The 'Output' Legitimacy of Financial Stability in EU Law: Beyond Economic Functionalism

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THE ‘OUTPUT’ LEGITIMACY OF FINANCIAL STABILITY IN EU LAW: BEYOND ECONOMIC FUNCTIONALISM

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Abstract

The objective of financial stability emerged as a core element of EU law following the financial crisis to guide unprecedented reform in financial regulation and supervision, bank recovery and resolution, fiscal policy, and other fields. This thesis explores the elusive concept of financial stability and the legitimacy of EU law measures pursued on this basis. With view to delineating the boundaries of the objective, a teleology is developed around the non-economic utility and the ideological underpinnings of financial stability as a shift away from laissez-faire liberalism in the European financial market. Owing to the lack of traditional democratic 'inputs' in financial stability policy, this teleology is used to assess the extent to which post-crisis reforms impact positively or negatively on the 'output' legitimacy of EU law. Accordingly, the concept of 'output' legitimacy is defined as extending beyond performance in the functionalist sense. Three case studies are presented: substantive tools in prudential and resolution policy (CRR II/CRD V and BRRD II), the institutional reforms of the European System of Financial Supervision and the Banking Union, and the special case of fiscal reform and financing assistance in the euro area. While the regulatory side is aligned with the teleology of financial stability, inconsistencies can be observed in relation to institutional and financing measures, which therefore threaten the output legitimacy of EU law. Finally, this thesis challenges the view that judicial review should remain deferential in expert policy fields and argues that review of financial stability could serve the purpose of minimising the social costs of policy.

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List of Abbreviations

AG: Advocate General

BCBS: Basel Committee of Banking Supervision

BRRD: Bank Recovery and Resolution Directive

BU: Banking Union

CFI: Court of First Instance

CJEU: Court of Justice of the European Union

CMU: Capital Markets Union

CRD: Capital Requirements Directive

CRR: Capital Requirements Regulation

DGS: Deposit Guarantee Scheme

EBA: European Banking Authority

ECB: European Central Bank

EDIS: European Deposit Insurance Scheme

EDP: Excessive Deficit Procedure

EFSF: European Financial Stability Facility

EFSM: European Financial Stabilisation Mechanism

EIOPA: European Insurance and Occupational Pensions Authority

EMU: Economic and Monetary Union

ESAs: European Supervisory Authorities

ESFS: European System of Financial Supervision

ESM: European Stability Mechanism

ESMA: European Securities and Markets Authorities

ESRB: European Systemic Risk Board

FCA: Financial Conduct Authority (UK)

FSB: Financial Stability Board

FSOC: Financial Stability Oversight Council (US)

GC: General Court

IORP: Institutions for Operational Retirement Pensions

IMF: International Monetary Fund

LOLR: Lender of Last Resort

MiFiD: Markets in Financial Instruments Directive
NCA: National Competent Authority
NRA: National Resolution Authority
SGP: Stability and Growth Pact
SIFI: Systemically Important Financial Institution
SME: Small and Medium Enterprises
SSM: Single Supervisory Mechanism
SRB: Single Resolution Board
SRF: Single Resolution Fund
SRM: Single Resolution Mechanism
TEU: Treaty on the European Union
TFEU: Treaty on the Functioning of the European Union
TSCG: Treaty on Stability, Coordination and Governance

Policy Tools & Related Abbreviations

CCoB: Capital Conservation Buffer
CCyB: Countercyclical Capital Buffer
CET: Common Equity Tier
DSTI: Debt-Service-To-Income (ratio)
FRTB: Fundamental Review of the Trading Book
G-SII: Globally Systemically Important Institutions
ICAAP: Individual Capital Adequacy Assessment Process
IPU: Intermediate Parent Undertaking
LCR: Liquidity Coverage Ratio
LGD: Loss Given Default
LTI: Loan-to-Income (ratio)
LTV: Loan-To-Value (ratio)
MREL: Minimum Requirement for Own Funds and Eligible Liabilities
NSFR: Net Stable Funding Ratio
O-SII: Other Systemically Important Institutions
SIFI: Systemically Important Financial Institution

RWA: Risk Weighted Assets

SRB: Systemic Risk Buffer

SREP: Supervisory Review and Evaluation Process

SA-CCR: Standardised Approach for measuring Counterparty Credit Risk

TLAC: Total Loss-Absorbing Capacity

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Statement of Copyright

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Forgive me, but I will not list your names (I also apologise for the ensuing change in tone). I would like to address something that has occupied my thoughts daily as I was writing this thesis, and to take this opportunity to acknowledge the many nameless victims of femicide.

Fatal violence against women is a structural problem, a product of ideological forces not unlike the ones I challenge in my dissertation. Every year in the United Kingdom alone, over a hundred women are killed by men. Many victims belong in one or more marginalised groups: racial and ethnic minorities, older adults, migrants and refugees, disabled persons, transgender women, the LGBT+ and queer community, persons without housing, persons in need of addiction treatment. While physical violence can be an isolated event, most victims are subjected to other forms of abuse, trafficking, coercive control, and stalking.

I am writing about this issue because victims of gender-based violence face an uphill battle for justice, or simply to be heard, against systemically entrenched negligence and inequality. I am also writing to remember. Sadly, I cannot name all victims of femicide—there are far too many. I dedicate this research to the ‘Unnamed’, whose family and friends are still searching for answers. I value the life you lived, and I hope you rest easy knowing you brought something special to the world. You are sorely missed.

Chapter 1: General Introduction

In the words of Jean Monnet, 'Europe will be forged in crises and will be the sum of solutions adopted for those crises'. In the last decade, we have witnessed the biggest recession since the 1930s, a migration crisis that saw more than five million people cross into the EU, and a pandemic that will be remembered for a staggering death toll and months in lockdown. This is in addition to the political storm caused by the withdrawal of the United Kingdom from the EU, the resurgence of far-right authoritarianism in some Member States, and insecurity in the border regions of Eastern Europe and the Middle East.

Put plainly, crisis is transformative. The European Union has changed drastically because of years of instability and can be expected to continue to change as new challenges emerge. It is, therefore, vital to analyse policy and legal responses to identify predictive patterns and the overall direction in which the EU is heading. I focus on the most impactful policy shift of the decade, the rise of financial stability as a core objective of EU law.

My thesis investigates the legitimacy of financial stability, as distinguished from its legality. In the context of financial stability, legitimacy is a question of "outputs" because the objective is mainly pursued by expert agencies that lack traditional democratic "inputs". My hypothesis is that there is a flawed understanding of both the concepts of financial stability and output legitimacy, which leads to policies that enjoy normative support, but which are likely to erode legitimacy in the empirical sense. In the sections that follow, I will introduce the history of financial stability as a policy objective, identify the aims of this research, and provide a breakdown of the thesis chapters.

1.1 Focus of my research: financial stability as an objective of EU law

Financial stability broadly refers to the uninterrupted functioning of the financial system, but its precise definition varies depending on the context in which it is discussed. It is a malleable concept not only because the financial system is constantly reinventing itself, but also

because financial stability is closely affected by political decisions in economic policy and other fields. Most scholars concede that financial stability is an inherently 'elusive' goal.[1]

The history of financial stability as a policy objective can be organised into three distinct phases. In the years preceding the financial crisis, financial stability was perceived as a secondary task of central banks and its regulatory dimension was largely overlooked. Both a product and a cause of laissez-faire capitalism, this approach directly contributed to the crisis. The second phase describes the rise of financial stability as an independent objective of prudential regulation and supervision, mainly due to the efforts of international actors. The third phase highlights the objective's unique trajectory in EU law, especially following the escalation of the crisis in the euro area into a sovereign debt crisis.

Throughout the 1990s and early 2000s, and mirroring the prevailing notion of market freedom, financial stability was treated as synonymous with unimpaired economic performance.[2] In the negative sense, instability was expressed in terms of price change, reduced consumption, fluctuations of investment—not as a systemic failure of regulation.[3] Financial stability was reduced to a by-product of monetary policy, despite warnings from authors such as Goodhart and Schoenmaker who saw the two as potentially conflicting.[4]

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[1] Gianni Lo Schiavo, *The Role of Financial Stability in EU Law and Policy* (Wolters Kluwer 2017) 16-19; Claudio Borio, 'The Search for the Elusive Twin Goals of Monetary and Financial Stability' in Lars Jonung, Christoph Walkner and Max Watson (eds.), *Building the Financial Foundations of the Euro* (Routledge 2008).

[2] 'Economic performance' refers to the connection between the financial sector and the real economy. The mainstream view was that corrective public action should not serve financial stability as a standalone objective, but to promote and reward market efficiency. Andrew Crockett, 'The Theory and Practice of Financial Stability' (1996) 144(4) *De Economist* 531, 532; Gary J Schinasi, 'Defining Financial Stability' (IMF Working Paper WP/04/187, 2004) 8.

[3] The benefits of regulation were overlooked or dismissed on grounds that financial stability would disincentivise market discipline, thus creating a moral hazard. See eg, on government guarantees 'safety net' policies, Morris Goldstein and Philip Turner, 'Banking Crises in Emerging Economies: Origins and Policy Options' (BIS Economic Papers No 46, October 1996) <www.bis.org/publ/econ46.pdf> accessed 16 September 2021.

[4] Charles Goodhart and Dirk Schoenmaker, 'Should the Functions of Monetary Policy and Banking Supervision Be Separated?' [1993] 47(4) *Oxford Economic Papers* 539; Charles Goodhart, 'Myths about the Lender of Last

Thus, the conventional view was that central banks should only interfere with the market once an asset bubble had burst and began affecting monetary policy goals (inflation). Labelled as the 'Jackson-Hole consensus', this approach falsely assumes that central banks are capable of mitigating instability using solely monetary policy tools, and it disregards the preventative side of financial stability altogether.[5]

The crisis was fuelled by another misconception, known as the 'composition fallacy', that supervision of individual credit institutions would ensure the stability of the financial system as a combined whole.[6] This alludes to the distinction between micro- and macroprudential policy. Prudential regulation and supervision seek to enhance the resilience of financial institutions to external or internal shocks, as opposed to measures that target illegal conduct.[7] It can be further categorised into micro-prudential and macroprudential policy: the former regulates firm-specific risks, the latter monitors the financial sector as a whole, with view to preventing system-wide threats.[8] It should be noted that macroprudential measures, such as

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Resort' [1999] 2(3) *International Finance* 339. For an overview of the role of central banks in finance, see Tommaso Padoa-Shioppa, 'Central Banks and Financial Stability' in *Regulating Finance: Balancing Freedom and Risk* (OUP 2004) 93-128.

[5] Anastasios G Malliaris, 'Asset Price Bubbles and Central Bank Policies: The Crash of the "Jackson Hole Consensus"' in Douglas D Evanoff, George G Kaufman and Anastasios G Malliaris (eds), *New Perspectives on Asset Price Bubbles: Theories, Evidence, and Policy* (OUP 2012).

[6] 'The main tool which regulators use to do so, is capital adequacy requirements, but the current approach has been found wanting. It implicitly assumes that we can make the system as a whole safe by simply trying to make sure that individual banks are safe. This sounds like a truism, but in practice it represents a fallacy of composition. In trying to make themselves safer, banks, and other highly leveraged financial intermediaries, can behave in a way that collectively undermines the system'. Markus K Brunnermeier et al, 'The Fundamental Principles of Financial Regulation' (Geneva Reports on the World Economy 11/2009, May 2009) xv-xvi <www.princeton.edu/~markus/research/papers/Geneva11.pdf> accessed 16 September 2021.

[7] Prudential regulation aims to enhance the 'safety and soundness' of the financial system, conduct-of-business regulation focuses on consumer protection and free competition. Frederic S Mishkin, 'Prudential Supervision: Why is it Important and What Are the Issues?' in *Prudential Supervision: What Works and What Doesn't* (University of Chicago Press 2001) 1.

[8] Macroprudential supervision is defined as 'oversight of the financial system as a whole' in Martin Wolf, 'Seven Ways to Fix the System's Flaws' *Financial Times* (London, 23 January 2012).

additional capital requirements for banks, carry very significant (compliance and other) costs. Therefore, the absence of a robust macroprudential toolkit prior to the crisis was a deliberate choice of free market ideology, not the product of inexperience or scientific ambiguity. An excessive reliance on self-regulation was the perfect environment for the crisis to occur.

Today, there is an overwhelming consensus that financial stability is an independent and global objective, pursued mainly through the vehicle of macroprudential regulation and supervision. This paradigm shift in the way that financial stability is understood and operationalised can be traced to the actions of international actors, namely the G-20, the IMF, and the Basel Committee on Banking Supervision.[9] These institutions played a key role in exposing the shortcomings of micro-prudential policy and spearheading reform efforts. A famous example of reform is the Dodd-Frank Act of 2010, which overhauled regulation and supervision in the US. Notably, the Dodd-Frank Act established two specialist agencies responsible for financial stability, the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR). These exemplify the newfound independence of this policy goal.[10]

Implicit in this shift is the acceptance of financial stability as a 'global public good'. This theory explains that individual market actors have little incentive to pursue financial stability, which must instead be provided by public authorities.[11] The public good terminology echoes

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[9] The G-20 summit of 2 April 2009 is considered a turning point in regulation and supervision. See generally, Malcolm D Knight, 'Reforming the Global Architecture of Financial Regulation: the G20, the IMF, and the FSB' (CIGI Papers No 42, September 2014) <eprints.lse.ac.uk/61213/1/SP-6%20CIGI.pdf > accessed 16 September 2021.

[10] Another example of the connection between financial stability and prudential policy can be found in the mandate of the Basel Committee on Banking Supervision (BCBS), which centres on 'strengthen[ing] the regulation and supervision of banks worldwide with the purpose of enhancing financial stability'. For a brief overview of developments in the USA, UK, and EU, see Lo Schiavo (n 1) 13-15; John Armour et al, Regulatory Architecture: What Matters?' in *Principles of Financial Regulation* (OUP 2016) 597 -615; For wider analysis of the global impact of the crisis, Johan A Lybeck, *A Global History of the Financial Crash 2007-2010* (CUP 2011).

[11] Joseph Stiglitz *et al*, 'Report of the Commission of Experts of the President of the United Nations Assembly on Reforms of the International and Monetary and Financial System' (UN 2009) 51

Bieri's formulation of financial stability as a 'nonrival' good, whose consumption does not preclude simultaneous consumption by others, and a 'nonexcludable' good, whose availability is not depleted by consumption to prevent future access.[12] As the dominant theory of financial stability, the 'public good' rationale supports the intensification of regulation and supervision (market interference) since the crisis. In addition, financial stability is considered a 'global' good, as the financial system is a network of networks that defy national borders.[13]

It follows that the rise of financial stability as an independent policy objective exemplifies a shift away from market freedom as the guiding principle of public action. This ideological shift is especially relevant to European integration, founded on the functionalist notion of market integration.[14] Yet the ideological transformation of the financial market is relatively unexplored in the EU law literature; my thesis considers this dimension as critical in delineating an elusive policy goal.

The EU and Eurozone dimension

The European response to the crisis follows in the path of international developments. EU reforms were precipitated by the de Larosière Report of 2009, which exposed the weaknesses

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<www.un.org/en/ga/econcrisissummit/docs/FinalReport_CoE.pdf> accessed 16 September 2021; See also, Mads Andenas and Iris HY Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility* (Routledge 2014) 413-424; Joel P Trachtman, 'The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation' in John H Jackson and Rosa M Lastra (eds), *International Law in Financial Regulation and Monetary Affairs* (OUP 2012) 185. Lo Schiavo provides a detailed review of the literature on the public good theory in relation to national and international financial stability, (n 1) 12-21.

[12] David Bieri, 'Regulation and Financial Stability in the Age of Turbulence' in Robert Kob (ed.) *Lessons for the Financial Crisis* (John Wiley 2010) 327.

[13] NB, Stiglitz *et al* (n 11).

[14] *Cf*. Andrew Moravcsik, *The Choice for Europe*: Social Purpose and State Power from Messina to Maastricht (Cornell University Press 1998).

of micro-prudential supervision and the fragmentation of prudential policy in the EU.[15] The report sparked the creation of new supervisory authorities to coordinate financial supervision at the supranational level and, in sharp contrast to their predecessors, these bodies were allocated direct supervisory and intervention powers.[16] The new architecture also includes a specialist macroprudential body, the European Systemic Risk Board (ESRB). On a substantive level, the de Larosière Report brought about an extensive remodelling of capital measures on the basis of Basel II. The CRR/CRD IV (now CRR II/CRD V) provides a degree of harmonisation of the requirements credit institutions must adhere to, reflecting the EU's near-crippling reliance on banking finance.[17] This legal framework includes many new macroprudential tools, but it also extends to micro-prudential policy, corporate governance, passporting, and other areas.[18]

While prudential policy reforms were heavily influenced by international developments, there are many differences between global and European financial stability. For instance, the division of competences in the EU precludes the ESRB from exercising the special or emergency powers of its US counterpart, the FSOC.[19] Equally, the EU's single rulebook is becoming less and less reliant on global standards. The most recent amendment of the CRR/CRD framework provides additional protection for SMEs, which represent 99% of all

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[15] Report of the de Larosière Group *ECO/259-EESC-2009-1476* [2009] OJ C318/ 57-65 <www.eesc.europa.eu/it/our-work/opinions-information-reports/opinions/de-larosiere-report> accessed 1 July 2020.

[16] Eilís Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' in Eddy Wymeersch, Klaus Hopt and Guido Ferranini (eds) *Financial Regulation and Supervision: A Post Crisis Analysis* (OUP 2012).

[17] For a thorough review of CRR/CRD IV measures, see Rainer Masera, 'CRR/CRD IV: The Trees and the Forest' [2014] 67(271) *PSL Quarterly Review* 381; Niamh Moloney, *EU Securities and Financial Markets Regulation* (3RD edn, OUP 2016) 30-36.

[18] See also, Lo Schiavo (n 1) 166-174.

[19] Jeffrey M Stupak, 'Financial Stability Oversight Council (FSOC): Structure and Activities' (Congressional Research Service, CRS Report, R45052, 12 February 2018). On the comparison between the EU and US regulatory architecture, see John Armour *et al* (n 10) 613.

businesses in the EU, as well as other EU-specific exceptions from the basic rules of Basel.[20] Specificity is both a challenge and an opportunity: while global standards may not always suit the EU's peculiar design, the EU can pursue a financial stability policy informed by its own rules and values.[21] This dimension is worth investigating even without turning to developments in the Economic and Monetary Union (EMU).

The third phase describes the influence of financial stability outside the strict boundaries of prudential policy. This phenomenon is not unique to the EU, but it is uniquely experienced due to the EU's incomplete federal architecture and differentiated integration in the EMU.[22] By 2011 it was clear that the financial crisis had escalated into a sovereign debt crisis affecting Eurozone countries, particularly in the periphery. Consequently, the EU's response had to extend beyond regulation and supervision and navigate an increasingly unstable political landscape. The objective of financial stability was employed as a justification for unprecedented supranational and intergovernmental compromises in the fields of bank resolution, deposit insurance, financing assistance (bailouts and bail-ins), and fiscal policy. In many ways, the EU was forced to trade a financial and economic crisis for a constitutional one.[23]

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[20] For example, the amended CRR II/CRD V provides a more robust 'proportionality' principle that subjects 'small and less complex' firms to less onerous conditions than the CRR/CRD IV and Basel III. Another example is the G-SII (Global Systemically Important Institutions) buffer than incorporates a range of EU-specific exceptions. See, Chapter 4.

[21] The clearest example is the Total Loss Absorbing Capacity (TLAC) ratio, a recapitalisation tool utilised by Basel. The first wave of reforms failed to incorporate this tool into EU law, despite its many advantages; it was eventually incorporated into the Minimum Requirement for own funds and Eligible Liabilities (MREL), but important differences remain between the global and EU approach to recapitalisation.

[22] The influence of EU financial stability outside the boundaries of prudential policy is acknowledged by authors who cover mainly the regulatory side. See eg, Rosa M Lastra, *International Financial and Monetary Law* (OUP 2015) 126.

[23] Menendez describes it as an existential crisis: '[w]e live in a period of crisis: as it has been argued, a multifaceted crisis, which is capable of highlighting our "economic, fiscal, macroeconomic, and political structure weaknesses"'. Augustin Jose Menendez, 'The Existential Crisis of the European Union' [2013] 14(15) *German Law Journal* 453, 454.

This is exemplified by *Pringle*, a case on the compatibility with EU law of an international-law mechanism created to provide financing assistance to Eurozone countries. In trying to reconcile this measure with a "no bailout" clause in EU law, the Court of Justice invokes the 'higher' telos of financial stability in the EMU.[24] This interpretation of financial stability as a higher-order objective is inconsistent with the letter of the EU Treaties. *Inter alia*, the Treaties stipulate that financial stability is a peripheral goal and subordinate to price stability. *Pringle* fundamentally alters the hierarchy of norms in the EMU, and is one of many examples of financial stability used in a transformative way.[25] Another example is the subsequent use of financial stability as an 'overriding public interest' (legitimate reason in the public interest), a judicial device used to justify extraordinary breaches of fundamental rights and proportionality.[26] Tuori goes as far as to place financial stability at the epicentre of a 'mutation' of the European constitution.[27] This inference is heavily debated,[28] but there is no doubt that EMU crisis measures confer on financial stability a distinct constitutional value.

Similarly, institutional developments highlight important constitutional dilemmas. The initial wave of financial stability reforms included the creation of three supervisory agencies, ESMA, EBA, and EIOPA. On the basis of a flexible interpretation of Article 114 TFEU, these agencies exercise emergency powers that no other EU agency does, which has led

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[24] *Pringle* (C-370/12) ECLI:EU:C:2012:756, paragraph 135. See Karlo Tuori and Klaus Tuori, *The Eurozone Crisis: A Constitutional Analysis* (CUP 2014) 129.

[25] On financial stability and the transformation of the EU's macroeconomic constitution, see Kaarlo Tuori, *European Constitutionalism* (CUP 2015) Chapter 6.

[26] *Kotnik* (C-526/14) ECLI:EU:C:2016:570, paragraph 69; *Ledra Advertising* (C-8/15) ECLI:EU:C:2016:701, paragraphs 69 & 74.

[27] Tuori (n 25).

[28] *Cf.* Bruno de Witte, 'Euro Crisis Responses and the EU Legal Order: Increased Institutional Variation or Constitutional Mutation?' [2015] 11(3) *European Law Review* 434; Alberto de Gregorio Merino, 'Legal Developments in the Economic and Monetary Union During the Debt Crisis: The Mechanisms of Financial Assistance' [2012] 49(5) *Common Market Law Review* 1613.

authors to caution about the 'agencification' of EU law.[29] Further, financial stability considerations are at the heart of the Banking Union project.[30] The Banking Union empowers the European Central Bank to carry out direct supervision of systemically important banks in the euro area (SSM), and establishes a supranational agency (SRM) and a centralised fund (SRF) to support bank recovery and resolution. These measures contribute to the preventative and corrective side of financial stability, but also cause unprecedented shifts in the vertical and horizontal balance of powers in the EU.

1.2 Objectives of my research: teleology & legitimacy of EU financial stability

As noted earlier, the focus of this dissertation is not on the legality of the reforms presented in the previous section. Every crisis requires a measure of legal creativity to overcome the legal shortcomings that created it in the first place. Instead, this dissertation focuses on the broader impact of these reforms on the legitimacy of EU law. Specifically, it challenges the view that "output" legitimacy is satisfied by the urgency of the crisis and the necessity of financial stability measures. In short, from the present point of view, output legitimacy is not solely concerned with material outcomes: it denotes a fundamental level of trust in the financial stability "project". This is threatened by policy measures adopted on this basis

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[29] Agencification refers to the permanent delegation of regulatory or executive authority to semi-autonomous bodies, often in situations where primary law prevents the EU institutions from pursuing specialised decision-making. Art 114 TFEU, on the approximation of national rules in the internal market, is the most common legal basis for the creation of EU agencies. A question that emerges is whether Art 114 can be used to confer discretionary or quasi-legislative powers to EU agencies, especially in areas such as financial regulation that generate additional obstacles to movement in the internal market. See, Giandomenico Majone, 'Regulatory Legitimacy' in *Regulating Europe* (Routledge 1996); Paul Craig, *UK, EU and Global Administrative Law: Foundations and Challenges* (CUP 2015) Chapter 4; Koen Verhoest, 'Agencification in Europe' in Edoardo Ongaro and Sandra van Thiel (eds) *The Palgrave Handbook on Public Administration and Management in Europe* (Palgrave Macmillan 2017); Michelle Everson, 'European Agencies: Barely Legal?' in Michelle Everson, Cosimo Monda and Ellen Vos (eds) *EU Agencies In Between Institutions and Member States* (Wolters Kluwer 2014); Johannes Pollak and Peter Slominski, 'EU Agencies in Times of Crisis: An Introduction' in Johannes Pollak and Peter Slominski (eds) *The Role of EU Agencies in the Eurozone and Migration Crisis* (Palgrave Macmillan 2021).

[30] See generally, Niamh Moloney, 'European Banking Union: Assessing its Risks and Resilience' [2014] 51(6) *CMLR* 1609.

which are inconsistent with the 'teleology' of financial stability. In other words, policies that are normatively justified can, in fact, erode legitimacy if they generate externalities or contradict what financial stability ultimately seeks to achieve.

Accordingly, based on the hypothesis that our understanding of both of financial stability and output legitimacy is incomplete, and thus policies that enjoy normative support may erode legitimacy in the empirical sense, this thesis aims to achieve the following objectives.

Firstly, I aim to outline the teleology of financial stability in EU law. Teleology refers to a broad definition of this concept, which takes into account what this objective seeks to achieve and its relationship with other objectives of EU law. This field is notably lacking in holistic accounts of financial stability, in part because the objective touches on areas that are extremely diverse, complex, and significant in their own right.[31] The most complete analysis of EU financial stability is presented by Lo Schiavo, who nevertheless concedes that the theoretical and constitutional implications of policy reform are beyond the scope of his research.[32] Generally, the literature struggles to move beyond the negative definition of financial stability as the antithesis of instability, which makes it difficult to conceive the limits of this objective in law. Thus, the starting premise of this research is that a positive definition is needed, however, it would be counterintuitive to provide a rigid conceptualisation of financial stability.

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[31] The following publications stand out. On the prudential dimension, Lastra, *International Financial and Monetary Law* (n 22) Chapters 1&3; Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' [2010] 47(5) *CMLR* 1317; Mads Andenas and Iris H-Y Chiu, 'Financial Stability and Legal Integration in Financial Regulation' (2013) 38 *ELR* 343. On the constitutional dimension, Kaarlo Tuori and Klaus Tuori, *The Eurozone Crisis: A Constitutional Analysis* (n 24); Kaarlo Tuori, *European Constitutionalism* (n 24) Chapter 6; Michelle Everson, 'Banking on Union: EU Governance Between Risk and Uncertainty' in Mark Dawson, Henrik Enderlein and Christian Joerges (eds) *Beyond the Crisis The Governance of Europe's Economic, Political and Legal Transformation* (OUP 2015).

[32] Lo Schiavo (n 1) 8. In political theory, Gundbert Scherf, *Financial Stability Policy in the Euro Zone* (Springer Gabler 2013).

A teleological approach is more appropriate because the financial system entails too many 'unknown unknowns' (Knightian uncertainty).[33] As a system-wide response, financial stability must remain flexible to capture an unpredictable range of threats.[34] In addition, EU financial stability transcends policy areas and defies the literature's expertise in prudential regulation and supervision. Therefore, defining this objective requires a broader perspective. For example, the ideological shift identified above is important because it describes financial stability as a substantive limit to market liberalisation. Another critical component of this teleology is the non-economic utility of financial stability, or its unique interaction with social policy objectives. Owing to the centrality of the financial system in modern society, financial stability measures have an extraordinary positive or negative impact on equality, employment policies, and other core objectives of Union law. Consequently, any investigation into legitimacy must consider the wide outcomes of financial stability, which is further supported by analysis of output legitimacy.

Secondly, it is necessary to dispel misconceptions about output legitimacy. Legitimacy refers to a 'belief' by virtue of which the persons exercising authority derive the right to do so.[35] In the context of European integration, Scharpf introduced a distinction between legitimacy 'inputs', roughly understood as representative and participatory democracy, and legitimacy 'outputs', in the sense of effective policy or a track record of success.[36] A third category of 'throughput' legitimacy can be construed as a subset of the previous two, but is worth discussing separately because it focuses on vital issues, such as inclusiveness, efficacy, accountability, and transparency.[37] It must be emphasised that throughputs cannot replace

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[33] Sheila Dow, 'Addressing Uncertainty in Economic and in the Economy' [2015] 39(1) *Journal of Economics* 33, 38.

[34] On 'systemic' risk and financial stability, see Rosa M Lastra, 'Systemic Risk, SIFIs and Financial Stability' [2011] 6(2) *Capital Markets Law Journal* 197.

[35] Max Weber and Talcott Parsons (ed), *The Theory of Social and Economic Organization* (Free Press 1964) 382.

[36] Fritz W Scharpf, *Demokratietheorie zwischen Utopie und Anpassung* (Universitätsverlag Konstanz 1970); Fritz W Scharpf, *Governing in Europe: Effective and Democratic?* (OUP 1999).

[37] Vivien A Schmidt, *Europe's Crisis of Legitimacy: Governing by Rules and Ruling by Numbers in the Eurozone* (OUP 2020) 31; Vivien A Schmidt 'Democracy and Legitimacy in the European Union Revisited: Input, Output and 'Throughput' [2013] 61(1) *Political Studies* 2.

outputs: a system that does not deliver appropriate outcomes will eventually lose its legitimacy, regardless of how efficient, inclusive, or transparent it is.[38] Consequently, output legitimacy is the most suitable conceptual tool for analysing technical policy fields, such as financial stability.[39] This theoretical angle also encapsulates the scholarly debate on technocratic decision-making in the EU following the financial crisis.[40]

However, output legitimacy should not be reduced to economic performance. From a strictly functionalist perspective, financial stability policy is legitimate so long as it contributes to the prevention or management of the next crisis. This is a reductive and dangerous logic; there are no limits to the application of financial stability interpreted in this way. Conversely, policy can generate many "outputs" or externalities, some of which are detrimental to legitimacy. In fact, Scharpf treats outputs as indissociable from inputs (and throughputs): trust in a project's capacity to deliver appropriate outcomes presupposes a degree of representation and other democratic qualities.[41] It follows that the legitimacy of EU financial stability is not solely determined by whether policy reforms contribute to financial stability in the EU. The wider teleology of the objective, which includes ideological and non-economic considerations, is a more appropriate tool for evaluating whether policy contributes to output legitimacy.

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[38] Thomas Risse and Mareike Kleine, 'Assessing the Legitimacy of European Treaty Revisions' [2007] 45(1) *Journal of Common Market Studies* 69, 74.

[39] Financial stability is pursued through policies that often lack democratic inputs. For example, banking supervision is the responsibility of national competent authorities and the ECB, who must maintain a degree of operational independence and are predominantly composed of unelected specialists.

[40] See eg, Christian Joerges, 'Constitutionalism and the Law of the European Community' in Mark Dawson, Henrik Enderlein and Christian Joerges (eds) *Beyond the Crisis: The Governance of Europe's Economic, Political, and Legal* Transformation (OUP 2015) 224-228; Tuori (n 25) 13, 'parasitic legitimacy'; Miguel Poiares Maduro, 'Europe Transformed. Exit, Voice … and Loyalty?' in Miguel Poiares Maduro and Marlene Wind (eds) *The Transformation of Europe: Twenty-Five Years On* (CUP 2017) 329, on 'cognitive dissonance' between the EU and its peoples.

[41] Fritz W Scharpf, 'Legitimacy Intermediation in the Multilevel European Polity and Its Collapse in the Euro Crisis' in Klaus Armingeon (ed) *Staatstätigkeiten, Parteien und Demokratie*. (Springer 2013) 569-579.

Thirdly, I apply my insights on output legitimacy, and the role of the teleology of financial stability in this context, to three case studies. The first case study centres on prudential and resolution policy, or substantive financial stability tools in the CRR/CRD and BRRD framework. This dimension is the strongest in terms of output legitimacy because policy tools are closely aligned with the teleology of the objective, especially following the most recent wave of amendments. For instance, EU-specific exceptions from Basel enable supervisory authorities to minimise the social costs of capital requirements, consistently with the non-economic utility of the objective. Some challenges remain, but overall, these are not detrimental to legitimacy. More concerning is the second case study, which centres on the institutional reforms of the ESFS and the Banking Union. For example, differentiated integration in the euro area restricts the tasks of EU supervisory authorities, who are best suited to pursue core elements of financial stability. I also examine the phenomenon of 'agencification' in EU law; *inter alia*, this is worrisome because financial stability requires political leadership in terms of balancing its economic and non-economic sides.

The most concerning dimension of financial stability is financing assistance, which is predetermined by fiscal policy reforms. The mainstream literature focuses on the intergovernmentalism of fiscal and financing measures.[42] This is certainly a critical issue which, similarly to agencification, can be seen as precluding political leadership and accountability. I concentrate on an equally important yet underappreciated theme: the role of the Court of Justice in financial stability. Specifically, the interpretation of financial stability in financing assistance cases is fundamentally at odds with the teleology of the objective. The clearest example is the 'strict conditionality' attached to financial stability, which provides a constitutional value to austerity measures, contrary to the ideological underpinnings of the objective in EU law. There are many more inconsistencies in the Court's case law.[43] Analysis will show that judicial review is central to the issue of output legitimacy, because the Court acquires an extraordinary role in financial stability.

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[42] De Witte (n 28); Tuori, *European Constitutionalism* (n 25) Chapter 6.

[43] For example, the Court's approach towards bail-ins in *Ledra Advertising* is more deferential than the earlier case of *Kotnik*, although it should be noted that *Kotnik* deals with burden-sharing in the context of state aid law.

Fourthly, this thesis elaborates on the role of judicial review in this field. My thesis is primarily intended to offer an alternative conceptualisation of legitimacy challenges, but I will briefly examine ways to improve output legitimacy. To be sure, regulatory and political solutions will prove important in realigning policy with the teleology of financial stability.[44] However, judicial review is intrinsic to output legitimacy too, both because the unique features of financial stability necessitate a level of judicial empowerment, but also because the Court's case law on financial stability generates the most inconsistencies between policy and teleology. There are aspects of the Court's case law that are more nuanced, and these should serve as the blueprint for judicial review going forward.[45]

1.3 Structure of my thesis

This thesis is organised around the objectives outlined in the previous section. Chapter 2 focuses on the concept of financial stability and is split into three parts. The first part explores the main findings of the literature on financial stability as a global objective of regulation and supervision. The second part looks at financial stability as an objective of EU law and identifies gaps in the EU law literature. The final part of this chapter explores the teleology of financial stability: its ideological underpinnings and its relationship with non-economic policy objectives.

Chapter 3 centres on the concept of output legitimacy. First, it seeks to answer the question of *why* output legitimacy is a suitable theoretical angle. It is explained that different strands of the literature converge on the issue of legitimacy being the main challenge emerging from the financial crisis, and that multiple accounts describe a phenomenon best explain in terms of output legitimacy. Second, this chapter challenges the notion that output legitimacy is synonymous with performance in the functionalist sense. The third part of this chapter delves

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[44] Analysis of such alternatives would require research beyond the scope and aims of this thesis.

[45] The application of the sector-specific principle proportionality and other examples of differentiation in the CRR/CRD regime can also inform judicial review.

deeper into the connection between output legitimacy and the teleology of financial stability, focusing on the role of *ex post* political and judicial review.

Chapter 4 explores substantive tools in prudential and resolution policy. The chapter begins by identifying micro-prudential and macroprudential tools, as well as corporate governance, disclosure, and other requirements in the CRR/CRD. Attention then turns to the crisis management dimension of financial stability, exemplified by deposit insurance and bank resolution tools. It will be argued that the regulatory dimension strongly enhances output legitimacy, not only because of the ideological shift that these tools represent in the internal market, but also because the recent retuning of financial stability coincides with the teleology explored previously. However, important challenges remain, such as the minimum harmonisation and voluntary reciprocity of macroprudential tools.

Chapter 5 targets institutional developments. This area is more problematic from a legitimacy standpoint. The chapter first looks at the creation of the European Supervisory Authorities (ESMA, EBA, EIOPA), as well as the Union's expert macroprudential coordinator, the ESRB. The second part of this chapter investigates the Banking Union, a curious example of differentiated integration in the euro area. Analysis covers the implications of agencification for output legitimacy, addressing the importance of *Meroni* and relevant case law. It is proposed that agencification is inconsistent with financial stability insofar as it weakens *ex post* accountability and political leadership. More importantly, the non-economic utility of financial stability is threatened by challenges facing individual agencies, such as the ESRB and EBA.

Chapter 6 covers two closely related topics, fiscal reform and financing assistance. The first part will provide a brief overview of the supranational 'six pack', 'two pack', and the intergovernmental Treaty on Stability, Coordination and Governance (TSCG). These measures make up the EU's 'enhanced surveillance' model of economic governance. The chapter proceed to analyse these reforms with reference to the role of the EU institutions, the fiscal capacity of the Union, and their connection to financial stability. The second part of this chapter examines the case law of the Court on the issue of bailouts and bail-ins in the euro area. The most important cases in this regard are *Pringle* and *Ledra Advertising*; it is

argued that the case law is highly inconsistent with financial stability as detailed in this thesis. This argument centres around the weak standard of review of financial stability measures, in an area already compromised by contentious fiscal reform.

Chapter 7 looks at possible ways to improve output legitimacy, by realigning the policy and teleology of financial stability. Brief mention is made to the precautionary principle, an approach put forward by several authors as a possible correction to challenges in regulation. While the precautionary approach faces its own weaknesses and would not solve the legitimacy challenges addressed in this thesis, it emphasises the role of *ex post* review in financial stability. This chapter proceeds to discuss the instrumental role of the Court in financial stability, and the crucial role of proportionality in improving legitimacy in this field.

Chapter 8 concludes this thesis with a summary of findings, the limitations of my thesis, and suggestions for future research.

Chapter 2: The Teleology of EU Financial Stability

2.1 Introduction

One of the aims of this thesis is to demonstrate that the legitimacy of certain financial stability reforms is especially frail. As legitimacy in this policy field is almost exclusively determined by "outputs", in the sense that it is typically pursued by expert bodies which lack democratic "inputs", the legitimacy challenge originates in our failure to identify, and therefore deliver, essential components of financial stability. Specifically, this chapter argues that the mainstream literature on financial stability overemphasises economic outcomes of policy, such as economic growth, and overlooks the ideological and non-economic components of financial stability. These broader considerations form part of the teleology used to evaluate output legitimacy in this thesis.

The starting point is to explain the dangers of economic functionalism in this field. By economic functionalism, I am generally referring to the subordination of non-economic policy outcomes to economic performance. In the EU, this concept can be linked to negative integration through market-oriented principles, such as free movement and market access.[1] The main weakness of a functionalist interpretation of financial stability as the prevention of the next crisis is that it assumes that "the market will provide" the conditions for social development, social equality, and other non-economic goals. However, financial stability entails many negative externalities, which can have a restrictive effect on social policy.[2] More importantly, the inherent uncertainty and complexity of the financial system implies that there may never be any causality between financial stability measures and economic

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[1] See generally, Kaarlo Tuori, *European Constitutionalism* (CUP 2015) Chapters 5 & 6; Miguel Poiares Maduro, *We the Court: the European Court of Justice and the European Economic Constitution. A Critical Reading of Article 30 EC* (Hart 1998) Chapter 1.

[2] This challenge is commonly expressed in terms of the distributional effects of financial stability. For an EU law perspective, see Anat Keller, 'The Possible Distributional Effect of the Loan-to-value Ratio and its Use as a Macro-Prudential Tool by the European Systemic Risk Board' (2013) 28(7) *Journal of International Banking Law Review* 266.

performance. The failure of financial stability tools is apparent when a crisis occurs—if at all.[3]

The question of legitimacy arises from the transformative role and potentially unlimited scope of financial stability in EU law. In the past decade, financial stability has served as the basis for unprecedented (and sometimes controversial) reforms in banking regulation and supervision, resolution policy and deposit insurance, financing assistance, and other areas. It is clear that financial stability is not only a desirable state of affairs, but an independent and emerging policy field encompassing 'normative' instruments which are absolutely necessary for the survival of the modern economy.[4] However, as a response to the biggest recession since the 1930s, there is an obvious risk that financial stability policy goes too far: an example is the extensive reform of fiscal policy during the sovereign debt crisis in the euro area, which may have contributed to the COVID-19 pandemic by restricting public health funding.[5] Therefore, it becomes imperative to define the boundaries of financial stability within a broader constitutional and political environment.

Since the financial crisis, many accounts of financial stability have emerged; international, regional, and national institutions have used their growing expertise to advance scientific knowledge on the subject.[6] Yet, despite its ubiquity in law and policy, most authors concede that defining financial stability remains an elusive task. First, as the financial system constantly reinvents itself, so must financial stability progress and evolve at a rapid pace. The

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[3] Howell E Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' [2007] 24(2) *Yale Journal on Regulation* 253, 258. In general, regulators are better at managing than preventing crises, see Stijn Claessens *et al*, *Financial Crises: Causes, Consequences, and Policy Responses* (IMF 2014) Chapter 1.

[4] Gianni Lo Schiavo, *The Role of Financial Stability in EU Law and Policy* (Wolters Kluwer 2017) 53. These include regulation and supervision, bank recovery and resolution, deposit insurance, burden-sharing, and more.

[5] Indeed, the Commission was forced to trigger the 'general escape clause' twice during the pandemic, suspending budgetary limits until 2023. The fiscal dimension is discussed in Chapter 6.

[6] For a detailed comparison of how expert institutions worldwide perceive financial stability, see Indranarain Ramlall, *Understanding Financial Stability: The Theory and Practice of Financial Stability* (Emerald Publishing 2019) 15-21.

legislative and decision-making process may not be able to "keep up" with current market practices.[7] Its effectiveness relies on the manoeuvrability of competent authorities within a predefined margin of discretion. Second, the stability of the financial system is susceptible to shifts in economic and monetary policy, as well as other fields (recently, public health).[8] It follows that defining this objective should not be approached as a strictly ontological exercise: we are required to ask not only what financial stability is, but what it seeks to achieve, and what is its relationship with other objectives of EU law.

Accordingly, this chapter emphasises the wider teleology of financial stability, with view to delineating the legitimate limits of policy. By teleology, I am describing the ideological underpinnings of financial stability as a shift away from laissez-faire liberalism in the financial market. The second component of this teleology is the non-economic utility of financial stability, derived from the importance of the financial system in modern society. On the one hand, financial instability has "human" consequences: it is a cause of unemployment, inequality, homelessness, even loss of life.[9] On the other hand, financial stability tools entail significant social costs, which may significantly restrict social development and other non-economic objectives. Social costs extend beyond the distributional effects of regulation and supervision, for example, financial stability is used in the case law of the CJEU as an 'overriding public interest' capable of justifying breaches of human rights and other core principles of EU law.[10] Contrary to the economic functionalist view, this thesis proposes that policy must actively seek to mitigate these externalities to be considered legitimate.

The discussion is structured as follows. Section 2.2 will explore the dominant theories of financial stability prior and following the financial crisis. In particular, this section highlights

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[7] The obvious example is the transposition of Basel III into EU law. See eg, Rainer Masera, 'CRR/CRD IV: The Trees and the Forest' [2014] 67(271) *PSL Quarterly Review* 381.

[8] Contagion and spill-over effects associated with the interconnectedness of the financial system are magnified manifold by the co-dependency of financial, price, and economic stability. Hence, some credit institutions are labelled as 'systemically important' because their failure can trigger a domino effect on the real economy.

[9] Steven L Schwarcz, 'Systemic Risk' [2008] 97 *Georgetown Law Journal* 193, 235.

[10] *Ledra Advertising* (C-8/15) ECLI:EU:C:2016:701, paragraphs 69 & 74.

the dominant theory of ‘public goods’, which denotes that financial stability must be produced through public action and to the benefit of the market as a whole. Attention is also given to the interpretation of financial stability as the prevention of systemic risk. Section 2.3 will then introduce the concept of financial stability in EU law. I will briefly cover the EU Treaties, secondary legislation and relevant case law, as well as the distinction between financial stability, price stability, and economic stability. This section provides an overview of the (limited) literature on this objective in EU law. Finally, Section 2.4 outlines the teleology of financial stability, which can further be divided into ideological considerations and non-economic utility.

2.2 “Mainstream” theories of financial stability: before and after the crisis

Just as with any concept transposed from economics into law, financial stability is innately difficult to explain in legal terms. It is perhaps more difficult to decipher than other policy objectives because it seeks to regulate an inherently unpredictable sector, the financial system, on a macro-scale. Thus, any exploration of financial stability must focus on policy shifts occurring during the crisis, which sparked countless reforms and reveal its essential characteristics. The most significant shift that can be observed during this time is the newfound independence of financial stability as an objective of (macro)prudential regulation and supervision.

This section explores three influential theories. It should be emphasised that these are limited in their focus on prudential policy, which may not fully capture the transcendent role of financial stability in EU law. I will begin by looking at the interpretation of this policy objective as one of unimpaired economic performance throughout the 1990s and 2000s. Analysis will then turn to the proliferation of macroprudential instruments, which can be linked to the concepts of systemic risk, pro-cyclicality, and the dominant theory of ‘global public goods’. My goal is to demonstrate that the literature recognises the importance of financial stability in society, even if the non-economic utility of the objective is often presented as an automatic outcome of economic performance.

2.2.1 Financial stability as unimpaired economic performance

Throughout the 1990s and 2000s, financial stability was interpreted consistently with liberal, market-oriented attitudes towards the regulation of financial services. In brief, financial stability was treated as synonymous with unimpaired economic performance.[11] Economic performance alludes to the connection between the financial system and the real economy: the mainstream view was that corrective public action is likely to create moral hazards, encouraging excessive risk-taking and jeopardising market equality/efficiency, which can impact negatively on growth and sustainability.[12] Thus, financial stability was not pursued as a standalone goal, but was conditional on promoting market efficiency and rewarding competitive behaviour.

Two of the leading authors in this period are Garry Schinasi and Andrew Crockett, whose work both supports this trend and highlights some of its dangers. Schinasi defines financial stability as a situation in which the financial system is 'capable of facilitating the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events.'[13] It is noteworthy that Schinasi draws attention to both exogenous and endogenous risk: the former refers to external shocks, the latter is created internally by the interactions between market participants.[14] The endogeneity of risk assumes that private market actors will act irrationally and that they have few incentives to promote stability, which contradicts the notion that corrective public action should be minimal. The main weakness of Schinasi's interpretation is that it offers little in terms of identifying specific hard law or soft law instruments of financial stability.

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[11] See eg, John Chant *et al*, 'Essays on Financial Stability' (Bank of Canada Technical Report No 95, September 2003) <www.banqueducanada.ca/wp-content/uploads/2010/01/tr95.pdf> accessed 16 September 2021. The authors define instability as 'the conditions in financial markets that harm, or threaten to harm, an economy's performance through their impact on the working of the financial system'.

[12] See eg, on 'safety net' policies, Morris Goldstein and Philip Turner, 'Banking Crises in Emerging Economies: Origins and Policy Options' (BIS Economic Papers No 46, October 1996) <www.bis.org/publ/econ46.pdf> accessed 16 September 2021.

[13] Garry J Schinasi, 'Defining Financial Stability' [2004] IMF Working Paper WP/04/187, 8.

[14] Ibid, 9. See also, Jakob de Haan, Sander Oosterloo and Dirk Schoenmaker, 'Financial Stability' in *Financial Markets and Institutions: A European Perspective* (2nd edn, CUP 2012), 393-394.

Crockett, on the other hand, describes financial stability as the absence of instability or 'fluctuations in the price of financial assets, or in the ability of financial intermediaries to meet their contractual obligations'.[15] Crockett highlights the shortcomings of regulation at the time, but only as one of many factors that impact on financial stability—not as a systemic failure.[16] While his work is comprehensive and should alert policy makers to the multi-layered nature of risk in the financial sector, the excessive focus on private responsibility and the moral hazard associated with regulation also supports a subordination of financial stability to market efficiency. In addition, defining the concept in negative terms is a trend that carries on to this day, which dilutes the boundaries between legitimate action (economic and non-economic utility) and functionalist attitudes that equate financial stability with crisis prevention.

A third branch of the literature draws attention to the financial system's ability to withstand extraordinary events. Padoa-Schioppa explains financial stability as a 'condition where the financial system is able to withstand shocks without giving way to cumulative processes which impair the allocation of savings to investment opportunities and the processing of payment in the economy'.[17] Both the emphasis on exogenous shocks as opposed to the behaviour of market actors, as well as the portrayal of instability in terms of investment opportunities, price changes, and reduction in payments/consumption demonstrates the ideological imperative of market efficiency. This precipitated the deregulation of the financial services industry leading up to 2008.[18]

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[15] Andrew Crockett, 'The Theory and Practice of Financial Stability' [1996] 144(4) *De Economist* 531, 532.

[16] Ibid, 557-560. *Cf.* Charles Goodhart, 'Some Regulatory Concerns' [1996] 132(4) *Swiss Journal of Economics and Statistics* 613.

[17] Tommaso Padoa-Schioppa, 'Central Banks and Financial Stability: Exploring a Land In Between' (Second ECB Central Banking Conference, October 2002) <www.ecb.europa.eu/events/pdf/conferences/tps.pdf> accessed 16 September 2021. Similarly, William Allen and Geoffrey Wood, 'Defining and Achieving Financial Stability' [2006] 2(2) *Journal of Financial Stability* 152, 155.

[18] See generally, Kenneth N Kuttner, 'Monetary Policy and Asset Price Volatility: Should We Refill the Bernarke-Gertler Prescription?' in Douglas D Evanoff, George G Kaufman and Anastasios G Malliaris (eds), *New Perspectives on Asset Price Bubbles: Theories, Evidence, and Policy* (OUP 2012).

The main achievement of the pre-crisis literature was distinguishing between three functions of financial stability. These are summarised by Schinasi *et al*:

'Financial stability is a situation in which the financial system is capable of satisfactorily performing its three key functions simultaneously. First, the financial system is efficiently and smoothly facilitating the intertemporal allocation of resources from savers to investors and the allocation of economic resources generally. Second, forward-looking financial risks are being assessed and priced reasonably accurately and are being relatively well managed. Third, the financial system is in such condition that it can comfortably if not smoothly absorb financial and real economic surprises and shocks'.[19]

The failure of this approach is that it perceives financial stability as a condition of the economy, not as a standalone policy field. Not only are the three functions vaguely expressed in terms of economic performance (for example, an efficient allocation of resources is a precondition for productivity), but Schinasi *et al*'s research was specifically targeted at central banks. There is an obvious overlap between all three functions and monetary policy.[20] The relationship between financial stability and monetary policy is a long-running debate in the literature: the conventional view was that financial stability could be pursued by central banks, who were best suited to counteract price fluctuations and other signs of instability through monetary policy tools. As such, financial stability was effectively reduced to a by-product of price stability, despite warnings from authors such as Goodhart and Schoenmaker that the two are potentially conflicting and must be pursued independently.[21]

Excessive reliance on monetary policy is associated with the 'Jackson-Hole consensus'. In the guise of maintaining independence between monetary policy and financial stability, this

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[19] Garry J Schinasi, *Safeguarding Financial Stability: Theories and Practice* (IMF 2006) 82.

[20] Eg, the emphasis on pricing and shock absorption. See Kuttner (n 18).

[21] Charles Goodhart and Dirk Schoenmaker, 'Should the Functions of Monetary Policy and Banking Supervision Be Separated?' [1993] 47(4) *Oxford Economic Papers* 539. Charles Goodhart, 'Myths about the Lender of Last Resort' (1999) Financial Market Group LSE <econpapers.repec.org/paper/fmgfmgsps/sp120.htm> accessed 01 July 2020. For an overview of the role of central banks in finance, see Tommaso Padoa-Shioppa, 'Central Banks and Financial Stability' in *Regulating Finance: Balancing Freedom and Risk* (OUP 2004) 93-128.

consensus recommends that central banks do not "prick the bubble": that they only interfere with the market once an asset bubble had burst and began affecting monetary policy targets, namely inflation.[22] While there is a connection between financial stability and monetary policy, it is clear that inflation is not a reliable or comprehensive measure of financial risk.[23] More importantly, by falsely assuming that central banks are capable of mitigating financial crises using only monetary policy tools, the Jackson-Hole consensus absolved public bodies of responsibility over the financial sector and contributed to self-regulation. This approach disregards the preventive side of financial stability, prioritising instead *ex post* action.

A further misconception was the 'composition fallacy', which alludes to the distinction between micro- and macroprudential policy. In broad terms, financial regulation encompasses 'prudential' and 'conduct-of-business' policies. The former can be explained as the 'regulation and monitoring' of the financial system to 'ensure its safety and soundness', the latter refers to safeguarding the competitive process and consumer protection.[24] Prudential policy is further categorised into micro-prudential supervision, or firm-specific oversight, and macroprudential policy which adopts a 'bird's-eye-view' of the entire sector.[25] Prior to the crisis, it was believed that supervision of individual credit institutions would ensure the stability of the financial system as a combined whole (fallacy of composition).[26]

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[22] Anastasios G Malliaris, 'Asset Price Bubbles and Central Bank Policies: The Crash of the "Jackson Hole Consensus"' in Douglas D Evanoff, George G Kaufman and Anastasios G Malliaris (eds), *New Perspectives on Asset Price Bubbles: Theories, Evidence, and Policy* (OUP 2012).

[23] Anders Vredin, 'Inflation Targeting and Financial Stability: Providing Policymakers with Relevant Information (BIS Working Paper 503, July 2015) <www.bis.org/publ/work503.pdf> accessed 16 September 2021.

[24] Frederic S Mishkin, 'Prudential Supervision: Why is it Important and What Are the Issues?' in *Prudential Supervision: What Works and What Doesn't* (University of Chicago Press 2001) 1. See eg, Section 1B(3) Financial Services Act 2012 on the operational objectives of the UK's Financial Conduct Authority.

[25] Ibid, 8. See also, Charles Goodhart, 'Linkages Between Macro-prudential and Micro-prudential Supervision' [2015] 30(10) *Butterworths Journal of International Banking and Financial Law* 607; de Haan, Oosterloo and Schoenmaker (n 14) 393.

[26] 'The main tool which regulators use to do so, is capital adequacy requirements, but the current approach has been found wanting. It implicitly assumes that we can make the system as a whole safe by simply trying to make sure that individual banks are safe. This sounds like a truism, but in practice it represents a fallacy of composition.

Thus, macroprudential policy was underdeveloped and underutilised. It should be noted that macroprudential measures carry a significant economic burden, in excess of minimum capital requirements that all credit institutions must comply with. They are also allocated on the basis of system-wide risks, and do not always reflect the risk-taking activity of individual institutions. It follows that the absence of a robust macroprudential toolkit prior to the crisis was a deliberate choice of free market ideology: macroprudential policy has a restrictive effect on market access and market equality.

Overall, the above analysis demonstrates that financial stability before the collapse of Lehman Brothers was diametrically opposed to public interference with the financial market. The potential benefits of financial stability, to the economy and society more generally, were outweighed by moral hazard considerations and a micro- outlook that prioritised the interests of private actors over system-wide interests. The magnitude of the financial crisis led to a radical reconceptualisation of financial stability.

2.2.2 Post-crisis theories: pro-cyclicality and systemic risk

The crisis brought about seismic changes in prudential policy, bank resolution, and other areas of financial stability. Through the efforts of international actors, namely the G-20, the IMF, the Basel Committee on Banking Supervision, and the newly established Financial Stability Board (FSB), a consensus emerged that financial stability is an independent objective of regulation and supervision.[27] These institutions were critical in exposing the dangers of deregulation, and in particular, the shortcomings of an excessive reliance on

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In trying to make themselves safer, banks, and other highly leveraged financial intermediaries, can behave in a way that collectively undermines the system'. Markus K Brunnermeier et al, 'The Fundamental Principles of Financial Regulation' (Geneva Reports on the World Economy 11/2009, May 2009) xv-xvi <www.princeton.edu/~markus/research/papers/Geneva11.pdf> accessed 16 September 2021.

[27] The G-20 summit of 2 April 2009 is considered a turning point in regulation and supervision. See generally, Malcolm D Knight, 'Reforming the Global Architecture of Financial Regulation: the G20, the IMF, and the FSB' (CIGI Papers No 42, September 2014) <eprints.lse.ac.uk/61213/1/SP-6%20CIGI.pdf > accessed 16 September 2021.

micro-prudential tools. I will not delve deeper into international efforts to reform prudential policy; these are extensively covered in the literature.[28] What is relevant to this thesis is the reconceptualisation of financial stability as a macroprudential target, and more generally, as the intensification of public intervention with the market. [29]

The starting point is to explore why financial stability has gained prominence since the crisis. Ramlall devotes considerable attention to answering this question. First, financial stability is directly related to the level of output produced in an economy, and 'lost output implies low corporate investment and lost jobs for households, both of which rank high in terms of […] social evils'.[30] Second, financial risk can never be eliminated, but it can be managed so that it does not restrict the output of the real economy. This necessitates effective and timely public action. Third, the rise of financial stability can be explained in relation to the shortcomings of monetary policy. Ramlall emphasises that monetary policy can be helpful, but is just as elusive as financial stability, therefore, it becomes important to pursue both goals separately.[31] Fourth, the macroprudential elements of financial stability specifically target the 'pro-cyclicality' of the economy (as well as structural risks).[32]

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[28] For a brief overview of developments in the USA, UK, EU, and internationally, see Lo Schiavo, *The Role of Financial Stability in EU Law and Policy* (n 4) 13-15, 21-29.

[29] Another example of the connection between financial stability and prudential policy can be found in the mandate of the Basel Committee on Banking Supervision (BCBS), which centres on 'strengthen[ing] the regulation and supervision of banks worldwide with the purpose of enhancing financial stability'. See also, John Armour *et al*, Regulatory Architecture: What Matters?' in *Principles of Financial Regulation* (OUP 2016) 597-615; For wider analysis of the global impact of the crisis, Johan A Lybeck, *A Global History of the Financial Crash 2007-2010* (CUP 2011).

[30] Ramlall (n 6) 25.

[31] Ibid, 26.

[32] Charles Goodhart, 'Procyclicality and Financial Regulation' (Bank of Spain, Estabilidad Financiera No 16, May 2009) <www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/09/May/Fic/IEF200916.pdf> accessed 16 September 2021; Charles Goodhart, 'Is a Less Pro-Cyclical Financial System an Achievable Goal' [2010] 211(11) *National Institute Economic Review* 81.

In sum, the 'pro-cyclicality' of the capitalist economy describes the increase in risk-taking activity in periods of economic growth, which eventually becomes unsustainable and culminates in a recession.[33] The downturn is a direct consequence of the lack of incentives for individual actors to sacrifice economic opportunities based on the collective effects of the risks they are undertaking.[34] Pro-cyclicality can also imply an increase in asset prices, as well as fluctuations in public spending during the business cycle.[35] This theory suggests that the build-up of risk is an organic feature of the financial system, experienced during booms and pointing towards a well-performing economy. In response to the proc-cyclicality of the economy, financial stability policy should manage all stages of risk (*ex ante*, mid-term resilience, *ex post*), to minimise the impact of instability on the real economy.[36]

This task is best explained with reference to another ubiquitous concept, that of 'systemic risk'. Perhaps the most influential definition of financial stability in law is derived from the work of Rosa M Lastra, who describes financial stability as the 'prevention', 'mitigation', and 'management' of systemic risk.[37] There are many advantages to Lastra's approach, explored below. At this stage, it is important to note that systemic risk is just as elusive and contentious a concept as financial stability.

To begin with, authors disagree on whether systemic risk exists—let alone its precise meaning.[38] Generally, the term denotes risk that threatens the collapse of the entire system, as

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[33] Brunnermeier *et al* (n 26).

[34] Ibid.

[35] Ibid.

[36] Jon Danielsson, Jean-Pierre Zigrand and Hyun Song Shin, 'Risk Appetite and Endogenous Risk' (2010) LSE Working Paper 2/647 <www.lse.ac.uk/fmg/workingPapers/discussionPapers/Risk%20Appetite%20and%20Endogenous%20Risk.pdf> accessed 15 October 2020.

[37] Rosa M Lastra, 'Systemic Risk, SIFIs and Financial Stability' [2011] 6(2) *Capital Markets Law Journal* 197, 207. Lastra uses this definition to refer to a variety of elements and to the evolutionary nature of financial stability.

[38] Schwarcz (n 9) 193.

opposed to its individual parts.[39] The key debate in the literature revolves around whether systemic risk is 'exogenous' or 'endogenous'. In line with the subordination of financial stability to free market ideology, systemic risk was originally treated as exogenous: caused by extraordinary shocks from outside the financial system that spread beyond their direct and immediate impact.[40] This interpretation of the concept places emphasis on the transmission of risk, for example, de Bandt and Hartmann explain that systemic risk is the product of contagion, a situation where financial institutions that were solvent during the initial shock can subsequently fail during the second round or later.[41] This strand of the literature equates instability in the financial system with a natural disaster, which underestimates the potential for the financial system to generate risk as part of its ordinary functioning.[42]

In more recent years, the work of Minsky and Kindleberger precipitated the view that systemic risk can be endogenous, created by and within the financial system.[43] Similarly, Borio acknowledges the evolution of systemic risk over time without excluding the possibility of contagion caused by unpredictable events. The gradual build-up of risk occurs directly because of the business cycle, and the interaction between the financial system and the real economy that results in the 'overextension' of booms leading to a downturn.[44] While

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[39] See generally, Söhnke M Bartram, Gregory W Brown and John E Hunt, 'Estimating Systemic Risk in the International Financial System' [2005] 86(3) *Journal of Financial Economics* 835.

[40] Enrico Perotti and Javier Suarez, 'Liquidity Insurance for Systemic Crises' (2009) CEPR Policy Insight <www.cepr.org/sites/default/files/policy_insights/PolicyInsight31.pdf> accessed 13 September 2021.

[41] Olivier de Bandt and Philipp Hartmann, 'Systemic Risk: A Survey' (2000) ECB Working Paper 35/2000 <www.ecb.europa.eu/pub/pdf/scpwps/ecbwp035.pdf> accessed 13 September 2021.

[42] Consistently with this view, the analytical model devised by Diamond and Dybvig in the 1980s comprises of self-fulfilling equilibria generated by exogenous shocks. Douglas W Diamond and Philip H Dybvig, 'Bank Runs, Deposit Insurance, and Liquidity' [1983] 91(3) *The Journal of Political Economy* 401. More recently, economists have modified this analytical model by incorporating non-exogenous shocks and other amplification mechanisms. See, Jean-Charles Rochet and Jean Tirole, 'Interest Rates and the Economy' [1996b] 28(4) *Journal of Money, Credit and Banking* 733.

[43] Hyman P Minsky, *Can "It" Happen Again? Essays on Instability and Finance* (Routledge 1982); Charles P Kindleberger, *Maniacs, Panics and Crashes* (CUP 1996).

