Because the positive or negative outcome of systemic consequences is also disputed amongst economists, the considerations surrounding systemic risk will invariably be subjective. Moreover, depending on how one considers the evidence behind the arguments often reflects how the concept is initially perceived. The confusion about the concept is adequately reflected by the statement that 'one observer might use the term "market failure" to describe what another would deem to have been a market outcome that was natural and healthy, even if harsh'.³ This reflects the difference between those who believe certain institutions or markets are too important to the economy at large to be allowed to fail, as opposed to those who feel that there should be natural selection by the market of those capable of surviving in order to achieve perfect competition within a given market.

How, therefore, can we give a definition of systemic risk which can be commonly accepted and recognised as a potential problem source? According to Kaufman, whose definition is the most generally shared, systemic risk is 'the probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system'.⁴ His definition is similar to the definition given by the Bank of International Settlements (BIS) which defines it as 'the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default'.⁵ The difference is that where Kaufman considers the trigger to be an event, the BIS considers it to be an institutional failure. Nevertheless, the focus is on a so-called domino effect and both underline the idea that banks or large financial institutions are more prone to contagion than other industries. Moreover, it is suggested that financial institution failure⁶ can have

³ G Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation' (1996) 16(1) *Cato Journal* 17.

⁴ *ibid*

⁵ Definition given by the Bank of International Settlements and quoted by S Schwarcz, 'Systemic Risk' (2008) 97(1) *The Georgetown Law Journal* 193.

⁶ Institutional failure or default occurs when the market value of its assets falls below that of its liabilities.

consequences for the economy at large. Arguably, economists would accept that in non-financial industries, when one participant fails, competitors pick up the business left behind.⁷

Conversely, Kaufman explains why banks are seemingly more prone to contagion and failures. However, first he highlights three reasons why banks are perceived as being more fragile.⁸ The first is capital insufficiency, whereby it is deemed that the capital held by banks does not readily cover the asset liabilities incurred through financial leveraging. The second is the notion of fractional reserve banking. The traditional role of banks is to transform assets from and into liabilities, where the assets which generally take the form of loans are difficult to liquidate prior to maturity. These are contrasted with liabilities in the form of deposits which are extremely liquid. In order for a banking institution to be able to maximise its returns, it will need to make sure that the reserves that it needs to pay depositors on demand are kept in the most efficient way possible, that is, by holding only the necessary amounts to honour the depositors' estimated demands. How efficiently an institution keeps its reserves will become evident when an unusual amount of depositors decide to withdraw their deposits at the same time, causing the bank to become illiquid. The third reason is the value of bank assets. It is likely that they will lose their real value in a scenario where the bank needs to liquidate its assets rapidly, or under a so-called 'fire sale'. Indeed, during the normal functioning of the bank, its assets will carry a certain face value and will maintain that value if sold under normal trading conditions. When it becomes a necessity for the institution to sell these assets in order to raise immediate liquidity, then due to their opacity and less liquid nature they will need to be sold at a far lower price in order to find a quick buyer. Goodhart sums up this situation by stating that 'a bank's assets may therefore be more valuable on a going concern basis than on liquidation'.⁹ These elements contribute to the idea that banks become more fragile according

⁷ L Lang and R Stulz, 'Contagion and Competitive Inter-Industry Effects of Bankruptcy Announcements' (1992) *Journal of Financial Economics* 32, 45.

⁸ G Kaufman, 'Bank Fragility: Perception and Historical Evidence' (Loyola University Working Paper no 96-6, 1996).

⁹ C Goodhart and others, *Financial Regulation: Why, How and Where now?* (Routledge 1998).

to the severity of the sudden downturns they can experience, and that a solvent but illiquid institution can be rendered insolvent through the chain reaction explained above, generating in turn a run on the bank.

Banks can be affected by contagion in two different ways, often referred to as rational and irrational systemic risk.¹⁰ Firstly, contagion can be rational because of the visibility of the fact that institutions are interlinked via a complex web of transactions where they hold deposit balances with each other. They also rely on mutual lending and borrowing and are part of a common clearing system. This raises the possibility that if one institution is unable to honour its liabilities *vis a vis* another institution, or if it drives the market downwards due to a fire sale of its assets, this means that the difficulties of one institution will invariably be felt by other linked institutions.

The second dimension is psychological and linked to information asymmetry. It is argued that bank runs automatically aggravate themselves.¹¹ Where one depositor at a point in time may find it difficult to withdraw their assets for temporary liquidity reasons, this may cause other depositors to attempt a withdrawal in the fear or belief that the institution in question is on the brink of insolvency. Such a rush will have the effect of creating a general panic, and due to the fact that financial institutions are intertwined, this may cause runs on other institutions, even though they are perfectly solvent and liquid at the time.¹² The psychological dimension also affects markets internationally. Indeed the so called 'bandwagon' effect means that international investors will follow each other into a growing market. However, when the said market begins to fall, then the same bandwagon departs from the market at greater speed,

¹⁰ G Kaminsky and C Reinhart, 'On Crises, Contagion and Confusion' (2000) 51(1) *Journal of International Economics* 145.

¹¹ P Cartwright, *Banks, Consumers and Regulation* (Hart Publishing 2004).

¹² C Ford and J Kay, 'Why Regulate Financial Services?' in F Oditah, *The Future of the Global Securities Market* (Clarendon Press 1996).

precipitating an economic downturn.¹³ In the same fashion, should this downturn occur in a developed economy, then this will cause panic in other jurisdictions where interlinkages exist. Considering that stock markets around the world are open in succession around the clock, they have a tendency to react to one another. If the US suffers a crash, this will be felt the following day on Asian markets and subsequently in Europe.

The distinction between those events that are information based or rational and those which are random or psychological is blurred and will often merge to create a situation which has both characteristics. The potential for a spill-over from a distressed financial institution to sound ones can affect the conduct of the whole system.¹⁴ For Kaufman, it is the perceived randomness of contagion which is most frightening and would therefore justify policy intervention.¹⁵

Most scholars¹⁶ recognise that a trigger event is a common denominator and has contagious consequences beyond its boundaries, affecting a 'banking, financial, or economic system, rather than just one or a few institutions'.¹⁷ Where the definitions differ, however, are on the size of the event and the scope of the consequences. Schwarcz discusses these variances where the trigger event varies from being a modest economic shock to the failure of an institution. The consequences will also vary from repercussions on other institutions to substantial market volatility and institutional default.¹⁸

The earlier definitions tended to be less focussed and tended to envisage less serious consequences. In 1992, Davis talked of unanticipated disturbances in the market with the

¹³ P Krugman, 'International Aspects of Financial Crises' in Martin Feldstein (ed), *The Risk of Economic Crisis* (University Chicago Press 1991) 85.

¹⁴ C Mann, 'Market Mechanisms to Reduce the Need for IMF Bailouts' (International Economics Policy Briefs No 99:4, 1999).

¹⁵ G Kaufman, 'Banking and Currency Crises and Systemic Risk: A Taxonomy and Review' (Working Paper Series WP-99-12, Federal Reserve Bank of Chicago, 1999) 34.

¹⁶ Schwarcz (n 5) 6.

¹⁷ P Bartholomew and G Whalen, 'Fundamentals of Systemic Risk' in George Kaufman (ed), *Research in Financial Services: Banking, Financial Markets, and Systemic Risk*, vol 7 (JAI Press 1995).

¹⁸ Schwarcz (n 5).

consequence of merely putting at 'danger' financial institutions and disrupting the payments mechanism.¹⁹ Others have drawn a parallel between the notions of systemic risk and financial crises. Bordo et al come to the conclusion that whether we are talking about systemic risk or financial crises, the payment system will be disrupted.²⁰ Although there are similarities between certain mechanical effects, such as market downturns, rushes to commodities and currencies, and general social afflictions, following the most recent financial crisis, systemic risk was the engine of the global financial downturn. As Davis suggests, it is the macro-economic depression that carries the greater weight and represents the consequences of systemic risk.²¹

More recent definitions go further than just considering the financial chain linking markets and institutions. Indeed, Mishkin's definition takes into consideration the information chain and talks of 'information flows' being disrupted.²² He addresses the issue of information asymmetry as a cause of systemic risk.²³ In this instance, the asymmetry of information can work both ways between depositors/borrowers and banks. In difficult times when there is contraction of the liquidity markets, lenders will be less inclined to lend or will simply be unable to find liquidity themselves. The asymmetry appears here where the bank is not in the best position to evaluate the value of a loan application. This leads to wider economic consequences where valid businesses may find themselves in difficulty if lending costs rise and the collateral value of their assets diminish. On the other hand, concerning runs on banks, the information disadvantage will be on the side of the depositor. Regarding systemic risk, it is often disputed whether depositors are capable of distinguishing an insolvent institution from

¹⁹ E Davis *Debt, Financial Fragility and Systemic Risk* (Clarendon Press 1992).

²⁰ M Bordo and others, 'Real versus pseudo-international systemic risk: some lessons from history' (Working Paper 5371, NBER working paper series, 1995).

²¹ Davis (n 19).

²² F Mishkin, 'Remarks on Systemic Risk and the International Lender of Last Resort' in D Evanoff, D Hoelscher & G Kaufman (eds), *Globalisation and Systemic Risk*, vol 6 (World Studies in International Economics 2009).

²³ FS Mishkin, 'Asymmetric Information and Financial Crises: A Historical Perspective' (3400 NBER, 1991).

an illiquid one.²⁴ Public information may not be sufficient as regulators and central banks may wish to keep negative information concerning an institution quiet until a solution has been identified. Beyond publicly available information, obtaining relevant information regarding a financial institution is costly and beyond the reasonable steps a depositor should take. It is therefore suggested that the generally available information on the soundness of a financial institution will consequently give other institutions with similar business models a bad press, raising their apparent risk profile and therefore occasioning sound and unsound banks the same fate.

As we have seen in these various definitions, the consequences vary from being institutional to being market wide. Originally, banks were the only type of institution that portrayed characteristics that enabled the types of consequences we have seen, mainly due to the fact that they were the sole providers of funds to the capital markets. Although still the prime provider, alternative sources can be identified, rendering bank failures less critical than before.²⁵ Therefore, other forms of financial institutions may possess the size and function to cause systemic turmoil. Schwarcz therefore suggests looking beyond international banking relationships and taking a step back and considering capital markets at large to identify the true mechanisms of systemic risk.²⁶ Investment strategies suggest that it is possible to generate a certain amount of return whilst maintaining volatility at a minimum. What this means is that, in a well diversified portfolio of investments, whether they be equity, bonds or alternative investments, losses on one side will be outweighed by the overall portfolio gains.

Furthermore, certain hedging tools can protect an investment from currency downturns or adverse fluctuations. What Schwarcz puts forward is that it is not possible to avoid overall market risk, in that irrational market movements may have systemic consequences similar to

²⁴ Kaufman argues that depositors do have a sense and sufficient understanding to identify a solvent bank; Kaufman (n 3) . Jacklin and Bhattacharya 1988, however, demonstrate that unless they incur great cost, depositors cannot reasonably determine whether a bank is solvent or not.

²⁵ Bordo (n 20).

²⁶ Schwarcz (n 5).

those considered for banks. In both cases, market shocks cause institutional failures, the difference being the stage of interlinkages. For this purpose, he takes the example of Long-Term Capital Management (LTCM), a non-banking financial institution which would have invariably failed had it not been for the intervention of the US Federal Reserve. In a pure banking systemic risk situation, the knock-on negative effects are principally due to balance sheet interlinkages based on mutual lending and borrowing with mutual clearing system discrepancies. In the case of LTCM, however, the fund was on the brink of failure due to its hedging activities and a severe irrational market downturn. The contagion however was only relevant due to its sheer size, and the fire selling of its assets would have invariably caused a global market downturn. When considering systemic risk we should therefore consider both the overall market and institutional interferences and not merely the failure of localised institutions. Banks will almost always be relevant to the mechanism of systemic risk as they have the greatest control over the payments systems, thus explaining why their influence is structural. The size of the bank will also be a factor in affecting the market. However, this may also be the case for non-bank financial institutions, provided that their size is sufficient to disrupt markets and linked institutions.

In an attempt to amalgamate the definitions above, it appears practical to break down the systemic risk process into four steps:

1. An event that shocks an element of a financial system, the element being either institutional or market related.
2. Information and payment flows are disrupted causing a chain of significant market losses and/or institutional failures.
3. Disruptions to the payment system causing a rise in capital costs and availability.
4. General economic disruption due to the rise of capital costs.

There is a school of thought that believes that systemic risk is an overblown notion with exaggerated consequences, and a bank failure should not be treated differently to the failing of any large corporation. Indeed, Kaufman argues that for a given jurisdiction the default of bank X should carry the same consequences as for company Y.²⁷ This argument is more relevant today due to the fact that the share of 'traditional' banking activity is shared by non-banking institutions and the emergence of 'shadow banking'. Moreover, he suggests that if there is demand for the services undertaken by the failing bank, then a new entrant into the market would be expected to appear. He does not, however, completely disagree with the fact that certain characteristics are particular to banking.²⁸ Indeed, he agrees that amongst banks, adverse economic contagion is likely to have far greater meaning in terms of the speed at which it spreads, its greater range and the likelihood of a larger number of failures occurring. He does, however, reject the contention that losses to creditors will go beyond the institution in difficulty. He finds little historical evidence that demonstrates that runs on banks go beyond their local spectrum due to the fact that depositors have the sense to recognise whether a bank is solvent or not. The financial crises that started in 2007 neither confirms nor refutes this contention. However, the constant failures throughout the US and beyond would tend to suggest that fear of failure was not localised.

Nevertheless, it can be argued that this crisis did find its origins amongst a banking crisis which Kaufman did not consider at the time. Indeed, he states that 'contrary to folklore, bank contagion on a nationwide scale has not been a common experience and, while large-scale banking failures exacerbate economic downturns, they do not start them'.²⁹ In subsequent analysis it will be clear that, although not exclusively, the origins of the crisis can be found in a form of banking incompetence in relation to the issuance of sub-prime mortgages and their

²⁷ Kaufman (n 3).

²⁸ G Kaufman 'Bank Contagion: A Review of the Theory and Evidence' (1994) 8(2) Journal of Financial Services Research 123.

²⁹ Kaufman (n 3).

related securitised financial products. On the other hand, in the UK, Northern Rock experienced a run on its liquidity in the traditional sense. It remained localised and other banks or building societies did not experience similar runs. Kaufman's thinking is similar to that of Benston who also argues that there is no historical evidence that solvent banks would be rendered insolvent due to a contagious run on an institution.³⁰ Because a failing bank will be isolated, and depositors will be able to recognise if a bank is solvent or not, there will be a natural shift of deposits from the failing institution to other local banks which are perceived to be safe. As a consequence, the local market will be aggregated from one bank to another. According to Benston, in the unlikely event that an entire local market were to be affected, then instead of creditors transferring their deposits from one failing institution to another, the tendency would be a flight to recognisably safe and liquid securities, such as government bonds or treasury bills. However, this will only be temporary, as the moment local banks are perceived to be safe again, then these securities will be sold and returned in deposit form to these institutions. Moreover, such securities are usually kept in specific and segregated client custody accounts. This means that the institutions holding such accounts will benefit from the deposits, albeit in a less liquid form, which will to a certain extent enable the institutions in difficulty to return to balance sheet stability. On this point, Kaufman concludes that the situation where intervention will need to be considered as a public policy concern is when there is a flight to currency due to the fact that no institution in any jurisdiction is deemed to be safe. Consequently, running depositors and the sellers of securities will retreat to currency, generating severe market contraction through security fire sales and causing true systemic consequences and bank failures.

Although public policy remedies and regulatory measures will be dealt with in the following chapters, like Kaufman, Flannery is of the opinion that in most cases systemic risk and bank

³⁰ G Benston, 'Regulating Financial Markets: A Critique and Some Proposals' (1999) AEI Studies on Financial Market Deregulation.

runs are aggravated by regulatory intervention. Except in extreme cases, such as LTCM above, regulation is only necessary to seal the fate of defaulting institutions as quickly as possible.³¹ The reason for this is that, based on historical US data, banks actually hold more capital prior to intervention by regulators. Via regulation, it is suggested that banks have taken a more relaxed attitude as they now believe that if they find themselves in times of trouble, then the government and ultimately the taxpayer will step in to assist them with a lifeline. The safety nets put in place not only give bankers a more relaxed attitude to their balance sheet, but will lead them to be more adventurous in the investments they undertake. Commonly referred to as moral hazard, employees become further removed from acting in the lasting interest of the banks they work for, thus leading them to make riskier decisions with potentially grave consequences. It is suggested that developments and innovations within the functioning of financial institutions and markets have led to an increased likelihood of systemic risk.³² These innovations have occurred on several levels; of most interest here are the interlinkages between markets and institutions globally, and structural financial innovation. From an institutional perspective, it has already been shown that by the very nature of their balance sheets, banks are prone to contagion. Presently, there are international banks acting as correspondents for local ones in order to manage the custody of foreign currency. This means that there is, yet again, a potential for asymmetry of information where the situation of the domestic institution as debtor or creditor may not be clear.³³

The considerable increase in the usage of international clearing systems has led to concern over sizeable cross-border settlement risk.³⁴ This risk arose at a time when settlement was completed at the end of the day, potentially leaving a critical time frame open where continuity in the payments system could be disrupted. As will be shown, although international

³¹ M Flannery 'Prudential Regulation for Banks' in *Financial Stability in a Changing Environment* (St Martin's Press 1995).

³² Bordo (n 20).

³³ R Guttentag and J Herring, 'Emergency Liquidity Assistance for International Banks' in *Threats of International Financial Stability* (Cambridge University Press 1987) 186-188.

³⁴ Bordo (n 20).

settlement still poses a number of challenges, the fact that clearing houses have guaranteed collateral in place means that continuity of the payments system should be achieved.

The increase in complexity of certain financial instruments is of concern because of their chances of increasing the likelihood of systemic risk due to the leveraged liabilities they can generate. These concerns were found in the cases of Barings and LTCM, where both firms technically defaulted due to market downturns and their leveraged exposure via derivative instruments. The case of Barings is straightforward and obviously relayed the message that at the time senior management did not understand the risks that their rogue trader was exposing the bank to.³⁵ However, the case of LTCM tends to contradict the idea that derivatives can be used to counter risk exposure.³⁶ Indeed, LTCM exposed itself when trying to hedge its exposure, which is today a commonly used and widespread tool. However, as discussed above, as far as investments are concerned it is impossible to hedge outside of the market, and one will invariably be exposed to a certain extent. Additionally, due to the size of the movements generated by LTCM, should they have not found themselves in difficulty, some other linked institutions might have.

However, the evidence presented by the most recent financial crisis would tend to suggest that, at a minimum, globalisation has reinforced the interconnectedness of financial services beyond mere transfer of financial burden. So why has this crisis been so special in terms of systemic risk? As Lipsky points out, prior to the crisis it was suggested that the globalisation of financial services in point of fact carried the positive suggestion that risk was actually spread out more thinly across borders, instead of being intensively localised in one region or

³⁵ G Gorton and R Rosen, 'Banks and Derivatives' (NBER Working Paper number 5100, April 1995). They highlight the idea that the more complex and opaque instruments escape the understanding of those at the top as they are usually from the 'old school' of banking.

³⁶ As quoted in Bordo (n 20), studies by Darby and Mackay 1994 argue that rather than increasing risk, derivatives on net balance reduce it.

jurisdiction.³⁷ On the other hand, for some time it is thought that cross-border risk can rise to a degree where several institutions, markets and jurisdictions are put in jeopardy by this interconnectedness.³⁸

The circumstances of the financial crisis that commenced in 2007 have presented the following chain reaction. The Bush administration, in its electoral manifesto, had as a target to house every US citizen. Facilities and pressures were placed on financial institutions to facilitate mortgages for all. This was made possible by financial institutions being overly lenient on allowing mortgages, in the belief that, in any case, they were fully collateralised by the property on which the mortgage was given. Moreover, in order to spread the risk more efficiently these sub-prime mortgages were bundled, securitised and sold in other developed finance centres. When it became apparent that these products were not performing under the weight of the increase in sub-prime mortgage delinquency, markets suffered and experienced liquidity problems with the consequence of a flight to purchase commodities. The effects were that markets crumbled in succession and the commodity prices were driven to new highs. Beyond the financial markets, these price hikes on staple foodstuffs, such as rice and wheat, meant that developing countries could afford to feed themselves with difficulty.³⁹ This is one example where we can see that an isolated incident had grave effects not only on the domestic market where it occurred but, similarly to other financial markets, with social grief in yet other jurisdictions.

II. Which risks deserve regulatory attention?

³⁷ J Lipsky, 'Through the Looking Glass: The Links between Financial Globalisation and Systemic Risk' in D Evanoff and others (eds), *Globalisation and Systemic Risk*, vol 6 (World Studies in International Economics 2009).

³⁸ M Goldstein 'International Aspects of Systemic Risk' (Institute for International Economics, 1994).

³⁹ A crisis timeline and review of the causes will be dealt with in Chapter II. For a general account of the origins of the crisis see T Kenc and S Dibooglu, 'The 2007-2009 financial crisis, global imbalances and capital flows: implications for reform' (2010) 34(1) *Economic Systems* 3; Financial Services Authority, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (March 2009) (the 'Turner Review').

As it has been shown in attempting to find a definition for systemic risk, opinions vary on the level of influence the consequences of an event may have. This means that the acceptance of systemic risk materialising will not be unanimous. In some circumstances it will be clear, however, at other times the distinction will be blurred. This raises questions as to what level of market disruption is down to systemic consequences or merely cyclical, and the number of financial institutions that need to fail to recognise the systemic nature of a banking crisis.

Bordo et al make the distinction between real and pseudo systemic risk.⁴⁰ They highlight two situations that are reported to be conducive to real systemic risk. The first is the contraction of banking reserves due to a flight to currency. As discussed above, Benston recognises this situation as the only real threat to the realisation of systemic risk. The second situation relates to a stock market crash of a size that induces fear in the ability of lenders to initiate or extend loans to the economy at large. Contrary to arguments presented by Kaufman, Bordo et al argue that these situations have not generated panic or contagion where quantitative easing measures have provided sufficient liquidity to stabilise markets and economies. The recent crisis generated unprecedented injections of capital to financial institutions and markets in order to avoid a total fallout. The general idea behind setting up quantitative easing measures is that funds are injected into the system at a rate to match the demand of liquidity in the market in order to enable banks to pursue their lending activities. The availability of such measures was essential during the crisis where unprecedented amounts of liquidity were injected into the system of the most affected countries. The overarching idea behind these measures is to create the correct balance between reassuring the market that liquidity is to be had, whilst not creating a moral hazard scenario where financial institutions would be inclined to take risky decisions on the basis that they will be bailed out in any case. Conversely, the crisis rendered the discussion regarding LOLR efficiency somewhat redundant as throughout it,

⁴⁰ Bordo (n 20).

the injection of liquidity via quantitative easing measures had little regard for the discussion on the strict lending of money to illiquid banks rather than insolvent ones.⁴¹ Even in the cases where liquidity was not made available, for instance Lehman Brothers, knowledge of the underlying financial situation of the investment bank was not clear enough to take a position on its viability. According to Mishkin, one of the key elements of an effective LOLR is exercising caution when its services are needed.⁴² Considering the apparent inability for LOLRs to employ such caution in times of crisis, one of the objectives of regulation must now be the avoidance of the necessity to use the function at all. This might be achieved both by preventative measures, that is, further prudential regulation and crisis management measures. The following chapters will include discussions on how the EU has introduced such measures.

Bordo et al also bring to light instances where others have found systemic consequences which they contend to be merely pseudo-crises. They consider them to be pseudo-crises due to the fact that they are merely financial distress situations that are invoked because they create losses to market participants. On both real and pseudo financial crises, they offer historical data demonstrating examples of both. Such data will be reviewed further on.

Although there have been calls for further harmonisation⁴³ of international regulation,⁴⁴ Benston considers that there is little difference between the risks presented at international level and those presented at a domestic one.⁴⁵ He accepts, however, that foreign branches may pose further risks due to the fact that they will be able to move assets around, therefore potentially affecting depositors in one jurisdiction rather than another. The general attitude

⁴¹ C Goodhart, 'Some Myths about the Lender of Last Resort' (1999) 2(3) International Finance.

⁴² F Mishkin, 'Systemic Risk and the International Lender of Last Resort' (Remarks made before the Annual International Banking Conference, Federal Reserve Bank Chicago, Illinois, 28 September 2007).

⁴³ G20, 'Declaration of the Summit on Financial Markets and the World Economy (G20 Summit, Washington DC, 15 November 2008) <<http://www.g20.utoronto.ca/2008/2008declaration1115.html>> accessed 20 April 2014.

⁴⁴ T Padoa-Schioppa and F Saccomani, 'Managing a Market-Led Global Financial System' in *Managing the World Economy: Fifty Years after Bretton Woods* (Institute for International Economics 1994).

⁴⁵ G Benston, 'International Harmonisation of Banking Regulations and Cooperation Among National Regulators: An Assessment' (1994) *Journal of Financial Services Research* 201.

towards international regulation has so far been that of home supervisory control, where the main regulatory authority will be of the jurisdiction where the head office is situated. For the purpose of the risk cited above, Benston believes that there should be reliance on foreign supervisors or at least the ability of the home supervisor to be able to control the assets throughout the branches in order to secure sufficient funds to protect depositors throughout the network. However, review of the literature that has collated empirical evidence would tend to suggest that there is limited evidence of systemic risk across an individual banking network.⁴⁶

Although it is beyond the scope of this Chapter to go into the details of all the objectives of regulating financial services,⁴⁷ these objectives can be categorised into two broad categories: the economic ones and the social ones. Although Schwarcz suggests that the usual justification for regulating financial risk is to maximise economic efficiency,⁴⁸ it appears that modern regulation finds other reasons which are socially orientated.⁴⁹ While systemic risk is mainly concerned with economic efficiency, its potential social ramifications cannot be ignored.

In risk management terms, when a risk is identified, it first needs to be categorised in order to recognise the appropriate steps that will be needed in order to mitigate the realisation of this risk. The most widespread approach is to identify which 'quadrant' the said risk finds itself in, in terms of probability of occurrence and impact. The four options of risk categorisation are: low probability and low impact, where risks are usually either ignored or set low on the priority list; low probability and high impact are usually cases that require external insurance; high probability and low impact are cases that require managing; and high probability and high impact are risks that need to be eliminated. If we take systemic risk as a jurisdictional risk it

⁴⁶ A Saunders, 'The Interbank Market, Contagious Effects and International Financial Crises' in Richard Portes and Alexander K Swoboda, *Threats to International Financial Stability* (Cambridge University Press 1987).

⁴⁷ Beyond those concerning systemic risk.

⁴⁸ Schwarcz (n 5).

⁴⁹ See H Davies 'Why regulate?' (Henry Thornton Lecture, City University Business School, 1998); Peter Cartwright, *Banks, Consumers and Regulation* (Hart 2004).

will be found that, based on historical data,⁵⁰ it will be located within the second quadrant, i.e., as low probability and high impact, requiring an external force to mitigate the realisation of systemic risk. It would be categorised as such because of the lack of frequent manifestation of systemic risk but mindful of its catastrophic consequences should it materialise. In this respect, Greenspan agrees that 'there will always exist the remote possibility of a chain reaction, a cascading sequence of defaults that will culminate in financial implosion if it is allowed to proceed unchecked'.⁵¹ Therefore, the issue requires regulatory intervention and policy structuring. Indeed, individual firms will neither have the drive nor the information to predict or reduce systemic risk.

Schwarcz comments that even in the case where banks would collectively be able to prevent systemic risk, they would not be inclined to do so as they would need to take into consideration the potentially far reaching social costs which in terms of internalisation would seriously hinder their profitability.⁵² Furthermore, he considers that the type of attitude carried out by market participants causes 'a type tragedy of the commons', whereby the participants will be inclined to maximise the use of the resources available to the detriment of the wider population. Finally, the rarity of the occasioning of systemic risk means that, in the minds of the market participants, the need to control such risks will be forgotten from one occurrence to another. For these reasons, regulating systemic risk appears both appropriate and necessary to preserve long-term financial and social stability.

The appropriateness of regulating systemic risk will be linked to the regulatory tools put in place and the cost benefit of such regulation in order to maintain efficiency. When working towards the mitigation of most risks, the costs of implementing the required measures must

⁵⁰ G Kaufman, 'Banking and Currency Crises and Systemic Risk: A Taxonomy and Review' (Working Paper Series WP-99-12, 1999) 43.

⁵¹ A Greenspan (Remarks at the VIIIth Frankfurt International Banking Evening, Frankfurt am Main, Germany, 7 May 1996) <http://fraser.stlouisfed.org/docs/historical/greenspan/Greenspan_19960507.pdf> accessed 24 January 2014.

⁵² Schwarcz (n 5) 198.

be evaluated at all times. Indeed, overly burdensome and costly regulation can result in causing risks to be over-priced and stifling business to the point where the cost of doing business is higher than the potential returns.⁵³ The cost benefit analysis of any type of regulation is therefore essential to make it meaningful and is the recognised tool in order to evaluate the efficiency of regulation.⁵⁴ Certain regulatory measures will, however, be promoted as having benefits that outweigh any conceivable cost. This is usually advocated, for example, in terms of environmental issues or critical social protection such as terrorist activity. Due to the potentially huge impact that systemic risk may have on an economy, such matters may be of legitimate concern for this purpose. In terms of systemic risk, the cost of reducing its occurrence will be based on the cost of the necessary measures to be taken to reduce the incidence, whereas the benefits are those savings, both economical and social, that will be achieved by reducing its materialisation. Schwarcz attempts to calculate the cost benefit of regulating systemic risk with the idea of reaching a workable formula to analyse the efficiency of potential intervention.⁵⁵ Further chapters will include analysis on whether the post-crisis reform agendas were sensitive to such issues.

This chapter has briefly considered several ideas concerning systemic risk, principally with the aim of gaining an understanding of the concept. It has been noted that there remains confusion and debate regarding the achievement of a commonly accepted definition of systemic risk. If not a definition per se, the notion was rationalised by breaking it down into four workable steps in order to accommodate those differing opinions. The notion has certainly gained a (forced) revived interest following the financial and banking crisis of 2007-09.

⁵³ J Eatwell and L Taylor, *Global Finance at Risk: The Case for International Regulation* (New Press 2000).

⁵⁴ RA Posner, *Economic Analysis of Law* (4th edn, Little, Brown and Company 1992).

⁵⁵ Schwarcz (n 5).

Following the evidence that the crisis provided in establishing the realities of systemic risk, it will be interesting to assess the public policy direction that has been taken to mitigate future systemic events. Due to the EU focus of this paper, the systemic risk elements of the ambitious post-crisis reform agenda highlighted in the de Larosiere report⁵⁶ will be assessed and evaluated. Indeed, the concept has certainly evolved in the light of the events that caused the crisis, but also from the way that the effects were managed. The unprecedented amounts of liquidity pumped into the market and the multitude of banking bail-outs must lead any reform agenda to focus not only on systemic risk prevention but also crisis management supervisory tools to enable the LOLR function to be implemented only in rare and isolated circumstances.

However, the crisis has not clarified the definition of systemic risk. If anything, it has demonstrated that the materialisation of systemic risk will be unexpected. A reform agenda must therefore take into consideration the organic nature of systemic risk as restricting the notion could lead to an inefficient regulatory response.

⁵⁶ High-Level Group on Financial Supervision in the EU, 'Report' (Jacques de Larosière (chair), DG Internal Market, Brussels, 25 February 2009) (de Larosière report).

CHAPTER II: THE SYSTEMIC RELEVANCE OF THE 2007-09 FINANCIAL CRISIS

The previous Chapter analysed some core conceptual notions of systemic risk in order to better understand the nature of the problem and its fundamental unpredictability. This Chapter briefly addresses the causes of the crisis that demonstrates its systemic relevance. The de Larosiere report will be used as a source due to its EU scope and the fact that it is the basis for the regulatory and supervisory reform agenda.

The crisis lasted for over two years and is considered to be one of the most systemically relevant. This point was made by the Turner Review, when it stated that although 'specific national banking crises in the past have been more severe ... what is unique about this crisis is that severe financial problems have emerged simultaneously in many different countries, and that its economic impact is being felt throughout the world as a result of the increased interconnectedness of the global economy'.¹

Indeed, the crisis demonstrated the level of financial interconnectedness on a global scale, as it began with the localised issue of US sub-prime mortgages and rapidly spread across borders, affecting the entire financial system. There have been numerous attempts to explain the causes of the crisis and most of them are valid to the extent that, in combination, they mutually reinforce each other's effects. The causes listed tend to have similar attributes that explain why this crisis was particularly relevant from a systemic perspective. They are generally characterised by a lack of understanding of financial risk, a misinterpretation of global interconnectedness in financial markets and a lack of transparency.

¹ FSA, 'The Turner Review: A regulatory response to the global banking crisis' (March 2009) Introduction page 5.

Establishing the causes of the crisis enables countries to launch a regulatory and supervisory reform agenda that ensures the same mistakes are not repeated. This has been the historic approach and reflects the ‘regulatory pendulum’ outlined by Coffee.² His ‘sine curve’ model of regulatory instability demonstrates an increase in regulation in the aftermath of a crisis, but once the social pressures are allayed and the financial interest groups regain political influence a period of regulatory liberalisation ensues.

On this occasion, the situation is somewhat different as it is a multitude of regulatory measures that demand reform due to the fact that systemic risk, as the culprit of the rapid contagion amongst financial centres, touches a multitude of regulatory issues. This means that a general rethink of regulatory and supervisory practices was necessary. The situation in the EU brings about further difficulties, as national differences in regulatory and supervisory practices have aggravated the situation. This is because the financial interconnectedness at EU level was developed with an EU supervisory system that was not equipped to deal with its dynamism.

During the crisis, in October 2008, the European Commission gave a mandate to a group of qualified individuals, under the Chairmanship of Jacques de Larosière, to advise on the future of financial regulation and supervision in the EU.³ The pivotal report was finalised in February 2009 and set out the roadmap for the future reform agenda in the EU. Due to the political and economic eagerness at the time for change, the ‘High-Level Group’ was no doubt given great latitude to suggest radical change. It is beyond the scope of this thesis to discuss the merits of the suggested causes of the

² J Coffee, ‘The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated’ (2012) 97 Cornell L Rev 101.

³ High-Level Group on Financial Supervision in the EU, ‘Report’ (Jacques De Larosière (chair), DG Internal Market, Brussels, 25 February 2009) (De Larosière report).

crisis. However, the de Larosière report presents an effective platform from which to consider the causes in order to analyse the EU post-crisis reform agenda in the following chapters.

This Chapter does not intend to be analytical, but rather to provide a point of reference in terms of the salient events and characteristics of the crisis. For this purpose, a brief timeline is included along with an appraisal of the underlying nature of the crisis. A list of the causes will then be provided with a concise explanation of their relevance for systemic risk purposes.

I. A brief timeline of events

Although the financial crisis is said to have started in 2007, the indications that the US sub-prime mortgage bubble was going to burst began in 2006 when inflation started rising and the US treasury tightened its monetary policy by increasing interest rates. By mid-2007, following rising defaults in sub-prime loans and falling prices of some credit securities, property prices fell, causing spiralling mortgage defaults. By this time, confidence was starting to fracture within the markets and amongst financial institutions as liquidity was becoming scarce.

By the summer of 2008, the strain on liquidity was affecting the larger institutions as mark-to-market losses increased. In the US, this resulted in the bail-out of Bear Stearns, one of the largest investment banks. It was greatly affected by its excessive leveraging and declining asset prices. By this point, the supply of credit was drying up on a global scale as liquidity was becoming scarce, causing house prices outside the US to start to fall.

By September 2008, general confidence was reaching its lowest point, aggravated by the failure of Lehman Brothers. The fact that the US Federal Reserve did not bail-out Lehman Brothers caused further concern as it confirmed that the idea that certain banks were too-big-to-fail was no longer the case. This caused further general public concern which instigated additional runs on financial institutions and caused the total seizure of interbank money markets, forcing the system to rely exclusively on the support of central banks. The sheer size of government and central bank support, and the pledge that systemically important banks would not be allowed to fail, kept the system on life support and, by the end of 2008,⁴ the effects were spreading to the real economy, with most EU countries entering periods of recession.

II. A Liquidity or Capital Crisis?

Although liquidity crises and capital crises have a tendency to merge rapidly after one of them emerges, identifying the type of financial crisis helps in understanding and forging a response. Liquidity crises are generally regarded as the more traditional kind of banking crisis and arise when a bank cannot meet its payment obligations.⁵ The direct consequence of this is a general panic that causes a run on the institution and other banks because customers lose faith in the system due to market interconnectedness and payment systems. Owing to the way banks hold liquidity using fractional reserves, the other banks also face problems of satisfying customer

⁴ European Central Bank (ECB), 'Measures designed to address elevated pressures in the short-term US dollar funding markets' (Press Release, 29 September 2008) <https://www.ecb.europa.eu/press/pr/date/2008/html/pr080929_1.en.html> accessed 19 January 2014.

⁵ RM Lastra and G Wood, 'The Crisis of 2007-09: Nature, Causes and Reactions' in Thomas Cottier, John H Jackson and Rosa M Lastra, *International Law in Financial Regulation and Monetary Affairs* (Oxford University Press 2012) 9.

withdrawal requests. A liquidity crisis is therefore triggered by a demand for money that cannot be satisfied due to its lack of availability.

A capital crisis is characterised by a sudden fall in the value of the assets of a bank's own funds, namely its capital. Due to the lack of transparency related to the bank's balance sheets, solvency concerns are raised. This is because shortness of capital could lead it to being unable to pay its debts. In such circumstances, customers may cause a run on the bank, causing a shortness of liquidity that could spread to other banks, triggering, in turn, a liquidity crisis.

It is safe to assume that the crisis of 2007-09 was a capital crisis due to the fact that it originated in the sharp depreciation of highly-leveraged debt instruments that were held by banks in the US and globally.

III. Contributing factors

A. Macro-economic issues

The build up to the crisis was characterised by a long period of economic growth that gave the impression of sustainability. When an economic situation is perceived as stable, optimism grows and investors typically tend to increase positions in the most popular financial products of the time.⁶ This period was also defined by plentiful liquidity and low interest rates which have been 'the major underlying factor behind the present crisis'.⁷ With low inflation and low interest rates, borrowing levels grew without any apparent need for monetary policy intervention. However, low inflation was only characteristic of consumer goods and services, and with inflation on the price

⁶ J Millar and others, 'The U.S. subprime mortgage crisis: what have we learned?' (2010) *Comp Law* 355, 356.

⁷ de Larosière report (n 3) para 6.

of financial assets rising, the indicators were misleading. A particular macro-economic imbalance occurred between the US and countries with current account surpluses. Indeed, the thirst for credit in the US was primarily financed by countries such as China and oil exporting countries seeking to place liquidity.⁸ Due to the fact that these countries pegged their currencies to the dollar, imbalances were caused by the linkage to the US's lax monetary policy.⁹ The liquidity inflow into the more secure assets, such as sovereign debt,¹⁰ caused their yield to fall and encouraged other investors to seek higher returns elsewhere.

Due to ample liquidity and low yields on investments, providers of investment products became more and more creative in their efforts to create instruments that offered high returns with a promise of low exposure generated by efficient diversification, as shown in *Figure 1*. Due to low interest rates and US Government pressure to promote home ownership,¹¹ a housing bubble was created with increasing amounts of mortgages held on banks' books. The creativity occurred when financial institutions converted their loans into mortgage-backed securities (MBS) and asset-backed securities (ABS), followed by a conversion into collateralised debt obligations (CDO) using special purpose vehicles (SPV) and structured investment vehicles (SIV). This whole securitisation system was prone to leverage on assets that were of a poor quality. This was problematic as the lack of transparency of the underlying assets was

⁸ European Union Committee, *The Future of EU Financial Regulation and Supervision* (HL 2008-09, 3-14).

⁹ The monetary policy ignored the asset-price bubble specifically related to an increase in property prices. See C Goodhart, 'What Weight Should be Given to Asset Prices in the Measurement of Inflation?' (2001) 111(472) *The Economic Journal* F355.

¹⁰ FSA (n 1) Exhibit 1.2.

¹¹ The US Government promoted light regulation of mortgage processes, and liberalised US Government sponsored entities, such as Fannie Mae and Freddie Mac, pushing them to promote home ownership to low income households. See de Larosière report (n 3) para 7.

repackaged in a way that made them appear diverse enough to be safe. This resulted in risk being miss-quantified for these financial instruments with a global appeal.

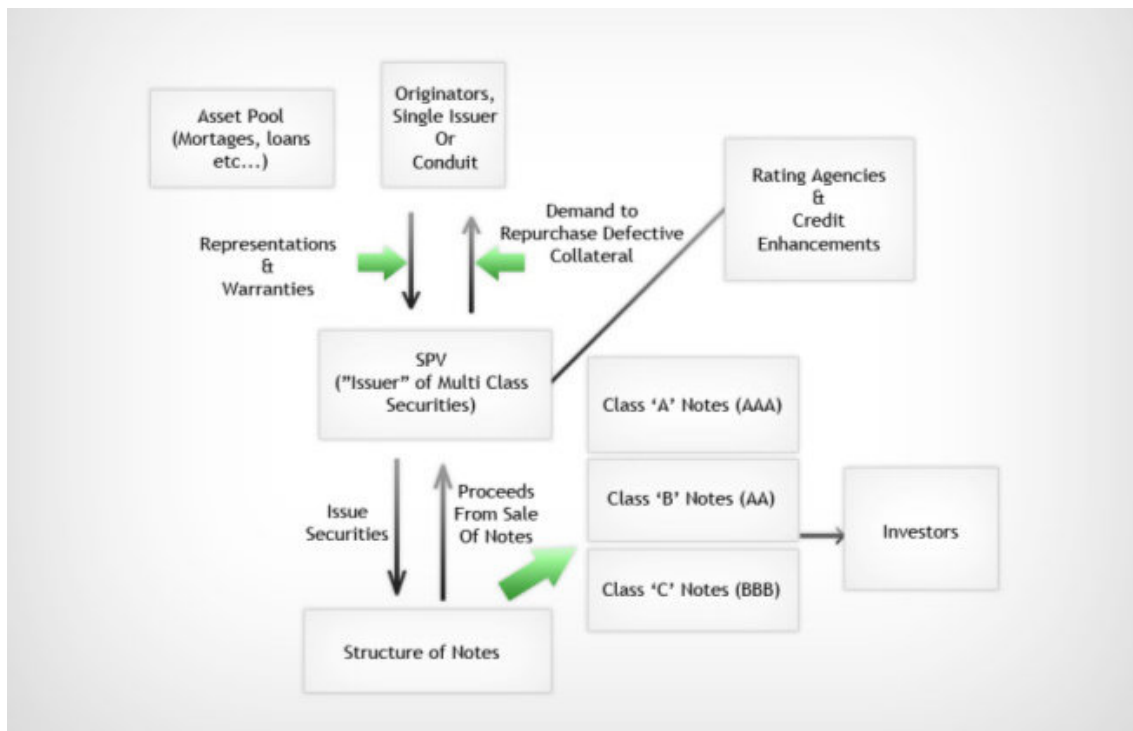


Figure 1: Basic Securitisation Flowchart (<http://legaljusticelawcenter.com/complaint-process.html>)

The search for higher returns and the belief that securitised instruments were of a low risk nature led to further increases in leverage, with investors and financial institutions alike seeking higher yields. The US investment banks were particularly exposed to this kind of leverage, with ratios exceeding 30 to 1.¹² Due to the leverage spiral, accounting mechanisms allowed for institutions to show increased profits whilst lowering their risk profiles without highlighting their ever-growing exposure to asset price fluctuations.

¹² Committee on Capital Markets Regulation, 'The Global Financial Crisis: A plan for Regulatory Reform' (May 2009) 60 <[http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf)> accessed 8 January 2014.

In principle, the safety aspect that is related to securitisation is justified. It was presented as a way of efficiently reducing the cost of credit intermediation and its associated risks by passing on the total credit risk to end investors. This had the effect of reducing the need for banks to raise capital in order to lend more. In addition, it reduces localised systemic risk as the securitised debt can be packaged and spread to other actors in the market, therefore also reducing the risk to the whole banking system.¹³ However, the crisis showed that the diversification process had not worked, since it transpired that, ultimately, the securitised debt was held within the banking system rather than with the end investors. Indeed, instead of passing on the holdings of securitised credit to the end investors as intended, the holdings were passed from one institution to another. These were re-securitised using CDOs or used as collateral to raise short-term liquidity. This created an opaque web of interconnections which were not visible to the market or the supervisors.

B. Failures to assess risk

Rather than being the specific cause of the crisis, securitisation was a *causa proxima*.¹⁴ Indeed, it led to a fundamental misconception of the link between credit and liquidity, and allowed firms to wrongly calculate the capital they should hold in order to mitigate the risk they were exposing themselves to. Due to the lack of transparency caused by the layers of securitisation, it became impossible to identify where the risk lay and whether it had been dispersed or concentrated. A total breakdown in confidence occurred at the first sign of uncertainty and fragility in the market. The de

¹³ FSA (n 1) 15.

¹⁴ Lastra and Wood (n 5) 17.

Larosière report points out two important aspects of this situation.¹⁵ The first is that the regulations in relation to capital requirements inspired by Basel I and Basel II were inadequate, and they actually acted to aggravate the situation by encouraging risks to be taken off the balance sheets. Indeed, Basel I focussed the quantification of risk solely on credit risk for the determination of capital to be held. This had the consequence of only taking into account the risks associated to credit that was held on the books. Although Basel II changed this to an extent, by widening the scope of risk beyond credit and market risk, Basel II was never adopted as law in the US, and it only introduced this improvement as a voluntary standard. However, once the crisis hit, banks were forced to put the assets back on their balance sheets, thus causing significant leverage spikes. The second aspect the report raises was the growing use of over-the-counter (OTC) derivative contracts; these played a part in creating opacity as they were not traded on regulated trading platforms.

The externalisation of maturity transformation, often referred to as ‘shadow banking’, caused other structures to act in a bank-like way.¹⁶ Indeed, they do this by borrowing short-term, in the form of demand deposits and short-term certificates of deposit and lending on with longer terms. By doing this they transform debts with very short maturities, into credits with very long ones. This activity was particularly prevalent in the US where mutual funds acted in a bank-like way by holding long term credit assets against the promise of prompt redemptions for investors. This was exacerbated by contractual provisions that preserved the capital of the overall investment. In times of falling asset values this caused mutual funds to fire-sell their assets to satisfy their self-

¹⁵ de Larosière report (n 3) 16.

¹⁶ FSA (n 1) 21.

imposed requirements and, in the process, this aggravated market difficulties. In conjunction, banking and shadow banking activities contributed to the build-up of historic levels of leverage by June 2007.¹⁷

The overall complexity of financial instruments and their confusing interconnectedness were the main reasons why risk was not visible. Financial instruments became so complex that a full understanding of their nature escaped the technicians, risk management, boards, regulators and investors to the extent that no one was in a position to evaluate or predict the consequences of the crisis.¹⁸ The overall complexity led actors in the financial markets to place an excessive amount of reliance on sophisticated mathematical formulas. It was assumed that such formulas were developed in a way that matched the complexity of the investments they were monitoring. However, it was problematic that most of the formulas took as their basis the value-at-risk model (VAR). The problem with this model is that it has been the standard for risk assessment since the early 1990s, generating forward looking risk predictions based on historical data. Although this is not necessarily a bad thing, the fact that the historical data was sourced over short periods of time did not provide sufficient data and brought about problematic pro-cyclicality. The ultimate result was that these formulas provided a false sense of security to those using them. The methodology was fundamentally flawed because it assumed and projected for each institution in isolation; it failed to capture interconnected market events and encouraged systemic risk as it measured risk at its lowest point.

C. Overreliance on credit ratings

¹⁷ Lastra and Wood (n 5) 19.

¹⁸ L Buchheit, 'We Made it Too Complicated' (2008) 27 *International Financial Law Review* 24.

The dependency of the market, regulators and supervisors on credit ratings is one of the tangible explanations for the crisis. In the same way that institutions misread the risks related to structured debt products, so did the credit rating agencies (CRAs) that assessed them. Their methodologies for rating these products were profoundly defective as they failed to provide for their fragility in downturn cycles.¹⁹ CRAs gave these products similar ratings to the most secure sovereign bonds and, once again, this instilled a false sense of security. This was aggravated by the fact that, due to the complexity of the instruments, investors and regulators did not look much further than the rating in establishing their risk of default.

The situation was exacerbated by the use of 'rating-based' triggers.²⁰ In order to achieve higher ratings, certain products contained clauses which stated that, should the value of the assets fall below a certain level or become subject to rating downgrades, then the investment would be wound up in order to protect investors. The fact that these triggers were used widely for such investments set them up to topple in a perfect domino effect when the price of assets started to fall. Once they simultaneously started winding down their positions, as they were contractually obliged to do so, the system froze due to an excessive shoring up of liquidity.

D. Regulatory and supervisory failures

The crisis revealed some considerable shortcomings on the regulatory and supervisory side in terms of preventing, mitigating and managing the crisis. The uncoordinated and erratic interventions by governments and central banks in providing liquidity to the

¹⁹ de Larosière report (n 3) para 19.

²⁰ FSA (n 1) 22.

market and bailing out institutions demonstrated the powerlessness of the regulatory system in place.

Generally, prior to the crisis, the regulatory and supervisory framework lacked macro-prudential provisions and oversight. The focus on individual firms meant that visibility of the interconnectedness between them was not available. The spread of the US sub-prime issue was difficult to cater for by EU supervisors as they lacked the information on off balance sheet positions that financial institutions had accumulated. Furthermore, the difficulties in assessing leverage incurred by financial institutions, and the lack of information regarding certain types of derivative contracts which were growing, meant that supervisors lacked the transparency to scale a timely response.