[44] Claudio Borio, 'Implementing the Macroprudential Approach to Financial Regulation and Supervision' [2009] 13 *Financial Stability Review*, *Banque de France* 31, 36.

this explanation indicates a strong link between pro-cyclicality and systemic risk, the latter is a broader category that includes structural and other types of threats. Therefore, systemic risk is best understood as follows: (1) an initial shock in the financial system created either exogenously or endogenously, (2) followed by financial institutions experiencing stress, (3) which is then amplified and transmitted to other financial institutions in the system, (4) ultimately having an impact on the real economy.[45]

The benefits of Lastra's conceptualisation of financial stability as the prevention, mitigation, and management of systemic risk are manifold. First, this definition emphasises the course correction that occurred during the crisis, specifically the emergence of macroprudential policy as a response to system-wide threats. Second, as Lastra points out, it denotes that financial stability requires both *ex ante* and *ex post* tools: it encompasses crisis prevention, crisis management, and resilience, as distinct elements of financial stability.[46] Third, regulatory and supervisory tools that target systemic risk offer a degree of flexibility to competent authorities. In EU law, for example, the systemic risk buffer (SRB) acts as a residual macroprudential tool to address risks that are not captured by counter-cyclical and other tools targeting systemically important institutions.[47] Overall, the concept of systemic risk brings a degree of clarity to the negative definition of financial stability as the antithesis of instability.

The danger is that systemic risk is inherently broad, and it fails to overcome the shortcomings of a defining financial stability in negative terms. Its flexible scope is unavoidable, as systemic risk concerns an unpredictable range of threats to the financial system. However,

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[45] On the role of macroprudential policy, see Rosa M Lastra, 'Systemic Risk and Macro-prudential Supervision' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (OUP 2015).

[46] Rosa M Lastra, *Legal Foundations of International Monetary Stability* (OUP 2006) 110. On resilience specifically, an element sometimes overlooked by the literature, see Anat Keller, 'The Mandate of the European Systemic Risk Board and Resilience as an Essential Component: Part 1' [2016] 31(1) *Journal of International Banking Law and Regulation* 13.

[47] See Chapter 4.

this can generate important challenges: for example, systemic risks tools are sometimes criticised for conferring to much discretion to competent authorities without a clearly defined methodology for their application.[48] As with most macroprudential tools, measures targeting systemic risk can generate significant economic and social costs. Moreover, the bigger weakness of this concept is that it difficult to apply to resolution, burden-sharing and other areas of financial stability outside of prudential regulation. Hence, this chapters explores the wider teleology of financial stability in EU law.

2.2.3 Financial stability as a 'global public good'

The theory of public goods is the dominant theory of financial stability since the financial crisis. Importantly, it provides a theoretical backdrop to the intensification of regulation and directly contradicts the moral hazard argument in earlier scholarship. In broad terms, the theory considers that private actors have little incentive to pursue financial stability, which must instead be provided by public authorities.[49] As a 'public good', financial stability is construed as a burdensome yet vital form of public action.

The terminology of 'public goods' indicates that certain goods in society are of collective consumption nature and, thus, underprovided in a system which favours private consumption—the free market.[50] By way of contrast to ordinary commodities, public goods are classified as 'nonrival' and 'nonexcludable'. The former denotes that their consumption does not preclude simultaneous consumption by others, the latter that their availability is not depleted by consumption to exclude others from accessing the commodity in the future.[51] In the early 2000s, in response to challenges in public health and environmental regulation, the

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[48] Masera (n 7), 403.

[49] Joseph Stiglitz *et al*, 'Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International and Monetary and Financial System' (UN 2009) 51 <www.un.org/en/ga/econcrisissummit/docs/FinalReport_CoE.pdf > accessed 16 September 2021.

[50] Lo Schiavo provides detailed analysis of financial stability as a public good, (n 4), 12-20.

[51] Richard Musgrave, 'Public Goods' in Gary Brown and Robert Solow (eds) *Paul Samuelson and Modern Economic Theory* (McGraw-Hill 1983) 141; Thomas J Micheli, *The Economic Approach to Law* (Stanford University Press 2004) 32.

theory became associated with international cooperation: it is believed that individual countries lack both the incentives and the capacity to produce collective consumption goods.[52]

The application of this theory to financial stability is not new, but the financial crisis gave new impetus for reform along this conceptual track. One of the most important enquiries into the public goods nature of financial stability is the report of Stiglitz *et al* for the United Nations General Assembly, delivered amidst the financial crisis. In the report, the authors emphasise the need for global and regional public goods, including climate response, biodiversity, and financial stability. They state:

'Ensuring global financial stability to support economic stability is a global public good. In a world of financial and economic integration, a failure in the financial system of one large country (or even a moderately sized one) can exert large negative externalities on others'.[53]

Trachtman adds that the producers of financial stability will not reap all of its benefits: this is noted as one of the major causes of the financial crisis, because it eliminated incentives to pursue financial stability through regulation and supervision. The public good of financial stability was 'underproduced'.[54] Conversely, public "bads" such as systemic risk were 'overproduced', as market actors failed to internalise the costs of their behaviour.[55] Stiglitz *et*

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[52] Ernesto Zedillo *et al*, 'Meeting Global Challenges: International Cooperation in the National Interest' (International Task Force on Global Public Goods Report, 2006) <ycsg.yale.edu/sites/default/files/files/meeting_global_challenges_global_public_goods.pdf > accessed 21 September 2021.

[53] Stiglitz *et al* (n 49), 15. The report also highlights 'the need for public intervention to provide the conditions and values of sustainable life ("public goods" and "social equity")' albeit not as a standalone or extraordinary goal, but as an organic result of sound economic policy.

[54] Joel P Trachtman, 'The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation' in John H Jackson and Rosa M Lastra (eds), *International Law in Financial Regulation and Monetary Affairs* (OUP 2012) 185.

[55] Ibid.

al refer to this phenomenon as a 'classic market failure'.[56] As a reaction to this failure, the public good nature of financial stability denotes specific policy choices.

First, as stated above, this theory points to the need for public action and the abandonment of the moral hazard logic that contributed to self-regulation prior to the crisis. Insofar as financial stability is 'nonrival' and 'nonexcludable', the consumption of this commodity is of collective benefit to society, not merely a prerequisite for economic performance. Second, financial stability is mandatory and legally enforced. As Bieri observes, private actors should not be allowed to 'actively withdraw from the influence of financial stability'.[57] Third, financial stability cannot be pursued solely *ex post facto*, for example, through monetary policy or other crisis management tools. Implicit in the nature of collective consumption commodities is a preventive function; viewed from this perspective, financial stability is comparable to the goals of environmental protection and public health regulation.

Accordingly, financial stability is a global objective.[58] Its benefits 'are available to all states, and the enjoyment of stability by one state does not reduce its availability to others'.[59] In the EU, for example, this supports supranational action, as individual Member States cannot achieve financial stability on their own. The international law dimension of financial stability is a growing area of research. Lupo-Pasini goes as far as to associate financial stability with the international law doctrine of 'common concern'. *Inter alia*, this doctrine entails a duty to cooperate at the global level, which the author considers as vital in overcoming some of the

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[56] Stiglitz *et al* (n 49); Lastra, 'Systemic Risk and Macro-prudential Supervision' (n 45), 313.

[57] David Bieri, 'Regulation and Financial Stability in the Age of Turbulence', in Robert Kob (ed) *Lessons for the Financial Crisis* (John Wiley 2010) 327.

[58] On emerging threat of protectionism, see Federico Lupo-Pasini, 'The Rise of Nationalism in International Finance: The Perennial Lure of Populism in International Financial Relations' [2019] 30(1) *Duke Journal of Comparative and International Law 93*.

[59] Trachtman (n 54) 185.

limitations of soft law agreements.[60] The shortcomings of soft law are especially relevant to the question of output and throughput legitimacy, explored in subsequent chapters.

The international dimension can be linked to another insight of the literature. The financial crisis brought about not only the intensification of regulation and supervision, but the 'institutionalisation' of financial stability.[61] However, as Andenas and Chiu argue, our understanding of financial stability is constantly progressing. It can be expected that private spheres of responsibility will continue to emerge; the role of the state in this process should be that of a 'public visible hand'.[62] They interpret financial stability as a 'framework-type public good', intended to further 'private aspirations and utility'.[63]

In conclusion, the theory of public goods highlights essential components of financial stability that were previously overlooked or underemphasised, which also explains its prominence in recent years. Some authors, such as Andenas and Chiu, associate this theory with private incentives, but financial stability is better understood as a collective asset. As Stiglitz *et al* put it, financial stability is a requirement 'for the conditions and values of sustainable life' and 'social equality'.[64] My only criticism of the public goods theory is that it

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[60] Federico Lupo-Pasini, 'Financial Stability as a Common Concern of Humankind' in Thomas Cottier (ed) *The Prospects of Common Concern of Humankind in International Law* (CUP 2021) 418-419. The author remarks that while soft law suits regulatory needs, the crisis management and supervision aspects of financial stability require hard law coordination.

[61] Dirk Schoenmaker, 'The Trilemma of Financial Stability' (2008) CFS-IMF Conference, 'A Financial Stabiltiy Framework for Europe: Managing Financial Soundness in an Integrating Market' <citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.594.3434&rep=rep1&type=pdf> accessed 5 October 2021.

[62] 'The role of financial regulation is to provide 'public goods' such as systemic stability, which underpins micro-prudential regulation and deposit guarantee schemes […] but the provision of which is subject to a collective action problem, and so the state is often looked to in order to supply it' in Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation* (Routledge 2014) 4, 413-469. See also, Mads Andenas and Iris H-Y Chiu, 'Financial Stability and Legal Integration in Financial Regulation' (2013) 38 *European Law Review* 343.

[63] Ibid.

[64] Stiglitz *et al* (n 49). This can either be seen as a fundamental aspect of economic management or an incidental effect of market process.

specifically concerns the positive impact of financial stability on society as a whole; yet it approaches the subject through the language of consumption and market utility. This precipitates a lack of research on the non-economic dimension, the social benefits and social harms, of financial stability.

2.3 Financial stability in EU law and policy

The trajectory of financial stability in EU law deserves special attention. The initial wave of reforms in the EU largely mirrors international efforts to strengthen regulation and supervision. However, escalation of the crisis into a sovereign debt crisis in the EMU brought about legal and institutional innovations, such as the separate objective of the 'stability of the euro area', and the establishment of the Banking Union.

This section will outline the main features of financial stability in EU law. I will begin with an overview of primary EU law, followed by brief reference to secondary legislation, the case law of the Court of Justice, and relevant "soft law" measures. As part of this analysis, I will briefly distinguish between types of stability in EU law. Finally, this section will give an overview of the literature on EU financial stability, with view to identifying gaps in the existing research.

2.3.1 Financial stability in primary law (EU Treaties)

As with most political objectives in EU law, the peculiar trajectory of financial stability can be attributed to the principle of conferral: the EU can only exercise the competences conferred to it by the Member States in the Treaties.[65] Historically, these competences centred around trade and market liberalisation.[66] It was not until the Treaty of Maastricht in the early 1990s that a *finalité politique* (political teleology) was formally declared—and that came with many compromises and omissions.[67] There are many examples of this political

[65] Art 5(1) TEU.

[66] See Niamh Dunne, 'Liberalisation and the Pursuit of the Internal Market' [2018] 43(6) *ELR* 803.

[67] See generally, Willem Maas, 'The Origins, Evolution, and Political Objectives of EU Citizenship' (2014) 15(5) *German Law Journal* 79.

vision, including the introduction into primary law of EU Citizenship, but the centrepiece of Maastricht was the single currency and single monetary policy. This was a singular moment in European integration and is sometimes presented as the end of economic functionalism.[68]

Relevant to this thesis, it should be acknowledged that there is no independent reference to financial stability in the EU Treaties. This is neither surprising nor problematic in a legal sense. First, the EU's *finalité politique* revolved around monetary policy, evidenced by the conferral of exclusive competences to the EU in this field. The EMU was and still is incomplete, as the fields of economic policy and financial regulation remain primarily the responsibility of the Member States. Financial stability was not part of the EU's agenda in the 1990s and 2000s because the Member States chose to pursue financial stability at the national level, consistently with the international attitude towards financial stability at the time.[69]

Second, despite the introduction of a single currency and other political objectives, the EU remained committed to market liberalisation through the gradual abolition of obstacles to trade.[70] Financial stability, as it was then conceived as a potential moral hazard, was not entirely consistent with this goal. The EU's stance mirrored the then global trend of deregulation and excessive reliance on monetary policy. Third, the EU financial market was incredibly diverse, especially prior to the withdrawal of the United Kingdom (which follows a distinctly Anglo-Saxon model of capitalism).[71] In addition to the political challenge of coordinating "varieties of capitalism", there was no indication that supranational action would contribute to financial stability.

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[68] Michael Burgess, 'Federalism and Building the European Union' [1996] 26(4) *Publius* 1, 14; Tuori (n 1) 178-183.

[69] See Larissa Dragomir, *European Prudential Banking Regulation and Supervision: The Legal Dimension* (Routledge 2010), Chapter 7.

[70] For example, the main goal of the Lamfalussy system was to enable coordination with view to abolishing barriers to entry.

[71] This alludes to a long-running debate in the corporate law literature, on 'varieties of capitalism'. See Jukka Snell, 'Varieties of Capitalism and the Limits of European Economic Integration' [2017] 13 *Cambridge Yearbook of European Legal Studies* 415. The term is derived from the work of Peter A Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (OUP 2001).

As a result, the only reference to the stability of the financial system can be found in Article 127(5) TFEU.[72] This provision authorises the European Central Bank to support the actions of national competent authorities insofar as these do not contradict monetary policy goals. Its significance is twofold. On the one hand, this provision demonstrates that financial stability is consistent with EU law and must be pursued to the extent allowed by the division of competences in the Treaties. On the other hand, it clearly cannot serve as the source of supranational financial stability, certainly not in its current formulation as an independent objective of regulation and supervision. Further, Art 127(5) supports the subordination of financial stability to price stability, and is difficult to reconcile with the broader influence of financial stability in bank resolution, deposit insurance, and fiscal policy.

Another possibility is that the goal of financial stability flows from Article 136(3) TFEU, which enables Member States to adopt extraordinary financing measures to reinforce the 'stability of the euro area as a whole'. However, this concept strictly concerns the euro area and was introduced to the Treaties in response to the sovereign debt crisis.[73] Conversely, the overhaul of the Union's financial stability toolkit precedes the amendment to Art 136. The addition of paragraph (3) was necessary to reconcile urgent financing assistance to Member States with the 'no bailout' clause in Article 125(1) TFEU. Confusion between financial stability and the 'stability of the euro area' is exacerbated by policy documents and the case law of the Court, which initially used the two terms interchangeably.[74] Therefore, the 'stability of the euro area' must be understood in the context of the EMU and is a more limited concept.

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[72] Similar reference to the supporting competences of the ECB can be found in Art 141 TFEU, and in Arts 3.3, 25.1 of Protocol 4 on the Statute of the ESCB, attached to the TFEU.

[73] Recital 4, Decision 2011/199 of the European Council of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, OJ L91/1.

[74] For example, Decision 2011/199 and *Pringle* refer to the 'financial stability of the euro area as a whole'. Art 136(3) and subsequent policy documents abandon the term 'financial'.

Brief reference can also be made to price stability economic/fiscal stability. 'Price stability' constitutes the primary goal of monetary policy.[75] The primacy of price stability in the EMU is enshrined in Article 127(1) TFEU, but the Treaties do not provide a definition the concept. According to the ECB, it refers to low levels of inflation and deflation for a prolonged period of time, a prerequisite for economic growth and employment.[76] 'Economic stability' alludes to macroeconomic health: including budgetary probity, low levels of public debt, resilience to external shocks, and price stability. The narrower concept of 'fiscal stability' centres mainly around public finances.[77] Fiscal stability is not a supranational objective *per se*; economic policy remains the exclusive competence of the Member States.[78] Nevertheless, the crisis significantly expanded the EU's 'surveillance' powers in economic policy.[79]

Returning to the issue at hand, it can be inferred that financial stability is derived from the core objectives of the Union, listed in Article 3 TEU:

'3. The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.

[…]

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[75] The distinction between price stability and financial stability has proven problematic precisely because of this reason. See *Gauweiler* (C-62/14) ECLI:EU:C:2015:400 and *Weiss* (C-493/17) ECLI:EU:C:2018:1000, on the ECB's Outright Monetary Transactions programme.

[76] The ECB Governing Council of 13 October 1998 defined price stability as '[…] a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%'. This was amended in 2003 to read 'below but close to 2%'.

[77] See Federico Lupo-Pasini, 'Economic Stability and Economic Governance in the Euro Area: What the European Crisis can Teach on the Limits of Economic Integration' [2013] 16(1) *Journal of International Economic Law* 235.

[78] Art 5(1), Arts 119-126 TFEU.

[79] See generally, Alicia Hinarejos, 'Fiscal Federalism in the European Union: Evolution and Future Choices for EMU' [2013] 50(6) *Common Market Law Review* 1621.

It shall promote economic, social and territorial cohesion, and solidarity among Member States.'

[…]

6. The Union shall pursue its objectives by appropriate means commensurate with the competences which are conferred upon it in the Treaties.'

Article 119 TFEU, on economic and monetary policy adds:

'1. For the purposes set out in Article 3 of the Treaty on European Union, the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.

2. Concurrently with the foregoing, and as provided in the Treaties and in accordance with the procedures set out therein, these activities shall include a single currency, the euro, and the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union, in accordance with the principle of an open market economy with free competition.'

These provisions indicate that financial stability is consistent with EU law as a prerequisite for economic growth, a social market economy, and the functioning of the internal market.[80] Individual aspects of financial stability, such as the mutualisation of funds in resolution and deposit insurance can also be linked to the principle of solidarity.[81] It should be pointed out the vast majority of financial stability reforms have been adopted on the basis Article 114

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[80] See also, Lo Schiavo (n 4), 47-48.

[81] Edoardo Chiti and Pedro Gustavo Texeira, 'The Constitutional Implications of the European Responses to the Financial and Public Debt Crisis' [2013] 50(3) *CMLR* 683, 699. Note that solidarity is an emerging area of research, see esp. Vestert Borger, *The Currency of Solidarity: Constitutional Transformations During the Euro Crisis* (CUP 2020), Chapter 4;

TFEU on the approximation of laws in the internal market, but other competences have been used, such as Article 53 TFEU on self-employed persons, and Article 127(6) TFEU on the supporting tasks of the ECB in prudential supervision.[82] Overall, the current formulation of financial stability in the Treaties would appear to suggest a subordination of financial stability to other objectives of EU law, from which it is legally derived. However, secondary legislation and the case law of the Court indicate otherwise. It is safe to assume that future Treaty amendments will list financial stability alongside the core objectives in Art 3 TEU.

2.3.2 Financial stability in secondary legislation and the case law

Despite the silence of the Treaties, financial stability features prominently in secondary legislation and the case law of the Court. Legislative instruments can be categorised into three groups: substantive measures, institutional reforms, and the Banking Union as a curious amalgam of both. The case law, on the other hand, focuses almost exclusively on constitutional issues raised in relation to either regulatory reform or economic policy measures. Brief mention will also be made to policy documents of expert agencies, which are incredibly influential in delineating the scope of EU financial stability.

The first category of legislative measures includes a new Capital Requirements Regulation and an amended Capital Requirements Directive (CRR/CRD IV and CRR II/CRD V).[83] This dual regime overhauled the Union's micro- and macroprudential toolkit, and extends to many

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[82] *Inter alia*, Art 53 TFEU was used for the Capital Requirements Directive (CRD), Art 127(6) TFEU was used for the Single Supervisory Mechanism (SSM), and Art 114 TFEU was used for the Capital Requirements Regulation (CRR), the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism (SRM) and the European System of Financial Supervision (ESFS). A further point of emphasis is that there are several international law agreements between euro area countries that impact on financial stability in EU law, such as the European Stability Mechanism (ESM) and the Treaty on Stability, Coordination and Governance (TSCG).

[83] (CRR) Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L176/1; (CRD IV) Directive 2013/36 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.

other policy areas, including corporate governance and authorisation/passporting of credit institutions. It is noteworthy that this set of tools focuses almost entirely on banking regulation, which reflects the EU's dependency on banking finance (as opposed to market finance). Another key instrument is the Bank Recovery and Resolution Directive (BRRD & BRRD II).[84] This Directive strengthens the crisis management side of financial stability by introducing a degree of harmonisation to all stages of the resolution process for failing banks. There are other examples of substantive reforms that fall under the umbrella of financial stability policy, including deposit insurance and the Capital Markets Union project.[85]

The second category of institutional reforms traces the transformation of the EU's supervisory architecture following the crisis. One of the earliest responses to the crisis was the creation of three supervisory agencies: the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA).[86] More importantly, the crisis led to the creation of a new macroprudential body, with a clear and direct mandate over financial stability. The European Systemic Risk Board (ESRB) is not a regulatory authority, but its soft law powers as a macroprudential coordinator are significant.

In the last decade, these agencies have conducted extensive research on financial stability within their mandate. They have adopted a range of soft law instruments, such as recommendations and opinions. One of the most important studies in financial stability is the

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[84] (BRRD) Directive 2014/59 of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, *OJ L173/190.*

[85] See Niamh Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System?' [2016] 41(3) *ELR* 307.

[86] See Eilís Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' in Wymeersch, Hopt and Ferranini (eds) *Financial Regulation and Supervision: A Post Crisis Analysis* (OUP 2012).

EBA's Opinion on Macroprudential Rules.[87] This document acknowledges the elusiveness of financial stability and its potential conflict with internal market rules.[88] Equally important is the ESRB's Handbook on Operationalising Macroprudential Policy. This report identifies key challenges in macroprudential supervision, such as the lack of harmonisation in non-capital based tools.[89] More generally, the ESRB has been especially active in issuing soft law recommendations to correct the application of macroprudential policy at the national level.

The third category of post-crisis reforms is worth discussing separately because it concerns the euro area specifically. The Banking Union project has three pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), and the European Deposit Insurance Scheme (EDIS) is still in the works.[90] Each of these pillars is intended to provide a degree of centralisation within the EMU (and participating countries). For instance, the SSM empowers the European Central Bank to directly supervise systemically-important credit institutions in the euro area. Similarly, the SRM provides a centralised decision-making structure for recovery and resolution procedures, as well as a common funding mechanism. The legal innovation of the Banking Union demonstrates the transformative potential of financial stability in EU law.

Finally, financial stability appears in the case law of the Court of Justice. The case law reflects the evolution of financial stability from an objective of prudential policy to a core objective of the EU that transcends policy areas. One of the earliest cases invoking the

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[87] European Banking Authority, 'Opinion on the Macroprudential Rules in the CRR/CRD' (June 2014) 44-47 <eba.europa.eu/sites/default/documents/files/documents/10180/657547/0e8efdbf-9cb3-4178-890a-9d27b1351486/EBA-Op-2014-06%20-%20EBA%20opinion%20on%20macroprudential%20rules%20in%20CRR-CRD.pdf?retry=1> accessed 01 December 2020.

[88] See eg, discussion on G-SII and O-SII buffers, pages 26-30.

[89] European Systemic Risk Board, 'Handbook on Operationalising Macro-prudential Policy in the Banking Sector' (2014) 54-56 <www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf?ac426900762d505b12c3ae8a225a8fe5> accessed 05 December 2020.

[90] See Niamh Moloney, 'European Banking Union: Assessing its Risks and Resilience' [2014] 51(6) *CMLR* 1609.

objective of financial stability is *Short Selling*.[91] This case was brought before the CJEU by the United Kingdom, who challenged the legality of ESMA. *Inter alia*, the UK claimed that ESMA's discretionary power to restrict the speculative practice of short selling breached the limits of Art 114 TFEU and other provisions of EU law. Financial stability is referenced by the Court in response to whether the creation of ESMA violated Articles 290 and 291 TFEU on the delegation of powers. The Court states:

'[…] Article 28 of Regulation No 236/2012 cannot be considered in isolation. On the contrary, that provision must be perceived as forming part of a series of rules designed to endow the competent national authorities and ESMA with powers of intervention to cope with adverse developments which threaten financial stability within the Union and market confidence. To that end, those authorities must be in a position to impose temporary restrictions on the short selling of certain stocks, credit default swaps or other transactions in order to prevent an uncontrolled fall in the price of those instruments. Those bodies have a high degree of professional expertise and work closely together in the pursuit of the objective of financial stability within the Union'.[92]

It is clear from the above that the Court adopts an open-ended interpretation of financial stability and defers to the professional expertise of ESMA and other EU bodies. In subsequent cases, financial stability is invoked to justify more radical change. The most important case explored in this thesis is *Pringle*, where the Court sought to reconcile intergovernmental financing assistance with the "no bailout" clause in the EU Treaties.[93] In doing so, the CJEU puts forward an interpretation of financial stability as a 'higher objective' of EU law, superseding goals explicitly stated in the Treaties, such as budgetary discipline.[94] A similar logic is implicit in *Ledra Advertising*, a case concerning the only large-scale bail-in of deposits in the EU.[95] The key legal issue was whether bail-ins are consistent with EU fundamental rights, and the Court deemed that financial stability considerations outweighed

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[91] *Short Selling* (C-270/12) ECLI:EU:C:2014:18.

[92] Ibid, paragraph 85.

[93] *Pringle* (C-370/12) ECLI:EU:C:2012:756.

[94] Ibid, paragraph 135.

[95] *Ledra Advertising* (C-8/15) ECLI:EU:C:2016:701.

the breach of the right to property in this instance.[96] *Pringle* and *Ledra* are crucial in the discussion on teleology and legitimacy, as they showcase the potentially unlimited scope of financial stability in EU law.

2.3.3 The literature on EU financial stability

The EU law literature emulates many of the findings of the wider scholarship on financial stability. The de Larosière Report of 2009 was instrumental in that respect.[97] This report traces the origins of the financial crisis and proposes ways to improve financial regulation in the EU. Specifically, it identifies 'inappropriate regulation, weak supervision and poor macro-prudential oversight' as some of the key causes of the crisis.[98] Accordingly, its proposals focus on reforming micro- and macroprudential policy both at the material and institutional level. De Larosière can be seen as the inspiration for the initial wave of secondary legislation, which includes the CRR/CRD IV and the creation of new supervisory authorities.[99]

Therefore, the earliest literature on EU financial stability focuses on the macroprudential dimension.[100] Special note can be made of the work of Andenas and Chiu, who apply the theory of public goods to EU financial regulation.[101] Equally influential is the work of Lastra in exploring the concept of systemic risk and investigating the connection between financial regulation and monetary policy.[102] Most relevant to my thesis is Anat Keller's research on the

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[96] Ibid, paragraphs 69 & 74.

[97] Report of the de Larosière Group *ECO/259-EESC-2009-1476* [2009] OJ C318/ 57-65 <https://www.eesc.europa.eu/it/our-work/opinions-information-reports/opinions/de-larosiere-report> accessed 1 July 2020.

[98] Ibid, 13.

[99] Niamh Moloney, *EU Securities and Financial Markets Regulation* (3RD edn, OUP 2016) 30-36.

[100] See eg, de Haan, Osterloo and Schoenmaker (n 14); Chryssa Papathanassiou and Georgios Zagouras, 'A European Framework for Macro-Prudential Oversight' in Wymeersch, Hopt and Ferranini (n 86).

[101] *Supra* (n 62).

[102] See eg, Lastra, 'Systemic Risk, SIFIs and Financial Stability' (n 37).

distributional effects of macroprudential policy and other challenges facing the ESRB.[103] Others, notably Niamh Moloney and Eilís Ferran, have written extensively on the role of the new supervisory authorities and the institutional architecture of financial stability.[104] This branch of the literature concedes that EU financial stability has evolved beyond its roots in prudential policy.[105]

Developments such as the Banking Union and *Pringle* transform EU financial stability from a target of regulation to a political objective with a clear constitutional value.[106] This is supported by Gianni Lo Schiavo, whose work is the most comprehensive account of financial stability in EU law and policy. Lo Schiavo identifies the normative instruments of financial stability and reaches the conclusion that it is a 'foundational' and 'supranational' objective of EU law.[107] Financial stability is 'supranational' in that it has a cross-border dimension which Member States are incapable of tackling on their own. Equally, the magnitude of financial stability reforms displays its 'foundational' role: financial stability is emerging as a core objective of the Union alongside market integration and price stability.[108]

Lo Schiavo defines financial stability as 'a normative environment as a result of which Europe is in a generalized and lasting state of economic growth'.[109] He lists four elements

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[103] Keller, 'The Possible Distributional Effect of the Loan-to-value Ratio and its Use as a Macro-Prudential Tool by the European Systemic Risk Board' (n 2); Keller, 'The Mandate of the European Systemic Risk Board and Resilience as an Essential Component: Part 1' (n 46).

[104] Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' [2010] 47(5) *CMLR* 1317; Ferran (n 86).

[105] Rosa M Lastra, *International Financial and Monetary Law* (Oxford University Press 2015) 126.

[106] On the link between EU financial stability, fiscal reform, and other developments, see Carmello Salleo, 'Single Market vs. Eurozone: Financial Stability and Macroprudential Policies' in Frankin Allen, Elena Carletti and Joanna Gray (eds) *The New Financial Architecture in the Eurozone* (European University Institute 2015) 194.

[107] Lo Schiavo (n 4).

[108] Ibid, 2-5. 'Foundational' objectives are typically those enshrined in Art 3 TEU.

[109] Ibid; Gianni Lo Schiavo, 'From National Banking Supervision to a Centralized Model of Prudential Supervision in Europe? The Stability Function of the Single Supervisory Mechanism' [2014] 21(1) *Maastricht Journal of European and Comparative Law* 110, 113.

that an "environment" of financial stability must achieve: 'institutionalisation', 'centralisation', 'integration', and 'top-down supervision'.[110] This is heavily inspired by the public goods theory: it is a nuanced and accurate depiction of a market-oriented version of financial stability. The present research seeks to demonstrate that, in addition to economic growth, financial stability is a precondition for social development. I also challenge the notion that centralisation and harmonisation will automatically improve the legitimacy of EU financial stability, although these solutions can be helpful in some areas, as Lo Schiavo suggests.[111] The potential 'trilemma' between financial stability and other goals (credit availability, free competition) in the Eurozone is exposed by Gundbert Scherf, who provides a holistic assessment of EU financial stability in political theory.[112]

A third strand of the literature focuses on a perceived constitutional 'mutation' caused by financial stability reforms.[113] In particular, Tuori is critical of the Court's interpretation of financial stability in *Pringle*, which served the purpose of 'constitutionally sanctifying the innovations which legal and institutional experimentation in management of the Eurozone had brought about'.[114] This refers to the abandonment of the Maastricht model of budgetary discipline, the intergovernmentalism of some financial stability measures, and the strict conditionality (austerity) attached to financing assistance. The next chapter delves deeper into the broader literature on the financial crisis and Europe's 'crisis of legitimacy'. Final note can be made of Michelle Everson's analysis of institutional and material financial stability reforms. In particular, Everson questions what the mainstream perceives as a paradigm shift in regulation and supervision, proposing instead that financial stability represents a fine-tuning of 'market utility'.[115]

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[110] Ibid, 113-114.

[111] Ibid 175.

[112] Gundbert Scherf, *Financial Stability Policy in the Euro Zone* (Springer Gabler 2013) 120-130.

[113] Kaarlo Tuori and Klaus Tuori, *The Eurozone Crisis*: *A Constitutional Analysis* (CUP 2014) 129-130.

[114] Tuori, *European Constitutionalism* (n 1), 191.

[115] Michelle Everson, 'Banking on Union: EU Governance Between Risk and Uncertainty' in Mark Dawson, Henrik Enderlein and Christian Joerges (eds) *Beyond the Crisis The Governance of Europe's Economic, Political and Legal Transformation* (OUP 2015).

In conclusion, there is a clear gap in the literature which tends to focus either on the technical or the constitutional dimensions of financial stability. With the exception of Everson, Scherf, and to an extent Tuori and Keller, the literature overlooks the potential social harms of financial stability policy; non-economic utility is mainly presented as an automatic consequence of economic performance. The next section will distinguish between the economic and non-economic sides, and outline the broader factors (teleology) that impact on the legitimacy of EU financial stability.

2.4 The ideology and non-economic utility of EU financial stability

My thesis examines the "output" legitimacy of financial stability, as distinguished from its democratic attributes ("input" legitimacy). In the preceding sections, I explained that the literature is generally lacking in holistic accounts of EU financial stability, but even more pronounced is the absence of any exploration of the positive and negative impact of financial stability on social development and social equality. This alludes to the non-economic utility of financial stability. Along with the ideological underpinnings of financial stability as a shift away from laissez-faire capitalism, non-economic utility forms part of a broader teleology used to evaluate output legitimacy in this thesis. A teleological approach which incorporates these broader considerations is necessary to define the boundaries of a transformative yet elusive objective of EU law.

This section begins by explaining that non-economic utility requires a balancing of the economic and non-economic sides of financial stability, as distinguished from the dominant approach in the literature which considers that economic growth will automatically deliver social policy goals. I then look at the ideological dimension as part of the wider "outputs" of policy that impact on its legitimacy. Finally, this section outlines the operational elements of this teleology, the most crucial of which is minimising the social costs of policy through differentiation between the groups affected by financial stability measures.

2.4.1 The non-economic utility of financial stability: what is it and why is it important?

The language of non-economic utility, as distinguished from 'social utility', is used in thesis to describe the strong positive and negative relationship between financial stability and social

policy.[116] This is not a radical reconceptualisation, but rather a teleological interpretation of financial stability which emphasises what the objective seeks to achieve, for reasons that will be explained below. There are similarities and differences between this theoretical angle and the existing research on financial stability in EU law.

The starting point is to acknowledge that the financial system occupies a central role in modern society. As Schwarcz illustrates in the context of systemic risk, financial collapse is a source of unemployment, poverty, crime, physical and mental health issues, even loss of life.[117] This is magnified tenfold in the EU, due to spillover effects in the internal market and the lack of true "federal" solutions, such as European fiscal capacity.[118] The most recent example is the COVID-19 pandemic. On the one hand, the ECB considers that loss of human life would have been much greater had financial stability measures not been in place to support public finances.[119] On the other hand, financial stability policies may have prevented certain countries in the periphery, who were under strict budgetary scrutiny as recipients of financial aid, from diverting funds towards their public health sectors.[120] To an extent, all authors recognise the potential benefits and harms of financial stability policy on society.

In particular, there is extensive research on the positive relationship between financial stability and social policy, which roughly describes social harms as the product of instability. It is said that financial stability has a distinct 'human' value: a financial crisis can be just as destructive on human life as a natural disaster—if not more, considering the globalised and

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[116] Social utility is often associated with financial innovation in the literature on financial regulation, thus, it conveys a market-oriented rationale. I use 'non-economic' utility as a more neutral term.

[117] Schwarcz (n 9), 235.

[118] *Supra* (n 79). Fiscal capacity refers to the EU's ability to raise tax funds independently; this entails a mutualisation of funds that could alleviate some of the consequences of a financial crisis in the EU.

[119] European Central Bank, 'Financial Stability Review', May 2020 <www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202005~1b75555f66.en.pdf> accessed 8 August 2020

[120] See Marco Buti, 'A Tale of Two Crises: Lessons from the Financial Crisis to Prevent the Great Fragmentation' (VoxEU, July 2020) <voxeu.org/article/lessons-financial-crisis-prevent-great-fragmentation> accessed 16 November 2021.

interconnected nature of finance.[121] Consistently with the theories of systemic risk and public goods, a stable financial system is a prerequisite for the real economy to provide growth, innovation, employment, and a range of other policies. It is also a precondition for price stability and fiscal stability, which facilitate non-economic goals.[122] Therefore, the literature agrees that social development cannot be pursued without a financial system capable of withstanding extraordinary threats and mitigating the constant build-up of risk as part of its ordinary functioning.[123]

Moreover, there is a positive connection between financial stability and social equality. The international consensus is that equality is connected to financial inclusion, or access to financial services.[124] As a precondition for sustainable development, financial stability improves financial inclusion. In the context of gender equality, 'greater inclusion allows the poor, and especially women, to borrow, save, generate and accumulate assets, manage risk and insure themselves (as individuals, households and small businesses)'.[125] Beyond access

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[121] Lisa Heinzerling and Frank Ackerman, 'Pricing the Priceless: Cost-Benefit Analysis of Environmental Protection' [2002] 150(5) *University of Pennsylvania Law Review* 1553, 1558-1564.

[122] See generally, Zlatuse Komarkova, Vilma Dingova and Lubos Komarek, 'Fiscal Sustainability and Financial Stability' (Check National Bank, Financial Stability Report 2012/13) 103-112; Bank for International Settlements, 'Towards a Financial Stability-Oriented Fiscal Policy' (BIS 86th Annual Report, 26 June 2016) <www.bis.org/publ/arpdf/ar2016e5.pdf > accessed 10 August 2021.

[123] Post-Keynesians generally emphasise that regulation must target 'financial fragility', see eg, Fernando J Cardim de Carvalho, 'Systemic Crisis, Systemic Risk and the Financial Instability Hypothesis' in Eckhart Hein, Torsten Niechoj and Engelbert Stockhammer (eds), *Macroeconomic Policies on Shaky Foundations – Wither Mainstream Economics?* (Metropolis 2009).

[124] 'Research shows that a lack of access to financial services perpetuates poverty and limits economic growth and job creation. Financial inclusion can lift the standard of living for the poor, including women and children. Recent IMF research found that women's financial inclusion increases GDP by 2-3%.13 Greater inclusion allows the poor, and especially women, to borrow, save, generate and accumulate assets, manage risk and insure themselves', in Clive Briault, 'How Can Supervisory Authorities Contribute to Meeting the UN SDGs? Climate Change, Financial Inclusion and Gender Equality' (Toronto Centre, TC Notes, June 2019) <res.torontocentre.org/guidedocs/How%20Can%20Supervisory%20Authorities%20Contribute%20to%20Meeting%20the%20UN%20SDGs%20FINAL.pdf > accessed 18 November 2021.

[125] Ibid.

to financial products, there is no doubt that a financial crisis exacerbates social stratification. For example, when jobs become scarce, 'racist, masculinist, and /or nationalist practices' become more pronounced.[126] It follows that the purpose (or *telos*) of financial stability policy is to facilitate both economic and social policy goals. Indeed, authors are critical of this 'abstract duality': economic policy facilitates social policy and vice versa.[127]

However, where the present dissertation differs from earlier research is that it emphasises the negative relationship between financial stability and social policy. A distinction between economic and social policy is necessary because financial stability is pursued at huge social cost. For instance, the most conventional financial stability tools are capital requirements for banks, which are estimated to cause a significant decrease in consumption—a primary metric of social welfare.[128] Equally, liquidity requirements and macroprudential policy are inherently controversial because they limit access to credit, which can disproportionately affect first-time house buyers and other vulnerable groups.[129] Of course, the most widely criticised element of EU financial stability is austerity, which has a demonstrably negative impact on social development and can exacerbate social inequality.[130] The EU law literature on this negative relationship between financial stability and social policy is scarce.[131]

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[126] James Heintz and Radhika Balakrishnan, 'Debt, Power, and Crisis: Social Stratification and the Inequitable Governance of Financial Markets' [2012] 64(3) *American Quarterly* 387, 391.

[127] Diane Elson, 'Social Policy and Macroeconomic Performance: Integrating the 'Economic' and the 'Social' in Thandika Mkandawire (ed) *Social Policy in a Development Context* (Palgrave Macmillan 2004) 63.

[128] Skander J Van den Heuvel, 'The Welfare Effects of Bank Liquidity and Capital Requirements' (FDIC Annual Conference, June 18) page 35 <www.fdic.gov/analysis/cfr/bank-research-conference/annual-18th/2-vandenheuvel.pdf> accessed 31 November 2021.

[129] See Keller (n 2); Philipp Hartmann, 'Real Estate Markets and Macroprudential Policy in Europe' [2015] 47(S1) *JMCB* 69.

[130] The EU's COVID-19 recovery package can be seen as an implicit rejection of austerity policies. The fiscal dimension is discussed further in Chapter 6.

[131] Primarily, the EU law research focuses on social policy in the context of macroprudential policy and the real estate market and/or credit availability. *Supra* (n 129).

In addition, contrary to the dominant view that financial stability is a 'nonrival' and 'nonexcludable' commodity, its effects are highly asymmetric. Larger banks have more opportunities than smaller enterprises to pass on their financial burden to the consumer.[132] A further example is the bail-in tool utilised in bank resolution: absent additional safeguards, this tool puts ordinary depositors at a disadvantage, favouring risk-assuming investors who have the resources and know-how to mitigate their losses.[133] Scherf notes that the asymmetric effects of policy are magnified in the Eurozone due to structural variation between national systems and other factors.[134] Accordingly, both the economic and non-economic sides of financial stability are crucial, but it should not be assumed that the *telos* of social development flows directly from economic performance.

A teleological approach that distinguishes between economic and non-economic utility offers the following advantages. First, it tackles what the literature describes as the 'elusiveness' of financial stability. The indeterminacy of financial stability is intrinsically connected to market-oriented approaches that fail to overcome the inherent uncertainty and complexity of the financial system. Primarily, this refers to Knightian and Keynesian uncertainty: some problems in the financial system are non-computable, due to the infinite number of moving parts, made even more unpredictable by feedback and feedforward loops. For Knight, this is a temporal issue;[135] Keynes considered that some things 'we simply do not know'.[136] Despite scientific progress in the last decade, the financial system entails too many 'unknown unknowns'. Thus, measuring the effects of policy is a near impossible task; there will often be no causal link between financial stability and actual economic outcomes.[137] Consequently,

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[132] Masera (n 7); Alison Lui, *Financial Stability and Prudential Regulation: A Comparative Approach to the UK, US, Canada. Australia and Germany* (Routledge 2017), Chapter 2.

[133] This is one of the reasons that bank resolution is supported by deposit insurance, and other safeguards.

[134] Scherf (n 112), 53. One of the factors Scherf considers is that financial stability belongs in the realm of 'quiet' politics. On this issue, see Pepper D Culpepper, *Quiet Politics and Business Power: Corporate Control in Europe and Japan* (CUP 2011).

[135] Frank H Knight, Risk, Uncertainty, and Profit (Hart Schaffner Marx 1921) 218.

[136] John M Keynes, 'The General Theory of Employment' [1937] 51 *Quarterly Journal of Economics* 209, 213-214.

[137] This issue is explored further in the context of 'throughput' legitimacy, in Chapter 3.

policy must take into account the non-economic utility of financial stability, because the economic dimension will always entail a degree of 'true uncertainty'.[138]

Second, a teleological approach that focuses on the non-economic outcomes of policy is made necessary by the transformative potential of financial stability in EU law. While other policy fields, such as environmental protection or public health, also face Knightian/Keynesian uncertainty, the distinguishing factor of financial stability is that it has served as the basis for unprecedented reforms in prudential and resolution policy, fiscal policy, and other core areas of integration. Its influence can also be attributed to the Court's expansive interpretation of financial stability as a 'higher' objective of EU law, precipitated by the sensitive political nature of reforms and the urgency of the crisis.[139] Yet the Treaties indicate a subordination of financial stability to price stability in the EMU and remain silent on EU-wide financial stability. Ultimately, two interpretations are consistent only if we construe financial stability as a precondition for both the economic and social objectives of the Union.[140] Legally and conceptually, financial stability is conditional on the objectives listed in Art 3 TEU, which include a social market economy and solidarity. Therefore, the non-economic utility of financial stability offers a way of delineating the boundaries of (legitimate) supranational action, by incorporating the EU's political and social teleology into analysis of a transformative policy goal.

Thirdly, these advantages are closely linked to the concept of legitimacy. As my next chapter will show, global and transnational governance is characterised by a complex web of

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[138] One of the potential weaknesses of my conceptualisation is that emphasising the non-economic side can lead to 'inaction bias', as the economic benefits of policy may never materialise, but social harms will gain immediate attention. However, the teleology used in this thesis must be assessed in the context of existing gaps in the literature on the non-economic dimension. Ultimately, inaction in the EU is exaggerated, see Pierre Schammo, 'Inaction in Macro-prudential Supervision: Assessing the EU's Response [2019] 5(1) *JFR* 1.

[139] *Supra* (n 94).

[140] Especially considering the EU's vulnerability to banking finance, which makes social policy excessively reliant on financial stability.

normative and empirical sources of legitimacy.[141] While some policies may enjoy normative legitimacy because they perform well in an economic sense, the significant externalities of financial stability could weaken empirical legitimacy, understood as actual support from the constituent public. In line with my conceptualisation of output legitimacy as a fundamental level of trust in the European "project" (as opposed to material outputs *per se*), the non-economic utility of financial stability is essential in overcoming a false dichotomy between democratic legitimacy and functionalist performance.

2.4.2 The ideology of EU financial stability: orthodox yet ground-breaking?

In addition to the non-economic utility of financial stability, the ideological underpinnings of this objective remain relatively unexplored in the literature. The problem that arises is that it is impossible to evaluate the "output" legitimacy of policy without reference to an ideological *telos*. I will proceed to identify the components of this dimension; subsequent chapters examine if policy is aligned with the ideological shift detailed here.

Before proceeding further, it is important to acknowledge an important caveat: the rise of financial stability in EU law should not be seen as shift in the overall economic ideology of the EU. On the contrary, there is extensive literature on the orthodox nature of post-crisis reforms, which serve the 'preservation of key elements of neo-liberal capitalism' and marginalise alternative economic visions.[142] Viewed from this perspective, the impetus brought about by the need to stabilise the European financial market merely advances the 'codification' of free market ideology.[143] Nevertheless, within the more narrow context of my

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[141] See also, Joseph H H Weiler, 'In the Face of Crisis: Input Legitimacy, Output Legitimacy and the Political Messianism of European Integration' [2012] 34(7) Journal of European Integration 825, 826-827.

[142] Jason Glynos, Robin Klimecki and Hugh Willmott, 'Cooling Out the Marks: The Ideology and Politics of the Financial Crisis' [2012] 5(3) *Journal of Cultural Economy* 297. Outside of the EU, see John E Roamer, 'Ideology, Social Ethos, and the Financial Crisis' [2012] 16(3) *The Journal of Ethics* 273.

[143] See Benjamin Farrand and Marco Rizzi, There is No (Legal) Alternative: Codifying Economic Ideologic Into Law' in Eva Nanopoulos and Fotis Vergis (eds), *The Crisis Beyond the Euro-Crisis: The Euro-Crisis as a Multi-Dimensional Systemic Crisis of the EU* (CUP 2019).

research, I identify an important shift in financial regulation, which is relevant in evaluating the legitimacy of wider financial stability reforms. Thus, the ideological discussion that follows is limited in focus to the flaws of economic functionalism in financial integration.

In the European context, economic functionalism refers to the chronic subordination of political and social policy objectives to the overarching goal of completing the internal market. A common narrative in European constitutionalism is that functionalism was the product of negative integration in free movement law, and that the Treaty of Maastricht marks a paradigm shift towards a new *finalité politique*—a political union or political teleology.[144] This shift is exemplified by the introduction of EU Citizenship as a source of rights for the non-economically active, and wider initiatives such as environmental protection. According to the literature, the most critical change brought about by Maastricht was the introduction of the single currency and the single monetary policy. Tuori describes this as a defeat of an 'ordoliberal' vision predicated on the principles market freedom and market equality.[145]

However, the centralisation of monetary policy in the EMU only encouraged the trend of 'permissive' interventionism in the financial market.[146] In terms of legislative initiatives, one of the centrepieces of prudential policy was the Lamfalussy process, whose primary purpose was to promote retail markets and to abolish barriers to cross-border movement.[147] Most notably, the introduction of the single monetary policy prompted a more activist stance by the Court of Justice, which continued to associate market integration with market

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[144] *Supra* (n 67).

[145] Tuori (n 1), Chapters 5 & 6.

[146] Ben Clift, 'French Responses to the Global Economic Crisis: The Poltiical Economy of "Post-Dirigisme" and New State Activism' in Wyn Grant and Graham K Wilson (eds), *The Consequences of the Global Financial Crisis: The Rhetoric of Reform and Regulation* (OUP 2012). On the 'permissive interventionism' of financial stability, see Everson (n 115).

[147] For an overview, see Lo Schiavo (n 4), 149.

liberalisation.[148] The best example of this approach is the "golden shares" line of cases in the 2000s, which effectively prescribe a singular economic vision in the internal market.[149] Therefore, against the conventional narrative, Maastricht intensified functionalist attitudes in the financial market; an approach which culminated in the subordination of financial stability to monetary policy (Jackson-Hole consensus) and an excessive emphasis on micro-prudential regulation (composition fallacy). It is submitted that financial stability has the potential to be a "truer" paradigm shift away from economic functionalism, for the following reason.

At its most basic level, the rise of financial stability as a standalone goal of EU law represents the failure of a market efficiency rationale. The abandonment of an interpretation of financial stability as economic performance, which overestimated the moral hazard associated with public intervention, exemplifies a radical course correction. While it is debatable whether post-crisis reforms actually overcome this weakness,[150] intensified public intervention in the European financial market conveys the Post-Keynesian logic that the capitalist economy will constantly invent novel threats as part of its ordinary functioning.[151] Hence, the looming threat of financial collapse necessitates counter-cyclical and other tools, which have a potentially restrictive effect on market freedom and market equality.

In principle, the EU's current financial stability toolkit contains many such tools. For instance, capital requirements seek to internalise the costs of risk-taking, by requiring credit institutions to set funds aside for a "rainy day". This directly contradicts the notion of market freedom and poses a potential obstacle to cross-border movement by establishing significant limits to market access. On the institutional side, the replacement of the Lamfalussy process with agencies that enjoy (*inter alia*) direct supervisory powers can also be seen as a form of intensified interference with the financial market. Other financial stability initiatives, such as deposit insurance, are strictly antithetical to market equality: deposit insurance shields certain

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[148] This refers to the Court's use of the principles of mutual recognition and home-country control to abolish barriers to cross-border movement.

[149] See eg, Wolf-Georg Ringe, 'The Volkswagen Case and the European Court of Justice' [2008] 45 *CMLR* 537.

[150] *Supra* (n 142); *Supra* (n 115).

[151] *Supra* (n 123).

groups of private actors from the consequences of their investment. As Scherf points out, financial stability is often pursued at the expense of free competition.[152]

It follows that financial stability can be construed as an ideological shift away from laissez-faire liberalism in the financial market.[153] Irrespective of how effective these policies are, or whether they go far enough in uprooting the EU's broader economic ideology, it is significant to recognise the implicit rejection of the neoclassical model of unfettered liberalisation and profit maximisation. Relevant to this thesis, this ideological shift is an essential component of the teleology of financial stability: it denotes that post-crisis reforms may be illegitimate if they perpetuate the subordination of political and social integration to the logic of the free market. More broadly, this alludes to the relationship between financial stability and market integration, explored further in Chapter 4.

2.4.3 The operational elements of a teleological interpretation

On an operational level, the non-economic utility and ideology of financial stability can be divided into four components. First, the normative instruments of financial stability remain unchanged, but some are more problematic than others. Financial stability is organised into three distinct functions: crisis prevention, mid-term resilience, and crisis management.[154] Crisis prevention includes regulation and supervision, mainly macroprudential policy. Mid-term resilience is also an objective of regulation and supervision, but it can extend to fiscal consolidation, recovery planning, and the strengthening of market finance as an alternative to banking finance. Crisis management concerns bank resolution, deposit insurance, burden-sharing, and financing assistance. While this classification reflects traditional views on financial stability, measures such as fiscal consolidation may be at odds with the non-economic utility of financial stability. In addition, the teleology explored above better supports wider reforms that contribute to the non-economic side of financial stability, such as equal pay rules in corporate governance and public investment initiatives.

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[152] Scherf (n 112), 167.

[153] The differences between an 'ordoliberal' and 'liberal' vision of the internal market are beyond the scope of this research.

[154] Lo Schiavo (n 4), 53.

Secondly, the main way through which policy can pursue the non-economic utility of financial stability is by actively seeking to minimise social costs. One of the criticisms of the Basel framework (the soft law model on which EU regulation and supervision are based) is that it follows a broad-brush, rules-based approach that generates many unwanted effects when transposed into hard law.[155] The best example is liquidity rules, which require institutions to set aside contingency funds that could be invested in society, and which can stifle liquidity as a result.[156] A further example is macroprudential policy, which encompasses many overlapping tools. This can lead to double-counting and the handicapping of core industries, such as the real estate sector. Consequently, the legitimacy of financial stability policy rests on how well negative effects on social development and social equality are prevented and managed—not merely on whether the next crisis is prevented.

Specifically, the goal of minimising social costs requires differentiation between social groups affected by policy. For example, using the prior example of the real estate sector, macroprudential policy must take into account disproportionate effects on first-time home buyers vis-à-vis privileged investors. Similarly, the bail-in tool can affect different classes of creditors and depositors. There are many ways through which policy can ensure adequate differentiation. For example, the EU's most recent banking package introduces a range of exceptions to Basel and utilises a principle of proportionality to alleviate the burden of financial stability on SMEs, which are instrumental in social development.[157] This goal is also linked to the institutional dimension, below.

Thirdly, the balancing of the economic and non-economic utility of financial stability is intrinsically connected to the question of 'throughputs'. Briefly, this refers to accountability,

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[155] An interesting dimension is the compatibility of Basel with non-western models, such as Islamic finance. See, Daniele D'Alvia, 'Risk, Uncertainty and the Market: A Rethinking of Islamic and Western Finance' [2020] 16(4) *International Journal of Law in Context* 1. Similarly, the EU has introduced many exceptions from Basel in CRR II/CRD V.

[156] Perotti and Suarez (n 40).

[157] See Chapter 4 on the use of proportionality in the CRR II/CRD V.

transparency, and inclusive governance.[158] On the institutional front, the EU's reliance on expert agencies to deliver financial stability may be inconsistent with the need to balance economic and non-economic objectives. This task is specifically reserved for the EU's political and judicial institutions, which operate within the cross-institutional system of accountability. The intergovernmentalism (international law) of EMU reforms may also be inconsistent with the non-economic utility of financial stability, to the extent that it reduces supranational throughputs. In this thesis, I focus on a rather underappreciated throughput: the role of the Court of Justice in defining the boundaries of policy and pursuing differentiation through the application of proportionality. Nevertheless, I recognise that the non-economic utility of financial stability ultimately requires *ex ante* political leadership and *ex post* political accountability.

It should be noted that there is a growing body of literature on the possible application of a 'precautionary principle' in financial stability. This principle was introduced in environmental and public health regulation to address inherent uncertainty, by enabling policy makers to consider the non-economic impacts of public action.[159] Broadly, it authorises pre-emptive measures, but imposes additional conditions such as continuous review to ensure their suitability over the long-term.[160] Thus, it can be seen as a way of operationalising non-economic utility. The EU law literature on this dimension remains limited, in part because the use of this principle in EU environmental and public health law is generally seen as ineffective.[161] While I consider the precautionary principle as incapable of

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[158] Vivien A Schmidt, 'Democracy and Legitimacy in the European Union Revisited: Input, Output and 'Throughput' [2013] 61(1) *Political Studies* 2.

[159] See Nicolas Treich, 'What Is the Economic Meaning of the Precautionary Principle?' [2001] 26(3) T*he Geneva Papers on Risk and Insurance* 334; David A Dana, 'A Behavioral Economic Defense of the Precautionary Principle' [2003] 97 *Northwestern University Law Review* 1315.

[160] See eg, *United Kingdom* v *Commission* (C-180/96) ECLI:EU:C:1998:192, paragraph 99; *Greenpeace* (C-6/99) ECLI:EU:C:2000:148, paragraph 44.

[161] The precautionary principle is described as an 'open invitation for arbitrary and unreasonable decisions by both regulators and judges' in Gary E Marchant and Kenneth L Mossman, *Arbitrary and Capricious: The Precautionary Principle in the European Union Courts* (Aei Press 2004) 65.

correcting the challenges of EU financial stability, especially the challenges outside of regulation, I briefly examine this proposal as part of the discussion on *ex post* review.

Finally, the ideological side of financial stability establishes substantive limits to market integration. In other words, it prescribes a particular vision of the internal market beyond economic functionalism. Financial stability reforms must be assessed against this backdrop; their legitimacy is informed by whether they are consistent with this ideological shift. The next chapter will delve deeper into the concept of legitimacy, as well as why legitimacy is a suitable theoretical angle.

2.5 Conclusion

This chapter has argued that a teleological interpretation of financial stability, that takes into account the ideological and non-economic dimensions, is necessary to evaluate its "output" legitimacy. At a basic level, financial stability represents the intensification of regulation and strengthening of macroprudential supervision, globally and in the EU. Consistently with this rationale, the mainstream literature identifies two of the key functions of financial stability: to counter the pro-cyclicality of the economy and to prevent or mitigate the build-up of systemic risk. Systemic risk concerns exogenous and endogenous threats to the financial system as a whole, which are capable of affecting the real economy. It was explained that these theories emphasise the economic side of financial stability and portray social development as a direct consequence of economic growth.

A further shift in the conceptualisation of financial stability revolves around the theory of 'public goods'. Contrary to the earlier belief that financial stability was likely to generate a moral hazard, the public goods theory explains that private actors have few incentives to pursue financial stability, which must instead by provided by public action. This supports the intensification of (macro)prudential regulation and supervision following the crisis, as well as the newfound independence of financial stability from monetary policy and the tasks of central banks. While the theory of public goods highlights the importance of public interference with the market, it also perpetuates a perception of financial stability as an economic commodity. This market-oriented rationale is incomplete because it overlooks important non-economic considerations.

These theories were widely emulated in Europe. Following the de Larosière report of 2009, the EU's supervisory architecture and prudential policy toolkit were overhauled to facilitate supranational financial stability. Further, owing to the escalating sovereign debt crisis in the euro area, the objective of financial stability was used to justify far-reaching reforms in fiscal policy, deposit-insurance, burden-sharing, as well as centralisation in the Banking Union. The EU law literature concedes that financial stability is an elusive yet transformative objective, however, there are significant gaps in the literature. First, there are very few holistic accounts of financial stability that bridge the gap between the regulatory and constitutional dimensions. Second, there is little emphasis on the non-economic teleology of the objective, and its relationship with other objectives of EU law.

The teleology used in this thesis focuses on the non-economic utility and ideological underpinnings of financial stability, as a means of defining the boundaries and evaluating the legitimacy of an otherwise elusive goal. The non-economic utility of financial stability describes the strong positive and negative relationship between this objective and social policy goals. As opposed to equating social development with economic performance, this approach assumes that financial stability entails significant social costs. For example, capital requirements can significantly restrict social welfare. On an operational level, the non-economic utility of financial stability requires a minimisation of social costs, through policy differentiation and appropriate 'throughputs'. I sought to demonstrate this approach overcomes the inherent uncertainty of the financial system, and provides a more comprehensive measure of "output" legitimacy.

The ideological side denotes that financial stability is potentially at odds with market integration, or a version of market integration that fails to move beyond economic functionalism. In particular, financial stability imposes significant limits to the principles of market equality and market freedom through various intrusive tools. While a strand of the literature considers financial stability as another form of 'permissive interventionism', in the narrower of this thesis, it is important to highlight this course correction away from laissez-faire policies in the financial market. This is another vital component of legitimacy, a concept explored in the next chapter.

Chapter 3: 'Output' legitimacy beyond performance

3.1 Introduction

There are many theoretical angles through analysis of financial stability can be conducted. One could focus on the relationship between EU law and international law in the context of financing assistance and fiscal reform, on shifts in the institutional balance of powers, administrative law perspectives, and more. My approach centres on the concept of legitimacy, which broadly refers to normative or empirical acceptance of the governing authority. This research is situated in a middle ground between Lo Schiavo's work on the normative instruments of financial stability and Tuori's emphasis on the 'mutation' of the Union's macroeconomic constitution.[1] The aim of this chapter is to explain why legitimacy is a suitable theoretical angle and to dispel misconceptions about the concept of 'output' legitimacy.

The main advantage of the concept of legitimacy is that it bridges the gap between the regulatory and constitutional dimensions of financial stability: it is broad enough to encompass issues of performance and effectiveness, democratic governance, the rule of law, and public accountability. Yet legitimacy is a tangible concept that can be linked to specific 'inputs', 'outputs', and 'throughputs'. Legitimacy is also a common theme in the literature on the financial crisis and a point of convergence for conflicting accounts of European integration. On the merits of legitimacy research, Bartolini notes:

'[…] the risk of miscalculating the extent to which true legitimacy surrounds the European institutions and their decisions ... may lead to the overestimating of the capacity of the EU to overcome major economic and security crises'.[2]

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[1] Gianni Lo Schiavo, *The Role of Financial Stability in EU Law and Policy* (Wolters Kluwer 2017); Kaarlo Tuori, *European Constitutionalism* (CUP 2015) 174-226.

[2] Stefano Bartolini, *Restructuring Europe: Centre Formation, System Building, and Political Structuring between the Nation State and the European Union* (OUP 2005) 175.

This thesis draws from the distinction between input and output legitimacy put forward by Fritz Scharpf to explain the unique features of European integration.[3] The input-output dichotomy captures the main tension around financial stability: technical policy objectives are primarily the responsibility of expert bodies that lack traditional mechanisms of democratic representation and participation (inputs). The legitimacy of such objectives is, therefore, derived from effectiveness or performance (outputs) and from appropriate process (throughputs). However, there are important misconceptions about outputs and throughputs, which can lead to policies that are normatively justified but which weaken legitimacy in the empirical sense.

Firstly, output legitimacy should not be reduced to functionalist (economic) performance. Scharpf's understanding of the concept is much broader: output legitimacy refers to a fundamental level of trust in the "project" of integration, as opposed to the material outputs of policy. Thus, output legitimacy cannot be completely separated from input legitimacy because representation and participation predetermine support in the decision-making process. In the context of financial stability, there will often be no 'causal' link between policy choices and policy outcomes, due to the inherent uncertainty and complexity of the financial sector.[4] To suggest that output legitimacy is synonymous with performance would imply that financial stability is legitimate simply because the financial system is not in collapse. My thesis challenges this reductive logic by looking at the broader, ideological and non-economic outcomes of financial stability.

Secondly, there is a misconception that throughputs are the sole means through which regulation, monetary policy, and other technical policy areas gain their legitimacy. Throughputs such as inclusiveness, accountability, and transparency are vital, and it is

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[3] Fritz W Scharpf, *Demokratietheorie zwischen Utopie und Anpassung* (Universitätsverlag Konstanz 1970); Fritz W Scharpf *Governing in Europe: Effective and Democratic?* (OUP 1999).

[4] Howell E Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' [2007] 24(2) *Yale Journal on Regulation* 253, 258.

sometimes necessary to discuss them separately to highlight governance issues in the EU.[5] However, there is a distinct threat of overestimating the role of efficient process in the context of financial stability, in line with a functionalist rationale that ignores the need to deliver appropriate (economic and non-economic) outcomes. Accordingly, this thesis considers throughputs as indissociable from the output dimension: throughputs are explored as part of the need to balance economic and non-economic utility. This chapter also underlines the importance of *ex post* accountability, which refers to a review of financial stability over the medium- and long-term.

The discussion is organised into three sections. Section 3.2 focuses on *why* legitimacy is a necessary theoretical angle, by reviewing the wider literature on constitutionalism and the financial crisis. Section 3.3 then distinguishes between normative and empirical legitimacy, and explores further the misconceptions about 'output' legitimacy. Section 3.4 concentrates on the connection between throughputs and outputs, specifically the unique role of *ex post* accountability in financial stability.

3.2 Europe's 'crisis of legitimacy': review of the literature on the financial crisis

The previous chapter looked at theories of financial stability before and after the financial crisis. It is also necessary to provide a review of the wider literature on the financial crisis to demonstrate why legitimacy is an appropriate theoretical angle for my thesis. This section will explain that conflicting strands of the European law literature converge on the issue of legitimacy as a major challenge. The literature also highlights a phenomenon, sometimes referred to as 'political messianism' or 'authoritarian managerialism', that is best understood through the lens of output legitimacy.[6]

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[5] Vivien A Schmidt, *Europe's Crisis of Legitimacy: Governing by Rules and Ruling by Numbers in the Eurozone* (OUP 2020) 25-55.

[6] Joseph H H Weiler, 'The Political and Legal Culture of European Integration: An Exploratory Essay' [2011] 9(3-4) *International Journal of Constitutional Law* 678; Christian Joerges, 'Constitutionalism and the Law of the European Community' in Mark Dawson, Henrik Enderlein and Christian Joerges (eds) *Beyond the Crisis: The Governance of Europe's Economic, Political, and Legal* Transformation (OUP 2015) 224-228.

For the purposes of clarity, this section borrows Tuori's classification of European constitutionalism into four schools: (i) administrative law, (ii) international law, (iii) federalism, (iv) transnational law.[7] While constitutionalism is not the focus of my thesis, and there are many accounts of European integration that elude this classification, Tuori's approach is helpful in organising a vast body of literature and emphasising differences in the way that authors approach legitimacy.

3.2.1 The administrative law perspective

The administrative or 'sub-constitutional' perspective,[8] whose most avid supporter is Peter L. Lindseth, approaches the issue of legitimacy from the premise that European governance has yet to cross the threshold of an autonomous constitutional order, irrespective of how the EU perceives itself.[9] This school utilises the language of administrative law to emphasise a principal-agent relationship between the Member States and the Union. Thus, the legal entrenchment of constitutional values at EU level follows a 'process of functional pre-commitment', whereby the agent institutions are assigned a scope of influence by the principal Member States.[10] The Treaties are seen as 'enabling legislation' in that they grant a degree of technocratic autonomy (not sovereignty) to the EU. It follows that legitimacy in this context ultimately rests on national political processes and national executive oversight.[11]

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[7] Tuori, *European Constitutionalism* (n 1) 1.

[8] The administrative law perspective in constitutionalism should be distinguished from the laws governing European administrative action. The origins of this perspective can be traced back to Giandomenico Majone, 'The European Community: An "Independent Fourth Branch of Government?"', in Gert Brüggemeier (ed), *Verfassungen für ein ziviles Europa* (Nomos 1994). For analysis of EU regulatory and administrative structures, and the 'administrative atmosphere' of integration, see, Mario Chiti, 'Forms of European Administrative Action' [2004] 68 *Law and Contemporary Problems* 37.

[9] *Cf.* Paul Craig, *UK, EU and Global Administrative Law: Foundations and Challenges* (CUP 2015) 410.

[10] Peter L Lindseth, 'The Perils of "As if" Constitutionalism' [2016] 22(5) *European Law Review* 696.

[11] Ibid; Peter L Lindseth, 'Transatlantic Functionalism: New Deal Models and European Integration' [2015] 2(1) *Critical Analysis of Law* 83. See also, Alexander Somek, 'Administration Without Sovereignty', in Peter Dobner and Martin Loughlin (eds) *The Twilight of Constitutionalism* (OUP 2010).

Moreover, this school considers that the use of constitutional language by legal elites threatens the legitimacy of the European project. This is because the constitutional narrative achieves a 'principal-agent inversion' ('as if' constitutionalism), which distorts the pre-commitment function and places national democratic processes under strict surveillance.[12] The link between supranational surveillance and financial stability is obvious: an example is the macroeconomic reforms that accompany financing assistance to Eurozone countries, which limit the role of national political processes in determining fiscal and other policies. Lindseth suggests that the expansion of the EU's competences restricts national political bodies' ability to generate (input) legitimacy, and as a result, these bodies cannot channel their legitimacy to the Union.[13]

In relation to the financial crisis, Lindseth argues that the crisis exposed the 'core contradiction of EU public law':

"National institutions are increasingly constrained in the exercise of their constitutional authority but supranational institutions cannot fill the void because they are unable to transition to genuine constitutionalism—that is the autonomous capacity to mobilise fiscal and human resources in a compulsory fashion".[14]

Overall, Lindseth believes that the crisis accentuated the subordination of national democracy to the sub-constitutional institutions of the EU.[15] This position implies that post-crisis reforms have done more to erode than to enhance input legitimacy in the form of representation and participation, establishing a system of 'regulatory discipline' at the expense of 'democratic and

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[12] Ibid, 'The Perils of "As if" Constitutionalism', 713-714.

[13] Ibid.

[14] Ibid, 701.

[15] This subordination is not the product of constitutional transformation, but of the 'hyper-intensification' of constitutional culture. This is specifically a response to Tuori's claim of sectoral constitutionalisation, which is conceptually tied to the role of financial stability in transforming the macroeconomic constitution of the Union. An analogy can be drawn between Lindseth's point and what Grimm describes as 'over-constitutionalisation', see, Dieter Grimm, 'The Democratic Costs of Constitutionalisation: The European Case' [2015] 21(4) *European Law Journal* 460.

constitutional solidarity'.[16] In connection to the present research, the administrative perspective would imply that supranational financial stability measures are illegitimate insofar as they contribute to a principal-agent inversion between the Member States and the EU. An analogy can also be drawn between 'regulatory discipline' and a functionalist interpretation of output legitimacy as economic performance; both concepts allude to the misconception that financial stability policy is legitimate solely because of the urgency of the crisis.

3.2.2 The international law perspective

The international law perspective warrants special attention, both as a waning orthodoxy of European integration, and due to the ubiquity of international law agreements during the sovereign debt crisis in the EMU.[17] Historically, international law has been instrumental in conceptualising the European Union as a complex legal order with constitutional characteristics.[18] These characteristics, however, are construed as operating within a quasi-contractual framework established by sovereign states. The peculiar institutional architecture of the EU is a by-product of advanced international law, not a *sui generis* or federal phenomenon.[19]

Similarly to the administrative perspective, this school considers legitimacy a product of national political processes. Treaty amendment is a good example: so long as the power of amendment is limited by national constitutional requirements and subject to ratification, the EU cannot be said to possess a constitution in the full sense of the word.[20] The Member States are seen as the democratic force from which legitimacy is derived, even though there

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[16] Lindseth, 'The Perils of "As if" Constitutionalism' (n 10), 701. Far from causing a 'democratic deficit', in the sense of flawed institutional design, this indicates a 'democratic disconnect': a more systemic decoupling of regulatory power and legitimacy. See generally, Peter L Lindseth, *Power and Legitimacy: Reconciling Europe and the Nation-State* (OUP 2010).

[17] For an overview of the international law perspective, see Bruno de Witte, 'The European Union as an International Legal Experiment' in *Gráinne de Búrca* and Joseph H H Weiler (eds) *The Worlds of European Constitutionalism* (CUP 2012).

[18] Ibid, 51. As de Witte describes it, a 'constitutional mode of operation'.

[19] Ibid.

[20] See, eg, Grimm (n 15).

can be doubts as to whether they represent a *pouvoir constituant* in a collective sense.[21] Tying legitimacy to the (international law) consent of the Member States significantly raises the bar on what can be classified as a constitutional "mutation" in context of the financial stability reforms.

I wish to highlight two insights of Bruno de Witte in relation to the crisis. First, de Witte suggests that financial stability measures reflect political reality—not political expediency. In other words, the intergovernmentalism observed during the crisis is a pragmatic and genuine attempt to reconcile the inevitable reform of the EMU with the existing framework of the EU Treaties.[22] This corresponds with the position of the Court of Justice.[23] While the crisis may have brought about changes in institutional practice, and perhaps even a temporary lapse in the rule of law, de Witte rejects the argument that EMU reforms indicate a systemic and deliberate erosion of the constitutional integrity of the EU.[24]

Second, developments which may seem unfair in the loose sense, such as macro-economic changes forced upon states which received financial assistance, do not amount to inequality in the constitutional sense.[25] These are merely a reflection of the allocation of political power in the EU.[26] At any rate, agreements entered by Member States *inter se* were ratified by

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[21] Ibid.

[22] Bruno de Witte, 'Euro Crisis Responses and the EU Legal Order: Increased Institutional Variation or Constitutional Mutation?' [2015] 11(3) *European Law Review* 434.

[23] Implicit in the emphasis on financial stability as a higher objective of economic and monetary policy; *Pringle* (C-370/12) ECLI:EU:C:2012:756.

[24] See also, Alberto de Gregorio Merino, 'Legal Developments in the Economic and Monetary Union During the Debt Crisis: The Mechanisms of Financial Assistance' [2012] 49(5) *Common Market Law Review* 1613, 1635-1640. *Cf.* Claire Kilpatrick, 'On the *Rule of Law* and Economic Emergency: The Degradation of Basic Legal Values in Europe's Bailouts' [2015] 35(2) *Oxford Journal of Legal Studies* 325.

[25] *Cf.* Federico Fabbrini, *European Governance in Europe: Comparative Paradoxes and Constitutional Challenges* (OUP 2016) 33.

[26] de Witte, 'Euro Crisis Responses and the EU Legal Order: Increased Institutional Variation or Constitutional Mutation?' (n 22) 451.

national parliaments.[27] In summary, de Witte's view is that the Union's response to the crisis may be inadequate, but it does not constitute an illegal transformation of the EU's constitution. Although the focus of this school is on constitutionality, de Witte's analysis denotes a normative understanding of legitimacy, derived from the wishes of the Member States. However, this conclusion does not exclude the possibility that financial stability measures may be inadequate, which would threaten legitimacy in an empirical sense.

3.2.3 The federalist perspective

Federalism is especially relevant to the discussion on financial stability, as the general spirit of federalism permeates regulation and supervision.[28] Sadly, it is often reduced to its most basic interpretation, which assigns all of Europe's woes to its decentralised institutional architecture.[29] While the link between federalism and centralisation goes a long way back,[30] the dichotomy between centralisation and decentralisation is inconsistent with federalism; as James Madison put it, federalism is 'unprecedented … it is what it is'.[31] Accordingly, analysis of output legitimacy in the context of financial stability must extend beyond the relative strengths of harmonisation/centralisation vis-à-vis decentralisation.

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[27] For a critical analysis of ratification, see, Nikos Skoutaris, 'On Sovereign Debt Crisis and Sovereignty: A Constitutional Law Perspective on the Greek Crisis', paper presented at the EU Democracy Observatory (EUDO) Dissemination Conference on 'The Euro Crisis and the State of European Democracy', Florence, 22 November 2012.

[28] See, eg, Kern Alexander, 'European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism' [2015] 40(2) *ELR* 154.

[29] Koen Lenaerts, 'EU Federalism in 3-D' in Cloots et al (eds.) *Federalism in the European Union* (Hart 2012) 14.

[30] Alexander Hamilton, *The Federalist No.9*, 'A firm Union will be of the utmost moment to the peace and liberty of the States, as a barrier against domestic faction and insurrection'; James Madison, *The Federalist No.10*, 'The smaller the society, the fewer probably will be the distinct parties and interests composing it […] the more easily will they concert and execute their plans of oppression. Extend the sphere, and you take in a greater variety of parties and interests; you make it less probable that a majority of the whole will have a common motive to invade the rights of other citizens […]'.

[31] On the conceptual weakness of this dichotomy, see, Albert Breton, 'Federalism and Decentralization: Ownership Rights and the Superiority of Federalism' [2000] 30(2) *Publius* 1.

Federalism is better understood as a balancing of the principles of 'unity' and 'diversity'.[32] The federal constitution plays a twofold role of preserving individual political communities whilst also fostering a common identity, from which legitimacy is ultimately derived.[33] In Europe, this manifests in a model of 'cooperative' (as opposed to 'dual') federalism, whereby competences are shared between the Member States and the EU and the institutional structure is layered, not separate.[34] This theory can explain some of the institutional innovations of financial stability (such as the Banking Union), which other schools consider detrimental to legitimacy. It should also be noted that European federalism is characterised by both functionalism and constitutionalism. The journey from Rome to Maastricht followed the route of sectorial and differentiated integration, but Maastricht represents a turning point towards strategies of federal polity-building, of which the EMU was the 'centrepiece'.[35] From this perspective, legitimacy is derived from policies that contribute to federal polity-building, and is threatened by policies that perpetuate a functionalist paradigm.

Unsurprisingly, the literature on the financial crisis focuses on the fiscal dimension, as fiscal capacity is a fundamental characteristic of the federal state.[36] Hinarejos notes that the Maastricht economic regime of fiscal discipline failed to anticipate structural inequality and

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[32] Pierre Pescatore, 'Preface' in Terrance Sandalow and Eric Stein (eds) *Courts and Free Markets:* Perspectives from the United States and Europe (Clarendon Press 1982); Lenaerts (n 29).

[33] See, eg, Habermas' concept of 'originally shared popular sovereignty', Jürgen Habermas, The Crisis of the European Union: A Response (Polity Press 2012) 37 – 39. The federal citizen is in many ways what Held describes as a 'cosmopolitan' citizen, who engages with many communities and has access to different forms of political participation. This implies a fluid concept of legitimacy, David Held, *Democracy and the Global Order: From the Modern State to Cosmopolitan Governance* (Polity Press 1995) 272.

[34] Tanja A Börzel and Madeleine O Hosli, 'Brussels between Bern and Berlin: Comparative Federalism Meets the European Union' [2003] 16(2) *Governance* 179, 188. On the evolving structure of European law, see, Robert Schütze, *From Dual to Cooperative Federalism: The Changing Structure of European Law* (OUP 2009).

[35] Michael Burgess, 'Federalism and Building the European Union' [1996] 26(4) *Publius* 1, 14.

[36] There is also a strong link between fiscal federalism, financial markets and risk-sharing. The Capital Markets Union project can be seen as an example. Sérgio Coimbra Henriques, 'The Role of the Capital Markets Union: Towards Regulatory Harmonisation and Supervisory Convergence' [2018] 10(1) *Perspectives on Federalism* 103, 111.

asymmetric shocks.[37] A federal approach was taken to remedy this failure,[38] which is implicit in the current surveillance model, under which Member States retain their fiscal powers but the EU is an enforcer of budgetary discipline. Hinarejos' main argument is that this model is unsustainable in the long term, because it poses the same challenge to national autonomy and national democratic processes as a classic federal model would, without benefiting from the effectiveness (financial stability) and the constitutional safeguards of the latter.[39] This position is consistent with the hypothesis that output legitimacy looks beyond economic necessity or the urgency of the crisis, because policy can generate unwanted externalities.

Other authors consider that the response to the crisis follows a federal direction,[40] which is nonetheless timid,[41] and may generate more challenges in the future.[42] The most important challenge is that of 'post-democratic executive federalism', a concept specifically used to

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[37] Alicia Hinarejos, 'Fiscal Federalism in the European Union: Evolution and Future Choices for EMU' [2013] 50(6) *CMLR* 1621, 1624-1626.

[38] Ibid. Hinarejos notes that sovereignty and fiscal discipline are better served by adhering to a strict policy of no bailouts, at 1628.

[39] Ibid, 1640. Fabbrini also highlights the paradox of Member States rejecting federalism yet entering into arrangements which 'sacrific[e] state sovereignty much more than would have been permitted in a federal system', Federico Fabbrini, 'The Fiscal Compact, the "Golden Rule," and the Paradox of European Federalism' [2013] 36(1) *Boston College International & Comparative Law Rev* 1, 37.

[40] Mark Hallerberg, 'Fiscal Federalism Reforms in the European Union and the Greek Crisis' [2011] 12(1) *European Union Politics* 127.

[41] For example, not embracing the principles of fiscal federalism may generate structural inequalities, Nikolaos Zahariadis, 'The Politics of Risk-sharing: Fiscal Federalism and the Greek Debt Crisis' [2013] 35(3) *Journal of European Integration* 271, 283.

[42] Challenges include: judicial enforcement of fiscal rules (soft federalism) without a robust administrative apparatus, Daniel R Kelemen, 'Law, Fiscal Federalism, and Austerity' [2015] 22(2) *Indiana Journal of Global Legal Studies* 379, 391-398; 'adversarial legalism', Daniel R Kelemen, Eurolegalism: The Transformation of Law and Regulation in the European Union (Harvard University Press 2011) 27; Capacity to tax and consistency with market integration goal, Miguel Poiares Maduro, 'A New Governance for the European Union and the Euro: Democracy and Justice' [2013] 16 *Yearbook of Polish European Studies* 111; Tension with the economics of federalism, Roger Van den Bergh, 'Farewell Utopia?: Why the European Union Should Take the Economics of Federalism Seriously' [2016] 23(6) *Maastricht Journal of European and Comparative Law* 937.

challenge the notion that legitimacy amounts to functionalist performance. Boriello and Crespy describe it as a form of coercive federalism:[43]

'The competences transferred to the EU level, in the name of the functional imperative, remain under the tight control of national governments while the role of EU institutions is limited to one of technocratic watch dog of common discipline. This model implies the abandonment of the ideal of "transnational democracy" (Habermas) or "democratic federalism" (Crum) whereby democratic procedures and practices largely shift towards EU institutions'.[44]

3.2.4 The pluralist/transnational law perspective

The final category is a residual one, encompassing a range of perspectives which adopt a transnational outlook on European integration[45] The distinguishing factor of transnational law is the subordination of the concept of statehood to that of emergent commonality—be it functional, or value oriented. This commonality shapes the legitimacy of a transnational community, as distinguished from the administrative or international law perspectives that interpret legitimacy as the product of national political processes.

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[43] See, John Kincaid, 'From Cooperative to Coercive Federalism' [1990] 509(1) *Annals of the American Academy of Political Science* 139. While Kincaid uses this term to describe American federalism, there are obvious analogies, for example, between 'federal intrusion' compensated by fiscal assistance and strict conditionality in the EMU.

[44] Arthur Boriello and Amandine Crespy, 'How to not speak the "F-word": Federalism Between Mirage and Imperative in the Euro Crisis' [2015] 54 *Journal of European Political Research* 502, 519-520. See, Habermas (n 33), 12-53; Ben Crum, 'Saving the Euro at the Cost of Democracy? [2013] 51(4) *Journal of Common Market Studies* 614.

[45] 'Transnational' denotes the formation of societies across borders, the rules that govern these societies are shaped by common economic or social interests outside the confines of the national legal system. See, Peer C Zumbansen, 'Transnational Law: Theories & Applications' [2020] TLI Think! Paper 15/20 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3601385> accessed 01 July 2020.

One of the dominant schools in EU law is that of constitutional pluralism. Its origins can be traced back to Neil MacCormick's 'Beyond the Sovereign State',[46] and the legacy of *Maastricht-Urteil* of the German Constitutional Court.[47] In summary, pluralism assumes the heterarchy and separate integrity of the constitutional orders of the EU and the Member States, as well as their inevitable clash over a shared space.[48] Many subsets of pluralism have emerged over the years. Weiler's 'substantive pluralism' (or 'constitutional tolerance') recognises heterarchical constitutional inputs, but also advocates the entrenchment of values, such as fundamental rights, at a meta level.[49] Walker, adopts a softer ('epistemic') model influenced by international law reciprocity between constitutional orders.[50] Others prefer the term 'plurality', which better describes the sectorisation of the EU constitution as well as the horizontal dynamic between multiple national constitutions.[51] It is important to distinguish between these perspectives, because the manner in which they approach legitimacy in the context of the financial crisis ranges from cautiously optimistic to deeply sceptical.

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[46] Neil MacCormick, 'Beyond the Sovereign State' [1993] 56(1) *Modern Law Review* 1. On the role of national constitutional Courts, see Martin Loughlin, 'Constitutional Pluralism: An Oxymoron?' [2014] 111(1) *Global Constitutionalism* 9.

[47] BverfG, 89, 155 [1993]. *Inter alia*, the GCC upheld the constitutionality of the Maastricht Treaty but declared EU acts subject to review and not legally binding in Germany if found to breach the division of competences. See, Miguel Poiares Maduro, 'Three Claims of Constitutional Pluralism' in Jan *Komárek* and Matej Avbelj (eds) *Constitutional Pluralism in the European Union and Beyond* (Hart 2012) 69-70.

[48] Maduro explains pluralism with reference to musical method and the 'harmonizing different melodies that are not in a hierarchical relationship', Miguel Poiares Maduro, 'Europe and the Constitution: What If this is as Good as it Gets?' in Joseph H H Weiler and Marlene Wind (eds) *European Constitutionalism Beyond the State* (CUP 2003) 98; See also, Julio Baquero Cruz, 'The Legacy of the Maastricht-Urteil and the Pluralist Movement' [2007] 14(4) *European Law Journal* 389; Neil Walker, 'Reconciling MacCormick: Constitutional Pluralism and the Unity of Practical Reason' [2011] 24(4) *Ratio Juris* 369.

[49] In many ways, this can be seen as a rejection of constitutional pluralism. Joseph H H Weiler, 'In Defence of the Status Quo: Europe's Constitutional Sonderweg' in Weiler and Wind (n 48), 10.

[50] Neil Walker, 'The Idea of Constitutional Pluralism' [2008] 65(3) *MLR* 317.

[51] According to Tuori, while pluralism focuses on the co-existence of the European and national constitutions, plurality is concerned with sectoral constitutions at the European level (economic, social, political, legal), Kaarlo Tuori, 'The Many Constitutions of Europe' in Kaarlo Tuori and Suvi Sankari (eds) *The Many Constitutions of Europe* (Ashgate 2010) 3.

Those on the optimistic spectrum defend pluralism as a theory and are critical of the 'autarchic' stance of various constitutional courts during the crisis.[52] Maduro acknowledges a cognitive dissonance between the EU and its peoples, which can be linked to an input legitimacy deficit, but remains hopeful that a 'new equilibrium' between supranational governance and national political legitimacy ('exit' and 'voice') is attainable.[53] Cautious optimism is sometimes accompanied by warnings of 'eurosclerosis' and calls for bolder integration initiatives in the EMU.[54]

On the more sceptical side, Tuori sees a clear mutation of the macro-economic constitution of the Union founded on 'parasitic legitimacy'. Parasitic legitimacy describes the 'sheer legitimating force' of constitutional language invoked during the crisis, which enables a culture of 'de-politicisation'.[55] This is specifically used to describe the consecration of financial stability in constitutional terms by the ECJ, which provides normative legitimacy to unprecedented reforms, but acts as in a 'parasitic' way in that it exhausts empirical legitimacy. Further, Tuori draws a comparison between the classic argument of a *gouvernement des juges* (judicial activism/jurocracy) in the context of free movement law, and a *gouvernement des experts* (technocracy) in relation to economic and monetary policy.[56]

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[52] This criticism is aimed at the use of national constitutional principles in a discretionary fashion, by the Portuguese and other constitutional courts. This is seen as an obstacle for social protection and the effectiveness of EU law overall. Miguel Poiares Maduro, Leonardo Pierdominici and *António Frada*, 'A Crisis between Crises: Placing the Portuguese Constitutional Jurisprudence of Crisis in Context' [2017] 4(1) *e-Pública* 43 <https://www.e-publica.pt/volumes/v4n1a02.html> accessed 01 July 2020; For a defence of constitutional pluralism, see, Leonardo Pierdominici, 'The Theory of EU Constitutional Pluralism: A Crisis in Crisis' [2017] 9(2) *Perspectives on Federalism* 121, 136-144.

[53] Miguel Poiares Maduro, 'Europe Transformed. Exit, Voice … and Loyalty?' in Miguel Poiares Maduro and Marlene Wind (eds) *The Transformation of Europe: Twenty-Five Years On* (CUP 2017) 329.

[54] László Andor, George Papaconstantinou and Miguel Poiares Maduro, 'Fiscal Rules and Fiscal Capacity: Breaking the Political Gridlock' [2019] STG Policy Brieds 2019/09 <https://cadmus.eui.eu/handle/1814/65605> accessed 01 July 2020.

[55] Tuori, *European Constitutionalism* (n 1) esp. at 13, 36, 220.

[56] Ibid, 217.

Other authors go even further. Joerges is exceedingly critical of 'authoritarian managerialism' in the EMU, and the post-constitutional transformation of Europe.[57] Majone, whose position was that the Union's democratic deficit had been grossly exaggerated, now talks of a 'democratic default'.[58] The implications for financial stability are summarised by Scharpf, who argues that EMU reforms lack democratic inputs, therefore, EU institutions essentially 'gamble' their legitimacy on being able to deliver results.[59] At the same time, Scharpf indicates that performance alone may not be able to overcome the absence of democratic inputs.[60]

Finally, Weiler treads a middle path between optimism and scepticism, emphasising the chronic nature of the crisis. He conceptualises regulatory and institutional failure in the EMU as a failure of 'political messianism', which attributes the EU's legitimacy problems to an enduring 'political deficit' at the heart of integration.[61] Weiler's political messianism is presented as a third form of legitimacy, but at the core of this argument is the distinction between normative and empirical legitimacy (or 'social' legitimacy, as Weiler calls it).

3.2.5 Further comment

To varying degree, all schools acknowledge constitutional change which can be tied directly or indirectly to the objective of financial stability in EU law. With the exception of the

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[57] It should be noted that Joerges adopts a conflicts-law perspective, as opposed to constitutional pluralism. Christian Joerges, 'Constitutionalism and the Law of the European Community' in Mark Dawson, Henrik Enderlein and Christian Joerges (eds.) *Beyond the Crisis: The Governance of Europe's Economic, Political, and Legal* Transformation (OUP 2015) 224-228.

[58] Giandomenico Majone, 'From Regulatory State to a Democratic Default' [2015] 52(6) *JCMS* 1216.

[59] Fritz W Scharpf, 'Monetary Union, Fiscal Crisis and the Disabling of Democratic Accountability' in Armin Schäfer and Wolfgang Streeck (eds) *Politics in the Age of Austerity* (Polity Press 2014) 140.

[60] Ibid.

[61] Weiler, 'The Political and Legal Culture of European Integration: An Exploratory Essay' (n 6); Martinsen also argues that in our focus on the role of the CJEU we are 'disregarding the more complex interplay of law and politics', Dorte Sindbjerg Martinsen, *An Ever More Powerful Court? The Political Constraints of Legal Integration in the European Union* (OUP 2015) 3-4.

international law perspective, the literature doubts the legitimacy of such change and identifies an intriguing phenomenon. Tuori describes this phenomenon as 'parasitic legitimacy'; Maduro, as 'cognitive dissonance' between the EU and its peoples; Lindseth explains it as a 'democratic disconnect'. Federalist authors use the term 'post-democratic executive federalism', while others refer to 'political messianism', 'managerialism', '*gouvernment des experts*'.

I propose that this phenomenon is not exceptional or new to European integration: it describes how policy areas that lack traditional 'inputs' draw their legitimacy from 'outputs', consistently with Scharpf's theorisation. Generally, this discussion can be linked to a long-running debate in political philosophy on the sources of legitimacy. There are two conflicting views: that legitimacy implies the *consent* of the governed, or that legitimacy flows from the beneficial *consequences* of policy.[62] Therefore, the review of the literature on the financial crisis indicates that output legitimacy is a suitable theoretical angle for evaluating financial stability reforms. I also focus on output legitimacy as a more "neutral" concept, not linked to a particular school of constitutionalism. The next section will delve deeper into the distinction between normative and empirical legitimacy, and what constitutes appropriate "outputs" in the context of financial stability.

Final note can be made of Schmidt's 'throughput' legitimacy, which represents a novel reconceptualisation of Europe's crisis of legitimacy. Schmidt's work was not covered in this section because throughput legitimacy is key to the teleology of financial stability and deserves separate attention.

3.3 Defining 'output' legitimacy: normative and empirical sources of legitimacy

Having demonstrated that various schools of European legal thought converge on the issue of legitimacy as the main challenge emerging from the financial crisis, and that some of these accounts describe a phenomenon that is conceptually linked to 'output' legitimacy, this section will elaborate on this concept. Legitimacy can mean different things and is derived

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[62] *Infra*, (n71).

from a range of sources. The discussion will trace the roots of this concept in political philosophy to distinguish between normative and empirical sources of legitimacy. I will then turn to Scharpf's distinction between 'input' and 'output' legitimacy, with view to dispelling misconceptions about the latter.

The main objective of this section is to demonstrate that output legitimacy is not simply a question of functionalist performance: financial stability policy can generate many outputs (externalities), some of which are detrimental to the legitimacy of EU law. Accordingly, this dissertation proposes that output legitimacy requires an alignment of policy and the broader teleology of financial stability, explored in Chapter 2. This teleology refers to a balancing of the economic and non-economic utility of financial stability and compliance with an ideological shift away from laissez-faire capitalism.

3.3.1 Normative vs. empirical: the sources of legitimacy in European governance

The starting point is to distinguish between normative and empirical sources of legitimacy, as this distinction is key to redefining output legitimacy. According to Max Weber, legitimacy is a 'belief', by virtue of which the persons exercising authority derive the right to do so.[63] Weber uses the term 'Legitimitätsglaube' to describe a 'belief in legitimacy', a level of faith in the political system. This is not a necessary element of 'Herrschaft', which roughly translates into 'authority', because many regimes exercise power through coercion.[64] Weber considers three sources of legitimacy: tradition, charisma, and legality/rationality.[65] In sum, legitimate authority can be derived from continuity with accepted customs, acceptance of individual political figures, and efficient decision-making within the broad rationality of the rule of law.[66]

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[63] Max Weber and Talcott Parsons (ed), *The Theory of Social and Economic Organization* (Free Press 1964) 382. *Cf.* David Beetham, 'Max Weber and the Legitimacy of the Modern State' [1991] 13(1) *Analyse & Kritik* 34.

[64] Ibid, 124 & 158.

[65] Ibid, 382.

[66] Weber's 'rational legal authority' describes rules being enacted and enforced consistently with other rules on how they must be enacted and enforced. Similarly, Hobbes ties legitimacy to legality and the rule of law; Thomas Hobbes, *Leviathan* (J M Dent 1914) 140.

Weber does not consider representation and participation to be superior to these sources. His approach is labelled as 'empirical' in that it describes verifiable elements of legitimacy; it does not prescribe 'normative' criteria. Conversely, a strand of the scholarship treats legitimacy as synonymous with democratic representation.[67] As Rousseau puts it, no coercive regime can maintain authority unless 'force has been transformed into right and obedience into duty'.[68] Another influential account of legitimacy is given by Pettitt, who argues that a state can be legitimate in the general sense 'and yet not succeed in furthering the cause of social justice very well'.[69] According to this strand of political philosophy, executive power can be legitimate despite its policies being misconceived, ineffective, or generally lacking public support.[70] This would seem to indicate that EU financial stability policy is legitimate irrespective of performance. However, it should be emphasised that Rousseau and Pettitt's 'normative' perspective is grounded in the democratic attributes of the nation-state, which may not translate to EU financial stability.

The above alludes to a long-running debate between deontology and utilitarian ethics, which separates the sources of legitimacy into *consent* and *consequence* based. The former assumes a social contract between the governing and the governed (normative), the latter follows the notion that authority is legitimate when it performs well in the interest of the governed

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[67] Robert Dahl, *Democracy and Its Critics* (Yale University Press 1989) 204.

[68] Jean-Jaques Rousseau, *The Social Contract* (Wordsworth Edition 1998) Chapter 3. Locke also offers a similar view, that a legitimate state is one that has acquired 'the executive power of the law of nature' and exercises violence or force only in accordance with that power; John Locke, *Second Treatise on Government* (1690) <www.earlymoderntexts.com/assets/pdfs/locke1689a.pdf> accessed 14 October 2021.See also, B Sharon Byrd and Joachim Hruschka, *Kant's Doctrine of Right* (CUP 2010), 52-58.

[69] Philip Pettit, 'Chapter 3: Political Legitimacy' in *On The People's Terms: A Republican Theory and Model of Democracy* (CUP 2012) 130.

[70] In addition to the above, many societal forces that are unique to their environment impact on legitimacy. For instance, religion and ethnic identity can be seen as possible elements of legitimacy. Broader considerations, such as international recognition of a regime, also shape how it is perceived.

(empirical).[71] This classification is challenged by global/transnational governance and the history of European integration. David Held argues that the emergence of cosmopolitan democracy and a global civil society fundamentally alter the legitimacy discourse: as the nation-state has begun to 'wither away', so must statist perspectives on legitimacy.[72] In his view, there is no 'common global pool of memories', thus, legitimacy must be interpreted as plurality in unprecedented form. [73] It follows that both normative and empirical sources of legitimacy in the context of global governance extend beyond the issue of democratic representation and can take many forms.

For instance, Habermas describes global and transnational human rights and social justice—not democratic representation—as a source of legitimacy in the international setting.[74] Yet he recognises that supranationalism may never meet the standards ('civic solidarity') of the nation-state.[75] This approach combines Weber's empirical perspective and Rousseau's normative approach. Others approach democratic participation as an empirical concept: Dahl explains that legitimacy diminishes with size, as supranational institutions offer fewer opportunities for citizen participation.[76] An even more diluted perspective is the 'neofunctionalist', which posits that EU law is the arena of 'industrialists, bankers, traders'—

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[71] Consent is epitomised by Rawl's statement, 'our exercise of political power is fully proper only when it is exercised in accordance with a constitution the essentials of which all citizens as free and equal may reasonably be expected to endorse in the light of principles and ideals acceptable to their common human reason', in John Rawls, *Political Liberalism* (Columbia University Press 1996) 137. Conversely, Bentham considers that 'the right and proper end of government in every political community is the greatest happiness of all the individuals of which it is composed', in Jeremy Bentham and Philip Schofield (ed), *First Principles Preparatory to Constitutional Code* (OUP 1989) 232.

[72] David Held (n 33), 233.

[73] Ibid, 125.

[74] Jürgen Habermas, Ciaran P Cronin and Pablo de Greiff (eds) *The Inclusion of the Other* (MIT 1998) 183.

[75] 'Even a world-wide consensus on human rights could not serve as the basis for a strong equivalent to the civic solidarity that emerged in the framework of the nation-state', in Jürgen Habermas and Max Pensky (ed), *The Postnational Constellation* (MIT 2001) 108.

[76] Robert Dahl, 'Can International Organizations be Democratic? A Skeptic's View', in *Democracy's Edges* (CUP 1999) 20-22.

a political and legal elite. The implication here is that EU law fails to appreciate the needs of the ordinary citizen in both a normative and empirical sense.[77]

In conclusion, the emergence of global governance dissociates normative legitimacy from statist perceptions of democratic representation.[78] This indicates that legitimacy can be derived in the normative sense from the necessity of supranational action. As a response to global market forces beyond the control of the nation state, EU financial stability clearly enjoys normative support. However, this is not conclusive: global governance also entails a complex interplay (plurality) between normative and empirical factors. Hence, a key premise of this thesis is that 'output legitimacy' should not focus exclusively on the normative dimension; financial stability policy is not legitimate solely because of the urgency of the crisis.

3.3.2 Scharpf's input and output legitimacy

The review of the literature in section 3.2 revealed that there are many terms used to describe the core dilemma of financial stability: as an expert policy field, financial stability will inevitably lack democratic inputs compared to other areas of European integration. The literature's search for new ways to describe this phenomenon can be attributed in part to a flawed understanding of output legitimacy, which only focuses on the material outputs of policy.[79] This functionalist understanding of output legitimacy as economic performance is not entirely consistent with Scharpf's theorisation of input and output legitimacy.

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[77] See Thomas Banchoff and Mitchell P Smith, *Legitimacy and the European Union: the Contested Polity* (Routledge 1999) 5.

[78] Ibid.

[79] For example, Weiler refers to 'political messianism' as a third type of legitimacy. In essence, messianism tackles the political teleology of European integration, as opposed to its effectiveness, but both dimensions can be explained with reference to output legitimacy. '[…] the justification for action and its mobilising force derive not from "process", as in classical democracy, or from "result and success", but from the ideal pursued, the destiny to be achieved, the "Promised Land" waiting at the end of the road. Indeed, in messianic visions the end always trumps the means' in Joseph H H Weiler, 'In the Face of Crisis: Input Legitimacy, Output Legitimacy and the Political Messianism of European Integration' [2012] 34(7) *Journal of European Integration* 825, 832.

Scharpf proposed a distinction between legitimacy 'inputs' and legitimacy 'outputs' to explain the unique features of supranational governance. The terminology is borrowed from Easton's input-output analysis of political models, and it signifies a trade-off between democratic representation/participation and effective policy outcomes in the EU.[80]

Input legitimacy refers to government '*of the people*' and '*by the people*', which alludes to notions of representative and participatory democracy.[81] This echoes Hobbesian/Rousseauian consent, but 'inputs' are not strictly normative; they can be empirically proven. Schmidt defines input legitimacy in the following terms:

'Input legitimacy represents the exercise of collective self-government so as to ensure government responsiveness to people's preferences, as shaped through political debate in a common public space and political competition in institutions that ensure political officials' accountability via general elections.[82]

The most straightforward example of input legitimacy is the direct representation of citizens in the European Parliament, but this concept could also encompass indirect avenues of participation, such as the subsidiarity tasks of national parliaments.[83] It is widely acknowledged that input legitimacy has been a weak point of European integration.[84] Financial stability is a

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[80] According to Easton, outputs are not the terminal point as they create feedback which informs inputs. David Easton, 'An Approach to the Analysis of Political Systems' [1957] 9(3) *World Politics* 383.

[81] *Supra*, (n 3).

[82] Schmidt, *Europe's Crisis of Legitimacy* (n 5), 31.

[83] Subsidiarity acts as the 'link' between the input and output dimensions by allowing national parliaments to regulate the allocation of decision-making power, Karolina Borońska-Hryniewiecka, 'Legitimacy Through Subsidiarity? The Parliamentary Control of EU Policy-Making' [2013] 1(1) *Polish Political Science Review* 73, 75.

[84] This can be linked to the 'democratic deficit' debate, the leadership role of the CJEU and negative integration through the case law on free movement. It is also due to conflicting visions of European 'government', European 'elections', European 'people'. Scharpf, *Governing in Europe: Effective and Democratic?* (n 3), Chapter 2; See also, Andreas Follesdal and Simon Hix, 'Why There is a Democratic Deficit in the EU: A Response to Majone and Moravcsik' [2006] 44(3) *JCMS* 533; Justin Greenwood, 'Organized Civil Society and Input Legitimacy in

prime example. Firstly, this is an area of shared competences between the Member States and the EU, thus, there are layers of "inputs" that often contradict each other.[85] Secondly, financial stability requires expert knowledge, technical agility, and operational independence—the conventional view is that the role of political institutions is marginal.[86] Policy makers must remain insulated from political pressures to perform their tasks effectively and efficiently. It could reasonably be inferred that the fewer the inputs, the more legitimate a technocratic body is. However, this proposition ignores the significant overlap between input and output legitimacy: democratic inputs predetermine how citizens perceive the outputs of policy.[87]

Output legitimacy describes the production of outcomes that meet the needs of society, or government '*for the people*'. While it can be construed in utilitarian terms as consequence-based legitimacy, Scharpf's formulation is not purely concerned with performance. Firstly, Scharpf refers to individual actors having a proven track record of effective policy formation and implementation, as opposed to the material outputs of policy *per se*.[88] Secondly, output legitimacy requires an inherent level of trust in the democratic and social attributes of the

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the EU' in Joan DeBardeleben and Achim Hurrelmann (eds), *Democratic Dilemmas of Multilevel Governance: Legitimacy, Representation and Accountability in the European Union* (Springer 2007).

[85] An example is banking supervision, which seeks to balance financial stability with credit availability and competitiveness, across a structurally diverse landscape where Member States assign fundamentally different functions to each objective. The lack of structural and political commonality is a major obstacle to democratic participation. On structural variation, see Gundberg Scherf, *Financial Stability Policy in the Euro Zone* (Springer Gabler 2013), Chapter 3.

[86] Marc Quintyn and Michael W Taylor, 'Regulatory and Supervisory Independence and Financial Stability' (IMF Working Paper WP/02/46, 2002) < www.imf.org/external/pubs/ft/wp/2002/wp0246.pdf> accessed 25 February 2021.

[87] Scharpf considers the input and output dimensions as a dual challenge, democratic legitimacy presupposes effective governing and problem-solving capacity. *Cf.* Michael Andrea Strebel, Daniel Kübler and Frank Marcinkowski, 'The Importance of Input and Output Legitimacy in Democratic Governance: Evidence from a Population-Based Survey Experiment in Four West European Countries' [2018] 58(2) *European Journal of Political Research* 488.

[88] Fritz W Scharpf, 'Legitimacy Intermediation in the Multilevel European Polity and Its Collapse in the Euro Crisis' in Klaus Armingeon (ed) *Staatstätigkeiten, Parteien und Demokratie*. (Springer 2013) 569-579.

decision-making process; it is not a *carte blanche* in areas lacking traditional inputs.[89] It follows that output legitimacy is more akin to support in a "project", as opposed to functionalist performance. Schmidt defines output legitimacy as follows:

'Output legitimacy describes acceptance of the coercive powers of government so long as their exercise is seen to serve the common good of the polity and is constrained by the norms of the community'.[90]

A possible example of output legitimacy is the unconventional tactics of the ECB during the crisis, which can be justified on grounds of protecting price stability during a dire phase of the crisis.[91] Scharpf considers this an example of *failed* output legitimacy, because the effectiveness of policy action is compromised by the lack of democratic inputs in the EMU.[92] Even so, unlike theories such as Tuori's 'parasitic legitimacy' or Joerges' 'authoritarian managerialism', Scharpf's output legitimacy is not exceptional; it is an integral feature of European integration. This conclusion is supported by prior analysis on the novelty of global governance, and the many (normative and empirical) sources of legitimacy in the EU. Therefore, output legitimacy is an appropriate concept for analysing financial stability reforms, provided that it is not treated as synonymous with performance.

3.3.3 Output legitimacy and the teleology of financial stability

My thesis considers that the teleology of financial stability outlined in Chapter 2 is crucial in determining the success or failure of output legitimacy, for the following reasons. First, Scharpf's conceptualisation of output legitimacy extends beyond performance in the functionalist sense. Scharpf does not explain output legitimacy in relation to material outputs,

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[89] Ibid. Scharpf invokes concepts such as trusteeship to describe output legitimacy: policy makers must exercise their mandates as 'trustees' of the common interest of the community, which Scharpf correlates to a robust welfare system and social policy.

[90] Schmidt, *Europe's Crisis of Legitimacy* (n 5), 31.

[91] *Gauweiler* (C-62/14) ECLI:EU:C:2015:400, paragraphs 47-50. For a more nuanced analysis of *Gauweiler* and output legitimacy, see, Fritz W Scharpf, 'De-Constitutionalization and Majority Rule: A Democratic Vision for Europe' [2016] MPIfG Discussion Paper 16/14 <https://www.econstor.eu/bitstream/10419/149130/1/876222955.pdf> accessed 01 July 2020.

[92] Ibid.

but as a pre-existing level of trust in either individual actors or the political system as a whole to deliver appropriate outcomes. An example is what Scharpf describes as the 'manifest failure' of output legitimacy in the EMU, which identifies the 'technocratic-authoritarian' governance of the ECB as a distinct threat to both output and input legitimacy—the two are interconnected.[93] Beyond the interplay between inputs and outputs, the inference that can be drawn from Scharpf's work is that output legitimacy should consider the broad outcomes of policy. To interpret financial stability policy as legitimate because it contributes to financial stability implies that there are no conceivable limits to technocratic decision-making.

Second, the normative legitimacy of financial stability is not in doubt; the key question is whether financial stability improves the legitimacy of EU law in an empirical sense. Performance is inadequate in capturing the empirical dimension, because even if the next crisis is prevented, financial stability policy can generate many externalities that impact negatively on legitimacy. Scharpf uses the example of austerity measures during the crisis to highlight an 'output' which is likely to cause the opposite of intended effect on output legitimacy.[94] This argument finds support in the wider literature, for example, Weiler considers that certain policies have 'normative legitimacy' in that they promote universally accepted goals (the example given is 'peace and prosperity'), but do not necessarily enhance 'social legitimacy', understood as empirically proven support from the public.[95] As such, the teleology of financial stability provides a better tool for measuring empirical legitimacy.

Thirdly, a teleological approach is necessary due to the unique attributes of financial stability. Even though scientific models of quantifying policy success have advanced significantly in the last decade,[96] financial stability remains an elusive target, as the mainstream literature

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[93] Scharpf, 'Legitimacy Intermediation in the Multilevel European Polity and Its Collapse in the Euro Crisis' (n 88).

[94] Ibid, 24-25.

[95] Weiler, 'In the Face of Crisis (n 79), 826-827.

[96] See eg, Piergiorgio Alessandri *et al*, 'Towards a Framework for Quantifying Systemic Stability' [2009] 5 *International Journal of Central Banking* 47, 53-68.

concedes.[97] In any event, qualitative and quantitative measurements are not easily visible to the ordinary citizen; financial stability belongs in the realm of 'quiet' politics.[98] This challenge can also be traced back to the inherent uncertainty and complexity of the financial sector. In sharp contrast with monetary policy, financial stability lacks a clear metric, such as inflation.[99] Further distinguishing factors include the overlap between the preventive and management sides of financial stability, differentiated integration in the euro area, and international law agreements that sit outside the scope of EU law altogether. These indicate that there will often be no causality between policy reforms and actual performance in the context of financial stability.[100]

Accordingly, the success or failure of output legitimacy depends on whether financial stability policy is aligned with the teleology of financial stability. As explored in Chapter 2, this teleology includes an ideological shift away from laissez-faire capitalism. Prior to the crisis, public intervention with the market was perceived as a potential moral hazard; financial stability was primarily seen as an *ex post facto* objective to be pursued through monetary policy tools.[101] The rise of financial stability as a standalone objective of EU law signifies the intensification of regulation and supervision, and more generally, a

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[97] This issue is explored in Chapter 2.

[98] Scherf (n 85), 53; Pepper D Culpepper, *Quiet Politics and Business Power: Corporate Control in Europe and Japan* (CUP 2011).

[99] Scherf, ibid, 16-17. The goal of price stability can be measured, for example, by identifying price changes and calculating the rate of inflation. In addition, the European Central Bank exercises exclusive competences over monetary policy. Itts legitimacy can be reconciled with a statist model whereby performance is the main criterion of legitimacy because the democratic attributes of the system are not in question.

[100] See eg, Yakov Ben-Haim and Maria Demertzis, 'Decision Making in Times of Knightian Uncertainty: An Info-Gap Perspective' (Economic E-Journal Vol 10, 2016) 4 <www.economics-ejournal.org/dataset/PDFs/journalarticles_2016-23.pdf> accessed 1 November 2020.

[101] Commonly known as the 'Jackson Hole consensus', this approach considers that central banks should only interfere with the market after a bubble had burst and began affecting inflation. It also assumes that central banks are capable of correcting financial imbalances through monetary policy, with very limited *ex ante* regulation and supervision.

subordination of the principles of market freedom and market access.[102] Consequently, policy reforms adopted on the basis of financial stability must coincide with this ideological shift to be considered legitimate. Indeed, there are many reforms that comply with this ideology. At the most basic level, macroprudential policy tools entail significant compliance and other costs, and these exemplify a system-wide interference with the free market.

More importantly, the legitimacy of financial stability is determined by both economic and non-economic outputs. An area often overlooked by the literature is the centrality of the financial sector in modern society: financial stability can either enable, or significantly restrict social development and other non-economic goals of European integration. This is because financial stability measures, such as minimum capital requirements for banks, can generate immense social costs. For example, credit availability—a precondition for public investment and many other social policy initiatives—fluctuates with the intensity of prudential requirements. This dimension is vital to the success or failure of output legitimacy. Measures which fail to minimise the potentially catastrophic effect of financial stability on social policy cannot be deemed legitimate merely on the basis that they contribute to economic policy goals. Overall, output legitimacy must look beyond the fallacy that the "market will provide" non-economic outcomes.

A final consideration is 'throughput' legitimacy, which I associate with the non-economic utility of financial stability. To explain, 'throughputs' can be seen as a vital subset of output legitimacy because the end goal of balancing the economic and non-economic sides of financial stability presupposes accountable, inclusive, and transparent process. The following section will delve deeper into throughput legitimacy and the role of *ex post* review in financial stability.

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[102] *Cf.* Michelle Everson, 'Banking on Union: EU Governance Between Risk and Uncertainty' in Mark Dawson, Henrik Enderlein and Christian Joerges (eds) *Beyond the Crisis The Governance of Europe's Economic, Political and Legal Transformation* (OUP 2015).

3.4 Throughput legitimacy and *ex post* accountability

This chapter has so far attempted to explain why legitimacy is an appropriate theoretical angle for my thesis, and to dispel the misconception that technical policy fields derive 'output' legitimacy from performance alone. The hypothesis that legitimacy should consider the ideology and non-economic utility of financial stability is incomplete without analysis of a pertinent concept: Schmidt's throughput legitimacy. Throughput legitimacy concerns process and it is presented as a separate source of legitimacy to underline challenges in European governance, but more accurately, it should be understood as an indispensable part of input and output legitimacy.[103]

This section argues that throughput legitimacy is intrinsically connected to the teleology of financial stability and the goal of minimising social costs. Specifically, I highlight the link between throughputs and the *ex post* side of financial stability, which refers to the review of policy over the long-term. With reference to unique challenges in this area of law, such as the inherent uncertainty of the financial system and structural variation across the EU, I demonstrate that *ex post* accountability is one of the most critical operational components of the teleology of financial stability.

3.4.1 The concept of throughput legitimacy

Throughput legitimacy is a concept that has gained prominence since the financial crisis. This can be explained by the many crises the European Union has faced in the post-Lisbon era, which have brought about drastic changes supranational governance. While process and accountability have always been part of the theorisation of legitimacy, reference to 'throughputs' as separate from 'inputs' and 'outputs' is necessary to shed light on contemporary challenges in the EU.

Vivien A Schmidt describes throughput legitimacy as a 'systems concept', capable of spotlighting elements of input/output legitimacy that are 'notionally situated in a neglected

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[103] For a perspective that considers throughputs as part of input legitimacy, see Weiler, 'In the Face of Crisis' (n 79). Generally, the boundaries of the concept will vary depending on the context in which it is discussed.

"black box" of governance'.[104] In contrast to government *of the people* and *by the people* (input legitimacy), and government *for the people* (output legitimacy), throughput legitimacy refers to 'government *with the people*'. This is a type of efficacious governance through processes that are accountable, transparent, inclusive, and open to interest intermediation.[105] It is also worth noting the link between throughput legitimacy and constitutional pluralism: both draw from theories of associative and deliberative democracy and seek to correct the flaws of representative democracy.[106] As such, throughput legitimacy is a concept specifically designed to address unique elements of global/transnational governance.

Schmidt distinguishes between four subcategories of throughput legitimacy. The first is efficacy, or 'streamlined operations', which refers to simple, efficient, and modernised systems.[107] This dimension is capable of alleviating some of the input deficits of European governance: for example, the use of qualified majority voting in the Council under Art 114 TFEU, which has served as the basis for many financial stability reforms, can be seen as a more efficacious route than unanimity voting (eg, under Art 352 TFEU).[108] The second criterion is accountability, which is crucial in the context of financial stability. Accountability encapsulates many issues, from *ex ante* control of expert bodies through a narrowly defined mandate, to supranational political scrutiny, judicial review, the subsidiarity role of national parliaments. It can also refer to cross-accountability between executive bodies, and to public accountability through elections and media coverage.

The third element of throughput legitimacy is transparency, the 'Siamese twin' of accountability.[109] Transparency broadly refers to access to information that enables

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[104] Schmidt, *Europe's Crisis of Legitimacy* (n 5), 31. Vivien A Schmidt, 'Democracy and Legitimacy in the European Union Revisited: Input, Output and 'Throughput' [2013] 61(1) *Political Studies* 2.

[105] Ibid, *Europe's Crisis of Legitimacy*, 34.

[106] Ibid.

[107] Ibid, 40.

[108] Ibid, 41-42. Of course, this lowers the threshold for authorisation of executive power, which is a potential threat to input legitimacy. This is a good example of the overlap between input and throughput legitimacy.

[109] Christopher Hood, 'Accountability and Transparency' [2010] 33(5) *West European Politics* 989.

accountability, especially through public dialogue.[110] Financial stability exemplifies one of the major shortcomings of transparency: while steps have been taken to provide the public with more information on capital requirements and other financial stability tools, it is unclear if the public can derive useful information from complex financial models to exercise control of policy.[111] Finally, the fourth element of throughput legitimacy is inclusiveness, or openness. This refers to a willingness to engage with all stakeholders to ensure that inputs come out of the decision-making process as 'uncorrupted outputs'.[112]

It can be inferred from the above that throughput legitimacy is very important to the discussion on EU financial stability. Indeed, many of the challenges identified by Scharpf as part of a 'manifest failure' of output legitimacy specifically pertain to accountability, transparency, inclusiveness.[113] It should also be highlighted that, despite Schmidt's starting premise that throughput legitimacy is neglected, most accounts of financial stability centre on governance and process. For example, Lo Schiavo's definition of financial stability revolves around the normative instruments of this objective, which implies that process is just as important as actual performance.[114] Similarly, Keller approaches the ESRB with a focus on accountability, transparency, and internal governance.[115] Much of the work on European

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[110] Maarten Hillenbrandt, Deirdre Curtin and Albert Meijer, 'Transparency in the Council of Ministers of the EU: An Institutional Approach' [2014] 20(1) *European Law Journal* 1.

[111] An example is the introduction of the SA-CR, a new method for calculation of liabilities in banking regulation. While it is generally seen to improve transparency by providing an objective and uniform test, its complexity makes it difficult to evaluate.

[112] Sandra Kröger, 'How Limited Representativeness Limits Throughput Legitimacy in the EU: the Example of the EU' [2019] 97(4) *Public Administration* 770. Kröger gives the example of environmental and anti-poverty groups as stakeholders who are underrepresented in the EU process.

[113] Schmidt, *Europe's Crisis of Legitimacy* (n 5), 14-17. On the link between process and input/output legitimacy, see Scharpf, 'Legitimacy Intermediation in the Multilevel European Polity and Its Collapse in the Euro Crisis' (n 88).

[114] Lo Schiavo (n 1) 53. Lo Schiavo notes that in defining financial stability we should focus on the normative instruments for its attainment. The process is, in a way, more important than the outcome.

[115] Anat Keller, 'Independence, Accountability and Transparency: Are the Conventional Accountability Mechanisms Suitable for the European Systemic Risk Board?' [2017] 28(5) *International Company and Commercial Law Review* 176.

Supervisory Authorities (ESAs) and the Banking Union highlights issues of political scrutiny and independence.[116] Therefore, the task of balancing the economic and non-economic sides of financial stability is connected to the throughput dimension.

However, this dissertation considers throughput legitimacy as a subset of output legitimacy, for two reasons. First, there is an excessive focus on governance and process in the literature of financial stability. The danger of this approach is that it perpetuates a functionalist narrative that equates legitimacy with efficient process, underemphasising the non-economic and ideological dimension. As Schmidt puts it, '[h]igh quality throughput cannot compensate for either bad policy output or minimal input participation'.[117] Accordingly, to avoid the conceptual pitfalls of a functionalist approach, it is important to consider throughputs as one of many factors that shape output legitimacy. Second, this thesis uses a broad definition of output legitimacy as a level of trust in the decision-making process, as opposed to actual performance. This interpretation of output legitimacy encompasses many of Schmidt's concerns in relation to throughput legitimacy.

Specifically, I consider throughputs as the best analytical tool to evaluate the *ex post* side of financial stability. To explain, the task of balancing the economic and non-economic utility of policy concerns both the *ex ante* stage of adopting financial stability measures, as well as the *ex post* phase of reviewing and adjusting policy over the long-term. Throughputs are relevant to both scenarios, but in light of the challenges addressed below, *ex post* political and judicial accountability acquire a special significance.

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[116] See Chapter 5.

[117] Schmidt, *Europe's Crisis of Legitimacy* (n 5), 38. See also, Jens Steffek, 'The Limits of Proceduralism: Critical Remarks on the Rise of "Throughput Legitimacy"' [2019] 97(4) *Public Administration* 784.

3.4.2 *Ex post* accountability: a critical component of financial stability policy

In the EU's complex legitimacy structure, accountability is important in every policy area.[118] This includes cross-institutional oversight, for example, the European Parliament exercising political scrutiny of the Commission, as well as judicial review, and other checks and balances. As Schmidt and other authors suggest, accountability determines the boundaries of executive power, and it ensures that policy complies with the rule of law and other key tenets of EU law. In the context of financial stability, *ex post* accountability is especially relevant to the goal of balancing economic and non-economic utility. On a conceptual level, the literature associates *ex post* accountability with the notion of risk—risk can only be managed over the long run.[119] On a practical level, the following challenges make *ex post* accountability one of the one ways to minimise the social costs of policy with view to enhancing output legitimacy.

'True' uncertainty in the financial system

One of the biggest challenges of financial stability is the inherent uncertainty and complexity of the financial system, briefly introduced in the previous chapter. It is difficult to evaluate output legitimacy purely in reference to the *ex ante* stage, because the financial system is an incredibly unpredictable environment—a 'network of promises'.[120] The complex interaction of a myriad of irrational actors on a global and interconnected scale becomes a 'channel for the transmission of contagion',[121] and generates cognitive biases affecting policy makers.[122]

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[118] An important discussion in the literature is on the accountability of the ECB, see eg, Larisa Dragomir, 'The ECB's Accountability: Adjusting Accountability Arrangements to the ECB's Evolving Roles' [2019] 26(1) *Maastricht Journal of European and Comparative Law* 35.

[119] See eg, Monique MH Pollmann, Jan Potters and Stefan T Trautmann, 'Risk Taking by Agents: The Role of Ex-Ante and Ex-Post Accountability' [2014] 123(3) *Economic Letters* 387.

[120] See Eric J Pan, 'Understanding Financial Regulation' (Cardozo Legal Studies Research Paper No 329, 2011) <papers.ssrn.com/sol3/papers.cfm?abstract_id=1805018> accessed 1 November 2020.

[121] Dan Awery, 'Complexity, Innovation and the Regulation of Modern Financial Markets' [2012] 2(2) *Harvard Business Law Review* 235, 275.

[122] An example of (hindsight) bias is the possibility of subjecting policy responses to 'overly specific lessons' learnt from a fat tail event. Baruch Fischhoff, 'For Those Condemned to Study the Past: Heuristics and Biases in

This alludes to the work of Knight and Keynes on the distinction between risk and uncertainty. In the 1920s, Knight distinguished between quantifiable 'risk' and 'true uncertainty', the latter is presently 'not susceptible to measurement' due to insufficient scientific knowledge.[123] In other words, financial stability policy will always entail a level of ignorance of underlying processes, relationships, strategies, or other variables.[124] In this setting, *ex post* accountability is necessary because policy makers start with models that may be relevant but 'cannot identify the likelihood with which they describe the economy'.[125]

Keynes' approach is more ontological, in that uncertainty is not seen as a temporal challenge. He suggests that for some matters 'there no scientific basis on which to form any calculable probability whatever'; some things 'we simply do not know'.[126] Keynes specifically describes the economy as a nonergodic stochastic process: a process affected by random, non-statistical variables which cannot be standardised through scientific advancement.[127] On the premise that 'the economic environment is not homogeneous over a period of time',[128] a Post-Keynesian school considers that corrective public action will always generate new 'unknown unknowns'.[129] Consequently, *ex post* accountability of financial stability is essential because every policy choice creates new ripple effects in the financial sector that make outcomes even more unpredictable.

Hindsight' in Daniel Kahneman, Paul Slovic and Amos Trevsky, *Judgment under Uncertainty* (CUP 1982), 335-354.

[123] Frank H Knight, *Risk, Uncertainty, and Profit* (Hart Schaffner Marx 1921).

[124] Ibid, 218.

[125] Yakov Ben-Haim and Maria Demertzis, 'Decision Making in Times of Knightian Uncertainty: An Info-Gap Perspective' (Economic E-Journal Vol 10, 2016) 4 <www.economics-ejournal.org/dataset/PDFs/journalarticles_2016-23.pdf> accessed 1 November 2020.

[126] John M Keynes, 'The General Theory of Employment' [1937] 51 *Quarterly Journal of Economics* 209, 213-214.

[127] See Paul Davidson, 'A Rejoinder to O'Donnell's critique of the Ergodic/nonergodic Explanation of Keynes's Concept of Uncertainty' [2015] 38(1) *Journal of Post Keynesian Economics* 1.

[128] John M Keynes, 'Professor Timbergen's Method' [1939] 49 *Economic Journal* 558.

[129] Sheila Dow, 'Addressing Uncertainty in Economic and in the Economy' [2015] 39(1) *Journal of Economics* 33, 38.

Note can be made of Minsky's financial instability hypothesis. Minsky considers that 'business cycles and financial crises are unchanging attributes of capitalism'.[130] The distinguishing factor of this (Post-Keynesian) approach is that it assumes that the financial system is constantly developing disequilibria until even the smallest shock can cause total collapse.[131] This feature of capitalism defies epistemology because the source of instability is the gradual evolution of financial fragility, as opposed to extreme events.[132] It follows that it will always be difficult to predict the next crisis and the social harm it could inflict.[133] Relevant to output legitimacy, the goal of balancing the economic and non-economic sides of financial stability needs to match the continual build-up of vulnerability over the medium- and long-term.

Cost-benefit analysis of financial stability measures

Ex post scrutiny is vital in pursuing the non-economic side of financial stability because of the use of 'cost-benefit' methods at the *ex ante* stage. In broad terms, a cost-benefit approach requires regulators to ascertain 'whether the benefits of regulation justify the costs of regulation'.[134] It amounts to a weighing of tools' potential benefits against their negative

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[130] However, Minsky was hopeful that its effects could be mitigated because 'the actual path an economy traverses depends upon institutions, usages, and policies', Hyman P Minksy, *Stabilizing and Unstable Economy* (Yale University Press 1986) 174-175.

[131] See Fernando J Cardim de Carvalho, 'Systemic Crisis, Systemic Risk and the Financial Instability Hypothesis' in Eckhart Hein, Torsten Niechoj and Engelbert Stockhammer (eds), *Macroeconomic Policies on Shaky Foundations – Wither Mainstream Economics?* (Metropolis 2009).

[132] For an attempt to develop measurement standards, see Alessandri *et al* (n 96), 53-68.