The general financial positions of regulated financial institutions were particularly problematic where there was a lack of consideration for their liquidity positions in relation to leverage on their proprietary trading book. The risks that were presented were wrongly modelled by the financial institutions, and the supervisors were not equipped to challenge them. The 'insufficient supervisory and regulatory resources combined with an inadequate mix of skills as well as different national systems of supervision made the situation worse'.²¹ In the regulatory toolkit, of particular concern was the absence of rules on liquidity provisioning.²²

Moreover, international cooperation and coordination was lacking. The competition for market share and the potential for regulatory arbitrage meant that national regulators were not inclined to share information and intervention methods.²³

²¹ De Larosière report (n 3) para 28.

²² Lastra and Wood (n 5) 16.

²³ *ibid* 16.

Additionally, despite the fact that some build-up of risk was visible, its cross-border relevance was not singled out as a problem serious enough to warrant coordinated action. In this respect, the supranational bodies failed to provide a platform to discuss and intervene in sectors of the finance industry that required concerted intervention. Bodies such as the International Monetary Fund (IMF) and the Financial Stability Forum (FSF) (now the Financial Stability Board) did not provide sufficient information at a global level nor did they consider with sufficient force the misalignments caused at a macro-economic level.

E. Corporate Governance shortcomings

Failures in corporate governance have become particularly newsworthy, most notably, in relation to bankers' remuneration. However, the issues in relation to corporate governance go far beyond this, in particular, in relation to board competence, management oversight, independence of the risk management function and shareholder responsibilities.²⁴

However, the issue of remuneration must be addressed. Given the focus on short-term results for the calculation of remuneration packages, the potential to hurt the long-term stability of the financial institution is real.²⁵ The short-termism is also an issue in relation to shareholders' expectations, where they put pressure on the institution to exceed expectations on a quarterly basis in order to generate a higher share price and dividends.

²⁴ A Arora, 'The corporate governance failings in financial institutions and directors' legal liability' (2011) 32(1) Comp Law 4.

²⁵ Millar (n 6) 360.

There were fundamental issues with the risk strategy of financial institutions prior to the crisis. The overall responsibility for ensuring that an institution's appetite for risk is clearly defined lies with the board and senior management. Competence issues and effective oversight were clearly lacking as the exposures incurred were beyond any reasonable risk strategy.

By setting out a list of causes of the financial crisis, the de Larosière report established its objective to establish a new regulatory agenda, introduce stronger coordinated supervision and establish effective crisis management procedures.²⁶ Arriving at the conclusion that 'too much of the European Union's framework today remains fragmented'²⁷ suggests that further harmonisation is necessary.

The level of harmonisation achieved will also be determined by how far the single regulatory rulebook for financial services can be taken. Achieving a uniform set of rules in response to the issues raised above will test the political willingness for change and the centralisation of powers at EU level.

²⁶ De Larosière report (n 3) Avant-Propos 4.

²⁷ *ibid* Avant-Propos 3.

CHAPTER III: REGULATORY RESPONSES TO THE CRISIS IN THE EU

Having established in the previous Chapter the causes of the financial crisis in the format that prepared the EU reform agenda, this Chapter will focus on the normative aspect of the agenda by focusing on the provisions with systemic risk relevance.

A strong regulatory reform agenda was to be expected in the aftermath of the crisis as evidence shows that regulatory developments occur following times of economic stress.¹ At EU level, this took the form of a drastic change of direction following a period of regulatory pause which was itself preceded by a period of regulatory liberalisation.² The main areas for regulatory reform presented by the G20 agenda have been addressed at EU level and cover: over-the-counter (OTC) derivative contracts, alternative investments, capital requirements and credit rating agencies (CRAs).³ The development of these measures in conjunction with the commitment to a single rulebook has demonstrated an eagerness to further centralise regulation at EU level and achieve, where possible, regulatory uniformity.

However, these measures have experienced varying levels of political commitment because of particular national sensitivities. Therefore, although the groundwork has been laid for a single rulebook via the reform agenda, the results stand to vary depending on the sector affected. This chapter will focus on the financial stability aspect of the reform agenda which to date has progressed further than the financial efficiency side of it.

¹ J Coffee, 'The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated' (2012) 97 Cornell L Rev 101; F Allen and D Gale, *Understanding Financial Crises* (OUP 2007).

² N Moloney, 'Resetting the location of regulatory and supervisory control over EU financial markets: lessons from five years on' (2013) ICLQ 955.

³ G20, 'Declaration of the Summit on Financial Markets and the World Economy (G20 Summit, Washington DC, 15 November 2008) <<http://www.g20.utoronto.ca/2008/2008declaration1115.html>> accessed 20 April 2014.

The four areas of regulation that are covered have presented differing challenges in terms of complexity, political commitment and framework alignment. The first that will be considered relates to the transparency issues in OTC derivative contracts. A common theme for systemic risk issues has been supervisory and market visibility. This has been the case not only to single out those situations that require attention but also, in times of crisis, to be able to measure a response. The second measure that will be dealt with is in relation to alternative investments. Although there is no clear data on what role they played or how they aggravated the crisis, the consensus has been to include them in the agenda on the basis that they were already coming under scrutiny prior to the crisis. Additionally, the conclusion that hedge funds may present systemic symptoms leads to the idea that this area should at least be catered for in terms of transparency. The third measure relates to the reform of capital requirements which has been the historical tool for systemic risk mitigation. As the previous regime based on the Basel II Accords was unsuccessful, reform was needed and this resulted in a new Capital Requirements Directive (CRD). The main reason for the failure of the previous requirements was that they lacked macro-prudential focus. Indeed, the fact that the measures were targeted at individual firms prevented supervisory oversight and reaction for the benefit of system stability. Finally, the regulation of CRAs will be examined in more detail than the others due to their tangible systemic impact. Indeed, from the outset, the use of ratings to determine the safety of an investment played a role in causing and aggravating the crisis. The reliance and trust that was placed on ratings meant that they were used in contractual arrangements between market players and were relied upon heavily by regulators. Regulation was required not only to place greater responsibility on the agencies for the ratings they prepare but also to disengage the rating process from regulatory and supervisory reliance.

These measures constitute the foundation of the single rulebook for financial services in the EU. Their ability to make regulatory standards uniform will be key to achieving greater financial stability and also constitute the tools with which supervisory practices will be established.

I. The European Market Infrastructure Regulation (EMIR)

A. The issue with over-the-counter (OTC) derivative contracts

Derivative instruments play a significant role in finance as they enable the shifting of economic risk from one party to another. The less visible element of trading derivative contracts, namely OTC ones,⁴ came under scrutiny post-crisis as they were considered to have had an aggravating effect. Their role was deemed significant because they facilitated the increase of leverage amongst interconnected participants, therefore aggravating the circumstances of each of them.⁵

The lack of transparency in OTC contracts also meant that the exposures were difficult to quantify. This opacity makes it difficult for regulators to perceive the build-up of concentration risk in the market; their complexity does not make it easier either. It also creates issues for the market participants and their respective interconnectedness due to the difficulty in obtaining basic market information, such as price and availability. Additionally, it makes it difficult to evaluate counterparty risk as it is challenging to know what the other party has and, in case of default, it becomes harder to find a replacement. The lack of transparency and the way in which they are interconnected are valid rationales for the industry to be regulated in the name of systemic risk. Up until the crisis, it was thought that limited regulatory intervention was warranted because such investments were essentially for institutional and sophisticated investors.

B. The European Markets Infrastructure Regulation (EMIR)

⁴ Derivatives can be defined as financial instruments whose value is derived from an underlying asset. They can be traded on a regulated market (exchange or multilateral trading platform (MTF)) or outside of such a market (OTCs). The purpose of trading outside the market is to allow for terms to be tailored to the parties' needs. See H Meakin, 'OTC derivatives and clearing' (2010) COB.

⁵ H Meakin, 'OTC derivatives and clearing' (2010) COB 2.

The de Larosière report⁶ identified both market visibility and derivative contracts as aggravators of the crisis by suggesting that ‘the nature of the system made it impossible to verify whether risk had actually been spread or simply re-concentrated in less visible parts of the system’⁷ and that ‘credit derivatives played a significant role in triggering the crisis’.⁸ It went on to specifically recommend that OTC derivative contracts should be simplified and standardised to enable better visibility.⁹

The Leaders Statement at the 2009 post-crisis G20 summit in Pittsburgh also stressed that global efforts had to be made to ensure that ‘all standardised OTC derivative contracts should be traded on markets or electronic trading platforms, where appropriate, and cleared through central counterparties by end of 2012 at the latest. OTC derivative contracts should be reported to trade repositories.’¹⁰ The objective and the timeframe were very ambitious, however, the EU obliged by bringing into force on 16 August 2012 the EMIR.¹¹ In line with the request of the G20 summit, EMIR requires standardised OTC derivatives to be cleared via central counterparties and all OTC derivative transactions to be reported to central repositories.¹²

EMIR cites three purposes for its implementation: to improve transparency in derivative markets; to mitigate systemic risk; and to protect against market abuse.¹³ It is what can be considered a fairly long and complex Regulation, and its overarching idea is to improve derivative contract visibility for the market and its supervisors in order to mitigate systemic risk.

⁶ High-Level Group on Financial Supervision in the EU, ‘Report’ (Jacques de Larosière (chair), DG Internal Market, Brussels, 25 February 2009) (de Larosière report).

⁷ *ibid* para 15.

⁸ *ibid* para 27.

⁹ *ibid* recommendation 8.

¹⁰ G20, ‘G20 Leaders statement’ (G20 Summit, Pittsburgh, 2009) para 13
<<http://www.g20.utoronto.ca/2009/2009communique0925.html>> accessed 20 April 2014.

¹¹ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories OJ L201/1 (EMIR Regulation).

¹² G Baber, ‘The EMIR of Strasbourg: a three year journey from Pittsburgh’ (2013) *Comp Law* 118.

¹³ EMIR Regulation (n 11) recital 7.

The division between regulatory and supervisory tasks is quite clear throughout the regulation with regards to systemic risk. With detailed provisions on clearing and reporting, the Regulation delegates the decision over what constitutes systemic risk to the competent authority, namely, the Member States' national competent authorities and the ESMA. The absence of clear parameters that define systemic risk is not surprising due to the complexity and unpredictability of the notion. Indeed, the purpose of the Regulation should be delimited to providing information that can be used for the supervisory appreciation of systemic risk in order to measure intervention where necessary. It is important to note that systemic risk in such regulations represents a key shift at EU level, where first of all it is freely quoted as a rationale for regulation, but it also understands that the notion is malleable and its causes and consequences can be unexpected.

One of the conditions for the Regulation to be effective is the need for information to be collected and processed in a uniform way. The Regulation foresees that if left to their own devices, Member States would adopt different national measures.¹⁴ The uniformity aspect is of importance for the purpose of processing the information efficiently, thus enabling a prompt assessment of systemic risks.¹⁵

It is also provided for that ESMA uses its discretion for the purpose of the selection process of those classes of OTCs that should be subject to clearing requirements. The discretion used should be in line with the intention of reducing systemic risk. To this effect, the Regulation offers some criterion in order to establish its status. For this, ESMA must consider the level of standardisation of the relevant class, its volume and liquidity and the availability of fair and

¹⁴ EMIR Regulation (n 11) recital 15.

¹⁵ *ibid* recital 37.

reliable pricing information.¹⁶ In weighing up the potential for systemic risk, it is also specified that ESMA may take into consideration the interconnectedness between the counterparties.¹⁷

Generally and specifically, the technical standards that are to be prepared by ESMA must maintain a systemic risk focus during drafting.¹⁸ This is particularly the case with regard to the thresholds that are to be established by ESMA for non-financial counterparties.¹⁹ The threshold determines whether the transaction of a non-financial counterparty is subject to the same clearing requirements as those from financial counterparties.²⁰ This is important because it is potentially burdensome to a non-financial counterparty to be included in the clearing process from both an administrative and a cost perspective. Where the non-financial counterparty falls below the threshold, the EMIR obligations are limited to a reduced catalogue of duties instead of those associated with the clearing obligations.²¹ However, it appears that the threshold level has been set quite high, although it can be amended by ESMA if it feels that there is a systemic risk justification. The clearing threshold is defined by the gross notional value of the relevant derivative position, which currently stands at either EUR 1 billion or EUR 3 billion depending on the type of derivative contract.²² These high trading amounts should not concern the majority of non-financial counterparties, and those that it does should be sufficiently resourced to fulfil the clearing obligations.

The review process and accountability aspect imposed by EMIR are also focused on systemic risk. Under the Regulation, the national competent authorities have the duty to review the

¹⁶ EMIR Regulation (n 11) recital 21 and art 5 (4).

¹⁷ *ibid* art 5 (4).

¹⁸ *ibid* art 4 (1) (b).

¹⁹ Article 2 (9) defines non-financial counterparties as undertakings established in the EU that are not central counterparties nor an EU authorised financial institution.

²⁰ EMIR Regulation (n 11) art 10.

²¹ B Geier and S Henkelmann, 'New regulatory requirements for the use of derivatives in structured finance transactions' (2014) JIBLR 194.

²² Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP [2013] OJ L52/11, art 11.

central counterparties on an annual basis, and these are also subject to on-site visits.²³ The systemic importance of the central counterparty will be relevant in order to determine the frequency and depth of the reviews. The volumes that are passed through them and the connections between the various counterparties will be of particular relevance in order to establish concentration risks and trends.

An annual report is also required at EU level in order to present the bigger picture of assessing systemic risk in relation to interoperability arrangements.²⁴ The report is to be prepared by the Commission in collaboration with the Member States, ESMA and the European Systemic Risk Board (ESRB).²⁵

Overall, EMIR addresses the concerns raised in relation to the opacity of OTC derivative contracts well and has done so within the short timeframe set by the G20. Due to the lack of policy constraints and political interference, the issue was to be addressed mainly in technical terms. The basis for the relevant supervisors to process the information collated under EMIR is set, and was able to be undertaken in a uniform way due to the lack of political sensitivities and also because it was an entirely new step which did not require Member States to align their different practices. The relatively unproblematic nature of this Regulation bodes well for the kind of process that needs to be achieved in order to write the single rulebook for financial services in the EU. The supervisory step will be next and it must demonstrate that EMIR to some extent assists in mitigating systemic risk, and is a tool that can be used by national competent authorities, chiefly ESMA.

II. The Alternative Investments Fund Managers Directive (AIFMD): an opportunistic inclusion

²³ EMIR Regulation (n 11) art 21 (3) and recital 29.

²⁴ The Regulation defines an interoperability arrangement as an arrangement between two or central counterparties that involves a cross system of transactions (Article 2).

²⁵ EMIR Regulation (n 11) art 85 (4).

A. AIFMD was opportunistic rather than crisis driven

The post-crisis measure that aimed to regulate hedge funds and private equity did not come as a surprise.²⁶ Hedge funds in particular had been a source of concern and regulatory focus prior to 2007. Although hedge funds were under scrutiny and valid rationales were put forward to bolster their regulatory framework, the post-crisis regulatory review was an opportunity to introduce concrete measures. Despite hedge funds not being responsible for the crisis, some of their characteristics did aggravate the systemic nature of the crisis and so their inclusion here is relevant.

Defining hedge funds is problematic as it is difficult to determine which investments fall within their remit. Due to the opaqueness of the investments usually held by hedge funds, their profiles are usually hard to define and are often described in very general terms, such as high trading volumes or extensive use of leverage. A common trait, however, is that they are usually only accessible to institutional or experienced investors.²⁷ In part due to these difficulties, the Directive takes a wide view and rather than introducing direct regulations for the funds themselves, the Directive regulates those that control them, namely, the alternative investment fund managers (AIFM) themselves.²⁸ Additionally, in order to cover all the bases, the Directive takes the all-encompassing view that all collective investment schemes that do not fall under the Undertaking for Collective Investment in Transferable Securities (UCITS)²⁹ must fall under the AIFMD.³⁰

However, there are exemptions which impose a simplified registration and reporting regime.

The conditions are mainly in relation to size and exclude fund managers who manage funds

²⁶ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, [2011] OJ L174/1 (AIFMD).

²⁷ FSA, 'Hedge Funds: A Discussion of Risk and Regulatory Engagement' (DP 05/04, June 2005) 10.

²⁸ AIFMD (n 26) recital 10.

²⁹ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2009] OJ L302/32.

³⁰ AIFMD (n 26) art 4 (1) (a).

with total assets of less than EUR 100 million or less than EUR 500 million that are not leveraged and which have no redemption rights for the first 5 years.³¹ These thresholds appear too low to have as their purpose to bring in scope only systemically relevant funds, therefore, it can be assumed that the other rationales for regulating hedge funds, such as consumer protection and supervisory oversight are the reason for them. Its geographical scope covers all EU-based AIFMs who manage alternative investment funds in the EU or not, and non-EU-based AIFMs who manage alternative investment funds in the EU or market non-EU funds in the EU.³²

B. Rationales for regulating hedge funds

There have been a number of historical concerns regarding the operation of alternative investments. Despite generally being restricted to experienced and institutional investors, indirect channelling of less experienced investor monies and their public appeal due to the potentially high returns have raised consumer protection concerns. Indeed, the risk associated with alternative investments and the high fees charged have consequently raised prudential interest.

The focus of this section will be on the systemic issues related to alternative investment rather than the generality of its rationales and consequences. Hedge funds are often linked to a variety of forms of leverage which is the first reason why they are said to have systemic relevance. Indeed, in case of failure, the exposure to the market is amplified according to the ratio of its leveraged assets. There are two ways that a heavily leveraged fund can cause systemic consequences.³³ The first is with regard to its financial counterparties, mainly banks, which provide the platform for the leverage. The leveraged amount could act as an unpaid credit line should the fund fail, thus causing losses to its counterparties. The second way is the

³¹ AIFMD (n 26) art 3.

³² *ibid* art 2.

³³ FSA, 'Assessing Possible Sources of Systemic Risk from Hedge Funds' (2011) 2. http://www.fsa.gov.uk/pubs/other/hedge_fund_report_july2011.pdf

potential for these funds to affect the market. Due to the leverage, the amounts dealt with at market level can be exponentially increased, in particular, because trading strategies are aligned and are similarly aggressive. Indeed, the use of similar risk management strategies entails similar entry and exit thresholds. This means that, in conjunction, they can affect market trends upwards or downwards.

There are also some advantages to having these financial instruments in the market. The FSA mentioned market liquidity and efficiency as being of particular benefit due to the frequency of volume used and the innovative nature of their trading strategies.³⁴ However, these advantages turned into disadvantages during the crisis as the liquidity aspect had the reverse effect and participated in shoring up liquidity; the innovative aspect was also lost due to the sensitivities surrounding securitisation.

There were pre-crisis efforts to regulate alternative investment vehicles in the EU although they generally appeared at Member State level in different forms.³⁵ The European Commission was an early supporter of a unifying process of regulatory practices, albeit for the main purpose of market efficiencies.³⁶ The European Central Bank (ECB)³⁷ responded to the Commission's Green Paper by suggesting that the most important factor why the fund industry was difficult to quantify from a systemic perspective was because of its lack of transparency.³⁷ Indeed, the secretive nature surrounding the investment strategies of hedge funds makes it difficult to create a regulatory framework which would be based on trading practices. An interpretation that was too narrow would allow for new strategies to escape the regulation and an approach that was too wide would encapsulate an array of set-ups that was too vast.

³⁴ FSA (n 27) 13.

³⁵ E Wymeersch, 'The Regulation of Private Equity, Hedge Funds and State Funds' (30 April 2010) Financial Law Institute Working Paper No 2010-06.

³⁶ Commission, 'Green Paper on the Enhancement of the EU Framework for Investment Funds' COM (2005) 314 final, para 3.

³⁷ ECB, 'Green Paper on the Enhancement of the EU Framework for Investment Funds: Eurosystem Contribution to the Commission's Public Consultation' (November 2005) 5 <<https://www.ecb.europa.eu/pub/pdf/other/euframeworkfundseurosystemen.pdf>> accessed 20 April 2014.

This partly explains the reasoning behind regulating and supervising the fund managers rather than the investment vehicles themselves. At the time, the European Parliament was more insistent that the Commission should take a closer look at the regulation of alternative investments.³⁸ In the pre-crisis era, the European Parliament was also more critical of the industry, and suggested more far-reaching regulatory measures than simply market efficiency and transparency by requesting that remuneration should be reviewed and financial stability ramifications should be considered.³⁹

The crisis confirmed these concerns only to a certain extent, and the hedge funds that failed in the initial stage of the crisis did not appear to cause any ripples.⁴⁰ This, however, did not prevent the 'regulatory pendulum'⁴¹ from incorporating the funds in its swing. Indeed, not only was the fund industry under scrutiny due to frauds such as Stanford and Madoff⁴² but there was a suggestion that they amplified some of the consequences of the crisis. As discussed above, due to leveraged positions and trading strategies, they found themselves in a position where they had to wind down their positions quickly in a fire sale manner in order to provide liquidity for investor redemptions causing pro-cyclical manifestations. In addition, hedge funds make extensive use of short selling tools and this was also quoted as being an aggravating factor of the crisis. A clear consensus was not reached on the exact role played by the fund industry in aggravating the crisis, although the general position remains that hedge funds do

³⁸ European Parliament, 'Resolution of 15 January 2004 on the Future of Hedge Funds and Derivatives' (T5-031/2004) <<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P5-TA-2004-0031+0+DOC+XML+V0//EN&language=LV>> accessed 20 April 2014.

³⁹ I van den Burg and PN Rasmussen, 'Hedge Funds and Private Equity: A Critical Analysis' (PES, March 2007).

⁴⁰ E Ferran, 'After the crisis: the regulation of hedge funds and private equity in the EU' (2011) EBOR 389.

⁴¹ H Scott, 'Reducing Systemic Risk through the Reform of Capital Regulation' in Thomas Cottier, John Jackson and Rosa Lastra (eds), *International Law in Financial Regulation and Monetary Affairs* (OUP 2012) 232.

⁴² D Brewster and J Chung, 'Hedge Funds Face Crackdown in the Wake of Madoff Affair' (*Financial Times*, 30 December 2008).

carry the potential for systemic risk.⁴³ There were several attempts by hedge fund associations to promote self-regulation in order to avoid being straightjacketed by regulation. However, those involved in taking the post-crisis era measures were reluctant to compromise and allow a light-handed approach. This resulted in hefty legislative measures, in particular in the EU.⁴⁴

C. The response of the EU

The post-crisis agenda in the EU therefore included the regulation of alternative investments. The divergence in views and reasons for regulating alternative investments meant that the only consensus was that the opportunity should be taken to introduce a framework and set an example at international level.⁴⁵ The different views and priorities led to lengthy discussions amongst the EU Institutions. The European Parliament was in favour of wide-ranging, stringent regulation and supervision for alternative investment funds that included private equity investments.⁴⁶ The Commission was concerned about competitiveness and regulatory over-reaction.⁴⁷ This eventually led the Parliament to force the Commission into introducing necessary proposals via the use of Article 225 TFEU.⁴⁸ The Council supported the European Parliament's view that regulatory measures should be extended to all actors in the finance industry that were relevant for financial stability that, so far, had not been sufficiently

⁴³ Basel Committee on Banking Supervision (BCBS), 'Review of the Differential Nature and Scope of Financial Regulation: Key Issues and Recommendations' (Joint Forum, January 2010) 9.

⁴⁴ Managed Fund Association, 'Sound Practices for Hedge Fund Managers' <<http://www.managedfunds.org/industry-resources/sound-practices-for-hedge-fund-managers/>> accessed 20 April 2014; Hedge Funds Standards Board, 'Best Practice Standards' <http://www.hfsb.org/sites/10377/files/standards_february_2012.pdf> accessed 20 April 2014.

⁴⁵ Commission, DG Market Services, 'Summary of responses to Hedge Funds Consultation Paper' (March 2009) 9.

⁴⁶ European Parliament, 'Report with recommendations to the Commission on transparency of institutional investors' (2007/2239 (INI)) (Lehne Report) <<http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A6-2008-0296&language=EN>> accessed 20 April 2014; European Parliament, 'Report with recommendations to the Commission on hedge funds and private equity' (2007/2238 (INI)) (Rasmussen Report) <<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-404.764+01+DOC+PDF+V0//EN&language=EN>> accessed 20 April 2014.

⁴⁷ Commission, 'Consultation Paper on Hedge Funds' (Working Document of the Commission Services (DG Internal Market), December 2008).

⁴⁸ Under Article 225 TFEU, the European Parliament upon a majority vote requested the Commission to 'submit any appropriate proposal on matters on which it considers that a Union act is required for the purpose of implementing the Treaties'.

regulated. It added that hedge funds and other alternative investments were to be included.⁴⁹ This view was further endorsed by the European Council, where eventually the UK also backed the view that all financial products and actors that presented systemic risk needed to be regulated irrespective of country of domicile.⁵⁰ The notion of country of domicile was particularly relevant and caused the AIFMD to establish stringent regulatory barriers by including fund managers that were not EU-based but marketed their services in the EU. Finally, in more muted tones the de Larosière report supported in its seventh recommendation the necessity to ‘improve transparency in all financial markets, and notably for systemically relevant hedge funds, by imposing in all EU Member States and internationally, registration and information requirements on hedge fund managers, concerning their strategies methods and leverage, including their worldwide activities’.⁵¹

The initial drafting by the Commission in 2009 failed to meet the objectives in a coherent manner. What followed was a series of debates and disagreements regarding scope, systemic significance and national interests which finally led to its formal adoption by the Council in May 2011.

D. The AIFMD

The result is a Directive which has a wide scope, both geographically and in terms of the type of investments it covers, and which introduces some significant features affecting the whole of the non-UCITS fund industry.

The first step for AIFMs was to become authorised under the Directive by the respective national competent authorities.⁵² From the outset, there were industry issues with the

⁴⁹ Council (ECOFIN), ‘Key Issues Paper’ (6784/2/09 REV 2, March 2009) 3.

⁵⁰ European Council, ‘Presidency Conclusions 19/20 March 2009’ (7880/1/09 REV 1) 16.

⁵¹ de Larosière report (n 6) 26.

⁵² AIFMD (n 26) art 7.

authorisation process. Notwithstanding the costs and the evaluation of funds that were to be considered in or out of its scope,⁵³ a major concern was raised with regard to licence compatibility and the range of activities that could be carried out under the Directive. Indeed, the Directive restricts a firm from undertaking activities that fall outside its immediate scope. This was problematic for firms which engaged in several lines of business, mainly asset management and fund management.⁵⁴ This meant that certain financial institutions needed to select or split their business lines between MiFID and AIFMD licenses.

The segregation of duties is a recurrent theme throughout the Directive, in particular in relation to custodianship, in order to ensure oversight and avoid conflicts of interest. Other conditions for authorisation include capital levels, own funds⁵⁵ and operating restrictions; in particular, those related to remuneration of executives and those in control functions.⁵⁶ The provisions in relation to remuneration generally follow those which were adopted in relation to other financial services, in particular, to banks. Other relevant operating requirements relate to the independent valuation process of in-scope funds. In order to achieve further transparency and investor reassurance, the Directive imposes on AIFMs the requirement to be independently valued at least on an annual basis.⁵⁷ Although such a provision is targeted at consumer protection, it does assist on a systemic level by giving supervisors independent and more concise information for the purposes of evaluation. This aspect is further reinforced by transparency and disclosure requirements.⁵⁸ Under these provisions, audited annual reports must be prepared and made available to supervisors and investors. These requirements go far in ensuring that supervisors obtain regular updates on the positions held by the fund, its liquidity and stress test results. An AIF reporting on its holdings is akin to capital requirement

⁵³ Although AIFMD covers all non-UCITS funds, those below the threshold have lighter thresholds but will generally be referred to as 'out of scope'.

⁵⁴ AIFMD (n 26) art 6 (2).

⁵⁵ *ibid* art 9.

⁵⁶ *ibid* art 13.

⁵⁷ *ibid* art 19.

⁵⁸ *ibid* art 22-24.

reporting for licensed financial institutions. Although it is not as formalised and in-depth, it does provide information that would allow for a systemic risk assessment of the industry in each Member State. The way such information can be channelled and analysed at EU level will be considered in the next chapter when discussing the new supervisory arrangements.

The Directive also introduces a large section on depositories, and regulates them accordingly should they wish to act as such for in-scope funds. Under the Directive, a depository must be engaged for each AIF where the depository has a high degree of responsibility in terms of asset safekeeping and cash flow control.⁵⁹ Two main reasons can be suggested for why depositories (essentially banks) were included in such a way. Firstly, due to the Madoff fraud⁶⁰ the notion of depository and the responsibility attached to acting in such a capacity came under scrutiny, following uncertainties about the successive UCITS Directives.⁶¹ The main concerns in this respect have been whether the duties of a depository can be delegated, and the extent of their responsibility in verifying the existence of the assets in deposit.⁶² The AIFMD resolved these two issues by limiting the tasks that can be delegated to a sub-custodian and imposing a strict liability regime on the named depository.⁶³ Secondly, banks are ideally placed as gatekeepers because not only do they have the resources to control AIFs but they also have the financial ability to compensate investors due to the strict liability regime introduced.

Although from a consumer protection perspective it is not objectionable to impose the liability on depositories for the existence of the assets,⁶⁴ should a fund fail and a depository is liable to return the assets to its investors, then this would result in an exacerbation of systemic risk.

⁵⁹ AIFMD (n 26) art 21 (1), (7) and (8).

⁶⁰ de Larosière report (n 6) para 98.

⁶¹ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2009] OJ L302/32.

⁶² R Weber and S Gruenewald, 'UCITS and the Madoff scandal: liability of depository banks?' (June 2009) BJI & FL 339.

⁶³ AIFMD (n 26) art 21 (8) and (12).

⁶⁴ The fact that there is a strict liability on depositories to ensure the existence of the assets that a fund is portrayed to hold stems from the Madoff fraud. The AIFMD aims to ensure that depositories take responsibilities for the assets they hold and take relevant steps to ensure they exist.

Indeed, it would be unreasonable to automatically assume that a depository has sufficient capital to cover the loss incurred by a failed fund. Additionally, the Directive does not make any correlation between the size of the depository and the size of the fund. With the basic capital requirement for a credit institution set at EUR 5 million, they could potentially act as a depository for funds in excess of one hundred times their capital. In such a case, the ramifications would be limited from a systemic perspective. However, such a scenario is feasible with higher amounts. To summarise, a failing fund could lead to a failing bank and the consequences that follow. Such a provision does not respect the legislative disengagement from systemic consequences that is discussed below. It would be reasonable here to expect the national competent authority for the depository to keep a close eye on the potential liabilities that could arise for credit institutions by setting the depositories capital against the size of the funds it wishes to become a depository for.

There were strong disagreements amongst the EU Institutions with regard to the limits that should be set for leveraging: the Commission wanted to be able to set general leveraging limits itself; the European Parliament wanted AIFMs to impose their own limits; and the Council was in favour of neither.⁶⁵ Eventually, the Directive went with the European Parliament's position whereby each fund manager is responsible for setting the leveraging limits of the funds it manages.⁶⁶ Ensuring that the AIFM discloses what has been set as a limit to investors would allow them to evaluate the potential risks. Supervisors could also ensure closer scrutiny of those funds which engage in higher leveraging. The fixing of a cross-industry limit could have potentially led to systemic consequences in the market should funds have had to wind down positions at the same time.

⁶⁵ European Parliament, 'Background Note on the alternative Investment Fund Managers Directive' (8 November 2010) <<http://www.europarl.europa.eu/news/en/news-room/content/20101105BKG92028/html/Background-note-on-the-alternative-investment-fund-managers-directive>> accessed 20 May 2014.

⁶⁶ AIFMD (n 26) art 15 (4).

However, supervisors can impose restrictions on the use of leverage for certain funds,⁶⁷ and in exceptional circumstances the ESMA may request the same of national competent authorities.⁶⁸ This will be an efficient tool in times of crisis where supervisory input will be available to control alternative investment fund activity from a leverage perspective, and the availability of information will give both national supervisors and EU ones⁶⁹ the ability to monitor fund activity and any systemic consequences that arise.⁷⁰ The practicality and the supervisory tools available to ensure this is done efficiently will be assessed in the following chapter.

E. The appropriateness of AIFMD

The crisis affected the alternative investment industry in two ways. The first was that, due to its opacity, the industry shrunk in its immediate aftermath as a result of market losses and diminishing investor confidence. However, the trend has since reversed and the appeal of hedge funds has returned, mainly due to efficient hedging strategies rather than return.⁷¹

The other way it affected alternative investments was by creating the opportunity to include their regulation and supervision in the post-crisis reform agenda. The question of whether hedge funds deserved to be regulated to such an extent despite a lack of evidence that they actively played a role in it is somewhat irrelevant if the following is considered. First, the hedge fund industry is a relatively small part of global financial business although it is not inconsequential, currently standing at above USD 2 trillion.⁷² This means that although it

⁶⁷ *ibid* art 24 (3).

⁶⁸ AIFMD (n 26) art 24 (5).

⁶⁹ Essentially, the ESMA and the ESRB.

⁷⁰ ESMA, 'Collection of information for the effective monitoring of systemic risk under Article 24 (5), first sub-paragraph of the AIFMD' (Opinion, ESMA/2013/1340, 1 October 2013).

⁷¹ L Fletcher and T Wilkes, 'Hedge Funds enjoy post-crisis popularity with 'safe' image' (17 September 2013) <<http://www.reuters.com/article/2013/09/17/uk-hedgefunds-performance-idUSLNE98G00620130917> accessed 10 May 2014.

⁷² KPMG, 'The evolution of an industry, 2012 KPMG/AIMA Global Hedge Fund Survey' (KPMG International) 4 <<https://www.kpmg.com/KY/en/IssuesAndInsights/ArticlesPublications/PublishingImages/the-evolution-of-an-industry.pdf>> accessed 10 May 2014.

should not be considered a prime concern, it is an area of industry worth keeping under supervision especially given the resurgence in this type of investment.

Secondly, the mere suggestion that hedge funds can exacerbate systemic risk should lead to a certain level of oversight in any case. Systemic risk is far from being an exact science and, as the crisis proved, unexpected causes and consequences are to be anticipated. Therefore, the least that can be expected from a reform agenda is for it to cover all the bases to ensure that those risks that can be mitigated are considered for regulatory and supervisory action in order to prevent their occurrence in the first place. This would be preferable to acting in a reactive manner.

Thirdly, the alternative investment industry was already under scrutiny and earmarked for regulatory action prior to the crisis. It can therefore be considered that regulatory action was already on the agenda, albeit with great disagreement as to rationale and form.⁷³ The crisis certainly created the opportunity to finalise the framework, allowing the scope of the Directive to be extended further than it would have been possible had the crisis not occurred.

For systemic purposes, the rationales that need to be focussed on are transparency and leverage limits. These could have been covered in a much simpler piece of legislation, a possibility which has led Ferran to state that, 'EU institutions could have indulged in regulatory excess'.⁷⁴ The need for supervisors to be able to understand the investment strategy of funds and their risks is a given for systemic purposes. Additionally, their ability to intervene is important should it be thought that a particular situation or strategy creates the potential for systemic risk. Such a position would tend to suggest that improved supervision rather than strict regulation is more appropriate. Additionally, due to the relative small proportion of global financial activity it represents, the length and complexity of the legislation can be seen as an overreaction.

⁷³ Commission (n 36) para 3.

⁷⁴ Ferran (n 40) 410.

The provisions regarding depositories also appear excessive and could carry negative systemic impacts as described above. The use of banks as gatekeepers of the finance sector is not new and has been seen, notably, in relation to anti-money laundering provisions. The cost of becoming a depository also stands to rise as measures to imitate fund managers and fund administrators net asset value calculation methods will have to be implemented, if they want to ensure that they are able to carry out their role in compliance with the Directive. Such provisions for depository services that cater for a more retail focussed clientele, such as instruments that fall under UCITS, makes sense, at least from an asset protection perspective. However, it should also be borne in mind that clients of funds that fall under the AIFMD will be for the most part institutional and sophisticated investors, and so some responsibility should be shifted to them.

This strict regulatory framework could, nevertheless, have some positive effects for the alternative investment industry in the EU. It could boost the appeal of hedge funds and the like due to an increase in consumer confidence related to their regulated status. Also, considering the restrictions on marketing funds in the EU, it could create an incentive for funds to relocate in order to benefit from full AIFM status.

III. The Capital Requirements Directive IV (CRD IV): A major step towards a single rulebook

A. Capital requirements and systemic risk

Capital requirements can be seen as the first line of defence when systemic risk materialises. Indeed, the ability for financial institutions to be able to bear losses is essential in order to ensure survival and limit further contamination of the system. The concerted regulation of capital requirements dates back to 1988 when the Basel Committee on Banking Supervision (BCBS) issued a set of standards that were subsequently adopted globally. The initial standards

evolved from simple forms of calculating minimum capital requirements focussing entirely on credit risk, to eventually covering market risk and operational risk.⁷⁵ The capital requirements in place prior to the crisis were insufficient and inadequately allocated. The Basel II requirements, which were destined to be able to cover all the risk categories, allowed the five largest US investment banks to achieve a leverage ratio of between 26 and 34 to 1.⁷⁶ Due to insufficient capital, two of the five failed (Lehman Brothers and Bear Stearns) and Merrill Lynch was forced to sell itself to Bank of America.

The question therefore arises as to what is a sufficient amount of capital that should be held by banks, and whether this can be addressed by regulation. The first two attempts by the BCBS were unsuccessful as they failed to prevent a large amount of institutions from failing. In fact, even prior to the crisis the majority of banks held capital in excess of their regulatory minimum in order to respond to their own economic models and market demands.⁷⁷ The risk exists that capital charges may be rendered too disproportionate under excessive post-crisis reform agendas. Indeed, the G20 summit in Pittsburgh called for capital requirements to be reviewed and increased, in particular for those systemically relevant banks, although it did not offer any particular guidance on how this should be achieved.⁷⁸ In the midst of the crisis, the BCBS started to review its current set of accords on the basis that changes must be brought about in respect of risk management procedures for securitisation positions, risk weighting of re-

⁷⁵ BCBS, 'International Convergence of Capital Measurement and Capital Standards' (July 1988) <<http://www.bis.org/publ/bcbs04a.pdf>>; and BCBS, 'International Convergence of Capital Measurement and Capital Standards' (Bank of International Settlements, June 2004) <<http://www.bis.org/publ/bcbs107.pdf>> accessed 20 May 2014.

⁷⁶ Committee on Capital Markets Regulation, 'The Global Financial Crisis: A plan for Regulatory Reform' (2009) 60 <[http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf)> accessed 20 May 2014.

⁷⁷ Scott (n 41) 232.

⁷⁸ G20 (n 10) para 13.

securitisation positions, internal governance principles and disclosure of certain instruments held on trading books.⁷⁹

At EU level, these changes were promptly adopted via the various CRDs.⁸⁰ However, these were immediate responses to the crisis. In late 2009, the BCBS announced a more drastic change to the accords that would focus more on bank capital and would become the Basel III Accords.⁸¹ The EU quickly followed suit by engaging in a consultation process that closely matched that of the BCBS.⁸² This was the groundwork for what has become the new EU capital requirements, known as the 'CRD IV' package.⁸³ The package sets out to introduce further changes to the corporate governance regimes of banks and investment firms and, in particular, remuneration policies, new rules to address the overreliance on ratings by CRAs, and to harmonise sanctioning policies to be imposed on banks and investment firms. CRD IV goes further than Basel III on several aspects. In terms of remuneration, it caps the variable element

⁷⁹ BCBS, 'Enhancements to the Basel II Framework' (July 2009) <<http://www.bis.org/publ/bcbs157.pdf>>; and BCBS, 'Revisions to the Basel II Market Risk Framework' (July 2009) <<http://www.bis.org/publ/bcbs158.pdf>> accessed 10 May 2014.

⁸⁰ 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 302/97; Commission Directive 2009/27/EC of 7 April 2009 amending certain Annexes to Directive 2006/49/EC of the European Parliament and of the Council as regards technical provisions concerning risk management OJ L 94/97; Commission Directive 2009/83/EC of 27 July 2009 amending certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council as regards technical provisions concerning risk management OJ L 196/14; Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies OJ L 329/3 (CRDs).

⁸¹ BCBS, 'Strengthening the resilience of the banking sector' (Consultative Document, December 2009) <<http://www.bis.org/publ/bcbs164.pdf>> accessed 10 May 2014. The Basel III Accords are contained in two documents: BCBS, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (December 2010) <<http://www.bis.org/publ/bcbs189.pdf>>; and BCBS, 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools' (January 2013) <<http://www.bis.org/publ/bcbs238.pdf>> accessed 20 May 2014.

⁸² Commission, 'Possible further changes to the Capital Requirements Directive' (Staff Working Document, 26 February 2010) <http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf> accessed 20 May 2014.

⁸³ 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 L176/338 and Regulation (EU) No 575/2013 of the European 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 L176/1 (CRD IV).

of an employee's remuneration at no more than 100 per cent of the fixed element. It gives further direction on board composition and its oversight duties and transparency obligations of the institution in terms of profit, tax and subsidiaries. It also gives more detail on systemic risk buffers.⁸⁴

An important legislative ramification of the CRD IV package is that, going forward, EU prudential supervision rules will be created by regulation rather than directive. The significance of this is that it points towards further uniformity across the EU and sets the stage for the implementation of the single rulebook. Regulations are directly applicable and take effect immediately in all Member States. This removes the potential for national divergences and makes the implementation more efficient and quicker.⁸⁵ This is also compatible with the recommendations made in the de Larosière report for further harmonisation of financial market supervision.⁸⁶

B. CRD IV – towards the single rulebook for financial services supervision

The first step of CRD IV which establishes it as the core document for the establishment of a single rulebook is through the definition provisions. Indeed, the Directive clearly states that the definitions mentioned in the Regulation will be applicable across the board and are included for the purpose of the single rulebook.⁸⁷ This suggests that these definitions will be applicable both at EU level and Member State level, thus rendering previous definitions redundant.⁸⁸ This situation already gives some cause for concern with regard to the boundaries of the single rulebook. Although it may be perfectly acceptable and reasonable for Member States to adopt the meanings given for capital requirements, beyond this, the extent is not

⁸⁴ Commission, 'Capital Requirements – CRD IV/CRR – Frequently asked questions' (Memo/13/690 Brussels, 16 July 2013) 4 <http://europa.eu/rapid/press-release_MEMO-13-690_en.htm?locale=en> accessed 20 April 2014.

⁸⁵ Memo 13/690 (n 84) 4.

⁸⁶ de Larosière report (n 6) recommendation 20.

⁸⁷ CRD IV (n 83) art 4.

⁸⁸ B Joosen, 'Further changes to the Capital Requirements Directive: CRD IV – major overhaul of the current European CRD legislation to adopt the Basel III Accord: Part 1' (2012) JIBLR 51.

clear. At Member State level, this could lead to issues where national implementation led to consolidations and cross-sectoral legislation. Where conflicts arise, this could lead to significant legislative work at Member State level. Indeed the necessity to either split the legislative provisions where application of the definition is not desirable or unexpected consequences in practice where uncertainty could arise. This is clearly an issue that should be foreseen when aiming to harmonise regulation to the point at which it begins to become uniform.

CRD IV brings about some substantial corporate governance measures, in particular, in relation to risk management arrangements. These are for the most part set out under the prudential supervision section⁸⁹ although other provisions also mention the need for risk management measures. Of particular relevance is the requirement for the constitution of an independent risk oversight function which should be a committee of the non-executive board.⁹⁰ The duties of the committee will consist of: acquiring the necessary knowledge, skills and expertise to understand and monitor the risk strategy of the institution; advise the non-executive board of the risk profile of the institution; assist in implementing a risk strategy; communicate regularly with the risk management function of the institution; access external expert advice when necessary; and determine the frequency of reports from senior management in relation to risk. There are also changes regarding the institutions' risk management function. Article 76 states that the function must be independent from the operational functions, and have sufficient authority, stature, resources and access to the management body. Member States are also required to ensure that the risk management function covers all risks the institution is potentially exposed to. The requirements mimic those put in place with regards to the anti-money laundering directives and the position of the Money Laundering Prevention Officer (MLRO). The position of the MLRO is regarded as an extension of the board's responsibility to

⁸⁹ CRD IV (n 83) Title VII, chapter 2.

⁹⁰ *ibid* art 76.

ensure the organisation is not used for money laundering purposes, but it is also considered an extension of the relevant authority given that the processing of suspicious activity reports is handled by this position. A similar template is used here, where the risk management function is to be undertaken in such a way that the whole organisation is risk assessed. Similarly, authority is required both in terms of stature and expertise in order to assert adequate influence where it is needed. Instilling this at institutional level should not be at the expense of any compromise as occurred in the post-crisis era; financial institutions are presumably risk assessing every decision and strategy. Here lies an important aspect for the success of the single rulebook. Regulatory incentives must exist for institutions to comply for their own interests and this will result in greater financial stability. Indeed, it is thought that regulations need to be designed in a way that they do not create any incentives for financial institutions to avoid them.⁹¹ This is also an important safeguard against regulations not being able to keep up with financial innovations, amplified by the fact that financial institutions have the ability to undermine regulators when putting their interests forward.⁹² Therefore, it is an important feature of regulatory design that regulatory incentives are created in the interest of financial stability and, in particular, with regard to risk management.⁹³ Following the losses incurred by financial institutions and in many cases reputational damage, incorporating a well thought out risk mitigating system will create incentives for financial institutions to allow their risk management departments to grow organically. This will result in greater financial stability. Adopting such a way of thinking in the writing of the rulebook will be a determinant of its success in the long term.

⁹¹ M Brunnermeier, A Crockett, C Goodhart, AD Persaud and H Shin, 'The fundamental principles of financial regulation' (Geneva Reports on the World Economy 11, ICMB Geneva 2009) 33 <<http://www.princeton.edu/~hsshin/www/Geneva.pdf>> accessed 20 May 2014.

⁹² C Goodhart, 'Is a less pro-cyclical financial system an achievable goal?' (Financial Markets Group, LSE, 2010) 23 <http://www.bcra.gov.ar/pdfs/eventos/goodhart_panel3_31_08_09.pdf> accessed 10 May 2014.

⁹³ C Borio, 'Implementing the macroprudential approach to financial regulation and supervision' (Financial Stability Review No 13, the Future of Financial Regulation, Banque de France, Paris, 2009) <http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etu_de04_rsf_0909.pdf> accessed 14 May 2014.

The Directive also intervenes in other governance areas, in particular, in relation to the management body. In order to achieve the effective management of an institution, firms must ensure that the management body has overall responsibility for the institution including its strategic objectives, risk strategy and internal governance. It should also be responsible for overseeing senior management and its Chair should be independent from the Chief Executive Officer position.⁹⁴ The competence of the members of management is also enhanced in that they must meet competence and reputational criteria and be dedicated to their role. To this effect, the Directive limits the number of directorships that may be held by managers of significant institutions.⁹⁵

In terms of the rules that allow institutions to calculate their own funds requirements, provisions have been put in place that are not found in the Basel III Accords. These pertain to the holding of debt instruments from a credit risk perspective but also a market risk one. The Directive requires that institutions, irrespective of the approach they take under the Directive, develop internal ratings-based approaches for calculating own funds requirements where their exposures are material or have a number of counterparties and where there are specific debt instrument risks.⁹⁶ The significance of this will be addressed in more detail in the next section. The rationale for it, however, relates to breaking the uniformity and therefore the cyclicity of internal rating processes.

As noted above, the excessive use of leverage was a particular cause for concern in the aftermath of the crisis, especially considering the failings of certain highly leveraged investment banks. The Directive therefore provides for excessive leverage and states that financial institutions must have policies and procedures in place that enable them to identify, manage and monitor the risk of excess leverage.⁹⁷ The objective of these provisions is that

⁹⁴ CRD IV (n 83) art 88.

⁹⁵ CRD IV (n 83) art 91.

⁹⁶ *ibid* art 78.

⁹⁷ *ibid* art 87.

institutions must be able to withstand stress events in terms of excessive leverage. In this respect, the issue has been raised that the definition of excessive leverage has not been clearly explained.⁹⁸ The Directive defines it as meaning ‘the risk resulting from an institutions’ vulnerability due to leverage or contingent leverage that may require unintended corrective measures to its business plan, including distressed selling of assets which might result in losses or in valuation adjustments to its remaining assets’.⁹⁹ Although the limits are set by the Regulation,¹⁰⁰ the consequences of the leverage are not ascertained once corrective measures have been implemented. Presumably, this is a matter for the relevant supervisory authority to reflect and implement measures. However, unlike most of the provisions, the European Banking Authority (EBA) has not been given the role of providing further guidance on the issue. The scope of the EBA’s authority will be dealt with in greater detail in Chapter V. However, considering the leading role given to the EBA regarding the compilation of the single rulebook, it would stand to reason that it has the freedom to offer guidance on all of its aspects.

Nevertheless, the EBA will play an important role in determining those financial institutions which are to be considered systemically important.¹⁰¹ To do this, the EBA will put in place, for the benefit of the national competent authorities, the criteria that should be used to determine and assess systemic risk situations and develop a stress testing regime. This is an important task as it will assist national competent authorities not only in determining which institutions need to be monitored more closely but also in measuring the action to be taken depending on the circumstances. Indeed, the Directive gives a certain amount of flexibility regarding the review of the capital requirements of systemically relevant institutions. It is important to note that the Supervisory Review and Evaluation Process (SREP)¹⁰² will remain

⁹⁸ Joosen (n 88) 56.

⁹⁹ CRD IV (n 83) art 3.

¹⁰⁰ CRR (n 83) art. 429.

¹⁰¹ CRD IV (n 83) art 97 (5).

¹⁰² The SREP is the supervisor’s assessment of the Internal Capital Adequacy Assessment Process ICAAP which each firm has to undertake. The ICAAP was introduced by Basel II in order for firms to take a wider view on the risks to which they are exposed.

with the national competent authorities.¹⁰³ Therefore, the guidance they receive from the EBA will be key to establishing the firms under their supervision which are systemically relevant. As such, the selection of systemically relevant firms remains influenced by the national supervisors and, in cases where such firms are deemed to have insufficient capital, then the additional capital charges are also left to their discretion. These provisions are bolstered by the requirement of implementing a framework of supervisory examination where priorities must be given to those firms which present a systemic relevance according to the SREP process, but also firms who appear careless by functioning in a way that their financial soundness is under threat.¹⁰⁴ National competent authorities must also be mindful of the impact of the decisions they take on cross-border activity and how it may affect another Member State.¹⁰⁵ These provisions clearly point towards a prioritisation at national level to consider systemic risk and apply their resources accordingly to those firms that are systemically relevant. Depending on the supervisory structure of Member States, this could have an impact on their functioning insofar as priorities may have to be reset for the benefit of the Union's financial stability.

C. A new direction for capital requirements

On the basis of the Basel III Accords, CRD IV brings about a significant change in the way regulation targets financial stability. Indeed, prior to the crisis, there was a discrepancy with the capital requirements where, although it was recognised that the stability of the whole system was the objective, it was primarily undertaken in a micro-prudential way.¹⁰⁶ The focus on individual institutions rather than their interconnectedness and their overall propensity to generate systemic risk was not conducive to system stability. There was also a lack of safety mechanisms that could be triggered in times of crisis. Instead, the liberal attitude prior to the crisis only led to aggravated circumstances, where governments bailed out institutions in an

¹⁰³ CRD IV (n 83) art 97.

¹⁰⁴ *ibid* art 99.

¹⁰⁵ CRD IV (n 83) 98 (2).

¹⁰⁶ S Schwerter, 'Basel III's ability to mitigate systemic risk' (2011) *JFR & C* 340.

erratic and inefficient way. In the same way as the previous capital requirements were drafted with a focus on micro-prudential supervision, so too were the bail-out proceedings, where firms were dealt with in an individual and inconsistent way.

The capital requirements stance needed to be adjusted, chiefly via the adoption of a macro-prudential focus.¹⁰⁷ Such a focus allows a better understanding of the interconnectedness of institutions and therefore the chances for systemic risk to materialise. In turn, this enables supervisors to intervene in a more efficient way and for the purpose of financial stability generally, rather than specifically for individual institutions.¹⁰⁸ CRD IV puts in place a system of prioritisation of systemically relevant information that is handled at Member State level and then escalated to EU level via a new supervisory structure. How the information is handled at supervisory level will determine the efficiency of the system. This will be assisted by adopting a uniform set of rules which are applied across the Union in the same way, through the introduction of the single rulebook, of which the CRD IV package is the basis on which it will be established.

Fundamentally, the inertia of the previous capital requirements also needed to be dealt with. For this purpose, CRD IV introduced countercyclical capital¹⁰⁹ and conservation buffers¹¹⁰ (CCB). The purpose of CCBs is to increase the resilience of the banking system during financial crises by ensuring that banks set aside capital in times of growth which can be used in times of hardship. There remains some debate on which indicators should be used to determine the

¹⁰⁷ A Persaud, 'Macro-prudential regulation: fixing fundamental market (and regulatory) failures' (Crisis Response Note No 6(6), World Bank Group, Washington DC, 2009) <<http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/Note6.pdf>> accessed 14 May 2014.

¹⁰⁸ JC Rochet, *Why Are There So Many Banking Crises? The Politics and Policy of Banking Regulation* (Princeton University Press 2008).

¹⁰⁹ CRD IV (n 83) art 130.

¹¹⁰ *ibid* 129.

periods where capital should be saved and where capital can be used.¹¹¹ The availability for supervisors to be able to implement CCBs represents their greatest tangible tool to mitigate systemic risk. Indeed, short of removing the authorisation to operate, the application of additional capital is a way of securing and isolating a problem early on in the process and avoiding contagion and moral hazard.

IV. Credit Rating Agencies and their pro-cyclicality

Following their suggested and well-publicised involvement in the sub-prime mortgage market collapse in 2007, the role of CRAs and their responsibility towards financial markets has reignited interest. Positioning CRAs within the financial system in terms of their accountability is likely to be difficult. The bad press they have received with regard to their involvement in the subprime mortgage debacle may at times have been exaggerated and may have led to misunderstanding in terms of the fundamental nature of CRAs. In essence, their role is to report facts in a manner which is understandable, as to the creditworthiness of the issuer of a given security, following a methodology which establishes a factual opinion. This position should in theory shield CRAs from criticism, as the rating they issue as a consequence of their collection of facts is purely objective insofar as their methodology is consistent. This theory, however, is flawed on several levels. From a structure perspective, CRAs are privately-run companies and are not immune to competition and income concerns. As will be shown, this may entail conflicts of interest under the 'issuer pays' model. Externally, credit ratings issued by CRAs are used by regulators in their assessments of financial institutions and via legislative provisions. Through this practice, CRAs are indirectly enrolled in the regulatory process and this causes further concerns of reliance on their issued ratings. A degree of responsibility has

¹¹¹ M Behn and others, 'Setting Countercyclical Capital Buffers Based on Early Warning Models. Would it work?' (European Central Bank, Working Paper Series No 1604, November 2013) <<http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1604.pdf>> accessed 14 May 2014.

therefore been placed upon CRAs, and such responsibility is the suggested reason for their role in the crisis. The justification of their responsibility and the ensuing systemic consequences of credit ratings are of particular interest to this thesis.

The definition offered by the International Organization of Securities Commissions (IOSCO) captures perfectly the role and importance played by CRAs in the modern financial system:

CRAs issue opinions on the future creditworthiness of a particular company, security or obligation as of a given date. These opinions tend to be relied upon by investors, lenders, and others, and, accordingly, CRAs can have an effect on securities markets in a variety of ways. Credit ratings can affect issuers' access to capital, influence the structure of financial transactions, and determine the types of investments fiduciaries and others can make. Some regulators use the ratings issued by CRAs for various regulatory purposes.¹¹²

Importantly, CRAs do not stand as mere providers of information but have a truly powerful influence on the behaviour of market participants and the markets themselves. The systemic relevance of credit ratings stems from their usage and reliance within the economic cycle. The regulatory response will therefore need to be proportional to the extent of credit ratings' pro-cyclicality.

Due to their suggested involvement in aggravating the financial crisis, the regulation of CRAs has been the focus of recent global initiatives. At an international level, the IOSCO has led the way with a revision of its Code of Conduct whilst encouraging harmonisation of the rules. The EU and the US have followed suit with a notable change of stance over the past decade. The changes at EU level are particularly pertinent for the purpose of this thesis, with institutional changes and a repositioning regarding harmonisation of rules following the seminal de Larosière report.

¹¹² International Organization of Securities Commission (IOSCO), 'Statement of Principles regarding the activities of Credit Rating Agencies (Technical Committee, 25 September 2003) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf>> accessed 1 May 2014.

A. How CRAs fit within financial markets

1. The role played by CRAs

Despite the reliance investors usually have on CRAs, their role is generally limited to assessing credit risk through the evaluation of debt and debt-related securities issued by both private and public entities. As described by Schwarz, the interpretation of an evaluation issued by a CRA must only be read in the context of the debt security, as opposed to equity securities which do not have contractually specified parameters, such as maturity or fixed principal amounts.¹¹³ A CRA will issue a public evaluation of the debt and the projected capability of its issuer to honour the principal at maturity. The rating is therefore more focussed on the debt security itself rather than the issuer, and this can cause confusion in the market.¹¹⁴ This does not exclude the fact that CRAs also rate companies and sovereigns. In relation to the rating, it is generally expected that the CRA will differentiate between whether the debt security is of investment grade or not. The term 'investment grade' is a notion of safety related to the security, and therefore broadly indicates the chances of the security maturing or defaulting. If a security is of investment grade, this indicates that the quality will be high enough to expect return at maturity; when a security is classified below investment grade, then it will be considered a speculative investment. Agencies, however, use a more detailed approach to rating debt securities.

The processes of evaluation undertaken by CRAs are similar to each other. They are based on information which is available both publicly and privately in order to reach an assessment on the quality of a given debt. Importantly, the issuer requests the evaluation and has the flexibility to choose the CRA which, as will be seen, can cause a number of challenges. The CRA will then score the security which is to be made public, usually using a letter system, such as

¹¹³ SL Schwarz, 'Private Ordering of Public Markets: The Rating Agency Paradox' [2002] University of Illinois Law Review.

¹¹⁴ *ibid*

AAA to B, to determine whether the security is of investment grade or not. This score carries considerable value as it will be a determining factor in the cost of the security and its success in the market. Indeed, the rating aims to enable potential purchasers to evaluate the quality of the security at a glance, and therefore construct their risk portfolios accordingly. For example, certain investment funds or institutions will only want to hold debt securities of the highest quality. This will be particularly relevant for investment strategies that seek safety in an investment rather than ultimate return. CRAs therefore also help in reducing the principal-agent problem, whereby the agent is bound by the investors' requirement for long-term safety.¹¹⁵ In fact, the availability of ratings facilitates the understanding between investors and intermediaries on what their requirements are in terms of safety. The alternative to such a codified dialogue would certainly involve complexities which would make it difficult for instruments, such as pension funds, to operate in an efficient way. Essentially, ratings offer ease of dialogue between market participants in a clear and concise way.

From a commercial perspective, issuers will find it very desirable to attract institutional business, such as pension funds, as the volumes tend to be high. Issuers will aim to align their products with the requirements of the potential client base that offers them the volume they seek.¹¹⁶ The fear here is that the commercial objectives outweigh and overshadow the true nature of a debt product. The overall rating process of securitised debt products related to US mortgages in the early part of the 2000s is a case in point. This revealed the commercially-driven practices of all parties involved in the rating of these products. Introducing ratings which are heavily skewed by commercial practices leads to a distortion in the nature of the codified dialogue that ratings aim to achieve in a principal-agent relationship.

Entering the select club of highly-rated debt securities also means that the issuer will be able to dictate the price due to its high demand and to the detriment of the investors' ability to

¹¹⁵ Bank of England (BoE), 'Financial Stability Report' (Issue no 22, October 2007).

¹¹⁶ T Hurst, 'The role of credit rating agencies in the current worldwide financial crisis' (2009) 30 *Company Lawyer* 2, 61.

negotiate.¹¹⁷ Although the price varies according to demand just like any other commodity, it remains inelastic due to the scarcity and consistent demand of highly-rated debt securities. The criticism that CRAs have come under since the subprime mortgage incident has naturally led them to exercise caution in their assessments; consequently, this has led to a reduction in the amount of highly-rated issues.

Beyond the marketability of the security, the issue will have cost implications depending on the quality of its rating, chiefly in relation to the cost of its access to capital. Indeed, with a high rating the market will recognise the issuer as a safe borrower who will therefore require lower interest rates, congruent with the lowering of the capital at risk. Conversely, the cost of raising capital will be much higher should the rating not reflect stability and certainty of repayment.¹¹⁸ The issuer will also be able to save on the issue itself if the rating is positive. The low yield of an asset-backed security should translate in the market into safety and low risk. The reliance on two elements, risk and yield, is such that investment decisions will be made on the sole basis of these, confirming the influence ratings have on capital markets.¹¹⁹

2. The difference between rating bonds and securitised debt

A crucial turning point for the use of credit ratings occurred when companies began financing themselves rather than going directly to the market. By using their own assets as collateral for sourcing liquidity, a critical change occurred in the way 'creditworthiness' could be contemplated. Rather than issuing debt in the traditional sense, for example, via the issue of bonds, a new breed of debt instruments, such as collateralised debt obligations (CDOs) and

¹¹⁷ Committee of European Securities Regulators (CESR), 'The role of credit rating agencies in structured finance' (Consultation Paper, February 2008).

¹¹⁸ Hurst (n 116).

¹¹⁹ Schwarz (n 113).

asset-backed securities (ABSs), were used.¹²⁰ The complexity of these instruments, as was illustrated in the first chapter, actually meant that the role of CRAs became more relevant in order to compensate for the ensuing information asymmetry. The issue of debt in the form of a security can be seen as a commodity like many others; it aims to attract customers in line with the product offered and its attributes. For all types of potential customers, whether institutional, professional or retail, it is unreasonable to expect them to be able to independently evaluate the attributes of a complex debt product. Particularly in relation to securitisation, it becomes very difficult to evaluate the risk levels of a given issue due to the salient lack of transparency typical of them.¹²¹ This is where CRAs intervene by bringing a balance to the information asymmetry inherent in such complex products. The IOSCO has considered these asymmetries and concluded that the role of CRAs is, in essence, to enable investors to evaluate and understand the risks involved in order to determine whether a given asset-backed security is in line with their investment objectives.¹²² The ratings offered by the largest CRAs have been consistently accepted, thus enabling investors to evaluate an issue against their risk appetite. Due to the complexity and lack of transparency of the instruments in question, issuers are keen to obtain a high credit rating for them as it is likely that investors will be limited to relying upon the rating as the sole source of information in the decision-making process on whether to invest or not.¹²³

Up until the crisis, CRAs were encouraged to rate these securitised debt instruments highly as it appeared to benefit all parties involved. Indeed, CRAs found themselves in the middle of what can be referred to as a two-sided market, where they acted to the perceived advantage

¹²⁰ Securities and Exchange Commission (SEC), 'Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies' (Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis, July 2008) 2.

¹²¹ J Coffee, 'The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets' (Testimony Before the Senate Banking Committee, 26 September 2007) 12.

¹²² IOSCO (n 11212).

¹²³ LR Lupica, 'Credit rating agencies, structured securities and the way out of the abyss' (2009) 28 Rev Banking and Fin L 639, 640.

of both the issuers and the investors.¹²⁴ Rochet and Tirole define a market as being two-sided when:

[T]he platform can affect the volume of transactions by charging more to one side of the market and reducing the price paid by the other side by an equal amount; in other words, the price structure matters, and the platform must design it so as to bring both sides on board.

CRA took on the role of platform in this model and acted as facilitators between investors and issuers; in the process, they benefited disproportionately. Indeed, due to the complexity and lack of transparency of these instruments, the issuers needed to persuade investors to acquire their products. To do so, they depended on CRA to provide an attractive rating in order to facilitate the investors' decision. In these terms, issuers were wholly dependent on the ratings they were given in order to be successful in the market. This dependence was not desirable as, in this case, CRA acted as an assurance of the quality of the underlying instruments. On the other hand, investors were keen to indulge in these products, as the rating/return ratio was far higher than other less complex instruments.¹²⁵

The poor branding of structured debt products and their untimely downgrading are two of the main reasons for the regulatory concern of CRA. Had they differentiated traditional debt products from the structured ones in any relevant way, then it is not unlikely that the attitude to CRA today would be very different. This differentiation is now recognised as crucial because the approximation of traditional debt products and structured ones under a single rating system is misleading and fundamentally flawed.¹²⁶ Indeed, there are two critical differences between these types of securities that CRA should have taken into account. The first are the yields these products offer. It is widely acknowledged that there is a correlation

¹²⁴ JC Rochet and J Tirole, 'Two-Sided Markets: an Overview' (12 March 2004). Available at https://frbatlanta.org/filelegacydocs/ep_rochetover.pdf accessed on 22nd June 2012

¹²⁵ FSA, 'The Turner Review: A regulatory response to the global banking crisis' (March 2009).

¹²⁶ *ibid*

between yield and risk. Where risk is related to the quality of a product, the higher the yield, then the lower the quality of a given investment.¹²⁷ Therefore, under the same rating system, it appears inconsistent that two investments with the same ratings would diverge to a large extent on the yield return.¹²⁸ As seen in the first chapter, this inconsistency misleads investors, and not only the less educated ones. The second difference relates to the underlying pool of assets upon which the debt security is issued. With a traditional debt security, the underlying pool is relatively straightforward as it relates to the assets of the company or the government on which it is based; these are perceivable and tangible assets. With secured debt securities, there is greater opaqueness in the underlying pool of assets.¹²⁹ As was established earlier, the identification of the underlying assets was close to impossible following a serial repackaging process and multiple layers of securitisation. With flexible branding of the underlying assets by intermediaries, CRAs should have been more alert to the fact that they were rating securities with unverified assets. This in itself should have caused CRAs to disclose that assets were taken at face value and not verified.

The reasons behind this misbranding are primarily commercial.¹³⁰ The pressures on financial institutions to sell these products (and consequently due to their opacity) meant that issuers were interested in finding the easiest way to inform investors of their quality. In this particular instance, CRAs did not assist in balancing the information asymmetry issue but, rather, they encouraged a greater gap. Investors did not need to change their habits in considering the purchase of securities because they were able to refer to a system that they were familiar with. A question remains over the extent to which investors were aware of the discrepancy between rating and yield, and whether this affected their decision-making process. The first step towards remedial action has been to suggest differentiating the symbols of traditional

¹²⁷ F Modigliani and MH Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (June 1958) 48(3) *The American Economic Review*.

¹²⁸ de Larosière report (n 6).

¹²⁹ de Larosière report (n 6).

¹³⁰ JP Hunt, 'Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement' [2009] *Columbia Business Law Review* 109.

debt securities and structured ones.¹³¹ The proposals have amounted to maintaining the current system with an annotation to act as a warning signal for investors. This appears to be an intermediate solution as it maintains, to a certain extent, that there are similarities between the two products without fundamentally changing how CRAs approach structured products. The warning signal will hopefully encourage investors and regulators to look further into the rated securities. However, it is questionable whether this will assist them in making a more informed investment decision. This leads on to the argument that a more relevant rating system would be required in this sense, either by giving the structured product a realistic rating that compares to traditional bonds so that investors can truly understand the discrepancy, or devising an entirely new rating system that could elucidate the risks for structured products.

More importantly, the relationship between CRAs and issuers needs to be reviewed in this respect, and the resulting conflicts of interest that emerge. Where the rating for traditional debt securities is relatively straightforward and only requires CRAs to act in their credit rating function, structured products have required the involvement of CRAs in the product assembly.¹³² In this role, CRAs advise issuers on how best to construct their security to achieve the desired rating. This aspect of the relationship is perverse as it assists the issuer in manipulating what should otherwise be an objective assessment. Not only does it cause further imbalance in terms of information asymmetry but it also suggests a certain amount of hypocrisy in the way that CRAs protect their methodology. On the one hand, they allow a certain insight to issuers into their methodology to enable the achievement of a rating; on the other hand, they have rigorously defended any form of regulatory involvement in the construction of their ratings. The aspects of regulating methodologies will be considered

¹³¹ FSA (n 125); de Larosière report (n 6); IOSCO (n 11212).

¹³² S Utzig, 'The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective' (ADBI Working Paper no 188, 2010).

further; however, the commercial aspects of issuing ratings must be kept in mind alongside the overall business model of CRAs.

3. The use of ratings and behavioural finance

The role played by CRAs in the investment decision process can be considered both practical and psychological. There are several ways that investors may wish to approach their decision-making process. They may wish to evaluate the risk/return of a given security themselves or call upon a third party to provide them with a concise evaluation. The complexity and amount of information available to investors is often overwhelming. Therefore, if they are not able to rely on synthesised and understandable information, they are likely to be deterred from investing in those that are less transparent.¹³³ The psychological element of the investment decision-making process carries importance, and simplifies the understanding of investor behaviour.

Behavioural finance offers two main investor characteristics which are of relevance here. The first is that investors are positive thinkers. They are constantly conscious of the best-case scenario outcome of their investment decisions and remain overconfident throughout the lifetime of the investment.¹³⁴ The second characteristic, which stems from the first, is that investors are selective about the information they acquire and wish to use for their investment decision. In fact, it is suggested that investors mainly tend to rely on information that confirms their initial belief, therefore adding little value to the decision itself and reinforcing the overconfidence element.¹³⁵ This could help to explain why in the good times there is less pressure to question positive thinking, and in the bad times why there is a surge of corrective measures. In terms of structured debt instruments, the high ratings applied to them by CRAs

¹³³ JT Prince, 'A General Review of CDO Valuation Methods' (2006) 12(2) *Journal of Structured Finance* 14.

¹³⁴ M Rabin and J Shrag, 'First Impressions Matter: a Model of Confirmatory Bias' (1999) 114(1) *Quarterly Journal of Economics* 37.

¹³⁵ CA Sims, 'Implications of rational inattention' (2003) 50(3) *Journal of Monetary Economics* 665.

confirmed the positive thinking that caused their promotion and the belief that highly-rated structured debt instruments could also offer high yields. Once the collapse of these instruments occurred, however, it suddenly became obvious that their rating did not reflect the reality of their quality. In addition to this, CRAs had strong track records and solid reputations in their rating of bonds. Therefore, rather than go through the costly and time-consuming process of evaluating these securitised debt instruments, it made sense to rely on CRAs via the ratings they issued on any given instrument.¹³⁶ Although perfectly logical at the time, their high rating did conflict with two basic investment principles. Firstly, the yield of a security is intrinsically linked to its risk of default. Therefore, investors should have been alert to the fact that although two securities may carry the same rating, their difference in yield is an indicator that they do not present the same risk profile. Secondly, the investment decision must be made by the investor in light of the risk, return and volatility they wish to achieve in the performance of the portfolios they are managing. Indeed, ratings issued by CRAs should not be relied upon as sole evidence of the suitability of an investment, but rather as an 'anchor' which supports additional information gathered.¹³⁷ More than the credit rating itself, the over-reliance on these ratings is important in considering the role played by CRAs prior to and during the crisis. To further rationalise this over-reliance on ratings, during the initial period (1997 onwards) the ratings were accurate in that very few defaulted, thereby comforting the investor with the idea that he need look no further than the rating given. Evidence tends to point to the fact that the higher the credit rating, the less information the investor requires, provided that the security is performing well.¹³⁸ Ratings were therefore used by investors beyond their scope, and resulted in an over-reliance on them with which they felt comfortable in their decision-making process.

¹³⁶ F. Partnoy, 'Rethinking regulation of credit-rating agencies: an institutional investor perspective' (2010) J.I.B.L.R. 188

¹³⁷ RJ Rosen, 'Investor behaviour in the period before the 2007-2008 financial crisis' in JR LaBrosse, R Olivares-Caminal and D Dingh (eds), *Managing Risk in the Financial System* (Edward Elgar 2011).

¹³⁸ Rosen (n 137).

4. The pragmatic approach and pro-cyclicality

Regulatory reports even suggest that investors sought out structured instruments based on their credit rating alone.¹³⁹ Notwithstanding regulatory pressures to hold a certain quality of security as capital, investment firms in their increasingly complex calculation of credit risk used the ratings as a determining factor irrespective of other important elements.¹⁴⁰ Their calculations, however, were flawed in that the securitised debt instruments were far more likely to be downgraded sooner than the traditional debt instruments, such as sovereign bonds. This was mainly due to the greater proportion of credit assets that were held by investors and the lack of historical data on these new varieties of structured credit.¹⁴¹ Here lies a key distinction between the evaluation of traditional debt securities and the structured ones: the latter are pro-cyclical whereas the former are far less so.¹⁴² There are several reasons why structured debt securities are far more predisposed to the financial cycle. The most important of these is the cocktail of assets and debt that constitute these instruments which render them prone to unidentifiable exposures. Unlike a corporate bond, for example, where the underlying asset is transparent and, in terms of identification, fairly straightforward, structured instruments are complex and opaque.¹⁴³ In the case of the corporate bond, there is a multitude of information publicly available on the company, in particular, if it is listed. On the other hand, in the case of structured instruments, the underlying parties involved are numerous and present at several layers within the structure. Discovering the nature of the underlying asset or liability is costly and time-consuming at best, and potentially impossible without being privy to information not available publicly. In the good times, it was seen as an advantage to have risk diversified as the default of one element would not jeopardise the

¹³⁹ FSA (n 125).

¹⁴⁰ SEC (n 120).

¹⁴¹ FSA (n 125).

¹⁴² R Cantor and C Mann, 'Are Corporate Bond Ratings Procyclical? An Update' (Moody's Investor Services, Moody's Global Credit Policy, Special Comment, May 2009).

¹⁴³ JD Amato and CH Furfine, 'Are credit ratings procyclical?' (2004) 28(11) *Journal of Banking and Finance* 2641.

integrity of the entire instrument. However, when faced with a global meltdown, the fact that many elements were linked enabled and facilitated the spread of defaults in a chain-like reaction. Unlike banks, which are more prone to connection via their liquidity positions, these instruments are more exposed to market trends as the asset value determines the credit rating which in turn engenders a variety of potential consequences.

In addition, Lord Turner also illustrates how the securitisation phenomenon encouraged pro-cyclicality contractually.¹⁴⁴ As with the idea of diversifying risk, the intention to protect the investor by installing rating-based triggers was seen as an innovative characteristic of structured debt instruments which mitigated their opacity. CRAs offered high ratings based on the idea that, should the underlying asset value fall below a certain threshold, then the investment vehicle backing the instrument would be wound up in order to safeguard a substantial amount of the investments sourced. In a similar way, CRAs exchanged high ratings for guarantees of liquidity against the collateral offered on derivative contracts. Should the subject of the collateral itself be downgraded, then it would be required to increase its value limit accordingly. In isolation, these protective measures may have proven effective; in combination, however, during the downturn, they participated in aggravating the downward cycle and shoring up liquidity. In the first case, the rating-based trigger would initiate the simultaneous liquidation of assets of a multitude of investment vehicles, assisting the market in its downward trend. In the second case, where the terms meant that a rating downgrade of the principal would cause liquid assets to be increased against the derived asset, this caused banks to provide their now limited amount of liquidity to these assets rather than allocate them more efficiently.

Under certain specific circumstances, therefore, CRAs present pro-cyclical characteristics which carry considerable consequences. The reliance on ratings for traditional debt securities is far less troublesome than for more complex ones where, in the recent crisis, not only did they

¹⁴⁴ FSA (n 125).

participate in the cycle but they also intensified it. As Lord Turner points out, the interconnectedness, in particular that generated at a private contractual level, is difficult to identify and therefore carries unquantifiable consequences. This makes the rating disengagement at the legislative level very different to the one at a private level. From a legislative perspective, identification is easy. It is the process of removing reliance that is more complex. At a private level, the identification is problematic and the removal easy; this will require strategic regulatory oversight where regulators could monitor the interconnectedness via rating maps, thus isolating the systemic triggers.¹⁴⁵

5. The reliance on credit ratings by regulators

Although reference was made to the credit rating benchmark in the US by courts and regulators in the 1920s, it was only in the aftermath of the Great Depression that reference was expressly made in financial regulation.¹⁴⁶ Up until that point, the use of credit ratings had been a purely private affair, where CRAs collected information on behalf of institutional investors and trustees who could not readily obtain sufficient information.

The recognition of the weakness of regulations set against the complexities of global finance today means that the role undertaken by CRAs has been valued by domestic regulators. However, this is not necessarily due to the quality of the information contained in their assessment, nor any particular historical performance in relation to prudential measures. The usage of ratings is related to the fact that they can easily be used as a global standard for investment evaluation.¹⁴⁷ There is evidence of usage of these ratings within legislation and regulatory requirements. McVea suggests that CRAs are enrolled in the regulatory process and

¹⁴⁵ ANR Sy, 'The Systemic Regulation of Credit Rating Agencies and Rated Markets' (IMF Working Paper No 09/129, June 2009) 3.

¹⁴⁶ RR West, 'Bond ratings, bond yields and financial regulation: some findings' (1973) 16 *JL & Econ* 159.

¹⁴⁷ F Partnoy, 'The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies' (1999) 77 *Washington University Law Quarterly* 619.

become *de facto* 'surrogate regulators'.¹⁴⁸ Indeed, regulators use the informational value of ratings to establish the risk profiles of the firms they regulate, notably in relation to capital requirements. This has been put on a statutory footing following the adoption of BASEL II in the EU in the form of the CRD.¹⁴⁹ Since the use of credit ratings is both pragmatic and accepted by industry as an evaluation standard and this has led regulators to feel comfortable in extensively relying on them for their prudential tasks. However, the evaluation of structured debt instruments in the build-up to the crisis has now led regulators and legislators to question the role CRAs play in a prudential strategy.

The CRD entitles credit institutions under the standardised approach¹⁵⁰ to use assessments made by CRAs in the risk weighting of their capital requirements for solvency purposes. For regulators, capital requirements are of the utmost importance as they are in place to protect creditors and depositors in the event of failure, and they offer stability to the financial system. Adequate capital levels may also play the role of preventing the failure of credit institutions as they can act as a cushion against shocks. Miller and others suggest six reasons in favour of adequate capital to be held by banks.¹⁵¹ The first is that it lowers the risk of bank failures. Unlike other industries, the fact that banks hold capital in sufficient amounts is crucial to their survival, particularly in times of crisis. Banks are different as their capital not only determines their ability to satisfy liabilities but also sets the boundaries of the amount of business they can actually pursue. This represents the capital necessary to sustain operating losses while still being able to honour withdrawals; under the Basel II Accords the minimum capital ratio¹⁵² was set at 8%. This is why it is important to set the capital requirements not only against the liabilities but also against the overall risk appetite of the institution. This notion has become

¹⁴⁸ H McVea, 'Credit rating agencies, the subprime mortgage debacle and global governance: the EU strikes back' (2010) 59(3) *International and Comparative Law Quarterly* 701.

¹⁴⁹ Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions OJ L 177/201 (CRD).

¹⁵⁰ CRD (n 149).

¹⁵¹ G Miller, R Carnell and J Macey, *Banking Law and Regulation* (4th edn, Aspen Law and Business 2003).

¹⁵² The capital ratio is the percentage of a bank's capital to its risk-weighted assets.

particularly fashionable in the light of the crisis, and has even led to the suggestion that banks should be split according to their appetite for financial and business risk, with different capital ratios being applied accordingly. The second reason is that it limits the potential for moral hazard as the capital will actually belong to the institution and is not provided for by external sources such as a central bank or a deposit guarantee scheme. Therefore, the initial safety net should be in the form of sufficient capital rather than external intervention. The third reason is that by acting as a buffer prior to the intervention of other safety-net schemes, the said schemes can be better organised and activated to a lesser extent. The fourth reason is that it reduces the misallocation of credit caused by the safety-net subsidy. The fifth reason is that it reduces the risk of 'credit crunches' due to the availability of spare liquidity. Finally, it increases competitiveness within the industry. This last reason will need to be considered with caution as it has become the target of regulators seeking to curtail the competitiveness of banks engaged in high-risk activities through the use of capital requirements.¹⁵³ However, when establishing regulations to achieve this, the legislator needs to be mindful of how to approach the normative element of evaluating the safety of bank capital and whether the inclusion of credit ratings by CRAs as a benchmark is desirable. Therefore, the qualitative nature of capital held by financial institutions is crucial, and the assessment has been facilitated by the use of ratings as a standard. The outsourcing of the regulatory task of indirectly evaluating the capital of financial institutions has bestowed upon ratings the force of law.¹⁵⁴ The crisis has proven this position to be dangerous as the unhealthy reliance on ratings by investors, issuers and regulators had led to an oversimplification of the assessment of an investment. It was unhealthy because the use of ratings had gone far beyond their initial mandate and they were regarded as an overall assessment of an issuer's presented risks. The reality remains that a credit rating is limited to assessing the credit risk, and therefore the

¹⁵³ B Penn and I Dewji, 'The interim report of the ICB: what does a ring-fenced retail bank look like?' (2011) 26(7) BJIB & FL 382.

¹⁵⁴ LJ White, 'The Credit Rating Agencies: Understanding their Central Role in the Subprime Debacle of 2007-2008' (Leonard N Stern School of Business, August 2009).

ability of an issuer to return the capital on a debt security. This assessment should be oblivious to share price and the realisation of a non-credit-related risk. A AAA rating given to an issue of a listed blue chip company should not in any way be used by investors as an indication of operational efficiency or market strategy; yet, it has often been perceived as such and not only by the less educated investors. In fact, the regulatory acknowledgement has led to an acceptance that ratings are more than just a credit assessment tool.

The alternative of using an entirely public entity to carry out such a role offers some advantages.¹⁵⁵ Regulators would no longer need to outsource this function which would put them at ease in terms of establishing their own risk profile of a given institution and evaluating the systemic consequences on their own terms. It would also assist in diminishing the conflicts of interest surrounding the 'issuer pays' model. The public agency could decide to carry out evaluations when they thought fit, rather than this being instigated by the firm itself. Investors would also benefit from a rating which could be considered entirely objective.

It would, however, present a fresh set of concerns. Conflicts of interest would not entirely disappear. Indeed, the public agency undertaking the rating would be conflicted when considering government debt; the rating of which is considered by the market to be an accurate measure of the health of an economy. Therefore a government-operated agency would tend to be biased or influenced adversely. Another issue is the fact that the quality of the rating itself would not necessarily improve as the cost and administration of maintaining a service that was viable would be too burdensome for a public agency. It is worth pointing out that although three CRAs dominate the market,¹⁵⁶ 130 operate globally, meaning that the public agency would need to cover the work carried out by these firms, which would be administratively unworkable. In this respect, a public agency would also find it difficult to evaluate when a rating was needed. Currently, the market plays this role and, due to the costs

¹⁵⁵ TE Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment' (2009) 59 Case W Res L Rev 227.

¹⁵⁶ Namely, Moody's, Standard and Poor's and Fitch.

involved, is able to determine the adequate timing of ratings. As a platform in the ‘two-sided market’, CRAs are able to resolve the principal-agent problem mainly due to their financial intimacy with the issuer.¹⁵⁷ The biggest concern, however, would be the aggravation of systemic risk via a reinforcement of the over-reliance on ratings. In fact, should a governmental agency take over the responsibility of rating debt securities, these would be seen as a form of regulatory sanction or worse, as a form of state guarantee. Criticism of CRAs following a financial crisis is not new, and during these periods improvements have been sought in the positioning and functioning of CRAs within the market.¹⁵⁸ Should this task be carried out by a public body, then it would be less inclined to be self-critical. It follows that further reliance would be placed on ratings where investors would be tempted to look no further than the rating as the debt would have been validated at state level, thereby reinforcing pro-cyclicality. Although having this function carried out by a public body is appealing to an extent, the disadvantages clearly outweigh the advantages.

B. Regulating CRAs

Historically, there has been a certain reticence to regulate CRAs in a formalistic way. Until the collapse of Enron, the consensus both in the EU and the US was that self-regulation was preferable because it was important not to interfere with the result of the rating process via normative intervention.

1. End of the ‘investor pays’ model

From an operational perspective, an event of particular interest occurred during the 1970s when CRAs experienced a fundamental shift. Up until then, credit rating reports were only available to those interested investors who wanted to better understand the risk element and

¹⁵⁷ Rochet and Tirole (n 124).

¹⁵⁸ CM Mulligan, ‘From AAA to F: How The Credit Rating Agencies Failed America And What Can Be Done to Protect Investors’ (2009) 50 BCL Rev 1275.

creditworthiness of a given security against payment. This so-called ‘investor pays’ model¹⁵⁹ was a cause for serious concern for CRAs as they were worried that with the widespread introduction of photocopying machines during the 1970s, their reports would be available to ‘free riders’. Issuers also had concerns that they were missing out on potential investors who were not privy to the contents of their credit rating reports. It is mainly for these two reasons that CRAs shifted to an ‘issuer pays’ model, where the issuer applies for a credit rating from a CRA and then pays for the evaluation. It was also thought that the rating would carry more weight as a public evaluation of a security would cause investors to trust the issue more due to the irrevocability of public information.

However, the Securities and Exchange Commission (SEC) was quick to identify the potential conflicts of interest of the ‘issuer pays’ model and quickly moved to introduce measures that would aim to put a price on high credit ratings.¹⁶⁰ In their desire to remain in the realm of self-regulation, they implemented a registration process in order to maintain a certain standard amongst CRAs and to keep out companies that would not uphold an ethical approach to ratings. This registration process bestowed upon the relevant agency the title of ‘Nationally Recognised Statistical Rating Organisation’ (NRSRO).¹⁶¹ The amendment to the Securities Exchange Act of 1934 in 1975 enhanced the use of ratings for the risk assessments of firms and their exposures. The registration procedure was only required when ratings needed to be used for regulatory purposes. However, this only confirmed the position played by the dominant players in the rating market. The key element to this process was that broker-dealers could diminish their capital requirements by holding debt securities which were evaluated as ‘investment grade’ by the NRSROs. In the US, the registration process accompanied by self-

¹⁵⁹ LJ White, ‘Credit rating agencies and the financial crisis: less regulation of CRAs is a better response’ [2010] JIBLR 170.

¹⁶⁰ SEC, ‘Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets As Required by Section 702(b) of the Sarbanes–Oxley Act of 2002’ (January 2003).

¹⁶¹ Securities Exchange Act 1934 amendment to r 15 c3-1 and adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No 34-11497 of 26 June 1975.

regulation was considered an adequate balance until the collapse of Enron.¹⁶² Indeed, CRAs had seemingly given it an overly-generous rating, and also were provided a tardy downgrade when the situation deteriorated. The criticisms are similar to those after the 2007/08 crisis, even though measures were taken to bolster the regulation of CRAs.

2. Is there still a case to be made for CRAs to self-regulate?

As is customary, the usual supporters of self-regulation are the affected market participants themselves, and it is no different in the discussion pertaining to the regulation of CRAs.¹⁶³ They argue that strict regulation of CRAs would be detrimental not only to their functioning but also to the market. They claim that self-regulation would enable them to keep costs lower and therefore allow them to allocate resources more efficiently. This, in turn, would translate into them being able to react more quickly and adequately to risks that their ratings may offer. This could be done through acknowledging international standards and ethical codes that CRAs would undertake to abide by. They also put forward the idea that strict sanctioning is not necessary as their prime asset is their reputation, and therefore, any adverse behaviour would go against their existing business model.¹⁶⁴ Acceptance of these arguments will very much depend on the importance given to ratings within the financial system. However, these arguments are also dependent on certain accepted concepts. Firstly, it is important that other market participants are able to monitor the quality of ratings. This is particularly time-sensitive in duration, as the consistent quality of ratings will only be achieved from issue to maturity by proving that a given rating adequately reflected the reality. These maturity periods can vary from the short term (5 years) to the long term (30 years), which in terms of competence evaluation reflect extremely long periods. This should also be accompanied by relevant information disclosures to enable a meaningful evaluation. In terms of reputation, as the crisis

¹⁶² D. Coskun, 'Credit rating agencies in a post-Enron world: Congress revisits the NRSRO concept' (2008) J.B.R. 9(4), 264

¹⁶³ Discussion Paper about Measures to Enhance the Independence, Quality and Transparency of Credit Ratings (December 2007).

¹⁶⁴ White (n 159).

has already damaged the one enjoyed by CRAs, it will take a considerable amount of time to be re-established in order for this to act as an adequate form of sanctioning. Moreover, such reputational pressures only operate effectively within perfect market conditions where one market participant stands to lose out to another. In economic terms, the CRA market can hardly be considered perfect due to the oligopoly under which it operates. The three large CRAs dominate the market to the extent that it is virtually impossible to consider a new entrant with sufficient resources to compete. The pendulum shift in position in relation to the self-regulation of CRAs is evident pre and post-Enron, and pre and post-crisis.

3. The various post-Enron approaches

The first development in the aftermath of the corporate collapses of Enron and WorldCom was a global initiative in the form of the IOSCO Statement of Principles and its related Code of Conduct.¹⁶⁵ This was still a self-regulatory regime by nature, and it put in place a series of principles governing the practices of those CRAs that signed up to it. The principles covered the main concerns that emerged regarding CRAs. However, without a supervisory body overseeing them, and with the absence of sanctions for non-compliance, it was exposed as being potentially ineffective in bringing substantial governance reform. Further, the principles were drafted in a vague and generic way which did not encourage harmonisation amongst CRAs. This, however, was in line with the *zeitgeist* of a principles-based approach as the Statement of Principles intended to 'state high-level objectives for which rating agencies, regulators, issuers and other market participants should strive in order to improve investor protection and the fairness, efficiency and transparency of the securities markets and reduce systemic risk'.¹⁶⁶

¹⁶⁵ IOSCO (n 112); IOSCO, 'Code of Conduct Fundamentals for Credit Rating Agencies' (Technical Committee, December 2004) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>> accessed 14 May 2014.

¹⁶⁶ IOSCO (n 112).

Notwithstanding its voluntary nature, signing up to the Code proved popular¹⁶⁷ and those CRAs that did sign up undertook to adopt it without taking advantage of its flexibility and opt-out provisions.¹⁶⁸ The Code became a moderate success in that, through its adoption, it at least succeeded in identifying the issues that needed to be addressed. These issues are covered in the three headings of the Code, namely, the quality and integrity of the rating process; CRA independence and the avoidance of conflicts of interest; and CRA responsibilities to the investing public and issuers. It also found success through inspiring similar measures both in the US and in the EU and through defining the objectives of limiting systemic risk and increasing consumer protection.

The US was the first to end the self-regulation regime of CRAs with the Credit Rating Agency Reform Act 2006.¹⁶⁹ Presumably, this can be explained by the fact that the collapse of Enron and WorldCom had a greater impact and significance in the US than anywhere else.¹⁷⁰ The process was initiated as early as 2002 with the Sarbanes–Oxley Act¹⁷¹ and its commissioning of the SEC to issue a report on the regulation of CRAs.¹⁷² The Sarbanes–Oxley Act instructed the SEC to look at five specific areas of concern in the functioning of the credit rating system. These related to the quality of information flows regarding the ratings themselves; the management of potential conflicts of interest; the alleged anti-competitive behaviour of the large CRAs; the possible reduction of regulatory barriers to entry into the market of new CRAs; and the ongoing monitoring of CRAs. The report found all these areas to be lacking and deserving of further consideration which was duly provided in the ensuing Concept Release of

¹⁶⁷ To date, membership consists of 77 affiliate members, 11 associate members and 115 ordinary members < <http://www.iosco.org/lists> > accessed 14 May 2014.

¹⁶⁸ Utzig (n 132132).

¹⁶⁹ Credit Rating Agency Reform Act of 2006.

¹⁷⁰ US Senate, 'Rating the Raters: Enron and the Credit Rating Agencies, Hearings Before the Senate Committee on Governmental Affairs' (107th Congress, 2nd Session, March 2002).

¹⁷¹ Sarbanes-Oxley Act 2002.

¹⁷² SEC (n 160).

June 2003.¹⁷³ The Concept Release suggested that the NRSRO regime be eliminated or amended in line with the target of lowering the regulatory barrier to entry of new players into the market. This suggestion highlighted the need to find an adequate institutional alternative as a number of SEC rules relied upon the NRSRO regime in its regulation of the firms it was in charge of supervising. Therefore, without substitution, the absence of the NRSRO regime would have made it difficult for the SEC to meet its own regulatory objectives. The alternative would have meant either delegating the credit rating task that the SEC relied upon to an alternative external institution, taking on the role itself or developing internal credit ratings for the regulated firms.

This confirms the idea that regulatory reliance on CRAs was already well-established, as the SEC recognised that although the use of ratings as a regulatory tool was not necessarily desirable, the alternatives would be too costly, burdensome or risky. Considering that the objective of reviewing the role of CRAs was because they were considered to have failed in the light of certain corporate failures, it would have been ironic that the result of the review would have led to less supervision of the CRAs. With this in mind, the SEC argued for modification of the approval process of NRSROs into a registration process rather than for its abandonment. On the one hand, this satisfied the issue of market entry for new participants and, on the other hand, it enabled the SEC to tighten up recognition and on-going supervision of NRSROs. The regime became one of oversight by disclosure and accountability for compliance of their own standards to be filed with the SEC.

In order to mitigate the complexities of an entire supervision of CRA activities, it was thought necessary to limit the supervision of the methodologies in place used by the agencies. Firstly, it is not desirable from a market perspective to have disclosure on the intricacies of the methodological approach as these are the essence of the intellectual property of CRAs. Should

¹⁷³ SEC, 'Concept Release: Rating Agencies and the Use of Credit Ratings under Federal Securities Laws' (June 2003).

the methodology become public, then the construction of debt securities would likely become a 'tick box' approach in order to achieve a targeted rating. Such formalism in the process would cause issuers to focus only on the areas they know will be addressed, and forgo a holistic approach in terms of a risk-conscious construction. This would also be to the detriment of investors as their choice would be limited because the securities on offer would become uniform. Of greater concern, however, would be the systemic consequences of uniformity on the debt market should a methodology not have taken into consideration an area at risk. This could cause further risks as these methodologies are an inexact science and would also create a negative form of arbitrage in the selection process by an issuer. CRAs should be able to maintain a certain amount of subjectivity in their rating construction because, in order to be relevant, the methodology will need to be organic and therefore tailored to the given security in a given situation at a given time. Finally, the SEC erred towards further internal process improvement in order for CRAs to manage their conflicts of interest. The segregation of the advisory line of business of CRAs and the reduction of dependence on the business of certain issuers were key recommendations. Creating Chinese walls between the advisory side of the business and the rating side was a key change to the way CRAs operated; the reform introduced a crucial hurdle to the idea that hiring a CRA to consult on the issue of construction would assist in achieving a higher rating. On the financial dependency aspect, a departure from financial addiction to a small number of large issuers meant that external pressures to offer high ratings was reduced.

As a consequence, the 2006 Act confirmed the idea that the SEC was reinforcing CRA supervision in a departure from the self-regulation approach. The caveat was that there would be no or limited regulatory influence over the methodological aspect of credit ratings as 'neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally

recognised statistical rating organisation determines credit ratings'.¹⁷⁴ The Act was revised in 2008 where focus again was on establishing a supervisory framework over the operational aspect of CRAs, such as record-keeping, managing conflicts of interest, enhanced disclosure requirements and enhanced transparency.¹⁷⁵ The successive amendments effectively made the IOSCO Code law in the US, where the SEC was granted enhanced supervisory power over CRAs. Nevertheless, these steps were considered to be sufficient for the objectives at hand, notably in terms of conflicts of interest management and the limitation of systemic risk.¹⁷⁶ However, in consideration of the Act, normative reform on the limitations imposed on the supervisory nature of CRAs would need to be considered whereby the SEC would shift its supervision from oversight to full regulation. At the time, the US approach to regulating CRAs showed that no thought was given to the ability of CRAs to issue ratings of a high-enough quality, but more to the way that CRAs were organised both internally and externally. It also showed that the task of controlling CRAs to the extent suggested by Partnoy is not realistic from a material and normative perspective, and therefore the regulatory role should be limited to mitigating operational risks. Here, a potential link can be found between the US and the EU approach in that the EU recognised this challenge from the outset and could explain their opposite stance in initially maintaining the self-regulatory approach.

Although the thought process was similar to the US, its result was different in that it maintained in the first instance the self-regulation approach. To support this trend, the steps that were to be taken under the European Commission's Financial Services Action Plan (FSAP) were deemed sufficient to adequately reposition CRAs within the financial system, and were confirmed by the consultation process of the Commission and the Committee of European Securities Regulators (CESR). On the consumer protection front, the MiFID was being finalised,

¹⁷⁴ Credit Rating Agency Reform Act of 2006, sec 15E(c)(2).

¹⁷⁵ SEC, 'Amendments to Rules for Nationally Recognised Statistical Rating Organisations' (17 CFR, Release No 34-61050, February 2010).

¹⁷⁶ Partnoy (n 136)

and this affected CRAs by shifting the burden of controlling the quality of investments by imposing further responsibility on financial institutions. Institutions that fell under the provisions were responsible for categorising their clients and therefore determining the amount of care owed according to whether they were considered retail, professional or counterparty clients.¹⁷⁷ In the first and second instances, the financial institution was responsible for evaluating the suitability and appropriateness of an investment. The MiFID provisions therefore encouraged financial institutions to be more aware of the investments they were purchasing for their clients, including debt securities. With this in mind, it can be seen that the EU view diverged from the US one on the level of responsibility that CRAs played in the investment decision process. In the case of the US, the burden of accuracy appears far greater in the rating process, as the focus of the SEC was on the regulation of CRAs themselves. The EU's intention already aimed to limit the reliance of credit ratings in a shift towards giving responsibility to other financial institutions in the process of matching the risk of a financial product in line with their client profile. Those categorised as eligible counterparties, in other words, licensed financial institutions, would offer an extra layer of quality control as they may have the means and knowledge to be able to offer an appreciation of a rating. The overall idea behind client categorisation was to rectify information asymmetry through imposing behavioural controls for financial intermediaries. To date, such a proposition has yet to be tested as the legislation was introduced in 2007 on the eve of the subprime mortgage debacle. It would have been interesting to see if a MiFID screening of a securitised debt security would have prevented the purchase of these securities for retail clients.

At the other end of the spectrum, the EU was also in the process of introducing the CRD which marked the introduction of the BASEL II Capital Accord. The chief impact for CRAs was the

¹⁷⁷ The different client categories offered varying amounts of protection depending on the categorisation given and varying amounts of administrative burden on the financial institutions.

registration process under the External Credit Assessment Institution (ECAI) regime.¹⁷⁸ The weight of the reliance on the ratings issued by ECAs very much depended on the choice of which approach financial institutions used to calculate their capital requirements. In short, the result was that the larger the institution, the more likely it was to opt for the more complex approach where capital savings could be achieved and where less reliance was made on the ratings issued by ECAs. This links in with the previous discussion on MiFID, where a shift of responsibility occurred on an opportunistic level from the ECAs to the financial institutions. On the other hand, the smaller financial institutions, which had less resources, would opt for the simpler capital calculation methods in order to review the ratings awarded by ECAs, and would be given less opportunity to manage their capital in an efficient way. The result was desirable in that those institutions which distanced themselves from ECAI ratings were rewarded with more flexibility on the use of their capital.

The first post-FSAP period was a moment of regulatory pause for the EU, where it evaluated what had been achieved prior to embarking on the second FSAP period. The EU trend at the time was to find innovative ways of regulating financial institutions, and to do so in a way that could organically grow with industry trends. During this period, priority was given to the risk-based and principles-based approaches over the rule-based approach in a move to improve regulatory standards and achieve 'better regulation' instead of more regulation.¹⁷⁹ Under this approach, there was no drive to implement further hefty regulatory designs, and in respect of CRAs it was viewed that to keep the self-regulatory process was preferable. However, the regime was enhanced following the CESR's recommendations.¹⁸⁰ The CESR suggested monitoring CRAs' compliance with the IOSCO voluntary Code via representations and meetings whereby any issues relating to the Code or particular issuers were to be discussed between the

¹⁷⁸ CRD, Annex VI. Their ratings must be issued objectively with systemic and well documented methodologies, as well as being free from political influence and economic pressure, available to all institutions with a legitimate interest and at least annually reviewed.

¹⁷⁹ FSA (n 125).

¹⁸⁰ Commission, 'Call to CESR for Technical Advice on Possible Measures Concerning Credit Rating Agencies' (Internal Market DG, July 2004).