[133] Raghuram G Rajan, 'Has Financial Development Made the World Riskier?' (NBER Working Paper No w11728, 2006) <papers.ssrn.com/sol3/papers.cfm?abstract_id=842464> accessed 2 November 2020. This echoes Minsky's work, see eg Hyman P Minsky, *Can "It" Happen Again?: Essays on Instability and Finance* (ME Sharp, 1982).

[134] Cass R Sunstein, 'The Cost-Benefit State' (Coase-Sandor Institute for Law & Economics Working Paper No. 39, 1996) <chicagounbound.uchicago.edu/cgi/viewcontent.cgi?referer=https://www.google.co.uk/&httpsredir=1&article=1497&context=law_and_economics> accessed 16 November 2020.

side-effects and prioritising instruments which are expected to have the highest net benefits.[135] While cost-benefit analysis is not mandatory, it is recommended by the European Systemic Risk Board as a 'practicable approach' for calculating the effects of macroprudential policy.[136] As such, it is the *de facto* method for deploying financial stability tools in the EU.

The use of cost-benefit analysis conveys the utilitarian logic of maximizing expected value.[137] Some authors describe it as a 'reductive' economic explanation which gives the illusion of scientific method, because regulation impacts society in ways that elude statistical valuation.[138] Indeed, some outputs of financial stability (such as social equality) have 'value' but no 'price'.[139] There is an obvious danger of misjudging the potential social costs of policy using cost-benefit analysis, and this approach can also diminish the intensity of regulation. As Huang states, policy makers are susceptible to 'bias towards […] variables which can be objectively measured and verified'.[140]

This thesis does not examine cost-benefit analysis further because this approach specifically concerns prudential regulation and supervision, whereas EU financial stability extends to

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[135] European Systemic Risk Board, 'Handbook on Operationalising Macro-prudential Policy in the Banking Sector' (2014) 17 <www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf?ac426900762d505b12c3ae8a225a8fe5> accessed 05 December 2020.

[136] Ibid.

[137] See eg, Lowry Rosemarie and Martin Peterson, 'Cost-benefit Analysis and Non-utilitarian Ethics' [2011] 11(3) *Politics, Philosophy & Economics* 258.

[138] Kevin T Jackson, 'The Scandal Beneath the Financial Crisis: Getting a View from a Moral-cultural Mental Model [2010] 33(2) *Harvard Journal of Law and Public Policy* 735, 738.

[139] Lisa Heinzerling and Frank Ackerman, 'Pricing the Priceless: Cost-Benefit Analysis of Environmental Protection' [2002] 150(5) *University of Pennsylvania Law Review* 1553, 1558-1564.

[140] Peter H Huang, 'Emotional Impact Analysis in Financial Regulation: Going Beyond Cost-Benefit Analysis' (Temple University Legal Studies, Research Paper No 21, 2006) <papers.ssrn.com/sol3/papers.cfm?abstract_id=870453> accessed 10 November 2020. See also, Paolo Angelini, Stefano Neri and Fabio Panetta, 'The Interaction Between Capital Requirements and Monetary Policy' [2014] 46(6) *Journal of Money, Credit and Banking* 1073.

many other areas.[141] Nevertheless, the discussion on cost-benefit analysis exemplifies the need for *ex post* review of policy to overcome regulatory bias and minimise social costs.

Structural variation and political capture

A further challenge in financial stability is explored by Gundbert Scherf.[142] Scherf's argues that there is a trilemma between financial stability, credit availability, and competitiveness. These objectives entail trade-offs, which are magnified by structural variation in the EU and public and private pressures. *Ex post* accountability acquires a special role in EU financial stability because of these challenges.

In relation to political (or regulatory) capture, Scherf notes that politicians do not agree on the definition of financial stability—let alone on the coordination of policy.[143] To add to that, the payoff structure of regulation is susceptible to political short-termism: its costs accrue now, while the benefits materialise much later.[144] Thus, the political landscape makes variation in outcomes an inevitable feature of financial stability. This is because of the sheer range of interests that shape policy: regulators face public pressures to protect the interests of depositors and taxpayers, as well as private pressures from bank shareholders, debtors, and creditors.[145] This phenomenon is especially prominent in the euro area because Member States cannot use monetary policy to appease stakeholders.[146] Empirical evidence also reveals significant asymmetries between the North-South and East-West.[147] In connection to the ECB, Scherf notes that it is the most independent bank in the world, yet it is not immune to national politics.[148]

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[141] On the connection between cost-benefit analysis and the precautionary principle, see Chapter 7.

[142] For a similar perspective in a comparative context, see Alison Lui, Financial Stability and Prudential Regulation: A Comparative Approach to the UK, US, Canada. Australia and Germany (Routledge 2017).

[143] Scherf (n 85), 3.

[144] See also, Keller (n 115).

[145] Scherf (n 85), 56-59.

[146] Ibid, 107-120, 190-198.

[147] Ibid, 158.

[148] Ibid, 61-68. Scherf is also critical of comitology and mutual recognition.

In terms of structural variation, not only do national authorities enjoy discretion in relation to specific policy tools, but their mandates vary considerably.[149] The operational structure of financial stability is determined by a bias towards objectives that complicate the regulatory trilemma even further.[150] For example, the US regulatory system favours the arm's length principle, which according to Scherf favours financial stability and competitiveness over credit availability. By comparison, a system oriented towards self-regulation (such as the UK) will prioritise credit access and competitiveness over financial stability. Therefore, the "output" of financial stability policy will vary according to the mandate, structure, and independence of national authorities. This makes the throughput dimension critical; Scherf's emphasis on the contested politics of financial stability also indicates that accountability should extend beyond political accountability, to other safeguards such as judicial review.[151]

Other challenges in EU law

In addition to the above, brief reference can be made to wider challenges in financial stability. One of the functions of *ex post* accountability is to balance financial stability with other objectives of EU law, such as market integration and price stability. While these are consistent in principle, financial stability can clash with other political objectives. For example, the *Pringle* interpretation of financial stability as a 'higher' objective indicates a subordination of price stability in the EMU.[152] Accordingly, *ex ante* and *ex post* accountability are necessary in light of the transformative potential of financial stability, which affects other core areas of integration.

Finally, the importance of throughputs is emphasised by the many institutional innovations and compromises associated with financial stability. The best example is the Banking Union: not only does this introduce a novel model for supervision and resolution in the euro area, but main components of this system are missing and may never be completed (such as EDIS).

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[149] Ibid, Chapter 3. On power concentration, see Lui (n 142), 185.

[150] Ibid, 120-130. The CRR/CRD encompasses these objectives to some extent.

[151] Scherf proposes the solution of a 'regulatory union'. At present, this seems untenable, politically and legally.

[152] *Supra* (n 55).

This incomplete institutional structure makes the balancing of the economic and non-economic sides of financial stability especially difficult, which is further complicated by the creation of various agencies that sit outside the EU's traditional accountability structure.[153] Indeed, the need for a robust system of accountability is exemplified by the fragmentation of financial stability across various dimensions: vertical (EU vs. Member States), horizontal (internal market vs. euro area), substantive (regulation vs. other policies).[154]

In conclusion, the output legitimacy of financial stability rests on whether policy is aligned with the teleology of financial stability explored in Chapter 2. This section has argued that 'throughputs', and especially *ex post* accountability, are essential in minimising the social costs of policy and generally pursuing the teleology of financial stability.

3.5 Conclusion

This chapter sought to explain why legitimacy is an appropriate theoretical angle for this thesis, to dispel misconceptions around output legitimacy, and to highlight the importance of throughputs and *ex post* accountability in financial stability. The overall conclusion is that many of the challenges addressed by the literature on the financial crisis can be associated with a functionalist interpretation of output legitimacy as performance; in reality, output legitimacy is a much more fluid concept which cannot be dissociated from the input and throughput side.

The first section explored various strands of European constitutionalism to demonstrate that conflicting schools of thought converge on the issue of legitimacy as the main challenge of the financial crisis. With the exception of the international law perspective, which centres on the narrow issue of intergovernmentalism, the majority of the literature identifies a peculiar

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[153] See generally, Michelle Everson, 'European Agencies: Barely Legal?' in Michelle Everson, Cosimo Monda and Ellen Vos (eds) *EU Agencies In Between Institutions and Member States* (Wolters Kluwer 2014). This is discussed further in Chapter 5.

[154] On wider institutional issues, see Larisa Dragomir, *European Prudential Banking Regulation and Supervision* (Routledge 2010) 164.

phenomenon in the EU's response to the crisis. Many terms are used to describe this phenomenon, including 'principal-agent inversion', 'political messianism', '*gouvernement des experts*', 'post-democratic executive federalism', 'managerialism'. It was proposed that output legitimacy is a more accurate and neutral way of conceptualising this challenge.

Accordingly, I challenge the misconception that supranational action enjoys output legitimacy so long as it delivers financial stability. The distinction between input and output legitimacy is derived from Scharpf's work: it describes a trade-off between the democratic inputs of participation and representation, and policy effectiveness. Yet Scharpf approaches output legitimacy as a fundamental level of trust that the system will perform correctly, as opposed to focusing on the material outputs of policy *per se*.[155] This can also be explained with reference to the complex system of normative and empirical sources of legitimacy in European governance. While financial stability enjoys normative legitimacy, for example as a reaction to the financial crisis, policy may generate externalities that weaken legitimacy in an empirical sense.

The interpretation of output legitimacy in this chapter is intrinsically linked with the teleology of financial stability presented in the previous chapter. The task of improving trust in the decision-making process ultimately requires policy to pursue a certain ideology, which in the case of financial stability refers to a shift away from laissez-faire liberalism. In addition, output legitimacy should not prioritise the economic side of financial stability over the non-economic dimension. Absent an effort to minimise the social costs of policy, normatively justified measures are likely to weaken the output legitimacy of EU law.

The final section examined throughput legitimacy and *ex post* accountability. While the literature looks at throughput legitimacy as a separate concept, questions of governance, process, and accountability are indissociable from output legitimacy. In particular, Scharpf considers weak accountability in the EMU as a cause of the 'manifest failure' of output

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[155] For example, outputs are discussed in the context of social welfare, as opposed to performance in the purely economic sense.

legitimacy in European integration. In the context of this thesis, throughput legitimacy is seen as an operational element of the teleology of financial stability: for example, balancing the economic and non-economic utility of financial stability requires a robust system of accountability, transparency, and other throughputs.

Specifically, the most critical throughput in this field is *ex post* accountability. This refers to the ongoing review of policy over the medium- and long-term, through political, judicial, and public scrutiny. The significance of the *ex post* dimension flows from unique challenges in financial stability policy. One of these challenges is the inherent uncertainty and complexity of the financial sector: public action generates new 'unknown unknowns', thus, *ex post* accountability is necessary to minimise unwanted effects. Further, EU financial stability is characterised by structural variation and political/regulatory capture, which complicates the task of minimising social costs and other elements of the teleology of financial stability. I return to the critical role of *ex post* accountability in Chapter 7, which delves deeper into judicial review as a possible solution to the legitimacy challenges identified in this thesis.

Chapter 4: Prudential and resolution policy tools in the CRR II/CRD V and BRRD II

4.1 Introduction

This chapter examines the key financial stability tools in EU law: prudential policy tools, deposit insurance schemes, bank recovery and resolution rules. At this stage, I will not look at developments exclusive to the euro area, namely the Banking Union, the Fiscal Compact, and financing assistance. The aim of this chapter is to apply the teleology explored in Chapter 2 to substantive prudential and resolution policy tools. I argue that recent amendments align policy with the ideological and non-economic attributes of financial stability, therefore, the regulatory dimension enhances the output legitimacy of EU law. Some challenges remain, especially in macroprudential policy, but the positives outweigh the negatives in this area.

The de Larosière report of 2009 was instrumental in launching the reform of EU financial regulation. The report identifies macroprudential policy as the primary means of operationalising financial stability, but more policies were included in the EU's 'Single Rulebook'—a term introduced by the Commission to describe a harmonised prudential regime derived from Basel.[1] This regime is intended to cover the financial market as a whole, for example, it encompasses ambitious initiatives such as the Capital Markets Union. However, the majority of these rules focus on banking, which at the time of the crisis made up 90-95% of the European financial market.[2] Owing to the EU's vulnerability to banking

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[1] The Basel Committee of Banking Supervision is an international forum and the main standard setter in prudential banking supervision. It operates through soft law instruments aimed at 'strengthen[ing] the regulation and supervision of banks worldwide with the purpose of enhancing financial stability'.

[2] See eg, Anthony Annet *et al*, 'Euro Area Policies: Selected Issues' (IMF Country Report, No 5/266, 2005) <www.imf.org/external/pubs/ft/scr/2005/cr05266.pdf> accessed 06 December 2020; European Savings and Retail Banking Group, 'Financial systems in Europe and the United States: Structural Differences Where Banks Remain the Main Source of Finance for Companies' (ESRBG Studies, May 2016) 4-5 <www.wsbi-esbg.org/SiteCollectionDocuments/EU-US.study.ESBG%20May.2016.pdf> accessed 06 December 2020.

finance, prudential policy is supported by a harmonised framework for bank failure, which includes deposit insurance as well as bank recovery and resolution rules.

The key legislative instruments I examine in this chapter are the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV).[3] These instruments regulate the level of funds banks must hold as contingency against instability, but they also establish a wider framework of authorisation, governance, risk-assessment, and disclosure requirements. I will also look at the Bank Recovery and Resolution Directive (BRRD), which covers the mid-term resilience and crisis management aspects of financial stability. Both the CRR/CRD IV and BRRD were recently amended by the CRR II/CRD V[4] and the BRRD II.[5] While the initial wave of reforms largely emulated Basel without accounting for the particularities of the European financial market, these amendments are better suited to EU financial stability. Overall, the EU's regulatory toolkit is closely aligned with the teleology of financial stability.

This deduction flows from three observations. First, the overhaul of prudential and resolution policy signifies a paradigm shift in the internal market, which coincides with the ideological

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[3] (CRR) Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L176/1; (CRD IV) Directive 2013/36 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.

[4] (CRR II) Regulation 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012, OJ L150/1; (CRD V) Directive 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ L150/253.

[5](BRRD II) Directive 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC, OJ L150/296.

underpinnings of financial stability. The extensive harmonisation of prudential and resolution policy tools establishes substantive limits to market liberalisation, and the abandonment of economic functionalism in integration is undoubtedly a positive in terms of output legitimacy. Second, the fine-tuning of the CRR II/CRD V and BRRD II demonstrates an attempt to incorporate the non-economic elements of financial stability into law and to minimise the social costs of policy. For example, the sector-specific principle of proportionality employed in this new framework allows for a flexible implementation of policy to support employment and other strategies. Thirdly, there are challenges in macroprudential policy and resolution tools, but these are a relatively minor threat to legitimacy considering the overall direction of financial stability policy in the EU.

This chapter is organised in three sections. Section 4.2 will provide an overview of the CRR/CRD framework and how it seeks to improve the resilience of the banking sector. Owing to the sheer complexity of these rules, I will not provide analysis of the CRR/CRD in this section. Section 4.3 will focus on bank failure, which includes deposit guarantee schemes, recovery planning, and resolution instruments. Brief reference will also be made to the Capital Markets Union as an alternative which can alleviate the consequences of bank failure. Finally, Section 4.4 will evaluate the output legitimacy of these rules. I argue that prudential and resolution policy tools are strongly aligned with the teleology financial stability put forward in this thesis.

4.2 Resilience of the Banking Sector (CRR/CRD)

Prior to the crisis, the resilience of the banking sector was only a peripheral goal of the EU. Supranational action was rare and, where it did occur, aimed at abolishing barriers to cross-border movement, which may have exposed banks to exogenous risk and contributed to the crisis.[6] The history of various Banking Directives and the Financial Services Action Plan serves as evidence of financial stability taking a backseat to market integration.[7] Thus, the

[6] On various dimensions of risk in prudential policy, see Rainer Masera, 'CRR/CRD IV: The Trees and the Forest' [2014] 67(271) *PSL Quarterly Review* 381, 381-387.

[7] Gianni Lo Schiavo, *The Role of Financial Stability in EU Law and Policy* (Wolters Kluwer 2017) 149-151.

unprecedented harmonisation and intensification of prudential policy tools represents a paradigm shift in the European financial market.

This section will provide a breakdown of the substantive requirements and instruments making up this paradigm shift. The EU's prudential toolkit comprises of capital-oriented measures under the CRR, macroprudential buffers in the CRD, national "flexibility" (supervisory) provisions, and various non-capital based rules. My main goal is to provide an overview of the CRR/CRD framework; analysis will follow in section 4.4.

4.2.1 CRR minimum requirements

Capital regulation determines how much capital, or financial resources capable of absorbing unexpected losses, a bank is required to hold at any given time.[8] It encapsulates the preventive function of financial stability. The global trend-setter in this domain is the Basel Committee on Banking Supervision (BCBS), a complex system of "soft law" initiatives on which the "hard law" CRR/CRD framework is based.[9]

Basel follows a "three pillar" system: Pillar 1 comprises of capital-oriented measures, Pillar 2 focuses on supervisory powers or "flexibility", while Pillar 3 covers market discipline (disclosure).[10] Another important classification concerns the quality of bank capital: Basel distinguishes between Tier 1 capital in the form of shareholder equity and retained earnings, and Tier 2 supplementary assets which are more difficult to liquidate, such as subordinated debt. Core Equity Tier 1 (CET1) refers to the highest quality assets; the term commonly appears in the CRR/CRD framework as the primary benchmark of a bank's strength.[11]

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[8] CRR, Recital 72.

[9] See Emily Lee, 'Basel III: Post-financial Crisis International Financial Regulatory Reform' [2013] 28(11) *Journal of International Banking Law and Regulation* 433; Peter Yeoh, 'Global Banking Reforms: Mission Accomplished?' [2018] 33(9) *Journal of International Banking Law and Regulation* 305; William A Allen *et al*, 'Basel III: Is the Cure Worse than the Disease?' [2012] 25 *International Review of Financial Analysis* 159.

[10] The Basel Framework (2019) is available at <www.bis.org/basel_framework/index.htm?m=3%7C14%7C697> accessed 01 November 2020.

[11] Ibid, CAP10.

The starting point for understanding this complex system is the CRR: a directly applicable instrument introduced in 2013 which follows the approach of maximum harmonisation.[12] The CRR lays down the basic minimum requirements that credit institutions must comply with, as distinguished from tools of macroprudential policy in the CRD which must be implemented through the vehicle of national law. The four key requirements in the CRR address capital adequacy, liquidity, leverage, and large exposures.

First, the CRR lays down 'own funds' (capital adequacy) requirements, which prescribe the quantity and quality of capital credit institutions must hold as contingency for a rainy day. These requirements target the medium-term solvency of the bank: its capacity to absorb unexpected losses, maintain market confidence, fulfil obligations to depositors, and pursue growth opportunities when appropriate. Article 92(1)(c) CRR sets the own funds requirement at 8% of risk-weighted assets (RWAs).[13] Mirroring Basel III, this is a cumulative ratio: 4.5% of CET1 capital, 1.5% of additional Tier 1 capital, the remaining 2% can be met with Tier 2 assets.[14]

Second, the CRR includes two liquidity requirements. As distinguished from capital adequacy, liquidity focuses on short-term cash outflows and the bank's ability to meet daily customer demand.[15] The main tool in the CRR is the Liquidity Coverage Ratio (LCR), which requires banks to maintain 100% of high-quality liquid assets needed to withstand 30 days

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[12] The implications of this approach are discussed by Lo Schiavo, (n 7), 167.

[13] RWA is a regulatory concept that measures the risk of loss associated with each credit exposure; it implies that own funds requirements are risk-adjusted. The CRR provides two methods of calculating RWAs: the standardised approach (Chapter 2, CRR), and the internal ratings-based (IRB) approach (Chapter 3, CRR). These are due to be revised by 2022. See European Banking Authority, 'Policy Advice on the Basel III Reforms: Credit Risk (2019) <eba.europa.eu/sites/default/documents/files/documents/10180/2886865/d383ee58-8665-4f8b-99d3-058984c2711e/Policy%20Advice%20on%20Basel%20III%20reforms%20-%20Credit%20Risk.pdf?retry=1> accessed 03 November 2020.

[14] CRR, Art 92(1)(a) & (b); Basel Framework, RBC 20.1.

[15] BCBS, 'Literature Review on Integration of Regulatory Capital and Liquidity Requirements' (Working Paper No 30, 2016) <www.bis.org/bcbs/publ/wp30.pdf> accessed 03 November 2020.

under gravely stressed conditions.[16] It should be noted liquidity rules can be very controversial and the LCR is no exception.[17] The main criticism concerns the binding nature of a rule requiring banks to set aside liquid assets, vaguely defined, which can have the opposite of intended effect on liquidity and financial stability.[18] Some of these concerns have been addressed by the CRR, and the ratio of 100% is binding as of 2018.[19]

The next liquidity requirement is the Net Stable Funding Ratio (NSFR). This targets the medium-term (1 year), over which a bank's available stable funding must match its required stable funding at a ratio of at least 100%.[20] This is intended to address liquidity mismatches caused by an overreliance on short-term wholesale funding, which was identified as a cause of the financial crisis. The CRR II makes the NSFR a binding requirement but deviates from Basel in that it includes a number of EU-specific adjustments, the most important of which is that small and non-complex firms are permitted to use a simplified version of the NSFR.[21] This is a noteworthy strategy as it aims to counterbalance some of the unintended negative effects of financial stability policy.[22]

Third, own funds and liquidity rules are supplemented by a Tier 1 leverage ratio, originally conceived as a discretionary (Pillar 2) measure. The leverage ratio, expressed as a percentage

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[16] CRR, Art 412(1).

[17] Lo Schiavo (n 7), 168-169.

[18] The "Goodhart critique", Charles Goodhart, 'Liquidity Risk Management' [2008] 11 *Financial Stability Review* 39, 41.

[19] Eg, banks can draw on liquidity funds in stress, CRR, Art 412(1); progressively given binding status, Art 460(2).

[20] CRR, Arts 413(1), 428b, 510. The available stable funding takes into account a number of indicators, such as the contractual maturity of a bank's liabilities; the required stable funding is calculated based on the risk profile of the bank's assets and exposures. See BCBS, 'Basel III: The Net Stable Funding Ratio' (October 2014) <www.bis.org/bcbs/publ/d295.pdf> accessed 03 November 2020.

[21] CRR II, Art 428ai & 428aq, Recital 53.

[22] Note that derogations must be approved by NCAs and, overall, there is considerable room for divergence between Member States.

of liquid Tier 1 assets divided by the bank's total (non-weighted) assets,[23] allows regulators to assess the bank's health and acts as a backstop to shortages of equity.[24] The CRR II makes the leverage ratio a binding (Pillar 1) requirement, set at 3% for all EU banks.[25] Consistently with Basel IV, the CRR II also introduces a more stringent ratio for Global Systemically Important Institutions (G-SIIs).[26] This tool has a broad exposure measure, capturing derivative, off-balance sheet and other exposures; it deviates from Basel in that EU-specific exceptions apply.[27]

The fourth requirement seeks to limit concentration risk by setting limits to large exposures. The general rule is that banks are prohibited from having total exposure to a client or group of connected clients exceeding 25% of their capital base.[28] In addition, any exposure equal to or higher than 10% triggers reporting requirements under Article 393 CRR.[29] The CRR II makes small yet impactful changes: it redefines eligible capital to exclude Tier 2 capital, a significantly more stringent requirement, and it lowers the exposure limit to 15% between G-SIIs.[30] The new framework also introduces a new method for calculating the exposure value of derivatives and ('long-settlement') transactions exposed to counterparty credit risk (SA-CCR).[31]

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[23] On risk weighting differences/advantages, see Leonardo Gambacorta and Sudipto Karmakar, 'Leverage and Risk Weighted Capital Requirements' (BIS Working Paper No 586, 2016) <www.bis.org/publ/work586.pdf> accessed 04 November 2020.

[24] This measure addresses over-leveraging, excessive reliance on borrowed funds, which was one of the key challenges presented by the crisis.

[25] CRR II, Art 92(1)(d); CRR, Arts 429 & 430. NB some countries already apply a higher ratio (eg, UK at 3.25%).

[26] 50% of G-SII buffer, *infra* (n 46).

[27] CRR II, Art 429a. These include exposures to central and local governments, exposures arising from export credits that meet certain conditions, and more.

[28] CRR, Art 395(1); calculation according to Art 390. The CRR II envisages a stronger role for the EBA, see Art 507.

[29] CRR, Art 392 on definition of large exposures; Art 393 reporting requirements. Art 400 exceptions (eg, unsecured exposures to public sector entities, assigned a 0% risk weight).

[30] CRR II, Art 395(1).

[31] CRR II, Arts 273-282. The new method is controversial: it is generally viewed as conservative and can have a big impact on IMA firms with large derivative books. See eg, European Banking Federation, 'SA-CCR: Why it

A recent development stemming from the Basel Committee is the Fundamental Review of the Trading Book (FRTB), a requirement targeting market risk and "fat tail" events (as opposed to credit risk).[32] The FRTB is currently incorporated into the CRR II as a reporting requirement, but a binding Pillar 1 requirement is on the horizon.[33] While the FRTB does not increase banks' capital costs, it fundamentally alters how capital is calculated.[34] It is anticipated that the FRTB will significantly increase compliance costs, as such, the CRR II exempts small and non-complex firms from this requirement.[35]

4.2.2 Macroprudential buffers in the CRD

CRR minimum requirements are core pieces of the EU's single rulebook, but they are adjusted according to the credit or market risk of individual institutions. Financial stability, in the strictest sense, represents an abandonment of the micro-economic approach. Accordingly, the CRD equips Member States with a range of macroprudential tools to address systemic risk. Despite their supplemental role and weaker harmonisation relative to the CRR, the implementation of CRD capital buffers is a critical element of EU financial stability.

First, the capital conservation buffer (CCoB) operates in a familiar way as a mandatory increase of the capital base of EU banks. This measure requires banks to hold an additional

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needs to be revisited in the course of the transposition of the agreement on the finalization of Basel III' (January 2020) <www.ebf.eu/wp-content/uploads/2020/03/EBF-position-on-revision-of-SA-CCR-clean.pdf> accessed 04 November 2020.

[32] The trading book covers instruments whose values is expected to fluctuate, such as hedging instruments (as opposed to the banking book of fixed maturity assets, such as customer loans). Market risk primarily concerns larger entities who would be affected from market price changes.

[33] CRR II, Art 430b. The Basel procedure begun in 2012 but has been marked by delays; the current implementation date is 2023. The European Commission is expected to submit a separate legislative proposal.

[34] See Lucia Alessi *et al*, 'Estimation of Potential Benefits of the Implementation of the Fundamental Review of the Trading Book and Leverage Ratio' (JRC Science for Policy Report, 2016) <publications.jrc.ec.europa.eu/repository/bitstream/JRC103768/jrc103768_crr_review_02112016_final3%20commentsivh_v2_identifiers.pdf> accessed 08 November 2020.

[35] CRR II, Art 325a.

2.5% of RWA in CET1 capital, above own funds requirements (10.5% total).[36] In the scenario that it is depleted, banks may operate as normal; some restrictions apply until it is replenished but these relate to capital distributions (payments made to owners).[37] The conservation range acts primarily as a signalling tool against breaches of CRR requirements.

Second, the countercyclical capital buffer (CCyB) can be seen as the flagship of the Union's macroprudential policy toolkit: it addresses the procyclicality of the financial system, one of the key challenges identified by de Larosière. Procyclicality refers to an increase in risk-taking behaviour during the upswing of the business cycle, which was amplified by limited regulatory intervention.[38] The CCyB aims to dampen lending activity in the upturn of the economy and can be adjusted to stimulate growth during economic contraction. This buffer is applied by the national competent authorities (NCAs) on an institution-specific basis, and it ranges from 0-2.5% of RWA held in CET1 capital.[39] The process for setting the CCyB, especially in cross-border situations, is an area of concern and is addressed subsequently.

Third, the CRD includes a dual buffer targeting Globally Systemically Important Institutions (G-SIIs) and Other Systemically Important Institutions (O-SIIs). This measure follows the theory that some banks are 'too big to fail' and seeks to reduce the moral hazard created by the expectation of government bailouts.[40] The G-SII buffer is a mandatory surcharge of 1-3.5% of CET1 of RWA: NCAs are required to allocate G-SIIs into five subcategories, each with a different ratio which reflects the linear increase in systemic significance.[41] NCAs are then required to identify which institutions fall within the O-SII category (of other

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[36] CRD V, Art 129(1).

[37] CRD V, Art 141(2) & (3).

[38] See Report of the de Larosière Group *ECO/259-EESC-2009-1476* [2009] OJ C318/ 57-65 <www.eesc.europa.eu/it/our-work/opinions-information-reports/opinions/de-larosiere-report> accessed 1 July 2020.

[39] CRD V, Arts 128(2), 130(1), 136.

[40] Recital 90, CRD IV.

[41] CRD V, Art 131(9). Systemic significance is defined as the 'expected impact exerted by the G-SII's distress on the global financial market'.

domestically important institutions) and apply a buffer of up to 3% of CET1 of RWA.[42] Art 131(3) CRD V provides some guidance on the identification of O-SIIs, but Member States have considerable discretion in the application of this tool.

Last, a key element of the CRD framework is the Systemic Risk Buffer (SRB), an optional CET1 capital buffer targeting non-cyclical or other macroprudential risks. Under its original formulation, NCAs were authorised to apply a rate of at least 1%.[43] There was no maximum limit, but notification and other requirements applied to higher rates. The SRB was a peculiar feature of the CRR/CRD IV framework: it did not appear in Basel and its US equivalent (Volcker Rule) was far more complex. Masera went as far as to label the SRB as the "more RWA capital" buffer.[44] However, the CRD V makes important changes to the calculation of this measure and clarifies the exposures to which it applies.[45] It also takes steps to ensure that this buffer does not duplicate the functioning of the CCyB and SIFI surcharges (G-SII and O-SII).[46] Member States must notify rates exceeding 3% to the ESRB, and "comply or explain" with the Commission's opinion on rates above 5%.[47]

4.2.3 Other elements of macroprudential policy (national flexibility & real estate)

In addition to the capital-based measures explored above, the success of financial stability as a policy goal rests on the wider macroprudential toolkit, which encompasses national flexibility and asset-based measures. In relation to flexibility, it is important to consider the role of Pillar 2 measures.

Pillar 2 was originally conceived as part and parcel of macroprudential policy. The non-exhaustive list in Article 104 CRD IV gave NCAs a wide range of powers, including the

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[42] CRD V, Art 131(5).

[43] CRD IV, Art 133(3).

[44] Masera (n 6), 403.

[45] CRD V, Art 133(2) & (5).

[46] CRD V, Art 133(8)(c); Art 133(9) notification procedure.

[47] CRD V, Art 133(10) & (11).

power to impose additional own funds requirements.[48] These could be imposed on the basis of the Individual Capital Adequacy Assessment Process (ICAAP), conducted by the bank, and the Supervisory Review and Evaluation Process (SREP), an assessment of the ICAAP conducted by supervisors. This dual process covers idiosyncratic risks (such as pension risk) which are not fully captured by Pillar 1. The macroprudential use of Pillar 2 proved a major source of controversy, as it led to double counting and divergence between Member States.[49] As a result, the CRD V limits the use of Pillar 2 to strictly micro-prudential risks and provides further clarification on Pillar 2 charges.[50]

Despite this recalibration of Pillar 2 measures, Member States retain some flexibility over macroprudential policy through Article 458 CRR. This provision enables Member States to adopt 'national flexibility measures' to address changes to the intensity of macroprudential or systemic risks at the national level.[51] These range from adjusting own funds requirements, to imposing further disclosure requirements.[52] It is critical that NCAs can identify a change at the national level liable to cause significant adverse effects. They must then notify any measures to the Commission and the ESRB, as well as explain why CRR minimum requirements or other tools are deemed inadequate in addressing this change.[53] This process also requires NCAs to present analysis of the potential impact of flexibility measures on the

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[48] Other powers include limits to remuneration and profit distributions; Liquidity and publication rules covered by Arts 105 & 106.

[49] See also, European Banking Authority, 'Opinion on the Macroprudential Rules in the CRR/CRD' (June 2014) 44-47 <eba.europa.eu/sites/default/documents/files/documents/10180/657547/0e8efdbf-9cb3-4178-890a-9d27b1351486/EBA-Op-2014-06%20-%20EBA%20opinion%20on%20macroprudential%20rules%20in%20CRR-CRD.pdf?retry=1> accessed 01 December 2020.

[50] CRD V, Arts 104, 104a. Importantly, Art 104a(4) specifies that at least 75% of additional own funds requirements shall be met with Tier 1 capital, of which at least 75% must be made up of CET1 capital. The CRD V also incorporates 'guidance on own funds', a non-binding requirement to hold internal capital above Pillar 1 and Pillar 2 requirements, as per Art 104b.

[51] CRR, Art 458(2).

[52] CRR, Art 458(1)(d).

[53] CRR, Art 458(2)(c).

internal market, 'based on information which is available' to them.[54] It can be inferred that this is a residual category of measures, whose impact can nonetheless be significant.

The next set of measures target the real estate market specifically. The real estate market is significant from a financial stability point of view, as there is a strong correlation between systemic risk and excessive lending in the housing or commercial immovable property market.[55] This sector is typically governed by indirect sectoral requirements, namely risk weights and A),[56] which dictate how direct capital requirements are to be calculated. Both risk weights and LGDs are harmonised under Articles 124 and 164 CRR respectively. For example, risk weights for residential and commercial immovable property are set at 35% and 50% respectively, or at 100% if conditions in Art 125 and 126 CRR are not met. Member States have some leeway to impose a higher rate of up to 150% if the inadequacy of risk weights is likely to affect 'current or future financial stability'.[57] Similarly, Article 164 sets minimum LGD values and authorises Member States to adjust these values based on financial stability considerations.[58]

Indirect capital requirements are complemented by an unharmonized set of asset-based (borrower-based) tools. Relying on national legislation, these tools are not strictly part of the CRR/CRD framework, but they can significantly impact macroprudential policy. Asset-based tools under national law operate on the terms and conditions of loans (as opposed to bank capital), by making the volume of credit granted dependent either on the value of the underlying real estate (Loan-To-Value or LTV ratio), or on the debt servicing capacity of the borrower (Loan-To-Income or LTI, Debt Service-To-Income limits or DSTI ratios).[59] They

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[54] CRR, Art 458(2)(f).

[55] See Philipp Hartmann, 'Real Estate Markets and Macroprudential Policy in Europe' [2015] 47(S1) *Journal of Money, Credit and Banking* 69.

[56] Loss given default refers to the share of an asset that is expected to be lost if the borrower defaults.

[57] CRR II, Art 124(2)(b).

[58] CRR II, Art 164(4) & (6).

[59] There is significant overlap between the various real estate tools, eg, higher RW assigned to loans that exceed LTV, LTI, or DSTI limits. See, European Systemic Risk Board, 'Handbook on Operationalising Macro-

are exceedingly popular among regulators due to their 'granular' and 'targeted' nature—their immediate impact on the capacity of borrowers to repay their debt.[60] As such, they can drastically improve banks' resilience to property price shocks.[61] However, despite extensive guidance by the ECB and ESRB on the application of these tools, lending standards still vary considerably across the EU. Such divergence impacts on the effectiveness of macroprudential policy and has the potential to increase the EU's vulnerability to real estate bubbles.[62]

4.2.4 Authorisation, governance, disclosure

In addition to capital requirements and macroprudential tools, the CRR/CRD framework is supported by a comprehensive system of authorisation, consolidation, corporate governance, and public disclosure rules. The following rules are critical in understanding the wider remit of financial stability.

Authorisation is the first step in the regulatory process. Article 8 CRD puts responsibility on the Member States to set the requirements for authorisation in national law, taking into account the technical standards adopted by the EBA, and to enforce the requirement that all credit institutions must obtain authorisation.[63] The CRD sets a number of limitations which serve financial stability, for example, the economic needs of the Member State are not

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prudential Policy in the Banking Sector' (2014) 54-56 <www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf?ac426900762d505b12c3ae8a225a8fe5> accessed 05 December 2020.

[60] Vítor Constâncio, 'Macroprudential Policy in Europe – Ensuring Financial Stability in a Banking Union' (Keynote Speech, Financial Stability Conference, October 2015) <www.ecb.europa.eu/press/key/date/2015/html/sp151028.en.html> accessed 06 December 2020.

[61] Therese Grace, Niamh Halissey and Maria Woods, 'The Instruments of Macro-Prudential Policy' (2015) 1 *Quarterly Bulletin of the Central Bank of Ireland* 90, 98.

[62] Jan Hannes Lang *et al*, 'Trends in Residential Real Estate Lending Standards and Implications for Financial Stability' (ECB Financial Stability Review, May 2020) <www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart202005_01~762d09d7a2.en.html#toc1> accessed 05 December 2020.

[63] The ECB is exclusively competent to authorise credit institutions in the EMU; Art 4(1), Council Regulation 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L287/63 (SSM Regulation).

relevant in the authorisation process.[64] Further, authorisation must be refused if a credit institution does not hold separate own funds or an initial capital of EUR 5 million.[65] The CRD also lists situations where authorisation can be withdrawn: these include failure to meet the minimum capital requirements in the CRR.[66] If authorisation conditions are met, banks are granted a 'single passport' to operate across the EU without further authorisation.[67]

An area of interest is the application of prudential requirements to third-country banking groups operating through subsidiaries and branches in the EU. The CRD V introduces an important rule on group consolidation: third-country groups with two or more branches in the EU and whose assets exceed EUR 40 billion must set up an Intermediate Parent Company (IPU) in the EU.[68] Importantly, the new consolidation rules apply to financial holding companies.[69] Third-country groups must meet prudential requirements on a consolidated basis, which aligns the CRR/CRR regime with the US framework on intermediate financial holding companies and can be seen as an important step in preventing promise shifting and other negative effects.[70]

Corporate governance of credit institutions is another area that was largely overlooked prior to the crisis and which the CRR/CRD sought to harmonise. The link between governance and financial stability lies in the belief that prudent management strategies will reduce excessive risk taking. Corporate governance rules in the CRD encompass board composition and diversity, appointment and oversight procedures, conflicts of interest, audit and financial

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[64] CRD IV, Art 11.

[65] CRD IV, Art 12(1). For an overview of exemptions and relevant rules, see Lo Schiavo (n 7), 170-173.

[66] CRD IV, Art 18.

[67] CRD IV, Art 33.

[68] CRD V, Art 21b. In some cases, rule apply to subsidiaries which do not provide financial activities.

[69] However, the 'approval' regime (as opposed to "authorisation") is not as strict as originally envisioned. See Linklaters, 'CRR2 and CRD V – The New Prudential Regulatory Landscape' (25 June 2019) 14-15 <lpscdn.linklaters.com/pdfs%2Fmkt%2Flondon%2FCRR2_Client_Publication_June_2019.pdf> accessed 05 November 2020.

[70] Ibid.

reporting, and remuneration policies.[71] The CRD V makes important changes as regards remuneration, for example, it introduces gender neutrality as a specific requirement, as well as extending the bonus cap (variable pay limit for staff who determine the firm's risk profile) to all firms regardless of size.[72] It also includes provisions on environmental, social, and governance risk (ESG) with view to promoting sustainable finance.[73]

Special attention must be paid to Pillar 3 disclosure rules in the CRR/CRD. These are intended to encourage market discipline through the dissemination of information about the banking system to the public. The CRR sets out detailed rules on disclosure in Articles 431-451, relating to the scope and frequency of disclosure, own funds and capital requirements, disclosure on individual exposures, remuneration policy, and other areas. The CRR II requires large institutions to comply with all disclosure obligations, while small and non-complex firms are only asked to disclosure basic regulatory metrics on an annual basis.[74]

To conclude, the CRR/CRD establishes a comprehensive toolkit of prudential and other tools. The CRR II/CRD V amendment addresses a number of EU-specific issues, notably the burden of financial stability tools on small and non-complex firms. The next section will explore deposit insurance and bank recovery/resolution rules.

4.3 Bank Failure (BRRD & DGS)

The CRR/CRD establishes a detailed framework for crisis prevention in the banking sector, significantly enhancing the *ex ante* capacity of regulators to respond to micro- and macroprudential risk. However, a limitation of prudential policy is that we will never be able to predict every factor that may lead to the next crisis—the Covid-19 pandemic stands out as

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[71] CRD IV, Recital 60, Art 88(1).

[72] CRD V, Art 92(2)(aa) gender neutrality; Arts 92(2) & 94 variable pay. Investment firms are covered by Directive 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU, OJ L314/64.

[73] CRR II, Art 449a disclosure rules; CRD V, Art 98 on tasks of EBA.

[74] CRR II, Art 433b.

an example. As such, crisis management tools are an important facet of financial stability. These provide an organised legal framework for addressing bank failure, but they also serve as a deterrent against breaches of capital requirements.

This section focuses on bank recovery and resolution under the Bank Recovery and Resolution Directive (BRRD). The financial crisis revealed a major gap in EU law, which relied solely on state aid to regulate large-scale bank failure.[75] The BRRD seeks to correct this problem through extensive rules on resolution that also incorporate crisis planning and early intervention. In addition to the BRRD, I will briefly introduce deposit insurance schemes and the Capital Markets Union, as alternative means of reducing the consequences of bank failure.

4.3.1 Recovery and resolution rules (BRRD)

Recovery and resolution rules apply when a bank fails or is likely to fail. This field differs from regular insolvency in that it takes into account the systemic importance of the ailing bank, which then triggers a special restructuring process to minimise not only economic losses, but also social costs.[76]

State aid law

Prior to the crisis, the EU had no legal framework governing bank failure. The EU's approach towards recovery and resolution was informed by the goal of market integration, prioritising the principles of home country control and mutual recognition. Both principles seek to minimise the burden of regulation in the internal market.[77] As a result, during the early stages of the crisis, recovery planning was limited and there were very few means of regulating widespread bank bailouts and extraordinary rescue packages.

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[75] Which is problematic because state aid rules are intended to prevent or limit extraordinary support to failing banks.

[76] See Lo Schiavo (n 7), Chapter 8.

[77] Ibid, 227-230.

The only applicable law was state aid, which is deeply problematic for two reasons. First, state aid is not a conventional financial stability tool, in fact, its purpose is to restrict extraordinary aid to companies that is likely to distort competition. Second, the Commission was faced with the monumental challenge of drafting guidance (soft law) for effective crisis management whilst also complying with stringent state aid rules.[78] Accordingly, the Commission's Communication on aid to the banking sector mandates the use of burden-sharing measures (bail-in). The balance between financial stability and market integration/free competition was achieved by making state aid conditional on the write-down of shareholder and subordinated creditor funds.

In *Kotnik*, the Court was asked to examine the incorporation into EU law of burden-sharing measures through quasi-legislative, state aid instruments. In assessing a potential breach of legitimate expectations and the right to property, the Court stated that these goals 'cannot be held to prevail in all circumstances over the public interest in ensuring the stability of the financial system'.[79] *Kotnik* demonstrates the transformative potential of financial stability, capable of overwriting key tenets of the internal market, such as state aid rules, and general principles of EU law, such as legitimate expectations. The Court's reasoning is discussed further in relation to financing assistance in Chapter 6. On the issue of bank failure, legislative action was urgently needed to support the emergence of supranational financial stability: to avoid further conflict with the internal market and to justify the legal innovation of "soft law" burden sharing.

BRRD

In light of the above, the EU adopted the Bank Recovery and Resolution Directive of 2014. The Directive follows a minimum harmonisation approach, introducing measures for the orderly winding up of banks and investment firms in the EU which must be implemented

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[78] Ibid. See also, Alberto Heimler and *Frédéric* Jenny, 'The Limitations of European Union Control of State Aid' [2012] 28(2) *Oxford Review of Economic Policy* 347; Joanna Dzia*ło, '*State Aid In The European Union In The Period Of The Economic Crisis' [2014] 17(1) *Comparative Economic Research* 5.

[79] *Kotnik* (C-526/14) ECLI:EU:C:2016:570, paragraph 91.

through national law.[80] Its provisions cover several dimensions of bank failure: *ex ante* drafting of resolution plans or "living wills", early intervention powers which apply without triggering resolution, and *ex post* resolution tools. The Directive also includes provisions on coordination between national authorities, and clarifies the objectives and principles that guide the resolution process.[81]

Article 1(1) details the scope of the BRRD, which is wide enough to include financial holding companies and branches of institutions established outside of the Union, in addition to financial institutions.[82] Member States are required to designate a national authority responsible for exercising resolution powers, under Article 3(1).[83] Title II then tackles recovery and resolution planning. Institutions are required to prepare recovery plans describing the measures to be taken should their financial position deteriorate. These are assessed by the resolution authority, which is also responsible for drafting resolution plans to come into effect when the institution meets the conditions for resolution.[84] Both recovery and resolution plans must be reviewed at least annually.[85] National authorities are also tasked with removing any impediments to resolvability identified during the planning phase.[86]

Title III addresses early intervention powers triggered when the institution infringes or is likely to infringe prudential requirements contained in the CRR/CRD.[87] Resolution authorities may require the management body of the institution to implement one or more of the measures contained in the recovery plan or to draw up alternative strategies. Institutions may also be required to remove and replace members of the management body, hold shareholders meetings, draw up debt restructuring plans, make changes to the operational

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[80] BRRD, Art 1(2).

[81] See Lo Schiavo (n 7), 231-241.

[82] This is significant. As the de Larosière report showed, a system-wide approach is needed.

[83] Art 3 also imposes conditions on central banks acting as resolution authorities.

[84] See BRRD, Art 15 on resolvability assessment.

[85] BRRD, Art 5(2) recovery; Art 10(6) resolution.

[86] BRRD, Art 17.

[87] BRRD, Art 27(1).

structure of the institution, and allow on-site inspections by the resolution authority.[88] A temporary administrator may be appointed if removal of senior management is deemed insufficient.[89]

Resolution is covered by Title IV. Article 31 distinguishes between the objectives of resolution and regular insolvency. In brief, resolution seeks to maintain continuity of banking services in such a way that reliance on taxpayer funds and financial contagion are minimised.[90] Other objectives such as protecting depositors and investors are given 'equal significance' under the Directive, but, as Lo Schiavo notes, these are difficult to balance and some degree of prioritisation is unavoidable.[91] Article 32(1) then sets out three essential conditions for resolution action: (a) the resolution authority must determine that the institution is failing or likely to fail, (b) any alternatives including supervisory or early intervention measures are deemed insufficient, (c) resolution action is necessary in the public interest.[92] In addition, Article 34 lays down a number of general principles which must be observed during resolution; these mainly harmonise the hierarchy of claims among creditors and other parties.[93]

Once the conditions for resolution are met, national authorities may avail themselves of the various resolution tools and general powers under Articles 37-72 BRRD. There are four main resolution tools: the sale of business tool,[94] the bridge institution tool,[95] the asset separation tool,[96] and the bail-in tool.[97] The focal point of the BRRD is the bail-in tool, which authorises

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[88] Ibid.

[89] BRRD, Art 29; strict temporal and substantive limits apply.

[90] BRRD, Art 31.

[91] Lo Schiavo (n 7), 236.

[92] Paragraph (4) expands on the term 'likely to fail'. According to paragraph (5), resolution is deemed to be in the public interest if it necessary and proportionate to the objectives in Art 31.

[93] Of note are financing arrangements for resolution, eg, BRRD, Arts 99-100.

[94] BRRD, Art 38 (partial or total disposal of assets).

[95] BRRD, Art 40 (transfer of business to temporary entity which is partially publicly owned).

[96] BRRD, Art 42 (transfer to asset management vehicle).

[97] BRRD, Art 43.

the write-down or conversion of an entity's liabilities into equity. In other words, it places then burden of resolution on creditors, shareholders, and depositors; replicating the losses that these groups would incur in a normal bankruptcy situation. The purpose of this measure is to protect taxpayer funds without impairing the institution's material operations. In terms of the scope of the bail-in tool, the BRRD excludes certain types of liabilities, such as covered deposits and contributions to deposit insurance, and permits further exclusions in exceptional circumstances.[98]

To prevent institutions from structuring their debt in such ways as to circumvent the scope of the bail-in tool, the BRRD provides for a Minimum Requirement for own funds and Eligible Liabilities (MREL).[99] In essence, this requires all institutions to hold additional capital and liabilities eligible under the bail-in rules, over and above CRR requirements. This is a significant add-on, as resolution authorities must set the MREL at a level (expressed as percentage of aggregate own funds and total liabilities) that ensures not only loss absorption, but also recapitalisation and restoring market confidence.[100] In its initial formulation under the BRRD, the MREL varied considerably from its global equivalent, the TLAC (total loss-absorbing capacity). For example, the TLAC only applies to globally systemically important institutions. Another difference between the two is that the TLAC is a fixed Pillar 1 buffer, whereas the MREL was heavily reliant on the case-by-case judgment of resolution authorities.[101]

BRRD II

The BRRD II, which was introduced alongside the CRR II and CRD V as part of the EU's most recent banking package, makes important changes in this regard. The primary change brought about by the BRRD II concerns the incorporation of the TLAC standard into the

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[98] BRRD, Art 44(2) & (3). Also, Art 48 on hierarchy of liabilities.

[99] BRRD, Art 45.

[100] BRRD, Art 45(6)(b); BRRD II, Art 45c(1)(b).

[101] See Tobias Tröger, 'Too Complex to Work: A Critical Assessment of the Bail-In Tool Under the European Bank Recovery and Resolution Regime' [2018] 4(1) *Journal of Financial Research* 35.

MREL, since both measures serve the same purpose.[102] Thus, the BRRD II imposes a fixed minimum MREL requirement for G-SIIs on the same level as the TLAC, and extends the application of a common minimum standard to a new category of 'top-tier firms'.[103]

Another key tenet of the BRRD II is subordination. Under the previous rules, MREL instruments were not automatically subordinated to non-MREL instruments, which meant that liabilities used during bail-in could potentially rank *pari passu* with liabilities excluded from bail-in. This was not only subject to legal challenge because creditors belonging to the same class could be treated differently, but it also caused divergence between Member States who sought to address this issue through national legislation.[104] The new rules provide for a—somewhat timid yet exceedingly complex—version of subordination that applies to G-SIIs, top-tier firms, and some other categories of banks.[105] Other differences between the MREL framework and the TLAC remain, for instance, the BRRD II does not eliminate the possibility of "double counting" regulatory capital and MREL.[106]

On the whole, the EU's capacity to respond to bank failure has substantially improved as a result of the BRRD and BRRD II. This framework includes overwhelmingly positive elements, such as resolution planning and early intervention powers. Moreover, the EU is

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[102] BRRD II, Art 45a-45m; CRR II, Arts 72a-72l, 92a, 104a & 104b; CRD V, Art 131(1).

[103] BRRD II, Art 45c(5) on top-tier firms (non-G-SIIs with assets exceeding EUR 100 billion). BRRD II, Art 45b and CRR II, Art 72a specify which liabilities are eligible to qualify as MREL. See also, BRRD II, Art 45f on resolution entities and internal MREL.

[104] "No creditor worse off" principle. This was also addressed by Directive 2017/2399 of the European Parliament and the Council of 12 December 17 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy, OJ L345/96 (Creditor Hierarchy Directive).

[105] See Norton Rose Fulbright, 'Banking Reform Updater: Bank Recovery and Resolution Directive II' (Publications, April 2020) <www.nortonrosefulbright.com/en/knowledge/publications/e028894f/uk-banking-reform-updater-bank-recovery-and-resolution-directive-ii#Asdefined> accessed 05 December 2020.

[106] See Linklaters, 'BRRD2 and the Revised MREL Framework' (April 2019) <lpscdn.linklaters.com/-/media/files/insights/publication/2019/april/brrd2-mrel.ashx?rev=ad6ec9ac-3ba2-4b1b-ab45-659d10b76254&extension=pdf&hash=79FAE9E14E06A4A964091179CFD2A878> accessed 05 December 2020.

better prepared to face the various aspects of bank failure through a comprehensive resolution toolkit, supplemented by a set of resolution principles and general powers. The shift away from the competitiveness rationale of state aid law is significant in its own right, but the BRRD and BRRD II give real shape to the crisis management dimension of financial stability.

Brief mention should be made to the Banking Union and specifically its second pillar, the Single Resolution Mechanism (SRM). While the BRRD aimed at achieving a degree of harmonisation across the EU, the SRM was fuelled by the particularities of the sovereign debt crisis in the euro area.[107] Thus, the SRM replicates and supplements the substantive rules in the BRRD with a stronger institutional design and centralised resolution funding for Eurozone countries.[108] Its scope, implementation, and interactions with the SSM and the CRR/CRD impact greatly on financial stability. The institutional balance of powers is explored in my next chapter.

4.3.2 Deposit Guarantee Schemes

Deposit insurance can be seen as a subset of banking law or as a separate branch of law altogether. In general, deposit guarantee schemes (DGS) act as insurance policy for depositors in the event of bank failure: they can be administered by public or private entities who undertake the protection of deposit accounts, such as savings accounts, either in full or in part. The connection between deposit insurance and financial stability can be elusive. On the one hand, deposit insurance is often under severe criticism for creating a moral hazard problem, to the extent that banks with insured deposits may engage in riskier tactics and

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[107] The example of the Cypriot bail-in illustrates that resolution conducted at the national level may still create a negative loop between sovereign debt and banks, and cause contagion. This supports the need for centralisation within the EMU. Masera (n 6), 409.

[108] Lo Schiavo (n 7), 245. On the co-existence of private and public backstop arrangements, see Anatoli Segura and Sergio Vicente, 'Bank Resolution and Public Backstop in an Asymmetric Banking Union' (ESRB Working Paper No 83, August 2018) <www.esrb.europa.eu/pub/pdf/wp/esrb.wp83.en.pdf?955d3588e24e459da778ca280165a7c9> accessed 5 December 2020.

generally undermine prudential goals.[109] Indeed, evidence shows that voluntary systems of deposit insurance can be a major contributing factor to bank failure.[110] On the other hand, as part of a wider safety net with strict regulatory oversight, DGS can discourage bank runs, increase transparency, and mitigate the wider consequences of bank failure on the real economy.[111] Thus, the conventional view is that DGS have an overall positive impact on financial stability.

The EU's stance on deposit insurance follows the global trend of strengthening crisis management to make prudential policy more effective.[112] The DGS Directive of 2014 follows the same approach as the first DGS Directive of 1994, in that it does not establish a centralised insurance scheme.[113] However, it goes much further in its attempt to harmonise deposit protection across Member States. First, the 2014 Directive sets the aggregate coverage level at EUR 100,000.[114] Second, read alongside BRRD provisions, it establishes a hierarchy of claims in insolvency and resolution proceedings. Thus, covered deposits, of EUR 100,000 or below,[115] rank ahead of deposits exceeding EUR 100,000 or made through third-country branches, which rank ahead of unsecured and non-preferred creditors.[116] Third, the DGS Directive provides rules on financing deposit protection. Member States are

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[109] Christine E Blair, Frederick Carns and Rose Kushmeier, 'Instituting a Deposit Insurance System: Why? How?' [2006] 8(1) *Journal of Banking Regulation* 4, 5-6.

[110] David C Wheelock and Sumbal C Kumbhakar, 'Which Banks Choose Deposit Insurance? Evidence of Adverse Selection and Moral Hazard in a Voluntary Insurance System' [1995] 27(1) *JMCB* 186.

[111] Blair, Carns and Kushmeier (n 109); *Cf.* Ivan Larov, 'Deposit Insurance in the EU Repetitive Failures and Lessons from Across the Atlantic' [2017] 54(6) *Common Market Law Review* 1749.

[112] On the relationship between the two, see Kevin Dowd, 'Bank Capital Adequacy versus Deposit Insurance' [2000] 17(1) *Journal of Financial Services Research* 7.

[113] Directive 2014/49 of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJ L173/149; Directive 94/19 of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, OJ L135/5.

[114] Art 6(1). This was first introduced by Directive 2009/14 of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, OJ L68/3.

[115] Excluding those in Art 5.

[116] BRRD, Art 108. This only applies to natural persons and SMEs.

required to reach the target of 0.8% of covered deposits by 2024 through mandatory contributions made by credit institutions.[117] Fourth, the Directive tasks national authorities with acting as a "single point of contact" in cross-border situations and introduces more rules on cooperation between Member States.[118]

This decentralised system is set to be replaced by the European Deposit Insurance Scheme (EDIS), a centralised initiative for EMU and cooperating countries, conceived as the 'third pillar' of the Banking Union.[119] The Commission's initial proposal reproduced elements of Directive 2014/49, including the coverage level (EUR 100,000) and funding targets (0.8%).[120] It also envisaged a three-phase implementation, starting with re-insurance (EDIS triggered once national funds were exhausted), followed by co-insurance (joint guarantees), and ultimately the full transfer and mutualisation of funds to the centralised authority.[121] This plan proved untenable, with Germany expressing strong opposition to both the implementation roadmap and the end goal of a fully-fledged EDIS.[122] A more limited re-insurance system was introduced in 2017, and various 'hybrid' models have been discussed since. It appears that the Commission is going ahead with its proposal—the Covid-19 pandemic may have provided the impetus for political compromise—but the end configuration of EDIS is still under discussion.[123]

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[117] Art 10(2).

[118] Art 14.

[119] EDIS will be administered by the SRM.

[120] See European Commission, 'Proposal for a Regulation of the European Parliament and the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme' COM(2015) 586 final, 2015/0270 (COD).

[121] Ibid.

[122] See Christopher Mitchell, 'United We Stand: Gruppenwettbewerb and European Banking Union' [2020] 29(4) *German Politics* 582; David Howarth, 'The Difficult Construction of a European Deposit Insurance Scheme: a Step Too Far in the Banking Union' [2018] 21(3) *Journal of Economic Policy Reform* 190.

[123] See also, Michael Huertas, 'EDIS - The Third Pillar of the EU's Banking Union: Big, Bold But Can it Be Built - Where Are We in 2020?' [2021] 36(1) *JIBLR 5.*

Lo Schiavo considers that such a centralised system of deposit protection is absolutely necessary to ensure financial stability.[124] It is certainly true that the current DGS system gives considerable discretion to the Member States. However, the EDIS is not an automatic solution to this problem. As Cerrone illustrates, much will depend on the precise implementation of the EDIS and whether it overcomes retained discretions, especially by countries such as Germany who have sought to protect their private DGS systems.[125] In either a centralised or decentralised system, closer attention needs to be paid to cross-border cooperation and the relationship between deposit insurance and prudential tools, as well as the role of deposit protection in light of the growth of non-banking finance.[126]

4.3.3 Capital Markets Union

Mitigating the consequences of bank failure is not merely a question of improving the banking system. The underlying cause of the problem is the EU's reliance on banking finance, thus, expanding alternative sources of finance is a priority for the EU. The Capital Markets Union (CMU) is the most important initiative in this direction.[127]

In 2015 the European Commission released its Green Paper, acknowledging the vulnerability of European economies to banking crises and the connection between financial stability and effective, regulated capital markets.[128] The Commission's initial action plan revolved around three key objectives: improving access to financing for SMEs and all businesses, increasing and diversifying sources of investment funding from all over the world, and ensuring that capital markets run efficiently both domestically and across borders.[129] Unlike the Banking

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[124] Lo Schiavo (n 7), 179.

[125] Rosaria Cerrone, 'Deposit Guarantee Reform in Europe: Does European Deposit Insurance Scheme Increase Banking Stability?' [2018] 21(3) *Journal of European Public Policy* 224, 236.

[126] Ibid.

[127] Niamh Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System?' [2016] 41(3) *European Law Review* 307.

[128] European Commission, 'Green Paper: Building a Capital Markets Union' COM(2015) 63 final, 4-5 <eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0063&from=EN> accessed 10 December 2020.

[129] Ibid.

Union, which entails institutional innovations in the euro area, the CMU is an EU-wide project that builds on the current institutional and regulatory architecture. On a substantive level, the CMU ranges from modernising the Prospectus Directive to furthering supervisory convergence. At the time of writing, 12 out of 13 legislative proposals submitted by the Commission have been agreed upon by the European Parliament and the Council.[130]

Prompted at least in part by the Covid-19 situation,[131] a new action plan was released in September 2020. This details 16 additional measures and recalibrates the objectives of the CMU, for example, by placing emphasis on sustainable economic recovery from the pandemic. Of note is the broader scope of the new Action Plan, for example, this includes efforts to improve market-based pension systems and the creation of single access point for information sharing.[132] A number of questions remain: one of the key challenges is the direction the CMU will take in light of Brexit, considering that London has the lion's share of derivatives trades and other types of market-based finance in Europe.

The CMU presents both a challenge and opportunity for financial stability. While the goals of expanding market-based finance and achieving financial stability are not irreconcilable, ultimately, the success of the CMU hinges on its implementation. A good example is SME financing. Despite efforts to encourage SME listing, a range of information and other market hurdles exist.[133] In response to this challenge, the 2020 Action Plan recommends simplified listing rules and other measures, but it is clear that the law is still 'frantically trying to catch

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[130] Eg, Regulation 2017/1129 of the European Parliament and the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, OJ L168/12 (Prospectus Regulation).

[131] See blog post by the vice president of ECB, Luis de Guindos, Fabio Panetta and Isabel Schnabel, 'Europe Needs a Fully Fledged Capital Markets Union – Now More than Ever' (ECB Blog, 2 September 2020) <ecb.europa.eu/press/blog/date/2020/html/ecb.blog200902~c168038cbc.en.html> accessed 10 December 2020.

[132] European Commission, 'A Capital Markets Union for People and Businesses - New Action Plan' COM(2020) 590 final.

[133] See Pierre Schammo, 'Market Building and the Capital Markets Union: Addressing Information Barriers in the SME Funding Market' [2017] 14(2) *European Company and Financial Law Review* 271.

up'.[134] Uncertainty as to the effects of regulation can be a major source of instability, especially considering that the CMU will expose SMEs to new and unforeseen risks.

Ultimately, the CMU stops short of prescribing major institutional changes or a harmonised regulatory framework for market-based finance. This is a rather timid step in comparison to banking law reforms, and my thesis will not delve deeper into this topic.

4.4 Reviewing the output legitimacy of the CRR/CRD & BRRD

Having outlined the main instruments of financial stability in EU law, this section will focus on the link between policy reform and legitimacy. As this is a technical area pursued by expert authorities, legitimacy is primarily a question of outputs. However, output legitimacy does not amount to performance in the functionalist sense, it must take into account the wider teleology of financial stability explored in Chapter 2. This teleology revolves around the ideological underpinnings of financial stability as a shift away from laissez-faire liberalism, and the non-economic utility of financial stability, which broadly refers to its relationship with social policy goals.

This section will argue that prudential and resolution tools exemplify an important ideological shift in the internal market, and that the recent amendments of the CRR II/CRD V and BRRD II are consistent with the non-economic utility of financial stability. For example, the abandonment of the "one-size-fits-all" transposition of Basel requirements is a positive step in minimising the negative externalities of policy. These developments are strongly aligned with the teleology of financial stability. Some challenges remain in macroprudential and resolution policy, but these do not detract from the overall conclusion that substantive financial stability reforms improve the legitimacy of EU law.

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[134] Jonathan McCarthy, 'European Capital Markets Union: a Revived Project but a Broader Agenda' [2020] 35(10) *JIBLR* 383, 392.

4.4.1 Financial stability as an ideological shift in the internal market

The overhaul of the EU's prudential and resolution policy toolkit is a watershed moment in the internal market. Implicit in the rise of financial stability as a supranational objective is a significant ideological shift towards social and political integration, comparable to the introduction of EU citizenship and the single monetary policy in the 1990s. This shift away from economic functionalism is a key component of the teleology explored in previous chapters, which therefore contributes to the output legitimacy of EU law.

The starting point is to acknowledge that market integration and financial stability are *prima facie* consistent. This flows from the interpretation of financial stability as a means to an end, a prerequisite for economic growth and prosperity.[135] Similarly, market integration is a building block for the progressive development of Europe.[136] Financial stability is necessary for completing the internal market, and equally, integrating markets can improve access to the funds needed for preventing or managing a crisis. However, there is an underlying tension between the two objectives: financial stability contradicts a liberal or ordoliberal version of the internal market that prioritises market liberty and market equality over systemic threats.[137] As Scherf puts it, market integration 'exerts political economy pressures that make competitiveness a more salient regulatory concern'.[138] This is evident in the misconception that financial stability would create a dangerous moral hazard, which precipitated the financial crisis. The transformation of the European financial market in the last decade demonstrates that financial stability is fundamentally at odds with unfettered liberalisation.

Historically, the Court has been instrumental in associating market integration with market liberalisation. The guiding rule in the case law is that any obstacles to cross-border financial

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[135] Indranarain Ramlall, *Understanding Financial Stability: The Theory and Practice of Financial Stability* (Emerald Publishing 2019) 25.

[136] Art 3 TEU, Arts 119-120 TFEU.

[137] For a critique of German ordoliberalism in the context of European integration, see Kaarlo Tuori, *European Constitutionalism* (CUP 2015), Chapter 5.

[138] Gundbert Scherf, *Financial Stability Policy in the Euro Zone* (Springer Gabler 2013) 167.

activity must be abolished irrespective of whether public action is discriminatory.[139] By definition, financial stability is inconsistent with this logic, as it entails significant costs and procedural requirements that can have a restrictive effect on economic movement. More importantly, the Court has gradually dissociated market liberalisation from the cross-border dimension. For example, the "golden shares" line of cases (free movement of capital) targets public ownership of systemically important companies, with only tentative links to cross-border movement.[140] While there are rare examples of a more nuanced approach,[141] the case law on the free movement of services, undertakings, and capital conveys a singular political vision predicated on market liberalisation.[142]

Similarly, the legislative history of the European financial market shows a clear preference for free market ideology. An important milestone was the introduction of the single currency in Maastricht, sometimes presented as the end of economic functionalism in the EU.[143] While an important pillar of the Union's *finalité politique* (non-economic integration), the single monetary policy also gave further impetus to the principles of mutual recognition and home-country control, encouraging a more activist stance by the Court. In this setting, supervisory and regulatory convergence were relegated to long-term goals. It was not until the Lamfalussy process in the early 2000s that common prudential standards were implemented, and these were mainly aimed at promoting retail markets and abolishing obstacles to movement, as opposed to financial stability.[144] In the wake of the financial crisis, financial

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[139] *Caixa Bank* (C-442/02) ECLI:EU:C:2004:586, paragraph 12 (freedom of establishment); *Alpine Investments* (C384/93) ECLI:EU:C:1995:126, paragraph 38 (free movement of services).

[140] The most conspicuous example is *Commission v Germany* (C-112/05) ECLI:EU:C:2007:623 (*Volkswagen*). See Wolf-Georg Ringe, 'The Volkswagen Case and the European Court of Justice' [2008] 45 *CMLR* 537.

[141] Eg, *Commission v Germany* (C-95/12) ECLI:EU:C:2013:676 (*Volkswagen II)*.

[142] On the evolution of the micro-economic constitution, see Tuori (n 137), Chapter 5. On liberalisation and prudential policy, Dragomir L, *European Prudential Banking Regulation and Supervision: The Legal Dimension* (Routledge 2010) Chapter 6.

[143] Ibid. Michael Burgess, 'Federalism and Building the European Union' [1996] 26(4) *Publius* 1.

[144] Dragomir (n 142), 105-108; Lo Schiavo (n 7), 149-150.

stability emerged as a 'global public good' to justify unprecedented interference with the market.[145]

The rise of financial stability as a supranational objective is a true turning point in European integration. Firstly, on a conceptual level, financial stability implies recognition of Minsky's instability hypothesis, or the assumption that the capitalist economy will produce novel threats through its ordinary functioning.[146] This conceptualisation is crucial: the endogeneity of risk outweighs the potential moral hazard of public intervention in the market. The prime example of this ideological shift is the countercyclicality of the CRR/CRD and BRRD. Countercyclical tools operate against the direction of the business cycle, to discourage risk-taking in the upturn and to stimulate growth in the downturn of the economy. The EU's macroprudential toolkit includes a dedicated countercyclical capital buffer of up to 2,5% RWA in CET1 capital—a significant add-on to basic capital requirements (10,5%). In addition, many elements of resolution policy are inherently countercyclical, such as recovery planning and early intervention in the upswing of the economy. These policies assume the lack of private incentives for financial stability, in sharp contrast to laissez-faire policies leading up to the crisis.[147]

Secondly, prudential and resolution policy establish substantive limits to market access and market liberty. This is exemplified by the scope and magnitude of capital requirements and macroprudential buffers in the CRR/CRD. In addition to pro-cyclicality, prudential policy regulates capital adequacy, liquidity, leverage, large exposures, market risk, and various types of structural or macroprudential risk. These policies establish a very intrusive regime, made more stringent by recent amendments. For example, the CRR II/CRD V imposes a mandatory leverage ratio (3%) on all firms, and excludes instruments of lower quality (Tier

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[145] Joseph Stiglitz *et al*, 'Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International and Monetary and Financial System' (UN 2009) 51 <www.un.org/en/ga/econcrisissummit/docs/FinalReport_CoE.pdf > accessed 16 September 2021

[146] Hyman P Minksy, *Stabilizing and Unstable Economy* (Yale University Press 1986) 174-175.

[147] The distinction between ordoliberalism and classical laissez-faire liberalism is explored in Josef Hien and Christian Joerges, *Ordoliberalism, Law and the Rule of Economics* (Hart 2017) 1-10.

2) from large exposures requirements. Recent amendments also alter the way capital is calculated: the introduction of the SA-CR and FRTB offer objective methods for assessing financial stability, which are expected to significantly increase compliance costs for credit institutions.[148] The EBA and other expert agencies concede that these rules can have a very restrictive effect on the internal market.[149] A tension between financial stability and market integration is anticipated by the legislator,[150] but the threshold for justifying potential breaches of internal market rules is set low.[151] For instance, in adopting flexibility measures, Member States must provide analysis of negative effects on the internal market, 'based on information which is available to the Member State concerned'.[152]

In addition to direct and indirect capital requirements, the EU's financial stability toolkit includes stringent authorisation requirements. These flow from the principle of mutual recognition, for example, credit institutions that meet initial capital requirements gain access to a 'single passport'. However, there are important exceptions. National authorities have extraordinary discretion in denying or withdrawing authorisation on the basis of financial stability considerations.[153] Further, third-country group consolidation rules in the CRD V

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[148] See Pricewaterhouse Coopers, 'Revised Standardised Approach for Credit Risk – Enhancing Risk Sensitivity' (PwC Hot Topic, January 2018) <www.pwc.co.uk/financial-services/assets/pdf/hot-topic-revised-standardised-approach-for-credit-risk-enhancing-risk-sensitivity.pdf> accessed 17 November 2021.

[149] EBA, 'Opinion on Macroprudential Rules in CRR-CRD' (n 49). Eg, pages 14-15.

[150] Hence, the CRD utilises a process of notification to minimise the potential negative impact on the internal market. Eg, O-SII buffer, Art 131(7); SRB, Art 133(11), etc. But see, *Infra* (n 152) on recent changes.

[151] Whereas the CRR/CRD IV used the same subjective test, the CRR II/CRD V introduces different tests depending on the measure in question. However, it remains to be seen if the new tests are effective in limiting the negative effects in the internal market; while EU institutions gain a stronger surveillance role, the responsibility remains with the Member State to justify macroprudential policy.

[152] Note that the CRR II/CRD V make important changes to the notification of flexibility measures. In brief, according to CRR II, Art 458(4), the Council using qualified majority voting may reject flexibility measures upon proposal from the Commission. It should also be noted that other provisions have replaced this subjective test. Eg, CRD V, Art 131(6)(a) on O-SII buffer now reads: the O-SII buffer must not entail disproportionate adverse effects on the whole or parts of the financial system of other Member States or of the Union as a whole forming or creating an obstacle to the functioning of the internal market.

[153] See eg, Art 14, SSM Regulation on the powers of the ECB in relation to systemic banks in the Eurozone.

make the creation of branches especially difficult, as these will have to meet prudential requirements on a consolidated basis.[154] This legal innovation aims to prevent promise shifting by systemically important institutions in the EU, despite the restrictive effect on the freedom of establishment. More generally, the current regime encompasses rules that dictate board composition, audit and financial reporting, remuneration, and many other areas of corporate governance. It follows that the current prudential policy toolkit qualifies the goal of market integration to an unprecedented degree.[155]

Finally, an ideological shift in the internal market is exemplified by bank recovery and resolution rules. These must be assessed against the backdrop of state aid law used as a financial stability tool in the early stages of the crisis. In line with an ordoliberal understanding of the state as an enforcer of market equality, the main purpose of state aid law is not to facilitate, but to prevent extraordinary assistance to ailing banks. This generated insurmountable challenges, and the Commission was forced to introduce a limited, soft law version of burden sharing in an attempt to reconcile financial stability with state aid law. Therefore, the creation of an expansive resolution toolkit supersedes ordoliberal ideology by authorising extraordinary assistance and transforming the role of the state into that of a helping hand. Crucially, this toolkit encompasses recovery and early intervention, which indicate interference with the market even before financial stability risks materialise fully.[156] Special attention can also be given to the harmonisation of deposit insurance. This body of rules seeks to shield depositors from the consequences of bank failure, in deviation from the principle of market liberty.

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[154] If those assets exceed the threshold of EUR 40 billion. *Supra* (n 68).

[155] This is exemplified by Scherf's analysis that in many regimes financial stability can only be pursued at the expense of competitiveness (and/or credit availability). This 'trilemma' denotes that the ideology of financial stability varies depending on structural reasons (ie, the design of the system in which it operates). See, Scherf (n 138) 120-130.

[156] On the limited use of these powers and how to improve early intervention, see European Banking Authority, 'Report on the Application of Early Intervention Measures in the European Union in Accordance with Articles 27-29 of the BRRD' (EBA/REP/2021/12) <www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1012929/EBA%20Report%20on%20EIMs%20under%20the%20BRRD.pdf> accessed 19 November 2021.

Overall, prudential and resolution policy reforms constitute the biggest ideological shift in the internal market since the Treaty of Maastricht. Developments such as the single monetary policy initiated political integration, but also encouraged liberalisation of the European financial market. By way of contrast, the various tools that make up EU financial stability establish extraordinary limits to market freedom and market access. Whereas the literature considers the single currency to be the "end" of economic functionalism in European integration, the emergence of supranational financial stability represents a more impactful course correction in the financial market.[157] The culmination of an ideological transformation initiated by Maastricht is an output of financial stability that undoubtedly improves the legitimacy of EU law.

4.4.2 The performance and non-economic utility of financial stability tools

In addition to the ideological shift explored above, prudential and resolution policy tools improve legitimacy because they strike a good balance between economic and non-economic performance. In previous chapters it was argued that financial stability is a precondition for social development, but can also entail negative externalities (social costs). For example, a 10% increase in capital requirements is estimated to cause a 0.17% permanent loss in consumption, a key metric of social welfare.[158] Accordingly, it was proposed that output legitimacy rests not only on whether the next crisis is prevented, but on whether policy actively seeks to minimise social costs. The following discussion centres on recent amendments, which address important shortcomings of the CRR/CRD and BRRD and align policy with the teleology of financial stability.

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[157] *Cf.* Michelle Everson, 'Banking on Union: EU Governance Between Risk and Uncertainty' in Mark Dawson, Henrik Enderlein and Christian Joerges (eds) *Beyond the Crisis The Governance of Europe's Economic, Political and Legal Transformation* (OUP 2015).

[158] Skander J Van den Heuvel, 'The Welfare Effects of Bank Liquidity and Capital Requirements' (FDIC Annual Conference, June 18) page 35 <www.fdic.gov/analysis/cfr/bank-research-conference/annual-18th/2-vandenheuvel.pdf> accessed 31 November 2021.

Before turning to the latest wave of reforms, the intensification of regulation and supervision is in itself conducive to social development. This flows from the recognition that markets will always be unstable, thus, public action is necessary to mitigate the severe consequences of instability on society. Relative to the situation prior to the crisis, the CRR/CRD IV and BRRD significantly strengthen the EU's capacity to prevent and manage instability relative to the situation prior to the crisis.[159] This can be linked to the EU's crippling reliance on banking finance, which threatens both economic and non-economic policy goals.[160] The best example is the COVID-19 pandemic: according to the ECB, the EU's financial stability toolkit performed well to prevent further escalation of the public health crisis.[161] Moreover, the Union's financial stability toolkit includes policies such as deposit insurance, which epitomise the non-economic utility of financial stability. Deposit insurance is likely to encourage risk taking; the partial harmonisation of this area demonstrates a political choice to minimise the social costs of bank failure despite the obvious moral hazard.[162] Therefore, the very existence of a single rulebook in banking is a positive step in terms of output legitimacy.

The CRR II/CRD V and BRRD II go much further in aligning policy with teleology of financial stability. Firstly, the CRR II/CRD V abandons the "one-size-fits-all" transposition of Basel rules into EU (hard) law.[163] One of the main criticisms of the CRR/CRD IV was that it sought to incorporate international standards into EU law without differentiating adequately

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[159] This effort encompasses initiatives such as deposit insurance, which are antithetical to a strictly economic interpretation of financial stability as market performance (eg, credit institutions required to set funds aside).

[160] The proliferation of CMU initiatives can also be linked to this shift, see Schammo (n 133).

[161] European Central Bank, 'Financial Stability Review', May 2020 <www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202005~1b75555f66.en.pdf> accessed 8 August 2020.

[162] *Cf*. Atilla Arda and Marc C Dobler, 'The Role for Deposit Insurance Funds in Dealing With Failing Banks in the European Union' (IMF Working Paper, No. 2022/002, January 2022) <www.imf.org/en/Publications/WP/Issues/2022/01/07/The-Role-for-Deposit-Insurance-Funds-in-Dealing-with-Failing-Banks-in-the-European-Union-511639> accessed 1 March 2022.

[163] Though Basel III is also criticised as not being conscious of subjective differences among market participants, Marco Bodellini, 'The Long Journey of Banks from Basel I to Basel IV: Has the Banking System Become More Sound and Resilient Than it Used to Be' [2019] 20(1) *ERA Forum* 81.

between firms of different sizes and risk profiles.[164] A one-size-fits-all approach generates negative externalities because it creates a divergence between risk weights and actual economic risks, thus, putting smaller enterprises at a disadvantage.[165] These institutions are intrinsic to financial stability, for example, smaller firms are less likely to engage in risky behaviour compared to systemically important institutions.[166] More importantly, small credit and investment firms are essential in social development: they enable financing to low income households, provide financial services to SMEs (which make up the lion's share of the European market, and are vital in employment and other policies), they have a low employee turnover, and they tend to be more engaged in their local community.[167] The CRR II/CRD V uses a sector-specific principle of 'proportionality' to ensure that capital and non-capital requirements are adjusted depending on the size and risk profile of each firm.

Proportionality is common in banking regulation, in fact, the current version of the principle is derived from pre-crisis legislation on the operating conditions of investment firms.[168] The CRR/CRD IV made vague reference to proportionality, consistently with its limited scope in Basel II. The new regime clarifies and extends the application of proportionality to a new category of 'small and non-complex institutions'. This classification applies to all firms that

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[164] Masera (n 6).

[165] See generally, Andreas Dombret, 'One Size Fits All? Applying Basel III to Small Banks and Savings Banks in Germany' (Speech, Deutsche Bundesbank, 2 February 2017) <www.bis.org/review/r170210a.htm > accessed 21 November 2021.

[166] Masera (n 6), 394-397. For example, SMEs are less able to circumvent capital requirements through credit restructuring; SMEs are also capable of screening customers, etc. According to Masera, a law that tries to apply to all firms is always going to be outdated, simply because of how difficult and time-consuming it will be to decide on rules that capture the complexity of the financial sector.

[167] See also COVID-19 reforms. Eg, Art 2(1) of Regulation 2020/873, which extends the application for adjustment of risk-weighted non-defaulted SME exposures laid down in Art 501 CRR. This instrument emphasises the role of SME finance in the COVID-19 recovery process.

[168] Eg. CRD IV, Art 76(2). The principle originates in Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L241/26, Art 7(2).

satisfy the nine criteria in Art 4(145) CRR II, which include size, interconnectedness, and risk profile conditions.[169] Small and non-complex firms then benefit from simplified obligations in relation to market risk, medium-term liquidity (NSFR), counterparty credit risk, and interest rate risk in the banking book.[170] Disclosure requirements are also reduced for smaller firms, which implies a significant decrease in compliance costs. Outside of prudential policy, the BRRD II also entails 'simplified obligations and waivers' for small firms.[171] In particular, firms who do not meet the threshold capital of EUR 730,000 are altogether excluded from recovery and planning obligations.[172] Consequently, the changes to sector-specific proportionality negate some of the social costs identified above. In relation to legitimacy, it is also worth noting that this adjustment is consistent with the general principle of proportionality in Art 5(4) TEU.[173]

Secondly, the CRR II/CRD V improves the non-economic utility of financial stability by authorising EU-specific exceptions to Basel. The best example is the amended leverage ratio under CRR II. On the one hand, the leverage ratio becomes a binding Pillar 1 requirement (3%), with more stringent conditions for G-SIIs. On the other hand, the CRR II identifies a range of exceptions that are designed to minimise social costs specific to the EU. The list is extensive; the most important exception is that public development institutions can exclude exposures arising in relation to public sector investments.[174] Exposures linked to promotional

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[169] CRR II, Recital 7, 53-57; See eg, Arts 428ai, 428aq, 433b.

[170] See above, section 4.2.1.

[171] The new regime builds on this approach with further exceptions.

[172] European Banking Authority, 'Report on the Application of Simplified Obligations and Waivers in Recovery and Resolution Planning' (EBA/REP/2020/40) <www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2020/961800/EBA%20Report%20on%20Simplified%20Obligations%20and%20Waivers%20under%20BRRD.pdf?retry=1> accessed 1 March 2022.

[173] Kerstin af Jochnick, 'Striking a Balance: Proportionality in European Banking Regulation and Supervision' (ECB Speech, 12 November 2019) <www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp191112_2~7c13940c3b.en.html> accessed 20 November 2021.

[174] CRR II, Art 429a(d) and (e).

loans to other credit institutions by public development banks are also exempted. This guarantees that investments will continue to be directed towards social policy goals, despite all banks being subjected to strict capital requirements.[175] There are more positive adjustments in the CRR II, for example, institutions may reduce exposures linked to pre-financing loans.[176] Pre-financing loans are temporary loans granted to borrowers to bridge financing gaps until the final loan is granted, and these are essential for first-time homeowners. Generally, the CRR II achieves a level of differentiation between regular investments and investments linked to social policy that contributes to the output legitimacy of EU law.

Thirdly, liquidity requirements deserve separate attention as one of the most controversial aspects of prudential policy. The broad criticism is that liquidity measures can be overly strict, inadvertently reducing liquidity by requiring institutions to set aside liquid assets. Goodhart gives the analogy of a taxi driver at a train station, who turns down a client because a taxi must be parked there at all times.[177] This inevitably generates social costs, although evidence suggests that these may not be as high as the costs of other capital requirements.[178] The CRR introduces a new medium-term liquidity requirement (NSFR), but supports a flexible application of both the NSFR and the LCR. The most critical change is that liquidity funds are made available to banks in times of stress.[179] The link between this adjustment and the non-economic utility of financial stability is exemplified by the recent pandemic. During the COVID-19 crisis, the ECB (acting as a competent authority under the SSM) utilised this exception to authorise the use of up to EUR 1.8 trillion in liquidity funds to meet the needs of

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[175] This can be compared to the UK's 'Social Investment Market' strategy, which prioritises the role of public investment banks in pursuing social policy goals.

[176] On central bank exposures excluded as a result of coronavirus, see Art 1(4) of Regulation 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic, OJ L204/4.

[177] Goodhart (n 18).

[178] Van den Heuvel (n 158); Marie Hoerova *et al*, 'Benefits and Costs of Liquidity Regulation' (ECB Discussion Paper, No 2169, July 2018) <www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2169.en.pdf> accessed 17 November 2021.

[179] CRR, Art 412(1).

households and small businesses.[180] Flexibility is also achieved through the application of proportionality to the NSFR: small and non-complex firms are excluded from its full scope.[181] Ultimately, liquidity measures are implemented progressively and on an extended timeframe to minimise negative externalities.[182]

Fourthly, the CRR II/CRD V fill in several gaps of the initial regime that improve economic and non-economic performance. One of the biggest shortcomings of the CRR was that it gave little attention to counterparty credit risk, or risk that counterparties to derivatives may default before final settlement of the transaction.[183] The CRR II fundamentally alters how counterparty credit risk is calculated through the introduction of the SA-CCR, which captures a much broader range of (private and social) costs than internal calculation methods.[184] Another important correction concerns third-country groups, which are required to set up an IPU in the European Union and meet prudential requirements on a consolidated basis. This is intended to prevent promise shifting and other negative externalities: it ensures that the costs of risk taking are internalised. As regards resolution, the BRRD II (and CRR II) achieves a level of differentiation that is consistent with the aforementioned principle of proportionality. Specifically, the amended MREL requirement is recalibrated to match the global TLAC standard, but this measure also extends to a new category of 'top-tier firms'.[185] Further, 'subordination' is introduced to distinguish between different types of liabilities used in a

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[180] For a brief overview, European Central Bank, 'FAQs on ECB Supervisory Measures in Reaction to the Coronavirus' (February 2022) <www.bankingsupervision.europa.eu/press/publications/html/ssm.faq_ECB_supervisory_measures_in_reaction_to_the_coronavirus~8a631697a4.en.html#_Section_3_–> accessed 10 March 2021.

[181] CRR II, Art 428ai & 428aq, Recital 53.

[182] In light of the COVID-19 pandemic, the NSFR was extended to 2023.

[183] Heikki Marjosola, 'Missing Pieces in the Patchwork of EU Financial Stability Regime? The Case of Central Counterparties' [2015] 52(6) *CMLR* 1491.

[184] See Deloitte, 'Capital Management Under the New Standardised Approach for Counterparty Credit Risk' (2020) <www2.deloitte.com/content/dam/Deloitte/ch/Documents/risk/deloitte-ch-sa-ccr-article-final.pdf> accessed 17 November 2021.

[185] *Supra* (n 103).

bail-in. In principle, these changes seek to minimise social costs, but questions remain about their effectiveness; these are explored below.

Finally, small but targeted changes can be observed in macroprudential policy and corporate governance. Macroprudential policy is an essential component of the teleology of financial stability: it assumes the systemic consequences of instability and epitomises the shift away from market liberalisation. The CRR II/CRD V achieves a much clearer distinction between micro- and macroprudential risks, by excluding the latter from Pillar 2 flexibility.[186] The virtually unlimited scope of Pillar 2 measures under the previous regime was a major source of uncertainty and divergence between Member States. Greater convergence helps to minimise social costs by ensuring that Member States do not misapply capital buffers. Similarly, changes to how SIFI surcharges and the SRB are calculated limit Member State discretion, although these tools still face important challenges. The last area of note is corporate governance. One of the centrepieces of the CRR II/CRD V is the requirement for gender neutral remuneration: the incorporation of equal pay as a means of reducing risk taking activity showcases the connection between financial stability and social development.[187] Corporate governance rules also encompass environmental, social, and governance risk (ESG), to support a long-term transition to sustainable development.[188]

Overall, the proportionality and differentiation of risks in the CRR II/CRD V enhances legitimacy by improving both economic and non-economic outputs of policy. However, the EU's financial stability toolkit is vast and ambitious; it is to be expected that challenges remain, especially in macroprudential and resolution policy, which are relatively new areas of integration. The following challenges present opportunities for future amendments and should not be seen as diminishing the significant progress that has been achieved so far.

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[186] Note that the Commission wanted to limit supervisory flexibility even further, Member State opposition led to this compromise.

[187] Note also proportionality exceptions in remuneration.

[188] The new framework incorporates elements of the 'European Green Deal'. CRR II, Art 449a disclosure rules; CRD V, Art 98 on tasks of EBA.

4.4.3 Weaknesses of CRR II/CRD V & BRRD II

Minimum harmonisation of macroprudential tools

The most challenging area of the CRR/CRD is macroprudential policy. On the one hand, the novel emphasis on macroprudential and systemic risk is a vital step in the right direction.[189] On the other hand, the impact of these tools depends on many variables, including Member State discretion and cross-calibration of different instruments. Lo Schiavo is especially critical of minimum harmonisation in this area, which he perceives as a major obstacle to effectiveness.[190] While further harmonisation could solve some of the issues with macroprudential policy, the true goal of future reforms should be to mitigate the inherently blunt nature of these tools, which generates many externalities.

This challenge is exemplified by the countercyclical capital buffer. The CCyB is set between 0-2.5% of RWA held in CET1 capital to address pro-cyclicality in the economy. In determining the appropriate rate, national authorities must follow a procedure laid out in Article 136 CRD, which requires publication of quarterly guides and taking into account relevant ESRB guidance. This procedure does not guarantee effectiveness, for example, banks may adjust their voluntary buffers to offset the intended effect of the CCyB.[191] More importantly, the CCyB is prone to time inconsistencies. This is because it is a time-varying tool, it must be reduced during contraction of the financial cycle to maintain sustainable flow of credit to the economy.[192] This presupposes that it is possible to determine when the financial cycle has turned, when 'no obvious "natural" financial cycle measure is

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[189] See generally, Rosa M Lastra, 'Systemic Risk, SIFIs and Financial Stability' [2011] 6(2) *Common Market Law Journal* 197.

[190] Lo Schiavo (n 7), 175.

[191] ESRB Handbook (n 59), 82.

[192] Carsten Detken *et al*, 'Operationalizing the Countercyclical Capital Buffer' (ESRB Occasional Paper No 5, 2014) <www.esrb.europa.eu/pub/pdf/occasional/20140630_occasional_paper_5.pdf> accessed 15 December 2020.

available.'[193] The ESRB concedes that the swing of the CCyB can be mistimed, which has the potential to dampen economic growth and generate social costs.[194]

Another example of the blunt nature of capital buffers is the systemic risk buffer (SRB). In its initial formulation under the CRD IV, the purpose and scope of application of this tool were intentionally vague to supplement other capital measures. This simplistic, "more RWA" approach was especially prone to regulatory capture.[195] The CRD V lays out a formula for its calculation and imposes strict conditions on Member States pertaining to *ex ante assessment* and notification. Article 133(1) CRD II abandons the terminology of 'non-cyclical risks', which according to the ESRB was a cause of 'inherent uncertainty'.[196] Thus, the CRD V introduces a degree of clarity in the application of this measure, but the SRB still applies to a broad range of macroprudential and systemic risks, and its use will vary considerably from country to country. This tool remains a less targeted, less direct alternative to the Volcker rule in the US.[197] Further, the uncertain effects of the SRB are exacerbated by its interaction with the O-SII buffer, which also entails considerable Member State discretion.[198]

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[193] Hanno Stremmel, 'Capturing the Financial Cycle in Europe' (ECB Working Paper No 1811, 2015) <www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1811.en.pdf?433a1559cac315388b97f337dba0b795> accessed 15 December 2020.

[194] ESRB Handbook (n 59) 26. Also worth noting that the CCyB is susceptible to regulatory capture, as political incentives shift over time.

[195] Scherf (n 138), Chapter 5.

[196] ESRB Handbook (n 59), 86.

[197] Masera (n 6), 403. The Volcker rule prohibits certain speculative activities, as opposed to requiring additional RWA funds.

[198] Under the CRD IV, the application of these charges was monitored through a notification procedure, which required national authorities to assess the risks of macroprudential policy on the internal market, based on information available to them CRD IV, Art 131(7)(b). This was an incredibly subjective condition, which led the EBA to conclude that the internal market goal was 'not sufficiently addressed' EBA Opinion (n 54) 30. Unsurprisingly, the CRD V replaces this model with a stricter authorisation procedure, whereby the onus is on the Commission to approve O-SII buffers CRD V, Art 131(5a).

In addition to capital buffers, national flexibility remains an area of concern. Despite the changes to Pillar 2, the CRR II maintains flexibility under Article 458 CRR. This enables national authorities to adjust not only disclosure obligations, but own funds and capital buffers. The use and impact of Article 458 CRR will vary considerably across the EU. Similarly, there is enormous variation in the structure of real estate tools (direct and indirect requirements). These are incorporated into different legal regimes, from consumer protection to bank solvency, therefore, real estate tools serve fundamentally different functions in different Member States.[199] It is exceedingly difficult for regulators to gauge the social costs of not only financial stability, but also consumer protection and other policies, especially in cross-border situations.[200] This is a challenge that cannot be resolved through further harmonisation of substantive rules, it requires much deeper change in the regulatory culture of Member States.[201]

At the same time, EU macroprudential policy has important gaps. Asset-based tools, operating on the conditions of loans (as opposed to bank capital) remain exclusively the responsibility of Member States. These tools are directly linked to the non-economic utility of financial stability: tools such as LTV and LTI limits can make lending more difficult by directly affecting the price of loans.[202] Thus, asset-based tools may disproportionately impact first-time house buyers and generate broader distributional effects.[203] This becomes an even bigger problem considering their granular nature and immediate effect on financial stability,

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[199] Hartmann (n 55), 77.

[200] See also, Anat Keller, 'The Possible Distributional Effect of the Loan-to-value ratio and its Use as a Macro-prudential Tool by the European Systemic Risk Board' (2013) 28 *JIBLR* 266.

[201] Scherf (n 138) 120-130.

[202] Compared to capital requirements, which have a less pronounced effect on cost of loans, Anil Kashyap, Jeremy C Stein, and Samuel G Hanson, 'An Analysis of the Impact of 'Substantially Heightened' Capital Requirements on Large Financial Institutions' (Harvard Business School, Mimeo, 2010) <www.hbs.edu/faculty/Pages/item.aspx?num=41199> accessed 15 December 2020.

[203] Keller (n 200), 268-269.

which implies that Member States are likely to overuse them.[204] Although ESRB guidance provides a level of coordination in this area, asset-based tools should be a priority for future harmonisation.

Voluntary & mandatory reciprocity of macroprudential tools

Another key challenge in macroprudential policy is the weak model of reciprocity governing cross-border situations. To explain, Member States have considerable flexibility in adjusting macroprudential policy. Policies implemented at the national level are affected by the policies of other countries and *vice versa* (knock-on effects).[205] For example, leakage occurs when a country raises capital requirements for domestic exposures, but these do not apply to foreign institutions providing lending into that country. This asymmetry between the treatment of domestic and foreign exposures can generate distortions in competition and be a source of moral hazard.[206] The CRR/CRD framework seeks to mitigate this problem through a system of mandatory and voluntary reciprocity, in part derived from Basel.

Reciprocity is not an independent principle of EU law, but it can be understood one of the "club rules" flowing from EU membership. The CRR/CRD deals with reciprocity on a case-by-case basis: measures addressing sector-wide risks are afforded a stronger (mandatory) standard, while tools targeting institution-specific risk may encourage voluntary reciprocation. This system is supported by the recommendations of the ESRB, which set the expectation that all macroprudential measures will be reciprocated voluntarily.[207]

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[204] This fuels inaction bias and a negative feedback loop, because financial stability is not as "loud", its benefits are less discernible in the political sense. *Cf.* Pierre Schammo, 'Inaction in Macro-prudential Supervision: Assessing the EU's Response [2019] 5(1) *JFR* 1.

[205] Recommendation of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2), 2016/C 97/02.

[206] Ibid.

[207] Ibid, Section 1, Recommendation C; Recommendation of the European Systemic Risk Board of 15 January 2019 amending Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2019/1), 2019/C 106/01.

The most obvious issue concerns voluntary reciprocity, exemplified by Article 458 CRR. There is a distinct possibility that a Member State uses Article 458 to address a particular threat, recognition of which is optional, while other Member States deal with that same threat using Article 124/164 CRR or other tools which must be reciprocated (mandatory reciprocity). As a result, credit institutions in the first Member State may be penalised twice for exposures to other countries. In this respect, the combination of voluntary reciprocity and national flexibility can amplify distortions in the internal market, as the EBA concedes.[208] It should be noted that the CRD V makes improvements in relation to voluntary reciprocity. A good example is the systemic risk buffer: if Member States choose to recognise a rate set by another authority, that rate can be cumulative and only the highest of the two buffers applies if they target the same risk.[209] However, reciprocation of SRB rates remains optional. Thus, the CRD V does not eliminate the possibility that some institutions may be forced to hold additional capital, while institutions in other Member States do not, despite being exposed to the same risks.[210]

Mandatory reciprocity is not an automatic solution to the above problem. For example, mandatory reciprocity is an important feature of the CCyB, which requires the reciprocation of rates below 2.5%.[211] Article 137 CRD enables Member States to recognise rates above 2.5%, but there is a clear potential for ring-fencing and other inconsistencies. According to the EBA, these can be corrected by extending mandatory reciprocity or establishing a 'comply or explain' procedure, but the CRD V achieves neither.[212] More generally, it is conceivable that a measure that must be reciprocated (such as Article 124 and 164 floors) is not correctly mapped to the level of risk between countries.[213] Rubio argues that reciprocity

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[208] EBA, 'Opinion on Macroprudential Rules in the CRR – CRD' (n 49), 42.

[209] CRD V, Art 134(4).

[210] EBA, 'Opinion on Macroprudential Rules in the CRR – CRD' (n 49), 33. Member States can however ask the ESRB to recommend recognition.

[211] CRD, Art 140(2).

[212] EBA, 'Opinion on Macroprudential Rules in the CRR – CRD' (n 49), 26.

[213] Ibid, 38. CRR II makes some improvements, eg, Art 124(2). Note that the ECB can also tighten, but not scale down, risk weights and loss given default parameters.

delivers better results than non-reciprocity overall, but there are circumstances where aggressive reciprocation can create monumental social costs.[214]

The bail-in tool & MREL in resolution policy

In addition to the challenges of macroprudential policy, concerns exist in relation to resolution policy. Overall, recovery and resolution rules are a necessary component of the teleology of financial stability.[215] Nevertheless, the bail-in tool and MREL are controversial elements of financial stability policy. As regards MREL, this is a Pillar 2 measure which remains unpredictable despite its recent recalibration with the TLAC. This is primarily because the BRRD II sets minimum standards which Member States can exceed, but also because of the sheer complexity of this requirement, which can generate compliance costs, double counting, and other unintended effects.[216]

In relation to the bail-in tool, the key challenge is uncertainty. In principle, it serves the vital function of preventing bank failure without a costly bailout funded by the taxpayer. Yet there are doubts as to whether this tool actually breaks the sovereign-bank nexus. For example, the costs incurred by shareholders and depositors may not compare to a bankruptcy situation but will still generate systemic effects that threaten financial stability.[217] Avgouleas and Goodhart consider that the bail-in tool does not eliminate the possibility for public bailouts.[218] A further issue is Member State discretion, as both MREL and the bail-in tool follow a minimum

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[214] Margarita Rubio, 'Cross-country Spillovers from Macroprudential Regulation: Reciprocity and Leakage' (CFCM Working Paper 17/09) 20 <www.nottingham.ac.uk/cfcm/documents/papers/cfcm-2017-09.pdf> accessed 10 December 2020.

[215] Gianni De Nicolò, Giovanni Favara and Lev Ratovski, 'Externalities and Macroprudential Policy' (IMF Staff Discussion Note, SDN/12/15, June 2012), pages 13-14 <www.imf.org/external/pubs/ft/sdn/2012/sdn1205.pdf> accessed 17 November 2021.

[216] *Supra* (n 106).

[217] See Anne-Caroline Hüser *et* al, 'The Systemic Implications of Bail-in: a Multi-layered Network Approach' [2018] 38 *JFS* 81.

[218] Emilios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-ins' [2015] 1(1) *JFR* 3; See also, Peter Benczur *et al*, 'Evaluating the Effectiveness of the New EU Bank Regulatory Framework: A Farewell to Bail-out?' [2017] 33 *JFS* 207.

harmonisation approach. Indeed, there are significant divergences in how these measures are implemented at the national level.[219] Finally, the bail-in tool is inherently complex, which is likely to create asymmetries: for example, those affected the most in a bail-in are natural persons who do not have the resources and expertise to take advantage of deposit protection and other exemptions.[220] This alludes to the potentially devastating effects of bail-ins on social development and social equality, an issue explored further in subsequent chapters.

4.5 Conclusion

Financial regulation and supervision are the main means of operationalising financial stability in EU law. Alongside regulation and supervision, which epitomise the preventive side of financial stability, bank recovery and resolution rules aim to enhance the EU's ability to manage instability *ex post facto*. Both dimensions have undergone extensive change in the last decade. On the preventive front, the EU sought to harmonise capital requirements for credit institutions and to establish a robust macroprudential toolkit inspired by Basel. The CRR/CRD framework also encompasses corporate governance, disclosure, and other rules aimed at improving the resilience of the banking sector. As regards crisis management, the BRRD introduces early intervention powers, recovery planning, and a comprehensive toolkit for bank resolution. A degree of harmonisation can also be observed in the adjacent area of deposit insurance.

This chapter tried to answer the question of whether these developments improve the "output" legitimacy of EU law. Consistently with the theoretical framework developed in previous chapters, output legitimacy refers not only to performance in the functionalist sense, but to the wider outputs or teleology of financial stability. This teleology emphasises the ideological underpinnings and non-economic utility of financial stability, which refers to the

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[219] See Christos Hadjiemmanuil, 'Limits on State-funded Bailouts in the EU Bank Resolution Regime (EBI Working Paper No 2 of 2017) <papers.ssrn.com/sol3/papers.cfm?abstract_id=2912165> accessed 05 December 2020.

[220] On the market effects of this tool, see Livia Pancotto, Owain ap Gwilym and Jonathan Williams, 'The European Bank Recovery and Resolution Directive: A Market Assessment' [2019] 44 *JFS* 100689.

strong positive and negative relationship between financial stability and social policy goals. Based on the analysis presented in this chapter, the CRR II/CRD V and BRRD II regimes are aligned with the teleology of financial stability, thus, they improve the output legitimacy of EU law.

In terms of the ideological underpinnings of financial stability, it was argued that the objective represents a paradigm shift in the internal market. This conclusion is supported by the various tools in the CRR II/CRD V and BRRD II. For example, own funds requirements, capital buffers, and authorisation requirements establish significant limits to market access and market freedom. Resolution policy also replaces state aid rules as a crisis management tool, prioritising systemic threats to the banking sector over market equality. Overall, the EU's financial stability toolkit qualifies the goal of market integration to such extent that it contradicts an ordoliberal (or laissez-faire liberal) vision of the European financial market. It follows that financial stability represents the biggest turn away from economic functionalism since the introduction of the single currency in Maastricht, which contributes to the legitimacy of EU law.

Moreover, recent amendments address many of the shortcomings of the initial prudential and resolution policy toolkit in relation to the non-economic utility of financial stability. The current regime utilises a sector-specific principle of proportionality to differentiate between firms of different sizes, which is significant in promoting employment policies, SME financing, and other initiatives. Differentiation of policy can also be observed in the various EU-specific exceptions to capital requirements, for instance, to protect public development banks with exposures linked to social development. These adjustments are crucial in minimising negative externalities (social costs), consistently with the teleology explored in Chapter 2. The CRR II/CRD V go as far as to incorporate gender neutrality rules in EU financial stability law, which demonstrates that the purpose of post-crisis reforms is not solely to prevent another crisis. These reforms deliver outcomes which strongly improve the legitimacy of EU law.

Notwithstanding the overwhelmingly positive adjustments of the CRR II/CRD V and BRRD II, challenges remain in macroprudential and resolution policy. The main area of concern is

the minimum harmonisation of macroprudential tools. There are several issues with the CCyB, the SRB, Article 458 CRR, real estate and asset-based measures, some of which can be corrected through further harmonisation. Others require structural changes in the regulatory culture of the Member States, which implies that maximum harmonisation may not be the solution. Another challenge is the weak system of voluntary and mandatory reciprocity governing macroprudential tools. The success of reciprocity rests entirely on ESRB coordination. Finally, this chapter explored some of the criticisms of the BRRD in relation to the bail-in tool and MREL. This issue is explored further in relation to financing assistance in the euro area and institutional reforms in the Banking Union.

Chapter 5: The European System of Financial Supervision (ESFS) and the Banking Union (BU)

5.1 Introduction

My previous chapter explored substantive reforms in prudential policy (CRR/CRD) and bank failure (DGS & BRRD). On the other side of the same coin, the legitimacy of financial stability policy depends on the institutional framework within which substantive tools operate. The institutional architecture of EU financial stability has undergone significant change, both in terms of EU-wide supervisory reorganisation and more ambitious initiatives in the euro area. This chapter focuses on the legitimacy of two critical reforms, the European System of Financial Supervision (ESFS) and the Banking Union (BU). My aim is to show that institutional reforms contradict key elements of the teleology of financial stability, which is an important obstacle to output legitimacy.

The ESFS was conceived as a response to the earliest stages of the crisis, and the shortcomings of decentralised, micro-prudential supervision.[1] One of the most important steps in the reform process was the development of the single rulebook in banking and the proliferation of macroprudential policy. Along with the single rulebook came reform of the committee based Lamfalussy process, who main purpose was to reduce barriers to integration, and its replacement by a supranational financial stability system, the ESFS.[2] The new supervisory architecture comprises of three supranational agencies with vast supervisory powers in relation to financial markets (ESMA), the banking sector (EBA), and insurance and

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[1] See Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' [2010] 47(5) *Common Market Law Review* 1381; 'Supervision in the Wake of the Financial Crisis: Achieving Effective "Law in Action" - A Challenge for the EU' in Eddy Wymeersch, Klaus J Hopt and Guido Ferrarini (eds) *Financial Regulation and Supervision: A Post Crisis Analysis* (OUP 2012) 71.

[2] See Eilís Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' in Wymeersch, Hopt and Ferranini, ibid, 117.

occupational pensions (EIOPA). A further addition is that of an expert macroprudential coordinator, the European Systemic Risk Board (ESRB).

While the ESFS goes a long way in enhancing convergence through expertise, it remains a decentralised system. Such fragmentation becomes untenable in the EMU due to the interconnectedness of banking supervision and monetary policy.[3] The Banking Union emerged as a solution to this unique problem.[4] It consists of two pillars: the Single Supervisory Mechanism (SSM) strengthens the role of the ECB in the supervision of Eurozone banks, and the Single Resolution Mechanism (SRM) provides a common framework for recovery and resolution among participating countries. A third pillar, the European Deposit Insurance Scheme (EDIS), is intended to create a centralised system of deposit insurance. EDIS has proven very controversial and is still in the making.

It should be noted that there is an abundance of literature on these topics. My goal is not to explore any one issue exhaustively, but rather to analyse the legitimacy of financial stability reforms as a whole. First, I address the phenomenon of 'agencification', which describes the delegation of executive power to technocratic agencies.[5] Consistently with the conceptualisation of output legitimacy as extending beyond performance, it is argued that agencification significantly restricts political leadership and *ex post* accountability of financial stability. This is problematic because 'throughputs' such as accountability are a vital operational component of the non-economic utility of financial stability. Equally, from an

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[3] Fragmentation impacts on the transmission of monetary policy and creates a negative feedback loop that threatens the effectiveness of prudential policies. Vítor Constâncio, 'Why EMU Requires More Financial Integration' (Speech by the Vice-President of ECB, Joint Conference of the European Commission and ECB, May 2018) <www.bis.org/review/r180507a.htm> accessed 01 March 2021.

[4] In this sense, the BU is both a cause and consequence of differentiated integration. See generally, Alexander C G Stubb, 'A Categorization of Differentiated Integration' [1996] 34(2) *Journal of Common Market Studies* 283; Menelaos Markakis, 'Differentiated Integration and Disintegration in the EU: Brexit, the Eurozone Crisis, and Other Troubles' [2020] 23(2) *Journal of International Economic Law* 489.

[5] See generally, Elizabeth Howell, 'EU Agencification and the Rise of ESMA: Are its Governance Arrangements Fit for Purpose' [2019] 78(2) *Cambridge Law Journal* 324; Merijn Chamon, 'EU Agencies: Does the Meroni Doctrine Make Sense' [2010] 17(3) *Maastricht Journal of European and Comparative Law* 281.

ideological perspective, institutional developments are far less novel than substantive reforms: agencification can be seen as extending 'market utility' through significant vertical and horizontal shifts in the balance of powers.

Finally, this chapter examines specific challenges pertaining to the Banking Union, the ESAs, and the ESRB. In relation to the Banking Union, I focus on the absence of centralised deposit insurance, and other issues with resolution policy, which contradict the teleology of financial stability because they reduce the EU's ability to minimise the social costs of financial stability policy. Further, differentiated integration in Banking Union complicates the tasks of the ESAs, and in particular the EBA, which has proven essential in supporting the application of substantive tools in a way that considers both the economic and non-economic utility of financial stability. Finally, the ESRB's soft law powers are significant: this body acts as a *de facto* macroprudential supervisor, but judicial and political scrutiny of its actions is minimal. While there are positive features in the current institutional architecture, the above inconsistencies with the teleology of financial stability indicate a significant threat to output legitimacy.

The chapter is organised as follows. Section 5.2 explores the formation of three new supervisory authorities (ESAs), mainly ESMA and EBA, and outlines the mission and powers of the ESRB. Section 5.3 details the creation and tasks of the SSM and SRM as the main pillars of the Banking Union. Brief reference is also made to the many compromises of EDIS. Section 5.4 focuses on the broad issue of agencification, and whether the delegation of unprecedented powers to expert agencies contradicts the teleology of financial stability. Section 5.5 identifies specific inconsistencies with non-economic utility, relevant to EDIS and the SRM, the ESAs, and the ESRB.

5.2 European System of Financial Supervision (ESFS)

In 2011, the ESFS replaced the Lamfalussy Level 3 Committees of Supervisors (CESR, CEBS, and CEIOPS) with three new supervisory agencies (ESAs), an expert macroprudential

body (ESRB), and the Joint Committee of ESAs for cross-sectoral coordination.[6] Under the new system, national supervisory bodies retain many of their direct powers and day-to-day tasks. Nevertheless, the introduction of the ESAs is a significant departure from Lamfalussy, which was mainly aimed at abolishing obstacles to integration and lacked 'proper' institution-building.[7] Lamfalussy also faced problems with implementation and enforcement due to its ineffective four-level structure.[8]

Whilst maintaining a decentralised model, the ESFS seeks to overcome the shortcomings of Lamfalussy by entrusting supervisory authorities with considerable standard-setting and coordination powers, as well as direct powers in limited circumstances. Further, the establishment of the ESRB is critical due to the intrinsic link between macroprudential policy and financial stability. This section will outline the mission, tasks, and organisation of these agencies. Owing to the scope and complexity of these reforms, analysis of legitimacy is reserved for sections 5.4 and 5.5.

5.2.1 European Securities and Markets Authority (ESMA)

The European Securities and Markets Authority (ESMA) is the most influential of the new supervisory authorities. ESMA is an entity with legal personality,[9] whose primary objective is to contribute to the stability and effectiveness of the financial system. Improving the functioning of the internal market is a secondary goal, along with consumer protection and other interests listed in Art 1(5) of its founding Regulation. Based on the tasks allocated to it, ESMA's mission is fourfold: (i) assessing risks to investors, markets, and financial stability,

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[6] Article 2(2), (ESMA) Regulation 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ L331/84.

[7] See Despina Chatzimanoli, 'A Crisis of Governance? — From Lamfalussy to de Larosière or Bridging the Gap between Law and New Governance in the EU Financial Services Sector' [2011] 2(3) *European Journal of Risk Regulation* 322.

[8] Duncan Alford, 'The Lamfalussy Process and EU Bank Regulation: Another Step on the Road to Pan-European Regulation' [2006] 25(1) *Annual Review of Banking & Financial Law* 389, 406-416.

[9] Art 5(1), ESMA Regulation. This is a significant precondition for many of ESMA's powers.

(ii) completing the single rulebook for EU financial markets (developing draft technical standards in accordance with tasks delegated to the Commission), (iii) promoting supervisory convergence through peer reviews, thematic studies, and other means, and (iv) pursuing direct supervision in limited circumstances.[10]

ESMA operates on a paradox. Its effectiveness is predicated on the exercise of key supervisory powers, yet its status as a European agency precludes it from ever becoming a supervisor in the classical sense. Not only would the conferral of such competences to an agency be politically untenable, but a potential breach of the subsidiarity principle. The subsidiarity rationale is reflected in the fact that ESMA has assumed direct supervision of specific entities best regulated at the European level: credit rating agencies, trade repositories, and securitisation repositories.[11] In this role, ESMA enjoys powers ranging from *ex ante* authorisation and monitoring, to *ex post* enforcement.[12] In light of Brexit, ESMA was granted additional powers over non-EU entities of systemic importance (third country CCPs) and cross-border activities (critical benchmarks and data reporting).[13] It should be emphasised

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[10] ESMA enjoys a wide range of powers: developing regulatory standards, issuing warnings to investors, issuing opinions to the Commission and other institutions, adopting guidelines and recommendations, taking individual decisions within its mandate; Art 8(1) & (2), ESMA.

[11] Arts 55-81, (EMIR) Regulation 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; See also new powers under (EMIR 2) Commission Delegated Regulation 2017/104 of 19 October 2016 amending Delegated Regulation 148/2013 supplementing Regulation 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards on the minimum details of the data to be reported to trade repositories C/2016/6624, OJ L17/1.

[12] Art 23b-d, Regulation 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation 1060/2009 on credit rating agencies OJ L146/1. On the links between ESMA's direct enforcement powers and *Meroni*, see Howell, 'The Evolution of ESMA' (n 5), 1036-37.

[13] Regulation 2019/2099 of the European Parliament and of the Council of 23 October 2019 amending Regulation 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs, OJ L322/1. On the link between EMIR 2.2 and Brexit, see Niamh Moloney, 'Reflections on The EU Third Country Regime for Capital Markets in the Shadow of Brexit' [2020] 17(1) *European Company and Financial Law Review* 35.

that these areas are exceedingly difficult to supervise along national lines and some were previously unregulated.[14]

The incremental expansion of ESMA's direct supervisory powers is 'interwoven' with a gradual transfer of wider operational powers to the agency.[15] Three examples stand out: ESMA's emergency powers over short sales, its gatekeeping role in the realm of financial innovation, and its duty to promote supervisory convergence. Regarding innovation, ESMA is responsible for consolidating knowledge on new and existing activities, developing analysis and coordinating national initiatives, as well as controlling market entry through product intervention (prohibition).[16] The new product governance regime in MiFID II and MiFIR grants ESMA extensive supervisory and enforcement powers, in line with the goals of consumer/investor protection and financial stability.[17] Moreover, ESMA's goal of promoting supervisory convergence implies a near-monopoly over rule supply.[18] ESMA's standard-setting powers can be described as quasi-legislative because they are subject to approval by the Commission.[19]

Short selling warrants special attention. The practice involves the sale of borrowed assets by an investor who speculates that the price of the assets will drop. The investor returns the

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[14] See generally, Gudula Deipenbrock, 'Direct Supervisory Powers of the European Securities and Markets Authority (ESMA) in the Realm of Credit Rating Agencies – Some Critical Observations in a Broader Context' [2018] 29(2) *European Business Law Review* 169.

[15] Howell, 'The Evolution of ESMA' (n 5), 1048.

[16] Art 9(5), ESMA Regulation. Product intervention is temporary, but ESMA may request the Commission to adopt permanent measures.

[17] See, Emilios Avgouleas, 'The Role of Financial Innovation in EU Market Integration and the Capital Markets Union' in Danny Busch, Emilios Avgouleas and Guido Ferranini (eds) *Capital Markets Union* in Europe (OUP 2018).

[18] Niamh Moloney, 'Reform or Revolution? The Financial Crisis, EU Financial Markets Law, and the European Securities and Markets Authority' [2011] 60(2) *International and Comparative Law Quarterly* 521, 530. An interesting question in relation to convergence, relevant to output legitimacy, is whether convergence stifles regulatory innovation.

[19] Ibid.

assets to the owner after having re-purchased at a lower price, which yields profit and can be used to hedge other investments. Short selling is considered a high-risk activity and regulated by the Short Selling Regulation.[20] This activity invokes ESMA's emergency powers: the agency is responsible for authorising, facilitating, coordinating, and reviewing short sales restrictions adopted by NCAs (or any other emergency measure).[21] In exceptional circumstances, ESMA may address decisions to individual market participants, prohibiting or imposing conditions on a transaction.[22] While ESMA's direct intervention powers are not unlimited (for example, they do not apply to sovereign debt or sovereign credit-default-swaps), they were subject to challenge in the *Short Selling* case.[23] In this case, the UK claimed that ESMA's emergency powers were largely discretionary, in contravention of the *Meroni* doctrine, Article 114, and other provisions of EU law. The Court rejected the UK's challenge on the basis that the EU legislator must be granted special discretion in times of crisis. This case is explored further below.

ESMA's extensive tasks raise obvious questions about accountability. Under its founding Regulation, ESMA is politically accountable to the European Parliament and the Council. This entails extensive reporting duties, and informal dialogue between ESMA and the Economic and Monetary Affairs Committee.[24] The European Parliament may also object to the appointment of the agency's chairperson and independent executive director.[25] Political accountability is by no means a safeguard against all transgressions, but it is capable of shining a spotlight on issues that may not be immediately apparent in a technical field. In addition to this, ESMA's decisions are subject to judicial review. On the day-to-day level, national courts monitor data collection and investigations. At the European level, the ESA's

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[20] (SSR) Regulation 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, OJ L86/1.

[21] Art 18(1) & (3) ESMA Regulation.

[22] Art 18(4)-(6) ESMA Regulation, Art 28(1) SSR. A similar procedure applies to breaches of EU law under Art 17(6) ESMA Regulation.

[23] *Short Selling* (C-270/12) ECLI:EU:C:2014:18.

[24] Recital 10, Art 3, ESMA Regulation.

[25] Art 48(2) & (5), Art 51(2) ESMA Regulation.

joint Board of Appeals seeks to protect the interests of those affected by ESMA's decisions and, during this process, the jurisdiction of the ECJ may be invoked under Article 263 TFEU.[26]

Other forms of accountability include the Commission's constant interaction with ESMA, which flows from the nature of the delegated tasks assigned to the agency. This extends beyond formal approval of draft technical standards, to budgetary control, and informal communication.[27] There are also external safeguards, such as the European Ombudsman, and pressures from other ESAs through their Joint Committee.[28] Finally, accountability can also be linked to ESMA's mandate and internal organisation. A point of criticism is that ESMA's powers are expressed in relatively flexible terms and have gradually increased.[29] The literature considers whether extensive governance changes, such as the creation of an independent Executive Board, are required to counteract the agency's emerging role. However, internal reorganisation can only go so far in improving independence due to the Commission's looming presence.[30] ESMA's sister authorities, EBA and EIOPA, demonstrate similar dilemmas.

5.2.2 European Banking Authority (EBA) & European Insurance and Occupational Pensions Authority (EIOPA)

The growing influence and centrality of ESMA in the field of financial supervision indicates a potential subordination of EBA and EIOPA. There is evidence suggesting the three ESAs were never conceived as equal partners, but this is certainly pronounced in their recent history.[31] Either directly, or indirectly as a result of political pressure, the creation of the Banking Union and other developments have altered the tasks, organisation, and accountability of EBA and EIOPA.

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[26] Art 60, ESMA Regulation.

[27] Art 10 on draft technical standards; Arts 62-65 on budget, ESMA Regulation.

[28] Howell, 'EU Agencification and the Rise of ESMA' (n 5), 337-338.

[29] Ibid.

[30] Ibid.

[31] Eg, direct supervisory powers of ESMA. Ferran (n 2).

The European Banking Authority does not enjoy the direct powers or visibility of ESMA, yet its expertise in banking is indispensable to the ESFS. The conferral of supervisory competences to the ECB through the Single Supervisory Mechanism is commonly seen as sabotaging EBA's supervisory potential, but it also reinforces the indirect role carved out for it. The agency's main priority is to promote a single rulebook for banking.[32] EBA has proven it is well positioned to play a leading role in the development of micro- and macroprudential policy as an EU-wide expert, and it has so far proven to be proactive and innovative in this capacity.[33] For example, Chapter 4 explored EBA's input in reviewing and refining the CRR/CRD IV. *Inter alia*, the principle of proportionality employed in recent amendments, which enhances output legitimacy by minimising the social costs of policy, stems primarily from EBA pressures.[34]

EBA's mission centres around financial stability and the protection of consumers, investors, and depositors. It is empowered to issue warnings, guidelines, recommendations, although its main tool for enhancing supervisory convergence is the adoption of draft technical and implementing standards.[35] These are delegated or implementing acts with a binding legal effect on third persons, subject to the Commission's endorsement.[36] The importance of this tool should not be underestimated, as the experience of Brexit and the monumental challenge

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[32] Art 8(1)(a), (EBA) Regulation 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, OJ L331/12.

[33] See Chapter 4, in particular EBA role in MREL II and proportionality reforms as part of CRR II/CRD V. In relation to financial stability, it also worth noting the importance of EBA in developing macroprudential policy tools through its opinions.

[34] For example, proportionality significantly reduces disclosure obligations and other compliance costs for smaller enterprises.

[35] Art 8(2), EBA Regulation. On the goal of convergence, see Donato Masciandaro, Nieto J Maria and Marc Quintyn, Exploring Governance of the new European Banking Authority—A Case for Harmonization?" [2011] 7(4) *Journal of Financial Stability* 204.

[36] Arts 10-15, EBA Regulation.

of replacing a comprehensive body of EU technical rules has shown.[37] Moreover, EBA is responsible for policing breaches of EU law in its area of expertise and granted mediation powers to settle cross-border disputes between national authorities.[38]

A core feature of the ESFS, the emergency powers of EBA mirror those of ESMA and EIOPA. It may instruct national authorities to take specific action or temporarily prohibit/restrict activities that threaten its core objectives.[39] Importantly, EBA's decisions do not apply solely to national authorities, but also to the ECB in accordance with the SSM Regulation.[40] This puts an EU *agency* in the position of potentially interfering with the tasks of an EU *institution*, which is not unprecedented, but it is a hierarchical anomaly.[41] This raises the 'existential' question of whether EBA's emergency powers are obsolete: informal communication with the ECB is the more conciliatory and efficient route.[42] Outside of these key tasks, the agency is also given a role in improving consumer protection, financial innovation, and payments regimes (transparency, simplicity, fairness). This entails reporting on market trends, coordinating education initiatives, developing training standards and disclosure obligations, as well as overseeing fringe areas such as shadow banking.[43] Considering the EU's reliance on banking finance, EBA contributes to financial stability in more ways than one.

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[37] Bank of England, 'UK Withdrawal from the EU: Changes Before the End of the Transition Period' (PRA Consultation Paper CP13/20, 22 September 2020) <www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp1320.pdf?la=en&hash=A47C0DDB161FDED551B75A2D4EA4FB7A1DDABB75> accessed 13 February 2021.

[38] Arts 17 & 19, EBA Regulation.

[39] Arts 9(5) & 18(3), EBA Regulation.

[40] Art 4(3), (SSM) Council Regulation 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L287/63.

[41] For example, the ECB is already bound by EBA technical standards.

[42] See Eilís Ferran, 'The Existential Search of the European Banking Authority' [2016] 17(3) *European Business Organization Law Review* 285.

[43] Art 9, EBA Regulation.

The internal organisation and processes of EBA have undergone significant change to accommodate the needs of differentiated integration in the EMU.[44] For example, the use of independent panels is extended to cover breaches of EU law.[45] Under the EBA Regulation of 2010, independent panels were conceived as a means of settling disputes between competent authorities, through the impartial assessment of a small team of representatives from countries not involved in the dispute.[46] There is an obvious trade-off between efficacy and inclusivity in the use of small-team panels, especially when they are extended to cover another key task of EBA. A more impactful change concerns voting in the Board of Supervisors.[47] As Schammo explains, independence and efficacy are sacrificed to appease non-EMU countries: in the adoption of draft technical standards (as well as warnings and recommendations), qualified majority voting must now include both a majority of countries participating in the SSM and a majority of non-participating countries.[48]

The European Insurance and Pensions Authority is the final supervisory agency created as part of the ESFS. Its mission covers both financial stability and consumer protection, with respect to the supervision of insurance and reinsurance companies, insurance intermediaries, and occupational retirement schemes.[49] EIOPA's advisory role is important. Through its

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[44] (EBA Amending) Regulation 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation 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 L287/5; Pierre Schammo, 'Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?' in Patrick J Birkinshaw and Andrea Biondi (eds), *Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU* (Kluwer Law International 2016).

[45] Monitoring breaches of EU law is one of the main tasks of all ESAs. See Art 17 EBA Regulation.

[46] Art 41, EBA Regulation.

[47] Schammo (n 44).

[48] Ibid; Article 44(1) EBA Amending Regulation. This rule also applies to budgetary matters (Chapter VI) and other areas.

[49] Art 8(1)(a), (EIOPA) Regulation 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, OJ L331/48.

dialogue with the Commission, it has proven instrumental in the adoption of minimum solvency requirements for pension schemes, and in establishing a risk-based approach to their calculation.[50] This joint effort culminated in the revised IORP II Directive (instruments for occupational retirement provisions), which strengthens governance, risk management, and disclosure/member communication.[51] EIOPA's influence in this process cannot be understated, in particular, its advice highlighted the potential of IORP requirements for pro-cyclicality and promise shifting, which steered the Commission's legislative proposal. This is an example of its intrinsic connection to financial stability.[52]

More broadly, EIOPA has the power to develop guidelines, issue recommendations, and to prepare draft regulatory and implementing standards.[53] Similarly to EBA, it polices breaches of EU law, cross-border disputes, and is tasked with promoting supervisory convergence and information sharing.[54] Its emergency powers also mirror those of its sister ESAs: it can require NCAs to perform a specific action, or directly restrict certain activities that pose a serious threat to its objectives.[55] A unique aspect of EIOPA is that it may assess the need for harmonisation in the area of insurance guarantee schemes, and accordingly prescribe its own involvement in this process.[56]

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[50] See eg, European Insurance and Occupational Pensions Authority, 'Advice to the European Commission on the Review of the IORP Directive 2003/41/EC' (BOS-12-015, 15 February 2012) <www.eiopa.europa.eu/sites/default/files/publications/pdfs/eiopa-bos-12-015_eiopa_s_advice_to_the_european_commission_on_the_review_of_the_iorp_directive.pdf> accessed 14 Feburary 2021.