CRA and the CESR. With this approach being broadly accepted, the review showed that CRAs generally abided by the principles laid down by the IOSCO Code which the European Commission deemed sufficient at this point, in line with the 'better regulation' policy.¹⁸¹

4. Post-crisis measures

Early in the crisis, the IOSCO reviewed its code of conduct in a response to the growing concern over the role played by CRAs, particularly in relation to the rating of structured debt products.¹⁸² Once again, the regulation of methodologies was dismissed in favour of a distancing of the reliance on ratings. The amendments promoted further transparency of the ratings through enhanced disclosure, the independence of CRAs, and through them acting responsibly towards investors and regulators. In order to improve the quality of the ratings without interfering with the methodologies, the revision promoted periodic reviews of the methodology¹⁸³ while ensuring their ability to organically cater for the moving target of risk for structured debt products.¹⁸⁴ The Code ring-fenced the methodology in terms of objectivity, where those analysts actually involved in the rating process were prohibited from advising on the design of structured debt products. This also ensured that the decision-making process for rating action (upgrade or downgrade) was done in an entirely objective manner.¹⁸⁵

Updates were also brought in to further mitigate conflicts of interest and encourage the independence of CRAs. Crucially, CRAs were to disclose whether a single client could materially affect the total income generated by the agency, with the materiality level set at 10 per cent of annual revenue.¹⁸⁶

¹⁸¹ CESR, 'Report to the European Commission on the compliance of Credit Rating Agencies with the IOSCO Code' (CESR/06/545, December 2006) 4.

¹⁸² IOSCO, 'Code of Conduct Fundamentals for Credit Rating Agencies' (Technical Committee, May 2008).

¹⁸³ *ibid* Rule 1.7-2.

¹⁸⁴ *ibid* Rule 1.9.

¹⁸⁵ IOSCO (n 182) Rule 1.14.

¹⁸⁶ *ibid* Rule 2.8.

The most important step forward brought in by the revision was to recognise the significant responsibility CRAs held towards investors and regulators. Up to this point, CRAs had been successful in maintaining their role as information providers which, insofar as it was correct, did not need to carry any warning signals. The Code succeeded in including that, in certain circumstances, ratings needed to contain further information in order to alert investors to relevant specifics.¹⁸⁷ This was primarily to remedy differences between categories of securities and address the mistake that investors made prior to the crisis when they did not differentiate between structured debt products and standard debt instruments. Under these clauses, CRAs were charged with educating investors on the meaning of the ratings they gave and their limitations, not just in their use but also with regard to the information that they had received from the issuers and any inconsistencies or lack of desirable information. This provision, in particular, became the official recognition that CRAs needed to be regulated in a formalistic way because their responsibility was recognised. The responsibility of CRAs was now substantiated at an international level in the same way as the rationale for regulating financial institutions dictates that it is due to the responsibility they have towards investors, financial markets and the economy at large. The CRA taskforce was to monitor the transition and encourage harmonisation on an international level while entrusting the implementation at a domestic level. It recognised the fact that the initiatives needed to be pursued by legislators at the level of the IOSCO enforcement of the Code would prove difficult. In November 2008, it stated that it favoured a 'consistent global regulatory approach to monitoring the activities of CRAs', while urging legislators 'to consider the regulatory consensus represented by the IOSCO Code of Conduct when framing legislation as any fragmentation runs the risk of a reoccurrence of problems with product ratings'.¹⁸⁸ In this address, it gave the G20 the task of coordinating a unified response to the regulation of CRAs. The difficulty here was not necessarily to

¹⁸⁷ *ibid* Rule 3.5.

¹⁸⁸ IOSCO, 'Statement by the International Organisation of Securities Commission Regarding Accounting Standards and Governance' (12 November 2008)
<<http://www.iasplus.com/en/binary/iosco/0811ioscog20.pdf>> accessed 14 May 2014.

encourage jurisdictions to legislate in favour of regulating CRAs but to do so in a harmonised way.

Therefore, the G20 carefully followed the recommendations and quickly pointed out that the existing IOSCO Code did not provide sufficient supervisory guidelines to an industry that was coming under severe criticism.¹⁸⁹ However, the Code, which had been reviewed some months before, was not under particular scrutiny as the language in the declaration targeted reforms that needed to be carried out by domestic regulators.¹⁹⁰ The consensus was that the time had come to move away from soft law provisions and push for national laws that would put in place a framework for prudential supervision of CRAs. This, however, should not be done without cross-border cooperation; the declaration itself stipulated that due to the global nature and interconnectedness of financial markets, ‘intensified international cooperation amongst regulators and strengthening of international standards’ needed to be achieved.¹⁹¹

There is evidence that such cooperation for the regulation of CRAs has occurred since the declaration, notably at EU level via ESMA where cooperation agreements and memorandums of understanding (MoUs) have been signed.¹⁹² Crucially, a MoU was signed in March 2012 between the SEC and ESMA outlining the scope of cooperation for cross-border operations.¹⁹³ Such an agreement goes beyond mere mutual assistance and lays the ground for a departure from the home supervisor rule.¹⁹⁴ In particular, Article 3 of the MoU determines the jurisdictional scope of mutual supervision where the impact is assessed to avoid supervisory

¹⁸⁹ G20 (n 3).

¹⁹⁰ *ibid* para 8: ‘Regulation is first and foremost the responsibility of national regulators who constitute the first line of defense against market instability’.

¹⁹¹ *ibid*

¹⁹² ESMA, ‘Credit Rating Agencies’ <<http://www.esma.europa.eu/page/CRA-documents>> accessed 20 May 2014.

¹⁹³ ‘Memorandum of Understanding between the SEC and ESMA Concerning Consultation, Cooperation and the Exchange of Information Related to the Supervision of Cross-Border Regulated Entities’ (March 2012) <http://www.esma.europa.eu/system/files/esma-sec_mou_march_2012.pdf> accessed 20 April 2014.

¹⁹⁴ The home supervisor rule broadly offers responsibility for cross-border business to the regulator in the country where the business elects its head office. In the EU this rule appears in directives such as MiFID.

overlap. It also encourages consultation with the supervised business to ensure that they find value in the task. These provisions appear carefully crafted to avoid friction between supervisors while discouraging regulatory arbitrage, where businesses feel they can avoid reporting their global activities to any one supervisor. Importantly, Article 4 provides a framework of cooperation and assistance where supervisors can benefit from the information gathered by their counterparts, which goes as far as facilitating on-site visits. Although it is a concise document and is not limited to CRAs, it marks a significant step forward in understanding and controlling the systemic consequences of regulators not having a global view of the businesses they are supervising. The cases of Lehman and more recently MF Global demonstrate that neither the US nor the UK authorities had a clear picture of these businesses. This led, on the one hand, to great difficulties in organising a bailout and, on the other hand, it provided a platform to disguise losses. Therefore, the development of enhanced agreements where regulators can communicate openly and freely on the details of the businesses they are supervising is a step towards reducing the systemic consequences of regulatory arbitrage and, specifically in the case of CRAs, towards gaining a greater understanding of their operation. Such exchanges between one jurisdiction and another raise concerns relating to data protection, but this is beyond the scope of this thesis.

Both the EU and the US reacted to the concerns of IOSCO and the agreements made by the G20 via the implementation of legislative measures. Although the scope of this thesis is on EU measures, it is important to note that the US reaction to the crisis appeared in a detailed piece of legislation, namely the Dodd–Frank Wall Street Reform and Consumer Protection Act 2010,¹⁹⁵ (the Dodd–Frank Act) and specifically to CRAs via amendments to the CRA Reform Act of 2006.¹⁹⁶

¹⁹⁵ Dodd–Frank Wall Street Reform and Consumer Protection Act 2010.

¹⁹⁶ <<http://www.govtrack.us/congress/bills/109/s3850/text>>

By 2008, the SEC had prepared a series of suggestions to enhance the provisions of the CRA Reform Act in an effort to improve the regulation of CRAs at an early stage. These suggestions took the form of two proposals¹⁹⁷ which were divided into three courses of action. The action requested followed in some detail the suggestions that were being made by the IOSCO through enhancement of the rules, and in some circumstances went further. Having said this, however, any interference with methodologies beyond their review and objectivity remained prohibited.¹⁹⁸ Of particular significance was the enhancement of supervisory action of the SEC over CRAs, which was also a theme primarily dealt with in the Dodd–Frank Act. In essence, this Act stripped CRAs of privileges they enjoyed in the past while enhancing supervisory powers and the right to bring action. It recognised the importance played by CRAs at a systemic level¹⁹⁹ and set their level of accountability at a similar one to securities analysts and auditors.²⁰⁰ The legislation also created a new arm of the SEC to handle its enhanced regulatory role, namely, the Office of Credit Ratings (OCR), giving it vast powers in terms of supervision, control and penalties for failing to comply.²⁰¹ As will be shown in more detail with the creation of ESMA, it is important to note that beyond supervision, the Act gave the OCR a capacity as rule-maker which may lead to conflicts with the Act and ultimately the potential for the OCR to review in more detail the controversial ability to dwell further into methodologies of CRAs.²⁰²

At EU level, the beginning of the crisis coincided with the end of a regulatory cycle which had brought about considerable development in the European regulatory framework. In the aftermath of the two hefty FSAPs, the European machinery was not inclined to a knee-jerk reaction in reviewing regulations that industry was still struggling to implement. In particular, it was also thought that the recent MiFID and CRD provisions were yet to be properly tested and

¹⁹⁷ SEC, ‘Proposed Rules for Nationally Recognised Statistical Rating Organisations’ (17 CFR, Exchange Act Release No. 34-57967, 16 June 2008); and ‘References to Ratings of Nationally Recognised Statistical Rating Organisations’ (17 CFR, Release No IC-28327, July 2008).

¹⁹⁸ Securities Exchange Act 1934, art 15E(2).

¹⁹⁹ Dodd-Frank Act (n 195) sec 931(1).

²⁰⁰ *ibid* sec 931(2).

²⁰¹ *ibid* sec 932(p).

²⁰² Dodd-Frank Act (n 195) sec 932(r).

therefore could potentially have mitigated the effects of the crisis and future ripples.²⁰³ This point makes sense if we consider that financial institutions implemented MiFID in November 2007; this would not have allowed sufficient time to enable flagging of investments which would have been considered unsuitable for certain client groups, as structured debt products could have been for retail clients.²⁰⁴ Additionally, proper consultation was considered highly desirable at the time so that the development of the regulatory framework would not conflict with growth and competitiveness in the EU.²⁰⁵ On this premise, the CESR was of the opinion that regulating CRAs was not necessary and that had they been regulated, it would not have been sufficient to prevent the crisis.²⁰⁶

However, the enthusiasm for regulatory pause was short-lived, particularly because of the de Larosière report²⁰⁷ which revealed a regulatory framework with considerable weaknesses that was incapable of foreseeing or preventing systemic risks. The Commission followed suit and embarked on a suggested new route of reform.²⁰⁸ CRAs were included in this reform programme as they were seen as posing a risk to market stability and this illustrates well the crisis reaction attitude swing of the EU. It is also suggested that regulatory reform for CRAs was motivated at an international level whereby the introduction of the 2009 regulation on CRAs²⁰⁹ was part of the EU supporting the G20 agenda.²¹⁰ The agenda requested at a high level that CRAs should be subject to some form of supervisory oversight and registration process.²¹¹ The EU obliged, but also intended to facilitate, at an international level, coordination for the

²⁰³ Commission, 'Europe's Financial System: Adapting to Change' COM (2008) 122 final.

²⁰⁴ MiFID describes structured products under the complex category.

²⁰⁵ Commission, 'White Paper of Financial Services Policy 2005-2010' COM (2005) 629 final.

²⁰⁶ CESR, 'CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance' (May 2008).

²⁰⁷ de Larosière report (n 6).

²⁰⁸ Commission, 'Driving European Recovery' COM (2009) 114 final.

²⁰⁹ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies [2009] OJ L302/1 (CRA Regulations).

²¹⁰ N Moloney, 'Reform or revolution? The financial crisis, EU financial markets law, and the European Securities and Markets Authority' [2011] ICLQ 521.

²¹¹ G20, 'Leaders Statement, Declaration on "Strengthening the Financial System"' (G20 Meeting, London, April 2009) <<http://london.summit.gov.uk/en/summit-aims/summitcommunique/>> accessed 20 April 2014.

regulation of CRAs.²¹² In essence, the 2009 Regulation was an interim solution while the Commission prepared the final product that could offer a compromise on this sensitive issue. The reason for this sudden haste was to demonstrate a speedy response to the G20 agenda pending the creation of ESMA. Therefore, not only was the regulation in line with the suggestions of the G20 but the EU also wanted to be seen as an effective mechanism to implement change.²¹³

Although the outlook was global, the intention was to create control from within the EU, whereby regulatory use of ratings could only be used by those agencies registered and supervised under the Regulation. The Regulation switched to a rule-based regime and covered governance, limited methodology constraints and transparency via disclosure requirements. The 2009 Regulation was rapidly updated throughout 2010 and then introduced in 2011.²¹⁴ The significance of this Regulation at European level is clear as it assists in granting direct supervisory powers to a new European authority.²¹⁵ ESMA came into being as a result of new regulations²¹⁶ and was the first regulatory organ with direct enforcement powers over financial institutions.²¹⁷ This represented a great step forward in terms of European regulation and was made possible for three main reasons. The first reason was that the crisis had caused a regulatory shift from an uneasy principles-based approach to a rules-based approach where it was recognised that more coordination was necessary at European level and where consensus had to be achieved, particularly in relation to issues of a systemic nature. The second reason was that CRAs were not regulated in the EU prior to the Regulation. Considering the EU dynamics, it was easier to establish a regulatory framework than remove authority from

²¹² In 2010, the CESR undertook a gap analysis with the US regime, and noted that although the regimes were similar, the US should amend the SEC rules and bring them up to date and in line with those under the Regulation (CESR/10-32).

²¹³ Commission, 'Impact Assessment for the 2010 Credit Rating Proposal' COM (2010) 289 final, 7.

²¹⁴ Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, [2011] OJ L145/30.

²¹⁵ Moloney (n 210).

²¹⁶ Annex regulations.

²¹⁷ The CESR coordinated this role in the intervening period between the 2009 Regulation and its 2011 amendment.

Member States. This was reinforced by the fact that the main CRAs were of US origin, and therefore the idea of a Member State trying to protect its own industry was not problematic. The third reason is that, since its inception, the CESR has gained authority and respect beyond its initial mandate, thereby paving the way for direct supervision.

The establishment in 2011 of ESMA,²¹⁸ alongside the other European Supervisory Authorities (ESAs), the European Banking Authority (EBA)²¹⁹ and the European Insurance and Occupational Pensions Authority (EIOPA),²²⁰ represents a considerable shift of EU policy in terms of financial regulation. Although academics have previously discussed the possibility of a more central or single EU regulator for financial services,²²¹ the political will was always limited by protectionist behaviour and an aversion to federalism.²²² This quickly changed in the light of the crisis, which led to the exposure of serious shortcomings in the existing EU rulebook and supervisory coordination.²²³ European Institutions and Member States alike supported the establishment of a new system of financial supervision based on the de Larosière report which clearly encourages greater oversight at EU level. This transition, and the powers of the ESMA will be considered in greater detail in the following Chapter.

²¹⁸ 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 [2010] OJ L331/84 (ESMA Regulation).

²¹⁹ 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 [2010] OJ L331/12 (EBA Regulation).

²²⁰ 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 [2010] OJ L331/48 (EIOPA Regulation).

²²¹ R Lastra, 'The Governance Structure for Financial Regulation and Supervision in Europe' (2003) 10 *Columbia Journal of European Law* 49.

²²² D Langevoort, 'Structuring Securities Regulation in the European Union, Lessons from the US Experience' in G Ferrarini and E Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (OUP 2006).

²²³ N Moloney, 'EU Financial Market Regulation after the Financial Crisis: "More Europe" or More Risks?' (2010) 47(5) *CMLR* 1317.

C. Facing the critics

1. Issues of accountability

The suggested part played by CRAs in the recent and past crises invites the question of their accountability. Generally, CRAs have been exempt from civil liability for the opinions they issue, making them the only type of financial institution to benefit from such exemptions. So far, both the EU and the US have been reluctant to address this aspect although it merits consideration.

Even more of a concern is the protection CRAs have enjoyed in the US since the Securities Act of 1933²²⁴ which was reiterated in the Credit Rating Agency Reform Act of 2006 where it is stated that 'no report furnished by a nationally recognised statistical rating organisation in accordance with this section ... shall create a private right of action under Section 18 or any other provision of law'.²²⁵ As the reports that are furnished by CRAs are to be considered in the US as 'opinions', they are dealt with in the same way as published material under the freedom of the press provisions.²²⁶ However, in consideration of the above, there are substantial differences between the objective and content of rating reports and general published material.

In principle, rating reports are relied upon by both investors and regulators to make informed decisions. Although we have seen an attempt to move away from such reliance by legislators, ratings are still decisive pieces of information. More importantly, the effect they have and the consequences of relying upon them go further than the immediate user; institutional investors, for example, will be vulnerable vis-à-vis their clients if ratings play an important part in their investment decision-making process. Without any recourse against, or liability

²²⁴ Securities Act 1933, sec 11.

²²⁵ Credit Rating Agency Reform Act of 2006, sec 15E(m)(2).

²²⁶ Partnoy (n 136).

attaching to, their opinion, CRAs are in a comfortable position as they risk neither reputation nor capital. Should CRAs be capable of being held liable for issuing negligent opinions, then it is probable that they would be more attentive to the details and the results of their findings.

From a regulatory perspective, credit ratings offer an easy way to supervise financial institutions and the quality of their capital. This is systemically relevant insofar as this is a fixed criteria as great reliance is placed on ratings to assess the safety of a given institution. Although financial institutions take into account a number of elements besides ratings, regulators have generally found that reviewing the rating was sufficient. Moreover, as Lord Turner points out, ratings were used to set contractually binding targets for instruments and institutions in order to protect the underlying principal of an instrument, thus causing a simultaneous downgrade to have a knock-on effect.²²⁷

Another difference to note between rating reports and traditional published material is the fact that, internally, CRAs are structured like financial institutions and not publishing houses. This is particularly relevant from the remuneration perspective, where senior officers are paid high wages in line with large financial institutions and these are significantly higher than publishers enjoy. High wages usually go hand in hand with responsibility and the ability to generate income. However, where responsibility is desired for high-ranking staff of CRAs, it is greatly diminished due to their immunity to civil litigation. Conversely, the ability to generate income is not necessarily desirable in an institution with regulatory usage and objectivity. As above, it is important for CRAs to maintain their integrity by avoiding adopting a commercial attitude to rating, as their only motivation should remain to produce a rating which is relevant, clear and useful.

There seem to be few arguments against making CRAs accountable to at least a certain degree, and although they have been blamed for playing an active role in the most recent crisis, they

²²⁷ FSA (n 125).

have neither suffered financially nor faced legal action. Partnoy even suggests that CRAs have become more profitable with declining levels of quality in the ratings. All these arguments point to the fact that CRAs are not held accountable enough for the important role they play within financial markets. Although steps have been taken from a legislative perspective to diminish their importance, they remain a financial institution, and therefore should be regulated as such.

The EU is taking action on this. The amended Regulation on CRAs²²⁸ has included certain provisions which point towards the development of CRA accountability. The Regulation provides that for the first time a financial institution will be directly regulated by a European Institution, namely, the ESMA. It is also the first time that regulated entities will be privately funding their supervision at European level, which translates into a buy-in of the process and a concern that CRAs are on a level playing field. Just like in the US, the legislation does not allow ESMA to interfere with the methodology employed, but does grant significant powers elsewhere, such as general investigative powers²²⁹ and the ability to impose fines.²³⁰ More importantly, the Commission has proposed to allow investors to bring civil liability claims against CRAs where rules have been broken.²³¹ The proposals offer a middle-ground solution, where civil liability claims will be allowed in respect of gross negligence and intentional breach of rules with the burden of proof lying with the CRA.²³² This appears a reasonable solution as CRAs will at least develop more consciousness in terms of procedural quality without encouraging opportunistic litigation.

2. Undoing the 'hard wiring'

²²⁸ Regulation (EU) 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) 1060/2009 on credit rating agencies [2011] OJ L145/30.

²²⁹ Regulation 513/2011 (n 228) sec 23c.

²³⁰ *ibid* sec 23e.

²³¹ Commission, 'Making credit rating agencies more accountable' (17 November 2011) http://ec.europa.eu/news/economy/111117_1_en.htm accessed 20 April 2014.

²³² EU Focus, 'Commission wants better quality credit ratings' (2012) 291, 19.

The G20 played an active role in promoting the regulation of CRAs, and more particularly through the Financial Stability Board (FSB), setting out principles which established a level global playing field whereby states could commence setting out regulatory agendas for the repositioning of CRAs. Acknowledging the fact that jurisdictions were able to focus more easily on the operational side of registering and creating oversight for CRAs in their respective jurisdictions, the FSB focused its principles on reducing ‘the cliff effects from CRA ratings that can amplify pro-cyclicality and cause systemic disruption’.²³³ The task of reducing regulatory reliance on ratings needs to be carried out on several fronts and through the intervention of global standard-setters, legislators and domestic regulators, but crucially it will affect the functioning of financial institutions on a governance level. The chief concern in this respect is the fact that financial institutions are overly-reliant on ratings for their credit assessments. Therefore, central to the reform will be an obligation for financial institutions to create further capacities to develop and cater internally for credit assessments and evaluations.

The fact that this task represents the most time-sensitive issue in terms of CRA regulation means that international coordination will be, at some level, desirable in order to avoid any form of regulatory arbitrage. To date, it can be seen that this has been the case due to the dynamism of the Commission in its promotion of its international regulatory rulebook²³⁴ and what appears to be efforts to create equivalences with the Dodd-Frank Act.²³⁵

For this purpose, the FSB outlines three groups of principles which set out objectives it believes should be considered in order to effectively remove reliance on ratings. The first principle deals with reducing the legislative reliance on ratings and suggests their removal wherever possible or their replacement with suitable alternative standards of creditworthiness. Undertaking this task without creating legislative gaps will require

²³³ Financial Stability Board, ‘Reducing Reliance on CRA Ratings’ (Report to G20 Finance Ministers and Governors, 14 October 2010).

²³⁴ Moloney (n 210).

²³⁵ Dodd-Frank Act (n 195).

jurisdictions to take particular care in crafting timetables which allow a smooth transition and which also enable market participants to familiarise themselves with the alternative methods for credit risk evaluations. The transition period will be sensitive both on resources and the ability for the smaller participants to adapt. The report emphasises that focus should primarily be on those legislative references that lead to ‘mechanistic responses’ by market participants; however, it does not specify which ones. The assumption made here is that the provisions which have the most systemic relevance should be prioritised. Jurisdictions will need to identify these on a case-by-case basis. For example, in the UK, Lord Turner identified some specific contractual provisions which proved to be systemically relevant.²³⁶ Despite national differences, some form of international coordination at this level appears favourable. In any case, it is likely that market participants will be involved in the process as they will need to evaluate how to integrate alternative methods to cater for credit risk. The EU has embarked on such a process, notably in terms of amendments to CRD provisions. However, the process of removing regulatory provisions has lessened with the ability to better supervise CRAs directly at EU level via ESMA. Its powers will be extensive, and of interest here is the ability to withdraw registration, suspend the use of ratings, engage in public censure and impose financial penalties.²³⁷

The FSB recognises that ratings still play an important part in the internal credit assessment process but suggests as its second principle that reliance by the market should be diminished. This should be supported by regulatory design, but primarily it will be via reform within financial institutions and how they use ratings within their own assessments. Depending on the size of the firm, this will vary as the smaller institutions will not have the resources or capacity to give a full credit risk analysis, and therefore will still have to rely to a certain extent on ratings or other publicly available materials. For this, the FSB suggests both public

²³⁶ FSA (n 125125).

²³⁷ Moloney (n 210).

disclosure of the methodology that a firm utilises to assess its credit risk and supervisory sanction depending on the size of the firm. The prime message here is that financial institutions should no longer blindly rely on ratings, and that they should not only introduce their own assessment based on other sources of information but should also be in a position to evaluate the rating itself. Here we can observe an important convergence between the two main objectives of limiting systemic risk and consumer protection. Smaller firms should be able to benefit from the new transparency provisions in relation to CRA methodology, where they will be able to partake in the evaluation process for their own needs and therefore take responsibility for the quality of the rating. In effect, they will be able to 'rate the rating' and take a position on what level of reliance they should place upon it. This is in line with the FSB's proposal that firms should not mechanically rely on ratings, the use of which will depend on resources. Incidentally, should a correlation be made between the size of an institution and the reliance on ratings, then systemic ramifications could be automatically mitigated. As it has been established that there is a correlation between the size of a financial institution and its systemic relevance, then the focus on limiting the use of ratings should be towards the larger firms. Conveniently, they will have the capacity to better undertake an independent credit risk assessment as they will be more heavily resourced. Taking it one step further, it could be argued that even those institutions that do not meet the critical size yet engage in business deemed to present higher risks, such as investment banking, would already have resources readily available to evaluate credit risk beyond the limited consideration of ratings. If an investment bank is capable of setting up complex financial debt products, then it is already in a better position to evaluate the credit risks to which its own firm is exposed. In such cases, if the upside (the regulatory capital requirement) is simplified by requesting a firm to hold a portion of its assets in investment grade obligations, the downside (the liabilities a firm will create by leveraging a portion of its assets) may be exploited by those firms with the ability to do so. In the case of Lehman Brothers, the bank over-exposed itself greatly to a single form of

complex structured debt securities, which benefited from investment grade ratings. It is difficult to know whether they did or did not understand the risks they were taking, but what is certain is that neither the regulator nor the CRAs could have realised the effect the rating had on their ability to leverage with the information they had to hand.

The FSB's third pillar of principles looks at specific areas of activity within financial markets. Throughout, the general idea remains the same – that market participants should not systematically rely on ratings, and supervisors should put in place appropriate provisions both in law and in governance to protect against such reliance. Overall, the wording remains vague, although one interesting idea that is particularly relevant to systemic risk emerges which links back to the Turner Review. Relating to private sector margin agreements, Principle III.4 stipulates that market participants should not use changes in ratings as automatic triggers in financial transactions.²³⁸ This presents two main difficulties: the first is that the restriction would relate to private contracts; and the second that enabling triggers on large volumes is economical, efficient and easy to implement. The difficulty will be not only in enforcing this on a supervisory level but also identifying a suitable alternative. The FSB suggests replacing such triggers with varying margin payments to satisfy the collateralisation of derivative exposures. In practice, however, this will require a considerable increase and reliance on automatic exchanges of monies, and this would expose further counterparty and liquidity risks where margin increases remain unsatisfied. It would also considerably increase the costs of entering into derivative contracts and prove administratively challenging. This remains the most innovative proposal put forward by the FSB, and although it will prove challenging to implement, such radical regulatory reform may prove to be necessary in order to address this aspect of systemic risk.

3. The problem of tardy downgrades

²³⁸ Financial Stability Board (n 233) Principle III.4.

Another criticism relates to the timeliness of re-evaluations of ratings.²³⁹ It is understood that these ratings should, to a certain extent, be organic and able to adapt to economic cycles. However, during the 2007 crisis, the downgrades were both tardy and erratic. Not only did they occur after it became common knowledge that the risk exposure relating to certain structured products was higher than estimated but they also appeared to downgrade *en bloc*, which made it appear that they had not carried out an in-depth assessment before downgrading. The lack of interest by CRAs in re-evaluating issues again appears to stem from a commercial perspective. In fact, there appears to be little financial incentive for CRAs to either review or downgrade an established rating, and this could explain their ex-post reaction.²⁴⁰ Notwithstanding this, a downgrade is also likely to offend the issuer, thereby potentially jeopardising the potential for future business. It appears, however, that the reasoning behind tardy downgrades goes beyond commercial pressures. The main reason for this is both operational and due to the fact that CRAs are not equipped to offer a system that efficiently updates their issued ratings. CRAs operate under the so-called 'look through the cycle' model,²⁴¹ which means that they do not provide an economic-cycle-related model. Rather, it is one where, once the rating has been established, it will remain until the CRA becomes aware of actual data that may change the creditworthiness of the issuer. Under such a model, the rating will be distanced from the economic cycle and therefore escape criticism of unrelated crisis ratings. Moreover, as they are contracted by the issuer, most of the information provided will originate from the issuer and, in particular, this will be information related to rating reviews. It would also be unreasonable to expect CRAs to react instantaneously to changes or risks occurring at corporate level. Not only would obtaining this sort of information be troublesome but presumably the CRA would need time to evaluate the said information and

²³⁹ The case of Lehman Brothers is famous for illustrating this point as even post-bankruptcy their issued debt remained above investment grade.

²⁴⁰ Coffee (n 121).

²⁴¹ El Altman and HA Rijken, 'A Point in Time Perspective on Through-the-Cycle Ratings' (2006) 62 Financial Analysts Journal 54.

include it in its rating. Furthermore, should the CRAs be forced by regulation to maintain up-to-date ratings, this would once again shift responsibility away from the investors and further entrench CRAs in the economic cycle. To regulate CRAs in terms of timeliness of updates therefore appears counter-intuitive and against current aims. In order to better mitigate the effects of tardy downgrades, it appears preferable to encourage the disengagement of ratings at a contractual and normative level. Should this be achieved, then it is likely that a lack of reliance on ratings in a formalistic way would lead such ratings to be used as one type of information among many others in the investment decision-making process. Finally, regulating this element of CRA activity would require a change in the typical business model of CRAs which is beyond the scope of financial regulation.

D. Conclusions on regulating CRAs

It appears that credit ratings have the ability to stimulate and aggravate economic cycles, rendering the question of their regulation pertinent to the consideration of systemic risk. However, their systemic relevance was considerably amplified with the rating of structured debt products, making CRAs key players in the sub-prime mortgage debacle. It is therefore important to distinguish between the ratings of traditional debt products and structured ones. The main difference lies in the opacity of the information available regarding the latter, thus causing an over-reliance on the rating. The fact that the rating became the main source of information in the investment decision-making process led to pro-cyclicality and cliff effects, as underlined in the seminal reports of Lord Turner and de Larosière. As providers of information, the ratings issued by CRAs were ill-equipped to handle the responsibility bestowed upon them by investors and regulators regarding structured debt products, and this evidenced shortcomings in the overall operation of CRAs. The fact that CRAs had such an impact sits uncomfortably with the fact that so far the efforts to mitigate systemic risk have focussed on large market participants. The realisation of systemic risk therefore could originate amongst

remote market participants, holding small triggers leading to cliff effects. The consideration of these players, however, could be sufficient without heavy regulatory measures provided that a body is put in place to monitor their activity and evaluate the potential tremors they could generate. At EU level, the ESRB will take on this role with a wide scope of powers to monitor markets and their participants.

The shortcomings revealed by the review of credit ratings in the light of the crisis are not of equal systemic importance. For example, conflicts of interest are to a certain degree inherent to the operation of CRAs due to their role in the agent-principal model. The mitigating measures are occasionally limited to an acknowledgement of these conflicts due to the fundamental business model under which they operate and the lack of viable alternatives.

In terms of regulating CRAs, there needs to be a dual approach, both at a micro level and at a macro one. At a micro level, better ratings are achievable by setting better corporate governance systems and a more relevant rating system to differentiate between traditional debt products and structured ones. In terms of the methodology employed, both the US and the EU are looking closer at how they can be monitored without interfering in the integrity of the process. Of more systemic relevance are the macro regulatory measures to be taken. These will mainly be concerned with the removal of regulatory and legislative provisions that rely on ratings. The distancing of CRAs from the regulatory process is crucial, but to do so, regulators and market participants will need to use alternative sources of information. The diversification of information will greatly limit the pro-cyclicality attributed to credit ratings, although a total removal is neither necessary nor desirable from an administrative perspective. In order to limit the cliff effects that have been linked to credit ratings, monitoring of the usage of ratings in the private sphere is necessary. The contractual usage of credit ratings on a large scale to protect investors is counter-productive. The disclosure of such a usage appears

sufficient insofar as a suitable supervisory regime is put in place to adequately evaluate them and restrict them when necessary.

The measures put in place at EU level are considerable and translate the zeal of the post-crisis era. Institutionally, the creation of the ESAs and more specifically ESMA answer the concerns surrounding CRAs and their regulation/supervision. The powers that ESMA enjoys are far reaching both in its role as a quasi-rule maker and a supervisor. With this novel positioning of ESMA amongst EU Institutions, and the powers it is intended to use leaves it open to challenges from many angles. Its relationship with other EU Institutions, market participants and domestic regulators will determine its fate and its ability to carry its agenda forward. Besides specific agenda items, such as the supervision of CRAs, ESMA will generally be employed in the role of approximating financial rules and achieving maximum harmonisation. Although it is enviable from a systemic perspective to have centralised monitoring, this holds the potential to stifle regulatory innovation at a domestic level and ignore regional specificities. Its relationship with the ESRB will be key in the containment of systemic risk within the EU. The coordination of their powers remains the main tool, and this will be considered in the following chapter.

V. Concluding remarks

These four areas of regulatory reform indicate that the writing of the single rulebook for financial services in the EU is well underway. The commitment to attaining the highest amount of uniformity at regulatory level is essential to enabling the proper supervision of systemic risk at EU level. However, the very different issues presented for each of the measures have resulted in their final form.

The less problematic of the measures was certainly EMIR, whereby the problem was identified and its response measured. Like many of the issues related to systemic risk, transparency was

the main concern. Resolving issues of supervisory visibility marks the first step in being able to tailor a response and a mechanism to remedy problematic areas of industry. Of course, this will rely on an efficient supervisory framework which will be dealt with in the following Chapter. So far, the regulation has been implemented under the guidance of ESMA without any particular market disturbance or cost.

The introduction of AIFMD was more controversial as the impact on industry was considerable. It has also been contentious as it has been seen as an opportunistic measure that did not have sufficient crisis relevance to be included in the reform agenda. However, due to prior concerns and high profile frauds, political resistance was absent. Commentators have tended to agree that the measures taken have not been proportional to the systemic impact alternative investments present. However, it appears that systemic risk has not been the only concern raised and that supervisory visibility was required for the purposes of consumer protection and criminal activity as well. The impact on this segment of industry is still unknown. However, it stands to change the landscape of alternative investments in the EU not only via the entry barriers it has erected but also with regards to new licensing arrangements.

As the prime tool to mitigate systemic risk, a solid review of capital requirements was necessary. It appears that the recalibration to a macro-prudential stance was successful, however, the complexity of the regulation has greatly increased and this has created implementation issues at Member State level. The greatest achievement for the purpose of systemic risk was the introduction of countercyclical buffers, providing an effective tool for supervisors to use to mitigate in the short and long term system failures. Reliance is once again laid on the new supervisory framework to render this regulation effective.

Finally, the inclusion of CRAs as regulated entities represents a significant step forward in terms of limiting interconnectedness in the market and supervisory reliance. The process that has been discussed also demonstrates well the global push to resolve cross-border issues of a

particular significance. From an EU perspective, the greatest implication relates to the direct supervisory powers gained by ESMA. How ESMA handles the role will certainly determine the ability of the ESAs to gain similar powers in other areas of supervision.

The post-crisis EU regulatory reform therefore appears to be a success insofar as it has managed to implement the G20 agenda in a relative short timeframe, and has succeeded in offering sufficient regulatory uniformity to enable solid foundations for the single rulebook. Its ultimate success, however, will be greatly dependent on the new supervisory framework and how these rules can be used to mitigate systemic risk in the future.

CHAPTER IV: THE EUROPEAN SYSTEM OF FINANCIAL SUPERVISION: SOME CRITIQUES AND PROPOSALS

The analysis in the previous chapter has demonstrated that the regulatory response has provided some concrete solutions to problems that were identified as a result of the crisis. The creation of the single rulebook constitutes the foundation on which further harmonisation can be achieved by being less permissive towards national differences. The effectiveness of these rules is greatly dependent on the ability of the supervisory framework to enforce them and capitalise on their effects. This is particularly relevant for systemic risk as these provisions have the commonality of providing enhanced transparency and therefore the supervisory visibility it needs to be managed.

This Chapter addresses this point by analysing the new supervisory framework that was put in place as part of the post-crisis reform agenda. From a political perspective, this issue is more sensitive as it relates to delegation of powers to EU agencies. Beyond the institutional tensions lies the effectiveness and legitimacy of the bodies constituting the European System of Financial Supervision (ESFS).

The financial crisis led to a general rethinking by Member States of their respective regulatory and supervisory set-ups. Reform has generally been concerned with redistributing the allocation of powers and responsibilities between their respective supervisors and central banks. The UK is a particularly good example of how this debate has been divisive from a political perspective. Historically, the Labour Government supported the idea of a single regulator and instigated the centralisation

of supervisory powers around the Financial Services Authority (FSA) in 1997.¹ After the crisis, and whilst Labour was still in government, it initiated a further centralisation of powers centred around the FSA.² The new Conservative-Liberal Democrat Coalition Government that came to power following the 2010 elections was intent on drastic change. It proceeded to shift prudential supervision away from the FSA, and re-organised the Bank of England (BoE) to cater for its new tasks. The FSA was abolished and replaced with an authority primarily involved with market conduct regulation and supervision.³

Prior to the crisis, there was a trend amongst Member States to converge towards the single supervisor model,⁴ post-crisis however the restructuring at Member State level shows no particular supervisory structure alignment. This divergence in views means that a bottom-up rationalisation of supervision in the EU is no longer possible. There is, however, a macro-prudential trend which is now burgeoning amongst Member States which involves the separation of prudential and market conduct supervisory roles. Indeed, the Twin Peaks model discussed below is gaining momentum and is becoming a favoured set-up for the positioning of the macro-prudential supervisor domestically.⁵ Having said this, the regulatory infrastructure at EU level has never been dependent on a domestic harmonisation of supervisory models. Before the crisis, there might have been an opportunity to harmonise the different regulatory models at Member State level in order to encourage a bottom-up approach. However, this missed opportunity

¹ E Ferran, 'Examining the UK Experience in Adopting the Single Financial Regulator Model' (2003) 28 Brooklyn Journal of International Law 257.

² HM Treasury, *Reforming Financial Markets* (Cm 7667, July 2009).

³ Financial Services Act 2012.

⁴ E Wymeersch, 'The Structure of Financial Supervision in Europe: About Single, Twin Peaks and Multiple Supervisors' (2007) 8 European Business Organisation Law Review 247.

⁵ E Wymeersch, 'The Institutional Reforms of the European Financial Supervisory System, an Interim Report' (January 25, 2010) Ghent University Financial Law Institute Working Paper No 2010-01.

only represents a minor setback as the responsibility to ensure that there is a smooth link between domestic, and EU regulatory and supervisory bodies is delegated to Member States. The implementation of the FSAP and the Lamfalussy process is a good example of how the top-down approach can be effective. Regulatory and supervisory reform therefore also needs to take a top-down approach.

The de Larosière report⁶ was instrumental in launching a reform of EU financial market supervision by identifying the shortcomings of the pre-crisis framework and suggesting considerable changes. The political mind-set and the urgency of EU Institutions and Member States at the time were such that the de Larosière group would have felt empowered to suggest radical change. With a clear intention of endowing EU agencies with further power, the report needed to be mindful of the constitutional limits and the principle that the day to day supervision of firms was to remain with national supervisors. The report put forward the idea of reform of the Level 3 Committees that were established as part of the Lamfalussy framework, whereby they would gain powers to give binding directions to national supervisors. In addition, they were able to take decisions that could affect financial institutions directly, establish binding standards and potentially being responsible for the licensing of some EU-relevant institutions.

Although the ESFS is an evolution of the Level 3 Committees set out by the Lamfalussy process, the added powers that the new authorities have been given are without precedent at EU level. This leads us to consider the ramifications of its establishment, with a particular focus on its constitutional and jurisprudential compliance. Sampling

⁶ High-Level Group on Financial Supervision in the EU, 'Report' (Jacques de Larosière (chair), DG Internal Market, Brussels, 25 February 2009) (de Larosière report).

the European Securities and Markets Authority (ESMA) as one of the three European Supervisory Authorities (ESAs) will give us a good perspective on how it has dealt with its positioning so far and what changes are worth considering. ESMA has been the busiest authority so far, in particular with regard to new legislation such as EMIR and the regulation of CRAs described in the previous chapter.

Another body worth considering, which forms part of the ESFS, is the European Systemic Risk Board (ESRB), a body which has been entrusted with oversight of systemic risk in the EU. The particularity of this Board is that it has been set up as a soft law body. Therefore, it is worth evaluating its effectiveness and, as a totally new body, whether the mandate it has been entrusted with is a realistic one.

I. Establishing the European System of Financial Supervision

In 2010, the legislation that gave effect to the new powers also rebranded the agencies; therefore, the Level 3 Committees became the European Banking Authority (EBA),⁷ the European Insurance and Occupational Pensions Authority (EIOPA)⁸ and the European Securities and Markets Authority (ESMA).⁹ Collectively, the ESAs were given legal personality.¹⁰ The legislation was a consensus based around the de Larosière report where the European Parliament wished to give the ESAs more powers, and the

⁷ Regulation (EU) 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing the European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L331/12 (EBA Regulations).

⁸ Regulation (EU) 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing the European Supervisory Authority (European Insurance and Occupational Pensions Authority), **amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC [2010] OJ L331/48.**

⁹ Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing the European Supervisory Authority (European Securities and Markets Authority), **amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L331/84.** Due to the substantial similarities between the 2 Regulations, unless quoted otherwise, they will be referred to as the ESA Regulations.

¹⁰ *ibid* art 5 (1).

Council and the Commission were more restrained. The details of the disagreements that occurred through the process are not necessarily pertinent to this study. However, some elements will be highlighted so that the final positions taken can be understood.

It would have made sense, at least from a practical perspective, to have the ESAs in a single geographical location. However, due to national sensitivities, they remained in the same locations as the Committees they replaced. Beyond the geographical positioning, it is important to safeguard effective cross-sectorial communication in order to ensure that supervision is not over-compartmentalised. Indeed, the interconnections between the different sectors cannot be ignored and are often quoted as an argument in favour of a single prudential supervisor. The dialogue between the sectors will therefore be ensured by the Joint Committee which is tasked to 'serve as a forum in which the Authorities shall cooperate regularly and closely and ensure cross-sectorial consistency'.¹¹ In particular, the Joint Committee is tasked to ensure coordination in relation to financial conglomerates, accounting and auditing, micro-prudential analyses which create vulnerabilities for financial stability, retail investment products, money laundering incentives and information exchanges with the ESRB.

Apart from some specificities, the composition of each ESA is the same. Each will have a Chairperson and an Executive Director, a Board of Supervisors and a Management Board.¹² The voting members of the Board of Supervisors will be representatives of the

¹¹ ESA Regulations (n 9) arts 54-57.

¹² *ibid* arts 40 to 53.

relevant national supervisory bodies;¹³ the European Commission, the ESRB and the other ESAs, as the case may be, will be non-voting members. The EBA has some specificities, such as the fact that representatives of the ECB and national Central Banks may also participate in a non-voting capacity. The Board of Supervisors takes its general decisions in a simple majority capacity and in some circumstances by a qualified majority.¹⁴ The fact that the norm is to vote by a simple majority has raised some concerns as it does not reflect individual Member States' market share. A heavy bias appears against the UK which takes nearly a third of EU wholesale financial market activity.

The Management Board is more compact, composed of the ESA Chairperson and six elected individuals from the voting members of the Board of Supervisors and, as non-voting participants, representatives from the Commission and the Executive Director.¹⁵ It also takes decisions based on a simple majority, with the maxim that it must be balanced, proportionate and reflect the Union as a whole.¹⁶ Here, it will be important to maintain the balancing and proportionate exercise when considering the countries that are part of the Eurozone, and those that are not. It will be particularly relevant when considering the Single Supervisory Mechanism (SSM) below.¹⁷ An important aspect for all appointees is that they must act independently and objectively in the interests of the EU.¹⁸ In theory, this negates the idea that the market share of individual Member States is not proportionally represented. The ESAs will need to act in the interests of the EU rather than on the individual concerns of Member States.

¹³ *ibid* art 40.

¹⁴ *Ibid* art 75.

¹⁵ *ibid* arts 45 to 47.

¹⁶ *ibid* art 45(1).

¹⁷ Commission, 'A Roadmap Towards a Banking Union' (Communication) COM (2012) 510 final.

¹⁸ ESA Regulations (n 9) art 1(5).

This is the origin of the situation where many Member States are reluctant to hand more power to EU supervisors, and as discussed below, this has created tension regarding the powers taken on by the ESAs. Independence is also reinforced by the financing aspect of the ESAs whereby there is a 40/60 split between the EU and the Member States respectively.¹⁹ The financial resources remain low, however, in contrast to national supervisors, and this is a clear sign that the ESAs are resourced to take on a limited amount of tasks. It is expected that the budget of the ESAs will be just over a quarter of that dedicated by the UK for its supervisory tasks although the budget allocated to the ESAs has doubled since their establishment.²⁰

The ESAs are primarily accountable to the European Parliament and the Council.²¹ This accountability materialises in different forms, via annual reports, work programmes, statements in response to questions by the European Parliament, opinions and consultations with Stakeholder Groups.²² As a body with a legal personality, there is also the possibility for administrative and judicial recourse. A decision made by an ESA may be contested by formal appeal to the Board of Appeal, a common body for all ESAs, which must remain independent and objective.²³ Actions before the ECJ are also possible regarding decisions taken and, as discussed below, these have already occurred.

¹⁹ *ibid* art 62.

²⁰ Directorate General for Internal Policies (DGIP, European Parliament), Policy Department A: Economic and Scientific Policy, 'Review of the New European System of Financial Supervision (ESFS) Part 1' (2013) <[http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507446/IPOL-ECON_ET\(2013\)507446_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507446/IPOL-ECON_ET(2013)507446_EN.pdf)> accessed 5 May 2014.

²¹ ESA Regulations (n 9) art 3.

²² *ibid* arts 16, 17, 34, 37, 40, 43 and 50.

²³ *ibid* arts 58-60.

The starting point for the powers of ESAs are those which their predecessors enjoyed as Level 3 Lamfalussy Committees (3L3).²⁴ The additional powers can be divided into two broad categories: those which improve procedural matters and communication as lessons learnt from the crisis, and those which represent a true supervisory power shift towards these agencies. In the first instance, these include mentions in terms of systemic risk giving them specific responsibilities in this area.²⁵ Generally, their supervision of systemic risk will go hand in hand with the ESRB's tasks as macro-prudential supervisor. Indeed, the ESAs are required to consider the monitoring and assessment of systemic risk as developed by the ESRB and respond to it accordingly.²⁶ The cooperation between the ESAs and the ESRB is also motivated by the fact that the ESRB is a soft law body, therefore, via the ESAs it gains hard support. In concrete terms, the ESAs and the ESRB have to collaborate to create a system of qualitative and quantitative indicators that will enable the ESFS to focus on those areas that present the highest risk in a risk-based approach way. Therefore, via information gathering and stress-testing, those firms that present the highest chance of affecting the system will be singled out and monitored more closely.

In order to better understand the mechanics of the ESAs, the ESMA will be taken as an example. The reason behind this selection is due to the fact that ESMA has been setting the standards on behalf of the ESAs and to date has had the heaviest agenda, in particular, due to the new legislation introduced that was discussed in the previous chapter.

II. A sample ESA: The European Securities and Markets Authority (ESMA)

²⁴ *ibid* art 8.

²⁵ ESA Regulations (n 9) arts 22-27.

²⁶ *ibid* art 22 (1).

ESAs replaced the 3L3²⁷ Committees which were inadequate and ill-equipped to tackle the growing crisis-led agenda. Standing as advisors to the Commission, the 3L3 Committees were not in a position to carry forward any aspect of the agenda without the Commission's involvement. Indeed, the rapidity with which the ESFS was put in place after the publication of the de Larosière report demonstrates the political will for institutional reform at the EU level. Not only is this evident from the institutional perspective but also from the powers given to the ESAs. Their creation was not without compromise however; amongst existing EU Institutions, and from a domestic perspective, the shift of powers was cause for concern.²⁸ Moreover, the European Parliament emerged as the main supporter of this shift of powers, and unlike the 3L3 Committees, it envisaged a growing shift of power to the ESAs as events may require. This position had the aim of avoiding the difficulty the CESR had in acquiring further supervisory powers from the outset of the crisis and, although the desire was there, the institutional set-up prevented the taking of legitimate independent action.²⁹

A. Respecting the silo-based structure

From the outset, a regulatory problematic issue arises with the position of ESMA within a silo-based structure.³⁰ Although the jury is still out on the most efficient structural strategy to address the regulation of financial services, it certainly appears that a silo-based one is out of favour as opposed to a consolidated one or a Twin Peaks

²⁷ This refers to the three committees that sat at the third level of the Lamfalussy process. These were the CESR, CEBS and CEIOPS and they advised on securities measures, banking and insurance respectively.

²⁸ N Moloney, 'EU Financial Market Regulation after the Financial Crisis: "More Europe" or More Risks?' (2010) 47(5) CMLR 1317.

²⁹ N Moloney, 'CESR and Supervisory Convergence at Level 3 of the Lamfalussy Process' in M Tison, H de Wulf, R Steenort and C Van der Elst (eds), *Perspectives in Regulation and Corporate Governance* (CUP 2009).

³⁰ The silo-based structure refers to the existence of specific supervisors for specific areas of industry as set up by the ESFS.

model that is considered below.³¹ The chief concern is the ability of the ESAs to coordinate their efforts efficiently in supervising an environment which does not respect silos, and where the most systemically relevant market participants often bridge the areas of such silo structures. Failure to efficiently coordinate across these silos leaves the door open to risks which were not previously common at EU level. As will be considered below, the ESRB will need to play its part in mitigating this effect. It is also problematic from a dialogue perspective with domestic regulators which mainly take the consolidated or Twin Peaks form. A review of this structure is scheduled as suggested by the de Larosière report and by Article 81 of the Regulation. The existence of this structure is, however, political by nature and relates to the aversion of giving a federal profile to the regulation of financial services within the EU, which a US SEC-style regulator would certainly be perceived as. The silo-based structure may also lead to cohesion difficulties within its structure. Indeed, ESMA's board of supervisors is composed of a supervisor from each Member State, the voting members, and representatives of the Commission, ESA and ESRB, and the non-voting members.³² For coordination purposes, the non-voting representatives will act as a basic mitigation technique for the silo-based risks. However, the governance process with the voting members will be more problematic. The selection process of the Member State representative could pose issues of legitimacy at national level. Indeed, under the consolidated model this is not an issue. For example, the FSA's initial set-up as an all-encompassing regulator would have clearly designated it as the appropriate representative. However, under the new UK arrangement, the FSA was split between

³¹ Wymeersch (n 4).