[51] Directive 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), OJ L354/37.

[52] See also on small/private pensions, Wolf Frieder and Georg Wenzelburger, 'Second Tier, Second Thoughts—Why it Turns out to be so Difficult for EIOPA to Create a Single Market for Private Pensions' [2016] 2(1) *European Policy Analysis* 39.

[53] Arts 8 & 10, EIOPA Regulation.

[54] Arts 17, 19, 29-31, EIOPA Regulation.

[55] Recitals 29, 30; Art 9(5), EIOPA Regulation.

[56] Art 26, EIOPA Regulation; See eg, European Insurance and Occupational Pensions Authority, 'Discussion Paper on Resolution

5.2.3 European Systemic Risk Board (ESRB)

The ESRB was established by Regulation 1092/2010 on the basis of Article 114 TFEU.[57] It does not have a strict mandate, but rather a 'mission' expressed broadly: 'the ESRB [is] responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability'.[58] The use of the term 'contribute' is vague and open-ended, implying a gradual evolution of the ESRB's tasks.[59] As with the ESAs, the smooth functioning of the internal market is a secondary goal of the ESRB.

The tasks of the ESRB include collecting and analysing data, identifying and prioritising risks, issuing warnings, and issuing recommendations for remedial action.[60] Recommendations are by far the most popular and effective tool at the disposal of the ESRB. These can be addressed to the EU as a whole, to individual Member States (supervisory and resolution authorities), the three ESAs, the European Commission; as of recently, the ESRB may also address warnings and recommendations to the ECB in its supervisory capacity.[61] In addition to recommendations, the ESRB can issue warnings. These are mainly used to

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Funding and National Insurance Guarantee Schemes' (EIOPA-CP-18-003, 30 July 2018) <www.eiopa.europa.eu/sites/default/files/publications/pdfs/eiopa-cp-18-003_discussion_paper_on_resolution_funding_and.pdf> accessed 11 February 2021.

[57] Recital 31, (ESRB) Regulation 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, OJ L331/1.

[58] Art 3(1), ESRB Regulation.

[59] Anat Keller, 'The Mandate of the European Systemic Risk Board and Resilience as an Essential Component: Part 1' [2016] 31(1) *Journal of International Banking Law and Regulation* 13, 14.

[60] Art 3(2), ESRB Regulation.

[61] Art 16(2), (ESRB Amending) Regulation 2019/2176 of the European Parliament and of the Council of 18 December 2019 amending Regulation 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, OJ L334/146.

address medium-term vulnerabilities in the real estate sector and are typically accompanied by a recommendation. The ESRB has published 13 warnings since 2010.[62]

While the ESRB lacks direct supervisory powers, its soft law measures are essential in recalibrating and reciprocating macroprudential tools. First, the prevention of systemic risk necessitates a bird's-eye view of the European financial market, especially because Member States enjoy wide discretion in relation to macroprudential capital buffers under the CRD. Second, ESRB recommendations can encompass areas of macroprudential policy that remain unharmonised, such as LTV, LTI, and DSTI ratios (asset-based tools). It was previously argued that these tools entail significant social costs, thus, the ESRB's guidance can ensure that Member States do not misapply or overuse asset-based tools.[63] Thirdly, the CRR/CRD relies extensively on the voluntary reciprocation of capital buffers in cross-border situations, which is exceedingly difficult without the monitoring and guidance of the ESRB.[64]

The ESRB is organised as follows.[65] The General Board is the main decision-making organ of the ESRB, responsible for performing the tasks listed above. It has broad membership including the president and vice-president of the ECB, the governors of national central banks, and representatives from the Commission and the ESAs.[66] National authorities are not represented in the Steering Committee, which has a supporting role and sets the agenda for General Board meetings.[67] In addition, the ESRB has an advisory technical and an advisory scientific committee.[68] The former supports the operations of the ESRB through policy analysis and advice, while the latter has the forward-looking task of conducting research on

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[62] European Systemic Risk Board, 'Warnings' (ESRB Policy) <www.esrb.europa.eu/mppa/warnings/html/index.en.html> accessed 28 January 2021.

[63] In fact, most of the ESRB's recommendations concern the application of asset-based tools in the real estate sector.

[64] See Chapter 4. It should be noted that the ESRB has gradually addressed new areas, such as liquidity, etc.

[65] Art 4, ESRB Regulation.

[66] Arts 6-10, ESRB Regulation.

[67] Art 11, ESRB Regulation.

[68] Arts 12-13, ESRB Regulation.

macroprudential policy. Finally, the secretariat, supported by the ECB's offices in Frankfurt, is responsible for the day-to-day administration of the ESRB.[69]

The ESRB is heavily reliant on the ECB not only at the administrative level, but also in leadership roles as the president of the ECB acts simultaneously as chair of the ESRB on a permanent basis.[70] The original text of the ESRB Regulation clearly envisioned ECB leadership as temporary and transitional, to be reviewed by 2013.[71] The European Parliament's review recommends an independent chair, as well as a selection procedure that mirrors that of the ESAs (EP can veto appointment). However, the ESRB Amending Regulation gave permanent effect to the initial arrangement.[72] It should be noted that safeguards are in place to ensure representation of multiple interests: for example, the first vice-chair of the ESRB is elected among the governors of the national central banks, with due regard for a balanced representation of euro and non-euro area countries.[73] The second vice-chair is the chairperson of one of the ESAs (currently, ESMA). Despite these safeguards, the leadership role of the ECB is a potential threat to the independence of the ESRB.[74]

Voting in the General Board is another area of controversy. In addition to the governors of national central banks, who have voting rights, Member States may appoint a further representative of their macroprudential supervisory authority.[75] This member has no right to

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[69] Art 4(4), ESRB Regulation.

[70] Art 5(1), ESRB Amending Regulation.

[71] Original text of Art 5(1), ESRB Regulation.

[72] European Parliament, Directory General for Internal Policies, 'Review of the New European System of Financial Supervision (ESFS): Part 2: The Work of the European Systemic Risk Board – The ESFS's Macro-Prudential Pillar' (IP/A/ECON/ST/2012-23, October 2013) page 86 <www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507490/IPOL-ECON_ET(2013)507490_EN.pdf> accessed 27 January 2021.

[73] Art 5(2), ESRB Amending Regulation. The vice-chair may only be re-elected once.

[74] See below, Section 5.5.3.

[75] Art 6(2) ESRB Regulation.

vote, which, as Ehrmann and Schure indicate, creates strong asymmetries.[76] First, Member States' macroprudential authorities will only have the right to vote if they are a central bank. This is problematic because certain macroprudential authorities will be excluded from decision-making in their field of expertise, while monetary policy institutions are granted a voting rights by default.[77] Second, the fact that Member States are only permitted one non-voting member implies that national authorities are either not represented continuously due to rotation, or in the case that Member States opt for a permanent representative, excluded altogether (eg, resolution authorities).[78] Under the current arrangement, the first-vice chair of the ESRB has no voting rights, as their Member State is represented separately.[79]

On the whole, the European System of Financial Supervision signifies a reorganisation of the institutional architecture to support various dimensions of supranational financial stability. Many of the powers allocated to these agencies are unprecedented, including the macroprudential tasks of the ESRB and the direct intervention powers of the ESAs. Before turning to the output legitimacy of these reforms, it is necessary to explore an even more ambitious development: the creation of the Banking Union in the euro area.

5.3 Banking Union (SSM & SRM)

The Banking Union was conceived as a solution to the sovereign debt crisis in the euro area. By 2012, it was already clear that the novel design of the EMU generated unique challenges: a higher degree of integration extends linkage between countries and magnifies the sovereign-bank nexus.[80] EU-wide reforms such as the CRR II/CRD V and BRRD II would

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[76] Michael Ehrmann and Paul Schure, 'The European Systemic Risk Board – Governance and Early Experience' [2020] 23(3) *Journal of Economic Policy Reform* 290, 295.

[77] Note that central banks are accountable at the national level, thus, incentives between monetary and macroprudential authorities are often aligned.

[78] Ehrmann and Schure (n 76), 295-296.

[79] Currently, the Governor of Sveriges Riksbank.

[80] Constâncio (n 3); Ignazio Visco, 'The Aftermath of the Crisis – Regulation, Supervision and the Role of Central Banks' (Harvard Kennedy School Lecture, 16 October 2013) <www.bis.org/review/r131021b.pdf > accessed 14 February 2021.

need to be supported by institutional changes in the euro area. The Banking Union is not a "union" in the true sense, rather it consists of 'significant institutional innovations'.[81] While centralisation is a feature of the Banking Union, other elements follow a decentralised structure, and some are altogether incomplete.[82]

This section will examine the two main pillars of the Banking Union, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). A third initiative, the European Deposit Insurance Scheme (EDIS), is still a work in progress and will only be briefly discussed. These developments fundamentally alter the operationalisation of EU financial stability in the euro area. Analysis of the legitimacy of these reforms will follow in subsequent sections.

5.3.1 Single Supervisory Mechanism (SSM)

The Single Supervisory Mechanism must be considered in tandem with substantive reforms, such as the CRR II/CRD V, which expanded and reorientated the EU's prudential policy toolkit towards supranational financial stability. These substantive reforms are centred around banking regulation and supervision, the systemic importance of which becomes even more pronounced in the euro area, in light of the single monetary policy. In this setting, the decentralised structure of the CRR II/CRD V becomes near untenable: fragmentation impedes the transmission of a common monetary policy, which in turn creates feedback loops that threaten the effectiveness of prudential policy.[83] The SSM was founded precisely on the need to reinforce price stability with a robust system for financial regulation and

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[81] Eddy Wymeersch, 'The Single Supervisory Mechanism' in Danny Busch and Guido Ferranini (eds) *European Banking Union* (OUP 2015) 103.

[82] Ibid; Lucia Quaglia, 'The Politics of an Asymmetric Banking Union' (EUI Working Papers, RSCAS 2017/48, 2017) <cadmus.eui.eu/bitstream/handle/1814/48007/RSCAS_2017_48.pdf?sequence=1%2526isAllowed=y> accessed 14 February 2021.

[83] Moloney, 'European Banking Union: Assessing its Risks and Resilience' [2014] 51(6) *CMLR* 1609, 1610-1616; European Central Bank, 'Financial Stability Review' (June 2012) pages 119-127 <www.ecb.europa.eu/pub/pdf/fsr/financialstabilityreview201206en.pdf> accessed 14 February 2021.

supervision.[84] Accordingly, the discussion below follows the conferral of prudential tasks to the ECB.

The SSM can be linked to the crisis prevention limb of financial stability. It concerns the supervision of credit institutions within the euro area, but non-Eurozone countries can opt in via a close cooperation agreement, should they choose to.[85] Unlike the ESFS and SRM, the legal basis for the SSM was not Article 114, but Article 127(6) TFEU. This provision authorises a unanimously acting Council to confer upon the ECB 'specific tasks' relating to prudential supervision, which more generally coincides with the supporting role of the ECB in this field envisioned by the Treaty of Lisbon. In reality, the SSM Regulation fundamentally alters the role of the ECB in prudential policy through a range of conferred tasks.

The SSM Regulation is mapped around two key distinctions. The first is between banks of 'significant relevance' and 'less significant banks', and the second is between micro-prudential and macroprudential supervision. Significance prescribes the allocation of micro-prudential tasks between the ECB and NCAs: it is determined by size, importance for the national economy, and a bank's cross-border activities, on an individual or consolidated basis.[86] Some banks are automatically treated as significant, for example, banks whose total assets exceed EUR 30 billion or banks that have requested/received ESM aid. The ECB is given the task of assessing whether a bank is of significant relevance, either at the request of national authorities or on its own initiative where significant cross-border activity is involved.[87]

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[84] *Supra* (n 3).

[85] Recital 11, Art 7, SSM Regulation.

[86] Art 6(4), SSM Regulation, elaborated on in (SSM Framework) Regulation 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (ECB/2014/17), OJ L141/1.

[87] Ibid.

Accordingly, the ECB is responsible for the day-to-day supervision of significant banks. This includes the three most important banks in each participating country, as well as banks that meet the aforementioned criteria.[88] The powers of the ECB in this regard far exceed the direct powers of ESMA or any other supranational body; the ECB explicitly assumes the role of a competent authority.[89] The application of capital requirements, conduction of supervisory reviews, consolidated and supplementary supervision are all brought under the centralised control of the ECB.[90] Furthermore, the ECB is responsible for the authorisation and passporting of significant credit institutions, enforcing corporate governance rules (such as remuneration rules under the CRR II/CRD V), and performing certain tasks linked with recovery planning and early intervention.[91]

The ECB may also adopt guidelines and recommendations, participate in the development of draft technical standards by the Commission and ESAs, and adopt Regulations within the narrow remit of organising and detailing its tasks.[92] In addition to its supervisory and quasi-legislative functions, the ECB is granted investigatory and enforcement powers under the SSM Regulation.[93] It should be noted that many of these tasks are governed by national law, especially in the case of CRD and BRRD requirements that grant Member States a degree of discretion in implementation. In such cases, the ECB is authorised to apply national implementing measures directly, over and above the requirements set by EU law.[94] National authorities remain in charge of monitoring less significant banks and relevant tasks, but they are required to report regularly to the ECB and, ultimately, the scope of their involvement is contingent on the ECB's classification of less significant banks.[95]

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[88] Ibid.

[89] Art 9(1), SSM Regulation.

[90] Art 4(1), SSM Regulation.

[91] Ibid.

[92] Art 4(3), Art 6(5), SSM Regulation.

[93] Arts 11-13, Art 18 on penalties, SSM Regulation.

[94] Art 4(3), SSM Regulation.

[95] Art 6(6), SSM Regulation.

Macroprudential tasks under the SSM are reconfigured on a less ambitious scale. In essence, the ECB is only granted reserve macroprudential powers under Article 5 of the SSM Regulation. First, NCAs are required to notify the ECB prior to adopting or adjusting instruments of macroprudential policy (CCyB, SRB, G-SII & O-SII, etc). In the event that the ECB objects to the proposed action, the NCA must 'duly consider' the ECB's reasons prior to finalising its decision. Second, the ECB is given the power to tighten (but not loosen) capital buffers, subject to close coordination with competent authorities in the Member State concerned.[96] On the whole, the ECB's reserve macroprudential powers do not significantly alter the division of tasks under the CRR II/CRD V, Member States continue to enjoy a considerable degree of flexibility.[97]

In terms of governance, the supervisory tasks of the ECB are governed by a Supervisory Board, which comprises of an independent chair, a vice-chair selected among the members of the ECB's Executive Board, four ECB members, and representatives of national authorities.[98] The choice to not use the traditional infrastructure of the ECB flows from the need to ensure separation of monetary and prudential policies, a goal explicitly stated in Article 25 of the SSM Regulation. In contrast to ESA's troublesome voting procedure, each member of Supervisory Board of the SSM has one vote and decisions are made by simple majority.[99] The independence of the Supervisory Board from outside pressures is further enshrined in Article 19.

The SSM Regulation also provides for accountability through cross-institutional oversight. The ECB is required to submit annual reports to the European Parliament, Council, Commission, and Eurogroup (informal meeting of finance ministers in euro area). The European Parliament and Eurogroup may also invite the chair of the Supervisory Board to attend a hearing on the activities of the SSM.[100] Parliamentary scrutiny, in particular, is key

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[96] Art 5(2) and (4), SSM Regulation.

[97] See Chapter 4.

[98] Art 26, SSM Regulation.

[99] Art 26(6), SSM Regulation.

[100] Art 20(4)-(5), SSM Regulation.

to the legitimacy of the SSM, whose mandate necessitates independence from most forms of political accountability. Beyond the watchdog role assigned to the European Parliament, the ECB is required to forward its reports to the national parliaments and respond to national parliamentary inquiries.[101] Finally, it should be noted that the jurisdiction of the Court of Auditors extends to include the supervisory tasks of the ECB.[102]

5.3.2 Single Resolution Mechanism (SRM)

Just as the SSM supports the application of substantive rules in the CRR II/CRD V, the SRM must be examined alongside the BRRD and BRRD II framework. The BRRD is structured around three phases linked to bank failure: (i) prevention, planning, and recovery, (ii) early intervention, and (iii) resolution. Each of these grants national resolution authorities a range of powers and responsibilities, the most important of which is the bail-in tool as part of the resolution phase.[103] The SRM does not introduce new measures, but rather seeks to address fragmentation through a supranational agency to support the application of existing tools (SRB) and a common source of resolution funding (SRF).[104] Hence, the legal basis used was Article 114 TFEU on the approximation of national rules pertaining to the internal market.

As a pillar of the Banking Union, the SRM applies to euro area countries and participating countries.[105] Article 1 of the SRM Regulation sets out the goal of creating a uniform resolution procedure, to be applied by the Single Resolution Board in coordination with EU

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[101] Art 21, SSM Regulation.

[102] Art 20(7), SSM Regulation.

[103] Art 43, (BRRD) Directive 2014/59 of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, *OJ L173/190.*

[104] (SRM) Regulation 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation 1093/2010, OJ L225/1.

[105] Art 4, SRM Regulation. Croatia and Bulgaria joined in 2020.

institutions and national authorities, with backing from the Single Resolution Fund. Article 2 then defines the scope of this procedure as encompassing credit institutions, financial holding companies, and other entities covered by group consolidation rules. Analogously to the ECB's role under the SSM, the SRB assumes the role of national resolution authorities.[106] A number of 'General Principles' contained in Article 6 are worth noting. These include a duty imposed on the SRB and relevant resolution actors to protect the unity and integrity of the internal market, which mirrors the ECB's duty in relation to supervision.[107] Another obligation of the SRB is to maintain a strict separation of its tasks from the fiscal responsibilities of the Member States, and to refrain from requesting extraordinary public support of failing banks.[108]

The division of tasks within the SRM is determined by Article 7, which largely mirrors the significance criteria in the SSM. The SRB assumes the tasks of resolution planning and adopting decisions in relation to all banks supervised by the ECB.[109] National authorities are responsible for all other entities (less significant banks).[110] There are two exceptions to this rule, which also demonstrate differences between the SRM and SSM. First, the SRB is responsible for cross-border entities not deemed 'significant'.[111] Second, where use of SRF is required, the SRB has the sole responsibility over resolution irrespective of the bank's significance.[112] Both of these are important in extending the SRB's influence beyond that of the ECB over 'less significant' banks.

The Board is composed of a Chair, a Vice-Chair, and four full-time directors; these are independent and chosen on the basis of merit following an open recruitment process.[113] In

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[106] Art 5(1), SRM Regulation.

[107] Art 6(2), SRM Regulation.

[108] Art 6(6), SRM Regulation.

[109] Art 7(2)(a), SRM Regulation.

[110] Subject to monitoring by the Board under Art 28, SRM Regulation.

[111] Art 7(2)(b), SRM Regulation.

[112] Art 7(3), SRM Regulation.

[113] Art 43, Art 56(4), SRM Regulation.

addition, NRAs may appoint voting representatives as well as a second, non-voting member in the case that resolution tasks are split between various authorities at the national level. The Commission and ECB are also permanent observers. The Board convenes in different compositions. The plenary session is responsible for administrative tasks, such as the annual work programme and budget, but also critical decisions such as the use of the SRF for an amount exceeding EUR 5 million or where extraordinary *ex post* financing contributions are required.[114] The chair, directors, and NRA representatives each have a vote, the vice-chair and other representatives are non-voting members. Moreover, there are two 'executive' sessions, the restricted (chair and directors) and unrestricted one (relevant NRAs included), responsible for implementation of most other decisions pertaining to individual banks.[115] All procedures of the SRB follow simple majority voting.[116]

The resolution procedure is detailed in Article 18 of the SRM Regulation. This can be initiated by the SRB or following communication from competent authorities (including the ECB). Similarly to the BRRD, the executive session is then asked to determine that resolution is required based on the following conditions: a bank is failing or likely to fail, private sector rescue and other supervisory or early intervention measures are not available (due to timing or other factors), and resolution is necessary in the public interest.[117] The adopted scheme places the bank under resolution and specifies the application of tools, any exceptions from the application of the bail-in tool, and the use of the SRF where applicable. The resolution scheme may be rejected by the Commission on grounds of its discretionary elements, or the Council on limited grounds (the criterion of public interest or the amount of the Fund) and following a proposal from the Commission.[118]

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[114] Art 50, SRM Regulation.

[115] Arts 53-54, SRM Regulation.

[116] Art 51, SRM Regulation.

[117] Art 18(1), SRM Regulation. Note that the ECB determines if a bank is failing or likely to fail and must be consulted on the second condition.

[118] Article 18(7), SRM Regulation.

A final point of note is the Single Resolution Fund. This is perhaps the most ambitious element of the SRM, a European fund to support bank restructuring and eventually replace national resolution financing.[119] The Fund can be used for a number of purposes, including loans and purchase of assets as part of the restructuring process, but not for direct recapitalisation.[120] The target level to be reached by 2024 is at minimum 1% of the covered deposits of all credit institutions authorised in the participating countries. This amount (estimated EUR 55 billion) is to be raised through private contributions from covered entities; *ex post* contributions can be raised in extraordinary circumstances.[121] The SRF is established by the SRM Regulation and administered by the SRB, but its core elements are regulated by an intergovernmental agreement.[122] The Agreement covers the transfer of funds to the various compartments of the SRF, the progressive mutualisation of all compartments, inter-compartmental lending, and potential non-euro area contributions. The SRB is authorised to seek alternative funding sources where *ex ante* and extraordinary *ex post* contributions are inaccessible, and the European Stability Mechanism (ESM) acts as a final backstop outside of EU law.[123]

5.3.3 European Deposit Insurance Scheme (EDIS)

The third pillar of the Banking Union is intended to be a European Deposit Insurance Scheme (EDIS), aimed at providing further protection to retail deposits in the euro area. In 2015, the Commission proposed a three-stage implementation process, beginning with re-insurance (EDIS triggered once national funds were exhausted), followed by co-insurance (joint guarantees), and ultimately the full transfer and mutualisation of funds to a centralised scheme to be administered by the SRM.[124] The substantive elements of EDIS build on the harmonisation of deposit insurance across the EU, achieved by Directive 2014/49 (DGS). For

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[119] Recital 19, SRM Regulation.

[120] Art 76, SRM Regulation.

[121] Arts 69-71, SRM Regulation.

[122] (IGA) Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund (8457/14, 14 May 2014). Along with the Fiscal Compact, this will be incorporated into EU law by 2025.

[123] Art 73, SRM Regulation.

[124] Ibid.

example, EDIS replicates the coverage level of EUR 100,000 and the funding target of 0.8%, set by the DGS Directive.[125]

The Commission's proposal was opposed by Germany, whose approach towards EDIS can be summed up as 'not now, but later'.[126] As a result, the Commission introduced a gradual re-insurance scheme in 2017, and various 'hybrid' models were subsequently proposed.[127] Germany's main concern is that (a) the mutualisation of funds at the European level will weaken national deposit insurance schemes, and (b) there is no legal basis in EU law for the transfer of national deposit funds to the European level.[128] It should be noted that the COVID-19 recovery package entails an unprecedented mutualisation of funds, which could provide the impetus for the completion of EDIS.[129] While the Commission remains committed to the goal of centralised deposit insurance for the euro area, the exact scope and configuration of EDIS is still being debated. It is highly likely that incremental progress will be made in the future, but a fully-fledged European deposit guarantee scheme may never materialise.

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[125] See European Commission, 'Proposal for a Regulation of the European Parliament and the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme' COM(2015) 586 final, 2015/0270 (COD).

[126] Christopher Mitchell, 'United We Stand: Gruppenwettbewerb and European Banking Union' [2020] 29(4) *German Politics* 582. See also, David Howarth, 'The Difficult Construction of a European Deposit Insurance Scheme: a Step Too Far in the Banking Union' [2018] 21(3) *JEPR* 190.

[127] See also, Michael Huertas, 'EDIS - The Third Pillar of the EU's Banking Union: Big, Bold But Can it Be Built - Where Are We in 2020?' [2021] 36(1) *JIBLR 5.*

[128] Which is why the transfer of funds to the SRF was achieved through an intergovernmental agreement, Germany exercising a veto in this area as well.

[129] See generally, Bruno de Witte, 'The European Union's COVID-19 Recovery Plan: The Legal Engineering of an Economic Policy Shift [2021] 58(3) *CMLR* 635; Federico Fabbrini, The Legal Architecture of the Economic Responses to COVID-19: EMU Beyond the Pandemic' [2021] 60(1) *JCMS* 186.

5.4 The 'agencification' of EU financial stability

The output legitimacy of post-crisis reforms rests on whether policy is aligned with the teleology of financial stability. Teleology refers to the ideological underpinnings of the objective as a shift away from economic functionalism, and to a balancing of the economic and non-economic utility of financial stability with view to minimising the social costs of policy. Before turning to specific challenges in the ESFS and the Banking Union, it is necessary to explore whether the broad paradigm of 'agencification' is consistent with this teleology.

Agencification describes the permanent delegation of executive or administrative power to semi-autonomous agencies. The literature approaches the agencification of EU financial stability mainly from the lens of legality, which centres on whether far-reaching institutional reforms exceed the scope of the EU Treaties. This section will illustrate that legality is not the essence of the problem: agencification undermines the 'throughput' dimension, a precondition for the non-economic utility of financial stability, and is at odds with the ideology shift implicit in financial stability. I will first provide background information on Article 114 TFEU, the *Meroni* doctrine on the delegation of administrative power, and the case of *Short-Selling*, before reviewing the legitimacy of agencification.

5.4.1 The issue of legality: Art 114 TFEU & the *Meroni* doctrine

The literature approaches agencification primarily from the perspective of legality, which considers whether the formation of EU agencies with direct intervention and quasi-legislative powers (such as ESMA) violates core provisions of EU law. The first area of concern is the use of Article 114 TFEU in financial stability policy. Traditionally, regulatory agencies were established on the basis of Article 352 TFEU, authorising extraordinary measures in pursuit of any of the objectives in the Treaties (flexibility clause).[130] Since the 2000s, the Commission encouraged Art 114 TFEU as an alternative legal basis: this provision concerns the approximation of national rules linked to the establishment and functioning of the internal

[130] Moloney, 'European Banking Union' (n 83), 1655. Art 352 follows a special legislative procedure that requires unanimity in the Council.

market.[131] In contrast to Art 352, which uses a special legislative procedure, Art 114 utilises the ordinary legislative procedure, which entails a co-legislative role for the European Parliament and a lower voting threshold (qualified majority) in the Council.[132] The general consensus is that the use of Art 114 is problematic, but there is disagreement as to whether it constitutes an outright violation of the Treaties.[133]

The remit of Art 114 is crucial to financial stability as the legal basis for the majority of post-crisis reforms. These include institutional reforms, the formation of the three ESAs, the ESRB, the SRM, as well as substantive measures, such as the CRR and BRRD.[134] In *Tobacco Advertising*, the Court adopted a rather narrow interpretation of Article 114: a prohibition of tobacco advertising fell under public health policy with only secondary effects on the internal market.[135] The Court emphatically rejected the notion that this provision can be construed as 'a general power to regulate the internal market', and stated that 'a mere finding of disparities

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[131] Chamon (n 5), 300. However, see *European Cooperative Society* (C-436/03) ECLI:EU:C:2006:277, paragraphs 44-45.

[132] On Art 114 and the authorisation of executive power, see Herwig C H Hoffman and Alessandro Morini, 'Constitutional Aspects of the Pluralisation of the EU Executive Through 'Agencification' [2012] 37(4) *European Law Review* 419, 421-428.

[133] For a critical perspective, see Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' (n 2); Ellen Vos, 'Reforming the European Commission: What Role to Play for EU Agencies' [2000] 37(5) *CMLR* 1113. For a more accommodating position, Gianni Lo Schiavo, *The Role of Financial Stability in EU Law and Policy* (Wolters Kluwer 2017) 161-166, 246-249.

[134] A similar dilemma emerges with regard to the SSM and the use of Article 127(6) TFEU. In this situation, subject-matter is not problematic, as the provision explicitly targets the prudential tasks of the ECB. The issue is one of degree: can a provision authorising conferral of 'specific' tasks to the ECB in a supporting capacity be used to redefine the role of this institution?

[135] *Tobacco Advertising* (C-376/98) ECLI:EU:C:2000:544.

between national rules and the abstract risk of obstacles' is insufficient to invoke Art 114.[136] However, subsequent case law is much more deferential to the EU legislator.[137]

There is an abundance of case law on this issue, but *ENISA* stands out in relation to regulatory agencies.[138] This case concerned the regulation of electronic communications services and cybersecurity. *Inter alia*, the UK challenged the establishment and conferral of harmonisation tasks to the European Network and Information Security Agency, on the basis that it breached the scope of Art 114. The Court affirmed an expansive interpretation of Article 114,[139] noting that the EU legislature could assign responsibility over 'implementation of a process of harmonisation' to a regulatory body, especially in technical fields where 'the adoption of non-binding supporting and framework measures seems appropriate'.[140] The technical complexity and interconnectedness of information systems meant that 'disparities likely to create obstacles' was capable of triggering Art 114, in sharp contrast to *Tobacco Advertising*.[141] While this logic can be applied to post-crisis reforms, cybersecurity is not comparable to financial stability from either a policy or constitutional perspective, and the powers of the ESAs and the SRB (SRM) far exceed those of ENISA.[142]

The second area of interest is *Meroni* and the delegation of regulatory authority. The Treaties are silent on the formation of agencies, although Lisbon extends the Court's jurisdiction over agencies and other bodies created under EU law, which implies that such delegation is not

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[136] Ibid, paragraphs 83-84, 97-100. Another factor considered was the restrictive nature of advertising bans, which could suggest that conceptual inconsistency between financial stability and market integration precludes the use of Article 114.

[137] Stephen Weatherill, 'The Limits of Legislative Harmonisation Ten Years after Tobacco Advertising: How the Court's Case Law has become a "Drafting Guide"' [2011] 12(3) *German Law Journal* 827.

[138] *ENISA* (C-217/04) ECLI:EU:C:2006:279.

[139] Expansive both in terms of its scope of application and ensuing range of measures, *Smoke Flavourings* (C-66/04) ECLI:EU:C:2005:743, paragraphs 41-43, 58.

[140] *ENISA* (n 138), paragraph 44. The only conceivable limit to this approach is that conferred tasks must be 'closely linked to the subject-matter' of the approximating act, paragraph 45.

[141] Ibid, paragraphs 62-63.

[142] Moloney, 'European Banking Union' (n 83), 1655.

inconsistent with the Treaties *per se*.[143] *Meroni* was delivered in 1958 and concerned a General Decision of the ECSC High Authority. Implementation of the Decision was delegated to two private law agencies. In invalidating the delegation, the Court established the following limits: first, a delegating body cannot assign to a regulatory body powers it does not exercise itself, second, these powers must be clearly defined (non-discretionary), so as to be subject to review on the basis of objective criteria.[144] Of note is the Court's reference to the 'balance of powers', a fundamental guarantee granted by primary EU law that was rendered ineffective by the delegation of discretionary powers to a body outside the scope of the ECSC Treaty.[145]

The question that follows is whether *Meroni* prevents the delegation of discretionary powers to agencies created during the crisis. It is difficult to follow this reasoning. Firstly, even if the Court in *Meroni* intended to establish a broadly applicable test, there are doubts as to whether it would apply to the formation of the ESAs and the Banking Union. These operate within the boundaries of the Treaties, whereas the Brussels agencies in *Meroni* were situated outside of EU law. Secondly, the ESFS and BU assume powers previously exercised at the national level, not by an EU institution.[146] In terms of judicial review, this "bottom-up" shift extends the Court's jurisdiction over administrative acts, in sharp contrast to *Meroni*. This can be linked to the term 'balance of powers' in *Meroni*, which bears little resemblance with the principle of 'institutional balance' developed in subsequent case law.[147] The principle of institutional balance denotes that 'each of the institutions must exercise its powers with due

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[143] Arts 263 & 267(b) TFEU. Also, delegated and implementing acts procedures under Arts 290 & 291 TFEU, replacing pre-Lisbon comitology.

[144] *Meroni* (Case 9-56) ECLI:EU:C:1958:7, pages 150-152.

[145] Ibid, page 152.

[146] Pieter Van Cleynenbreugel, 'Meroni Cirvumvented? Article 114 TFEU and EU Regulatory Agencies' [2014] 21(1) *MJ* 64, 81.

[147] Derived from Chernobyl, *Chernobyl* (C-70/88) ECLI:EU:C:1990:217. Merijn Chamon, 'EU Agencies Between Meroni and Romano or the Devil and the Deep Blue Sea' [2011] 48(4) *CMLR* 1055, 1058.

regard for the powers of the other institutions'.[148] By way of contrast, the Court in *Meroni* uses the term 'balance of powers' to describe a threat to effective judicial protection.[149]

In addition to Art 114 and *Meroni*, brief reference can be made to *Romano*.[150] This case concerned the delegation of quasi-legislative (interpretative) powers from the Council to a body established under secondary EU law. The Court concluded that the delegation was unlawful, on the basis that a body tasked with applying EU legislation should not exercise powers of interpretation that yield legally binding results.[151] Some authors view this case as a continuation of *Meroni*, others as a narrow judgment of limited precedential value.[152] At any rate, there are obvious parallels between *Romano* and the quasi-legislative powers of the ESAs.

The above issues are explored in *Short Selling*, on the legality of ESMA's emergency powers under Article 28 SSR. Specifically, the Court was called to examine whether the conferral of discretionary to ESMA violates Art 114, *Meroni* and *Romano*, as well as Articles 290 and 291 on delegated and implementing acts. The Court found that there was no conflict between these provisions and the creation of this agency. First, the Court distinguished ESMA's position from the facts of *Meroni*, noting that EU law imposes significant checks and balances to ESMA that did not apply to the Brussels agencies in the 1958 case.[153] A similar

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[148] Ibid, paragraph 22; *Parliament v Council* (C-133/06) ECLI:EU:C:2008:257, paragraph 57.

[149] Ibid, 1058-1059. Chamon links the 'balance of powers' to a protective function (flowing from the separation of powers), which is intrinsically linked to judicial protection, not inter-institutional relations. At any rate, *Meroni* predates principles such as direct effect and supremacy that fundamentally alter any version of the 'balance of powers' that the Court may have intended in the 1950s.

[150] *Romano* (Case 98/80) ECLI:EU:C:1981:104.

[151] Ibid, paragraph 20.

[152] Note the court does not cite *Meroni* once in this case. For an overview of the literature on *Romano*, see Chamon (n 147), 1063. *Cf.* Van Cleynenbreugel (n 146), 82; Edoardo Chiti, 'An Important Part of the EU's Institutional Machinery: Features, Problems and Perspectives of European Agencies' [2009] 46(5) *CMLR* 1395, 1420-1424.

[153] *Short Selling* (n 23), paragraphs 41-55.

reasoning applies to *Romano*.[154] Second, Art 114 114 was confirmed as a valid legal basis. The Court puts forward an expansive interpretation of the conditions needed to trigger Article 114 as well as the measures that can be adopted under it, based on the rationale that the EU legislator must be granted further discretion in times of crisis.[155] Finally, the Court emphasises that ESMA's emergency powers must be assessed from the broader perspective of financial stability; powers flowing from its technical expertise in this field do not violate the rules on the delegation of powers under Arts 290 and 291 TFEU.[156]

Returning to the question of legality, it is difficult to criticise the Court's reasoning in *Short-Selling*. The use of Art 114 to create a body with the powers of ESMA is unprecedented, but not inconsistent with *ENISA* and the logic of legislative discretion in technical fields, especially during the biggest financial crisis since the 1930s. Equally, *Meroni* bears little resemblance to *Short Selling*. In particular, the CJEU notes that effective judicial protection is guaranteed, for example, through the explicit recognition of its jurisdiction over regulatory agencies under Art 263 TFEU. The least persuasive argument in *Short-Selling* is that financial stability requires a high degree of discretion, which contradicts the conclusion that the institutional balance is unaffected. Nevertheless, the Treaties are not very restrictive on the delegation of powers to regulatory bodies (indeed, the Treaties are silent on this issue) and a broad interpretation of Article 290 and 291 would be inconsistent with earlier case law.[157]

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[154] Ibid, paragraph 65. This claim is rejected on the basis that Arts 263 and 277 TFEU (on judicial review) specifically enable agencies to adopt measures of general application, thus, Art 28 SSR cannot be considered inconsistent with *Romano*.

[155] Ibid, paragraphs 102-109, 114. The Court reiterates its position that the legislator must be afforded a high degree of discretion in technical fields. Thus, the mere absence of a common regulatory framework was enough to trigger Article 114, and any measures that seek to prevent 'the [future or potential] creation of obstacles' are consistent with this provision.

[156] Ibid, paragraph 84.

[157] Stefan Griller and Andreas Orator, 'Everything Under Control? The "Way Forward" for European Agencies in the Footsteps of the Meroni Doctrine' [2010] 35(1) *ELR* 3, 12. It is difficult to draw the line between different forms of delegation that may impinge on the prerogatives of the Legislature, the clear priority of Arts 290-291.

Overall, there is no doubt that the creation of agencies during the financial crisis is unprecedented, perhaps 'barely legal'.[158] Yet, despite the 'virtually unlimited' scope assigned to Art 114, the Court had begun eroding the boundaries of this provision shortly after *Tobacco Advertising*; and the Court's reasoning on *Meroni* is coherent.[159] Ultimately, a measure of legal creativity is necessary to overcome the limitations that led to the financial crisis in the first place. The more fundamental question is whether agencification threatens the legitimacy of EU law, explored below.

5.4.2 Reviewing the output legitimacy of agencification

One the main premises of this thesis is that financial stability reforms must be assessed from an 'output' perspective, but output legitimacy extends beyond functionalist performance. The outputs of policy must coincide with the teleology of financial stability, which describes an ideological shift away from laissez-faire liberalism in the financial market, and a balancing of the economic and non-economic utility of financial stability. The next section (5.5) examines individual agencies and inconsistencies with this teleology that emerge from governance and other issues. The analysis that follows in this section centres on the broader question of whether the paradigm of agencification is inconsistent with the teleology of financial stability.

Accountability as an operational element of non-economic utility

To begin with, the task of balancing the economic and non-economic aims of integration is typically reserved for the EU's political and judicial institutions. Consistently with Scharpf's conceptualisation of output legitimacy, the 'output' side is indissociable from the throughput dimension: for example, it was previously argued that *ex post* accountability (review of policy over the long-term) is a vital operational element of the teleology of financial stability.[160] Accordingly, the first challenge to legitimacy that emerges from the creation of

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[158] Michelle Everson, 'European Agencies: Barely Legal' in Michelle Everson, Cosimo Monda and Ellen Vos (eds) *EU Agencies In Between Institutions and Member States* (Wolters Kluwer 2014).

[159] Van Cleynenbreugel (n 146), 67.

[160] See Chapter 2.

expert agencies with quasi-legislative and direct powers is that the scope for political leadership and *ex post* accountability in this field is significantly reduced. The analysis below focuses on ESMA in light of the *Short Selling* judgment, with brief comment on the SSM.

First, it should be noted that *Short Selling* sets an incredibly low threshold for the authorisation of executive and administrative power under Art 114 TFEU. The fact that the discretionary powers of ESMA can be reconciled with prior case law on Art 114 does not alleviate legitimacy concerns, but rather points to a chronic (input and throughput) legitimacy deficit in the EU.[161] A similar observation can be made on the adoption of the SSM under Art 127(6) TFEU. Wymeersch argues that Art 127(6), which concerns the conferral of 'specific tasks' in prudential policy to the ECB, is an appropriate and open-ended legal basis.[162] However, recourse to the supporting competences of the ECB to justify the biggest competence shift in the EMU since Maastricht is deeply concerning. From a legitimacy standpoint, this competence shift is critical because the ECB takes on the role of competent authorities and applies national law, but is not accountable to national political processes.[163] Thus, the legal grey area in which financial stability agencies operate is tied to the question of legitimacy, irrespective of whether their constitutionality is in question.

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[161] Andreas Follesdal and Simon Hix, 'Why There is a Democratic Deficit in the EU: A Response to Majone and Moravcsik' [2006] 44(9) *JCMS* 533; Giandomenico Majone, 'Europe's Democratic Deficit' [1998] 4(1) *European Law Journal* 5.

[162] In particular, vague reference to 'policies relating to prudential supervision' appears limitless. Eddy Wymeersch, 'The Single Supervisory Mechanism or 'SSM', Part One of the Banking Union' (NBB Working Paper No 255, April 2014) pages 17-19. <www.nationalebankvanbelgie.be/doc/ts/publications/wp/wp255en.pdf> accessed 15 February 2021. A further issue is that the use of Art 127(6) precludes the transfer of supervisory tasks outside of prudential policy (eg, conduct risk and consumer protection).

[163]Concetta Brescia Morra, 'From the Single Supervisory Mechanism to the Banking Union: the Role of the ECB and the EBA' (LUISS Academy, Working Paper 2/2014, June 2014) pages 9-10 <core.ac.uk/download/pdf/34704057.pdf > accessed 16 February 2021. The author presents A comparative argument to argue for a stronger role for EBA.

Second, the scope for political leadership in financial stability is impaired by the 'broad and vague' legislative framing of ESMA and other agencies' powers.[164] This challenge is evidenced by the gradual expansion of ESMA's powers.[165] For example, in 2020 the agency submitted a report to the Commission recommending that investment management companies be brought under the scope of its product intervention powers, on the basis that excluding these companies contributes to an uneven playing field.[166] There is also discussion for permanent product intervention mechanisms, despite the Court in *Short Selling* relying on the temporary nature of ESMA's powers to reconcile its discretionary powers with the *Meroni* doctrine.[167] Generally, the agency is becoming bolder.[168] Not only have legislative amendments expanded its direct intervention powers, but ESMA exercised these powers for the first time in 2018 (restricting binary options and contracts for differences).[169] According to some authors, the incremental expansion and proactive attitude of ESMA results in a 'de-politicisation' of EU law,[170] which contradicts the need for political leadership as a means of minimising the social costs of policy.

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[164] Howell, 'EU Agencification and the Rise of ESMA (n 5), 339.

[165] Art 9(5), ESMA Regulation as amended by (Amending) Regulation 2019/2175 of the European Parliament and of the Council of 18 December 2019 amending Regulation 1093/2010 establishing a European Supervisory Authority (European Banking Authority), Regulation 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), Regulation 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), Regulation 600/2014 on markets in financial instruments, Regulation 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, and Regulation 2015/847 on information accompanying transfers of funds, OJ L334/1.

[166] See Pablo Iglesias-Rodríguez, 'ESMA as a Residual Lawmaker: The Political Economy and Constitutionality of ESMA's Product Intervention Measures on Complex Financial Products' [2021] 22 *EBOLR* 627.

[167] Ibid. *Meroni* (n 144), paragraph 50.

[168] *Supra* (n 5).

[169] European Securities and Markets Authority Decision 2018/795 of 22 May 2018 to temporarily prohibit the marketing, distribution or sale of binary options to retail clients in the Union in accordance with Article 40 of Regulation (EU) No. 600/2014 of the European Parliament and of the Council. OJ L 136/31.

[170] Kaarlo Tuori, *European Constitutionalism* (CUP 2015) esp. at 13, 36, 220. See also, Chamon, 'EU Agencies Between Meroni and Romano' (n 147); Ellen Vos, 'Agencies and the European Union' in Tom Zwart and Luc Verhey (eds) *Agencies in European and Comparative Law* (Intersentia 2003) 131; Michelle Everson and Ellen

Third, *ex post* accountability of ESMA is impaired by a peculiar power dynamic between ESAs and EU institutions. Importantly, ESMA's relationship with the Commission neither guarantees its independence, nor is it capable of curtailing its direct and quasi-legislative powers.[171] For example, the Commission exercises control over ESMA's finances, but will defer to the agency's technical expertise when it comes to rule-setting.[172] As AG Jääskinen remarks in *Short Selling*, the key issue is that supervisory authorities sit outside the EU's inter-institutional system of accountability.[173] For instance, the European Parliament's oversight of ESMA is much more limited than its influence over the Commission, or the ECB in its supervisory capacity (SSM).[174] As regards national accountability, national competent authorities have a leadership role in the ESFS, yet domestic political and judicial processes are weakened. For instance, the agency is not required to seek prior authorisation from the national courts when conducting on-site investigations, as is sometimes the case with national supervisors.[175]

Vos, 'European Agencies: What About Institutional Balance?' (Maastricht Faculty of Law Working Paper No 4, July 2014)
<papers.ssrn.com/sol3/papers.cfm?abstract_id=2467469 > accessed 12 February 2021.

[171] Howell, EU Agencification and the Rise of ESMA (n 5), 339, ESMA operates in a system that is 'complex and not necessarily conducive to guaranteeing ESMA's autonomy or its effective accountability'.

[172] Ibid. This is typical of principal-agent relationships, which in this case is complicated by multiple avenues of accountability and control, perhaps even causing an 'accountability overload'. On the effectiveness but structural weakness of soft law mechanisms, see Niamh Moloney and Pierre-Henri Conac, 'EU Financial Market Governance and the Covid-19 Crisis: ESMA's Nimble, Responsive, and Speedy Response in Coordinating National Authorities through Soft-Law Instruments' [2020] 17(3-4) *ECFR* 363, 371-373.

[173] The AG raises this argument in relation to Articles 290 and 291 TFEU, Opinion of Advocate General Jääskinen in *Short Selling* (C-270-12) ECLI:EU:C:2013:562, paragraph 85.

[174] Howell, 'EU Agencification and the Rise of ESMA' (n 5) 342.

[175] Ibid.

A more fundamental threat to accountability emerges from differentiated integration in the euro area.[176] The SSM is praised for its accountability model, perceived as 'tailor made' for the sensitive role of the ECB.[177] However, the co-existence and conflicting tasks of multiple micro- and macroprudential authorities is concerning. This challenge is exemplified by the complete reversal of the supervisory dynamic within the EMU, which complicates the application of prudential tools and the role of agencies such as the EBA.[178] A further challenge that emerges from this dynamic is that national courts can interfere with ECB decisions through the interpretation of national law, but the review of the CJEU remains limited.[179] Equally, political accountability is fragmented,[180] and the European Parliament and national parliaments exercise a purely investigatory role.[181] This can be linked to the issue of transparency: key data and processes remain confidential, and disclosure practices are exceedingly divergent among Member States.[182] Gandrud and Hallerberg argue that 'the current lack of transparency is particularly striking' when compared to the well-established practices of the FFIEC, the US equivalent of the Banking Union.[183] Overall, the

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[176] Frank Schimmelfennig, Dirk Leuffen and Berthold Rittberger, 'The European Union as a System of Differentiated Integration: Interdependence, Politicization and Differentiation' in Benjamin Leruth and Christopher Lord (eds), *Differentiated Integration in the European Union* (Routledge 2016).

[177] Gijsbert Ter Kuile, Laura Wissink and Willem Bovenschen, 'Tailor-made Accountability Within the Single Supervisory Mechanism' [2015] 52(1) *CMLR* 155.

[178] See Katalin Mérő and Dóra *Piroska*, 'Rethinking the Allocation of Macroprudential Mandates Within the Banking Union – a Perspective from East of the BU' [2018] 21(1) *JEPR* 1.

[179] On the role of national courts, Ter Kuile et al (n 177) 183-185. On the European Courts, early signs show deference to the broad mandate of the ECB. For instance, in the *Förderbank* case a credit institution challenged the ECB's classification as a significant bank. The General Court notes that the role of the MSs under the SSM is not to exercise national competences, but to implement the exclusive competences of the Union. On the basis of this logic, the General Court assigns a potentially unlimited discretion to the ECB. *Förderbank* (T-122/15) ECLI:EU:T:2017:337, paragraphs 72 and 92.

[180] Ibid, 166. On national accountability, see Benedikt Wolfers and Thomas Voland, 'Level the Playing Field: The New Supervision of Credit Institutions by the European Central Bank' [2014] 51(5) *CMLR* 1463, 1481-1482.

[181] Christopher Gandrud and Mark Hallerberg, 'Does Banking Union Worsen the EU's Democratic Deficit? The Need for Greater Supervisory Data Transparency' [2015] 53(4) *JCMS* 769, 773-774.

[182] Ibid, 770.

[183] Ibid.

agencification of financial stability creates numerous accountability challenges, which is fundamentally at odds with the teleology of financial stability.

The ideology of institutional reforms

The second component of the teleology of financial stability is an ideological shift away from laissez-faire liberalism, implicit in the proliferation of macroprudential and other types of public intervention in the European financial market. At face value, the replacement of the Lamfalussy architecture and the strengthening of prudential and resolution policy with supranational supervisory agencies is consistent with this ideological shift. There are many developments that coincide with the goal of establishing limits to market integration. For example, ESMA's direct supervision of credit rating agencies, trade repositories, and securitisation repositories is undoubtedly a positive step in this direction, as these institutions operate across borders and cannot be supervised at the national level.[184]

Nevertheless, the ideology of institutional dimension is not as novel as substantive reforms in the CRR II/CRD IV and BRRD II. Substantive prudential and resolution policy tools effectively establish an entirely new field, as the European financial market was previously dominated by free movement and state aid law. Insofar as free movement and state aid law are guided by the principles of market freedom and market equality, substantive financial stability reforms signify a shift away from unfettered liberalisation and private responsibility. Conversely, the creation of expert agencies to the detriment of both national and supranational accountability conveys a functionalist logic that is inconsistent with the progress made on the substantive front. Everson notes:

'[…] the ESFS is also a responsive creature of market utility: the three ESAs, led by specialist national regulators and shielded from political influence, have been inserted into the existing supervisory paradigm, wherein they are charged with the unavoidably conflicting roles of 'improving the

[184] *Supra* (n 14).

functioning of the internal market', 'ensuring the integrity, efficiency and orderly functioning' of markets, combatting 'regulatory arbitrage', and securing 'consumer protection […]''[185]

Thus, the creation of expert agencies reinforces a system of 'permissive interventionism' and selective liberalisation with view to bolstering market integration and competitiveness, in as much as it is intended to support financial stability.[186] In fact, considering that prudential and resolution policy remain largely decentralised, the primary function of the ESAs in relation to macroprudential policy and other aspects of the CRR/CRD is to ensure the uninterrupted functioning of the internal market. For example, the CRR II/CRD V replaces an earlier notification procedure with strict authorisation of capital buffers (such as the O-SII buffer), which must be granted by the Commission based on recommendation of the EBA that the measure in question will not restrict cross-border movement.[187] As regards the Banking Union, Everson is critical of the 'market-driven exit from crisis' rationale of the SSM and SRM, and especially the ECB as 'the lead actor in the squaring of the circle between welfare-maximizing efficiency and financial stability in the Eurozone'.[188]

It should be noted that Everson extends this criticism to substantive measures in the CRR/CRD. However, the inherent conflict between financial stability and market utility is much more pronounced on the institutional side in light of the accountability challenges identified above. The 'de-politicisation' of financial stability through institutional reforms denotes a new version of economic functionalism, that far exceeds the market utility of harmonisation in prudential and resolution policy. Ultimately, the two dimensions are indissociable, but agencification can be seen as the principal ideological threat.

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[185] Michelle Everson, 'Banking on Union: EU Governance Between Risk and Uncertainty' in Dawson M, Enderlein H and Joerges C (eds) *Beyond the Crisis The Governance of Europe's Economic, Political and Legal Transformation* (OUP 2015), 147.

[186] Ibid; See also, Ben Clift and Sean McDaniel, 'Capitalist Convergence? European (dis?)Integration and the Post-crash Restructuring of French and European Capitalisms' [2019] 26(2) *New Political Economy* 1.

[187] See Chapter 4.

[188] Everson, 'Banking on Union' (n 185), 150.

A final point of note is the use of Article 114 TFEU, which epitomises the economic functionalism of institutional reforms. A comparison can be drawn with the US 'commerce clause', a provision on interstate trade that served as the basis for the 'federalisation' of financial supervision in the US.[189] In sharp contrast to the US commerce clause, which can only be deployed if there is factual evidence that integration has already occurred (doctrine of 'dual federalism'), Art 114 can be triggered by purely hypothetical obstacles to the internal market to *initiate* market integration.[190] On the basis of this comparison, Art 114 can be seen as a market liberalisation device; there is a clear ideological tension between Art 114 and financial stability, which underlines the threat to output legitimacy.

5.5 Challenges pertaining to EDIS & SRM, EBA, and ESRB

Beyond the broad issue of agencification, institutional reforms face various challenges that weaken the output legitimacy of EU law. In Chapters 2 and 3, it was argued that output legitimacy should not be reduced to functionalist performance. Accordingly, while the overall performance of the ESFS and Banking Union is positive, there are important inconsistencies between institutional reforms and the teleology of financial stability. A key element of this teleology is the link between financial stability and social development/social equality, which implies that legitimate policy is one that seeks to minimise social costs.

This section focuses mainly on the SRM and EDIS, the EBA, and the ESRB. I argue that the many compromises of the Banking Union, differentiated integration impacting the tasks of ESAs, and governance issues facing the ESRB, contradict the above teleology. On the whole, the institutional side of financial stability is far more problematic than the substantive dimension explored in the previous chapter.

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[189] US Constitution, Artl.S8.C3.1. Régis Bismuth, 'The Federalisation of Financial Supervision in the US and the EU: A Historical-Comparative Perspective' in Mads Andenas and Gudula Deipenbrock (eds) *Regulating and Supervising European Financial Markets* (Springer 2016).

[190] Ibid, 239.

5.5.1 Deposit insurance and resolution funding in the Banking Union

The biggest threat to output legitimacy in the institutional context is the current design of the Banking Union. The most glaring omission of the current regime is that of supranational deposit insurance. While the EU's response to the COVID-19 pandemic achieves a degree of mutualisation of funds that could provide the impetus for completing EDIS, this pillar of the Banking Union has already been diluted through many compromises.[191] It is unclear whether EDIS will ever be completed and in what format. The most likely scenario is that the Commission will go ahead with this measure, but the final product will fail to achieve a uniform DGS which mitigates the vulnerabilities of national schemes.[192] It should be noted that centralised deposit insurance is not a panacea: for example, Germany's concern that national schemes will be impaired in the short-term and mid-term is valid. The current proposals maintain discretion at the national level, which suggests a fragmented regime that will alter the vertical balance of powers without achieving a full mutualisation of funds or reducing protectionism.[193]

Nevertheless, the importance of EDIS lies in its relationship with the other pillars of the Banking Union. Deposit insurance is intimately linked to the non-economic utility of financial stability: it imposes a significant burden on credit institutions with view to shielding the most vulnerable depositors from the consequences of collapse.[194] Accordingly, the current model of centralised supervision and resolution without supranational deposit insurance conveys a functionalist rationale that prioritises economic performance over the wider impact of policy in society: the missing pillar of the Banking Union is the one that primarily serves the purpose of minimising social costs. In particular, the use of the bail-in tool in resolution—

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[191] Christopher Mitchell, 'United We Stand: Gruppenwettbewerb and European Banking Union' [2020] 29(4) *German Politics* 582.

[192] David Howarth, 'The Difficult Construction of a European Deposit Insurance Scheme: a Step Too Far in the Banking Union' [2018] 21(3) *JEPR* 190; Michael Huertas, 'EDIS - The Third Pillar of the EU's Banking Union: Big, Bold But Can it Be Built - Where Are We in 2020?' [2021] 36(1) *JIBLR 5.*

[193] Rosaria Cerrone, 'Deposit Guarantee Reform in Europe: Does European Deposit Insurance Scheme Increase Banking Stability?' [2018] 21(3) *JEPP* 224, 236.

[194] See Chapter 4.

a measure that is likely to cause many unwanted externalities—is difficult to reconcile with the teleology of financial stability without completion of EDIS.[195] Overall, despite the many questions around EDIS, centralised deposit insurance would improve the output legitimacy the EU law.[196]

Relevant to deposit insurance, the performance of the SRM is a major area of concern. First, there are striking gaps in the design of this mechanism. The lack of last-resort support (fiscal backstop) within the boundaries of EU law certainly prevents the SRM from attaining its main intended outcome, ending the 'diabolic loop' between banks and governments.[197] As Moloney indicates, the relationship between the SRM and the ESM is not clear, and there are doubts as to whether the 2008 crisis would have been prevented under the current regime.[198] The 'incrementalism' of the SRM more generally points to the unequal bargaining power of Member States within this arrangement.[199] Quaglia notes that a 'power vacuum' emerges from the from the gradual weakening of national resolution authorities without a fiscal backstop in EU law: Member States lose power, but the wider social costs of bank failure are felt at the national level due to inadequate risk-sharing.[200]

Second, the existing elements of the SRM, namely the SRF and bail-in tool, face significant challenges. The bail-in tool remains untested, although initial experience sends a 'mixed

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[195] On the consequences of bail-in, see discussion on case law in Chapter 6. *Inter alia*, the haircut of deposits is a major cause of social inequality as risk-aware investors have the means to mitigate their losses.

[196] Lo Schiavo (n 133), 179. In either a centralised or decentralised system, closer attention needs to be paid to cross-border cooperation and the relationship between deposit insurance and prudential tools, as well as the role of deposit protection in light of the growth of non-banking finance.

[197] Daniel Gros and Dirk Schoenmaker, 'European Deposit Insurance and Resolution in the Banking Union' [2014] 52(3) *JCMS.* 1, 2. See also, David G Mayes, 'Banking Union: the Disadvantages of Opportunism' [2018] 21(2) *JEPR* 132.

[198] Moloney, 'European Banking Union' (n 83), 1627-1629.

[199] Ibid, 1629.

[200] Lucia Quaglia, 'The Politics of an 'Incomplete' Banking Union and its 'Asymmetric' Effects' [2018] 41(8) *Journal of European Integration* 955, 966.

message'.[201] As in the case of Italy in 2016, governments may oppose a bail-in on grounds that it would hurt confidence in the banking sector.[202] A further question is whether the current procedure is fast enough to be practicable, as banks can go from soluble to insoluble in a matter of hours.[203] The Italian example confirms Avgouleas and Goodhart's concern that the bail-in tool does not eliminate public bailouts.[204] Considering the many social costs associated with a bail-in, its questionable effectiveness highlight a major threat to output legitimacy.[205] Similarly, the SRF faces numerous challenges. The most obvious one is that direct recapitalisation of banks using the Fund is prohibited, which is an obstacle to alleviating pressures on governments and reducing their dependency on the ESM for extraordinary bailouts.[206] Another question is whether the SRF will simply run out of money: studies show that the SRF is capable of withstanding failures in a major bank, but in scenarios of high contagion public support is inevitable.[207] Therefore, the crisis management dimension of financial stability appears especially frail. In addition to the social costs that measures such as the bail-in tool generate, the many compromises of the Banking Union magnify the accountability challenges identified previously.

5.5.2 Differentiated integration and the role of EBA (and EIOPA)

The Banking Union also alters the tasks and governance of EU-wide supervisory authorities, such as the EBA and EIOPA. The main area of concern is internal governance: as Schammo indicates, pressures to protect the interests of countries who are not participating in the

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[201] David G Mayes, 'Banking Union: the Problem of Untried Systems' [2018] 21(3) *Journal of Economic Policy* Reform 178, 178.

[202] Ibid, 178-179. The example of Spain in 2017 sends a more positive message.

[203] See also, Thomas F Huertas, 'Banking Union: the Way Forward' in Juan *Castañeda*, David G *Mayes* and Geoffrey *Wood (eds) European Banking Union: Prospects and Challenges (Routledge 2015).*

[204] Emilios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-ins' [2015] 1(1) *JFR* 3; See also, Peter Benczur *et al*, 'Evaluating the Effectiveness of the New EU Bank Regulatory Framework: A Farewell to Bail-out?' [2017] 33 *JFS* 207; Anne-Caroline Hüser *et* al, 'The Systemic Implications of Bail-in: a Multi-layered Network Approach' [2018] 38 *JFS* 81.

[205] *Supra* (n 195).

[206] On ESM recapitalisation, see Moloney, 'European Banking Union' (n 83), 1628.

[207] Hüser et al (n 204).

Banking Union have brought about voting changes in EBA's Board of Supervisors, which undermine both efficacy and independence.[208] A further dilemma is whether the direct intervention powers of EBA and EIOPA should be abolished in light of the centralisation of supervisory competences achieved by the SSM.[209] On the one hand, this could alleviate some of the challenges identified previously in connection to the discretionary powers and accountability of ESAs. On the other hand, the threat of direct intervention strengthens compliance and enforcement; removal of this tool would render the ESFS 'toothless'.[210]

Notwithstanding the broader criticism that agencification contradicts the non-economic utility of financial stability by reducing political accountability, EBA and EIOPA have a positive track record of minimising the social costs of financial stability. For example, EBA was instrumental in correcting the Commission's one-size-fits-all transposition of Basel rules into EU law, which put smaller enterprises at a disadvantage and impeded a range of social policy goals.[211] The amended principle of proportionality in the CRR II/CRD V is a direct product of EBA's analysis of the economic and non-economic effects of financial stability policy. Similarly, EIOPA is responsible for the reform of the IORP Directive and facilitating the development of occupational retirement savings. Beyond the added safeguards for pension schemes, there are broader connections between IORP II and the non-economic utility of financial stability. For example, EIOPA pressures led the Commission to incorporate environmental, social and governance risks as part of how pension funds conduct their own-risk assessment.[212]

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[208] *Supra* (n 44).

[209] See Jens Gal, 'Legitimationsdefizite und Kompetenzen der EIOPA im Lichte der Meroni-Rechtsprechung' [2013] 102(4) *Zeitschrift für die gesamte Versicherungswissenschaft 325.*

[210] *Supra* (n 48).

[211] See eg, European Banking Authority, 'Report on the Application of Simplified Obligations and Waivers in Recovery and Resolution Planning' (EBA/REP/2020/40) <www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2020/961800/EBA%20Report%20on%20Simplified%20Obligations%20and%20Waivers%20under%20BRRD.pdf?retry=1> accessed 1 March 2022.

[212] *Supra* (n 50).

While the formal role of EBA and EIOPA in prudential policy is tied to economic performance, their advisory function has proven critical in curbing the Commission's focus on liberalisation in the financial services industry. This informal role becomes even more important as the Capital Markets Union project advances.[213] Therefore, the governance and independence issues identified above pose a threat to output legitimacy to the extent that the main agencies affected have a positive track record in supporting the non-economic utility of financial stability.

5.5.3 *Ex ante* and *ex post* accountability of the ESRB

As regards the ESRB, the main concern expressed in the literature concerns the soft law powers of this agency. Some authors dismiss the effectiveness of the ESRB on the ground that it lacks direct supervisory and enforcement powers—unlike a true "federal" supervisor.[214] By comparison, the UK's Financial Policy Committee (FPC) has the power to unilaterally set macroprudential buffers and follows a strict "comply or explain" model that ensures compliance with its recommendations.[215] However, this comparison is flawed. First, the ESRB is not a supervisory authority, it works alongside national authorities which retain flexibility to address risks particular to their jurisdiction. This dynamic is inherently federal: for example, the Financial Stability Oversight Council (FSOC) in the US exercises similar soft law powers to the ESRB.[216] Second, the degree of non-compliance with ESRB warnings and recommendations is negligible.[217] From 2011-2019, only 1.2% of its instruments were not observed by the national competent authorities.

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[213] For example, in the adoption of the PSD2 Directive on payment services and electronic money, the EBA proposed fraud data collection and other policies.

[214] A 'toothless talking shop' according to House of Commons Treasury Committee, 'Opinion on Proposals for European Financial Supervision' (HC 1088, 16 November 2009) page 49 <publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/1088/1088.pdf> accessed 12 February 2021.

[215] Ibid.

[216] Although their intervention powers differ.

[217] 1.2% non-compliance from 2011-2019, Ehrmann and Schure (n 76), 302.

In fact, it is the prevalence of soft law measures in macroprudential policy that is potentially inconsistent with the teleology of financial stability. In many ways, the ESRB acts as a *de facto* supervisor, yet its recommendations and warnings are not subject to judicial review, and *ex post* political scrutiny of its actions appears to be marginal.[218] The European Parliament is critical in reviewing the acts of the ESRB, but this institution lacks formal routes of exercising control such as appointment or removal powers with respect to the chair of the General Board. Experience so far shows that parliamentary review is very limited, and it is further complicated by the shared leadership of the ESRB and the ECB. For example, in Annual Hearings the ESRB chair is often asked questions pertaining to monetary policy and their role as president of the ECB.[219] Moreover, the sensitive work of the ESRB implies that some of its acts will not be available to the public to protect independence.[220] The weak accountability and transparency of the ESRB defies the importance of throughputs in balancing the economic and non-economic sides of financial stability, and is a clear threat to output legitimacy.

This is further illustrated by voting and governance issues. Most notably, the ESRB's operational reliance on the ECB is problematic in a number of ways. From a purely economic perspective, it is paradoxical for the ESRB to be excessively reliant on a competent authority (under the SSM), as the European Parliament notes.[221] This challenge becomes more prominent as the ESRB is expanding its work outside of banking.[222] From the perspective of

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[218] Anat Keller, 'Independence, Accountability and Transparency: Are the Conventional Accountability Mechanisms Suitable for the European Systemic Risk Board?' [2017] 28(5) *International Company and Commercial Law Review* 176.

[219] Ibid.

[220] Ibid, Keller proposes that a practice used in monetary policy, whereby MEPs can ask questions of the ECB which are then published on the Official Journal of the EU, would go a long way in making public and parliamentary scrutiny more substantive.

[221] European Parliament (n 72), 86-87.

[222] The wider issue is the ECB is—rightly or wrongly—associated with specific outputs. Schmidt notes that the 'mantra of austerity' of this non-majoritarian institution, as well as its involvement in the troika, create a specific image of the ECB as an 'ogre'. Viven A Schmidt, *Europe's Crisis of Legitimacy: Governing by Rules and Ruling by Numbers in the Eurozone* (OUP 2020) 169-173.

accountability, the appointment of an independent chair 'whose professional standing was contingent upon the successes and failures of the ESRB' would better facilitate a balancing of the economic and non-economic utility of financial stability.[223] It is also worth highlighting the overrepresentation of central banks in the General Board. Enabling representatives of resolution and other authorities to participate as non-voting members, and/or a rotating vote held by different authorities depending on the subject-matter would ensure a better representation of economic and non-economic interests.[224]

Finally, on the *ex ante* front, the ESRB's mandate remains conveniently open-ended. For example, Keller points out that 'resilience' is an important facet of macroprudential policy that is missing from the ESRB's mission.[225] Resilience is intrinsic to the non-economic utility of financial stability because a resilient system is capable of absorbing the wider social costs of policy.[226] Another potential problem is that the ESRB's broad mission dilutes the distinction between micro- and macroprudential policy. As explained in Chapter 4, this is a major area of concern because the potential overlap between the two can lead to double-counting and other negative externalities, especially considering the minimum harmonisation of national flexibility measures.[227] On the whole, correcting the *ex ante* and *ex post* accountability of the ESRB would contribute to the goal of minimising social costs and improve the legitimacy of EU law.

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[223] European Parliament (n 72) 86.

[224] *Supra* (n 78).

[225] See Keller, 'The Mandate of the European Systemic Risk Board' (n 59), 22.

[226] Note the ESRB has cited this concept in its secondary instruments.

[227] See, eg, intermediate objectives of macroprudential policy, European Systemic Risk Board, 'Handbook on Operationalising Macro-prudential Policy in the Banking Sector' (2014) page 7 <www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf?ac426900762d505b12c3ae8a225a8fe5 > accessed 05 December 2020. Both the scholarship and the European Parliament in its review recommend the introduction of a colour-coded map for different types of risk to better define 'systemic risk', European Parliament (n 72) 77; Keller, 'Independence, Accountability and Transparency' (n 218) 194.

5.5.4 Strengths of the current regime

The purpose of the above analysis was to show that even if economic performance is generally positive, institutional reforms are likely to impact negatively on output legitimacy. Brief reference can be made to some positive elements of the current regime.

On the issue question of throughputs, it should be emphasised that some agencies perform better than others. For example, the SRM/SRB is praised for efficacious and inclusive processes: these include the appointment of independent directors in the Board, the use of simple majority voting, and the various consultations that are required, for instance, during the resolution procedure under Article 18 SRM. Its accountability model also improves on the ESA model, mainly due to the Commission's powers to reject or request changes to resolution schemes, and to adopt delegated acts pertaining to the SRB's tasks.[228] The role of the European Parliament and national parliaments is not drastically improved on the ESA model, but it does alleviate some of initial concerns about the undemocratic nature of the SRB.[229] It should also be mentioned that the Intergovernmental Agreement on the SRF is applied consistently with EU law, and will be formally brought under the jurisdiction of the Court of Justice by 2025.[230]A potential area of weakness is transparency, but some progress has been made on disclosure of statistical data. For example, as of December 2020 the SRB began publishing MREL metrics that make it easier for political actors to assess the resolvability of credit institutions.[231]

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[228] Art 93, SRM Regulation. The Council role is more limited, but still important.

[229] Article 45-46, SRM Regulation. See, Marta Božina Beroš, Marin Beroš, 'The Single Resolution Board: What About Accountability?" in Johannes Pollak and Peter Slominski (eds) *The Role of EU Agencies in the Eurozone and Migration Crisis* (Palgrave Macmillan 2021).

[230] Art 2, IGA. More generally on judicial review of SRB decisions, see Dominik Skauradszun, 'Legal Protection Against Decisions of the Single Resolution Board Pursuant to Article 85 Single Resolution Mechanism Regulation' [2018] 15(1) *European Company and Financial Law Review* 123; Jolien Timmermans, 'Guess Who? The SRB as the Accountable Actor in Legal Review Procedures' [2019] 12(1) *Review of European Administrative Law* 155.

[231] Eg, Systemic Risk Board, 'MREL Dashboard – Q2.2020' (09 December 2020) <srb.europa.eu/sites/default/files/2020-12-09_single_resolution_board_mrel_dashboard_final.pdf> accessed 01

As regards the economic side of financial stability, the key agencies of ESMA and the SSM are perceived as highly effective. ESMA has conducted critical work as part of the Brexit negotiations, identifying relevant risks, preparing for a no-deal scenario, and developing a supervisory framework for relocating firms.[232] As direct supervisor, ESMA has monitored instances of negligence by credit rating agencies (breach of conflict rules), in addition to breaches of authorisation and other CRAR rules.[233] A good example is a fine exceeding EUR 5 million imposed on the Fitch Group for negligent behaviour between 2013-2018, which would be practically unenforceable without ESMA's centralised powers.[234] Equally, not only have markets responded well to the SSM, but the ECB has been especially active during the COVID-19 crisis, conducting vulnerability analysis, allowing temporary reductions to capital requirements to adjust for market volatility, and issuing several recommendations and

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April 2021. The BRRD II (eg, Art 45i) imposes additional disclosure obligations on the SRB. See generally, Nicolas Véron, 'Taking Stock of the Single Resolution Board' (European Parliament, PE 634.393, March 2019) <piie.com/system/files/documents/veron201903.pdf> accessed 01 April 2021.

[232] European Securities and Markets Authority, 'Update on the UK's Withdrawal from the European Union – Preparations for Possible No-deal Brexit Scenario on 31 October 2019' (Press Release, 7 October 2019) <www.esma.europa.eu/press-news/esma-news/esma-update-uk's-withdrawal-european-union-preparations-possible-no-deal-brexit> accessed 17 February 2021; 'General Principles to Support Supervisory Convergence in the Context of the United Kingdom Withdrawing from the European Union' (ESMA42-110-433, 31 May 2017) <www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf> accessed 17 February 2021.

[233] European Securities and Markets Authority, 'ESMA Fines Fitch €5,132,500 for Breaches of Conflict of Interest Requirements' (Press Release, 28 March 2019) <www.esma.europa.eu/press-news/esma-news/esma-fines-fitch-€5132500-breaches-conflict-interest-requirements> accessed 17 February 2021; 'ESMA Fines Five Banks €2.48 Million For Issuing Credit Ratings Without Authorisation' (Press Release, 23 July 2018) <www.esma.europa.eu/press-news/esma-news/esma-fines-five-banks-€248-million-issuing-credit-ratings-without-authorisation> accessed 17 February 2021.

[234] Ibid.

opinions.[235] This proactive approach extends to the Ukrainian crisis and the implications of international sanctions for Russian banks operating in the euro area.[236]

5.6 Conclusion

This chapter examined the legitimacy of institutional reforms linked to the goal of financial stability. Specifically, the teleology developed in Chapters 2 and 3 was applied to the creation of European Supervisory Authorities (ESAs), the European Systemic Risk Board (ESRB), and the three pillars of the Banking Union (SSM, SRM, EDIS).

It was firstly argued that the overall paradigm of agencification is inconsistent with the teleology of financial stability. Analysis focused on the case of *Short Selling* and the creation of ESMA. While the literature approaches the creation of supervisory authorities with quasi-legislative and discretionary intervention powers from the perspective of legality, the more pertinent issue is that of *ex ante* and *ex post* accountability, which is intrinsically connected to the non-economic utility of financial stability. There are many indications that political and judicial accountability of supervisory agencies is lacking. For instance, the *ex ante* framing of ESMA's powers is inherently broad and its powers are gradually expanding. In addition, *ex post* accountability is weakened by the fact that agencies sit outside of the inter-institutional architecture, and due to a 'bottom-up' shift of competences which reduces the influence of national accountability processes.

Moreover, agencification is potentially at odds with the ideological shift implicit in financial stability. Contrary to substantive prudential and resolution policy reforms, that establish

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[235] On market response, Livia Pancotto, Owain ap Gwilym and Jonathan Williams, 'Market Reactions to the Implementation of the Banking Union in Europe' [2020] 26(7-8) *The European Journal of Finance* 640; For an overview of the ECB's response to the COVID-19 crisis, Taylor Wessing, 'COVID-19: How the European Financial Regulators are Responding' (Insights, 7 April 2021) <www.taylorwessing.com/en/insights-and-events/insights/2020/05/covid-19-how-the-european-financial-regulators-are-responding> accessed 11 April 2021.

[236] Martin Arnold, 'ECB to Oversee Wind-Down of Russian-linked Bank in Cyprus' (Financial Times, 24 March 2022) <www.ft.com/content/b8d1cf4f-5160-4666-aae3-73f9d9ae7c0f> accessed 25 March 2022.

significant limits to market integration in an area previously dominated by free movement and state aid law, institutional reforms occur at the expense of national competences and supranational political leadership. These vertical and horizontal power shifts evoke a market-efficiency rationale, and imply that the ideology of institutional reforms may not be as novel as the substantive dimension.

Secondly, this chapter explored specific challenges facing the Banking Union, the EBA, and the ESRB. In relation to the Banking Union, the key challenge is its heavily compromised design. The most important omission is that of centralised deposit insurance (EDIS), which is essential to the goal of minimising the social costs of financial stability policy. Viewed alongside the uncertain performance and many externalities of the bail-in tool as part of the SRM, the absence of centralised deposit insurance is a major threat to output legitimacy. Other challenges include the lack of a fiscal backstop and the unclear relationship between the SRM and the intergovernmental ESM.

Further, differentiated integration in the Banking Union affects the tasks and governance of ESAs, mainly the EBA. Notwithstanding the broader criticism of agencification, the EBA has a positive track record: for example, this agency was instrumental in introducing a new version of the proportionality principle in the CRR II/CRD V, which goes a long way in reducing the social costs of prudential policy. However, the potential of EBA is significantly limited by the Banking Union, which brought about important governance changes that threaten its independence. Similarly, the ESRB faces governance issues that flow its operational reliance on the ECB and the inadequate representation of national authorities in voting procedures. Another important limitation of the ESRB is that its soft law powers are not subject to judicial review and political accountability of its actions is marginal.

Overall, these challenges demonstrate that there is tension between institutional reform and the teleology of financial stability, which therefore impacts negatively on the output legitimacy of EU law.

Chapter 6: Fiscal Reform and Financing Assistance

6.1 Introduction

The previous chapters focused on substantive and institutional reforms in prudential policy and bank resolution. This chapter investigates the connection between EU financial stability, economic governance, and financing assistance (bailouts and bail-ins). While all dimensions of financial stability have broad constitutional implications, the fiscal/financing side is intimately tied to legitimacy: it invokes the relationship between EU law and international law, horizontal and vertical power shifts, and the application of judicial review and fundamental rights. My main goal is to demonstrate that developments in this area contradict the teleology of financial stability, or the ideological underpinnings and non-economic utility of this objective, which poses a threat to output legitimacy.

The first half of this chapter focuses on economic governance and the EU's 'enhanced surveillance' model, which describes the peculiar power structure between EU institutions and euro area countries in fiscal policy. The crisis brought about many reforms that empower EU institutions to monitor and enforce strict budgetary limits and other fiscal requirements. Yet economic policy remains largely decentralised because the EU lacks fiscal capacity, or the ability to raise funds independently. This compromise between fiscal federalism and decentralisation perpetuates some of the challenges identified previously, mainly in relation to accountability and the goal of minimising the social costs of financial stability.[1] This discussion also sets the legal background for financing assistance, a topic that is closely connected to EU financial stability.

The second half of this chapter covers financing assistance granted to Eurozone countries. My focus in on the case law of the Court of Justice because it provides an excellent synopsis

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[1] Note that financial stability and fiscal sustainability are not identical, but there is a big overlap between these goals. On fiscal federalism and the challenges of the current model, see Alicia Hinarejos, 'Fiscal Federalism in the European Union: Evolution and Future Choices for EMU [2013] 50(6) *Common Market Law Review* 1621.

of the main legal and political developments. The Court's jurisprudence is directly responsible for the constitutional 'consecration' of financial stability in EU law.[2] This is vital from an output legitimacy standpoint, as the Court's interpretation determines the purpose and scope of this objective. The most important cases explored in this chapter are *Pringle* and *Ledra Advertising*.[3]

The first case concerned the compatibility with EU law of the intergovernmental European Stability Mechanism (ESM), a body administering financial assistance to Eurozone countries. This was seen as potentially violating the "no bailout clause" in Article 125(1) TFEU. In reconciling the creation of this international body with EU law, the Court put forward a radical interpretation of financial stability as a 'higher' objective in the EMU, which is wholly inconsistent with the teleology explored in this thesis.[4] For instance, one of the issues that emerges from this interpretation is that it provides a constitutional backing to austerity (strict conditionality). This level of judicial deference defies the purpose of minimising the social costs of policy and the need to balance the economic and non-economic sides of financial stability.

The second case is *Ledra Advertising*, on the participation of EU institutions in intergovernmental bail-ins. Bail-ins can be distinguished from bailouts as a more fundamental threat to legitimate expectations and the right to property. The key issue in *Ledra* was the applicability of EU fundamental rights to bail-ins conducted outside the scope of EU law. The Court is widely praised for declaring that EU institutions are always bound by the Charter even when they operate outside EU law.[5] The novelty of this judgment is strongly exaggerated in the literature. Beyond the application of the Charter to the acts of institutions outside of EU law (admissibility), the substantive review of financial stability in *Ledra Advertising* and surrounding case law is especially frail. This judgment grants financial stability a virtually unlimited scope, contrary to the need for *ex post* accountability and other

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[2] Kaarlo Tuori and Klaus Tuori, *The Eurozone Crisis: A Constitutional Analysis* (CUP 2014) 129.

[3] *Pringle* (C-370/12) ECLI:EU:C:2012:756; *Ledra Advertising* (C-8/15) ECLI:EU:C:2016:701.

[4] Ibid, paragraph 135.

[5] *Infra* (n 181).

elements of the teleology explored above. Analysis also touches on surrounding case law, such as *Florescu* and *Chrysostomides*, which similarly demonstrate an alarming level of judicial deference.[6]

The chapter is structured as follows. Section 6.2 will introduce economic governance reforms, both within the scope of EU law and the international Treaty on Stability, Coordination and Governance (TSCG). Owing to the sheer scope and complexity of these reforms, analysis is reserved for Section 6.3. This section will investigate the role of EU institutions in economic surveillance and broader issues pertaining to the many compromises of fiscal reform. Section 6.4 focuses on bailouts in the EMU and the case of *Pringle*. Finally, Section 6.5 will address *Ledra Advertising* on intergovernmental bail-ins and surrounding case law. The central debate in the latter two sections is the Court's judicial review of financial stability.

6.2 Fiscal sustainability I: six-pack, two-pack, and the TSCG

This section will outline fiscal policy reforms achieved via supranational and intergovernmental instruments during the financial crisis. Fiscal sustainability and financial stability are not synonymous, but there is a strong two-way interaction between the two: high public debt is a source of instability, and equally, an unstable financial sector escalates pressures on public finances.[7] Moreover, there is overlap between the concepts of financial stability and fiscal sustainability in policy documents and in the case law of the CJEU.[8] This dimension is critical in evaluating the output legitimacy of EU financial stability.

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[6] *Florescu* (C-258/14) ECLI:EU:C:2017:448; *Chrysostomides* (C-598/18 P) ECLI:EU:C:2020:1028.

[7] See generally, Zlatuse Komarkova, Vilma Dingova and Lubos Komarek, 'Fiscal Sustainability and Financial Stability' (Check National Bank, Financial Stability Report 2012/13) 103-112; Bank for International Settlements, 'Towards a Financial Stability-Oriented Fiscal Policy' (BIS 86th Annual Report, 26 June 2016) <www.bis.org/publ/arpdf/ar2016e5.pdf > accessed 10 August 2021.

[8] This overlap is exemplified by the objective of the 'stability of the euro area' in Art 136(3) TFEU.

This section will first outline the main elements of the so-called "six-pack" and "two-pack", a set of reforms intended to strengthen supranational economic surveillance. I will then turn to the Treaty on Stability, Coordination and Governance (TSCG), an international agreement which underpins fiscal consolidation in the euro area. Finally, brief reference will be made to recent developments and the performance of economic governance reforms during the COVID-19 pandemic. My aim is to provide a clear overview of fiscal reforms, analysis of which is reserved for the next section.

6.2.1 Incomplete supranationalism: from Maastricht to the "six-pack" and "two-pack"

There is a strong two-way interaction between financial stability and fiscal sustainability. As the economy expands through the growth of private debt in the upturn phase, public debt emerges in the downturn to mitigate instability and sustain the new boundaries of the economy.[9] Equally, high public debt can be a source of systemic risk in the financial sector. Not only does it erode the fiscal barrier required to address extraordinary events, but credit institutions that hold government liabilities are exceedingly vulnerable to macroeconomic shocks.[10] As banks rebalance their portfolios to less risky assets, other policy initiatives can be affected, leading to increasing housing costs and other externalities.[11]

The final link in the chain is monetary policy. Formally "divorced" from fiscal affairs, monetary policy still has a key role in the management of sovereign debt. For instance, monetary policy can be used to improve liquidity in government bond markets. Public debt impacts on the transmission of monetary policy: it invites big inflation as a means of reducing the debt burden, it can make interest rates unsustainable as they contribute to debt, and it

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[9] See, Virgilijus Rutkauskas, 'Financial Stability, Fiscal Sustainability and Changes in Debt Structure After Economic Downturn' [2015] 94(3) *Ekonomika* 70.

[10] Udaibir S Das *et al*, 'Managing Public Debt and its Financial Stability Implications' (IMF Working Paper, WP/10280, December 2010) <www.imf.org/external/pubs/ft/wp/2010/wp10280.pdf> accessed 10 August 2021.

[11] Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, 'The Real Effects of Debt' (BIS Working Papers No 352 ,September 2011) <www.bis.org/publ/othp16.pdf> accessed 10 August 2021.

leads to political pressure on central banks to act.[12] Empirical evidence suggests that central banks become more 'active' as fiscal problems emerge.[13] Thus, despite their formal separation, there is an inevitable overlap between fiscal, monetary, and prudential policies.[14]

This can create big asymmetries in the EMU, an area where monetary policy is centralised, economic policy is pursued by national governments but coordinated at the European level, and prudential tasks are intricately divided across various systems.[15] It is because of these asymmetries that economic governance has been described as the weak point of the EMU.[16] Importantly, the scope and intensity of European economic governance has changed drastically over time. It is necessary to distinguish four stages since Maastricht: the early period from 1992-2005, the second stage from 2005-2008, crisis and response from 2008-2014, and the phase of consolidation between 2014-2020.[17] The COVID-19 pandemic marks a new and unpredictable chapter for economic governance and is addressed separately.

To pave the way for the common currency, the Treaty of Maastricht introduced the requirement that government deficits must be limited to 3%, and public debt levels to 60% of GDP.[18] The Commission took the role of monitoring these values, and an enforcement

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[12] Rudi Dornbusch, 'Debt and Monetary Policy: The Policy Issues' in Guillermo Calvo and Mervyn King (eds), *The Debt Burden and its Consequences for Monetary Policy* (Palgrave Macmillan 1998); Charles Goodhart, 'Monetary Policy and Public Debt' (Banque de France, Financial Stability Review No 16, 2012) 123-130 <publications.banque-france.fr/sites/default/files/medias/documents/financial-stability-review-16_2012-04.pdf> accessed 10 August 2021.

[13] António Afonso, José Alves and Raquel Balhote, 'Interactions Between Monetary and Fiscal Policies' [2019] 22(1) *Journal of Applied Economics* 132.

[14] Hans J Blommestein and Philip Turner, 'Interactions Between Sovereign Debt Management and Monetary Policy under Fiscal Dominance and Financial Instability' (OECD Working Papers on Sovereign Borrowing and Public Debt Management No 3, 2012) <www.oecd.org/finance/public-debt/49931946.pdf> accessed 10 August 2021.

[15] Afonso, Alves and Balhote (n 13). See Chapters 4 and 5 on the division of tasks in financial stability.

[16] Rosa M Lastra, *International Financial and Monetary Law* (OUP 2015) 291.

[17] Antonio Estella, *Legal Foundations of EU Economic Governance* (CUP 2018) 134.

[18] Art 1, Protocol 12 on the Excessive Deficit Procedure. On the (lack of) economic rationale for these values, see Paul De Grauwe, *Economics of Monetary Union* (OUP 2016) 148-149.

procedure involving a tedious back-and-forth between the Council and non-compliant Member States was established.[19] The Stability and Growth Pact (SGP) was adopted in 1997 to improve enforcement and provide clarity on the limits set out in Maastricht: it comprises of a (non-binding) European Council Resolution, and two Regulations detailing preventive and corrective rules.[20] The SGP applies to all EU countries and is generally associated with a rigid approach towards economic coordination.[21] For example, the SGP sets a 1 year deadline for deficit corrections, and establishes a non-discretionary sanctioning system.[22]

A rigid system of coordination can be difficult to reconcile with the exclusive competences of the Member States in fiscal policy and, due to political pressure, the SGP amendment of 2005 reverted to a more fluid model. For example, secondary legislation abandons the reference to a 60% public debt level, and 'differentiated' medium-term budgetary objectives were explicitly authorised.[23] The 2005 amendment also implemented changes to the corrective arm of the SGP, introducing exceptions and granting special discretion on the Commission to assess 'any other factors' put forward by Member States as justification for excess over the deficit value.[24]

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[19] Art 104c(2). Note Art 109k(3) derogation for non-Eurozone countries.

[20] (SGP) Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997, OJ C236/1; Council Regulation 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L209/1; Council Regulation 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L209/6.

[21] Estella (n 17), 141-144. The SGP is described as the price that countries of the periphery had to pay to join the Eurozone.

[22] Art 6, Regulation 1467/1997. Note emphasis on deficit.

[23] Recital 5 and Art 2a, Council Regulation 1055/2005 of 27 June 2005 amending Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 352M/183.

[24] Art 2.3, Council Regulation 1056/2005 of 27 June 2005 amending Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L174/5. For example, the Commission is required to assess international solidarity and contributions to EU objectives.

The third reform of the SGP began in 2010, following the realisation that the Greek economy was on the verge of collapse and about to send into disarray the entire Eurosystem.[25] The European Council took a leadership role in this process which, beyond fiscal reforms, encompasses financing assistance and supplementary strategies such as the European Semester, the Euro Plus Pact,[26] and "Europe 2020". Authors emphasise that fiscal reforms were not urgently needed, they were mainly intended to compensate for recourse to bailouts—a measure prohibited by the EU Treaties.[27] The "no bailout" clause in Article 125(1) TFEU is examined below in relation to the case law of the ECJ.

The system that emerged during the crisis is described as an 'enhanced surveillance' model, which alludes to a new turn to rigidity without going as far as to contradict the coordinating role of EU institutions in economic policy. It encompasses the supranational "six pack" and "two pack" measures, as well as an international Treaty on Stability, Coordination and Governance in the EMU (TSCG). The TSCG includes an amended Fiscal Compact, which imposes duties on Member States to fulfil strict fiscal goals. Even though enhanced surveillance operates within the constitutional boundaries established by Maastricht, this model entails an unprecedented transfer of competences from the national to the European level.[28]

"Six pack"

The first of these developments, the six pack, was introduced in 2011. It is made up of five Regulations and a Directive, which can be divided into two further categories: the first group of measures seeks to enhance the preventive and corrective arms of the SGP, the second

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[25] See Gianni Lo Schiavo, *The Role of Financial Stability in EU Law and Policy* (Wolters Kluwer 2017) 90-92.

[26] This was an intergovernmental agreement adopted in 2011, whereby Member States expressed their commitment to transpose EU fiscal rules into national law.

[27] Steve Peers, 'The Stability Treaty: Permanent Austerity or Gesture Politics?' [2012] 8(3) *European Constitutional Law Review* 441.

[28] See generally, Paul Craig, 'The Stability, Coordination and Governance Treaty: Principle, Politics and Pragmatics' [2012] 37(3) *European Law Review* 232.

introduces a new macroeconomic imbalances procedure.[29] For purposes of brevity, I will cover the main features of the six pack without going into depth on each legislative instrument.

The first group consists of Regulations 1175/11, 1177/11, 1173/11, and Directive 2011/85. One of the most notable additions to the preventive arm of the SGP introduced by these reforms is the concept of 'structural balance', calculated by excluding the effects of the economic cycle and other temporary macroeconomic measures from the budget balance.[30] This value, further defined in the TSCG, must be used 'as a reference' in the medium term, which strongly reduces any flexibility afforded by the EU Treaties.[31] The structural balance also serves a starting point for the Commission's surveillance 'missions', another feature of the six pack that enables the Commission to probe into national policies and, in some cases, conduct on-site investigations. It is clear from the onset that the six pack represents a sharp turn to rigidity, and this is further achieved with harmonisation of national budgetary frameworks under Directive 2011/85.[32]

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[29] Regulation 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L306/12; Council Regulation 1177/2011 of 8 November 2011 amending Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L306/33; Regulation 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area, OJ L306/1; Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, OJ L306/41; Regulation 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, OJ L306/25; Regulation 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, OJ L306/8.

[30] On this concept, see Ringa Raudla and James W Douglas, 'Structural Budget Balance as a Fiscal Rule in the European Union—Good, Bad, or Ugly' [2021] 41(1) *Public Budgeting and Finance* 121.

[31] Arts 5(1); Art 3(1)(b) specifies the 0,5% value. (TSCG) Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

[32] See Estella (n 17), Chapter 7.

Moreover, the six pack makes important changes to the sanctioning regime of the SGP. The 1997 rule that non-interest-bearing deposits will be preferred over fines is overturned, thus, fines become the primary sanction for failing Member States.[33] The Council may also intensify sanctions if Member States do not comply with a prior notice. Additional rules apply to euro area countries.[34] This is a source of inconsistency: for example, non-interest-bearing deposits remain the preferred sanction for the euro area in the preventive phase of the SGP.[35] This level of complexity is the product of a clash of philosophies during an arduous legislative process, a common criticism of 'enhanced surveillance'.[36] Perhaps the most critical change is the novelty of "reverse" qualified majority voting. This entails the automatic adoption of sanctions recommended by the Commission unless they are rejected by a qualified majority vote in the Council. Voting changes make the entire process more efficient, but significantly raise the bar for challenging sanctions.

The second category of measures establishing a new Macroeconomic Imbalances Procedure (MIP) is composed of Regulations 1176/11 and 1174/11. These instruments target the Eurozone specifically, supplementing fiscal governance reforms with thorough marcoeconomic stability checks.[37] This is a major departure from the Maastricht regime both in substance and in method: the reforms clearly extend the influence of EU institutions in this area and follow a strict, rules-based approach. The Regulations first introduce and define the concept of 'macroeconomic imbalance' as a situation that has the potential to adversely affect the functioning of the national economy, the euro area, or the EU.[38] Key to identifying imbalances is the 'scoreboard', a detailed set of indicators that EU institutions can use to monitor potential threats at their earliest stages.

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[33] Ibid, 173.

[34] Art 11, Regulation 1177/11; Art 12 on calculation of fines. These are read in conjunction with Art 126(11) TFEU.

[35] On this issue, see Estella (n 17), 173-174.

[36] Markus K Brunnermeier, Harold James and Jean-Pierre Landeau, *The Euro and the Battle of Ideas* (Princeton University Press 2016), Chapter 2.

[37] In itself this is notable, from a division of competences perspective.

[38] Art 2(1), Regulation 1176/11.

The Macroeconomic Imbalances Procedure draws inspiration from the Excessive Deficit procedure (EU-wide), but they differ in important ways. The process begins with an alert mechanism, which then enables the Commission to conduct in-depth reviews and make recommendations to the Council. The Council may either recommend 'preventive action', or formally initiate MIP. In the latter scenario, Member States must establish a corrective action plan. If the action plan is rejected by the Council, the Member State faces sanctions in the form of interest-bearing deposits and fines. Reverse qualified majority voting is once again used as a means of making sanctions as "automatic" as possible.

"Two pack"

The two-pack is a set of additional fiscal coordination and surveillance measures for the Eurozone.[39] It was adopted at a subsequent stage, in part because Regulations 472/13 and 473/13 were intended to supplement EU-wide reforms, but also because they were subject to intense negotiations. Regulation 472/13 concerns 'enhanced surveillance', a process initiated by the Commission when a Member State is either facing severe economic difficulties or in receipt of financing assistance. 'Enhanced surveillance' is conducted by the Commission in collaboration with the ECB, the IMF, and the European Supervisory Authorities (ESAs). Member States placed in enhanced surveillance must comply with extensive reporting and other requirements, and draft macroeconomic adjustment programs for long-term recovery and repayment of bailout funds. Reporting (and other requirements) extend to the post-surveillance phase.

Regulation 473/13 focuses mainly on the preventive side, establishing a number of deadlines for the preparation of fiscal plans and the adoption of government budgets. This instrument also empowers the Commission to conduct budget assessment and to submit its findings to

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[39] Regulation 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, OJ L140/1; Regulation 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, OJ L140/11.

the Eurogroup, in the form of a non-binding opinion. The Regulation also alters the Excessive Deficit Procedure, placing the onus on the Member States to draft 'economic partnership programmes' outlining structural reforms—as opposed to merely complying with the recommendations of the EU Institutions. Economic partnership programmes can subsequently be incorporated in a corrective action plan, should the Member State enter the Macroeconomic Imbalances Procedure.

6.2.2 Extraordinary intergovernmentalism: Treaty on Stability, Coordination and Governance (TSCG)

In addition to the supranationalism of the six pack and two pack, the reform of economic governance is characterised by extraordinary intergovernmentalism. In the context of economic governance, 'intergovernmentalism' refers to international law agreements between Member States and is associated with a 'mutation' of the EU constitution.[40] This is because of its prevalence during the crisis as a means of circumventing the strict boundaries of the Treaties on crucial aspects of economic policy. As will be shown below, this is certainly true of financing assistance (bailouts and bail-ins). The Treaty on Stability, Coordination and Governance (TSCG) occupies a peculiar position in EU law: the agreement is entirely consistent with EU law, but it was adopted as an international treaty due to the UK and Czech Republic's resistance to Treaty change.[41] Accordingly, it was agreed that the TSCG will be incorporated into EU law by 2025.[42]

The TSCG was finalised in 2012 and is preceded by other intergovernmental initiatives.[43] It has so far been ratified by 22 Member States: the 19 countries that make up the Eurozone, as well as Romania, Bulgaria, and Denmark. The remaining five, Croatia, the Czech Republic, Hungary, Poland, and Sweden, have either not signed or not ratified the Treaty; they are not bound by its provisions (and remain ineligible for financing assistance). Article 1 TSCG sets

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[40] *Cf. Bruno* de Witte, 'Euro Crisis Responses and the EU Legal Order: Increased Institutional Variation or Constitutional Mutation?' [2015] 11(3) *ELR* 434

[41] Craig, 'The Stability, Coordination and Governance Treaty' (n 28).

[42] Art 16, TSCG.

[43] *Supra* (n 26).

out the goal of strengthening fiscal discipline in the EMU through a more robust Fiscal Compact, in addition to wider coordination and governance reforms. Financial stability is not explicitly mentioned in this provision, but many of the provisions of the TSCG are relevant for financial stability.[44]

The 'nuclear' clause of the TSCG is contained in Article 3.[45] This provision is significant for two reasons. First, it reiterates the 1997 requirement that government budgets must be 'balanced or in surplus', then attaches the specific value of 0,5% to the concept of structural balance introduced in the six pack.[46] This value supersedes the nominal balance of 3% established by Maastricht, which was criticised as ineffective and contradictory to empirical data.[47] The new target of 0,5% is considered more appropriate, but is much stricter.[48] Second, Article 3 contains the "golden rule" that the balanced budget rule must be incorporated into national law.[49] By preference, it must be incorporated into the national constitutions, but this is not mandatory.[50] The incorporation of the balanced budget rule is a prerequisite for financing assistance through the European Stability Mechanism (ESM).[51]

On the corrective side, the TSCG makes further changes. An automatic correction mechanism is triggered 'in the event of significant observed deviations' from medium-term objectives, and this requires Member States to implement measures based on 'common principles' recommended by the Commission.[52] Article 4 sets the rate of debt reduction in

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[44] On the connection between the two, see Lo Schiavo (n 25).

[45] Estella (n 17), 169.

[46] Note if debt is significantly below 60%, then allowed up to 1% structural deficit.

[47] *Supra* (n 18).

[48] For analysis of the most appropriate value, see Michael Artis and Marco Buti, '"Close-to-Balance or in Surplus": A Policy-Maker's Guide to the Implementation of the Stability and Growth Pack' [2000] 38(4) *Journal of Common Market Studies* 563.

[49] Art 3(2) & Title IV, TSCG.

[50] See generally, Federico Fabbrini, 'The Fiscal Compact, the "Golden Rule," and the Paradox of European Federalism' [2013] 36(1) *Boston College International & Comparative Law Rev* 1.

[51] Recital 5, Treaty Establishing the European Stability Mechanism (2012) T/ESM 2012-LT.

[52] Arts 3(1)(e) & 3(2), TSCG.

instances where government debt exceeds 60% of GDP, at one twentieth annually. The total period of debt reduction is to be determined by the Commission, which is further empowered to ensure compliance with the golden rule.[53]

Following the example of the two-pack, Title III fundamentally alters the Excessive Deficit procedure. Article 5 authorises the use of economic programmes detailing structural reforms for states who have entered the procedure under Article 126 TFEU. The Commission and Council are tasked with endorsing and monitoring implementation of economic programmes, as well as enforcing reporting requirements. Article 7 then introduces reverse qualified majority voting for Member States who are in breach of the excessive deficit criterion. The TSCG also strengthens the role of the Court of Justice, in cases brought to it by Contracting Parties,[54] to issue binding judgments and to sanction non-compliance with the Fiscal Compact (fine not exceeding 0,1% of GDP).[55]

Titles IV and V focus on coordination and governance beyond the SGP. Notably, Article 9 refers to financial stability as a secondary objective of economic policy coordination. Article 10 also mentions enhanced cooperation as a means of ensuring the proper functioning of the euro area, without undermining the internal market. Articles 12 and 13 envision a stronger (informal) role for the Euro Summit and national parliaments.

6.2.3 Recent developments

The initial reform period of 2011-2013 was followed by developments on multiple fronts. First, there have been several reviews and fine-tuning of EU economic governance. In as early as 2014, the Commission reported that the average fiscal deficit in the EU fell from 4,5% in 2011 to around 3% GDP.[56] The same report emphasises the success of the corrective arm of the SGP, as well as the rules-based approach, but notes that many of the tools remain

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[53] Art 8 on rule enforcement; Arts 5-7, TSCG.

[54] This denotes a self-enforcement rationale, or "naming and shaming".

[55] Art 8(2), TSCG on sanctions.

[56] Page 5, European Commission, 'Report on the application of Regulations (EU) no 1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011, 472/2013 and 473/2013', COM(2014) 905 final.

untested.[57] Modest changes were achieved in 2015, for example, improving the representation of EU institutions in international organisations such as the IMF.[58]

A shift towards flexibility can also be observed during this time. This stems primarily from the Commission and the political commitments undertaken by President Juncker since his appointment in 2014. As part of this effort, the Commission agreed to apply a new matrix for assessing cyclical conditions affecting national economies, to allow more time for the correction of fiscal consolidation outcomes that emerge from exogenous factors beyond the control of Member States, to consider the long-term positive impact of structural reforms and to delay the EDP where necessary, and to mobilise investment funds across the EU.[59] These commitments do not undermine the rules-based approach of the SGP, but they highlight the potential for flexibility within the boundaries of the current framework.

By 2017, all Member States who were bound by the "golden rule" had amended their national laws to implement the 'substance' of the Fiscal Compact, but heterogeneity can be observed as to the form and scope of national provisions.[60] In the same year, the Commission took steps to incorporate the TSCG into secondary EU law. This is a complicated process: many of the provisions of the TSCG go further than the EU Treaties, for example, amending voting and other elements of the Excessive Deficit Procedure.[61] These cannot be incorporated into EU law without Treaty amendment, indeed, the Commission's proposal focuses exclusively on Article 3 TSCG, leaving other provisions unchanged. The legal basis for the

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[57] The corrective arm of the SGP enabled 12 out of 23 Member States to complete and exit the Excessive Deficit Procedure by 2014. The report also notes that the MIP was never used.

[58] For a clear timeline of events, see European Commission 'Timeline: The Evolution of EU Economic Governance' (Europa.eu) <ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/timeline-evolution-eu-economic-governance_en#id2015> accessed 21 May 2021.

[59] Estella (n 17), 182-186.

[60] European Commission, 'Communication - The Fiscal Compact: Taking Stock', C(2017) 1200 final.

[61] Filippo Croci, 'Is it worth the effort? The European Commission's Proposal for Integrating the Substance of the 'Fiscal Compact' into the EU Legal Order' (Revue Ecu/Euro, May 2018) <resume.uni.lu/story/the-integration-of-the-fiscal-compact-into-the-eu-legal-order> accessed 21 May 2021.

proposed Directive, Article 126(14)(2) TFEU, is also controversial due to the mere consultative role of the European Parliament.[62]

The COVID-19 crisis posed the biggest test of 'enhanced surveillance' since 2013. In many ways, the pandemic was more dire than the financial crisis due to the complete shutdown of economic activity for extended periods across the EU, which also coincided with Brexit and its restrictive effects on trade. In summary, the Commission swiftly abandoned its overriding focus on fiscal consolidation and triggered the general escape of the SGP, an exception introduced in 1997 that was previously never used.[63] This clause does not affect the procedures of the SGP; it suspends budgetary limits and enables Member States to depart from their medium-term adjustment paths, so long as the overall objective of fiscal sustainability is not endangered.[64] Even more remarkably, the Council adopted a gargantuan recovery package of EUR 750 billion (in 2018 prices).

Several conclusions can be drawn from the EU's response to the pandemic, but we should be mindful of the extraordinary circumstances of the COVID-19 crisis. On the one hand, the EU's reaction the pandemic has been asymmetric: the recovery process favours countries with little public debt, who had already recovered from the financial crisis.[65] Asymmetry can be seen as an indictment of a rigid model; while the Commission can be praised for its flexible approach during the pandemic, it has not commented on whether permanent reform of the enhanced surveillance model is needed.[66] On the other hand, the recovery package takes into account unique challenges in the periphery and authorises the dissemination of funds to countries with below average GDP.

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[62] A similar concern was expressed by national parliaments as part of their subsidiarity role.

[63] This was extended recently until 2023.

[64] European Commission, 'Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact', COM(2020) 123 final.

[65] See Marco Buti, 'A Tale of Two Crises: Lessons from the Financial Crisis to Prevent the Great Fragmentation' (VoxEU, July 2020) <voxeu.org/article/lessons-financial-crisis-prevent-great-fragmentation> accessed 16 November 2021.

[66] Ibid.

Overall, the EU's recourse to supranational measures within the boundaries of EU law has been highly praised, and the mutualisation of funds achieved as part of the recovery process bodes well for other initiatives, such as centralised deposit insurance.[67] However, it must be pointed out that there is a level of political consensus on COVID-19 that was absent during the financial crisis.[68] As such, it is difficult to draw broader conclusions from the COVID-19 crisis on the success or failure of economic governance reforms. The next section will delve deeper into the challenges facing the current regime and its link with financial stability.

6.3 Fiscal sustainability II: Reviewing the EU's 'enhanced surveillance' model

The previous section outlined the fiscal policy changes brought about by supranational and intergovernmental reforms during the crisis. This section will delve deeper into the implications of these reforms for financial stability. The key debate in the literature centres around whether the far-reaching shift of competences to the EU is justified in light of the rigidity and many gaps of the current model. This is often framed in terms of comparing 'enhanced surveillance' with a complete 'fiscal union', but some authors call for a decentralised or 'cooperative' model of economic governance.

The discussion is structured around the challenges facing EU economic governance. I will address the role of EU institutions and perceived weakening of national fiscal autonomy, which coincides with the weakened political and judicial accountability in financial stability. Other challenges, such as the link between fiscal sustainability and austerity or inequality are also addressed, as macroeconomic reforms predetermine the output legitimacy of financial stability. Analysis of fiscal policy is important in its own right, but it also serves the purpose of contextualising the subsequent sections on financing assistance.

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[67] See generally, Bruno de Witte, 'The European Union's COVID-19 Recovery Plan: The Legal Engineering of an Economic Policy Shift [2021] 58(3) *CMLR* 635.

[68] Marco Buti and George Papaconstantinou, 'The Legacy of the Pandemic: How Covid-19 is Reshaping Economic Policy in the EU (CERP Policy Insight, No. 109, April 2021) <cepr.org/sites/default/files/policy_insights/PolicyInsight109.pdf> accessed 16 November 2021.

6.3.1 The role of EU institutions: power shifts and *ex post* accountability

The first relevant issue is the empowerment of the Council and the Commission at the expense of national fiscal autonomy, and at the exclusion of the European Parliament. Competence shifts in economic governance are crucial for financial stability: they complement reforms explored in relation to the ESFS and Banking Union and inform the delivery of financing assistance, explored below. Thus, I will subsequently explain that the Court's case law on financing assistance exacerbates some of the challenges identified in this section.

The main beneficiary of fiscal reform is the Council. The Council already had a leading role in economic policy under Articles 121 and 126 TFEU, and crisis reform does not fundamentally alter this dynamic. Nevertheless, the six-pack/two-pack and TSGC expand the scope and intensity of EU surveillance, by extending procedures such as the Excessive Deficit Procedure, and by introducing new tools such as the Microeconomic Imbalances Procedure. Accordingly, the Council has the final say on key (non-compliance and sanctioning) recommendations and decisions. In particular, the new sanctioning system gives the Council significant enforcement powers in relation to budgetary limits and economic programmes.[69] It is evident that the Council has evolved from a mere representative of the Member States to a primary decision-maker in economic policy.[70]

This implies that while the EU's powers in economic surveillance are expanding, supranational accountability remains exceptional. The Council is not the only intergovernmental body to benefit from fiscal reform: the Eurogroup and Euro Summit have also extended their influence and played a key role in coordinating economic policy and

[69] This includes many other responsibilities. For a summary of the institutional dynamic, see Lo Schiavo (n 25), 111.

[70] This can also be linked to the use of reverse qualified majority voting, which conveys the rational of expedient decision making over interest mediation.

financing assistance, on an informal level.[71] It should be emphasised that the actions of 'informal' bodies are beyond the review of the Court of Justice, despite their immense political influence.[72] Furthermore, Lo Schiavo points out that the intergovernmentalism of economic governance impedes financial stability policy, as the two are intrinsically connected but financial stability entails many supranational elements.[73] This argument can be extended to the non-economic side of financial stability: the intergovernmentalism of fiscal policy adds another layer to a highly fragmented financial stability policy, which makes the goal of minimising social costs inherently difficult.[74] For example, centralised resolution is intrinsically connected to the non-economic utility of financial stability, yet crucial components of resolution policy (namely, the fiscal backstop) remain outside the scope of EU law altogether. Therefore, the intergovernmentalism of fiscal reform can be linked to the failures of output legitimacy identified in this thesis.

Despite the Council's leading role, the Commission has gained many new powers and responsibilities. The Commission does not have a formal decision-making or legislative role, yet its soft-law instruments and discretion make it a *de facto* leader in economic policy. Broadly, it is tasked with monitoring budgetary limits, assessing compliance and other elements of the current regime, and ensuring that reporting obligations are met by the Member States. These tasks are achieved through its proposals to the Council, and through recommendations and opinions addressed to the Member States. For instance, it has issued extensive country-specific recommendations in May 2020 to address the COVID-19 crisis.[75]

The Commission's powers are critical, not only because Member States tend to comply with its soft-law recommendations. Owing to the use of reverse qualified majority voting in the

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[71] Note that under Lisbon, the Eurogroup has a semi-president president and other formal characteristics despite its 'informal' status.

[72] *Infra* (n 168).

[73] Lo Schiavo (n 25), 112.

[74] On fragmentation and COVID-19, see Waltraud Schelle, 'Fiscal Integration in an Experimental Union: How Path-Breaking Was the EU's Response to the COVID-19 Pandemic?' [2021] 59(S1) *JCMS* 44.

[75] Ibid.

Council for important aspects of economic policy (such as sanctioning), the enhanced surveillance model is structured around the expedient adoption of the Commission's proposals. Beyond the obvious criticism of a 'competence creep' in economic policy, this system significantly erodes *ex post* accountability, a vital element of the teleology explored in this thesis.[76] Importantly, the Court is more willing to defer to the Council as a legislator and representative of the Member States. Thus, reverse qualified majority voting enables the Commission to act in a quasi-legislative capacity entirely outside the jurisdiction of the Court.[77] A further analogy can be drawn between the Commission's soft law powers, and the wider issue of expert financial stability agencies using a similar model.

The question of *ex post* accountability also concerns the role of the European Parliament. The European Parliament lacks any decision-making powers under the current surveillance system, which denotes a 'clear legitimacy deficit' in the input sense.[78] While a turn to supranationalism can be observed as a response to the COVID-19 crisis, the involvement of the European Parliament in this process remains limited.[79] Further, the Court of Justice occupies a peculiar role in the context of the TSCG. One the one hand, it can impose sanctions on Member States which fail to comply with the 'golden rule' in proceedings initiated by the Contracting Parties.[80] This points to a 'judicialization of economic affairs', as Fabbrini notes.[81] On the other hand, the traditional review of the Court is limited, not only because of the Commission's soft law powers, but because many provisions of the TSCG remain outside of EU law.

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[76] *Cf.* de Witte, The European Union's COVID-19 Recovery Plan' (n 67).

[77] An example of judicial deference to the Council is *Chrysostomides* (n 6), examined below.

[78] Lo Schiavo (n 25), 108; Tuori and Tuori (n 2) 213-215.

[79] Ibid, Lo Schiavo.

[80] Art 8(2), TSCG.

[81] Federico Fabbrini, *European Governance in Europe: Comparative Paradoxes and Constitutional Challenges* (OUP 2016), Chapter 2.

Final note can be made of the ECB's indirect influence over economic policy.[82] While the ECB has no formal role in the current surveillance model, its "whatever it takes" monetary policy approach certainly contributes to competence shifts from the national to the EU level. This is evident in *Gauweiler* and *Weiss*, which significantly erode the boundaries between economic and monetary policy.[83] The connection between these developments and financial stability lies again in the broader question of accountability. As Goodhart and Lastra argue, the Court has refused to 'guard the guardians' of financial stability policy; there are effectively no safeguards when it comes to either the economic or non-economic sides of financial stability.[84]

6.3.2 Enhanced surveillance vs. fiscal union vs. cooperative federalism

A further question is whether the current model of enhanced surveillance performs well in both an economic and non-economic sense. The recent pandemic adds an interesting angle to this discussion: fiscal mechanisms have performed inadequately during this time, but the pandemic can also be seen as an exceptional crisis. Overall, the output legitimacy of the EU's enhanced surveillance model is heavily contested in the literature.

As a product of political and legal compromise, the enhanced surveillance model strikes a middle ground between fiscal federalism and decentralised governance that in some respects goes too far, and in other ways does not go far enough. This model imposes strict limits on the powers of Member States to pursue social and other policies, yet it also represents a missed opportunity for a true supranational solution that would justify far-reaching competence shifts by virtue of its effectiveness and longevity.[85] Hinarejos frames this

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[82] The accountability of the ECB is beyond the scope of this thesis.

[83] *Gauweiler* (C-62/14) ECLI:EU:C:2015:400; *Weiss* (C-493/17) ECLI:EU:C:2018:1000. See Ana Bobic and Mark Dawson, 'A. Court of Justice Quantitative Easing at the Court of Justice – Doing whatever it takes to save the euro:Weiss and Others' [2019] 56(4) *CMLR* 1005.

[84] See Charles Goodhart and Rosa M Lastra, 'Populism and Central Bank Independence' [2018] 29(1)(3) *Open Economies Review* 49. This is similarly one of the arguments of the German Federal Constitutional Court in Weiss.

[85] Hinarejos (n 1).

dilemma in the following terms: the current framework displays strong elements of fiscal federalism but lacks the safeguards of a fiscal union.[86] She explains that economic governance pursues three objectives: fiscal sustainability/budgetary probity, Member State equality, and resilience to asymmetric shocks.[87] The current system contributes to the first of these objectives, but the latter two goals are largely ignored. In connection to this thesis, the subordination of the latter two objectives to the functionalist goal of fiscal consolidation significantly impedes the non-economic utility of financial stability.

Before elaborating on this challenge, it is necessary to consider the perceived strengths of the current model. Generally, post-crisis reforms improve the preventive and corrective arms of the SGP. On the preventive side, the rules-based approach of the six-pack and two-pack is a marked improvement on its 2005 iteration: there are detailed benchmarks and clearly defined budgetary limits, and the 'golden rule' ensures that these are implemented at the national level. In addition, extensive reporting obligations and new surveillance procedures led by the Commission significantly limit Member State divergence. On the corrective side, the sanctioning regime of the SGP has changed drastically. In particular, the automatic correction mechanism under the TSCG and the Microeconomic Imbalances Procedure strengthen the EU's capacity to rectify high levels of public debt in the euro area. In light of the EU's limited mandate over economic policy under the Treaties, these reforms go a long way in promoting fiscal consolidation.[88]

However, the current model faces many problems. Albeit stretching the boundaries of surveillance and coordination, national implementation of key elements of the enhanced surveillance model remains fragmented; this is acknowledged by the Commission in relation to the golden rule.[89] The COVID-19 crisis showcases the failure of a fragmented model predicated on fiscal consolidation: the EU's response to twice invoke the general escape clause and suspend budgetary limits demonstrates that fiscal consolidation fails to account for

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[86] Ibid.

[87] Ibid.

[88] Lo Schiavo (n 25) 111.

[89] *Supra* (n 60).

non-economic objectives such as supporting the public health sector.[90] The ensuing response to the pandemic is praised for achieving a level of mutualisation of funds and promoting institution-building through supranational measures such as the Recovery and Resolution Facility.[91] This could provide the impetus for completing essential components of the non-economic utility of financial stability, namely centralised deposit insurance. However, the pandemic is devoid of the moral hazard elements and political sensitivity of the financial crisis—there is 'a common threat that requires a common response'.[92] Thus, recent developments in economic policy do not translate into progress in financial stability.

Brief note can be made of the ideological underpinnings of financial stability, as a crucial element of output legitimacy. Importantly, the rigid economic model created by Maastricht and the ensuing SGP precipitated the liberalisation of the financial market. These developments encouraged an activist Court in free movement law and institutional reforms such as Lamfalussy which prioritised integration over systemic threats to the financial system.[93] Consequently, a concern in relation to the enhanced surveillance model is that it imposes strict limits on public action which may contribute to deregulation. More generally, the primary emphasis on fiscal consolidation is intimately tied to a liberal economic ideology.[94]

To conclude, many authors embrace Hinarejos' suggestion for a more centralised approach, be it through establishing a European fiscal capacity or other measures such as the issuance of EU public debt instruments (Eurobonds).[95] Others believe that the pandemic demonstrates

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[90] *Supra* (n 68).

[91] Ibid ; de Witte (n 67).

[92] Ibid.

[93] See Chapter 4.

[94] On the EU's economic ideology, see Jason Glynos, Robin Klimecki and Hugh Willmott, 'Cooling Out the Marks: The Ideology and Politics of the Financial Crisis' [2012] 5(3) *Journal of Cultural Economy* 297.

[95] On the suggestion of Eurobonds, see Lo Schiavo (n 25), 115.

the need for a flexible or decentralised model.[96]This strand of the literature argues that, owing to the lack of supranational instruments that would enhance the EU's resilience to asymmetric shocks, a more discretionary approach would enable Member States to respond better to a range of threats.[97] This could take the form of an adaptable system whereby fiscal rules are periodically negotiated.[98] The decentralised approach may be more consistent with the ideological and non-economic aspects of financial stability, but this discussion is beyond the scope of this thesis.

6.3.3 Further challenges: equality and austerity

A further issue raised by Fabbrini concerns Member State equality. He explains that broad developments in fiscal policy and financial stability entrench an uneven power dynamic between states.[99] Contrary to the anti-hegemonic attributes of EU law, the empowerment of the Council, European Council, and other intergovernmental bodies favours larger states. These asymmetries have spilled over to international agreements such as the TSCG and the ESM, and there is significant evidence that these favour wealthier countries. Absent supranational safeguards, the outcome is a complete domination of some Member States through economic and financial stability policy.[100] This indicates that the social costs of policy may extend to a macro-scale, which poses a major threat to output legitimacy.[101]

A final challenge is that of austerity. The EU's economic governance model not only requires Member States to enshrine into national law the requirement of budgetary probity, but this is also a requirement for ESM financing assistance. Moreover, the Commission and Council are

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[96] Raffaele Fargnoli, 'Adapting the EU Economic Governance to New Macroeconomic and Political Realities' [2020] 55(5) *Intereconomics* 320.

[97] Charles Wyplosz, 'The Eurozone Crisis and the Competitiveness Legend' [2013] 12(3) *Asian Economic Papers* 63, 74-76.

[98] De Grauwe (n 18), on the difficulty of enforcing rules that are not backed by economic rationality.

[99] Fabbrini, 'The Fiscal Compact, the "Golden Rule," and the Paradox of European Federalism' (n 50).

[100] Ibid. Fabbrini also argues that this cannot be solved by increased parliamentarianism, rather it requires a new separation of powers.

[101] The issue of inequality can also be linked to the COVID-19 pandemic, and the asymmetric responses that are a direct product of macroeconomic programmes.

given extensive powers to monitor macroeconomic reform programmes.[102] Austerity is fundamentally at odds with the non-economic utility of financial stability: while improving resilience to shocks, far-reaching structural reforms entail significant social costs, such as unemployment and social stratification. Indeed, austerity is used as an example by Scharpf to explain the 'manifest failure' of output legitimacy.[103] This failure is clearly reflected in the COVID-19 crisis, as countries in the periphery that had undertaken strict budgetary buts were hit hardest by the pandemic.[104] It is difficult to dissociate budget cuts from the overwhelming of healthcare systems and the loss of human life, in addition to the complete shutdown of social care and other policies.[105] This inconsistency with the teleology of financial stability is explored further below.

6.4 Financing assistance I: *Pringle* & the 'higher' objective of financial stability

Having examined the connection between financial stability and fiscal sustainability, the remaining parts of this chapter focus on financing assistance granted to ailing Member States during the crisis. There are several possible angles from which this topic can be approached. I concentrate on the role of the Court of Justice in reviewing bailout and bail-in measures. Firstly, the case law provides a synopsis of the legal and political issues arising between 2010-2013. Secondly, judicial review is an essential component of output and throughput legitimacy in the context of financial stability.

This section focuses on *Pringle*, a pivotal judgment on the compatibility of intergovernmental bailouts with EU law. My main aim is to analyse the Court's interpretation of financial stability as a higher-order *telos* of integration. It will be argued that this interpretation is inconsistent with the teleology of financial stability and, as such, a threat to output legitimacy.

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[102] Lo Schiavo (n 25), 111.

[103] Fritz W Scharpf, 'Legitimacy Intermediation in the Multilevel European Polity and Its Collapse in the Euro Crisis' in Klaus Armingeon (ed) *Staatstätigkeiten, Parteien und Demokratie*. (Springer 2013) 569-579.

[104] *Supra* (n 68).

[105] *Supra* (n 96).

6.4.1 *Pringle* & the European Stability Mechanism

Pringle was the most important case of 2012, if not the decade. It came at a time when the global financial crisis had escalated into a sovereign debt crisis in the Eurozone. The initial response came in the form of the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) in 2010. The former was a funding programme available to all Member States within EU law, the latter was a loan facility created through an international agreement between Eurozone countries.[106] These mechanisms issued bonds and other debt instruments to support ailing Member States but, ultimately, proved inadequate due to the magnitude of the crisis.[107] As a result, the European Stability Mechanism (ESM) was established in 2012 as a direct route for 'financial assistance to euro area Member States experiencing or threatened by financing difficulties'.[108]

The ESM is a permanent fiscal solidarity mechanism founded on an international agreement (ESM Treaty). As a fiscal backstop for the Eurozone, it complements temporary lending facilities such as the EFSM and the EFSF, as well as subsequent institutional reforms, namely the Single Resolution Mechanism.[109] Despite the economic and political need for a fiscal backstop, it was not immediately obvious that the ESM was compatible with the EU Treaties; it was previously highlighted that reform of the Fiscal Compact was a *quid pro quo* for the creation of the ESM. Specifically, the ESM faced a key obstacle: the "no bailout clause" in Article 125(1) TFEU, which states that the Union or Member States 'shall not be liable for or assume' the commitments of a Member State.

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[106] With some voluntary contributions from other MS. MS could also receive assistance from the International Monetary Fund. See generally, Rodrigo Olivares-Caminal, 'The EU Architecture to Avert a Sovereign Debt Crisis' [2011] 2 *OECD Journal: Financial Market Trends* 167; Anne Sibert, 'The EFSM and the EFSF: Now and What Follows' (IP/A/ECON/FWC/2009_040/C7, September 2010) <www.europarl.europa.eu/document/activities/cont/201009/20100908ATT81666/20100908ATT81666EN.pdf > accessed 4 May 2021.

[107] Ibid, Olivares-Caminal 180.

[108] Art 3, ESM Treaty.

[109] On the challenges of a non-EU fiscal backstop, see Chapter 5.

In addition to the political compromise of fiscal reform, the ESM Treaty required a third paragraph to be added to Article 136 TFEU, a provision pertaining to Member States whose currency is the euro. A new paragraph (3) was added via Decision 2011/199 of the European Council, using the simplified revision procedure under Article 48(6) TEU.[110] The paragraph reads:

'The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality'.

The case of *Pringle* centres around this amendment. Mr. Pringle, a member of the Irish Parliament, sought a declaration that the amendment of Article 136 TFEU by Article 1 of Decision 2011/199 was unlawful, claiming that the obligations the ESM imposed on Eurozone countries breached EU law. The Irish Supreme Court referred the case to the CJEU, asking (i) whether Decision 2011/199 was valid having regard to the use of the simplified revision procedure and the content of that Decision, (ii) whether MSs could enter into and ratify an international agreement such as the ESM in light of Article 125(1) TFEU and other provisions of EU law, and (iii) if MSs could conclude and ratify the ESM Treaty before the entry into force of Decision 2011/199.

The judgment was delivered by a full court of 27 judges, on 27 November 2012. The first question required the CJEU to determine whether Decision 2011/199 encroached on the Union's exclusive competences over monetary policy in the Eurozone. The Court considered that the objective of 'monetary policy is to maintain price stability'.[111] Conversely, the ESM aims to safeguard the 'stability of the euro area as a whole', an objective which was seen as

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[110] Decision 2011/199 of the European Council of 25 March 2011 Amending Article 136 of the Treaty on the Functioning of the European Union with Regard to a Stability Mechanism for Member States Whose Currency is the Euro, OJ L91/1. The special legislative procedure under Art 48(6) TEU authorises amendments to Part Three of the TFEU on the basis of unanimity voting.

[111] *Pringle* (n 3), paragraph 54.

'clearly distinct from […] price stability'.[112] This is founded on the premise that 'an economic policy measure cannot be treated as equivalent to a monetary policy measure for the sole reason that it may have indirect effects on [price stability]'.[113] According to the Court, both financing assistance and the new economic governance of the euro area fell under economic policy because they concerned the 'management of financial crises'.[114] Thus, Decision 2011/199 had no impact on the Union's exclusive competences.[115]

In addition to monetary policy, the Court was invited to comment on the coordination of economic policies, and to consider whether the Union's limited powers in this field precluded the establishment of the ESM. The Court emphasised that the ESM Treaty is an international agreement, therefore, its adoption fell within the competences retained by the Member States.[116] Further, the requirement for strict conditionality ensured that the ESM Treaty would not be used by the Member States to circumvent their obligations under EU law.[117] Consequently, both the use of the simplified revision procedure as well as the content of Decision 2011/199 were deemed lawful, as they did not confer any new competence on the Union. The Court also noted that the ESM Treaty was 'silent on any possible role for the Union's institutions'.[118]

On the issue of the no bailout clause, which is pivotal to the interpretation of financial stability, the Court explained that the aim of Article 125(1) TFEU is to encourage a 'sound budgetary policy'.[119] However, the Court added that budgetary discipline was conditional on the 'attainment of a *higher objective*, namely maintaining the financial stability of the

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[112] Ibid, paragraph 56.