³² ESMA Regulations (n 9) art 40(4).

two new authorities.³³ Establishing a coherent and continuous process may become difficult with the potential struggle at a national level to assign a suitable representative. If the potential is there for the representative to have insufficient legitimacy at a national level, then this may reflect on the perceived robustness of ESMA as an EU supervisory authority.

B. A regulatory duality to ESMA's powers

There is a regulatory duality to the powers taken on by ESMA in that it has the ability to act both as rule-maker and supervisor, the latter being traditionally a Member State competence. The legal and political ramifications of this duality indicate a will to push forward the potential for centralisation of regulatory authority at EU level. Moloney argues that although the powers do not go far enough on the rule-making side, they are dangerously extensive on the supervisory side.³⁴ The distinction between rule-making and supervision appears on occasion conjectural in the context of financial regulation as these are invariably linked and, as has been shown, recent regulatory developments have been more concerned with supervision strategies rather than rule conception. However, the distinction is useful in this instance as the distribution of rule-making and supervisory powers at EU level is contentious and currently experiencing fundamental change. It also brings forward Moloney's theory that there is an imbalance between these powers within ESMA.³⁵ ESMA has been entrusted with a hefty agenda, and this begs the question whether it is able to carry out the agenda

³³ The FSA has been replaced by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The PRA acts as a subsidiary of the Bank of England and is responsible for promoting stability and prudent operation of the financial system and the FCA has responsibility for general consumer protection issues and market infrastructure. For a review of the UK changes see J Perry, R Moulton, G Barwick, R Small, J Green and N Kay, 'The new UK regulatory landscape' (2011) COB 1.

³⁴ N Moloney, 'The European Securities and Markets Authority and institutional design for the EU financial market – a tale of two competencies: Part 1: rule-making' (2011) 12(1) EBOR 42.

³⁵ *ibid*

with the tools it has been given, not only from a power perspective but also from a resource perspective.

The nature of the agenda is extensive and flexible,³⁶ in the same way that the European Parliament meant its powers to be. Therefore, a partial answer will be given on the basis of how ESMA will assert itself amongst other EU Institutions and how it will be able to assist the development of a comprehensive pan-EU rulebook, and therefore take a step closer to greater harmonisation. For example, the objective of removing regulatory arbitrage risks will be a moving target, as will be the necessary resources required to achieve it.³⁷

The first side of the duality of its powers is as a limited rule-making EU Institution. These powers can be divided into three different categories: to issue guidance; to propose technical standards; and to create precedents with its individual decisional powers over market participants. The guidance aspect will be a continuation of the process of recommendation and clarification that the CESR undertook. The Committee's scope, however, was limited due to the uncertainty of its mandate and the non-binding nature of the guidance it issued. It is suggested, however, that there were legal effects³⁸ in this guidance insofar as they are eligible to be used by the courts as interpretative documents.³⁹ For ESMA, the requirement is clear under Article 16 that both domestic regulators and regulated entities must comply with issued

³⁶ ESMA Regulations (n 9) Article 1(5) identifies that ESMA's objective is to 'protect the public interest by contributing to the short, medium, and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses'. To do this, Articles 8 and 9 set out the tools at ESMA's disposal. Moreover, the Regulation offers a list of Directives and Regulations upon which ESMA may base its objectives and duties (Article 1(2)).

³⁷ *ibid* art 1(5).

³⁸ In the same way as guidance that is issued by national supervisors, such guidance can be taken into account by the Courts and be considered industry best practice.

³⁹ Moloney (n 34) 65.

guidance where possible.⁴⁰ In practice, it will replicate the weight that guidance issued by domestic regulators has on industry. Insofar as the guidance follows general interests, policy direction and forges best practice, it will be difficult for firms to argue against compliance in a 'comply or explain'⁴¹ environment. Moreover, compliance with its guidance will be monitored in a formalistic way via direct consultation with industry and in its annual report. This, combined with ESMA's ability to directly sanction market participants, will create a portfolio of precedents upon which the supervisory direction will be formed, and will be of central importance to how ESMA will position itself as a supervisory body.

The most critical normative power given to ESMA is its ability to influence technical standards.⁴² These can take the form of Binding Technical Standards (BTS), Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS). The BTS represent a new form of normative power under the EU umbrella, unlike the RTS and ITS which are provided for respectively under Articles 290 and 291 of the Treaty.⁴³ Under the BTS provisions, ESMA can propose technical standards with the oversight of the Commission. However, it does represent a form of delegated power under the Treaty, as opposed to the RTS and ITS, which are clearer, and formal delegations of quasi-rule-making powers. The question arises as to the need for the BTS regime and its ability to sit comfortably within the power dynamics of EU Institutions. According to Moloney, the creation of the BTS regime clearly demonstrates a will to harmonise

⁴⁰ ESMA Regulations (n 9) art 16.

⁴¹ The 'comply or explain' approach is different to the 'comply or else' approach – the former giving room for individual exceptions or circumstances, the latter leading directly to sanctions.

⁴² ESMA Regulations (n 9) arts 10-15.

⁴³ Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C326/47 (TFEU).

supervisory decision-making while bridging rules and guidance.⁴⁴ However, the way in which the technical standards will be used will very much depend on ESMA's ability to navigate its power with the support of the main EU Institutions with, from the outset, a preference from the Commission for BTS and a preference from the Parliament for RTS. The BTS regime will enable ESMA to forge its rule-making ability because, via this regime, they will have more flexibility for rule-making design. Also, despite the requirement that technical standards should not direct policy,⁴⁵ it is likely that this medium will offer the strongest interpretation. From the outset, therefore, ESMA will be inclined to actively propose technical standards in order to cement its ability and demonstrate independence from the Commission in the way it was intended and in a departure from the CESR stance. If the post-crisis political zeal for further centralisation persists, it is likely that, under this regime, ESMA will be the institution of choice to develop the trend. In such a position, policy implications within the technical standards will invariably become apparent and evident from the areas on which ESMA focuses its technical standards development. For example, a focus on developing technical standards under the MiFID legislation would reflect a consumer protection angle as opposed to a market one under the OTC derivatives proposals.⁴⁶

There are, however, some considerable hurdles to ESMA's ability to act as a consistent and long-term quasi-rule-maker. The first of these pertains to its ability to operate within the parameters of the Treaty provisions. ESMA will operate as an Institution under Article 114 of the Treaty, which has the purpose of facilitating the operation of the internal market as opposed to modifying it. It is, therefore, questionable whether

⁴⁴ Moloney (n 34) 66.

⁴⁵ ESMA Regulations (n 9) art 10(1).

⁴⁶ Commission, 'Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories' COM (2010) 484 final.

ESMA will not, in certain circumstances and within its mandate, overstep its Treaty limitations. Indeed, if ESMA is going to be the institution of choice for enhancing harmonisation and be in part responsible for the development of an enhanced rulebook, then there is the possibility that it could forge the dynamics of centralisation rather than simply facilitating them. Although the consensus⁴⁷ on this issue is that ESMA's powers sit comfortably within the remit of Article 114 of the Treaty,⁴⁸ there is nevertheless the possibility of future challenges depending on ESMA's ability to promote its technical standards and position itself within the current development of new supervisory structures both domestically and at EU level.

A similar constraint to ESMA's ability to operate resides in the principles that emerged in the formative *Meroni* ruling.⁴⁹ Crucially, the ruling provides that discretionary powers cannot be delegated away from EU Institutions and that only clearly defined executive powers can, provided that they are adequately supervised by an EU Institution or Treaty framework. In terms of rule-making, this translates into an inability of non-EU institutions to implement rules of general applicability. The Commission has, however, been sensitive to the *Meroni* principles with regard to the powers of ESMA. Via its impact assessments, notably in relation to rating agencies, it considers that ESMA will operate within the *Meroni* principles even if it does have more manoeuvrability in the application of the rules than the EU is used to.⁵⁰ Moreover, where the rule-making powers of ESMA are most prevalent, via the ability

⁴⁷ DGIP (n 20).

⁴⁸ ESMA Regulations (n 9) recital 17.

⁴⁹ Case 9/56 *Meroni v High Authority* [1957-1958] ECR 133.

⁵⁰ Commission, 'Impact Assessment Accompanying the document Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies and a Proposal for a Directive amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers (Staff Working Paper) SEC (2011) 1354.

to form technical standards, safeguards have been put in place to ensure institutional oversight. Therefore, whether ESMA is initiating a BTS, RTS or ITS, an EU Institution will have the ability to review and influence the outcome. Although this is, in theory, a desirable safeguard from an institutional perspective, such provisions could lead to further constraints for ESMA to operate as an efficient quasi-rule-making body, and cause delays for the achievement of a substantial centralised rulebook. Once again, ESMA could find itself the subject of challenges to its powers as a rule-maker, from a domestic perspective where a loss of influence may be felt, but more crucially from EU Institutions that may feel they are losing law-making powers (which historically has been a source of tension between them).

Beyond the politics and inter-institutional rivalries at EU level, the Commission will be the most exposed, particularly in relation to the BTS regime. Indeed, its relationship with the CESR was generally consensual, chiefly due to the absence of the concrete powers the CESR held.⁵¹ As a consultative body, it presented itself more as an extension of the Commission than as an independent body, and this will invariably be different to ESMA's position considering the scope of its powers. The Commission's oversight powers over the issuance of BTS also have their limitations due to the fact that they are more procedural than substance-orientated. The spirit of the oversight is more orientated towards legal compatibility, and towards ensuring that all the necessary steps have been taken from a framework perspective, but not to unilaterally review draft technical standards proposed by ESMA. ESMA itself has clarified its position on the matter by stating that the standards should be amended in only exceptional cases by the Commission, as the powers of creation of technical standards

⁵¹ N Moloney, *EC Securities Regulation* (2nd edn, OUP 2008).

have been delegated from the legislator to itself.⁵² The way in which the relationship between the Commission and ESMA develops has the potential to considerably affect efficient and timely rule-making. In essence, ESMA will need to strategically position itself with its technical ability in order to suitably carry forward its agenda with minimal institutional interference. The Meroni principles will put in place constraints which domestic regulators have not had to contend with, leading to an inability to formally pass rules independently, and this will generate a certain amount of unease.

The second prong to ESMA's powers relates to its ability to directly supervise EU financial markets and its participants. Under the CESR, supervision at EU level was limited to coordination and soft guidance as to how supervision should be carried out at domestic levels.⁵³ Due to the lack of political will, there was, prior to the crisis, little effort to initiate a supervisory shift to an EU body.⁵⁴ This presupposes that rules on the books were the single most apparent EU element to market participants where supervisory techniques and enforcement were left to the domestic regulators' discretion. The de Larosière report, however, identified weaknesses in the ability of the EU to efficiently coordinate supervision, notably with respect to mitigating cross-border risk issues. The report not only identified risks at a macro level but also at a micro one, with issues of supervisory competence and domestic oversight of the regulatory process. ESMA therefore acquires a novel power for an EU agency, which is the operational nature of supervision. This acquisition of supervisory power appears to raise considerable issues of ability and acceptance. The complex nature of supervisory

⁵² Committee of European Securities Regulators, 'Frequently Asked Questions Regarding the EU Regulation on Credit Rating Agencies: Common Positions Agreed by CESR Members' (ESMA, 4 June 2010) <http://www.esma.europa.eu/system/files/10_521.pdf> accessed 5 May 2014.

⁵³ Commission, 'Review of the Lamfalussy Process. Strengthening Supervisory Convergence' COM (2007) 727 final.

⁵⁴ Moloney (n 51).

strategy in a domestic context has already been discussed; ESMA will also be burdened with developing its legitimacy as a new form of EU body and facilitating cross-border coordination. This, coupled with the lack of experience at EU level for direct supervision, leaves ESMA with a complex task of supervisory innovation. This is all the more arduous as there are no examples of such levels of cross-border supervision to rely upon, and also because the crisis did not point towards an efficient supervisory strategy that mitigated its effects.⁵⁵

There are two main strands to the supervisory powers of ESMA: on the one hand, powers to ensure centralisation at EU level; and on the other hand, powers to directly supervise market participants and domestic supervisors. In terms of centralisation, ESMA has been given the task of ensuring coordination and convergence of the supervision of financial markets across the EU. Within the spectrum of these powers, ESMA is, in times of crisis, the point of contact and is responsible for monitoring developments. To do this, it will assist in the development of new crisis mitigating structures in cooperation with EU Institutions,⁵⁶ partner up with the ESRB to assess cross-border issues and the health of market participants,⁵⁷ and coordinate responses to crisis situations.⁵⁸ There are also emergency provisions under Article 18 that provide for it to consult and facilitate action amongst competent authorities in situations that carry a serious threat to the financial stability of the Union. Overall, ESMA is entrusted with the task of developing a common supervisory culture across the EU and of promoting the mutual delegation of supervisory activities between competent

⁵⁵ FSA, *The Turner Review: A regulatory response to the global banking crisis* (March 2009).

⁵⁶ ESMA Regulations (n 9) arts 22-27.

⁵⁷ *ibid* art 32.

⁵⁸ *ibid* art 31.

authorities.⁵⁹ ESMA will gain influence in this respect by being able to participate in colleges of supervisors. This gives a formal recognition of its legal personality. It also gives it the opportunity to influence the conduit of problem solving, and to be in a position to efficiently mediate where conflict arises. ESMA recognises the importance of this ability to participate in colleges of supervisors,⁶⁰ and it could potentially become an effective way to communicate and promote its position amongst domestic supervisors.

The convergence aspect of its powers clearly defines the intention of the EU to create a regulatory superstructure under which domestic supervisors will operate. The de Larosière report intended for a body to be created that could conduct uniform supervision, and ESMA seems to be on track to do this. Consideration of how it will operate its direct supervisory powers is not without problems. Of particular concern to Moloney is the standardisation trend that will invariably emerge and which could stifle regulatory innovation.⁶¹ With ever-growing convergence, and with less flexibility for domestic supervisors to implement their strategy, the risk for systemic regulatory failure increases. Local supervisors will gradually find it more and more difficult to operate independently and introduce elements that may be specific to a given jurisdiction. Their inability to experiment and learn via trial and error may also lead to inconsistencies and prejudice healthy regulatory competition. The FSA has been particularly innovative when addressing supervisory strategy and techniques. Their early focus on a risk-based approach and outcome-led regulation set an example on how to efficiently allocate resources. The specific nature of the risk-based approach is

⁵⁹ *ibid* art 28.

⁶⁰ ESMA 'FAQ' 8 <http://www.esma.europa.eu/system/files/10_521.pdf> accessed 20 January 2014.

⁶¹ Moloney (n 34) 178.

to consider the amount of failure which is acceptable under a probability and impact matrix. Dealing with such issues at EU level will be generally less effective, although limiting the approach only to systemically relevant institutions is feasible. ESMA, however, may be able to mitigate the lack of local innovation by dedicating efforts to its peer review powers.⁶² Article 30 provides for the fact that ESMA is in a position to monitor and evaluate the capacity of local supervisors to operate to a high level while implementing the EU agenda. Although this appears to be a policing of supervisors to operate within the EU policy direction, it could benefit ESMA to learn of local specifics, and therefore, support certain initiatives and cater for them. To achieve this, it will in turn need to adopt a risk-based approach on its own convergence agenda as to how many domestic specifics it will allow. Invariably, the balance will be precarious between convergence and reasonable flexibility at domestic level. This balance will be all the more difficult to achieve when taking into account domestic regulatory objectives and economic priorities, specifically when these have not been established at EU level.⁶³

The direct supervision powers over local supervisors, market participants and products are extensive, and represent a considerable departure from the supervisory detachment of the past. The ability of ESMA to carry these powers forward will greatly depend on its acceptance as a competent authority and the resistance of domestic supervisors to these direct powers. To do so, it will need to make its powers useful in the context of dispute resolution as provided for in Article 19 rather than an aggressive approach to the enforcement of EU law as provided for in Article 17. How ESMA will

⁶² ESMA Regulations (n 9) art 30.

⁶³ Moloney (n 34) 178.

approach these powers remains hypothetical at this point and most likely will be event-driven. The CRA situation has been setting the pace, chiefly due to the lack of national sensitivities towards CRAs in the EU, and their lack of previous supervision.

The vehicle by which ESMA was given extensive supervisory powers over CRAs was the 2011 CRA Regulation itself. Such a procedure could become a template for enhancing ESMA's powers in certain specific areas without affecting the general emergency status of them under its founding regulation. ESMA is not the only body with supervisory powers over CRAs as the Regulation provides certain competences for the Commission and domestic supervisors. Primarily, ESMA will be responsible for: the registration process;⁶⁴ the general supervision of CRAs;⁶⁵ and the charging of fees,⁶⁶ with the Commission retaining oversight over the registration process and the fees. The trend of limiting regulatory interference with methodologies has not changed, and is provided for under Article 23, whereby their usage will remain with the domestically elected competent authority. The local authorities will be the operational arm of ESMA in this respect, but in a limited fashion, where the tasks must be specific and not of a nature that dilutes ESMA's authority.⁶⁷ In return, the competent authorities have the duty to notify ESMA of any infringement that comes to their attention and request suspension of the rating, whereupon ESMA will consider whether to act or not.⁶⁸ Should ESMA act, then its decision to investigate or sanction will potentially be subject

⁶⁴ Regulation (EC) 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies OJ L302/1, art 15 (CRA Regulations).

⁶⁵ *ibid* art 16.

⁶⁶ *ibid* art 19.

⁶⁷ *ibid* art 30.

⁶⁸ *ibid* art 31.

to judicial review. The form may be considered by the local courts, but the lawfulness of the decision is the remit of the Court of Justice.⁶⁹

Overall, the supervisory powers at the disposal of ESMA over the CRAs are virtually fully-formed. ESMA can request sight and copies of all relevant documentation relating to ratings, arrange interviews and request statements with the extended ability to test methodologies in context.⁷⁰ The sanctioning powers are equally extensive and complete, ranging from withdrawal of registration, rating restrictions and fines.⁷¹ The enforcement of these sanctions are also provided for where it is stated in Article 23b that administrative sanctions can be directly exercised by ESMA, and this sidesteps the issue of competence to enforce the sanction at domestic levels. Fines, however, would need to be dealt with via the civil law procedure in place within the Member State in question.⁷²

The scope of ESMA's direct supervisory powers over CRAs is extensive, and they were certainly only possible due to the non-sensitive nature of regulating CRAs in the EU. It was also a relatively easy area of systemic risk control to legislate. It does, however, pave the way for similar enhanced ESMA supervision for other areas of financial regulation deemed necessary. The extended supervision of CRAs also benefited from not being overly concerned with Member State fiscal privileges, which remains a significant hurdle for supervisory centralisation. Indeed, Member States have the opportunity to object and suspend a decision where they feel their fiscal responsibilities are being affected, thereby having the potential to considerably curtail

⁶⁹ *ibid* art 23 (b).

⁷⁰ *ibid* art 22 (a).

⁷¹ *ibid* arts 24 and 36 (a).

⁷² *ibid* art 36 (d).

the development of ESMA's powers.⁷³ The Regulation has considered and provided for this impact which could arise with decisions taken on sovereign bonds or corporate bonds issued by companies presenting systemic characteristics.⁷⁴

Similarly, with respect to ESMA's quasi-rule-making powers, its supervisory ones also need to be considered in relation to Treaty and *Meroni* constraints. As discussed, the Treaty provides for harmonisation measures to be taken under Article 114, which are the main objectives of the ESAs. In their role as authorities aiming to achieve a more centralised control function at EU level for financial services, this bodes well as a strategy for approximation. However, as Moloney points out, this becomes more problematic under the direct supervision powers which ESMA is gaining.⁷⁵ The role of ESMA to centralise regulatory functions at EU level is clearly a step towards maximum harmonisation in line with recent EU policy for financial services, and furthermore, it is respectful of the Treaty. The direct sanctioning of market participants and domestic institutions is more problematic under the Treaty, however, as penalties will go beyond mere approximation of standards. The binding nature of the authorities' decisions makes it all the more sensitive and leaves the possibility open to challenge from Member States who feel that they are losing further control over their financial market. Once again, the positioning success is dependent on establishing good relations with domestic regulators and supervisors while asserting itself as a strong supervisor.

The effect *Meroni* had on shaping the supervisory element of ESMA is greater than that of its rule-making role. The *Meroni* ruling has played a crucial role in shaping EU

⁷³ ESMA Regulations (n 9) art 38.

⁷⁴ CRA Regulations (n 64) art 24.

⁷⁵ Moloney (n 34).

agencies and the scope of their powers, mainly by protecting the realm of EU institutional discretion.⁷⁶ Yet, as previously discussed, ESMA has many unusual features in comparison to other agencies, chiefly with respect to a greater delegation of powers from the Commission and its area of supervision being sensitive by nature. Indeed, the Commission has never held direct supervisory powers over market participants or domestic regulators in relation to financial services; it has traditionally been involved in setting policy and the legislative process. Thus, although the quasi-rule-making powers of ESMA may be taken from the Commission, in terms of supervisory powers the power shift will originate from Member States and their respective regulatory authorities. It is arguable, therefore, whether the *Meroni* principles are appropriate in offering an adequate protective framework in the case of the supervisory powers of ESMA. As a result, the *Meroni* ruling stands to challenge ESMA's powers on both fronts, with a questionable delegation of power from the Commission to ESMA on the one hand, and on the other, a challenge as to whether *Meroni* offers adequate safeguards in operational terms for financial services. The effect of these potential challenges could seriously jeopardise the scope of its operation and make it ineffective, whether a challenge actually occurs that renders it formally weak, or whether ESMA operates under the fear of such challenges.

C. The importance of ESMA's independence

In no small way, ESMA's independence (and its ability to operate independently) will be of the essence for its effectiveness. In the Regulation establishing ESMA, there is a

⁷⁶ D Curtin, 'Holding (Quasi)-Autonomous EU Administrative Actors to Public Account' (2007) 13 European Law Journal 523.

formal recognition of this independence in Article 5⁷⁷ which also bestows upon ESMA legal personality.⁷⁸ This independence is further guaranteed under the Regulation⁷⁹ where ESMA is assigned to act in the interest of the EU as a whole without being influenced by, nor seeking to influence, any other EU Institution, Member State or private body, and to do so independently and objectively. Another feature of this independence comes in the form of its novel funding, with a mixture of EU, Member State and private funding.⁸⁰ In practice, however, ESMA may need to affirm itself as an independent body and overcome the hurdles which are already apparent. To its advantage, it has to a certain extent replicated the network-based model that was apparent under the CESR, which will invariably assist in communication and institutional positioning. Its ability to assert itself at EU level will also define its position at international level. Indeed, depending on the development of its supervisory powers as outlined above, it stands to become the authority of choice to establish international standards and become counterparty to supervisors at international level, crucially, with the SEC. Article 33⁸¹ effectively provides for ESMA to be able to enter into international arrangements with third parties. The wording, however, is quite weak with the use of 'arrangements' that are non-binding on the EU or Member States. Again, this will develop depending on whether the relationship with the Commission is one of dependence or hostility.

ESMA may also find that it is unable to fully make use of its powers from a resource perspective, which in turn could become problematic for its pursuit of centralisation.

⁷⁷ ESMA Regulations (n 9) art 5.

⁷⁸ The exact status of ESMA is somewhat ambiguous because although it is designated as an agency, its powers clearly go beyond that and it is defined in Article 5 as a Union body with legal personality.

⁷⁹ ESMA Regulations (n 9) arts 42, 46, 49, 52, and 59.

⁸⁰ *ibid* recital 59.

⁸¹ *ibid* art 33.

Its resources are, so far, limited both from a budgetary and staffing perspective, with an estimated budget of Euros 24M and 120 members of staff projected for 2013. This compares unfavourably with the budget of the FSA which for 2010/2011 stood at GBP 458M.⁸² However, this is a somewhat unfair comparison. Firstly, ESMA will not be an all-encompassing regulatory authority at EU level like the FSA was in the UK.⁸³ Secondly, ESMA and the other ESAs will utilise the resources available at domestic levels. The extent to which this will be feasible will be down to legislative design. As was discussed in relation to the CRA regulation, specific provisions are made to cater for the usage of domestic resources which could become a template for the operation of ESMA. Caution will need to be exercised, however, with respect to limitations of the delegation of authority from ESMA to domestic regulators; this relationship could be a defining point towards ESMA's legitimacy. The FSA, for example, whilst still in existence gave its support to the Authority, was willing to be open-minded about cooperation with the ESAs and was committed to the development of the ESFS.⁸⁴ It is likely that over time ESMA's budget will increase in line with its support and growing agenda. This agenda will need to be perfected because, as Moloney points out, there is no current direction to the agenda although it is likely that, outside times of crisis, it will be a consumer protection direction.⁸⁵ In contrast, in times of crisis, it is likely to be more product-orientated and market-driven given the context.

⁸² Moloney (n 34) 216.

⁸³ The restructuring of the UK regulatory landscape is not considered here with the recent shift of powers away from the FSA to the Bank of England.

⁸⁴ FSA, 'The European Supervisory Authorities'

<<http://www.fsa.gov.uk/pages/about/What/International/european/esas/index.shtml>> accessed 5 May 2014.

⁸⁵ N Tait, 'ESMA Watchdog Prepared to Clash with Brussels' (*The Financial Times*, 2 March 2011) <<http://www.ft.com/cms/s/0/4b67a246-44e8-11e0-a8c6-00144feab49a.html#axzz33WaR7UJU>> accessed 5 May 2014.

III. Unleashing the ESAs' Powers

It appears, therefore, that ESMA has been granted considerable powers, chiefly in the supervisory sphere. Its regulatory powers are of some consequence but are kept on a much tighter leash due to the issue of the delegation of powers discussed above which has the effect of limiting its independence. The limitation of this independence is necessary in order to keep the ESAs within the boundaries of what is permissible under the Treaty and *Meroni*. Importantly, the ESAs need to be safe from challenge by EU Institutions and stakeholders in order to give the new regulatory framework the assertiveness it needs.

A. The importance of the case law in shaping the parameters of ESAs' powers

1. *Meroni and Romano*

The CJEU has been instrumental in setting up the parameters of what powers can be delegated from the Commission to the EU agencies, most notably with the *Meroni* decision. Three relevant principles have emerged from this decision which is still considered valid jurisprudence today.⁸⁶ The first is that the delegation of power must be explicit and never presumed.⁸⁷ The second is that an agency cannot receive powers different from those held by the delegating institution in order to avoid any loss of accountability.⁸⁸ The third and most relevant principle established by *Meroni* is that powers may be delegated from the Commission to other EU bodies on the condition that the power does not give any discretion in terms of policy-making.⁸⁹ It is important

⁸⁶ C Di Noia and M Gargantini, 'Unleashing the European Securities and Markets Authority: governance and accountability after the ECJ decision on the Short Selling Regulation (Case C-270/12)' (2014) EBOR 1, 33.

⁸⁷ *Meroni* (n 49) 151.

⁸⁸ *ibid* 149.

⁸⁹ *ibid* 152.

that the delegation can only take place for clearly defined and restricted powers because to give a non-EU institution more could breach the institutional equilibrium as set out by the Treaties.⁹⁰ The decision in *Romano*⁹¹ went further by stating that acts ‘having the force of law’ could not be delegated. There is, however, a crucial difference between the two cases. In the case of *Meroni*, the delegation of powers originated from the Commission whereas in the case of *Romano* they came from the Council and European Parliament. The implication of this is that the delegation of power could involve a normative element rather than an executive one. Indeed, considering that an EU Institution can only delegate to the extent of its own powers, then those given by the Council or European Parliament could carry greater ability to delegate normative powers as opposed to those stemming from the Commission’s powers which can be constrained to normative interpretations, thus raising concerns of democratic legitimacy.

Another reflection with regard to *Meroni* is the fact that the decision was made prior to the signing of the Lisbon Treaty. The implication of this is that prior to the Treaty, there were no explicit safeguards in terms of legality reviews for bodies other than EU Institutions.⁹² The *Meroni* decision would have been, at the time, motivated by such considerations and would have wanted to ensure that no exercise of power could escape judicial oversight. This aspect now appears redundant due to the new Treaty

⁹⁰ T Tridimas, ‘Precedent and the Court of Justice: A Jurisprudence of Doubt?’ in Julie Dickson and Pavlos Eleftheriadis (eds), *Philosophical Foundations of European Union Law* (OUP 2012).

⁹¹ Case 98/80 *Giuseppe Romano v Institut National d’Assurance Maladie-Invalidite* [14 May 1981] ECR 1241, para 20.

⁹² The Lisbon Treaty reinforced the idea that administrative decisions could face a judicial review that was outlined in Case T-411/06 *Sogelma v European Agency for Reconstruction* [2008] ECR II-2771, para 36, with Articles 263 and 267 TFEU.

provisions, although it does raise the question of sub-delegation and the positioning of agencies within the EU framework.

Indeed, the ESAs are on track to gain further supervisory powers at the expense of national supervisors. This has raised the issue over whether *Meroni* is applicable considering that delegation will originate from Member States, or their respective supervisors, rather than from the Commission.⁹³ This issue is raised because the Treaties do not explicitly confer certain powers held by national competent authorities on the Commission. Therefore, some of the powers may appear to side-step the Commission all together and appear as a direct delegation from Member State to agency. Providing that the power which is delegated is within the parameters set out by *Meroni* (in terms of limited policy discretion), then it is thought that the chronological chain of delegation is irrelevant as long as the Commission is competent to acquire the competence under the Treaty.⁹⁴

There has been concern in relation to the extent that *Meroni* has been respected, specifically in relation to powers that go beyond the nature of the executive functions that it sets out to restrict.⁹⁵ In search of further administrative efficiencies, it is expected that agencies will have a greater involvement in the application of EU policy and take over more powers in lieu of the EU Institutions. This will cause the boundaries of *Meroni* to be tested and to be opened up to challenge. This is even more likely in

⁹³ Case C-270/12 *United Kingdom v Parliament and Council* [2014] OJ C85/4, Opinion of Advocate General Jääskinen, paras 6, 90-91.

⁹⁴ JP Schneider, 'A Common Framework for Decentralised EU Agencies and the Meroni Doctrine' (2009) 61 *Administrative Law Review* 29.

⁹⁵ M Chamon, 'EU Agencies: Does the Meroni Doctrine Make Sense?' (2010) 17 *Maastricht Journal of European and Comparative Law*.

the case of sensitive economic and financial policy where the ESAs will be particularly vulnerable to challenge.

2. *United Kingdom v Parliament and Council*

It is unsurprising, therefore, that ESMA's powers came under review in 2012 and were challenged by the UK.⁹⁶ The proceedings sought the annulment of Article 28 of the Regulation and questioned its legality on short selling and certain aspects of default swaps.⁹⁷ Article 28 deals with ESMA's intervention powers in exceptional situations which gives them authority to restrict certain financial instruments in circumstances where the financial stability of the Union is under threat. This is a particularly sensitive issue for the UK as its financial services market share is the largest in the EU. Under this Article, ESMA can require natural or legal persons to report or notify short positions⁹⁸ to the relevant authority⁹⁹ and prohibit and impose conditions on the entry into a short sale.¹⁰⁰ These powers can only be used in circumstances where they 'address a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union and there are cross-border implications',¹⁰¹ and where no authority is already dealing with the threat.¹⁰²

The UK contended that Article 28 violated principles laid down in both *Meroni* and *Romano*, basing its case on four grounds of annulment. First, it claimed that Article 28

⁹⁶ Case C-270/12 *United Kingdom v Parliament and Council* [2014] OJ C85/4. (The *Short Selling Case*)

⁹⁷ Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of default swaps [2012] OJ L86/1 (Short selling Regulations).

⁹⁸ Short positions are regarded as a risky trade. This usually involves a party selling a stock he does not necessarily own. These trades came under scrutiny during the crisis. Jill Treanor, 'What is a Short Position?' (*The Guardian*, 23 July 2008)

<<http://www.theguardian.com/business/2008/jul/23/stockmarkets.shares>> accessed 5 May 2014.

⁹⁹ Short selling Regulations (n 97) art 28 1 (a).

¹⁰⁰ *ibid* art 28 (1) (b).

¹⁰¹ *ibid* art 28 (2) (a).

¹⁰² *ibid* art 28 (2) (b).

breached the limits set by the Court in *Meroni* regarding delegation of powers. Secondly, the UK claimed that Article 28 sought to empower ESMA to pass measures of general application which had the force of law, and this was contrary to the ruling in *Romano*. The third contention was that Article 28 purported to confer power on ESMA to adopt non-legislative acts of general application in breach of Articles 290 and 291 TFEU. Finally, it claimed that Article 114 TFEU was the wrong legal basis for the adoption of measures which empowered ESMA to adopt individual decisions that were binding on third parties where action by the Member State was deemed insufficient. Overall, the crux of the UK's argument concerned the discretionary nature of ESMA's powers to decide what would constitute a triggering event, which measures to adopt in response and the extent of its application.

The UK's position was vigorously contested by the Council, the European Parliament, the Commission, Spain, France and Italy. Interestingly, the Council and the Parliament called on the Court to consider the cases of *Meroni* and *Romano* as put forward by the UK, but with the spirit of the Lisbon Treaty in mind which strived towards a modernisation of agency law.¹⁰³ This modernisation refers particularly to the availability of judicial review for agency acts which have legal effects. With respect to the legal basis of Article 114 TFEU, the European Parliament and the Council claimed that Article 28 fell within its remit due to the fact that it amounted to a harmonising measure under EU internal market law.

The ECJ dismissed the action on all points. It clarified the fact that *Meroni* was still effective jurisprudence despite the fact that some of its principles had been rendered

¹⁰³ Opinion of Advocate General Jaaskinen (n 93).

irrelevant due to the Lisbon Treaty. It was a question of which powers could be delegated and to what extent.¹⁰⁴ The Court found that the powers available to ESMA were sufficiently clearly defined in the Regulation,¹⁰⁵ were subject to judicial review considering the objectives set out by the EU Institutions and were compatible with the Treaty. The Court was helped in this decision by some parameters that were put in the Regulation, such as the requirements that if another competent authority is dealing with the issue of taking effective action to address a threat, then ESMA must allow it. ESMA must also be mindful of the efficiency of financial markets and not cause any detriment due to its decision. This appears to be a complex criterion to fulfil as it can be expected that intervention by ESMA under Article 28 will invariably cause or aggravate uncertainty for market participants, and may also shore up liquidity due to increased stress on market perception. The Court further bolstered its decision by stating that the principles set out in *Romano* with regard to the fact that the Treaty allows agencies to adopt acts of general application is valid, providing the parameters of *Meroni* are respected.

The decision clearly points towards greater independence for the ESAs, and provided that they are within the remit of *Meroni* and *Romano*, they should be safe in terms of taking on further delegated powers. The constraints, however, mean that they are not safe from challenge in the carrying out of their powers and need to be mindful of national sensitivities. The idea that the true transfer of power is between the ESAs and the national supervisors raises issues of supervisory and regulatory effectiveness.

¹⁰⁴ Case C-270/12 (n 96) paras 45-53.

¹⁰⁵ Short selling Regulations (n 97).

The cautiousness in terms of moving forward with further independence and powers for agencies is a sign of unease as EU agencies move into uncharted territory. Indeed, the ESAs are the agencies which benefit from the most extensive powers, not only in the stricter sense but also due to the political sensitivity of financial regulation. In terms of effectiveness, it is important to consider whether they should benefit from further independence and autonomy, and whether the cautiousness is justified.

Observers have commented that the new ESFS is a success, albeit insufficient and 'untenable' as a long term solution.¹⁰⁶ To grant the ESAs further powers in terms of autonomy and independence in their rule-making activity, and ability to impose sanctions, means rendering the agencies similar to national supervisory bodies.¹⁰⁷ Considering what has been discussed above, there is, however, a crucial difference with regard to the limits that ESAs will have in terms of independence in comparison with their national counterparts. That difference lies in the lack of independence from the Commission while national supervisory bodies tend to be established as bodies independent from the influence of institutional intervention.¹⁰⁸ This is a matter of nuance if we consider the continuing Europeanisation and centralisation of supervisory powers. If the powers originate from the national supervisors rather than the Commission, this becomes an accepted and explicit channel for the transfer of power. Consequently, the ESAs will gain a form of further independence from the Commission in terms of delegation of powers, albeit not in terms of accountability. This appears

¹⁰⁶ E Wymeersch, 'Europe's New Financial Regulatory Bodies' (2011) 11 *Journal of Corporate Law Studies* 443.

¹⁰⁷ E Ferran, 'Understanding the Shape of the New Institutional Architecture of EU Financial Market Supervision' (University of Cambridge Legal Studies Research Paper Series 142, May 2011).

¹⁰⁸ E Chiti, 'An Important Part of the EU's Institutional Machinery: Features, Problems and Perspectives of European Agencies' (2009) 46 *Common Market Law Review* 1399.

acceptable under the Regulation¹⁰⁹ establishing the ESAs, provided that the Meroni principles are respected.

B. ESAs' accountability is problematic

The accountability aspect towards the Commission does create effectiveness issues. We currently find ourselves in a situation where ESAs are gaining powers at the expense of national supervisors, which also seems to be the favoured trend going forward. The Commission, however, stands as an accountability buffer for the actions taken by the ESAs. In the first instance, therefore, we may find that there is a duplication of tasks between ESAs, the national supervisors and regulatory bodies. The Commission effectively remains the body that is responsible for the acts of ESAs such as the drafting of a technical standard which, once reviewed by the Commission and approved, becomes a technical standard.¹¹⁰ This means that the technical standards that are reviewed by the Commission need to be done in a competent way if the chain of accountability is to be respected. This is due to the fact that a draft technical standard cannot be appealed against, only the standard itself. Additionally, this cannot be directed against ESMA but against the Commission. Therefore, the level of competence at Commission level needs to equate to that of ESAs' if we are to ensure that the Commission is not simply approving the agencies' drafts blindly. Therefore, the effectiveness of the system is jeopardised and this questions the necessity for the agencies in the first place.¹¹¹ In terms of effectiveness, therefore, it would make sense to increase the discretion of ESAs' rule-making powers and devolve direct accountability respectively.

¹⁰⁹ ESA Regulations (n 9).

¹¹⁰ *ibid* art 60.

¹¹¹ Chamon (n 95) 292.

On the supervisory side, there are also inefficiencies. Due to the sensitivity of the imposition of sanctions, the Commission also appears as an intermediary between the action taken by the ESAs and the recipient.¹¹² Here again a duplication of tasks occurs if the ESA is unable to assert its intervention. Should the Commission be called to evaluate or re-evaluate a decision taken by an ESA, then the re-evaluation process would need to occur again at Commission level. The issue is amplified if we consider the fact that the Commission is more prone to political interference than a typical independent supervisor would be.¹¹³ The procedural and administrative inefficiencies that we are currently witnessing originate from the inability to centralise at EU level, and amongst the Institutions, rather than difficulties originating from Member States upwards. Therefore, it would appear that, both from a regulatory and a supervisory perspective, handing more power to the ESAs would be efficient.

Beyond constitutional concerns, further centralisation of powers at ESAs' level carries its share of complications. Firstly, if the flow of powers from Member State to ESAs persists, then we expose the EU to a potential lack of regulatory competition. This is based on the idea that a regulator, left to its own devices in a totally independent capacity, may carry out policies of a self-interested nature.¹¹⁴ If this behaviour occurs, however, it is likely to be reflected at a lower and domestic level as the broad lines of effective regulation and the themes that concern regulators today are set and discussed at international levels in order to ensure market compatibility. Nevertheless,

¹¹² A good example of the complexity of the procedure can be found in ESA Regulations (n 9) art 17.

¹¹³ L Enriques, 'Regulators Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's view' (2009) 30 *University of Pennsylvania Journal of International Law* 1147.

¹¹⁴ E Ferran, *Building an EU Securities Market* (CUP 2004) 104. Deakin supports the idea that regulatory diversity should be preserved in S Deakin, 'Legal Diversity and Regulatory Competition: Which Model for Europe?' (Centre for Business Research, University of Cambridge, Working Paper No 323, 2006). See also on the topic of regulatory competition J Black, *Rules and Regulators* (OUP 1997).

at a lower level this type of behaviour should be permitted in order to allow for domestic specificities. A similar argument can be brought against the claim that where there is a lack of regulatory competition there is also a lack of regulatory innovation.¹¹⁵ Again, the current situation, with global pressures to implement and consider regulatory themes that are addressed by international bodies such as the FSB, IMF and the Basel Committee, means that regulatory innovation now takes place on a different level.

Of greater concern is the possibility that a centralised regulatory power would be inclined to introduce an excessive amount of regulation.¹¹⁶ Depending on resources, if a single regulator were responsible and accountable for the stability and the good functioning of an entire financial system, then it would be more disposed to want to cover all the bases due to the accountability it bears. Such an attitude would lack efficiency and indicate the return of less effective regulatory techniques such as the rules-based approach. It is unlikely, however, that the EU framework would allow for such latitude, let alone the constitutional limitations. There is, however, a tool that could be exploited to a similar effect by the ESAs and these are the non-binding standards. The issuance of these standards could have the effect of slowing down the system due to the administrative imposition on national regulators. Indeed, with the requirement to comply or explain, there needs to be consideration of the issue, and at

¹¹⁵ J Macey, 'Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty' (1994) 15 *Cardozo Law Review* 934.

¹¹⁶ C Goodhart, 'Regulating the Regulator – An Economist's Perspective on Accountability and Control', in Eilis Ferran and Charles Goodhart (eds), *Regulating Financial Services and Markets in the 21st Century* (Hart Publishing 2010) 151. In relation to regulatory efficiency, Taylor agrees with Goodhart and suggests that 'a single regulator could potentially become an over-mighty bully, a bureaucratic leviathan divorced from the industry it regulates', in M Taylor, *'Twin Peaks': A Regulatory Structure for the New Century* (Centre for the Study of Financial Innovation 1995). Briault however argues the opposite - that a single supervisor can introduce great efficiencies: C Briault, 'The rationale for a single national financial services regulator' (1999) *JIFM* 252.

least a response from the national authority, an excessive amount of which could slow down the system and result in inefficiencies. In order to stop the potential for an ESA agency to take unreasonable regulatory measures, the most logical course of action would be to have a system to replace those with decisional powers within the ESAs. However, such a process does not respect the chain of accountability as described above. Indeed, the Commission does not have any say in the appointment of members of the Board of Supervisors who would remain the responsibility of Member States. In times of strain and disagreement, the independence of these Members would be merely conjectural.¹¹⁷ However, this would entail partisanship away from a centralised EU, and it would be shown to favour domestic policy which in turn would negate the possibility of an over-zealous regulator. To ensure balance in this respect, a proposal to give the Commission appointment powers at this level was discussed but ultimately dropped.¹¹⁸ Therefore, although from an accountability sense it would stand to reason that the Commission or the Council have appointment powers at this level, it would be surprising that the absence of such a provision would lead to excessive or unreasonable regulatory powers being exercised at ESA level.

C. Flexibility is available for ESAs to acquire further powers

Although the recent decision in the *Short selling case*¹¹⁹ has confirmed certain powers of ESMA, it also opened the door to the possibility of ESAs acquiring further powers due to ‘flexibility’ in interpretation of the jurisprudence and the Lisbon Treaty. Taking the ESAs to the next step will inevitably require pushing the boundaries set by *Meroni*

¹¹⁷ Chamon (n 95) 301-303.

¹¹⁸ Commission, ‘Draft Interinstitutional Agreement on the Operating Framework for the European Regulatory Agencies’ COM (2005) 59 final.

¹¹⁹ Case C-270/12 (n 96).

and the Treaty. Drastic constitutional changes in this respect are not currently on the cards. However, some adjustments on ESAs' level of accountability could be instrumental in terms of regulatory efficiency.

On the regulatory front, the relationship between the ESAs and the Commission is not as dependent as it might first appear. Indeed, the safeguards in place have the effect of rendering it inefficient rather than overly-reliant, due to a potential duplication of tasks that could lead to sub-optimal outcomes. This is as a consequence of trying to establish a chain of accountability that would render the ESFS constitutionally compliant. More particularly, due to the fact that the true shift of power is between the national regulators and the ESAs, the relationship between the ESAs and the Commission could be one of competing regulatory bodies rather than subordinated ones. Efficiency gains could be made with such a perception shift, as, rather than the Commission being a controlling body, it would be a contesting one. It could safeguard against the issues noted above by challenging the work of ESA rather than being an extension of an EU Institutions' policy direction. Such a positioning could also act as an incentive for ESAs to behave in an appropriately responsible manner towards regulatory innovation in order to ensure its mission was carried out. To a certain extent, this *modus operandi* is already taking place with regard to the implementation of technical standards and the fact that the Commission can only intervene to amend or reject them in exceptional circumstances.¹²⁰ The next step for the ESAs to develop their independence further depends greatly on their relationship with the Commission.

¹²⁰ With regards to the implementation of the EMIR Regulations and the amending technical standards, ESMA imposed itself in spirit against the Commission as a truly independent regulator. ESMA requested that the implementation date be pushed back due to difficulties in complying with the Regulation. The Commission rejected the delay, stating the standard was clear enough. Although the date stood, ESMA

There are several ways in which this might be developed concretely. Di Noia and Gargantini have suggested changing the Commission's approval process with regard to technical standards.¹²¹ Indeed, modifying the way the Commission deals with technical standards and having its approval implied rather than expressly endorsed would make the process more efficient but also develop the regulatory competition that could be lacking in the future. The overall idea would be for the Commission to adopt and equip itself with tools that would enable it to adopt a risk-based approach in terms of regulatory measures that deserve its attention. The mechanism would need to be effective in flagging up those measures which may raise issues or be problematic so that the Commission would be prompted to intervene at the relevant time. The Stakeholder Groups and the Board of Appeal could play a role in this scenario where, due to their composition, the former could raise issues directly with the Commission should there be industry or consumer concerns, and the latter could act in an early warning capacity when concerns were being raised with an eventual judicial review. Any concerns could be further raised by an earlier consultation phase. ESMA has already proved to be proficient in consulting and maintaining information available via its reports and by announcing its current and future areas of interest. However, the formality of an early consultation phase which would take place prior to the Commission's consideration would act as an efficient early warning mechanism.

The most important element in implementing an implicit approval regime by the Commission would be the maintenance of its rights to veto and amendment. Although the ESAs are also accountable to the Council and the European Parliament, the

issued a note to industry which stated that the commencement of reporting under EMIR would be a soft implementation in order to allow industry to get up to speed with the reporting requirements.

¹²¹ Di Noia and Gargantini (n 86) 39.

procedure of removing their quasi-regulatory powers is a step removed from reviewing regulatory standards, and should only be able to be taken if there is a subsequent disagreement between the effectiveness of the Commission's review and the other EU Institutions.¹²²

The greatest difficulty in giving further independence to the ESAs stems from the constitutional constraints of Articles 290 and 291 TFEU. It has already been noted that the independence given to ESAs in terms of draft technical standards, and the ability for the Commission to only intervene in exceptional circumstances is already a step too far in reducing its Treaty privileges.¹²³ The next step, where implicit approval would be the norm, may not be sufficient to consider the normative acts of the ESAs as compliant with the Treaty.¹²⁴ Such a situation can only be temporary and, as suggested, the relationship between the ESAs and the Commission needs to evolve in order to allow for a more efficient regulatory framework. The constitutional tension that exists, coupled with the current trend of encouraging more flexibility in terms of normative powers for the agencies, is promising in terms of rethinking some of the constitutional constraints.

The principles laid down by *Meroni* are slightly less problematic in this instance, especially in light of the decision taken in the *Short selling case* where more flexibility was encouraged in terms of its interpretation. However, it does not reduce the requirement that delegated powers must be sufficiently specific and must not offer any discretion in terms of policy direction. The concerns about the limits to the

¹²² Di Noia and Gargantini (n 86) 40.

¹²³ M Chamon, 'EU Agencies Between Meroni and Romano or the Devil and the Deep Blue Sea' (2011) 48 *Common Market Law Review* 1067.

¹²⁴ A Neergaard, 'European Supervisory Authorities. A New Model for the Exercise of Power in the European Union?' (2009) 11 *Euredia* 627.

applicability of the Meroni principles are still open to interpretation and, in particular, the extent of the flexibility to be adopted. Some commentators have found that it would be sufficient for the Commission to have a last say mechanism, such as a veto, to preserve its constitutional privileges.¹²⁵ Others, though, have found it more difficult to reconcile it with the idea of a legitimate equilibrium under the terms of the Treaty.¹²⁶ If we take the former view, the potential to extend ESAs' powers without the need for constitutional change is real.

Turning to the supervisory aspect of ESAs' powers, any development appears more dependent on the relationship with national authorities rather than any EU Institution. Indeed, by adopting a 'hub and spoke' model, the intention was to centralise the rule-making tasks whilst having a supervisory drive at Member State level.¹²⁷ Again, there is a balance to be struck in this respect, whereby the advantages of having national supervisors with a certain amount of autonomy need to be set against a move to harmonise supervisory practices. Due to national sensitivities, the ESAs need to be tactful in the development of a greater harmonisation of supervisory practices. The ESAs have some leeway here on which stance to adopt. They can either opt to act as a coordinating entity, whereby greater harmonisation is the long term target, or encourage and maintain autonomous national supervision. The preferable solution is certainly to accomplish a good balance on both approaches. However, achieving either will greatly depend on ESAs' ability to impose itself as a convincing supervisory authority, and certainly also on the willingness of national supervisors to coordinate

¹²⁵ S Griller and A Orator, 'Everything Under Control? The 'Way Forward' for European Agencies in the Footsteps of the Meroni Doctrine' (2010) 35 *European Law Review* 27.

¹²⁶ Chamon (n 95) 292.

¹²⁷ E Wymeersch, 'The European Financial Supervisory Authorities or ESAs' in Eddy Wymeersch and others (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (OUP 2012) 235.

and be open to cooperation with the ESAs. Due to the fact that the representatives of the national supervisory representatives sit on the Board of Supervisors, the ESAs maintain a strong intergovernmental set-up. It would be inappropriate to qualify the ESAs as supervisors of the supervisors. However, there is an element of inspection over national practices¹²⁸ and this will greatly depend on how coordinated the national authorities want to be with regard to their supervisory practices.

D. The harmonisation of supervisory practices will be tension driven

The willingness to engage or not in an exchange of supervisory practices may well turn out to be driven by conflictual stances.¹²⁹ Indeed, where there is a divergence of opinion, and where one national supervisor might be at a competitive loss in relation to another, then these situations are most likely to be raised and resolved at ESA level. The issue is to what extent the ESAs also want to drive the convergence of practices. The issuance of guidance and recommendations issued by the ESAs fall outside the remit of Articles 290 and 291 TFEU, and therefore, could become a powerful tool for the ESAs to impose supervisory direction. The ability to harmonise practices is also bolstered by the voting mechanism which, in a departure from the consensus approach under the 3L3 Committees, is now by qualified majority or simple majority which may encourage the backing of ESA intervention in order to obtain a more homogenous system.¹³⁰

The convergence of supervisory practices will be a step by step mechanism, where the most relevant supervisory issues will be harmonised when needed. As was described

¹²⁸ *ibid* 236.

¹²⁹ P Shammo, 'EU Day-to-Day Supervision or Intervention-Based Supervision: Which Way Forward for the European System of Financial Supervision?' (2012) 32 *Oxford Journal of Legal Studies* 26.

¹³⁰ Di Noia and Gargantini (n 86) 44.

above, the greatest supervisory power so far gained has been by ESMA in its supervision of CRAs. Two elements combined to make this possible. The first was post-crisis driven where the regulation and supervision of CRAs was seen as a necessity. The second was that there were no national sensitivities in the EU as the CRA industry is US-based. Outside of these considerations, reaching harmonisation of supervisory practices is going to be challenging. The *Short selling* case demonstrated how national sensitivities can stall the process, and although the Court decided ESMA's powers under the regulation did not breach EU law, it will have the effect of confirming the weakening of national supervisors.

E. Balancing interests with a governance review

The review of the ESFS undertaken by the Directorate General highlighted the fact that the involvement of competent authorities has had the effect of diminishing the powers of the ESAs where, on occasion, the Chairperson's initiatives have been rejected due to national sensitivities.¹³¹ In the same breath, however, it is mentioned that the inclusion of the national competent authorities gives a 'sense of ownership' over the ESAs which is crucial in attaining any sort of harmonising practices.¹³² It does, however, appear that this 'sense of ownership' has failed to materialise, which would confirm the view that the composition of the Board of Supervisors needs to be reviewed if EU interests are to be put before national ones.¹³³ Possible composition changes could involve including enhanced voting rights for EU Institutions other than the Commission and more executive powers handed to the Management Board. The

¹³¹ DGIP (n 20) 34.

¹³² *ibid*

¹³³ International Monetary Fund, 'Financial Sector Assessment Program European Union: Issues in Transparency and Accountability' (Technical Note, IMF Country Report No 13/65, March 2013) 11.

lack of supervisory expertise of EU Institutions being present on the Board could be counterbalanced by a devolution of powers to the Management Board whilst encouraging a Europeanisation of supervisory processes. This counterbalance is necessary if, as above, it can be concluded that currently there is an overwhelming mismatch in favour of national discretion.

Such a governance review would avoid Treaty changes that would confer more supervisory powers on the ESAs. It would also have the benefit of splitting functions within the ESAs between monitoring and management functions.¹³⁴ An important element to such a competence redistribution would be for the EU Institutions to also nominate a significant number of members of the Management Board in order to avoid a mere displacement of the existing imbalance. The chief concern for avoiding a restructure of the ESAs in governance terms has been the potential for excessive interventionism at the domestic level.¹³⁵ This is reinforced by the idea that EU Institutions, especially the Commission, if overly represented at ESA level, would not have the tendency to try and counter the inclination. In this respect, the Council and the European Parliament would be more sensitive to such issues. In order to avoid an excessive counterbalance occurring, removal of any internal ESA influence from the Commission might be desirable. Indeed, with the harmonisation equilibrium left to national competent authorities on one side, and with representatives with equal powers nominated by EU Institutions other than the Commission, balance could be achieved.

¹³⁴ L Enriques and G Hertig, 'Improving the Governance of Financial Supervisors' (2011) 12 *European Business Organisation Law Review* 367.

¹³⁵ E Ferran, 'Crisis-driven Regulatory Reform: Where in the World is the EU Going?' in Eilis Ferran and others (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press) 48.

F. The limitations of supervisory harmonisation

In combination with a rebalancing of interests via governance changes, a review of how supervisory harmonisation is to be dealt with at ESA level could also be beneficial. Currently, and due to the composition of the Supervisory Board, the supervisory practices promoted by the ESAs are driven by a consensus of the majority. There will be an inevitable part stemming from national interest considerations rather than EU interest ones.¹³⁶ Here, a safeguard mechanism would be useful so that a harmonisation of supervisory practices has some EU relevance and is in the interest of the Union. Such a mechanism could, on the one hand, promote integration of practices whilst avoiding uniformity.¹³⁷ ESAs would need to be able to verify EU relevance of a particular process objectively. Such a procedure could be carried out by the Stakeholder Groups, for example. This would have the advantage of representing the affected parties, especially industry where meaningful harmonisation of supervisory practices makes sense from a practical and economic perspective. Indeed, it could be foreseen that for industry stakeholders that have an EU-wide presence, the ability to centralise their regulatory and compliance functions would not only be financially advantageous but would also be conducive to more supervisory certainty.

Moreover, there are considerable advantages in maintaining a certain amount of national discretion and autonomy.¹³⁸ The ESAs could implement a national exception rule, and accept divergent approaches which appear reasonable. This would mitigate the loss of regulatory competition and maintain supervisory creativity by maintaining a source of supervisory solutions and experiences that could be shared amongst

¹³⁶ DGIP (n 20) 34.

¹³⁷ Di Noia and Gargantini (n 86) 46.

¹³⁸ Shammo (n 129) 13.

competent authorities. This would presuppose once again that the competent authorities were willing to work and learn from one another. This will have the effect of generating a certain amount of convergence which would be most useful in times of crisis. As discussed above, post-crisis measures are more likely to be solution-driven than policy-driven. Therefore, where issues of particular significance arise, such as with CRAs, then the opportunity for supervisory uniformity will arise. The crisis might also have brought about a certain humbleness to supervisors that were previously confident in their ways. The fact that national competent authorities have mismanaged market irrationalities due to misunderstood concepts has demonstrated the limitations of certain supervisory concepts.¹³⁹ This will hopefully enable better dialogue and exchange of ideas amongst supervisors.

A particularly relevant issue related to supervisory uniformity is the suggestion that it may increase systemic risk. Left to their own devices, national competent authorities will tend to focus their efforts on different types of risk, chiefly those that are likely to affect them the most, therefore leading to an efficient compartmentalised allocation of resources. Consequently, uniformity could remove the risk-based nature of financial supervision by applying resources inefficiently. Thus, brashness at ESA level is not desired as to apply supervisory pressure in the wrong place would risk the aggravation of systemic risk.

The system for improvement needs to be created and driven by the ESAs. They need to encourage and implement uniform processes where there are undeniable certainties

¹³⁹ Wymeersch (n 106) 449.

that no unwanted ramifications are expected¹⁴⁰ and allow for a certain amount of discretion where national particularities are noticeable, or where there are signs of unpredictability. For this, a proposal to review the governance outlined above is essential, where a more balanced Board of Supervisors and Management Board would be established in terms of national vs EU interests - with greater executive power handed to the Management Board and with the Board of Supervisors acting more in a monitoring capacity in order to ensure effectiveness. Importantly, review should be made on a regular basis to ensure that supervisory practices adopted by the ESAs and promoted amongst competent national authorities be reviewed with the purpose of ensuring relevance to the EU. This mechanism should allow for ESAs to take a hard line on supervisory uniformity across the EU where there is confidence in the methods, and a more flexible approach where there is doubt in order to encourage supervisory competition and creativity. Finally, there is also the economic and practical benefit of greater reliance and competent authority buy-in in order to compensate for the limited resources available to the ESAs.

IV. The European Systemic Risk Board: Systemic Risk Champion or Information Post-Box?

A. Creation of the ESRB

Under Recommendations 16 and 17, the de Larosière report clearly suggests the creation of a body specifically dedicated to macro-prudential supervision, which in the

¹⁴⁰ Di Noia and Gargantini take the example of the varying lengths of time needed for a prospectus to be approved under the Prospectus Directive. Such divergence is deemed unnecessary and as a maximum harmonisation tool should not be a problem to make uniform such a procedure. Di Noia and Gargantini (n 86) 47.

report is referred to as the European Systemic Risk Council (ESRC).¹⁴¹ The rationale for this recommendation originates in one of its key findings, a lack of macro-prudential effort at EU and Member State level, let alone on a global scale, and with regard to financial services generally. Indeed, the crisis rapidly revealed unexpected interconnectedness within financial markets, but also its complexities and opaqueness. It was found that no entity or country held sufficient information on a macro level. The lack of information and transparency contributed to countries having difficulties in measuring their responses to the crisis, and they were, therefore, not in a position to mitigate the ramifications. As a result, they were ill-equipped to deal with the consequences.

Considering the criticisms made by the de Larosière report regarding the shortcomings of the pre-crisis supervisory framework, it appears that macro-prudential supervision is still in its infancy. However, the debate as to what constitutes macro-prudential supervision and its positioning remains a matter of discussion.¹⁴² Despite progress at domestic and EU levels, the lack of experience with this type of supervision leaves the notion somewhat open to interpretation. Indeed, macro-prudential supervision is most often associated with the notion of systemic risk, which is also the position taken in the report. The uncertainty regarding both concepts already presents the challenge of giving a macro-prudential supervisor a place and a mandate within the EU framework.

Traditionally, such a role in terms of macro-prudential supervision has been the remit of the central banks. To a certain extent, this was done more or less efficiently by the Member States but not sufficiently well according to the de Larosière report. The

¹⁴¹ de Larosière report (n 6) III, b.

¹⁴² Bank for International Settlements, 'Macroprudential Instruments and Frameworks: a Stocktaking of Issues and Experiences' (CGFS Publications no 38, May 2010) 8.

emergence of the Twin Peaks supervisory model has certainly contributed to reinforcing macro knowledge at central bank level.¹⁴³ This model, also called an objective-based model, creates and distinguishes system supervision as an objective which aims to ensure financial stability by preventing one institution infecting another institution, or the whole system.¹⁴⁴ However, the focus on the objective will require a tailored sub-supervisory technique in order to attain the objective. The introduction of the Twin Peaks model in the UK had for its core purpose to reduce the frequency of severe financial crisis in the future.¹⁴⁵ The de Larosière report also stated that at EU level, proximity to the ECB for such a role is essential, and further, it must be in a position to centralise information collected at domestic level via a specific mandate. The Report suggests handing this mandate to a specific body closely linked to the ECB which would replace what was, at the time, the Banking Supervision Committee (BSC) of the ECB. The introduction of the Twin Peaks model in several jurisdictions has raised the question of positioning the body responsible for system supervision and monitoring. Although a discussion of the model is not one currently debated at EU level,¹⁴⁶ it does raise the question of the position a body responsible for macro-prudential supervision should take and its proximity to either the agencies or the ECB.

The two early adopters of the Twin Peaks model, Australia (1996) and the Netherlands (2008), have taken different positions in this respect, with Australia holding the prudential role parallel to the Central Bank and the Netherlands incorporating it within. In both cases, the model's core design is not jeopardised, provided that the

¹⁴³ M Killick, "'Twin Peaks', a new series or new chimera? An analysis of the proposed new regulatory structure in the UK' (2012) *Comp Law* 366.

¹⁴⁴ L Silverentand, K Broekhuizen, "'Twin Peaks' in the Netherlands' (2008) *Euro Law* 13.

¹⁴⁵ Killick (n 143).

¹⁴⁶ There has been forward looking discussions about the adoption of an objectives-based approach at EU level. See de Larosière report (n 6) recommendation 24 and Wymeersch (n 5).

model 'involves two separate, integrated agencies'.¹⁴⁷ In this respect, the UK Government has strongly favoured the total integration of the prudential side of regulation of larger firms within the BoE. They feel in this respect that it is important that one authority has overall responsibility for financial stability, whether it be monetary or systemic.¹⁴⁸ To this extent, the BoE has held the mandate for maintaining financial stability since 2009, though it only acquired the tools in 2013 when the formal transition to the Twin Peaks model occurred.

In the current state of affairs at EU level, and providing that the move towards a single mega-supervisory body is not likely to happen, Member States have a greater responsibility to link the micro and macro-prudential information. This is in order to consider isolated institutional issues, and set them against the bigger picture of jurisdictional stability. The intention, and the prime concern of the UK Government when orchestrating the transition was to enable prompt transfer of information between the decision-makers on monetary stability and those responsible for system stability.¹⁴⁹ The intended result is the potential for pre-emptive action on both levels. It might be overly simplistic to conclude that because the BoE holds the purse strings in terms of the LOLR function, that it must therefore also be the information collector as suggested in the policy document. This is not to negate the need for the LOLR to have full and prompt information, but this function is far removed from the way we now understand systemic risk. The need for early red flags and prudential action has the intention of negating the need for an LOLR. What is relevant, however, is the ability to

¹⁴⁷ D Llewellyn, 'Institutional Structure of Financial Regulation and Supervision' (Paper presented at the World Bank and IMF Conference, Aligning Supervisory Structures with Country Needs, Washington, June 2006) 27.

¹⁴⁸ HM Treasury, *A new approach to financial regulation* (Cm 8012, February 2011) para 3.38.

¹⁴⁹ Conservative Party, 'From Crisis to Confidence - A Plan for Sound Banking' (Policy White Paper, 2009).

monitor not only how micro-prudential information can cause systemic risk, which remains the chief purpose, but also how macro decisions can affect individual institutions.

Beyond effective flows of information, there are few arguments that lead us to conclude that the integration of the function within the Central Bank is essential. Provided that the information flow is effective and prompt, then the objective of system stability can be situated within or without. The UK has taken the distraction argument of regulatory priorities to heart when crafting the new model as it clearly points to the fact that within the FSA, consumer protection was a constant priority over prudential supervision.¹⁵⁰ One may suggest that this argument could be duplicated with the new model, where the BoE may prioritise its more traditional role. To this effect, the new structure of the BoE cites two separate core purposes, monetary stability and financial stability, with governance equipped to deal with these purposes in apparently equal measure.¹⁵¹ This keen dual prioritisation, and departmental segregation will be important in managing decision-taking when a policy decision conflicts with either of the core purposes. This issue has been pointed out in the US where it is suggested that the Federal Reserve has experienced such conflicts with a traditional prioritisation for the more immediately visible monetary aspect.¹⁵² Conversely, it may not be desirable for monetary policy to be overly-burdened with

¹⁵⁰ Lord Turner, 'Evidence to the House of Lords Select Committee on Economic Affairs, Banking Supervision and Regulation' (June 2009).

¹⁵¹ BoE, 'News' <http://www.bankofengland.co.uk/publications/Pages/news/2014/058.aspx> accessed 20 January 2014.

¹⁵² Di Noia and Di Giorgio, 'Should Banking Supervision and Monetary Policy Tasks Be Given To Different Agencies?' (*eRepositori*, 19 October 2009) <<http://repositori.upf.edu/bitstream/handle/10230/911/411.pdf?sequence=1>> accessed 20 April 2014; C Goodhart and D Shoemaker, 'Institutional Separation between Supervisory and Monetary Agencies' (LSE Financial Markets Group, Special Paper no 52, April 1993).

financial stability concerns which could potentially lead to an overall wrong long term direction.¹⁵³ This appears to be a burden that will need to be borne at some level, and therefore, centralising at Central Bank level may be preferable provided that a solid governance infrastructure is in place in order to balance both objectives with information availability in both instances. There are a few conclusive arguments against and in favour of incorporating this role within the Central Bank function. If it is not incorporated then it needs concrete and efficient information flows with the Central Bank or relevant decision-maker. If it is incorporated then its governance framework needs to be constructed in such a way that too many tasks are not under a single roof, as was the case with the FSA.¹⁵⁴

The proposal, made by the de Larosière report to create the position of a body similar to the suggested ESRC outside of the ECB is not critical. The EU has not, and would be unable to adopt a Twin Peaks approach, preferring to operate its supervision via specialised agencies, as discussed above. Notwithstanding the existence of the traditional EU Institutions and the ECB, the ESRC therefore needs to be a centre for the collection and dissemination of information in an effective way amongst these institutions. For this purpose, the de Larosière report insists on the strategic positioning of the body, certainly with proximity to the ECB and with its logistical support. The composition must also be strategic and be positioned within and amongst the national bodies responsible for system stability, and the ESFS.

The positioning of the macro-prudential supervisor also raises questions of how far supervision should be centred on Central Bank competence. Throughout the crisis, the

¹⁵³ R Heller, 'Prudential supervision and monetary policy' in JA Frenkel and M Goldstein (eds), *International Financial Policy* (International Monetary Fund 1991).

¹⁵⁴ M Taylor, 'Twin Peaks' (September 2009) *Financial World*.

performance of Central Banks in terms of mitigating the aggravation of systemic risk was rather poor. Therefore, centralising the macro-prudential supervisor around a Central Bank function appears short-sighted and to be at the expense of monetary and traditional supervisory functions. Indeed, significant risks to financial stability are also dependent on monetary policy. Furthermore, the technicality of the output of prudential supervision needs to be evaluated. Different countries adopt different stances in this respect. In the UK, for example, the Financial Policy Committee forms part of the BoE, and does not include any voting members from the UK Treasury.¹⁵⁵ On the other hand, Germany has its Financial Stability Committee located within the Federal Ministry of Finance which also includes a third of its voting members.¹⁵⁶ Central Banks have shown a tendency to direct their monetary policy towards price stability rather than the potential of reducing systemic risks.¹⁵⁷ There is also the argument that central banks lack sufficient knowledge in terms of insurance and securities risks, and they are not in a position to obtain sufficient information in a timely fashion. These aspects must be kept in mind when discussing the positioning and composition of a macro-prudential supervisor. The consensus, however, remains that Central Banks cannot be dissociated from the role of macro-prudential supervisor,

¹⁵⁵ BoE, 'Members of the Financial Policy Committee' <www.bankofengland.co.uk/financialstability/Pages/fpc/members/default.aspx> accessed 20 April 2014.

¹⁵⁶ BaFin (Federal Financial Supervisory Authority), 'Financial Stability Commission' <https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2013/fa_bj_2013_04_afs_en.html?nn=3698804#doc3772698bodyText1> accessed 20 April 2014.

¹⁵⁷ Directorate General for Internal Policies (DGIP, European Parliament), Policy Department A: Economic and Scientific Policy, 'Review of the New European System of Financial Supervision (ESFS) Part 2' (2013) 67 <[http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507490/IPOL-ECON_ET\(2013\)507490_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507490/IPOL-ECON_ET(2013)507490_EN.pdf)> accessed 5 May 2014.

given that in the post-crisis era they must be mindful of the duality of modelling monetary policy.¹⁵⁸

The de Larosière report mentions that the task of the ESRC should be to ‘form judgements and make recommendations on macro-prudential policy, issue risk warnings, compare observations on macro-economic and prudential developments, and give directions on these issues’.¹⁵⁹ At this early stage, no executive decisions for this body were likely, reinforcing the idea that this body is to be at the heart of financial services regulation from an informational perspective but with limited powers. The report highlights two main conditions that need to be met in order for a macro-prudential supervisor to be effective. These relate to fluid flows of information and effective warning mechanisms when weaknesses are detected.¹⁶⁰ The way these conditions are implemented will determine the amount of power the body will be able to wield. Indeed, the report already suggests that the flow of information from institutions and Member States towards the ESRC ‘must be mandatory’. Also, the warning mechanism must be graduated within a framework that ensures appropriate action. This leads us to the idea that although the ESRC would be a body put in place for the transmission of information, it was from its earliest mention earmarked for a certain amount of enforcement capabilities.

As the de Larosière report was generally well-received by the various EU Institutions,¹⁶¹ the Ecofin Council of 9 June 2009 gave the Commission the go-ahead with the relevant

¹⁵⁸ J Carmassi, C Di Noia and S Micossi, ‘Banking Union: A federal model for the European Union with prompt corrective action’, *Economic Policy* (CEPS Policy Brief 282, 18 September 2012) 4.

¹⁵⁹ De Larosière report (n 6) para 177.

¹⁶⁰ *ibid* para 180.

¹⁶¹ Commission, ‘Driving European Recovery’ COM (2009) 114 final.

proposals. The ESRC, now rebranded as ESRB, was to be part of the ambitious enhancement of the financial stability, regulation and supervision of the EU.¹⁶²

The Commission, in its proposal prepared the basis for the Regulation that would establish the ESRB.¹⁶³ It generally followed the recommendations made by the de Larosière report, although the language used in its ‘Explanatory Memorandum’ appeared less promising in terms of enforcement powers. Indeed, the de Larosière report suggested some concrete powers, albeit via the Economic and Financial Committee (EFC), in order to enforce recommendations. However, the Commission set out to enable it to increase ‘moral pressure’ on the recipients, stating that it was to be ‘conceived as a ‘reputational’ body with a high level composition that should influence the actions of policy-makers and supervisors by means of its moral authority’.¹⁶⁴ In terms of access to information, however, it wished to guarantee that the ESRB had access to all relevant information that would be required for the exercise of its role as a macro-prudential supervisor, not only from EU Institutions, national supervisors or Member States, but it also lay down the possibility of requesting information from financial institutions deemed systemic. It is not clear how or who would decide that a firm was systemic, it simply mentioned the criteria of size, interconnectedness and risk profile.¹⁶⁵

¹⁶² Council of the European Union (2948th meeting, Economic and Financial Affairs, 9 June 2009) <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/108392.pdf> accessed 15 March 2014.

¹⁶³ Commission, ‘Proposal for the Regulation of the European Parliament and of the Council on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board’ COM (2009) 499 final.

¹⁶⁴ *ibid* para 6.2 of the Explanatory Memorandum.

¹⁶⁵ Commission (n 163) para 6.2.2 of the Explanatory Memorandum. From an EU perspective, the use of the Bank of International Settlements ‘Indicator-Based Methodology’ is worth considering due to the cross-jurisdictional element. This methodology aims to calculate the impact that a failure of a bank can have on the global financial system, and could be used for effects on the EU financial system. Via a fixed

B. A lack of legal personality

Of greater relevance to the ESRB's ability to impose itself as a body with enforcement powers is the suggestion of its lack of legal personality. The Commission wished to establish the ESRB under Article 114 TFEU, which it believed would give it the legal basis for the ESRB to carry out its mandate across the entire spectrum of financial services, and also to establish an innovative framework which would distinguish its responsibilities from the other ESFS bodies. The choice of establishing it under Article 114 has appeared questionable, essentially because it could give rise to challenges in the future. Indeed, the delimitation of the scope of EU powers is a constant feature of EU law and Article 114 is contentious because it has relatively open provisions which have the purpose of harmonising national regulations in order to further facilitate EU harmonisation. The requirement to use this Article for the creation of such a body is that it must be clear from its constituting document that its purpose is for the improvement of the establishment and functioning of the internal market.¹⁶⁶ The use of Article 114 and the interpretation by the ECJ has often been regarded as too liberal,¹⁶⁷ although the ECJ has clarified that the tasks given to such a body must be closely linked to the harmonising legislation.¹⁶⁸ The Regulation which established the ESRB states in its Recitals that the body will contribute in achieving the objectives of the internal market, and will contribute to financial stability which is necessary for

criteria it calculates the systemic relevance according to cross-jurisdictional activity and liabilities, size, interconnectedness, substitutability and infrastructure and complexity. Each of these categories uses individual indicators in order to establish a profile and enables the grouping of institutions based on their scoring. Subjective assessment is also provided for where supervisory judgement must be considered. Bank of International Settlements, 'Global Systemically important banks: assessment methodology and the additional loss absorbency requirement' November 2011.

¹⁶⁶ G M Borchardt and K C Wellends, 'Soft Law in European Community Law' (1989) 14 EL Rev 267, 297.

¹⁶⁷ Donald Slater, 'The scope of EC harmonising powers revisited' (2003) 4(2) German Law Journal.

¹⁶⁸ Case C-217/04 *ENISA* [2006] ECR I-3771.

further financial integration.¹⁶⁹ However, simply stating this for the satisfaction of the provisions of the Treaty will not protect it from challenge if the carrying out of its mission is not in tune with this statement. The determinant as to whether the ESRB is constitutionally safe will depend on the reality of the tasks handed to it, and how the ESRB achieves its mission.

The importance for the creation of any institution to be based on a sound legal framework is essential, even more so when dealing with sensitive and politically relevant issues such as financial regulation. The choice of selecting Article 114 over Article 308, which has been used to establish numerous EU agencies, no doubt has an element of strategy to it where, in the first instance, the approval is based on qualified majority voting whereas under Article 308 a Member State is allowed to exercise a veto. There is also the issue that it would have been difficult from a technical perspective to reconcile the ECB's powers and link it with another legally established body in terms of independence.¹⁷⁰ It is beyond the scope of this Chapter to consider this strategy. However, there is a ramification worth considering. The creation of the ESRB is suggested as a substantial cog in the new EU supervisory mechanism for the purpose of attaining financial stability. On the other hand, Article 114 has for its purpose common market integration, so, generally speaking, the proposals under the de Larosière report could be thought of as pertaining more to the smooth functioning of the single market rather than to its integration. Moreover, it has also been suggested that financial integration and financial stability are not mutually reinforcing.

¹⁶⁹ 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 [2010] OJ L331/1, recitals 30 and 31 (ESRB Regulations).

¹⁷⁰ C Zilioli, 'The EU September Package of Reform: A view from the EU institutions' (New Paradigms for Financial Regulation in the EU and the US - Conference, QMUL, London, 11 December 2009).

Therefore, potentially what are needed for the containment of systemic risk are integration blockers.¹⁷¹ Capital flows could be limited amongst Member States via pricing methods where, theoretically, less integration would lead to greater financial stability by the limiting of the impact of contagion.¹⁷² This, however, appears to be an overly simplistic view from a policy perspective as the EU is clearly aiming to achieve a more integrated and harmonised financial market at the expense of some localised financial stability. The balancing act of integration versus stability is clearly one to be taken at policy level. If the further integration of the financial market leads to an increase in chances of systemic risk materialisation, then an effective framework with a competent macro-prudential supervisor is increasingly necessary.

Financial integration in the EU has typically been faster and more efficient than the supervisory framework which is intended to govern it, enabling a platform for systemic risk to occur without the ability to monitor it. The purpose of the Lamfalussy process was to limit the gap between the dynamism of financial services and the slow pace at which regulatory innovation was introduced. This aspect has been highlighted as a facilitator of the recent crisis. So far, the reports and measures taken have mostly been in the form of a catching up of the financial evolutions that have taken place over the past decade. Nevertheless, the development of financial integration and supervision are processes that ideally should go hand in hand and not be dissociated from one another. Moreover, in this way concessions are easier to achieve without one systematically influencing the other. Although the introduction of the AIFM Directive is recent, it can be suggested that it has already influenced the development of the

¹⁷¹ Treasury Commons Select Committee, *Opinion on Proposals for European financial supervision* (HC 2009-09, 1088) para 30. Opinion given by Barbara Ridpath.

¹⁷² M Dungey and D Tambakis (eds), *International Financial Contagion: Progress and Challenges* (Oxford University Press 2005) chapter 1.

market.¹⁷³ The Commission has clarified that the ESRB is to contribute directly to achieving the objectives of the internal market and it goes further to suggest that ‘it is only with arrangements in place that properly acknowledge the interdependence between micro and macro-prudential risks can all stakeholders have sufficient confidence to engage in cross-border financial activities’.¹⁷⁴

Crucially, establishing the ESRB as a soft law body sidesteps the issues of delegation of powers to agencies in the current EU legal framework.¹⁷⁵ Indeed, EU institutions cannot delegate to agencies the power to take legislative acts and make decisions which would involve political discretion, arbitrate between conflicting political interests or carry out complex economic assessments. The ESRB will no doubt be involved in carrying out complex economic assessments. However, the lack of decision-making powers means that it remains within the remit of what powers can be delegated to agencies constitutionally. This does not mean that it is completely safe from challenge, although the current EU trend for flexible interpretation of the legal framework should allow it to carry out its mandate without interference.¹⁷⁶

C. The Regulation establishing the ESRB

The Regulation¹⁷⁷ establishing the ESRB remains fairly short, and apart from minor exceptions follows on from the Commission’s Proposal. The Regulation clearly places

¹⁷³ As described in the previous Chapter, a dip in hedge fund activity was noted during the negotiation phase of AIFMD.

¹⁷⁴ Commission (n 163) para 19.

¹⁷⁵ K Lenaerts, ‘Regulating the Regulatory Process: Delegation of Powers in the European Community’ (1993) 18 EL Rev 23.

¹⁷⁶ D Gerardin, ‘The Development of European Regulatory Agencies: Lessons from the American Experience’, in D Gerardin, R Munoz and N Petit (eds), *Regulation Through Agencies in the EU* (Edward Elgar 2005) 215-216. For a contrasting view see S Griller and A Orator, ‘Everything Under Control? The “way forward” for European Agencies in the Footsteps of the Meroni Doctrine’ (2010) 35 EL Rev 3.20.

¹⁷⁷ ESRB Regulations (n 169).

the ESRB within the ESFS without differentiating it from the other agencies, insisting on good cooperation between these agencies and the existence of ‘appropriate and reliable information flows between them’.¹⁷⁸ This is an important aspect for the ESRB as it relies on information to be able to carry out its mission, objectives and tasks. An interesting aspect of the Regulation is that it offers a definition of systemic risk which is a rare occurrence, albeit a must for this Regulation. It states that:

[S]ystemic risk means a risk of disruption of the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.¹⁷⁹

The presence of this definition also creates a safeguard from a constitutional perspective by creating the strong link required by Article 114 TFEU between the tasks of the ESRB and the subject-matter of the harmonising laws. The definition links the necessity to contain systemic risk with stability and soundness of the financial system, which are essential to the good functioning of the financial market. Moreover, the ECJ has confirmed that such a body may be established under Article 114 TFEU at the discretion of the legislature for the purpose of implementing a process of harmonisation, which is defined here in macro-prudential terms.¹⁸⁰ The definition, however, appears purposefully vague and all-encompassing compared to definitions considered in the first chapter, which, on the one hand, gives the ESRB a very wide scope in which to carry out its objectives, but, on the other hand, gives it greater room to operate. Indeed, neither the nature of the disruption nor its chances of

¹⁷⁸ ESRB Regulations (n 169) art 1 (4).

¹⁷⁹ *ibid* art 2(c).

¹⁸⁰ Case (C-66/04) *Smoke Flavourings* [2006] ECR I-10553.

materialisation are mentioned, potentially leaving the scope of action open to relatively small disruptions. The types of firms that could be systemically relevant is also completely left open which is controversial in that small to medium-sized financial intermediaries are unlikely to be systemically interesting from a EU perspective. As suggested above, due to the multi-jurisdictional aspect of the EU, the Bank of International Settlements (BIS) methodological approach appears adequate. Indeed, without suggesting that such firms cannot carry systemic consequences, they are more likely to remain the remit of micro-prudential supervision. Such a definition reflects the uncertainty surrounding systemic risk. It may, however, prove to be counter-productive where it is important for the ESRB to focus on the truly systemically relevant information it receives rather than trying to cover all events. Beyond this definition, it will in practice show that the ESRB will be able to prove its ability to focus and create a precedent of information which is systemically relevant.

The mission, objectives and tasks outlined in the Regulation generally follow those suggested by the de Larosière report and proposed by the Commission, although there is a slight escalation in the positioning of the ESRB. It acquired the ability to directly address the Council with emergency situations¹⁸¹ and can participate where appropriate in the ESFS Joint Committee.¹⁸² Due to its legal standing, the ability of the ESRB to concretely react in a conflict situation is likely to be complex and indirect. Once again, with a relatively wide scope and numerous institutions to report to, time will tell how the ESRB will be able to exercise its authority. Indeed, via its governance structure, it is in a position to exercise influence, chiefly through the composition of

¹⁸¹ ESRB Regulations (n 169) art 3 (2) (e).

¹⁸² *ibid* art 3 (2) (h).

the General Board with voting rights. As set out in the de Larosière report, proximity to the ECB and the domestic Central Banks is of the utmost importance. Therefore, the ESRB will have on its General Board the President and the Vice-President of the ECB, and the Governors of the national Central Banks. In addition, a Member of the Commission will have a vote, as will the Chairpersons of each ESA and the Advisory Scientific Committee and the Advisory Technical Committee.¹⁸³ Members of the Board without voting rights will comprise of one high-level representative per Member State of the competent national supervisory authorities and the President of the EFC.¹⁸⁴

The structure of the General Board, therefore, ensures that all relevant agencies and institutions are participating in the process of reviewing the relevant conclusions reached by the ESRB, and will disseminate the information effectively. The only party which is absent from the permanent General Board are industry representatives. This, however, is covered by Article 9 (4) which leaves open the possibility for the Board to invite high-level representatives from international financial organisations to attend the General Board meetings where appropriate. Although, since the introduction of the Lamfalussy process consultation with industry has been enhanced to a formal level, the potential inclusion of industry representatives at the General Board meetings actually represents a considerable step forward, towards greater dialogue with industry. This is even more important considering the insight that industry has in terms of financial trends. This dialogue will be more important at micro-prudential level and hopefully transmitted via the Governors of the national Central Banks. Finally, the Regulation also opens the possibility of representatives from third countries attending

¹⁸³ *ibid* art 6 (1).

¹⁸⁴ *Ibid* art 6 (2).

General Board meetings.¹⁸⁵ This, of course, could be relevant where systemic risk is seen to potentially originate or impact a non-Member State. For instance, at the instigation of the crisis, an informative dialogue between the US and the EU may have enabled a certain mitigation of the effects.

The membership of the General Board has raised some concerns in terms of size and bias.¹⁸⁶ Indeed, it is well populated in terms of members, which raises the question of the effectiveness of its operation and its ability to process information and issue recommendations that are not diluted and untimely. In comparison, the FSB has over 60 members and is encouraging further members to join, which reflects positively on this point. This is also reinforced by the idea that the ESRB will primarily be entrusted with processing information and issuing recommendations and warnings on which other institutions will act. So far, evidence has shown that despite its size, the quality of discussions at Board level have been better than expected, with the caveat that the size is partly to blame for the lack of direction attributed to the ESRB.¹⁸⁷ Indeed, a reduction in the size of the General Board might be worth considering, especially due to the fact that two representatives per Member State have a seat. It has been suggested that reducing Member State representation to its respective macro-prudential supervisor would render the ESRB more effective and focussed.¹⁸⁸ However, the lack of consistency of macro-prudential positioning at Member State levels compromises its feasibility, at least in the short to medium term. Indeed, identifying a consistent group of macro-prudential supervisors that could alone constitute the General Board entails issues of competence and conflicts of interest. Although such a

¹⁸⁵ ESRB Regulations (n 169) art 9 5.

¹⁸⁶ Treasury Select Committee (n 171) paras 36-39.

¹⁸⁷ DGIP (n 157) 59.

¹⁸⁸ *ibid* 60.

position might be held in name by a body in a given Member State, the true prudential aspect could be held by another, leading to a lack of competence. Member States that have elected to hand the position to finance ministries are particularly concerned, which may also raise issues of politically interested discussions being introduced at ESRB level. Thus, although a reduction in the Board size is desirable to a certain extent, the arrangements at Member State level prevent us from considering it until a certain alignment of prudential supervisors is achieved.

In terms of effectiveness, the General Board has been found to be spending an unnecessary amount of time on issues of a procedural and administrative nature.¹⁸⁹ The Steering Committee, which has 14 Members, is better-equipped to deal with such issues, and would release the Board from such matters. The Steering Committee could prepare the agendas for the meetings in order to ensure focus is given to the relevant areas and that time is saved on discussing issues that can be handled by other ESRB Committees. This would allow the Board to carry out its central role of decision-making in a more efficient way. In addition, it would give the Committee considerable power to steer the focus of the Board. This was set out in the legislation to a certain extent.¹⁹⁰

Ferran and Alexander suggest that beyond the size of the General Board, the issue of over-representation of Central Banks at the expense of fiscal representation and representatives from the insurance and securities sector is more serious.¹⁹¹ This could become an issue should the scope of the ESRB's mandate be widened to include a more substantial decision-making ability because the current membership, being

¹⁸⁹ *ibid* 59.

¹⁹⁰ ESRB Regulations (n 169) art 4 (3).

¹⁹¹ E Ferran and K Alexander, 'Can soft law bodies be effective? The special case of the European Systemic Risk Board' (2010) ELR 757.

mainly central bankers, would not be best suited to taking decisions that would balance political and economic interests. This is certainly an area where fiscal representation would be desirable.¹⁹²

In substance, the initial role of the ESRB will be to collect, collate and distribute information regarding systemically relevant situations that occur in the finance industry. Additionally, although it is not specified, the closer scrutiny will no doubt be chiefly focussed on the larger financial institutions, primarily banks. The decisive action will then be passed on to the relevant authorities, where fiscal direction may be required, and be applied at this point in time. Therefore, the requirement to have strong representation on the General Board appears at this juncture to be premature. It would be short-sighted, however, not to consider the need for the ESRB to concern itself with insurance companies and funds as these have been proven to be systemically relevant in the cases of AIG and LTCM.¹⁹³

The General Board will normally vote and act by simple majority,¹⁹⁴ where for the more important decisions such as issuing a recommendation or making a warning public, a quorum of two-thirds of the members will need to be present, and a majority outcome will be required. The General Board will be mainly assisted by two

¹⁹² A Sibert, *Systemic Risk and the ESRB* (European Parliament 2009) para 3.

¹⁹³ American Insurance Group was one of the largest bailouts throughout the crisis, the ramifications of its potential failure were such that it raised once again the debate regarding 'too big to fail'. LTCM was a fund manager who collapsed due to an over-exposure to the Russian market. The consequence of its failure raised the issue of the potential for systemic consequences with regards to investment funds. See A Davidson, 'How AIG fell apart' (*Reuters*, 18 September 2008) <<http://www.reuters.com/article/2008/09/18/us-how-aig-fell-apart-idUSMAR85972720080918>> accessed 20 June 2014; D Shireff, 'Lessons from the collapse of hedge fund, Long Term Capital Management' (International Financial Risk Institute, 2008) <http://eml.berkeley.edu/~webfac/craigne/e137_f03/137lessons.pdf> accessed 20 June 2014.

¹⁹⁴ ESRB Regulations (n 169) art 10 (2).

Committees, the Advisory Scientific Committee (ASC),¹⁹⁵ which was absent from the Commission's proposal, and the Advisory Technical Committee (ATC).¹⁹⁶ The first will be composed of experts generally found in the field to have the necessary expertise to provide assistance to the ESRB and also the freedom to organise consultations with the various relevant stakeholders.¹⁹⁷ The Regulation is focussed on having the maximum amount of parties involved in order to be able to gather as much information as possible. Again the role of the Advisory Technical Committee is rather vague with its only stated mandate to provide assistance and advice to the ESRB.¹⁹⁸ The composition of this body, which resembles the General Board at a lower hierarchical level, has been criticised for its lack of effectiveness due to Member State focussed representation.¹⁹⁹ If divergent national interests are causing ineffectiveness at ATC level, then a review of its composition needs to be tabled. Injecting independent members could help counterbalance the different interests, particularly if these are placed at the top of the ATC in a way that focus could be channelled towards EU interests. The ASC has acted as an effective counterbalancing committee in tabling issues the ATC did not want to pursue.²⁰⁰ However, the mixed composition of the ASC, of industry and academics did not materialise as expected. There is currently an overwhelming majority of academics and insufficient representation from industry, in particular from the small and medium-sized firms. This should be rectified sooner rather than later as the benefits of academic technical input need to counterbalance the realities and sensitivities of

¹⁹⁵ ESRB Regulations (n 169) art 12.

¹⁹⁶ *ibid* art 13.

¹⁹⁷ *ibid* art 12 (5).

¹⁹⁸ *ibid* art 13 (3).

¹⁹⁹ DGIP (n 157) 61.

²⁰⁰ *ibid* 62.

industry. This would also assist further in counterbalancing the divergence found at ATC level.

There is a body of work that considers the legitimacy of rules that are dependent on the involvement of interest groups. In particular, Scharpf assesses the legitimacy of institutions, regimes, procedures and rules according to 'input legitimacy' and 'output legitimacy'.²⁰¹ He explains that input legitimacy is linked to the general idea of 'government by the people', whereas output legitimacy is related to the concept of 'government by the people'.²⁰² For regulatory purposes, input legitimacy is to be seen as addressing the will of the parties affected via their participation in elaborating the regulation. Input legitimacy is more concerned with the process of establishing a regulatory measure in terms of fairness and representation. Output legitimacy is primarily concerned with the way the regulatory outcomes affect and meet the expectations of those concerned by the regulation. Here, the focus is directed on the substance of the regulation to the extent that those responsible for its drafting are competent rather than representative. There are trade-offs with both approaches and efforts have been made to establish measures that could improve the legitimacy of regulatory approaches.²⁰³ Although it is beyond the scope of this thesis to approximate this approach to the ESFS, it could be argued that increasing industry representation would assist in developing both input and output legitimacy concerns.

²⁰¹ Fritz Scharpf, *Governing in Europe: Effective and Democratic?* (Oxford University Press 1999).

²⁰² Scharpf (n 201) 7-11.

²⁰³ KO Lindgren and T Persson, 'Input and Output Legitimacy: Synergy or Trade-Off? Empirical Evidence from an EU Survey' (2010) 17 *Journal of European Public Policy* 449.

Since inception, the ESRB has had the President of the ECB as its Chair; this was tabled for review after five years.²⁰⁴ Change at this level is desirable as it is a cause of loss of effectiveness and accountability. The main issue that has arisen as a consequence of the President of the ECB holding this position is the lack of time to be able to perform this role. The recent review by the Directorate General has shown that the President has had to prioritise his duties, consistently in favour of the ECB.²⁰⁵ The question of accountability arises because, due to the fact that the ECB President holds the Chair, this has a tendency to shift accountability onto himself rather than the ESRB. Additionally, when reporting at the European Parliament the MEPs have appeared confused about the different roles of the President of the ECB and the Chair of the ESRB, which further exacerbates the need for separation at this level. Therefore, it appears logical that, going forward, the Chair of the ESRB should be filled by a full-time professional with sufficient knowledge and expertise to navigate the ESRB within the ESFS and institutions with a macro-prudential focus. A former Central Bank Governor could fit the profile. There would also be some advantages in including the European Parliament in the selection process in line with the appointment process of the other ESAs.²⁰⁶ This would ensure an open selection process in favour of a Chairperson with sufficient independence.

The Regulation goes on to briefly outline four tasks entrusted to the ESRB. The first relates to the collection and exchange of information which the Regulation sets out in Article 15 (1) stating that ‘the ESRB shall provide the ESAs with the information on risks

²⁰⁴ ESRB Regulations (n 169) art 5.1.

²⁰⁵ DGIP (n 157) 61.

²⁰⁶ ESA Regulations (n 9) art 48.

necessary for the achievement of their tasks'.²⁰⁷ Once again, the wording is all-encompassing, giving the ESRB very little in the way of guidance other than that it should be mindful of the tasks of the ESAs and the kind of information they might need to mitigate the occurrence of systemic risk. The rest of the Article details how the ESRB can obtain and disseminate information. Although the processing of information might appear to be a very bureaucratic task, in systemic risk terms it takes on a different meaning and, as discussed below, it will be the premise on which the effectiveness of the ESRB will be evaluated.

The second task it is entrusted with concerns its ability to issue warnings and recommendations.²⁰⁸ Once again, the Regulation gives little in the way of guidance or direction and employs very permissive language in that warnings or recommendations may be issued to any of the ESAs, Member States, the Union as a whole or national supervisory authorities. A recommendation may also be issued to the Commission with respect to EU legislation. However, the ESRB does not have the power to address individual firms directly²⁰⁹ and the stated warnings or recommendations may be of a general or specific nature.²¹⁰ Again, it appears the Regulation intends that the ESRB should determine and set a precedent for the way it operates. However, deciding that the ultimate power to decide on the declaration of emergency situations does not lie with the ESRB removes a considerable amount of responsibility and power from it. There are two main arguments in favour of this. The first is that it will safeguard the constitutional standing of the ESRB by not delegating powers to it that would fall outside the conditions of Article 114 of TFEU. The second argument refers to the

²⁰⁷ ESRB Regulations (n 169) art 15 1.

²⁰⁸ *ibid* art 16.

²⁰⁹ *ibid* art 16.

²¹⁰ *ibid* art 16 (2).

considerable effect the declaration has on shifting more power to the ESAs once an emergency situation has been declared, which gives them the possibility to intervene more directly in supervising financial market activity.²¹¹ Similarly, the ESRB will not be empowered with the final decision-making process regarding the classification of firms in terms of potential risk, but will be restricted to participating in establishing the criteria for financial institution stress testing.

The third task is in relation to the follow-up on the recommendations it makes.²¹² The ESRB, in the first instance, is due to receive a response by the recipient of the recommendation which must be in the form of an explanation of actions taken or an explanation of why no action was deemed necessary or taken.²¹³ If the ESRB is not satisfied with the follow-up, recourse to the Council or an ESA is available. The enforcement ability of the ESRB appears rather poor, and would greatly depend on the action of the Council or the ESA as the case may be, in order to decide to enforce or not.

Finally, the Regulation provides for when the ESRB deems it appropriate for a warning or recommendation to be made public.²¹⁴ This ability ultimately represents the biggest threat in the small arsenal of enforcement action that the ESRB has access to, in particular, if the warning relates to a financial institution where embarrassment and negative publicity could ensue. This also carries the chance to accelerate the realisation of systemic risk should such a warning cause panic with awareness of any particular exposure a financial institution is subjected to. As was seen in the case of

²¹¹ Ferran (n 107).

²¹² ESRB Regulations (n 169) art 17.

²¹³ *ibid* art 17 (1).

²¹⁴ ESRB Regulations (n 169) art 18.

Northern Rock, information regarding the problems surrounding the mortgage lender were kept confidential by the BoE, fearing that public knowledge would cause a run on the bank, which is ultimately what happened. This power, however, is moderated by the fact that it needs to run any intention by the Council before making the information public.²¹⁵ It must also notify the recipient in a timely manner.²¹⁶ The overall timeframe of the process is not defined, this is problematic when dealing with an imminent materialisation of systemic risk where time would be of the essence.

The ESRB will also be entrusted with coordination beyond the EU, this will mainly involve communicating with the IMF and the FSB.²¹⁷ With the knowledge that mitigating systemic risk needs to be coordinated on a global level, the generality of the provision could lead the ESRB to develop its powers on an international stage. On the other hand, due to its lack of formal enforcement powers, it may also lack legitimacy at this level.

Essentially, this short Regulation offers little in terms of detail or guidance on the way the ESRB must achieve its objectives and tasks. The wording is also very general which may translate the sentiment of uncertain boundaries for the materialisation of systemic risk. On the other hand, it gives this body flexibility and a potential wide scope of action in terms of information gathering and processing. However, this falls short of a macro-prudential supervisor in the traditional sense. The ESRB is, on paper at least, greatly supported by the ECB, the Council and ESAs in terms of enforcement. From the outset, its independent effectiveness is therefore in doubt. Its soft law status also appears at odds with the post-crisis move towards hard provisions, more

²¹⁵ *ibid* art 18 (1).

²¹⁶ *ibid* art 18 (3).

²¹⁷ *ibid* art 3 (2) (i).

harmonisation and a single rulebook for financial services. With the absence of legal personality, an open mandate stated in very general terms and few recourses to concrete enforcement, it raises the question as to whether the ESRB is actually equipped to become the systemic risk champion of the EU or whether it will merely become a post-box for information transmission.

D. Assessing the ESRB's potential for effectiveness as a soft law body

'Soft law' can be defined as 'rules of conduct that are laid down in instruments which have not been attributed legally binding force as such, but nevertheless may have certain (indirect) legal effects, and that are aimed at and may produce practical effects'.²¹⁸ Although 'soft law' is primarily used to define a certain type of rule-making, it can also be used to denote a certain approach to supervision and enforcement such as guidance and recommendations.

It seems that as soon as a body or organisation is given a mandate without formal normative powers, it is often described as lacking in ability or authority. However, soft law bodies can be effective and exert a considerable amount of power far beyond the mere symbolism that is often attributed to them.²¹⁹ At an international level, financial regulation falls, for the best part, under the notion of 'soft law', which means non-formally binding or enforceable standards, statements and guidelines that nevertheless have the ability to influence the behaviour of countries.²²⁰ The influence exercised is obviously not one of fear of sanctions, although they may result in such, but more from an economic and social aspect.

²¹⁸ L Senden, *Soft Law in European Community Law* (Hart 2004) 112.

²¹⁹ GC Shaffer and M Pollack, 'How Hard and Soft Law Interact in International Regulatory Governance: Alternatives, Complements, and Antagonists' (2010) 94 *Minn L Rev* 706.

²²⁰ CM Chinkin, 'The Challenge of Soft Law: Development and Change in International Law' (1989) 38 *ICLQ* 850.

Compliance with soft law at an international level is facilitated from the outset by the fact that it originates from a common goal amongst adopters.²²¹ Kirton and Trebilcock argue that soft law instruments are easier to negotiate and allow for deeper cooperation as they do not have to worry about enforcement.²²² Indeed, agreement on the objective greatly facilitates the process of establishing a set of means by which to achieve it. If it is agreed that a given issue needs to be tackled and mitigated, not only is it easier to put in place an infrastructure but the adoption of non-binding standards means that concessions are more easily made at an international level. This is also valid for soft law bodies established to reach a certain objective. It might be suggested that only the countries interested in achieving the said objective would become a participant in the body, and therefore, more open to consensus.²²³ If such bodies are not bound by systematic conflicting votes and vetoes, then it means the body can be more flexible to react and adopt measures which are up to date. In financial services terms, this represents a substantial advantage as laws and regulations have often been accused of lacking in the ability to keep up with dynamic financial markets.²²⁴

Once standards are in place, soft law is generally fuelled by a moral obligation and a certain amount of competitiveness in terms of being at the forefront of best practice.²²⁵ This is particularly true in terms of financial regulation where international finance and trade can be made difficult by countries not adopting acceptable standards. This has been obvious with measures aimed at combating money

²²¹ AM Slaughter, *A New World Order* (Princeton University Press 2004) 180.

²²² JJ Kirton and MJ Trebilcock (eds), *Hard Choices, Soft Law: Voluntary Standards in Global Trade, Environment and Social Governance* (Ashgate 2004).

²²³ D Zaring, 'Three Challenges for Regulatory Networks' (2009) 43 *International Lawyer* 211.

²²⁴ Alan Boyle, 'Some Reflections on the Relationship of Treaties and Soft Law' (1999) 48 *ICLQ* 901, 903.

²²⁵ FSB, 'Framework for Strengthening Adherence to International Standards' (January 2010).

laundering. In this instance, the FATF has been instrumental in imposing global common standards via its recommendations,²²⁶ and these have been transposed into EU law under the successive Anti-Money Laundering Directives.²²⁷ Those countries which fall short of the expectations may be open to being blacklisted, and the financial institutions in those countries will find it difficult to engage in cross-border business. More than just shaming, failing to adhere to international standards can carry concrete consequences. This particular process has also been efficient in bringing to light the activities of 'tax havens' and countries which are prone to corruption.

Countries are also encouraged to adhere to certain international standards, or be a participant in a soft law body as this may benefit them by lowering the funding costs of its sovereign debt in two ways. The first is that the lending countries will use the fact that they will decide the terms of the borrowing by using it as a bargaining tool to coerce the borrowing country into adopting a given international standard. The lending country is motivated to do so because it believes, on the one hand, that by adopting the said standards, the chance of default is lower; and on the other, it avoids a form of jurisdictional arbitrage where the lending country would be at a disadvantage. The second is that CRAs may take such criteria into account when rating government issued bonds, where the inability for a country to adopt a relevant standard, or introduce a standard into domestic law could be seen as a sign of weakness or lack of stability.

²²⁶ Financial Action Task Force (FATF), 'FATF 40 Recommendations' (FATF Standards, October 2003) <<http://www.fatf-gafi.org/media/fatf/documents/FATF%20Standards%20-%2040%20Recommendations%20rc.pdf>> accessed 19 February 2014.

²²⁷ Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing OJ L 309/15.

Financial institutions also find it desirable to be seen as irreproachable when it comes to best practice. Showing their clientele that they are doing things right can be seen as a form of marketing. However, the incentive seems to come from a need to convince their respective regulatory bodies that they do not need external intervention on the way they carry out their business. This ties in with the suggestion by soft law theorists that, provided a measure modifies behaviour, then it can be considered to have a certain degree of effectiveness.²²⁸ They want to show that they can be trusted to self-regulate, or demonstrate that, beyond their respective country's attitude to the standards, they are willing to participate. In the late 1990s, the Wolfsberg Group²²⁹ were credited with having influenced the changes that occurred regarding the FATF recommendation in 2000. Participation in the Group or statements by private banks that they adhered to the Wolfsberg principles was sufficient to demonstrate good behaviour in this respect. However, no auditing, supervision or formal document sign up was necessary so whether those firms actually put their statement into practice and to what degree could not be verified. In the EU, these principles were gradually covered by the successive Anti-money Laundering Directives, thereby turning the Group into a lobbying tool for private banks to influence hard laws instead.

Soft law must not be seen as a lesser hard law option, but actually as a useful tool with attributes that are in many circumstances fit for the international legal landscape,²³⁰ as opposed to hard law which operates within a strict framework. Not only is it difficult to achieve a consensus, but any result may turn out to be difficult to implement at the domestic level. The establishment of the EU legal framework has been a long and

²²⁸ DG Victor, K Raustiala, EB Skolnikoff, *The Implementation and Effectiveness of International Environmental Commitments: Theory and Practice* (MIT Press 1998) 398.

²²⁹ Wolfsberg Group <<http://www.wolfsberg-principles.com/>> accessed 25 March 2014.

²³⁰ Shaffer and Pollack (n 219) 706.

technical process where, in order to achieve a harmonisation process that works, decades of trial and error have been necessary. This testifies to the multiple difficulties that would be encountered by trying to introduce laws that are ill-fitting at a domestic level. Indeed, the compatibility and enforceability of laws that are not coherent would potentially lead to an inability of countries to comply.²³¹ Soft law on the other hand is flexible and malleable, meaning that reaching the objectives and the intended purpose of the law does not necessarily disturb domestic legislature. This does not necessarily mean that soft law needs to be imprecise and vague. The greatest success of international financial law was achieved by the successive Basel Accords, in an attempt to harmonise capital requirements at a global level. The technical standards that have generally been issued have been of great detail and, more recently under Basel 3, have been very complex. The fact that these are drafted by technicians and experienced practitioners rather than by legislators is notable in the drafting. The traditional body of legislative wording is replaced here by precise guidance on how to calculate capital requirements. In this instance, the successive Capital Requirement Directives have transposed these standards with great accuracy into hard law, with tools and technical capital calculations adopted virtually directly by financial institutions.²³² Klabbers suggests that it is when precision is lacking in soft law measures that negative consequences may arise when they are transformed into normative categories.²³³

Another specificity of soft law is its ability to be used in simulated test format. If it is unsuccessful in achieving its objective, or the objective no longer exists, then it can be

²³¹ H Hillgenberg, 'A Fresh Look at Soft Law' (1999) 10 EJIL 499.

²³² The Internal Capital Adequacy Assessment Process (ICAAP) is a good example of the complexity and technicalities instilled by the Basel Committee.

²³³ J Klabbers, 'The Undesirability of Soft Law' (1998) 67 Nordic Journal of International Law 381, 385.

set aside and forgotten without a formal process.²³⁴ Depending on the reason for the abandonment, this can be seen either as a positive or a negative. If the reason is because the initial purpose has lost its *raison d'être*, then this presents the advantage of being able to wind down whatever was put in place without formality. However, if the *raison d'être* remains but the process to achieve it is seen as burdensome or too costly, then the abandonment may take place for the wrong reasons, and prove that it does not have the persuasiveness of hard law to persevere with the objective. The main advantage with this aspect, though, is the trial and error process which can be made possible by the flexible framework. If an aspect of the soft law is seen to be inadequate or not crucial to attaining the objectives, then it can navigate through the process until stabilised with minimal formality. This flexibility does, however, expose it to the criticism of being unrepresentative, illegitimate, opaque, unaccountable and open to having its objectives hijacked by lobbying interests.²³⁵ With regard to accountability and legitimacy, Ferran and Alexander suggest that it is paradoxical that such concerns are raised and are more intense when a soft law method is successful. Its success can be measured by the level of compliance that it experiences and its popularity which inevitably raises its profile and gives rise to the criticisms listed above. This is particularly the case in international financial regulation as tensions can rise in times of crisis and economic doubt.²³⁶

During and after the crisis, the fact that international financial regulation was governed by soft law principles came under criticism. Soft law was accused of not being optimal

²³⁴ KW Abbott and D Snidal, 'Hard and Soft Law in International Governance' (2003) 54 *International Organisation* 421.

²³⁵ Ferran and Alexander (n 191) 758.

²³⁶ C Brummer, 'How International Financial Law Works (and How it Doesn't)' (2011) 99 *The Georgetown Law Journal*.

and that it was in need of strengthening due to the fact that the warning mechanism of the FSB and the IMF was lacking and insufficient.²³⁷ However, the limitations of soft law might not lie, in this instance, with its own ability, but more with the willingness of countries to put in place an effective supervisory regime at international level. It is difficult to place blame on organisations like the FSB or IMF if they do not have at their disposal adequate tools or sufficient information in order to address systemic risk. There are obvious limitations to soft law, and in order for it to be effective a balance needs to be achieved regarding the expectations and the amount of commitment made by the relevant parties. Moreover, due to the fact that soft law can be ignored, and although we recognise that this is not desirable for reasons of peer pressure and economic advantages and reputation, in times of stress, a country may forgo those pressures in favour of other priorities. However, Ferran and Alexander suggest that absent or creative compliance is not solely an issue for soft laws but that there is evidence to suggest that hard laws can also fall foul of this behaviour.²³⁸ Interestingly they take as an example the fact that in 2010 the countries that had signed up to the OECD transparency standards in terms of taxation and compliance could be considered 'light'.²³⁹ Adherence to the standards has greatly increased since then, but we need to take into consideration the fact that the crisis has drained the coffers of the affected countries and they are now in search of revenue. This has led to greater political

²³⁷ ER Carrasco, 'The Global Financial Crisis and the Financial Stability Forum: The Awakening and Transformation of an International Body' (2010) 19 *Transnational Law and Contemporary Problems* 203; IMF, 'Initial Lessons of the Crisis for the Global Architecture and the IMF' (IMF Strategy, Policy and Review Department, 2009).

²³⁸ Ferran and Alexander (n 191) 757.

²³⁹ OECD, 'A Progress Report on The Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard: Progress made as at 18th February 2010'.

commitment by adopting the G20 recommendations.²⁴⁰ However, the OECD recognises that the 'real test of whether the Global Forum has achieved its goal is whether it has improved transparency and made exchange of information more effective in practice'²⁴¹ as opposed to merely signing up to the terms. Consequently, although creative compliance may not exist to the same extent with hard and soft law, both need an element of political will in order to be effective.

In the foreseeable future, it is difficult to imagine financial regulation at an international level without the use of soft law bodies and measures. In many circumstances, it will be the only available option and, in this way, it must be seen on balance as more helpful than objectionable.²⁴² Reform is likely as the financial crisis considerably consolidated views on further regulatory integration at an international level.²⁴³ In certain circumstances, the lack of domestic protection will push towards a hardening of soft measures, as was seen with the introduction of CRA Regulations.

Soft law mechanisms have also been used within the EU. There is, however, an important difference to mechanisms at an International level, taking into consideration the fact that the EU is founded on the basis of countries committed to founding a common market from the outset. This, coupled with the legal infrastructure that now governs the EU, eliminates the argument that soft law measures need to be used as

²⁴⁰ The Global Forum was restructured in September 2009 in response to the G20 call to strengthen implementation of these standards <<http://www.oecd.org/tax/transparency/>> accessed 23 February 2014.

²⁴¹ OECD, 'Progress Report to the G20 Leaders: Global Forum update on Effectiveness and On-going Monitoring, September 2013' <http://www.oecd.org/tax/transparency/progress_report__G20.pdf> accessed 23 February 2014.

²⁴² Boyle (n 224) 913.

²⁴³ FSB, 'Framework for strengthening adherence to International Standards' (9 January 2010) <http://www.financialstabilityboard.org/publications/r_100109a.pdf> accessed 9 February 2014; DW Arner and MW Taylor, 'The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?' (2009) 32 University of South Wales Law Journal 488, 498-500.

the default option. EU soft law measures generally take a harder tone than international ones as usage under EU law is governed by the founding treaties, and these measures may have directly enforceable consequences on individuals.²⁴⁴ The coexistence of soft and hard law at EU level seems to have fared well, but this again raises concerns about the legitimacy of the soft law measures, specifically because they may have a direct impact on individuals. Indeed, the choice of soft law could be perceived as sidestepping the proper process of legislating, in an effort to speed up a measure that might have encountered more resistance as a hard measure. However, it is generally thought that the usage of soft law within the EU is a useful tool, even more so because its usage is governed by the Treaty. This is a safeguard that does not exist at an international level.²⁴⁵

Prior to the crisis, soft law measures held an important strategic role within the regulation of financial services in the EU. The idea of a single rule book was set aside in favour of innovative ideas such as risk-based and principles-based approaches. The purpose at EU level was in an effort to keep up with the dynamism of financial services. Early on, the Lamfalussy process pointed towards EU financial regulation with the intention that it should be overseen by a set of principles, with the technicalities left up to Level 3 Committees and national regulators. Although the role of these bodies has been hardened under the new framework, and their abilities to enforce have become more tangible, soft methods are likely to remain as the issuance of

²⁴⁴ Case C-322/88 *Salvatore Grimaldi v Fonds des Maladies Professionnelles* [1989] ECR 4407.

²⁴⁵ European Parliament, 'Institutional and Legal Implications of the Use of Soft Law Instruments' (Resolution) (2007)2028(INI), P6_TA (2007)0366).

guidance of the ESA bodies and recommendations issued by bodies such as the ECB and the ESRB are deemed necessary for the efficient running of the framework.²⁴⁶

For the EU, it has become far easier to harden the stance post-crisis on measures related to financial services than it was at international level due the legal framework that was available. By selecting Regulations over Directives, the EU now has the ability to limit national discretion and immediately move towards greater harmonisation.²⁴⁷

However, soft measures will retain a place within the EU framework, albeit repositioned. Beyond the ESRB, which is positioned as a soft law body, the ESAs will also generate over time a certain amount of soft law precedent. For example, the ESMA has demonstrated its ability to guide institutions directly through the process of implementing EMIR with flexibility.²⁴⁸ While it does not represent a hardening of financial regulation, it will have a harmonising effect by removing further national discretion.

E. A status in tune with its mission

Although post-crisis we have seen some concrete measures to harmonise and reinforce the regulation of financial services in the EU, it can be seen that the achievement of this at a macro-prudential level presents far greater challenges. This helps to explain the reasons for using soft law measures embodied within the ESRB.

²⁴⁶ Ferran (n 107).

²⁴⁷ Commission (n 161) 114, para 2.2.

²⁴⁸ ESMA, 'ESMA informs Commission of its intention to ease certain frontloading requirements under EMIR' (8 May 2014) <<http://www.esma.europa.eu/news/ESMA-informs-European-Commission-its-intention-ease-certain-frontloading-requirements-under-EMI?t=579&o=page%2Fpost-trading>> accessed 15 June 2014.

The most concrete power handed to the ESRB has been in terms of information gathering and processing. The effective collection and processing of data at micro and macro-levels is a prerequisite for the operational supervision of systemic risk. The bureaucratic appearance of this task is diluted by the novel and technical aspects that stem from the processing of such information, and which represents a considerable hurdle for the ESRB in carrying out its mission. Indeed, according to the Regulation, the ESRB holds considerable powers to request information. However, the effectiveness of the request for information will be dependent on how the mechanisms of the request operate in practice.²⁴⁹ It must be noted that the ESRB has the power to request rather than require the relevant bodies to produce information. The request is, however, reinforced by the requirement that the listed bodies are obliged to co-operate closely with the ESRB, and provide all information necessary in order for it to fulfil its obligation.²⁵⁰ This means that failure to comply with a request from the ESRB could lead to a breach of obligation under EU law, meaning its soft law status has, to an extent, hard law backing. Should the mechanisms be effective and timely for the collection of information, then the technical task of analysing and processing the data in a format that raises awareness in terms of potential systemic risks will also need to be effective and usable.

A potential area of tension may arise on the territorial demarcation of macro and micro-prudential supervision. According to the Regulation, the ESRB can request information from individual firms where specific data is deemed necessary.²⁵¹ The necessity could arise from an interest in the liquidity or solvency of a systemically

²⁴⁹ B Weder di Mauro and U Klueh, 'Reshaping Systemic Regulation in Europe' (2010) 16(2) *The Brown Journal of World Affairs* 179.

²⁵⁰ ESRB Regulations (n 169) art 15 (2).

²⁵¹ *ibid* art 15 (4)–(5)

relevant institution. This could blur the line between macro and micro-prudential, and create tensions between the ESRB and the domestic supervisor who is responsible for the supervision on a micro-prudential level. This could potentially jeopardise the ESRB's effectiveness where the legal obligation to provide such information could be contested.

The issuance of recommendations and warnings are not binding but, similar to the information-gathering task, there is solid procedural and institutional back-up. The issuance of recommendations falls under the 'comply or explain' obligation which affects any recipient. The necessity to act on behalf of the recipient creates an outright consciousness to consider the issue raised. If the ESRB is not satisfied with either the explanation or the action taken, then it has the power to refer the matter to the relevant ESA, the Council or the Chair of the Parliament's Economic and Monetary Affairs Committee.²⁵² Furthermore, should the recipient of a recommendation object to its nature or content, it has the obligation to take it up with the relevant ESA.²⁵³ From a legal perspective, the ESA will be bound to support the ESRB under its obligation to cooperate closely and take account of the recommendations and warnings produced by the ESRB.

Of all its powers, the most important one is the ability to make a warning or recommendation public.²⁵⁴ The publicity of a warning could however have the adverse effect of creating further concerns in the market, and potentially reinforcing systemic consequences, so already from this perspective the ESRB will want to exercise caution in the use of this power. It is also the power which will come under the most scrutiny

²⁵² *ibid* art 17 (2).

²⁵³ ESA Regulations (n 9) art 36 (5).

²⁵⁴ ESRB Regulations (n 169) art 18.

as the public issuance of a warning or recommendation can lead to a hearing before the European Parliament and will at least be mentioned in the ESRB's annual report.²⁵⁵

The recipients of warnings or recommendations will be most wary of this power, and the ability to name and shame will give them pause for thought concerning the overall tasks undertaken by the ESRB.

There has been a consensus for action in various areas of regulatory reform which were swift in their implementation, such as the AIFMD, EMIR and the CRA Regulations. However, the scope for institutional reform is not open-ended and is greatly limited by political, legal and practical considerations. Unlike the ESAs which are evolutions of an existing framework,²⁵⁶ the ESRB is a totally new concept that introduces concrete macro-prudential regulation at an EU level. This means that political nervousness remains high as domestic implications remain uncertain. This leads uncertainly to the idea that the ESRB could entertain harder enforcement powers in the future although the nature of its task may lend itself to being part of a hybrid mechanism of hard and soft law measures which are now apparent within the ESFS.

The urgency to regulate systemic risk to a greater extent has increased since the crisis, and has led the notion into uncharted territory. This pressure to regulate systemic risk is both economic and political. The materialisation of systemic risks throughout the crisis was costly in monetary terms; therefore, the political perspective will only follow reform insofar as it is meaningful from a cost benefit perspective. Should the regulation of systemic risk impinge on the ability of a jurisdiction to generate income, then it is likely that the political enthusiasm will diminish proportionally with the

²⁵⁵ ESRB Regulations (n 169) arts 17 (3) and 19 (2).

²⁵⁶ ESAs have taken on the functions of the committees they replace, in addition to the right to introduce binding technical standards.

likelihood of occurrence. Establishing the ESRB as a soft law body facilitates the achievement of the mission to deliver a new framework for micro and macro-prudential supervision.²⁵⁷

The consensus of having this element of macro-prudential supervision in a soft format is reinforced by the introduction of hard measures which cover areas of systemic risk regulation. Indeed, this has been seen in certain sections of EMIR and AIFMD which are dedicated to regulating systemic risk. However, the issue that arises in the case of the ESRB is that the ramifications of the notion of systemic risk are hard to pin down from a normative perspective. How it manifests itself is also very uncertain, which also explains the wide definition given by the regulation and its reluctance to pinpoint specific situations.²⁵⁸ It appears desirable, however, that the regulation should not try to confine the notion as it is clear that systemic risk is embryonic and prone to evolving in different forms. Therefore, such flexibility is desirable in the initial stages of active supervision by the ESRB as it will enable it to establish areas of focus and refine its tasks. In terms of positioning, however, it may prove to be a weakness for the ESRB in the first instance as it will have little in terms of concrete specific matters to refer to in the exercise of its mandate. Once again, it will be down to how the ESRB can position itself in determining the scope of the framework within which it can operate, and be persuasive as to its tasks within the ESFS. In essence, the ESRB will forge the notion of systemic risk supervision within the EU insofar as it can appear a legitimate and credible macro-prudential supervisor.

²⁵⁷ European Council, 'Presidency Conclusions' (18-19 June 2009).

²⁵⁸ AW Lo, 'The Feasibility of Systemic Risk Measurement: Written Testimony Financial Services Committee Hearing on Systemic Risk Regulation' (MIT, 19 October 2009).

Systemic risk also appears to be an area of regulation which will be organic with only sporadic supervisory intervention. As we have seen with the post-crisis legislative measures, each area of concern within financial services appears to be systemically risk-assessed, either from the perspective of not creating potential for systemic risk, but also to entertain the potential for legislative drafting that would assist in systemic risk mitigation. The fact that the occurrence of systemic risk on a catastrophic level, as was seen during the crisis, is a rare event, then testing the effectiveness of the ESRB may not happen for a long time. The difficulty in assessing the effectiveness of the ESRB is that its successes will not necessarily be visible. Due to the sporadic and occasional nature of systemic risk, only failures in macro-prudential supervision will be visible when systemic risk materialises.

F. The ESRB's positioning will be crucial

The broad meanings given generally to the notions of macro-prudential and systemic risk and the drafting of the Regulation mean that the ESRB's work is open-ended as to its mandate and concrete tasks. The success or importance of the ESRB within the new ESFS will greatly depend on its ability to position itself beyond an information gathering agency. The way in which the Regulation is drafted does not clearly define how ambitious it wishes the ESRB to be nor how accountable it should be in relation to the recommendations and warnings it makes. However, the meaningfulness of the macro-prudential framework would be lost if its authority were limited to gathering information. The true test will be with how the other agencies or recipients of the recommendations treat the information received. The advantage of the soft law set-up is that it uses moral pressure and this will encourage the other institutions to take it

seriously due to the efforts recently made in regulating systemic risk and the recognition of the need for a macro-prudential supervisor. Therefore, if it can be assumed that in the formative years the ESRB will be regarded as an important indicator on where to focus efforts to mitigate systemic risk, then the impact of its advice will be extensive. Its potential influence will extend beyond the consideration of the agencies. In fact, it stands to affect general policy at EU-level on several fronts; for example, this could involve competition issues, fiscal considerations and the free movement of capital. The element of accountability will also be a determinant in the positioning of the ESRB, and will need to be proportional to the authority it is able to assert. The principal elements of accountability are the annual reporting and hearings before the Parliament.²⁵⁹ To a certain extent, the dialogue between the ESRB and the European Parliament will determine the focus taken by the ESRB. Indeed, during the hearings, depending on how the MEPs focus their questions and concerns will invariably determine how the ESRB is to carry out its mission. So far, the dialogue between the ESRB and the European Parliament has not been conducive to effective systemic risk management.²⁶⁰ Indeed, on the one hand, the ESRB has been reproached for not being able to communicate efficiently about its understanding of key systemic issues in the EU. On the other hand, the European Parliament has not challenged the ESRB on this aspect. Therefore, both parties have focussed on crisis issues and immediate issues, such as the Greek debt crisis.

It is important to introduce an improved dialogue at this level and, in particular, a focus on medium and long-term risk mitigation. A possibility here would be to have a

²⁵⁹ ESRB Regulations (n 169) art 19.

²⁶⁰ DGIP (n 157) 71.

fixed agenda where the ESRB's reporting would be divided into past, present and future risks in order to ensure these issues are addressed. For ease of reference, MEPs would benefit from a reporting format that would clearly highlight the prioritisation of risk suggested by the ESRB. An effective reform of the working process of the ESRB would include a rigidly presented agenda in order to ensure that the issues were correctly delivered. This, in turn, would facilitate effective challenge from the European Parliament. Moreover, it would also be advisable to have a mechanism where the Parliament could rebuke the ESRB if it was not satisfied with its performance. Currently, such a system of redress does not exist.²⁶¹ Accountability will be what cements the ESRB as the responsible agency for macro-prudential supervision and will act as a determinant of the future quality of the recommendations issued by it. The more the ESRB is held accountable for its actions, the more it will need to focus on quality which will in turn determine that its actions are taken seriously.

The overall effectiveness of the ESRB and its potential to impose itself within the ESFS remains under question and enigmatic. It would be short-sighted to conclude that the ESRB will only be able to exert influence rather than power. In isolation, this would be true if the ESRB had to rely solely on its credibility to assert itself. However, being part of the hybrid mechanism where it finds itself, and being a soft law body within a framework that has hard bodies which are bound to support it, means that it finds itself in a far more assertive position than other soft law bodies, such as the FSB. The downside to these indirect powers is that the ESRB's success is dependent on the ability, and to a certain extent the willingness of the institutions on which it relies to

²⁶¹ M Kawai and M Pomerleano, 'Strengthening Systemic Financial Regulation' in M Kawai, D Mayes and P Morgan (eds), *Implications of the Global Financial Crisis for Financial Reform and Regulation in Asia* (Edward Elgar 2012).

use the information provided to them. The association with the other bodies may also mean it will be forcibly involved with disputes as to the legitimacy of their actions. In fact, within the new regulatory framework, the powers of the ESAs have already come under scrutiny and been the subject of legal action.²⁶² It would, therefore, not be surprising that the actions of one of the ESAs which relied on a warning or recommendation of the ESRB would drag it into the debate.

The ESRB's effectiveness will depend on its ability to be successful in three aspects. The first is that its technical mission is complex and novel. The ability of soft law bodies to be able to assert themselves very much depends on them gaining a solid reputation for technical competence. The mechanics of the ESRB's operation will, therefore, be key in enabling it to gain credibility. The second aspect will require the ESRB to be able to take advantage of the established framework of the EU. Although complex, there is purpose to the set-up, and the positioning of the ESRB makes it responsible for macro-prudential supervision. It must find its place within the framework and use its influence in a way that demonstrates a usefulness beyond being a mere central bankers' talking group of which it has been accused. Finally, the ESRB must take advantage of the clever hybrid mechanism of which it is a part. Legally constituted as a soft law body, it enjoys considerable indirect powers via the other ESAs and in its relationship to EU Institutions. In this case, it is unlikely that a policy change would set limits to financial integration. Therefore, its mandate will persist, and whether it is successful or not, will inevitably lead to a formalising of its powers.

²⁶² Case C-270/12 *United Kingdom v Parliament and Council* [2014] OJ C85/4.

The ESRB also needs to raise its profile by being more visible and transparent. So far, it has failed to raise awareness of its activities and output.²⁶³ It has tried to change this trend by creating a 'Systemic Risk Dashboard'²⁶⁴ which compiles data in a concise and clear way. However, the data remains technical, and it is difficult to identify which risks are currently regarded as significant. As discussed above, the communication of potential risks is the cornerstone of its mission. In order to be regarded as an effective body, it must be able to communicate a prioritisation of risks on a regular basis. A method of colour coding is provided for in the Regulation which to date has failed to materialise.²⁶⁵ To an extent, and being conscious of market sentiment, the reports of the ESRB need to be newsworthy. A short report that would use a colour coding warning system would enable it to gain importance and improve its transparency. The creation of a 'Heat Map' constituted one of the suggested improvements set out by the Directorate General for Internal Policies.²⁶⁶ It suggested that the severity of risks warnings could be updated on a quarterly basis, but more importantly it suggested the rationale for arriving at the risk prioritisation and the actions to be taken. However, to gain awareness of the body and its work, a very simple document, with the colour codes and only prevalent risks, would draw attention and interest to the other reports prepared by the ESRB. Adopting such measures will be key in seeing its position evolve within the EU framework and give it the profile it needs to fulfil the future tasks it has already been empowered to undertake.

²⁶³ DGIP (n 157) 74.

²⁶⁴ ESRB, 'Risk Dashboard' (February 2014)

<http://www.esrb.europa.eu/pub/pdf/dashboard/140331_ESRB_risk_dashboard.pdf?9ecdb991e22c63ae1a28450029ec3bba> accessed 24 February 2014.

²⁶⁵ ESRB Regulations (n 169) art 16 (4).

²⁶⁶ DGIP (n 157) 77.

The new Capital Requirements Directive²⁶⁷ and Capital Requirements Regulation²⁶⁸ (the 'CRD IV Package'), as discussed in Chapter IV, introduces some measure of particular systemic relevance. To this effect, the ESRB has been given tasks under the Directive to coordinate macro-prudential policies. These tasks can be divided under three of the provisions: the Countercyclical Buffer (CCB), the Systemic Risk Buffer (SRB), and the assessment of macro-prudential instruments.

Article 136 requires designated authorities of Member States to set CCBs on a quarterly basis.²⁶⁹ To this extent, the ESRB has been empowered to give guidance to the designated authorities in the form of recommendations on the variables that these authorities might use to calculate their CCBs. The scope of the guidance to be provided by the ESRB is set out in Article 135 (1)²⁷⁰ whereby the ESRB must 'ensure that authorities adopt a sound approach to relevant macro-economic cycles', offer general guidance on the measurement and calculation of the deviation from long-term trends of ratio of credit to GDP and the calculation of buffer guides, guidance on variables that indicate the build-up of system wide risk' and give guidance on 'qualitative criteria that indicate that the buffer should be maintained, reduced or fully released'.²⁷¹ Article 138 states that the ESRB may also issue recommendations on the CCB and rate the exposure to third countries where the ESRB considers it necessary. It may not, however, issue recommendations in relation to individual Member State CCBs.

²⁶⁷ 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 L176/338 and Regulation (EU) No 575/2013 of the European and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1, 338.

²⁶⁸ Regulation (EU) No 575/2013 (n 267).

²⁶⁹ Directive 2013/36/EU (n 267).

²⁷⁰ Directive 2013/36/EU (n 267).

²⁷¹ *ibid* art 135 (1).

Member States may introduce at their discretion SSBs which constitute a common equity tier one capital for their respective financial sector, or elements of it. The purpose of this is to mitigate long-term non-cyclical systemic or macro-prudential risks. The procedures that are set to establish the SSB trigger a variety of tasks for the ESRB which are contained in Article 133. In particular, the ESRB will be required to issue opinions and recommendations with regard to the establishment of the SSB.

Under Article 458,²⁷² Member States will also have discretion to ‘gold plate’ CRD measures where they identify a particular weakness or change in intensity of their respective financial sector. However, under this provision the Member States need to notify all the EU Institutions including the ECB and the ESRB, and submit relevant evidence of the necessity to apply stricter measures. This will trigger tasks for the ESRB, notably the requirement to provide an opinion to the EU Institutions and the Member State on the necessity, effectiveness and proportionality of a measure.²⁷³ Beyond the measure itself, the ramifications of the ESRB’s requirements are extensive, such as providing recommendations to Member States which do not recognise the exceptional measure;²⁷⁴ provide a recommendation or opinion to the Commission on the potential need to expand such measures to the whole of the EU;²⁷⁵ and assist the Commission to draw up a report on the potential requirement for the use of such measures.²⁷⁶

These new duties and tasks raise the profile of the ESRB and give it the legitimacy that it was earmarked to have. More than merely processing information, under CRD IV the

²⁷² Regulation (EU) No 575/2013 (n 267).

²⁷³ *ibid*

²⁷⁴ *ibid*

²⁷⁵ *ibid* art 459.

²⁷⁶ *ibid* art 459.

ESRB holds concrete duties that are instrumental for the good operation of the harmonisation of capital requirements across the EU. However, it will 'be challenging, if not impossible, to execute under the ESRB's current institutional structure'.²⁷⁷ Indeed, the operation of the ESRB currently relies on analytical capacity from the Member States and works on a project basis. The provisions under CRD IV give the ESRB duties which would arise on a regular basis, and also demand prompt responses, one month under most provisions. It is difficult to evaluate how many opinions or recommendations it will need to issue under the requirements, but it appears that any number would be too burdensome. It is also worth considering that any opinion or recommendation prepared would need to be approved by the General Board. This would, therefore, not only increase the time needed to issue them but would also weigh heavily on the already inefficient system. This confirms the need to streamline the decision process at ESRB level as discussed above in order for opinions and recommendations to be promptly issued. Nevertheless, of particular relevance to the CRD IV Regulations is the need of the ESRB to quantitatively increase its analytical competence.

V. Concluding remarks on the ESFS

The establishment of the ESFS must be regarded, overall, as a success for the development and harmonisation of regulatory and supervisory practices for financial services at EU level. To consider it a success, one must view the considerable developments that have occurred post-crisis, and the timeliness with which it was set up. The greatest sign of progress, and the move towards concrete harmonisation can

²⁷⁷ DGIP (n 157) 81.

be seen in the powers that ESMA has gained with respect to CRAs. This has been possible as a result of the lack of political sensitivity in this area of supervision, and also because of the evidence that CRAs acted as an aggravator of the crisis. Such acquisition of powers is a sign of things to come, albeit in a tension-driven and piecemeal fashion.

The unusual speed of implementation of the ESFS has, of course, left room for improvement, and we might consider that the next step towards harmonisation is in its infancy. The problem remains as to whether the next step will require major changes at a constitutional level and a jurisprudential level, or whether adjusting the system will generate sufficient benefits. Due to the fact that Treaty change in this direction could involve significant discussions amongst Member States, therefore not be timely, some areas of the system could be amended and prove to be of great benefit without necessitating Treaty change. In particular, some governance changes could be brought about that would greatly enhance the positioning of the ESAs and enable it to gain independence. Recent case law has also pointed towards further flexibility so that ESAs can increase their powers.

Despite the fact that, to date, the ESRB has not been entirely convincing, its remit is due to expand. Unlike the ESAs, the ESRB is a totally new body with a new mandate for the EU. Its designated role as a *prima facie* macro-prudential supervisor does not sit comfortably with its lack of enforcement powers and its soft law status. However, the political nervousness and the fear of the unknown will dissipate provided that the ESRB can position itself within the EU framework and demonstrate sufficient competence in this role. Like the ESAs, some small adjustments to the Board will help to improve its standing. The main problem is that there are governance issues, in particular, the one

related to the position of Chair currently held by the President of the ECB. In terms of positioning, the ESRB could also benefit from some publicity to raise its profile by creating more concise, newsworthy reports, whilst remaining, of course, mindful of market sensitivities. Despite these concerns, the ESRB is promised a more prominent future because of the additional powers that have been conferred on it, in particular, under the CRD IV provisions. It appears that, currently, the ESRB is simply not equipped to carry out its duties under CRD IV. There is now a short time-frame within which the ESRB will need to improve its governance issues and acquire further analytical staff if it wants to be able to fulfil this role.

The greatest threat to the ESFS as a whole is the establishment of the SSM which aims to create a banking union. Its introduction presents many challenges, but of greatest concern is its ability to supplant the ESFS. Indeed, although it is conceived primarily as a banking focussed micro-prudential supervisory arrangement, it is also ear-marked to use macro-prudential tools, such as setting varying capital buffers. The predominance of banks in terms of prudential oversight at EU level only supports the idea that the SSM could become a competing set-up, notwithstanding its proximity to the ECB. The next Chapter will focus on how the ESFS and the SSM can co-exist.

CHAPTER V: THE SINGLE SUPERVISORY MECHANISM AND THE POTENTIAL FOR IT TO SUPPLANT THE ESFS

The previous Chapter aimed to provide a detailed insight into the new ESFS regime, noting considerable changes and advancements for the EU supervisory framework. The Chapter argued that it can be considered a success for the EU save some weaknesses that need to be addressed. This final Chapter will comment on the new initiative to coordinate banking supervision in the Eurozone and how this will affect the standing of the ESFS.

In 2012, the Eurozone Heads of State and Governments called upon the European Commission to present proposals to provide for a Single Supervisory Mechanism (SSM) that involved the European Central Bank (ECB). The European Commission set out its vision to 'address significant threats to financial stability across the Economic and Monetary Union' in its Roadmap towards a Banking Union.¹ The essence of the document was to make two legislative proposals: a Regulation conferring new powers to the ECB,² and the other amending the founding Regulation of the European Banking Authority.³ Jointly, these proposals would form and be known as the SSM. The SSM is the first pillar of the Banking Union and the one that is at its most advanced stage; the

¹ Commission, 'A Roadmap Towards a Banking Union' (Communication) COM (2012) 510 final.

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 [2013] OJ L287/63 (SSM Regulations).

³ 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 287/5 (EBA Regulations).

other pillars are the Single Resolution Mechanism (SRM) and the Single Deposit Guarantee Scheme (SDGS).

The key message set out by the Commission in support of the proposals was that the coordination between supervisors that had been set out at ESFS level was insufficient, and this was particularly the case in relation to a single currency. The urgency of the move was primarily motivated by Member State debt issues and the fact that banks were dependent on state aid for survival. This, in turn, has put the Euro currency under pressure, rendering the issue particularly relevant at Eurozone level. This has created a strong rationale for increasing control and monitoring over Member States that are part of the Eurozone. The time was opportune, with fiscal governance remaining a sensitive topic, control over systemically relevant banks appeared to be an easier angle to take, in particular considering that the debt crisis was aggravated by the bailing out of ailing banks. Indeed, the Eurozone's rescue fund, the European Stability Mechanism (ESM) could previously only be used to finance banks via loans to national governments, which increased their respective debts and borrowing costs accordingly. In order to allow the ESM to finance banks directly, it was essential to establish a supervisory link between the banks and the EU, and break the sovereign one.⁴

The powers granted to the ECB under the SSM are extensive, effectively setting it up as a supervisor of the supervisors. Although this bodes well for the development of uniform supervisory practices at SSM level, it raises the question of how it can be incorporated within the bigger EU sphere. The fact that the SSM has been established with relative haste to resolve sovereign debt issues leads to the idea that spheres

⁴ A Carr, 'Banking Union: story of the emperor's new clothes?' (2013) 2 JIBFL 67, 68.

within the EU could be developing at different speeds. This is of particular concern with regard to the steps that have been achieved at ESFS levels, especially with regards to the fragility of some of its components. Of interest to this chapter will be the question of how the establishment of the SSM can fit in with the development of the ESFS, in particular the EBA and the ESRB, and to argue that the success of the SSM will be at the expense of a supervisory rift being created at EU level.

I. Establishment of the SSM

The Commission set out to prepare the SSM Regulations under three main themes. These governing themes are: firstly, a direct acquisition of supervisory powers by the ECB over banks that are set-up in the Eurozone; secondly, the further integration of crisis management tools and an enhanced common system for deposit protection; and finally, that the remit of the EBA will include the development of a single rulebook for banking regulation that will have EU-wide relevance. The Council agreed with the Commission, however, it intended for the rulebook to have a wider EU appeal and reach, thus creating a more stable and secure monetary union.⁵

The SSM has been designated as one of the key elements of the Banking Union, and with the ECB as principal body with oversight, it has a close link with the ESFS. Indeed, in the previous chapter the tangible links between the ESRB and the ECB were outlined, and it was suggested that although they should exist, they are currently too close, for example, the ESRB is chaired by the President of the ECB. Whereas the ESFS is composed of the three ESAs covering banking, securities and markets, and insurance and occupational pensions across the EU, the SSM is limited to the banking sector in

⁵ European Council, 'Conclusions' (EUCO 205/12, 14 December 2013).

the Eurozone. There are, however, possibilities for non-Eurozone countries to enter under the scope of the SSM by establishing 'close cooperation' agreements with the SSM, the conditions of which are provided for under Article 7.⁶ It is worth suggesting two main reasons why the SSM is Eurozone focussed. The first is that the identified problem and rationale for reinforcing the banking supervision was due to the Euro debt crisis and the strain it was carrying from a monetary perspective. The second is that achieving consensus for a full EU banking union would have had the effect of weakening the result; in particular, resistance would have originated from the UK.⁷

Under the Regulation,⁸ the tasks conferred on the ECB are found under Article 4 in micro-prudential terms and under Article 5 for the macro-prudential ones. The overall applicability will be discussed below. However, it is important to highlight that although the focus of the ECB will be on ensuring 'a smooth and sound overview over an entire banking group',⁹ it also considers that 'smaller institutions can also pose a threat to financial stability'.¹⁰ Therefore, its tasks will apply to a potentially wide array of institutions, and this suggests that it will relieve national competent authorities from prudential regulation in relation to these firms. Some of the tasks mentioned are significant in terms of supervisory powers. For example, the first task mentioned gives the ECB the power to grant or withdraw credit institution licenses.¹¹ This appears as an extraordinary power to delegate, as although there are conditions that the ECB must

⁶ SSM Regulations (n 2).

⁷ Foreign Affairs Committee, *The Future of the European Union: The Eurozone and the EU* (HC 2013-14, 1-82).

⁸ SSM Regulations (n 2).

⁹ *ibid* recital 5.

¹⁰ *ibid* recital 15.

¹¹ SSM Regulations (n 2) 4 (1)(a).

respect,¹² the business continuity ramifications for the larger institutions carry domestic and economic consequences. This point is particularly relevant when considering the reluctance of the UK to join the Banking Union because delegating such a power would amount to loss of control of an industry that constitutes one of its largest Gross Value Added contributors.¹³

The other tasks go into greater detail on the acquisition of powers, such as taking the role of home supervisor when a credit institution wishes to establish a branch in a non-participating Member State or wants to engage in cross-border banking activities. It can also take the role of host supervisor where the institution is not established in a participating Member State.¹⁴ This measure appears at odds with certain provisions that have tended to favour financial integration. Indeed, mainly under the Markets in Financial Instruments Directive (MiFID), there are provisions that allow financial institutions to ‘passport’ their licence from one Member State to another without the need for approval.¹⁵ The condition for a financial institution to do so is one of notification rather than approval, providing the financial institution does not engage in activities that it is not permitted to carry out in its home Member State. This integration process was provided for under free movement principles with the potential to harmonise practices without creating uniformity. The provisions required financial institutions that wished to passport their services to abide by specific rules of

¹² *ibid* art 14.

¹³ The Gross Value Added element contributed by the financial sector currently hovers around 10%, and was calculated at 9.4% for 2011. See House of Commons Library, ‘Financial Services: Contribution to the UK Economy, Economic Policy and Statistics’ (SN/EP/06193, 21 August 2013).

¹⁴ SSM Regulations (n 2) art 4 (1)(b).

¹⁵ **Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC** [2004] OJ L145/1, art 31.

the host country, thus reducing opportunistic regulatory arbitrage. In this respect, harmonisation is desirable both for Member States and financial institutions, in assisting with a bottom-up approach for the development of common supervisory standards. Here lies the potential for a rift to be generated should the ECB hamper the passporting provisions. Although it is provided that the ECB is required to respect the same laws as a national supervisor would and treat each institution fairly,¹⁶ the fact that it holds the ability to remove licences means that its opinion on cross-border activity will be persuasive.

The ECB is also tasked with day-to-day supervision, such as assessing a financial institution's minimum regulatory holdings,¹⁷ own funds requirements, securitisation, large exposure limits, liquidity, leverage and reporting obligations on such matters.¹⁸ Going even further, the ECB will be able to review institutional governance arrangements, remuneration policies, internal control mechanisms and processes provided for under their respective Internal Capital Adequacy Assessment Processes (ICAAP).¹⁹ The Regulation also proposes that the ECB carry out direct supervisory reviews in tandem with the EBA and in an analytical capacity. In particular, this refers to stress tests in order to determine whether a given financial institution has sound management and processes in order to mitigate potential risks.

¹⁶ SSM Regulations (n 2) art 1.

¹⁷ *ibid* art 4 (1) (c).

¹⁸ *ibid* art 4 (1) (d).

¹⁹ *ibid* art 4 (1) (e); ICAAP is a process of self-evaluation of adequacy of capital that was introduced under the Basel II Accords. The ICAAP, beyond the standard credit risk calculations, should offer the full picture of risks that a financial institution could face and how they intend to mitigate it, either via additional capital provisions or adequate processes. ICAAPs are generally approved by the national competent authority as valid following the Supervisory Review and Evaluation Process (SREP). Although the process is formalised, this represents a time consuming and complex task for both financial institutions and supervisors.

The macro-prudential tasks are less involved, although they have the potential to carry considerable weight. Under Article 5, the prime tasks conferred upon the ECB are in relation to capital buffers and countercyclical capital buffers. These were described in the two previous chapters when considering the CRD IV provisions and the powers held by the ESRB. Capital buffers are excesses of capital that may be required by a competent authority in excess of the regulatory minimum standards. The Article provides for the ECB to be notified of the intention to apply capital buffers by national competent authorities and be able to object with reasons within 5 days.²⁰ Crucially, however, the ECB has the ability, on its own accord, to apply higher capital requirements including countercyclical ones.²¹ Again, this represents a considerable acquisition of powers for the ECB as they can be applied to jurisdictions in their entirety or strategic parts of them. Indeed, under this provision, the ECB could decide to unilaterally apply the higher capital requirements of one country over another. The ramifications are considerable, in particular in comparison to the cautiousness with which the ESRB was handed powers to give opinions and recommendations in terms of capital buffers as discussed in the previous chapter. The Regulation clearly outlines the fact that the ECB must cooperate closely with all authorities that form part of the ESFS.²² It is, however, surprising that the ESRB is not explicitly mentioned under Article 5 as a required counterpart for reaching such decisions. Constitutional issues must also be taken into consideration. Here, the question arises as to whether the acquisition of such powers by an EU institution is within its remit.

²⁰ SSM Regulations (n 2) art 5 (1).

²¹ *ibid* art 5 (2).

²² *ibid* art 3.

The Regulation ensures that the ECB is in a position to adequately appropriate the powers of the national competent authorities when it is required to perform the above mentioned tasks. It states that the ECB should act as the exclusive competent and designated authority where appropriate, stripping national competent authorities of any recourse with respect to the items covered by the Regulation.²³ It goes one step further by stating that the ECB 'shall also have all the powers and obligations, which competent and designated authorities shall have under the relevant Union law, unless otherwise provided for by this Regulation'.²⁴ Moreover, there is the potential for the ECB to call upon national authorities to act upon instructions where the ECB has not been conferred such powers under the Regulation.

Its powers are divided into two categories: the investigatory powers²⁵ and the supervisory ones.²⁶ The specific investigatory powers include the right to request the necessary information in order for the ECB to fulfil its tasks in relation to credit institutions,²⁷ financial holding companies,²⁸ mixed-activity²⁹ and mixed financial holding companies³⁰ established in a participating Member State. The investigatory powers extend to any person or third parties which are recipients of outsourced functions in relation to these entities.³¹ In terms of general investigatory powers, the ECB may also request the above persons or bodies to submit documents,³² examine

²³ *ibid* art 9 (1).

²⁴ *ibid* art 9 (1).

²⁵ SSM Regulations (n 2) art 10.

²⁶ *ibid* art 14.

²⁷ *ibid* art 10 (1) (a).

²⁸ *ibid* art 10 (1) (b).

²⁹ *ibid* art 10 (1) (d).

³⁰ *ibid* art 10 (1) (c).

³¹ *ibid* art 10 (1) (e) and (f).

³² *ibid* art 11 (1) (a).

their books and records,³³ obtain written or oral explanations³⁴ and interview any other person who so consents and for the purpose of collecting information relating to the subject matter of an investigation.³⁵ In cases where it is found that there is an obstruction to an ECB investigation, then the respective Member State should provide it with the necessary assistance.³⁶ In order to carry out its tasks, or if required in the course of an inspection, the ECB may conduct on-site visits, providing the national competent authorities receive sufficient prior notification.³⁷

The specific supervisory powers afforded to the ECB cover standard licensing authorisations and the ability to remove them.³⁸ A credit institution applicant will first need to comply with the national laws where it wishes to set up, and these will be reviewed by the national competent authority which will then produce a draft decision to be approved or rejected by the ECB.³⁹ It can be concluded that the ECB's approval is implicitly granted if it does not reply with an objection within 10 working days. In a similar fashion, if a national authority deems it necessary to withdraw an authorisation, it must submit a proposal to the ECB who will then make its decision on the merits put forward.⁴⁰

The Regulation also provides for the ECB to have extensive tangible supervisory and sanctioning powers. The format of these powers gives the ECB the kind of powers that can be expected from a national competent authority and which can affect the running of a business both in financial and organisational terms. These include the ability to

³³ *ibid* art 11 (1) (b).

³⁴ *ibid* art 11 (1) (c).

³⁵ *ibid* art 11 (1) (d).

³⁶ *ibid* art 11 (2).

³⁷ *ibid* art 12.

³⁸ *ibid* art 14.

³⁹ SSM Regulations (n 2) art 14 (2) and (3).

⁴⁰ *ibid* 14 (5).

require credit institutions to hold funds in excess of the regulatory requirements;⁴¹ set deadlines for implementation of corrective measures;⁴² issue specific provisioning policies;⁴³ restrict lines of business;⁴⁴ review remuneration practices;⁴⁵ use net profits to strengthen own funds;⁴⁶ restrict distributions to shareholders;⁴⁷ impose restrictions on maturity mismatches;⁴⁸ require additional disclosures;⁴⁹ and remove members of management.⁵⁰

In terms of pecuniary penalties, the ECB is granted the ability to impose fines and these need to be 'effective, proportionate and dissuasive'.⁵¹ These penalties may amount to twice the amount of the profits gained or losses avoided due to the breach if this can be calculated, alternatively, up to 10% of the annual turnover of the previous year.⁵² If the latter is to be used, then the results of the financial group will be used rather than the affected component.⁵³

In terms of organisation, a Supervisory Board will be established within the ECB in order to carry out the planning and the execution of the tasks listed above.⁵⁴ It will be composed of a Chair who will be proposed by the ECB and approved by the European Parliament, it must be a full-time professional who does not hold any office with a national competent authority. The Vice Chair will be chosen from amongst the

⁴¹ *ibid* 16 (2) (a).

⁴² *ibid* art 16 (2) (c).

⁴³ *ibid* art 16 (2) (d).

⁴⁴ *ibid* art 16 (2) (e).

⁴⁵ *ibid* art 16 (2) (g).

⁴⁶ *ibid* art 16 (2) (h).

⁴⁷ *ibid* art 16 (2) (i).

⁴⁸ *ibid* 16 (2) (k).

⁴⁹ *ibid* art 16 (2) (l).

⁵⁰ *ibid* art 16 (2) (m).

⁵¹ *ibid* art 18 (3).

⁵² SSM Regulations (n 2) art 18 (1).

⁵³ *ibid* art 18 (2).

⁵⁴ *ibid* art 26 (1).

Executive Board of the ECB. Both positions will be confirmed by a Council Implementing Decision. The other voting members of the Supervisory Board will be made up of four representatives of the ECB to be appointed by the ECB's Governing Council and will not perform any duties within the ECB relating to monetary functions.⁵⁵ Furthermore, for each participating Member State, a national competent authority representative will be put forward. In terms of voting, decisions will be taken by a simple majority,⁵⁶ except when taking decisions of a transitional nature attached to the TEU and TFEU.⁵⁷

The ECB will dedicate a separate budget line for the tasks it carries out under the SSM, acting as a safeguard from the monetary tasks carried out by the ECB.⁵⁸ It will also be useful to have separate accounts in order to levy appropriate supervisory fees directly from the credit institutions it supervises.⁵⁹

An Administrative Board of Review will carry out, upon request, administrative reviews of the decisions taken by the ECB.⁶⁰ The Board will be composed of individuals of repute and competence from Member States, and exclude staff in employment at the ECB or national competent authorities. They will need to review decisions in an independent capacity and in the public interest.⁶¹ The nuance of having a review body which acts in the public's interest rather than the interests of the EU, which can be found within the ESFS, demonstrates the intention to create a counterbalance to the extensive powers acquired by the ECB under the Regulation. In the same way, the

⁵⁵ *ibid* art 26 (5).

⁵⁶ *ibid* art 26 (6).

⁵⁷ *ibid* art 26 (7).

⁵⁸ *ibid* art 29 (1).

⁵⁹ *ibid* art 30 (1).

⁶⁰ *ibid* art 24 (1).

⁶¹ SSM Regulations (n 2) art 24 (4).

review process is accessible to individuals and legal persons who are directly affected by an ECB decision.⁶²

In terms of accountability, the ECB will be accountable to the European Parliament and the Council under the Regulation.⁶³ Their accountability will be monitored through annual reports, hearings upon request and confidential discussions with the Chair and Vice Chair of the competent committees of the European Parliament; these are requirements under the TFEU.⁶⁴ Accountability is also ensured towards national parliaments through annual or ad hoc reports to the European Parliament whereby they may address reasoned observations to the ECB and request a response in writing.⁶⁵

Under the SSM, in order to counterbalance the new ECB powers, the Commission suggested amending the EBA Regulation in order to avoid hampering the functioning of the internal market for financial services.⁶⁶ For the purposes of the SSM, the relevant changes to the Regulation affect two particular areas. The first area of change relates to the attempt to rebalance the institutional relationship between supervisory authorities which have banking relevance, namely, the EBA, ECB and ESRB. The ECB Regulation creates a new group, the Eurozone Member States, whose interests are considerably catered for under the new provisions. This requires the interests of the Union as whole, and the non-Eurozone Member States, to be rebalanced. The amendment to the EBA Regulation therefore introduces new text that specifies that ‘when carrying out its tasks, the [EBA] shall act independently, objectively and in a

⁶² *ibid* art 24 (5).

⁶³ *ibid* art 20 (1).

⁶⁴ *Ibid* art 20 (8).

⁶⁵ *ibid* art 21 (1).

⁶⁶ EBA Regulations (n 3) recital (4).

non-discriminatory manner, in the interests of the Union as a whole'.⁶⁷ For this, it may need to prohibit certain areas of financial activity. However, to do so it must act in coordination with the Commission and the relevant national authorities, which may in this case also be the ECB.⁶⁸ To further bolster the interests of the Union versus the ones of the Eurozone Member States, the EBA may, in cooperation with the ESRB, initiate Union wide assessments of the resilience of financial institutions to adverse market developments.⁶⁹ Such provisions aim to ensure that the EBA does not gain monopolistic supervisory powers over certain Member States and suggests that its measures should be taken in the Union's interest.

The other area of change which is relevant to the establishment of the SSM is related to the EBA being the prime body responsible for the creation of a single rulebook for the EU. Although the initial establishment of the ESFS did not present a clear position on whether supervisory practices should be uniform or converged, the fact that the EBA has been entrusted with this role clearly indicates a desire to keep up with the uniformity attempt of the SSM. For this purpose, the amendment states that the EBA must 'contribute to the establishment of high quality common standards and practices'⁷⁰ and develop a 'European supervisory handbook on the supervision of financial institutions in the Union as a whole which sets out supervisory best practices for methodologies and processes'.⁷¹ How the EBA intends to enforce the application of the rules will greatly determine the level of uniformity reached. Further, it should achieve the result that the EBA must also align its practices with other supervisors in

⁶⁷ EBA Regulations (n 3) art 1 (5).

⁶⁸ *ibid* art 21 (1).

⁶⁹ *ibid* art 32 (2).

⁷⁰ *ibid* art 8 (1).

⁷¹ *ibid* art 8 (1).

the same way. Indeed, the EBA must ‘foster the consistency of the application of Union law among the College of Supervisors’ and promote ‘joint supervisory plans and joint examinations’.⁷²

The development of a single rulebook, as provided for under the amendment of the EBA Regulation, is forward-looking in terms of financial innovation. Here, a clear sign of supervisory uniformity is evident, with which the EBA must strive to coordinate the supervision of innovative financial activities.⁷³ Regarding the discussion in the previous chapter on regulatory competition, here the fact that the uniformity of supervisory practices for new products would hamper regulatory innovation and the possibility of testing different practices might be an area of concern. The argument that maximum harmonisation presents the risk of regulatory stagnation through a governance policy of uniformity is relevant here. As discussed in Chapter IV, and argued by Tridimas, there needs to be a preservation of sufficient substantive flexibility in legislative acts to provide a capable system of delegated legislation.⁷⁴ In order to avoid divergent transposition of the rules, there has been a lifting of technical standards to binding acts under the ESFS regime, therefore expanding the scope for regulatory uniformity. The Commission has been reassuring in this respect by stating that technical standards would still be used in cases where flexibility is necessary to respond to market developments.⁷⁵ Despite the aim for uniformity via the avoidance of divergent regulatory approaches, there are measures to enable the framework to react to particularly alarming situations. This does not resolve the issue that the framework

⁷² EBA Regulations (n 3) art 21 (1).

⁷³ *ibid* art 9 (4).

⁷⁴ Panagiotis Tridimas, ‘EU Financial Regulation: Federalization, Crisis Management, and Law Reform’ in Paul Craig, Grainne de Burca (eds), *The Evolution of EU Law* (OUP 2011) 793.

⁷⁵ Commission, ‘Proposal for Omnibus I Directive’ COM (2009) 576 final 5.

does not lend itself to regulatory experimentalism. This, however, is not a new trend for the EU, and although the Lamfalussy process was seen as particularly innovative from an EU perspective by allowing for flexibility and differentiation, it failed to permeate the regulatory process.⁷⁶ Under the new structure, the active promotion of consistent approaches to supervision simply do not allow for Member State manoeuvring in applying the norms to their specific circumstances.⁷⁷ This argument is bolstered by the recent decision relating to the UK challenge to ESMA's powers with regards to short selling.⁷⁸ The terms under which the single rulebook is to be established therefore appear to prevent allowances for regulatory innovation and experimentalism, and potentially result in an over-prescriptiveness, in loopholes and inflexibility.⁷⁹

II. The SSM's supervisory scope

The Regulation offers the potential for the ECB to cover virtually all credit institutions in the Eurozone. This, of course, would be undesirable from an administrative perspective but also smaller, domestic firms should not in principle generate concern for the ECB. The ECB will therefore need to select which credit institutions are worthy of its attention. The scope of firms to be supervised will define the nature of the SSM.

The SSM attributes tasks and powers relating to the prudential supervision of credit institutions to either the ECB or national competent authorities, and is dependent on the qualification of the credit institution as significant or less significant. The notion of

⁷⁶ T Idema and RS Keleman, 'New Modes of Governance, the Open Method of Co-ordination and Other Fashionable Red Herring' (2006) 7 *Perspectives on European Politics and Society* 108.

⁷⁷ CF Sabel and J Zeitlin (eds), *Experimentalist Governance in the European Union* (OUP 2010) 4.

⁷⁸ Case C-270/12 *United Kingdom v Parliament and Council* [2014] All ER (EC) 251.

⁷⁹ J Black, M Hopper and C Band, 'Making a Success of Principles-based Regulation' (2007) 1 *Law and Financial Markets Law Review* 191.

prudential supervision is not defined in the Regulation. However, Article 4(1) provides a list of tasks that are in accordance with 'Union law'.⁸⁰ Presumably, all other tasks are not to be taken on by the ECB and remain with the national competent authorities. Exclusions are provided for in Recital 28 whereby the ECB will not be responsible for supervision of payment services, anti-money laundering and terrorist financing, and consumer protection. It also states that the ECB will not be responsible for the functions of competent authorities over credit institutions in relation to markets in financial instruments. The presumption to be made here is that all the provisions under MiFID are not necessarily to be excluded from the ECB's scope as some provisions, such as licensing conditions, clearly fall within Article 4. However, the general day-to-day matters, such as supervision over best execution and investment suitability, are to remain with national competent authorities. These excluded tasks will remain with the national competent authorities irrespective of whether a credit institution falls with the ECB's remit for prudential supervision.

The competence of the ECB will therefore be delineated by the notion of what constitutes a significant credit institution. For this purpose, the Regulation stipulates five criteria as a status determinant. There are, however, prior constraints to take into account. Credit institutions under Union law are undertakings whose business combines taking deposits from the public and granting credits for their own account.⁸¹

This potentially excludes a number of institutions which only provide one or the other

⁸⁰ Pending the realisation of the Single Rulebook, Union Law will encapsulate primarily Regulation (EU) 575/2013 of the European Parliament and the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012 OJ L176/1, binding regulatory and technical standards 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 176/338.

⁸¹ Primarily, Regulation (EU) 575/2013 (n 80) art 4.

service. From an establishment perspective, those institutions with branches in a participating Member State, which have been established in a non-participating Member State, can be eligible to come under ECB supervision. Those institutions established in countries outside of the EU cannot be supervised by the ECB even though they have a branch in a participating Member State. In such cases, supervision will remain with the national competent authority.⁸² This is particularly relevant for a number of US and Swiss banks which have the potential to fall within the criteria to be considered a significant institution.

The other limitation is in relation to credit institutions which are established in a participating Member State outside of the Eurozone and which have entered into a close cooperation agreement as provided for under Article 7. The difficulty here is that, although the Member State has elected to be considered a participating Member State, the ECB cannot issue legal acts with direct effects on significant credit institutions. In such cases, only the national competent authority can issue specific binding decisions upon instruction from the ECB.⁸³ In terms of legislative acts of the ECB, relevant Member States need to ensure that equivalent measures are binding for the credit institutions established in a participating non-Eurozone Member State.⁸⁴

The first criterion mentioned under Article 6(4) is that of size, whereby a credit institution will be considered to be of significant size if the total value of its assets exceeds 30 billion Euros. There are concerns as to how this might be calculated as this must be checked not only for each credit institution but also on a consolidated group

⁸² SSM Regulations (n 2) art 6 (4).

⁸³ SSM Regulations (n 2) art 7.

⁸⁴ *ibid* art 7 (2) (b).

basis.⁸⁵ For the purpose of calculating total assets for a group, it will be determined on the highest level of consolidation within the participating Member States. Lackhoff raises the question as to whether, in this instance, the perimeter of consolidation should be the prudential one or the accounting one. The latter takes a wider view of the notion of a group, and would therefore bring a greater amount of institutions under the size criterion. He takes as an example a large car manufacturer which has a small credit institution within its group. The systemic relevance in this instance might not be interesting from the ECB's perspective and could also bring about extensive national sensitivities. For the purpose of financial supervision, the prudential notion of a group appears far more relevant as it measures the size of banking activities more accurately. Of course, there is the pragmatic issue of calculation, and with the accounting approach, data will be more available due to group accounts being prepared under near uniform standards.⁸⁶ This, however, is a technicality where fragmented reports could be prepared for the credit institutions that form part of the same group, or be reviewed by the ECB under the provisions of particular circumstances, whereby although a firm falls within the criteria, the ECB can deem it to be less significant.⁸⁷

The second criterion takes into account the economic relevance of a credit institution within its respective Member State.⁸⁸ A credit institution will be deemed significant if

⁸⁵ K Lackhoff, 'Which credit institutions will be supervised by the single supervisory mechanism?' (2013) JIBLR 454.

⁸⁶ The International Financial Reporting Standards (IFRS) are used in over two thirds of the G20 countries, and will be adopted in 2014 across the EU as a single standard. See the European Financial Reporting Advisory Group (EFRAG), 'An EU Perspective on the Move Towards Global Accounting Standards' (16 October 2012) <<http://www.efrag.org/Front/n1-1022/NewsDetail.aspx>> accessed 17 March 2014.

⁸⁷ SSM Regulations (n 2) art 6 (5).

⁸⁸ *ibid* art 6 (4) (ii).

the total value of its assets exceeds 20 per cent of the gross domestic product of the participating Member State of its establishment. Despite the 20 per cent threshold not being reached, a national competent authority may notify the ECB that it considers a particular credit institution to be of significant relevance in this respect. The ECB will decide, following a comprehensive assessment, whether the categorisation is founded or not. The basis on which the ECB may accept or reject the categorisation is not provided for in the Regulation. However, it can be imagined that this could be where credit institutions have a particular significance or relate to a particular institution specialising in high risk activities, or which generate a particular exposure to a section of the economy or substitutability issues.

The third criterion involves credit institutions which have particularly relevant cross-border activities.⁸⁹ In order to establish that the cross-border activities are sufficiently significant, the credit institution will need to have banking subsidiaries in more than one participating Member State and its cross-border assets or liabilities represent a significant amount in relation to its total assets or liabilities. Concerns have been raised over the notion of banking subsidiaries and whether it intends to eliminate the possibility of using this criterion for credit institutions with a cross-border network of branches.⁹⁰ There is a reasonable explanation for excluding branch networks under the home-host supervisory rules.⁹¹ Indeed, in the case of branches, as the home supervisor maintains control over the network of branches, the overall visibility is not much

⁸⁹ SSM Regulations (n 2) art 6 (4) (iii).

⁹⁰ Lackhoff (n 85).

⁹¹ In the case of branches, the home supervisor is responsible for the network of branches in other Member States, save exceptional circumstances, such as systemically significant branches which can hand certain supervisory tasks to the host supervisor. In the case of subsidiaries, the host supervisor is responsible for supervision. See Jonathan Fletcher and others, 'Subsidiaries or Branches: Does One Size Fit All?' (IMF Staff Discussion Note, SDN/11/04, International Monetary Fund, 7 March 2011) 17.

different from visibility within a single Member State. Moreover, in the case of branches, a credit institution's overall exposure is easier to establish due to regulatory reports being consolidated at home supervisor level. In the case of subsidiaries, however, the overall picture could be more opaque due to different supervisors holding different elements of information. This also amplifies the potential for disguising the true nature of financial assets via varying levels of securitisation as was discussed in Chapter two.

If a credit institution has made a request for, or is in receipt of, public financial assistance, it will automatically be considered significant. Although the EFSF no longer provides assistance, the ESM or any new arrangements under the second pillar of the Banking Union should provide direct assistance via a recapitalisation instrument which should be available from 2015.⁹² Any beneficiary credit institution will therefore automatically fall under the supervisory scope of the ECB. Should the credit institution form part of a larger supervised group, then that group will also fall under its scope. The ECB would begin supervision of the relevant credit institution from the request date rather than the date on which assistance was granted. This stands to reason as time would be of the essence in exerting control over an institution that found itself in the situation of requesting assistance. Moreover, it is likely that the ECB will take on an advisory role towards the ESM, giving opinions or recommendations when necessary.

⁹² See M Santa and J Strupczewski, 'Euro zone agrees on direct bank recapitalisation in 2015 – Eurogroup Head' (*Reuters*, 5 May 2014) <<http://uk.reuters.com/article/2014/05/05/uk-eurozone-banks-recapitalisation-idUKKBN0DL17H20140505>> and ESM, 'FAQ on the main features of the future ESM direct bank recapitalisation instrument' <<http://www.esm.europa.eu/pdf/FAQ%20Direct%20Bank%20Recapitalisation%20280620131.pdf>> accessed 17 May 2014.

The final criterion is Member State specific as the ECB will take over supervision of the three most significant credit institutions by participating Member State.⁹³ It is not specified upon which criteria the three most significant institutions will be established, however, it can be predicted that size will be the chief factor.

The purpose of Article 6 is to ensure that the ECB will supervise those credit institutions which are systemically relevant. However, it may be the case that although a firm fulfils the criteria above it is not necessarily systemically relevant. To provide for this, and also to enable the ECB to control the amount of firms that fall under its supervision, Article 6 provides for particular circumstances where credit institutions might be considered less significant. For the criteria of size, importance for the economy and significance for cross-border activities, this will only be possible in relation to the applicable methodology.⁹⁴ Conversely, the ECB may decide that even though a credit institution does not meet the criteria, it nevertheless deems it to be a sufficient exposure and therefore significant and/or necessary in order to ensure consistent application of high supervisory standards.⁹⁵ Consequently this gives the ECB discretion in including any credit institution in participating Member States, provided that the purpose is in line with the objectives of the SSM.

III. The SSM may cause a supervisory rift

As was discussed with regard to the new UK arrangement where the BoE has taken on the dual task of ensuring monetary and system stability, the same issue now arises with regard to the ECB. The problems with combining these tasks in a single authority

⁹³ SSM Regulations (n 2) art 6 (4).

⁹⁴ The methodology will be established by the ECB under its framework arrangements as provided for in the Regulation.

⁹⁵ SSM Regulations (n 2) art 6 (5) (b).

were noted.⁹⁶ Indeed, Goodhart and Shoenmaker list conflicts of interest and systemic stability as the basic arguments for discussion, but conclude that there is no overwhelming argument for either a model that combines the functions or one that does not. However, of particular relevance is the fact that it is undesirable for a supervisor to be responsible for monetary and system stability issues. This is mainly because the former will generally take precedence due to the immediacy and the publicity that is usually attached to it.⁹⁷ It is, therefore, relevant to question whether the powers granted to the ECB overlap its traditional monetary responsibilities. The Regulation has included governance provisions which aim to ensure an adequate separation of the two functions.⁹⁸ However, there are a number of hurdles to its achievement in practice.

An initial stumbling block appears at Treaty level where it is stated that the priority of the ECB is price stability.⁹⁹ Indeed, as considered in the case of the BoE, there will be instances when monetary decisions may conflict with system stability ones. In such cases, the internal governance strain will be most pronounced and effective segregation will be tested. However, TFEU Article 127(6) does provide for the fact that the European Parliament and the Council may confer additional tasks upon the ECB in relation to the supervision of financial institutions, albeit not insurance undertakings. Considering this constitutes a new function, new objectives can be set for the ECB.¹⁰⁰ Here, the statement of objectives mentioned in the Regulation will form a valuable

⁹⁶ See in particular C Goodhart and D Shoenmaker, 'Should the functions of Monetary Policy and Banking Supervision be Separated?' (1995) 47 Oxford Economic Papers 539.

⁹⁷ As discussed in Chapter IV.

⁹⁸ SSM Regulations (n 2) art 25.

⁹⁹ Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C326/47, art 127 (1) (TFEU).

¹⁰⁰ E Wymeersch, 'The European Banking Union, a first analysis' (Financial Law Institute Working Papers, WP 2012-07, October 2012).

part of the ECB's statutory mandate.¹⁰¹ This is further reinforced by the general objectives of the Union under TEU Article 3, whereby the new powers will contribute to the general advancement of the Union's economic policies and stability. The constitutional structure, therefore, clearly allows for the ECB to take on the role as provided for under the SSM Regulations. However, its ability to remain independent in times of policy strain will most likely tilt in favour of monetary policy.

The decision-making process allocation does not appear perfect either. The ECB has been given considerable leeway to establish its own internal procedures. However, it has not been able to give the Supervisory Board complete decision-making powers as this remains the responsibility of the Governing Council.¹⁰² Therefore, the Supervisory Board cannot decide alone, which means that the ultimate deciding body in terms of system stability is the body that is also responsible for monetary policy. These responsibilities should ideally be separated, although some creative thinking has gone into the internal process in order to avoid possible conflicts of interest. Article 26(8) of the Regulation provides for implicit approval by the Governing Council of decisions taken by the Supervisory Board. A period of time will be defined within which the Governing Council will need to respond only if it objects, and must do so in a reasoned way, citing monetary policy concerns in particular. Due to the monetary aspect of a possible rejection,¹⁰³ a non-Eurozone participating Member State will be given the opportunity to give its reasoned disagreement. This dialogue will be governed by

¹⁰¹ E Ferran, 'The New Mandate for the Supervision of Financial Services Conduct' (2012) 65 Current Legal Problems 411.

¹⁰² Protocol (No 4) on the Statute of the European System of Central Banks and of the ECB [2012] OJ C326/230 art 12 (ECB Statute).

¹⁰³ This is mainly because Member States that do not form part of the Eurozone do not get representation on the Governing Council; ECB Statute (n 102) art 10 (1).

Article 7(7) and can lead to the cancellation of the cooperation agreement with that particular Member State.

Such considerations, therefore, have the potential to create unease for those countries wishing to form part of the SSM, but which fall outside of the European Monetary Union framework.¹⁰⁴ This is the case even though they have been assured under the Regulation that the rules of procedure of the Supervisory Board will ensure equal treatment of all participating Member States.¹⁰⁵ Indeed, non-Eurozone Member States that wish to opt in will be faced with a crucial disadvantage due to a lack of participation in the ultimate step of decision-making at ECB level. Moreover, the close cooperation agreements appear relatively fragile given that there is the option of breaking the cooperation upon disagreement. Here, it is difficult to find a quick-fix procedural solution as it appears that only a Treaty change would allow for a more varied composition of the General Council, which could put both categories on an equal footing.¹⁰⁶ The fact that Treaty change has not occurred prior to the introduction of the SSM could create an ever-expanding rift between the countries that are part of the monetary union and those that are not, in particular with regard to the development of the other pillars planned under the Banking Union.

Although the majority of non-Eurozone Member States wished to join the SSM from the outset, the fact that the UK is firmly opposed is significant. Indeed, as the largest financial services centre in the EU, and specifically in banking terms, harmonising supervisory practices without it simply cannot be considered. This is even more so

¹⁰⁴ It appears that to date a majority of non-Eurozone Member States wish to join the SSM, with the exception of the UK, Poland, Czech Republic and Sweden.

¹⁰⁵ SSM Regulations (n 2) art 26 (12).

¹⁰⁶ E Ferran and V Babis, 'The European Single Supervisory Mechanism' (2013) 13 (2) JCLS 255, 274.

because it is the country that hosts the most non-EU banks.¹⁰⁷ Indeed, with the wider perspective of creating a truly integrated financial market and a single rulebook, it can never truly be achieved without the UK as it is simply too big to be side-lined. We can, indeed, differentiate between regulatory and supervisory practices at this point. The UK is drawn into the regulatory process via the ESFS at the same rate as other Member States, but there is strong reluctance to hand over supervisory powers to centralised institutions as was evidenced in the *Short selling case*.¹⁰⁸ Once again, unless Treaty change is achieved in order to at least set all Member States on a level playing field in terms of the SSM, opposition to the ECB taking a greater supervisory role will not be feasible.

Another particularity that assists somewhat in creating a balance and democratic legitimacy is the fact that the European Parliament and Council approve and appoint the Chair and Vice-Chair of the Supervisory Board.¹⁰⁹ The advantage is that, as EU Institutions, their preference would be towards leaders that have agendas that point towards supervisory harmonisation at EU level rather than being overtly Eurozone focussed. This will be hard to evaluate in practice although it will give some comfort to the non-Eurozone countries that the entirety of the selection process is not solely in the hands of the ECB. However, it has raised concerns relating to political involvement affecting its independence and accountability.¹¹⁰

The relationship between the EBA and the ECB will be key in cementing the SSM within the greater scope of the ESFS. The SSM provisions generally portray the ESFS bodies as

¹⁰⁷ European Banking Federation, 'EU Banking Sector: Facts and Figures' (2010) <<http://www.ebf-fbe.eu/uploads/Facts%20&%20Figures%202010.pdf>> accessed 20 February 2014.

¹⁰⁸ Case C-270/12 *United Kingdom v Parliament and Council* [2014] OJ C85/4.

¹⁰⁹ SSM Regulations (n 2) art 26 (3).

¹¹⁰ Ferran and Babis (n 106) 270.

complementary to the ECB's new tasks. However, it appears that overlaps are inevitable. Although the Eurozone sphere is within the EU, the powers of both institutions are not necessarily complementary because of different mandates and their legal access to certain powers. Indeed, unlike the powers conferred on the ESAs, which are mainly confined by *Meroni*,¹¹¹ the ECB under the SSM Regulation has been given far greater powers of supervisory intervention.

In terms of rule-making, the EBA and ECB have access to different sets of powers. On the one hand, the EBA has the set of powers described in the previous chapter, namely, to develop binding technical standards and take binding decisions. On the other hand, the ECB, under Article 132 TFEU, has the power to make regulations for the purpose of carrying out its tasks. The SSM Regulation aims to ensure that overlap is limited by stating that 'the EBA is entrusted with developing draft technical standards and guidelines and recommendations ensuring supervisory convergence and consistency of supervisory outcomes within the Union. The ECB should not replace the exercise of those tasks by EBA'.¹¹² The wording of the SSM Regulation goes further in trying to ensure that the ECB carries out its tasks in line with all relevant Union laws, and that it remains bound by the regulatory and implementing standards developed by the EBA and its work towards a single rulebook.¹¹³ However, the paragraph ends by offering the ECB a certain latitude as it may 'adopt regulations only to the extent necessary to organise or specify the arrangements for the carrying out of the tasks conferred on it by this Regulation'.¹¹⁴ Therefore, even though the ECB is clearly directed towards respecting the direction of the EBA, the potential exists for it to pass

¹¹¹ Case 9/56 *Meroni v High Authority* [1957-1958] ECR 133.

¹¹² SSM Regulations (n 2) recital 32.

¹¹³ SSM Regulations (n 2) art 4 (3).

¹¹⁴ *ibid* art 4 (3).

regulations to carry out its tasks that may not be entirely congruent with the direction given by the EBA.

Despite the strong wording stating that the ECB is required to respect the work of the EBA, the final paragraph of Article 4 gives the ECB the possibility to exert influence over the implementation of technical standards prepared by the EBA. It goes even further in suggesting that the ECB should point out technical standards that need to be amended, presumably to avoid conflicts with the issuance of its own Regulations. Overall, the Article does not give sufficient safeguards to give precedence to EBA technical standards over Regulations prepared by the ECB, thus potentially giving rise to conflicts and SSM prevalence over the ESFS.

On the supervisory side, there are greater questions of congruence between the two bodies. Under the SSM Regulation, the ECB is entrusted with the preparation of a supervisory manual which will serve as a uniform process for the national authorities that fall within its remit.¹¹⁵ Its purpose is to ensure the consistency of supervisory outcomes within the SSM. How the ECB's supervisory manual and the EBA's rulebook will converge is an open question. The potential for conflicts exists and originates primarily from the different supervisory objectives and their legal standing. Indeed, the fact that these two bodies are targeting different ultimate goals causes differences in specificities and application. On the one hand, the EBA is seeking to converge supervisory practices; allowing for certain divergences within the harmonisation process, and the fact that the ECB is focussing on supervisory uniformity already suggests the beginning of a two speed supervisory EU. Moreover, the legal standing

¹¹⁵ *ibid* art 6 (5).

will be different if the single rulebook is constrained in application due to *Meroni*, where it will be based on a best practice regime. In contrast, the ECB's manual will certainly be more prescriptive. Indeed, the ECB will have the possibility to intervene at any time to ensure that there is a consistent application of supervisory standards,¹¹⁶ which will invariably coax the national authorities into compliance with the manual. For this purpose, it is likely that, should a conflict arise between the rulebook and the manual, then those countries that fall under the supervision of the ECB will tend to comply with the manual as the legal risk is far greater. Moreover, the consequence of the ECB exercising pressure against the softer touch of the EBA will be cause for concern for the development of the ESFS. Furthermore, despite the consumer protection and anti-money laundering provisions being excluded, there are no guidelines protecting the remit of either the single rulebook or the manual.

The potential for overlap is further increased by the mutual recognition of both documents. On the one hand, the ECB should act in compliance with the EBA's supervisory handbook¹¹⁷ and, on the other, it can be expected that the ECB will influence the single rulebook.¹¹⁸ From the outset, it appears promising that both recognise common goals although it is likely that such a relationship will reinforce the influence of the ECB. Indeed, although it should act in line with the EBA's requirements, it is predictable that the ECB manual will be far more detailed than the rulebook as it will be more prescriptive, and therefore, more precise for the purposes of certainty. It is not the objective of the ECB to allow for general deviation from its rules as this would defeat its purpose. Therefore, although the principle laid down in

¹¹⁶ SSM Regulations (n 2) art 6 (5).

¹¹⁷ *ibid* art 4 (3).

¹¹⁸ Ferran and Babis (n 106) 278.

the single rulebook would be respected, it may be the case that the ECB has the power to mould it and detail it to its own needs. This puts the ECB in a powerful coordinating role where its supervisory influence stretches beyond the participating Member States; it also puts the *raison d'être* of the EBA at risk, or at least side-lines it. Indeed, the EBA does not fundamentally have the power to assert itself against the consolidation of Member States under the SSM. For example, the UK is able to affirm itself due to the financial might it represents, especially in banking terms. Therefore, although protections exist, in reality it lacks the positioning to resist being overcome by SSM influence.

The fact that the ECB's independence is strongly protected by Article 130 TFEU could have raised concerns regarding the EBA being able to impose its binding decisions on the ECB. In the Regulation, however, it was set out that such decisions could bind the ECB but only in its supervisory capacity. Alternative arrangements would have put the EBA in a delicate position, and are worth considering in order to exemplify its relative fragility. Two alternative solutions were put forward. The first was to create an exception towards the ECB where it would not have been bound by the decision but confined to a 'comply or explain' capacity. The other proposal, even less favourable to the EBA, would have been the removal of its ability to bind all national competent authorities to its decisions. Both would have considerably weakened and side-lined the power of the EBA as a supervisory authority.¹¹⁹

Another risk to the viability of the EBA's position was with regard to the voting mechanism of its decision-making process. Indeed, by creating the Eurozone

¹¹⁹ Ferran and Babis (n 106) 279.

supervisory sphere under the ECB auspices, the chances of creating a dominant interest group amongst Member States was strong enough for the Regulation to change the modalities of the voting process for the Board of Supervisors. In the original Regulation establishing the EBA, decisions on regulatory matters were to be taken by vote on a qualified majority and decisions on supervisory matters by simple majority.¹²⁰ The amendment to the Regulation now provides for the division created by the SSM, and although regulatory matters are still decided by a qualified majority, the final result must include at least a single majority from those participating Member States and a simple majority of non-participating Member States. The same applies to supervisory decisions where, although the simple majority system remains, there must also be a cascading simple majority of both spheres. Moreover, the amended Regulation also provides for review of the voting procedures by the Chair, and suggests that the Board must aim for consensus.¹²¹ In terms of balancing the interests between the participating and the non-participating Member States, an equilibrium seems to have been achieved. However, it stands to be distorted depending on the number of non-Eurozone Member States who decide to sign the cooperation agreement in order to become participating Member States. To date, it appears that a majority of Member States are likely to sign up. This leads to a new issue of imbalance because, should the UK and maybe a handful of other Member States be the only ones not to join, then this would lead to a possible veto for these Member States which could block the process at EBA level.

¹²⁰ Regulation (EU) 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing the European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L331/12, art 44 (EBA Regulations).

¹²¹ EBA Regulations (n 120) art 44 (4).

This creates a serious issue at rule-making level and could jeopardise the meaningfulness of the ESFS as a whole. Indeed, the rationale for establishing the ESFS after the crisis was to increase harmonisation at EU level in order to generate a more integrated and stable internal market for financial services. Should the SSM undermine the regulatory process of the ESFS, then the splitting of the two spheres would only be accentuated. Not only will it cause a stalling of the process at EBA level and limit the harmonisation process, it also stands to increase the pace at SSM level, where the level of regulatory and supervisory standardisation will increase, leaving the minority Member States marginalised.

Instead of being a body which unites regulatory and supervisory practices, the EBA stands to become a forum for disagreement should the SSM, under the guidance of the ECB, impose itself as a dominant body. It is unlikely, however, that tensions will ultimately be resolved by strict application of the voting process. The EBA will aim to mediate any disagreements prior to deciding in order to achieve its consensus goals. Dispute resolutions are likely to take place elsewhere. First, there is the possibility that the Commission steps in to resolve the issue by rejecting or amending a standard set by the EBA in order to safeguard the Union's interests.¹²² However, this is unlikely to occur with any kind of regularity as it would be unpopular not only from a legitimacy perspective but also due to the fact that such intervention can only be entertained in exceptional circumstances.¹²³

¹²² EBA Regulations (n 120) arts 10 and 15.

¹²³ *ibid* recital 23.

It is more likely that tensions stemming from frictions between the EBA and the SSM will be resolved, or at least discussed between the BoE and the ECB.¹²⁴ Indeed, the future strength of the EU's regulatory and financial framework seems to be in the hands of these two bodies. They have the opportunity to polarise the EU due to their spheres of influence, but also to unite upon their agreement. Either way, the interests of the Union will not necessarily be represented, and this further undermines the ESFS in its tasks and objectives. It can also be seen that, should the debate be shifted between these two parties and consensus is not achieved, the unifying momentum created by the crisis would be compromised.

A degree of comfort can be taken from the EBA Board of Appeal decision of 24 June 2013 with respect to the EBA's supervisory powers.¹²⁵ It stated that the scope of its intervention powers is relevant insofar as they could in the future come up against the ECB in its supervisory role. The relevance of the decision is that it introduces two essential tests for the interpretation and scope of the EBA's powers and tasks.¹²⁶ The first test relates to the EBA's ability to intervene in supervisory matters where a breach of Union law is suggested.¹²⁷ Indeed, there need not be any concrete evidence that Union law has effectively been broken, a suggestion or 'appearance of' is sufficient to trigger the potential for intervention. However, due to its limited resources and to avoid the necessity of intervention the decision also clarified that intervention is optional and at the discretion of the EBA.¹²⁸ It will therefore be interesting to see how these powers will work in practice with the investigatory powers of the ECB and

¹²⁴ Ferran and Babis (n 106) 282.

¹²⁵ *SV Capital OU v European Banking Authority* (24 June 2013) ESA Board of Appeal Decision 2013-008.

¹²⁶ D Janssen, 'Interpreting the EBA's powers: a case comment on the EBA's Board of Appeal Decision 2013-008, 24 June 2013' [2013] 7(6) LMFRR 311, 311.

¹²⁷ EBA Regulations (n 120) art 17.

¹²⁸ *SV Capital OU v EBA* (n 125) para 11.

whether an overlap will cause tension in this respect. It is foreseeable that both investigative functions will be applicable to a given situation whereby a breach of rules set by the ECB could have Union law implications, thus raising the potential for EBA intervention.

IV. The ESRB's lack of independence from the ECB is problematic

With regard to the relationship between the ECB and the ESRB, an excessive proximity was already highlighted in the previous chapter. Indeed, the main concern centred on the fact that there was an unwarranted amount of influence in governance terms whereby the Chair of the ESRB was held by the President of the ECB and the Vice-Chair was appointed by the ECB's Governing Council. The issue was that, in terms of accountability, there was parliamentary confusion surrounding the fact that the head of both the ECB and the ESRB was the same person, and this tended to weaken the ESRB's true mandate.

It now appears that the SSM will enhance the ECB's importance within the ESRB. The Regulation is limited to requiring the ECB to cooperate closely with the ESRB.¹²⁹ The potential for the ECB to exert further influence on the ESRB will grow, however, with supervisory convergence at SSM level. The fact that the ESRB's General Board is composed of central bankers from the Member States leads us to believe that there will be a convergence of views from the participating Member States. Therefore, not only will the ECB be in a position to control the leading positions of the ESRB, it will also be able to control a majority of the General Board's voting. With the ECB dominating the decision-making process, the ESRB's independence and effectiveness

¹²⁹ SSM Regulations (n 2) art 3.

will be considerably jeopardised. Moreover, there is a chance that the themes for discussion will become centred around banking issues at the expense of the other systemically relevant topics, such as securities and insurance. Therefore, the advantage of having a macro-prudential supervisor that can reach across industry would be lost, and this would also damage coordination at ESFS levels.

A further significant encroachment on the ESRB's standing is the fact that the ECB under the SSM has been given macro-prudential tasks and powers.¹³⁰ Considering the current trend of positioning the macro-prudential supervisor within the central bank,¹³¹ the ECB appears to be an effective body for this role. Under its supervisory role, the ECB will have access to the information it needs to make decisions on systemic relevance and will be able to take decisive action if required. Indeed, the Regulation gives the ECB considerable powers to 'apply higher requirements for capital buffers than are applied by the national competent authorities ... including countercyclical buffer rates'.¹³² Therefore, its competence in requesting financial institutions to hold further capital is not only specific but can extend to institutions within a Member State. This could be problematic for the ESRB in rendering the ECB the 'de facto macro-prudential authority in respect of banks in the "Banking Union"'.¹³³ In the previous chapter, it was established that the ESRB was having difficulties asserting itself as an effective macro-prudential supervisor, chiefly because of difficulties in demonstrating its ability to carry out its mandate. Such a position is

¹³⁰ SSM Regulations (n 2) art 5.

¹³¹ As was discussed in Chapter IV in relation to the Twin Peaks model.

¹³² SSM Regulations (n 2) art 5 (2).

¹³³ Directorate General for Internal Policies (DGIP, European Parliament), 'Review of the New European System of Financial Supervision (ESFS). Part 2: The Work of the European Systemic Risk Board (ESRB)' (2013) 82.

not helped by the fact that the ESRB is set up as a soft law body and there is a hefty procedural path in order to carry out decisive action.

Upon reviewing the effectiveness of the ESFS, the Directorate General pointed out the two main reasons why it is of the utmost importance that the ESRB remains the 'pre-eminent forum for discussions and decisions over macro-prudential policy in the EU.'¹³⁴ The first is that the SSM is not pan-EU. In order to be an effective supervisory body, especially in macro-prudential terms where access to information is key, the full picture is required. This is especially the case considering the fact that the UK, which represents half of all banking activity in the EU, is dramatically opposed to joining. The second is that, despite the extensive powers given to the ECB under the SSM, the scope remains banking focussed. This leaves aside other systemically relevant areas of finance, and in particular, the interconnectedness between them.

Overall, the ECB's powers are extensive, in addition to which political support and a solid legal framework make it a likely successful supervisor within the SSM. Unfortunately, due to the fact that the SSM restricts its scope to participating Member States, it is likely that it could create a two speed EU for regulatory and supervisory purposes. The eagerness of the Eurozone countries to push forward with reform carries the risk of marginalising those who are reluctant to participate. The drivers of reform have indeed been Euro focussed due to a loss of confidence in the currency and issues of sovereign debt. However, the SSM appears to have been popular with the non-Eurozone Member States; therefore, its influence stands to increase with the only caveat being firm resistance from the UK. Rather than marginalisation, the EU's

¹³⁴ *ibid* 83.

supervisory future appears to be fractured. The victim of the fracture is likely to be the ESFS, and in particular, the EBA and the ESRB who stand to become irrelevant in their positions should the ECB take advantage of its ability to control these bodies.

The SSM could also indirectly lose out as a consequence of this fracture. Indeed, if a stalemate arises in the development of the single rulebook, or if harmonisation is hampered due to excessive compromise, then the ECB could find itself with supervisory powers that lack regulatory uniformity. In effect, should the ECB lack sufficient regulatory measures to carry out its supervisory tasks, then it would need to refer to national law, thus allowing national authorities to regain competence.

At the first sign of ECB dominance in financial supervision and regulation, the EU Institutions should step in to introduce reform in order to empower the ESFS with further control and influence. In the previous chapter, a review of ESRB governance was proposed. This could be the first step in creating greater independence from the ECB, notably by having an independent Chair. This would not only help the agenda setting to be EU focussed but would also offer a clearer demarcation in mandates.

Another step would be for the ESRB and EBA to have input and influence over the SSM. This has presumably been avoided due to political sensitivities; however, by doing so this would greatly assist in legitimising the EBA and the ESRB. Going further, certain tasks could be delegated to ESFS bodies which would not only relieve the ECB of some duties but also give EU legitimisation to the SSM. For example, the ESRB would be competent to assist the ECB in the selection process of those credit institutions that were be deemed to be significant. Due to its access to information, it could also assist

in determining countercyclical capital buffers, and in so doing expand its relevance to the EU.

The EBA has also been handed the important task of compiling a single rulebook, the importance of which should not be diminished by the ECB's influence. The sensitivities surrounding this process are vast and need to be handled in a way that does not stall the overall process. The main provisions currently constituting the single rulebook were discussed in the third chapter. Consensus was necessary in order to achieve this level of harmonisation, and one common form was the requirement to review the provisions after a certain period. This settled some political sensitivities but it also signalled that the EU was prepared to be flexible. The success of these provisions, therefore, is highly dependent on the ability to 'correct and calibrate'.¹³⁵ This means that the task of the EBA is considerable in that it has the duty to encourage not only further completion of the rulebook but also consolidate its current status.

V. Concluding remarks

The SSM Regulations have given extensive supervisory powers to the ECB which now sits as the most influential supervisor in the EU. Not only should it be considered a supervisor of supervisors within the Eurozone but, due to governance arrangements, it also carries great influence amongst the ESFS bodies. In banking terms at least, the ECB stands to be able to shape the future of financial supervision in the EU.

The extent to which the ECB will assert itself will be at the expense of the EBA and the ESRB. Although the EBA maintains control over regulatory issues for banking and the single rulebook, the SSM Member States may coalesce to influence its direction. The

¹³⁵ N Moloney, 'Resetting the location of regulatory and supervisory control over EU financial markets: lessons from five years on' (2013) ICLQ 956.

challenge for the EBA will be to maintain its focus on supervisory convergence in the interests of the EU.

The ESRB appears in an even more precarious situation than the EBA due to the fact that, to date, it has been unable to assert itself as a viable macro-prudential supervisor. However, the fixes for the ESRB appear more straightforward. With a governance reshuffle and the acquisition of substantial powers under CRD IV, it could still gain prominence at EU level.

The overall picture for the convergence of supervisory practices at EU level appears bleak. Despite substantial progress made via the ESFS, the SSM stands to create a two speed Union. Even more to the detriment of the Union, by asserting itself as a strong supervisor for most Member States, and with control over monetary policy, the European banking supervisory landscape appears polarised between the ECB and the BoE. The reaching of consensus at this level can only be detrimental to the interests of the Union if these central banking superpowers promote their own interests.

Some of the issues that were explored in this chapter and the previous one can be remedied and mitigated against in the short term. However, with the SSM gaining influence, only Treaty change to strengthen the ESFS's position will ensure that the supervisory landscape is harmonised to an adequate level.

CONCLUSION

The 2007-09 financial crisis represents a pivotal point in time for the concept of systemic risk, affecting the way it is defined and how its effects can be mitigated. Indeed, the materialisation of systemic risk throughout the crisis has provided new evidence of its manifestations, thus giving the opportunity to review pre-crisis literature. The unpredictability of the notion was also evidenced by the appearance of areas not previously considered to be relevant from a systemic perspective.

The trigger event of the crisis fits in well with literature descriptions of a capital crisis, where the assets held by financial institutions fall in value causing solvency concerns.¹

The ensuing manifestations resulted in catastrophic consequences for the real economy on a global scale. However, total collapse was avoided by the unprecedented amount of liquidity injections from governments. This ties in with the arguments of Bordo et al regarding real and pseudo crises, where the latter is preventable by the provision of emergency funding, although it was probably not foreseen to this extent.²

The unexpected ramifications of the interconnectedness of opaque financial products and their apparent low risk nature has called for a rethink of many aspects of financial regulatory content and supervisory structuring. The multi-jurisdictional aspect of the European Union means that the dynamics are different because of the need to contend with a unified yet fractured system.

This study set out to explore the reform agenda introduced by the EU in terms of the regulatory measures that were created as a response to the crisis, and the new

¹ P Bartholomew and G Whalen, 'Fundamentals of Systemic Risk' in George Kaufman (ed), *Research in Financial Services: Banking, Financial Markets, and Systemic Risk*, vol 7 (JAI Press 1995).

² M Bordo and others, 'Real versus pseudo-international systemic risk: some lessons from history' (Working Paper 5371, NBER working paper series, 1995).

supervisory infrastructure that allows for 'laws on the books' to be effective 'laws in action'.³ It is also argued that the reform has been successful in responding to the causes of the crisis, and has done so whilst respecting an ambitious timeframe. On the regulatory side, with limited political friction, consensus has been easier to achieve in the immediate aftermath of the crisis due to the costs incurred by Member States in keeping their systems afloat. However, political commitment is limited to the backswing of the regulatory pendulum. Therefore, it is crucial that the new supervisory structure cements its position in terms of authority and competence in order to enable the reform agenda to develop progressively. Indeed, the unpredictability of systemic risk calls for a malleable regulatory and supervisory framework.

The aim of writing a single rulebook is not new for the EU. However, with the reform it has achieved a foundation on which to build it. The chief concern on the development of a single rulebook pertains to the level of harmonisation that is desirable for financial services within the EU. The push for uniformity has considerable advantages in the EU, in particular, in relation to efficiency of oversight and mitigating regulatory divergences for core objectives. However, there are also disadvantages in that uniformity can restrict regulatory innovation and experimentalism. Therefore, it is important that the framework should cater for divergences where they are necessary.⁴ This will be an arduous task, and is one which currently lies with the Commission in its decision whether to approve binding technical standards or non-binding ones. This could potentially be a source of friction with Member States in the future where disagreements over supervisory influence could be resisted. How this discretion will be

³ N Moloney, *How to Protect Investors: Lessons from the EC and the UK* International Corporate Law and Financial Market Regulation (CUP 2010).

⁴ P Tridimas, 'EU Financial Regulation: Federalization, Crisis Management, and Law Reform' in Paul Craig, Grainne de Burca (eds), *The Evolution of EU Law* (OUP 2011) 793.

utilised in the future will be interesting and it will, to an extent, determine the advancements that can be made by the ESFS in enabling the ESAs to acquire further direct powers.

Some elements of the new regulatory framework also suggest the possibility for greater direct supervision by the ESFS over financial institutions in the future. The reform in relation to credit rating agencies will be crucial in determining the lead role that ESAs might take in the future. This brings the discussion back to the advantages of having centralised supervisory functions and the extent to which they may remove discretion from national competent authorities. It leads to the view that the outlook for supervisory powers is decidedly horizontal at ESFS level, and this will restrict Member State manoeuvring in applying regulations to their specific circumstances.⁵ This position has been further reinforced by the European Courts in the recent case where the UK challenged ESMA's authority with regard to short selling, which ultimately failed.⁶

The renewed importance of monitoring systemic risk is further increased by the introduction of a new body dedicated to its oversight. However, its initial set-up leads us to believe that a certain nervousness can be attributed to its establishment as a soft law body with limited enforcement powers. Furthermore, its independence is jeopardised by being overly influenced by Central Banks, in particular the ECB. The thesis makes the argument that it is not because the ESRB is set up as a soft law body that will prevent it from being effective, but in fact governance issues. This study suggests that some fixes are available, notably in governance terms, which would

⁵ CF Sabel and J Zeitlin (eds), *Experimentalist Governance in the European Union* (OUP 2010) 4.

⁶ Case C-270/12 *United Kingdom v Parliament and Council* [2014] All ER (EC) 251.

reinforce the various bodies constituting the ESFS and provide them with greater independence without requiring Treaty changes. Indeed, it stands to gain considerable autonomy by severing its governance dependency on Member States and EU Institutions. Despite this, taking the ESFS bodies to the next level of supervisory powers will require Treaty change as it has been argued that the new framework is already challenging the boundaries of existing Treaties and relevant European case law.

This thesis also considers the steps that have been taken for the establishment of a banking union amongst Member States that have adopted the single currency. The Single Supervisory Mechanism (SSM) grants considerable supervisory powers to the ECB over banks in the Eurozone and those which are in countries that elect to be part of the SSM. The scope will be limited to institutions deemed to be systemically significant. In combination with the support of national competent authorities, the ECB's powers, competence and authority stand to make it an effective supervisor. The chief issue raised here is that the SSM does not sit comfortably alongside the ESFS. Despite provisions that aim for cooperation between the two systems, the influence of the ECB is far too extensive in both systems with regard to supervisory matters. This causes an imbalance at EU level amongst EU institutions, but also amongst Member States. Indeed, a polarisation between those Member States that are grouped around the ECB and the few that resist and look to the powerful Bank of England, could jeopardise the interests of the European Union. This thesis argued that the successful creation of the banking union stands to cause a supervisory rift in the EU whilst weakening the position of the bodies falling under the ESFS. The consequence of this is the development of a 'two speed' model of financial services supervision in the EU.

However, the study does suggest that the EU is in a much better position to mitigate the effects of systemic risk on the regulatory front, despite certain worrying weaknesses in the supervisory framework. In this respect, further centralisation and independence at ESFS level is desired. Failing this, the EU's regulatory regime will likely find itself in an even weaker position where those institutions that have the regulatory knowledge will not have a sufficiently permissive framework in which to work. The danger being that policy in terms of systemic risk is pursued and influenced by those institutions which are also responsible for monetary policy, namely Central Banks.

This thesis is limited to systemic risk issues and neither the wider perspective of the reform agenda nor how the new framework might affect other areas of financial services supervision is addressed. Empirical elements were also not considered and these may have assisted in measuring the impact of the reform agenda. It may have been of relevance, for example, to consider the effects of the 'systemic risk dashboard' introduced by the ESRB and its usefulness so far to financial and EU Institutions.

Some interesting perspectives are also raised by this study which deserve further consideration. For the purposes of systemic risk, greater technical analysis of the countercyclical buffers under CRD IV would enable a better understanding of how the regulatory framework has been strengthened and to what extent. Also, greater discussion on the criteria for selection of financial institutions to be considered systemically relevant would carry weight in delimiting the scope of systemic risk supervision.

Following formal reviews of the reform agenda in coming years, the next phase of strengthening the EU regulatory and supervisory framework will be crucial in cementing the harmonisation process.

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