[113] Ibid.

[114] Ibid, paragraphs 57, 59-60.

[115] Ibid, paragraph 63.

[116] Ibid, paragraphs 67-68.

[117] Ibid, paragraph 69.

[118] Ibid, paragraphs 73-74.

[119] Ibid, paragraph 135.

monetary union'.[120] It follows that budgetary discipline is aligned with the end goal of the ESM Treaty. Moreover, the Court affirmed the ECB's position that strict conditionality attached to financing assistance strengthened its compatibility with Art 125(1). It was noted that macroeconomic reforms associated with strict conditionality encouraged a sound budgetary policy,[121] and ensured that the 'ESM will not act as guarantor of the debts of the recipient Member State'.[122]

In sum, the ESM Treaty was deemed consistent with EU law, including the tasks allocated to the EU institutions by the Treaties.[123] In reply to the second and third questions, the Court found nothing in EU law capable of precluding the ratification of the ESM Treaty by the Member States even prior to the entry into force of Decision 2011/199.[124]

6.4.2 The 'higher' status of financial stability & strict conditionality

In comparison to the case studies explored in Chapters 4 and 5, financing assistance is the most problematic area of financial stability from an output legitimacy standpoint. This is only because of the broad significance of financing assistance for fiscal reforms, but also because in evaluating the legality of bailouts and bail-ins, the Court delivers critical judgments on the nature and scope of EU financial stability. *Pringle* stands out for the interpretation of financial stability as a 'higher objective' of EU law, which stands in conflict with the teleology explored in this thesis.

Before turning to the implications of this interpretation, it must be acknowledged that the creation of a fiscal backstop is a positive outcome of *Pringle*. Not only is a rescue mechanism in itself vital to the long-term survivability of the EMU, but it complements bank resolution and other crisis management policies. In theory, the strict conditionality attached to financing assistance also contributes to the preventative side of financial stability by discouraging

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[120] Ibid, paragraph 135. Emphasis added.

[121] Ibid, paragraph 143.

[122] Ibid, paragraph 136.

[123] Ibid, paragraphs 160-169.

[124] Ibid, paragraph 184.

budgetary imbalances. The literature rightly points out that *Pringle* strikes a delicate balance between legal and economic realities.[125] As Hinarejos explains, *Pringle* stands in a 'legal grey area', but it would have been catastrophic if unelected judges dismantled an emergency mechanism with broad political support.[126] It is not the outcome, but the reasoning of the Court in *Pringle* that contradicts the non-economic utility of financial stability.

The most obvious tension between *Pringle* and the teleology of financial stability stems from the strict conditionality attached to financing assistance. Strict conditionality refers to far-reaching austerity measures, relied upon by the Court to reconcile intergovernmental bailouts with the objective of budgetary discipline in Article 125(1).[127] There is a clear clash between the non-economic utility of financial stability and macroeconomic reforms that are associated with a range of social harms, from unemployment to social inequality.[128] Indeed, this is the main example used by Scharpf to dispel misconceptions around output legitimacy: austerity is justified in the normative sense due to the urgency of the crisis, but it is likely to erode output legitimacy in the empirical sense because it generates negative externalities that make it unpopular.[129] It should be emphasised that *Pringle* goes much further than validating the Member States' competence to adopt macroeconomic measures: it suggests that key elements of financial stability will only be compatible with EU law if they are accompanied by austerity measures. While austerity may not be incompatible with financial stability as such, this interpretation overlooks the non-economic side of financial stability entirely.

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[125] See eg, Stanislas Adam and Francisco JM Parras, 'The European Stability Mechanism through the Legal Meanderings of the Union's Constitutionalism: Comment on Pringle' [2013] 38(6) *ELR* 848, 864; Bruno de Witte and Thomas Beukers, 'The Court of Justice Approves the Creation of the European Financial Stability Mechanism Outside the EU Legal Order: Pringle' [2013] 50(3) *CMLR* 805, 848.

[126] Alicia Hinarejos, 'The Court of Justice of the EU and the Legality of the European Stability Mechanism' (2013) 72(2) *Cambridge Law Journal* 237, 240.

[127] *Pringle* (n 3), paragraph 143.

[128] For example, the EU's response to COVID-19 suggests that financial stability and austerity are potentially incompatible.

[129] Scharpf, (n 103), 569-579.

Two further comments can be made on strict conditionality. Firstly, strict conditionality is not only presented as a precondition for financing assistance but is attached to the higher-order status of financial stability. To explain, the Court attempts to reconcile ESM assistance with the no bailout clause in Art 125(1) by construing financial stability as a 'higher objective' of EU law, which trumps other goals in the EMU such as budgetary discipline.[130] As Tuori and Tuori explain, the Court 'consecrated in constitutional terms the idea of a two level teleology and the definition of a higher objective as the financial stability of the euro area as a whole'.[131] Accordingly, this constitutional consecration extends to austerity, as the financial stability measures in question are only compatible with EU law if they are accompanied by strict conditionality. Beyond what Tridimas and Xanthoulis describe as a 'normative legitimisation' of austerity, *Pringle* prescribes as a constitutional requirement a type of macroeconomic reform that poses a threat to the non-economic utility of financial stability.[132] From the perspective of output legitimacy, this is far more alarming than any of the issues explored in regulation and institutional reform.

Secondly, the subordination of non-economic goals to the rationale of budgetary discipline is not supported by sufficiently robust economic analysis. *Pringle* assumes that strict conditionality will act as a safeguard against budgetary threats. However, as Craig points out, the grant of financing assistance in circumstances 'that the market would not provide' inevitably 'diminishes the incentive for budgetary probity'.[133] From an ideological perspective, financial stability entails public intervention with the market irrespective of this moral hazard. Another relevant question is whether financing assistance constitutes an outright assumption of Member States' debt obligations, which the Court answers in the negative. Tuori and Tuori question this logic: if financing assistance is intended to settle an existing debt, how can the recipient Member State remain responsible to a creditor who is no

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[130] Tuori and Tuori (n 2), 129-130.

[131] Ibid.

[132] Takis Tridimas and Napoleon Xanthoulis, 'A Legal Analysis of the Gauweiler Case: Between Monetary Policy and Constitutional Conflict' (2016) 23(1) Maast*richt Journal of European and Comparative Law* 17, 39.

[133] Paul Craig, 'Pringle: Legal Reasoning, Text, Purpose and Teleology' [2013] 20(1) *Maastricht Journal of European and Comparative Law* 1, 8.

longer a creditor?[134] Thus, the Court uses strict conditionality as a means of navigating the text of the Treaties, but in doing so, it relies on a functionalist understanding of financial stability that contradicts both economic and non-economic elements of its teleology.[135]

Further challenges to output legitimacy flow from the higher-order status of financial stability. Beyond the obvious tension with the Treaties, which mention financial stability as a peripheral objective in the EMU,[136] there is little conceptual support for an interpretation of financial stability as a standalone *telos* of integration. The need to minimise social costs assumes that financial stability does not trump other core objectives of the Union: financial stability acts as a facilitator for both economic and non-economic policy objectives. More importantly, the teleology of financial stability requires high-quality throughputs, such as accountability. The throughput side is significantly impaired by the interpretation of financial stability as a 'higher' objective, whose boundaries are unclear. The virtually limitless scope of financial stability is exemplified by the following.

On the one hand, financial stability 'has taken the place of price stability' in the EMU.[137] The subordination of price stability implies that the Union's exclusive competences are a means to achieving the *telos* of financial stability and, therefore, potentially not exclusive. The Court used a 'centre of gravity' test to determine if financing assistance constituted an unlawful interference with the EU's exclusive mandate over monetary policy.[138] Based on this test, financing assistance was deemed to be economic policy with mere indirect effects on monetary policy. Worryingly, a similar logic can apply to objectives other than price stability, as is the case with fundamental rights explored in the context of *Ledra Advertising*.

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[134] Tuori and Tuori (n 2), 125.

[135] Note the Court invokes solidarity only in the context of Art 122(1) TFEU.

[136] Prior to the amendment of Art 136, the only references to financial stability in primary EU law were found in Article 127(5) TFEU and Article 3(3.3) of Protocol 4 on the European System of Central Banks. These provisions describe the 'stability of the financial system' as a peripheral objective of the ESCB.

[137] Tuori and Tuori (n 2), 133.

[138] See, Armin Steinbach, 'Effect-Based Analysis in the Court's Jurisprudence on the Euro Crisis' [2017] 42(2) *ELR* 254, 261.

Pringle appears to suggest that so long as future reforms follow a functionalist interpretation of financial stability (crisis prevention or crisis management in the abstract), Member States can interfere with the division of competences without Treaty change.[139] The Court's interpretation of financial stability in *Pringle* effectively eliminates the scope for accountability in this area of law, which as explained in previous chapters, is an operational element of the teleology of financial stability.

On the other hand, *Pringle* redefines the competences of the Member States. Although the Court rightly notes that the ESM Treaty is silent on the role of EU institutions in bailouts, the higher-order status of financial stability extends the limits of economic surveillance.[140] For instance, it was previously explained that the Commission has acquired significant monitoring and enforcement powers in economic governance. These become far more intrusive as they no longer fall under the limited scope of economic policy but can be seen as components of supranational (and higher-order) financial stability. According to Paul Craig, the EU institutions have obtained a 'very broad substantive discretionary power […] without procedural constraint' over this field.[141] The higher objective of financial stability extends the challenges identified in relation to the EU's enhanced surveillance model.

As a final note, the intergovernmentalism of the ESM can be linked to the throughput challenge identified above. From the perspective of legality, international law agreements between Member States do not amount to constitutional 'mutation'.[142] However, *Pringle* stands for an exceedingly deferential review of intergovernmental stability measures. Authors go as far as to say that the Court 'resorts to whichever type of argument affords at least a

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[139] Ibid.

[140] See Päivi Leino and Tuomas Saarenheimo, 'Sovereignty and Subordination: On the Limits of EU Economic Policy Coordination' [2017] 42(2) *ELR* 166.

[141] Paul Craig, 'Pringle and Use of EU Institutions Outside the EU Legal Framework: Foundations, Procedure and Substance' [2013] 9(2) *ECLR* 263, 283.

[142] de Witte, 'Euro Crisis Responses and the EU Legal Order' (n 40). Similarly, the golden rule of budgetary discipline in national constitutions supports the Court's reasoning.

semblance of justificatory argumentation to uphold the ESM'.[143] The broader consensus is that there is a lack of 'accountability' and 'effective judicial oversight' of intergovernmental measures.[144] The intensity of judicial review is explored further in the next section.

6.5 Financing assistance II: *Ledra Advertising* & the intensity of judicial review

A separate question is whether the level of judicial review applied in bailouts and bail-ins is consistent with the teleology of financial stability. This section focuses primarily on bail-ins, measures that rely on credit and depositor funds (as opposed to public funds) for the rescue of financial institutions. This is a less common but enormously complex and controversial solution to bank failure. I argue that this dimension shows a level of judicial deference in financial stability that is fundamentally at odds with both the goal of minimising social costs and the need for *ex post* accountability in financial stability.

The most important case in this area is *Ledra Advertising*, often praised for extending the application of fundamental rights to the actions of EU institutions outside of EU law. With reference to the recent cases of *Florescu* and *Chrysostomides*, this section demonstrates that the novelty of *Ledra Advertising* is strongly exaggerated. Before turning to the intensity of judicial review, it is necessary to examine the case of *Kotnik* on the issue of bail-ins in the internal market.

6.5.1 Bail-ins in the internal market: *Kotnik* & state aid law

The issue of bail-ins was first addressed in the case of *Kotnik*.[145] Prior to the adoption of the BRRD and SRM, the only provisions of EU law that could be applied to the scenario of bank failure were state aid rules. As explored in previous chapters, this was incredibly problematic: state aid rules are too limited to deal with the recovery or winding up of credit institutions. The case of *Kotnik* examines the legality a 2013 Commission Communication authorising

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[143] Gunnar Beck, 'The ECJ, Legal Reasoning, and the Pringle Case- Law as the Continuation of Politics by Other Means' [2014] 39(2) *ELR* 234, 250.

[144] Ibid.

[145] *Kotnik* (C-526/14) ECLI:EU:C:2016:570.

state aid to five Slovenian banks, on the condition that aid would be accompanied by burden-sharing measures.

The facts of this case are important in distinguishing it from subsequent case law. In December of 2013, the Bank of Slovenia adopted reorganisation measures to assist in the recapitalisation, rescue, and winding up of five banks showing capital shortfalls. On the next day,[146] the Commission authorised the writing off of equity capital and subordinated debt for the five banks,[147] on the basis of its Banking Communication that sought to strengthen the principle of burden-sharing (as opposed to a traditional bailout). The Communication targets subordinated creditors: it requests that Member States apply bail-in tools before aid is granted (*ex ante* burden-sharing), and seeks to reduce the aid given to a minimum through the requirement that all other capital generating measures are exhausted before any public funds are made available.[148] In its preliminary reference the Slovenian Constitutional Court asked if the Banking Communication is binding on Member States, and whether bail-in provisions are compatible with, *inter alia*, the principle of legitimate expectations, the right to property in Article 17(1) of the Charter, and the principle proportionality.

On the nature of the Commission's Communications, the CJEU explained that these should be seen as 'guidelines' and are not binding on the Member States.[149] In relation to the principle of legitimate expectations, the Court emphasised that there was no guarantee that traditional bailout measures would provide a more favourable outcome for creditors, or that the Commission would approve of the aid in the first place. Going further, the Court stated that even if the circumstances gave rise to legitimate expectations, the 'stability of the

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[146] A deal had already been agreed between the government and the Commission on the basis of sincere cooperation under Art 4(3) TEU.

[147] The latter being more controversial because in the event of insolvency/winding-up, subordinated debt holders are paid after the holders of ordinary debentures. This assumption of a higher risk offers a higher rate of return.

[148] (Banking Communication) Communication 2013/C 216/01 from the Commission on the Application, from 1 August 2013, of State Aid Rules to Support Measures in Favour of Banks in the Context of the Financial Crisis, OJ C216/1.

[149] *Kotnik* (n 145), paragraphs 43-45.

financial system' constitutes an overriding reason in the public interest capable of restricting the application of the principle of legitimate expectations.[150]

Further, the Court determined that burden-sharing would not breach the right to property, so long as the "no creditor worse off" principle was observed.[151] The distinction between shareholders (and holders of ordinary debentures) and subordinated creditors was important in the context of proportionality, where the Court stated that measures for 'converting subordinate rights or writing down their value' must 'not exceed what is necessary to overcome the capital short-fall of the bank concerned'.[152]

Finally, the CJEU was called to examine whether the bail-in provisions of the Banking Communication violated Directive 2012/30 on the alteration of the capital of public limited liability companies. In this context, the CJEU noted that bail-in measures could only be adopted with view to 'preventing a systemic risk and ensuring the stability of the financial system'.[153] Distinguishing the facts of this case from *Pafitis*,[154] the Court explained that the grant of state aid was 'intended, in an exceptional context of a national economy being affected by a serious disturbance, to overcome a systemic financial crisis capable of

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[150] Ibid, paragraph 69. Specifically, the Court noted that financial stability considerations are capable of precluding transitional measures in situations where Member States need to adjust to new obligations such as burden-sharing.

[151] Ibid, paras 72-76. "No creditor worse off" requires that subordinated creditors do not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted.

[152] Ibid, paragraphs 101-102. Note that the CJEU does not address the proportionality of measures affecting shareholders. This was considered by AG Wahl in paragraphs 124-130 of his Opinion (C-526/14) ECLI:EU:C:2016:102. The literature considers that the CJEU's omission does not reduce the overall importance of the judgment on the application of proportionality to bail-in measures. See Stefano Lucchini *et al*, 'State Aid and the Banking System in the Financial Crisis: From Bail-out to Bail-In' [2017] 8(2) *Journal of European Competition Law and Practice* 88, 97.

[153] *Kotnik* (n 145), paragraph 88.

[154] *Pafitis* (C-441/93) ECLI:EU:C:1996:92. In this case the CJEU ruled that Member States must not adopt bank reorganisation measures without approval from the shareholders of that bank.

adversely affecting the national financial system as a whole and the financial stability of the European Union'.[155]

Kotnik is significant for two reasons. Firstly, on the topic of financial stability, the judgment builds on *Pringle*: it supports an interpretation of financial stability as an independent objective of EU law that influences not only economic policy, but the internal market. Drawing from Article 107(3)(b) TFEU, which enables the grant of state aid to remedy a serious disturbance in the economy of a Member State, the Court determines that financial stability considerations may 'prevail' over other interests such as market integration and free competition.[156] It should also be noted that *Kotnik* invokes financial stability as an 'overriding reason in the public interest' capable of restricting the principle of legitimate expectations.[157] This can be seen as further evidence of the incremental expansion of financial stability as an objective of EU law.

Secondly, *Kotnik* sets a curious precedent for bail-in measures. On the one hand, the Court affirms that Member States are not bound by the provisions of the Banking Communication, and may opt against the *ex ante* application of burden-sharing to subordinated creditors. On the other hand, it declares that Member States 'take the risk' that the Commission will declare the aid incompatible with the internal market if they choose to deviate from measures aimed at ensuring financial stability.[158] Ultimately, the Court treats the choice of measures as a question of proportionality, however, AG Wahl warns that it will be excessively difficult to convince the Commission that a basic tenet of its Communication should not apply.[159] Thus, *Kotnik* demonstrates that it is near impossible to challenge measures flowing from the objective of financial stability.

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[155] *Kotnik* (n 7), paragraph 90.

[156] In this case, the interest of protecting investors. Ibid, paragraphs 88-91.

[157] Ibid, paragraph 69.

[158] Ibid, paragraph 100.

[159] Opinion of AG Wahl in *Kotnik* (n 152), paragraph 42.

Nevertheless, the Court's reasoning in *Kotnik* demonstrates positive elements. Importantly, the judgement concerns subordinated creditors, who willingly assume financial risk and are compensated with a higher rate of return on their investment because of it.[160] This is a much less controversial scenario than the writing off of deposits in *Ledra Advertising*. Even so, the Court the Court in *Kotnik* deferred to the discretion of the Member States on when to adopt bail-in measures, requiring the Commission to examine the proportionality of measures which fell outside the scope of its Banking Communication.[161] These nuanced elements are missing from *Ledra Advertising*, as will be shown below.

6.5.2 *Ledra Advertising* & related case law

The background to *Ledra* and *Mallis* is important in understanding their implications for financial stability. Following the second Greek bailout in October 2011, which imposed a 53.5% haircut on Greek bond holders,[162] Cypriot banks suffered a heavy loss of nearly €12 billion (which equalled to over 60% of the Cypriot GDP). Despite a €2.5 billion loan from Russia, by June 2012 both Moody's and Fitch had downgraded Cypriot bonds to junk, and Cyprus became the fifth Eurozone country to request an international bailout.

A deal between Cyprus and the troika was reached in March 2013: Cyprus would be granted €10 billion in financing assistance, provided that an additional €6 billion was raised through a bank levy of 9.9% for deposits exceeding €100.000 and a 6.75% levy for deposits below €100.000. Seen as anathema by the public, the Cypriot parliament rejected the bail-in terms on 18 March.[163] After a failed attempt to secure another loan from Russia, a final deal was reached between Cyprus and the troika on 25 March. The new deal limited the scope of the

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[160] See Seraina Grünewald, 'Legal Challenges of Bail-In' (ECB Legal Conference 2017, September 2017) <www.zora.uzh.ch/id/eprint/144029/1/Gruenewald_ECB_Legal_Conference_Eproceedings_2017_12.pdf> accessed 21 November 2020.

[161] Stefano Lucchini and others (n 152).

[162] This haircut did not affect bonds held by the ECB, which had also negotiated the bailout.

[163] For a brief overview of the events which led to the Cypriot bailout see, Hillary Osborne and Josephine Moulds, 'Cyprus bailout deal: at a glance' (Guardian, 25 March 2013) <www.theguardian.com/business/2013/mar/25/cyprus-bailout-deal-at-a-glance> accessed 23 April 2020.

bail-in to two main banks and excluded deposits below €100.000. However, depositors with over €100.000 in the two main banks suffered immediate losses exceeding 30%,[164] and a further 52.5% was frozen and subject to future adjustments. In addition, strict capital controls were imposed on all banks—related measures are still in force at the time of writing.[165]

While burden-sharing measures had been used before, the Cypriot bail-in was unique in that in entailed a haircut of deposits.[166] The appellants in *Ledra* challenged the Memorandum of Understanding on Specific Economic Policy Conditionality concluded between Cyprus and the ESM and sought compensation for the losses suffered on grounds of Union liability.[167] Specifically, it was claimed that the ESM Treaty unlawfully expanded the powers of the Commission and the ECB, and that the bail-in was incompatible with the division of competences in EU law because the two institutions were its true authors. Moreover, it was argued that the Commission and the ECB's alleged actions violated depositors' right to property contained in Article 17(1) of the Charter.[168]

The CJEU repeated its position in *Pringle* that the ESM did not alter the 'essential character' of the Commission and the ECB.[169] Specifically, it was considered that participation in the procedure resulting into the Memorandum of Understanding, by means of advice or technical expertise, could not classify the Memorandum 'as an act that can be imputed' to those

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[164] 37.5% converted to shares, but the nominal value chosen for the conversion meant a loss of approximately 30% of deposits. The amount to be converted was finalised at 47.5% according to Cypriot government officials, Το Βήμα, 'Κύπρος: Στο 47.5% το Κούρεμα των Καταθέσεων άνω των 100.000 ευρώ' (To Vima, 2013) <www.tovima.gr/finance/article/?aid=524224> accessed 4 April 2021.

[165] Cyprus: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding of 29 April 2013. Although formally lifted in 2015, capital controls led to a radical restructuring of deposits and the introduction of procedural rules that remain to this day.

[166] Note that *Kotnik* affected investors. See also bail-in tool under BRRD and SRM.

[167] The ESM would provide €9 billion. Another €1 billion was provided by the IMF.

[168] In addition, *Mallis* (C-105/15 P) ECLI:EU:C:2016:702 challenged a Eurogroup statement that referred to the conditions attached to the bailout.

[169] *Ledra* (n 3), paragraph 56.

institutions.[170] However, the Court went further to say that the involvement of EU institutions in an international bail-in could be unlawful.[171] This was especially because the Commission maintains its role as 'guardian of the [EU] Treaties' and 'it should refrain from signing [an international agreement] whose consistency with EU law it doubts'.[172]

This conclusion opened the door for discussion of the second question on non-contractual liability for losses suffered as a result of the bail-in. On this issue, the Court reaffirmed that the right to property is subject to 'general interest' restrictions.[173] In *Ledra*, the general interest pursued by the Memorandum was 'the objective of ensuring the stability of the banking system of the euro area as a whole'.[174] Owing to the 'imminent risk of financial losses,' the restriction of the right to own acquired property was deemed to be proportionate.[175] Thus, the Commission's actions did not amount to a sufficiently serious breach of the appellants' right to property, and the conditions for non-contractual liability were not satisfied.

Florescu

The case of *Ledra Advertising* is often explored alongside *Florescu*.[176] The latter does not invoke the objective of financial stability because the case concerned measures preceding the financial crisis (and indeed the Treaty of Lisbon). In this case the Court was asked to examine the validity of a structural reforms in Romania, pursued in accordance with a Memorandum of Understanding between Romania and the European Community. Specifically, the measure in question prohibited the combining of a public retirement pension with income from an

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[170] Ibid, paragraph 52.

[171] Ibid, paragraphs 57-59. See Alicia Hinarejos, 'Bailouts, Borrowed Institutions, and Judicial Review: Ledra Advertising' (EU Law Analysis, 2016) <eulawanalysis.blogspot.co.uk/2016/09/bailouts-borrowed-institutions-and.html> accessed 23 April 2020.

[172] Ibid, paragraph 59.

[173] Ibid, paragraph 71.

[174] Ibid.

[175] Ibid, paragraph 74.

[176] *Florescu* (n 6).

activity carried out in public institutions if the amount of the pension exceeded the amount of the national gross average salary. The applicants were judges who were prohibited from combining their retirement pension with income from their university teaching.

While *Florescu* examines traditional austerity reforms (as opposed to bail-in measures), it is significant in expanding the rationale of *Ledra Advertising*. For the first time, the Court construed the Memorandum of Understanding as 'an act of an EU institution'.[177] In addition, the Court held that the Charter applied to the actions of the Member State because structural reforms could be seen as 'implementing EU law'—thus establishing a connection between national austerity measures and the Memorandum of Understanding. As Markakis and Dermine explain, the Court's reasoning is 'truly unprecedented'.[178]

Chrysostomides

The most recent case in the Cypriot bail-in saga is *Chrysostomides*.[179] This expands on the *Mallis* judgment, which held that a statement of the Eurogroup was not subject to an annulment challenge under Article 263 TFEU. In *Chrysostomides*, the Court was asked whether the Eurogroup was an EU law body under Article 340(1) TFEU. In addition, the applicants claimed that Article 2(6)(b) of Council Decision 2013/236 imposed specific economic reforms without any margin of discretion, thus the losses suffered could be attributed to the EU institutions consistently with Article 268 and 340 TFEU.

The CJEU in *Chrysostomides* upheld its earlier reasoning in *Ledra Advertising* and *Mallis*. In response to the first question, the actions of the Eurogroup were seen as purely informal and not giving rise to non-contractual liability.[180] On the legality of Decision 2013/236, the Court held that Article 2(6)(b) 'merely requires, in general terms, that the Cypriot authorities

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[177] Ibid, paragraph 35.

[178] Menelaos Markakis and Paul Dermine, 'Bailouts, the Legal Status of Memoranda of Understanding, and the Scope of Application of the EU Charter: Florescu' [2018] 55(2) *CMLR* 643, 661.

[179] *Chrysostomides* (n 6). For an overview of the events that led to this case, see Panicos Demetriades, *A Diary of the Euro Crisis in Cyprus* (Palgrave Macmillan 2017).

[180] *Cf.* General Court in *Chrysostomides* (T-680/13) ECLI:EU:T:2018:486.

maintain or continue to implement [the measure in question], without defining in any way the specific rules for that operation'.[181]

6.5.3 Admissibility and substantive review (proportionality and human rights)

The literature's response to *Ledra Advertising* is generally positive. Hinarejos emphasises that this was the first time that the CJEU acknowledged a direct connection between international financing assistance and EU law.[182] *Ledra* is seen as enhancing 'judicial protection within the ESM framework and […] the protection of fundamental rights often affected by austerity measures in a crisis context'.[183] It should also be noted that the Court took this step despite AG Wahl's suggestion that the Commission is not 'required to impose the standards of the EU Charter on acts which are adopted by other entities or bodies acting outside the EU framework'.[184] Thus, the conventional view is that *Ledra* 'should be welcomed by anyone concerned with the preservation of fundamental rights in the framework of the new governance of the Eurozone'.[185]

Similarly, *Florescu* is praised for interpreting a Memorandum of Understanding as an act attributable to EU institutions, and for extending the scope of its review to encompass national implementing measures. *Florescu* signifies that austerity reforms must be interpreted consistently with all provisions of primary and secondary EU law, including the Charter.[186] This is seen as qualifying the strict conditionality attached to financial stability. Broadly, *Florescu* indicates that MoU adopted within EU law will be subject to the review of the Court. Some argue that the rationale of the judgment extends to financing agreements outside

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[181] *Chrysostomides* (n 6), paragraph 116.

[182] Hinarejos, 'Bailouts, Borrowed Institutions, and Judicial Review' (n 171).

[183] Sophie Perez Fernandes, 'Editorial: Engaging EU Liability within the European Stability Mechanism Framework' (Unio EU Law Blog, 2016) <officialblogofunio.com/2016/09/30/editorial-of-october-2016/> accessed 23 April 2020.

[184] Opinion of AG Wahl in *Ledra Advertising* (C-8/15) ECLI:EU:C:2016:290, paragraph 86.

[185] Paul Dermine, 'ESM and Protection of Fundamental Rights: Towards the End of Impunity?' (Verfassungsblog, September 2016) <verfassungsblog.de/esm-and-protection-of-fundamental-rights-towards-the-end-of-impunity/> accessed 17 April 2020.

[186] Markakis and Dermine (n 178).

of EU law, as these are supported by Council Decisions and other EU acts.[187] My position is that the novelty of both judgments is strongly exaggerated.

The above case law raises two distinct issues, first, on the admissibility of claims against financial stability measures, and second, on the substantive review of such measures. As regards admissibility, Article 51(1) of the Charter contains no limits on the application of fundamental rights with respect to the Commission and the ECB. Conversely, the EU institutions are expected to 'promote' the application of the Charter 'in accordance their respective powers'.[188] Further, a connection between financing assistance and EU law had already been established in *Pringle*, where it was stated that the Commission is required 'to check, before signing the MoU defining the conditionality attached to stability support, that the conditions imposed are fully consistent with the measures of economic policy coordination'.[189] Ultimately, it would be paradoxical if EU institutions 'could escape the constraints of the Charter merely because they happen to be acting pursuant to treaties between member states, rather than EU law'.[190]

Thus, the ratio of this judgment is limited in that it only captures the rather straightforward scenario whereby EU institutions are party to an international agreement. *Mallis* and *Chrysostomides* demonstrate that the Court is very reluctant to extend this reasoning to informal bodies such as the Eurogroup, irrespective of their strong influence in bailouts and bail-ins, and despite the General Court reaching the opposite conclusion.[191] *Florescu*, on the other hand, concerned a MoU adopted within EU law under exceptional circumstances preceding the financial crisis. I share the view that the ratio of *Florescu* should be extended to financing measures generally, but it is unlikely that it would apply to international agreements beyond what was already stated in *Ledra*. It will certainly be difficult to establish

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[187] Ibid.

[188] Article 51(1) Charter. This is a point made by AG Wahl in his Opinion in *Ledra* (n 184), paragraph 85.

[189] *Pringle* (n 3), paragraph 112.

[190] Steve Peers, 'Towards a New Form of EU Law?: The Use of EU Institutions Outside the EU Legal Framework' (2013) 9(1) *ECLR* 37, 53.

[191] *Supra* (n 180).

a direct connection between national (implementing) measures and an EU act when the MoU is adopted outside of EU law, even if this is supported by Council Decisions; these can be seen as supplementary and not affecting the scope of obligations of the Member States, similarly to *Chrysostomides*.[192] At any rate, there is doubt as to whether *Florescu* would cover all types of EU acts: the case concerns an entirely distinct factual scenario and does not invoke financial stability at all. As such, *Florescu* should not be seen as a continuation of *Ledra*, but rather as an exceptional case.[193]

The issue of admissibility must be assessed in the context of the growing intergovernmentalism of financial stability and other areas, as well as the extensive use of soft law instruments by the Commission and expert agencies.[194] A potential inconsistency with the teleology of financial stability emerges from the limited jurisdiction of the Court in this field, which is essential to the goal of *ex post* accountability and minimising the social costs of policy. Therefore, despite the welcome application of the Charter to EU institutions acting outside of EU law, the overall picture is one of judicial restraint. This poses a threat to output legitimacy, especially considering the deferential review of measures that are admissible.

Turning to the issue of substantive proportionality and human rights review, there is tension between the Court's deferential standard and the teleology of financial stability. First, it was already discussed in the context of *Pringle* that the Court puts forward an expansive interpretation of financial stability that trumps other (economic and non-economic) policy objectives in the EMU. *Kotnik* and Ledra *Advertising* build on this interpretation, recognising financial stability as an overriding reason in the public interest, and going as far as to justify a

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[192] According to the Court, the Council Decision merely reiterated the need for implementation of macroeconomic reforms and did not alter the margin of discretion of the Member State.

[193] See also Eleanor Spaventa, 'Constitutional Creativity or Constitutional Deception? Acts of the Member States Acting Collectively and Jurisdiction of the Court of Justice' [2021] 58(6) *CMLR* 1697.

[194] Ibid, Spaventa discusses 'hybrid' acts in other areas of EU law.

breach of human rights.[195] Thus, the case law stemming from *Pringle* extends some of the challenges identified previously.

Second, the Court's case law establishes an unassailable standard for EU financial stability, which is inconsistent with the aim of minimising the social costs of policy. To explain, the Court does not provide any indications as to how—if at all—the general interest of financial stability can be balanced against other objectives. In *Ledra*, the Court refers to imminent financial losses and potential spill-over effects to conclude that the bail-in measures were proportionate and did not affect the 'very substance' of the right to property.[196] By its very definition the objective of financial stability will concern situations where financial loss and spill-over effects are imminent. Worriyngly, the Court cites *Kotnik* on this issue yet fails to appreciate that *Kotnik* recommended optional measures, which only targeted creditors as distinguished from depositors. *Ledra Advertising* also authorised strict capital controls which lasted for several years.[197] By failing to distinguish between different classes of individuals affected by the bail-in, the Court applies a one-size-fits-all version of financial stability that imposes the same burden on domestic and foreign depositors, and which treats both groups as risk-assuming investors.

Ledra is a missed opportunity to establish substantive limits to financial stability.[198] Given that financial loss and spill-over effects will always be present in times of crisis, *Ledra* stands for the proposition that financial stability considerations will automatically satisfy a soft standard of proportionality.[199] Accordingly, financial stability is only qualified by the requirement that the 'very substance' of fundamental rights must be protected. However, the

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[195] See eg, *Nold* (Case 4-73) ECLI:EU:C:1974:51.

[196] *Ledra* (n 3), paragraph 74.

[197] *Supra* (n 165).

[198] Hinarejos concedes that the Court sets a 'high threshold' for judicial review. Hinarejos, 'Bailouts, Borrowed Institutions, and Judicial Review' (n 171).

[199] See generally, Francesco Costamagna, 'The Court of Justice and the Demise of the Rule of Law in the EU Economic Governance: The Case of Social Rights' (Collegio Carlo Alberto Working Papers, No. 487, December 2016) <www.carloalberto.org/assets/working-papers/no.487.pdf> accessed 20 February 2020.

Court does not elaborate on this condition, in fact, there is no differentiation between depositors and investors even if the essence of their right to property is fundamentally different. At any rate, the condition of essentiality should complement, not replace, proportionality review.[200]

It should be noted that the Cypriot bail-in was inherently asymmetric, in that the persons affected the most were ordinary citizens who did not have the means of spreading their deposits to several banks. A further issue is corruption, and there are reports that the political and economic elite were able to transfer their deposits abroad before capital controls were put in place.[201] On the whole, the bail-in generate huge inequalities in wealth and opportunity, eroding the welfare of the most vulnerable social groups. While the right to property has never been absolute, the Court's deferential approach equates financial stability with the functionalist goal of preventing/managing the crisis, which disregards the social costs of policy and the need for *ex post* accountability in this field. This is entirely inconsistent with the non-economic utility of financial stability and a severe threat to the output legitimacy of EU law.

Further comment on Ledra Advertising

A further issue is that the case law lacks any conceptual clarity on the meaning or scope of financial stability. As Tuori and Tuori indicate, 'what "financial stability of the euro area as a whole" means is far from evident' and it has not been defined in primary or secondary EU law.[202] In addition, the 'wide variety' of measures justified on this basis 'testifies to the

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[200] *Nold* (n 195), paragraph 14. The Court's reasoning traditionally parallels the German essentiality theory; whereby human rights can be restricted so long as the restriction is proportionate. However, the substance of these rights cannot be violated and is, thus, examined as a separate issue. The Court in *Ledra* effectively substitutes proportionality with an essentiality test.

[201] General Witness, 'Bank Records Link President of Cyprus to "Troika Laundromat"' (General Witness, 14 August 2019) <www.globalwitness.org/en/campaigns/corruption-and-money-laundering/treasure-island-cyprus-troika-laundromat/> accessed 24 April 2020.

[202] Tuori and Tuori (n 2), 133.

vagueness of the concept'.[203] For instance, in *Pringle* alone there are four different variations of 'stability'.[204] *Ledra* adds to this confusion by making reference to the 'stability of the banking system' in the euro area. While recent case law and policy documents distinguish more clearly between 'financial stability' and the 'stability of the euro area',[205] the Court's approach towards these objectives appears purely intuitive. From an output legitimacy standpoint, this can be seen as an extension of economic functionalism as it results in a subordination of the non-economic side of this objective.

The final challenge exemplified by *Ledra* and the events leading up to the Cypriot bail-in is the potential for financial stability to be misused as a punitive tool. It should be remembered that, prior to the bail-in, Cyprus had received a €2.5 billion loan from Russia, at a time when EU-Russian relations were deteriorating.[206] Russian citizens held considerable investments in Cypriot banks and, through those investments, benefited from free movement extending across the EU.[207] It is widely reported that the German government and other political actors pressured the Cypriot government into accepting the conditions of the bail-in to punish Russian investors in Cyprus and to appease their own electorates.[208] It is immaterial whether these reports are true or not, but it is of paramount importance that there are no legal barriers

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[203] Ibid.

[204] See eg, *Pringle* (n 3), paragraphs 65, 93, 96 and 135. The Court utilises the terms 'stability of the euro area as a whole' and 'financial stability of the euro area as a whole' regarding Art 136(3) TFEU and Decision 2011/199 respectively. In addition, the Court refers to the 'stability of the euro' currency, and to the 'stability of the monetary union'.

[205] See eg, *Chrysostomides* (n 6), paragraph 161.

[206] See generally, Igor Delanoe, 'Cyprus, a Russian Foothold in the Changing Eastern Mediterranean' [2013] 17(2) *Middle East Review of International Affairs* 84.

[207] Ibid.

[208] This is reported by both scholars and journalists. See eg, Alexander Apostolides, 'Beware of German Gifts Near Elections: How Cyprus Got Here and Why it is Currently More Out Than In The Eurozone' [2013] 8(3) *Capital Markets Law Journal* 300; Kalman Kalotay, 'The 2013 Cyprus Bailout and the Russian Foreign Direct Investment Platform' [2013] 3 *Baltic Rim Economies – Bimonthly Economic Review* 58; Patrick Collinson, '10 Lessons From the Cypriot Bailout' (The Guardian, 29 March 2013) <www.theguardian.com/money/2013/mar/29/10-lessons-cyprus-bailout> accessed on 21 April 2020.

preventing the misuse of this objective at the expense of individuals' rights. Taking into account the near impossibility of challenging financial stability measures, as well as the lack of conceptual clarity surrounding this objective, it becomes clear that financial stability has the potential to become a *carte blanche* in times of crisis. Hence, even if EU financial stability enjoys normative legitimacy, not all measures pursuing financial stability will improve legitimacy in an empirical sense.

6.6 Conclusion

This chapter explored one of the most unique elements of EU financial stability outside of prudential and resolution policy. The first two sections covered economic governance/fiscal reforms. These are relevant to the discussion on output legitimacy because of the strong relationship between economic stability and the stability of the financial sector; fiscal rules also predetermine the grant of financing assistance to Eurozone countries. The last two sections address the issue of financing assistance: the focus of these section was on the case law on bailouts and bail-ins in the euro area.

The financing dimension poses the biggest challenge to output legitimacy. The most important case in this area is *Pringle*, which interprets financial stability as a 'higher' objective of EU law in an attempt to reconcile extraordinary financing with a "no bailout" clause in the Treaties. The following inconsistencies with the teleology of financial stability emerge from this interpretation. First, it is difficult to conceive of any limits to financial stability interpreted as a standalone *telos* of integration; not only does this interpretation overlook the need to balance the economic and non-economic sides of financial stability, but it significantly impairs accountability. Second, the higher-order status of this objective is conceptually and legally attached to strict conditionality. This denotes a constitutionalisation of austerity measures, a policy choice that entails huge social costs.

The second most important case is *Ledra Advertising*, where financial stability is used as an overriding reason in the public interest to justify breaches of human rights. The case concerned the only bail-in of deposits during the euro area crisis. While the Court's willingness to review the involvement of EU institutions in an international agreement is welcome, the proportionality review of bail-on measures in *Ledra* is exceedingly deferential.

In particular, there is no distinction between investors who willingly assume financial risk and vulnerable classes of depositors; there is no balancing of the economic and non-economic utility of financial stability. The surrounding case law centres on issues of admissibility. While it is positive that the Court is willing to review the involvement of EU institutions in international bailouts, this is a very modest step in ensuring the legitimacy of financial stability measures.

The above challenges are amplified by the EU's enhanced surveillance model in economic governance. Fiscal reform follows two main directions: the supranational six-pack and two-pack, and the intergovernmental TSCG. These drastically enhance the EU institutions' powers in monitoring and enforcing budgetary limits and other fiscal rules. However, the main beneficiary of these reforms is the Council and other intergovernmental bodies. Intergovernmentalism is not inconsistent with the teleology explored in this thesis as such, but it causes further fragmentation of financial stability policy, which limits political and judicial accountability. Further issues include the use of "reverse" qualified majority voting and the marginal role of the European Parliament. On the whole, the weak accountability of these reforms poses a threat to output legitimacy: accountability is a precondition for minimising the social costs of policy, especially over the medium- and long-term.

On the issue of fiscal reform, the literature raises the question of whether vertical and horizontal power shifts are justified considering the many compromises of the current surveillance model. Some consider that a more complete version of fiscal federalism is necessary to improve its effectiveness. Others see the COVID-19 as evidence that a rigid framework of supranational economic surveillance limits Member States capacity to respond to asymmetric shocks. For the purposes of this dissertation, it is sufficient to highlight that this debate is linked to financing assistance: for example, the higher-order status and strict conditionality of financial stability in *Pringle* flow precisely from the need to reconcile extraordinary aid with a rigid and incomplete fiscal model.

Chapter 7: Precaution and the Role of Judicial Review in Financial Stability

7.1 Introduction

My thesis explored output legitimacy challenges in the context of financial stability in EU law. With reference to prudential policy and resolution, institutional reform, and fiscal/financing measures, I demonstrated that economic performance is one of many factors that impact on the legitimacy of this policy objective. First, financial stability policy needs to comply with the underlying ideological shift away from laissez-faire policies in the financial market. Second, prudential and other reforms must seek to minimise the many social costs of financial stability, as a precondition for social development and social equality. These considerations are vital in enhancing trust in the European "project", consistently with my interpretation of output legitimacy. In this chapter, I argue that judicial review is critical in aligning policy with the above teleology, not only because many of the challenges explored previously stem from the case law, but also because the very nature of financial stability necessitates judicial empowerment.

Relevant to the intensity of judicial review is the precautionary principle, a legal principle designed specifically to capture the non-economic utility of regulation in the fields of environmental protection and public health. In brief, the precautionary principle seeks to overcome inherent uncertainty and complexity by enabling pre-emptive public action even when the economic benefits or harms of such action are uncertain.[1] At the operational level, it imposes additional *ex ante* and *ex post* conditions, the most important of which is that it requires the continuous review of precautionary measures to ensure their suitability over the long-term. Accordingly, a growing body of literature considers that applying this principle to financial stability can overcome some of the challenges of a strictly economic approach,

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[1] *United Kingdom* v *Commission* (C-180/96) ECLI:EU:C:1998:192, paragraph 99.

which relegates non-economic goals to residual features of market performance.[2] The inference that can be drawn from the precautionary literature is that additional *ex ante* and *ex post* scrutiny would better align policy with the non-economic utility of financial stability, therefore enhancing output legitimacy.

However, my goal is not to argue in favour of a precautionary approach in financial stability. As a principle designed to improve regulation and supervision, the precautionary principle is difficult to apply to all dimensions of financial stability in EU law, which extends to fiscal policy and financing assistance. Moreover, the CJEU's interpretation of the precautionary principle in EU environmental and public health law faces its own challenges: the principle is generally perceived as deferential and ineffective in other areas of EU law.[3] Therefore, the discussion on the precautionary principle is merely intended to emphasise similarities between financial stability and environmental/public health regulation, as policy fields dealing with inherent uncertainty and complexity. In particular, this comparison highlights the essential role of judicial review in balancing the economic and non-economic utility of financial stability.

The remaining parts of this chapter delve deeper into the connection between judicial review and legitimacy in the context of financial stability. Contrary to the notion that judicial activism is a threat to democratic legitimacy, it is suggested that judicial review is necessary to counteract the technocratic governance of the euro area. The Court's current deferential approach poses the biggest threat to output (and throughput) legitimacy because it erodes the limits of policy, which contributes to the subordination of the non-economic dimension of financial stability to purely economic initiatives. It should be emphasised that aligning policy with the teleology of financial stability is mainly a regulatory and political task; I focus on

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[2] See eg, Hilary J Allen, 'A New Philosophy for Financial Stability Regulation' [2013] 45 *Loyola University Chicago Law Journal* 173; Hugues Chenet, Josh Ryan-Collins and Frank van Lerven, 'Finance, Climate-Change and Radical Uncertainty: Towards a Precautionary Approach to Financial Policy' [2021] 183 *Ecological Economics* 1.

[3] Gary E Marchant and Kenneth L Mossman, *Arbitrary and Capricious: The Precautionary Principle in the European Union Courts* (Aei Press 2004) 65.

judicial review because its significance is commonly overlooked, but it is not a solution to all the challenges identified in this thesis.[4]

Based on the above, I propose a model of judicial review that targets issues of admissibility and proportionality. As regards admissibility, the Court is inevitably restricted in its review due to the intergovernmentalism of euro area reforms and the excessive reliance on soft law instruments in prudential and resolution policy. Addressing these challenges, for example, through further harmonisation in areas such as macroprudential policy will enable the Court to pursue a more active role in financial stability. More importantly, the principle of proportionality is the main tool available in EU law for balancing the economic and non-economic sides of financial stability. Consistently with the use of sector-specific proportionality in prudential and resolution policy, the general principle must serve the purpose of differentiation: judicial review must act as a safeguard against a 'one-size-fits-all' approach which fails to take into account the social costs of policy. It is suggested that this approach is not limited to a 'partial' or 'strict' standard of review, it can inform different levels of judicial deference.

The discussion is organised as follows. Section 7.2 focuses the precautionary principle as a method employed in environmental and public health regulation to capture non-economic effects of policy. Section 7.3 explores the role of judicial review in financial stability. I address the strong connection between judicial review and legitimacy, and the unique attributes of financial stability that necessitate extraordinary judicial empowerment. Section 7.4 examines proportionality and comments briefly on admissibility in the Court's case law as two areas where improvement can be made.

7.2 The precautionary principle: maximising non-economic utility?

The precautionary principle deserves special attention as a concept specifically designed to capture the non-economic attributes of policy in fields facing inherent uncertainty, such as

[4] Indeed, there are many dangers associated with judicial empowerment, such as the CJEU's history of negative integration which contributes to economic functionalism, explored below.

environmental regulation and public health law. There is extensive literature on the connection between the precautionary principle and financial regulation, particularly in the US and internationally. The EU law literature on this topic is very limited.[5] This is, firstly, because EU financial stability extends beyond its origins in regulation: it is especially difficult to conceive of a precautionary approach that captures the influence of financial stability in the EMU. Secondly, the precautionary principle has a troubled history in EU environmental and health regulation, and is generally perceived as ineffective.

My goal in this section is neither to explore all aspects of the precautionary principle, nor to argue in support of its application to EU financial stability. Extending the principle to all dimensions of financial stability would require a measure of legal creativity and, ultimately, it would not address all the legitimacy issues explored in this thesis. Nevertheless, the precautionary principle warrants attention as a proposal put forward by a strand of the literature that focuses on the non-economic utility of financial stability. More importantly, this discussion reveals the critical role of judicial (and political) scrutiny in minimising the social costs of policy.

7.2.1 The precautionary principle vs. cost-benefit analysis

The precautionary principle is commonly presented as an alternative to cost-benefit analysis. As explained in Chapter 3, cost-benefit analysis is the main method for deciding when to apply financial stability tools: it entails the weighing of a measure's potential benefits against its negative side-effects to ensure that policy yields the highest net benefits.[6] There is a deeply polarised debate on the advantages or disadvantages of a precautionary approach vs. cost-benefit analysis. Proponents of precaution see it as a means of enabling action when the

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[5] For a rare example, see Aerdt Houben, 'Aligning Macro- and Microprudential Supervision' in Joanne A Kellermann, Jakob de Haan and Femke de Vries (eds), *Financial Supervision in the 21st Century* (Springer 2013), 209.

[6] European Systemic Risk Board, 'Handbook on Operationalising Macro-prudential Policy in the Banking Sector' (2014) 17 <www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf?ac426900762d505b12c3ae8a225a8fe5> accessed 05 December 2020.

benefits of such action are not immediately obvious (inaction bias), specifically to capture the intangible, non-economic utility of regulation.[7] Others consider precaution to be a 'mantra' with no real impact on the substance of policy, which can impede decision-making by imposing strict procedural requirements.[8]

The main formulation of the precautionary principle can be found in the Rio Declaration of 1992, issued by the United Nations Conference on Environment and Development (UNCED). Principle 15 of the Declaration reads: '[w]here there are threats of serious and irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation'. In EU law, the CJEU interprets precaution to mean that 'where there is uncertainty as to the existence or extent of risk to human health, the [EU] institutions may take protective measures without having to wait until the reality and seriousness of those risks become fully apparent'.[9] In sum, the precautionary principle aims to mitigate social harm by enabling protective action even when the precise effects of policy are uncertain.[10]

Similarities between financial regulation and environmental/health law

Uncertainty is the connecting factor between environmental/public health protection and financial stability. Authors propose the application of the precautionary principle to financial regulation on the basis that, similarly to natural ecosystems, the financial system is

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[7] On analysis of the advantages over cost-benefit analysis, see Allen (n 2), 185-190.

[8] Described as 'an incoherent slogan rather than a useful analytical tool' in Todd J Zywicki, 'Baptists? The Political Economy of Environmental Interest Groups' [2002] 53 *Case Western Reserve Law Review* 315, 333; Cass R Sunstein, 'Beyond the Precautionary Principle' (2002) 151(3) *University of Pennsylvania Law Review* 1003, 1003-1004.

[9] *United Kingdom* v *Commission* (n 1), paragraph 99; *Commission v Denmark* (C-192/01) ECLI:EU:C:2003:492, paragraph 49; *Greenpeace* (C-6/99) ECLI:EU:C:2000:148, paragraph 44.

[10] For an overview of the roots of this definition in economics, see Nicolas Treich, 'What Is the Economic Meaning of the Precautionary Principle?' [2001] 26 *The Geneva Papers on Risk and Insurance* 334.

characterised by an infinite number of moving parts that elude statistical valuation.[11] This was previously explored in the context of 'Knightian' and 'Keynesian' uncertainty, or the notion that scientific advancement generates new 'unknown unknowns' in the financial system.[12] It was explained that there will often be no "causality" between financial stability measures and economic performance.[13] Similarly, environmental and public health regulation face inherent uncertainty in that a natural disaster or a pandemic can occur irrespective of policy choices.

The common challenge that emerges in environmental/health regulation and financial regulation is that policy makers are asked to take action that entails significant compliance and opportunity costs, when the benefits of such intervention with the market may never materialise.[14] In most cases, the full benefits of regulation will not be evident from the onset.[15] In this setting, the use of cost-benefit analysis generates cognitive (inaction) bias and irrational market behaviour.[16] For example, Kysar demonstrates that regulation is likely to prioritise fat-tail events, or high-impact crises whose probability of occurring is low, over

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[11] On the 'reductive' nature of economic methods, see Douglas A Kysar, 'Ecologic: Nanotechnology, Environmental Assurance Bonding and Symmetric Humility' [2010] 28 *UCLA Journal of Environmental Law and Policy* 201, 215.

[12] John M Keynes, 'The General Theory of Employment' [1937] 51 *Quarterly Journal of Economics* 209, 213-214; Sheila Dow, 'Addressing Uncertainty in Economic and in the Economy' [2015] 39(1) *Journal of Economics* 33, 38.

[13] Yakov Ben-Haim and Maria Demertzis, 'Decision Making in Times of Knightian Uncertainty: An Info-Gap Perspective' (Economic E-Journal Vol 10, 2016) 4 <www.economics-ejournal.org/dataset/PDFs/journalarticles_2016-23.pdf> accessed 1 November 2020.

[14] According to Huang, 'regulators are susceptible to 'bias towards […] variables which can be objectively measured and verified' in Peter H Huang, 'Emotional Impact Analysis in Financial Regulation: Going Beyond Cost-Benefit Analysis' (Temple University Legal Studies, Research Paper No 21, 2006) <papers.ssrn.com/sol3/papers.cfm?abstract_id=870453> accessed 10 November 2020. See also Allen (n 2).

[15] David A Dana, 'A Behavioral Economic Defense of the Precautionary Principle' [2003] 97 Northwester University Law Review 1315, 1322.

[16] Ibid.

other types of (endogenous) risk.[17] Consequently, the precautionary principle is put forward as a solution to cognitive biases and other challenges that arise from inherent uncertainty and complexity.

A further challenge faced in financial regulation and environmental or public health regulation is that the consequences of inaction on society will often be severe. These fields can be considered as systemic because a potential crisis can upset many other policy initiatives—the COVID-19 pandemic stands out for its disruptive effects on the economy and on society generally. Accordingly, the literature considers that both financial stability and environmental/public health protection have a non-economic utility or 'social value'.[18] This refers to their impact on human life, which has no 'price' that can be measured in strictly economic terms.[19] While the connection between financial stability and human life may not be immediately obvious, the importance of the financial system in modern society as well as its natural fragility may indicate that financial instability is a more constant threat than either environmental or public health risks.[20]

The operational elements of precaution

Based on the above comparison, authors propose the application of a precautionary principle to financial stability. On an operational level, the distinguishing characteristic of the precautionary approach is that it seeks to counteract the potential costs of pre-emptive action by imposing strict *ex ante* and *ex post* requirements.[21] On the *ex ante* front, it requires a reversal of the burden of proof, accompanied by any available scientific evidence in support

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[17] Kysar (n 11), 216. This can be linked to Minsky's financial instability hypothesis, Hyman P Minksy, *Stabilizing and Unstable Economy* (Yale University Press 1986) 174-175.

[18] See eg, Dan Awery, 'Complexity, Innovation and the Regulation of Modern Financial Markets' [2012] 2(2) *Harvard Business Law Review* 235, 257-258.

[19] Heinzerling L and Ackerman F, 'Pricing the Priceless: Cost-Benefit Analysis of Environmental Protection' [2002] 150(5) *University of Pennsylvania Law Review* 1553, 1564.

[20] Chenet, Ryan-Collins and van Lerven (n 2).

[21] For a general overview of these conditions see, Saule T Omarova, 'License to Deal: Mandatory Approval of Complex Financial Products', 90 *Washington University Law Review* 64, 68-71.

of the proposed measure.[22] To explain, it is the responsibility of those proposing action to demonstrate it will not be harmful, not the responsibility of those affected by it to show actual or potential harm. On the *ex post* side, the precautionary principle requires a continuous and thorough review of the measures in question to ensure their effectiveness over time.[23] Thus, the precautionary principle assumes that course correction is necessary in delivering appropriate outputs, and relies on judicial and political scrutiny to mitigate inherent uncertainty and complexity.

In the context of financial stability, the *ex ante* reversal of the burden of proof would apply to both market actors and regulators. On the one hand, market actors would need to demonstrate that their actions (financial products) will not be a threat to financial stability and society generally. For example, Ju considers that too-complex-to-predict practices would be prohibited under the precautionary principle, until uncertainty as to their harmful effects on society is resolved by scientific evidence.[24] On the other hand, this reversal in the burden of proof could improve the quality and intensity of regulation. Specifically, it would not suffice that a measure has a number of desirable characteristics: the precautionary principle asks regulators to demonstrate that their actions bear no long-term harmful effects.[25] The general view is that the precautionary principle would reduce inaction bias, because it would compel regulators to look beyond the immediate compliance costs of regulation and to incorporate social harm in their analysis.[26] In broad terms, this requirement is consistent with the teleology of financial stability, as it actively pursues a minimisation of social costs.

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[22] Note that some authors distinguish between the burden of proof and the burden of personation. Eg, Nicholas Ashford, 'The Legacy of the Precautionary Principle in U.S. Law: The Rise of Cost Benefit Analysis and Risk Assessment as Undermining Factors in Health, Safety and Environmental Protection' in Nicolas De Sadeleer (ed), *Implementing the Precautionary Principle: Approaches from the Nordic Countries, EU and USA* (Earthscan 2006).

[23] Chenet, Ryan-Collins and van Lerven (n 2).

[24] Jinyul Ju, 'Getting Global Financial Stability Trough Precautionary Principle' (*T*hird Biennial Global Conference Online Proceedings Working Paper No 2012/10, 2012) 16-17 <papers.ssrn.com/sol3/papers.cfm?abstract_id=2087749> accessed 15 October 2020.

[25] Allen (n 2), 194-195.

[26] Dana (n 15), 1332; Kysar (n 11).

Equally, the precautionary principle requires that protective measures are temporary and subject to *ex post* judicial review for as long as uncertainty as to the level of risk in society persists. This can be linked back to the role of *ex post* accountability in balancing the economic and non-economic effects of policy, explored in Chapter 3. In the context of precaution, the main purpose of *ex post* scrutiny is to minimise 'public harm', defined loosely by the Commission as a concept that encompasses non-economic considerations, such as a measure's acceptability to the public.[27] As such, Koen Lenaerts describes precaution as a 'trust-enhancing' principle: the *ex ante* and *ex post* conditions are specifically targeted at generating confidence in European governance, even when policy makers face inherent uncertainty.[28] There is an obvious parallel between the trust-enhancing attributes of precaution and the output legitimacy of financial stability.

However, it is difficult to conceive how a precautionary approach would resolve the issues discussed in the context of the EMU, which becomes clear when considering the history of precaution in EU law.

7.2.2 The troubled history of precaution in EU law & the dangers of this approach

EU law has a long history of precaution, with references to precautionary language in as early as the 1960s.[29] The principle itself was introduced into primary legislation by the Treaty of Maastricht. Under Title XVI on the Environment, the precautionary principle is linked to the operationalisation of environmental protection and to the related goal of protecting public

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[27] Preamble, Communication from the Commission on the Precautionary Principle COM/2000/1.

[28] Koen Lenaerts, 'In the Union We Trust: Trust-Enhancing Principles of Community Law' [2004] 41(2) *Common Market Law Review* 317.

[29] The provisions of Directive 65/65, which established a prior authorisation process for proprietary medicinal products, stand out as a prime example. Directive 65/65/EEC of 26 January 1965 on the approximation of provisions laid down by Law, Regulation or Administrative Action relating to proprietary medicinal products, OJ 1965 L 22, 369.

health.[30] The development of the precautionary principle in the case law of the Court can be attributed to the "mad cow" crisis in the 1990s—it is intrinsically connected to crisis response.[31] In terms of its place on the hierarchy of norms in EU law, the Court of First Instance in *Artegodan* notes that the precautionary principle is a general principle of EU law, in light of its application across policy fields to both acts of the EU institutions and of the Member States.[32] This forms the basis for the argument that it could apply to EU financial stability.

However, the case law of the CJEU on the precautionary principle suggests that it would only exacerbate the challenges identified in this thesis. Firstly, there is no universal definition of the concept, and the Court has invoked several formulations of precaution. For example, in *BSE*, it was considered that the principle enables EU institutions to take pre-emptive action 'without having to wait until the […] risks become fully apparent'.[33] Conversely, in *Pfizer* the GC appears to suggest that EU institutions are obligated to take positive action out of precaution.[34] In more recent cases, the Court has reverted to its earlier conceptualisation: precaution forms part of the Court's proportionality assessment, and can indicate the necessity of protective measures even in the absence of scientific evidence on the magnitude of the threat.[35]

Secondly, there is no settled standard for the evidence that protective measures must be accompanied by. In principle, the Court requires 'as thorough a scientific risk assessment as

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[30] The precautionary principle operates alongside other principles, such as "polluter pays." See, *R v Secretary of State* (C-293/97) ECLI:EU:C:1999:215, paragraph 51. For an overview of these principles see, Dirk Vandermeersch, 'The Single European Act and the Environmental Policy of the European Economic Community' [1987] 12 *European Law Review* 407, 415-417.

[31] *BSE* (C-180/96) ECLI:EU:C:1998:192.

[32] *Artegodan* (T-74/00) ECLI:EU:T:2002:283, paragraph 184. A good example of this is *Commission v Denmark* (n 9), where the Court applied its reasoning from *BSE* in relation to acts of the Commission to the acts of the Member States.

[33] *BSE* (n 31), paragraph 99.

[34] *Pfizer* (T-13/99) ECLI:EU:T:2002:209, paragraph 444.

[35] *Pillbox 38* (C-477/14) ECLI:EU:C:2016:324, paragraph 55.

possible' of the relevant risks.[36] Nevertheless, the Court limits its review to whether the severity and likelihood of a risk are examined scientifically, as opposed to commenting on the intensity or even taking into account the outcome of the scientific assessment.[37] For instance, in *Pfizer*, an expert agency conceded that there was no immediate risk, and yet the evidence presented before the GC was deemed to be 'sufficiently reliable and cogent' to support precautionary action.[38] This is further reflected in cases dealing with acts adopted by the Member States, primarily in the context of free movement restrictions. In *Toolex*, the key issue was whether restrictions on the marketing and use of trichloroethylene (an industrial solvent) were justified, as the chemical was suspected of causing cancer. The Court's review of scientific assessment was satisfied by the fact that it was unclear at what dosage the substance became dangerous, without any examination of the probability of harm materialising.[39]

It follows from the above that the application of the precautionary principle in EU law is inherently deferential to both the EU institutions and the Member States.[40] In *Pfizer*, it was noted that when an EU institution is 'required to make complex assessments in the performance of its duties, its discretion also applies, to some extent, to the establishment of the factual basis of its action'.[41] Accordingly, the EU 'judicature is not entitled to substitute its assessment of the facts for that of the [EU] institutions', and must limit its review to ascertaining whether the 'discretion in that regard is vitiated by a manifest error or a misuse of powers or whether the institutions clearly exceeded the bounds of their discretion'.[42] This

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[36] *Pfizer* (n 34), paragraph 162.

[37] Joakim Zander, 'The Precautionary Principle in EU Law' in *The Application of the Precautionary Principle in Practice* (CUP 2010), 121.

[38] *Pfizer* (n 34), paragraph 162.

[39] *Toolex* (C-473/98) ECLI:EU:C:2000:379, paragraphs. 42-45.

[40] Marchant and Mossman (n 3), 65.

[41] *Pfizer* (34), paragraph 168.

[42] Ibid, paragraph 169.

standard of proportionality assessment is in line with the *Fedesa* doctrine on the discretionary powers of the EU institutions.[43]

By analogy, precaution has served as one of the key justifications for non-discriminatory acts of the Member States that violate free movement provisions. For example, in *Commission v Netherlands*, the Court explained that 'discretion relating to [the objective of public health] is particularly wide where it is shown that uncertainties continue to exist in the current state of scientific research'.[44] Marchant and Mossman describe this standard as an 'open invitation for arbitrary and unreasonable decisions by both regulators and judges'.[45]

Therefore, applying this version of the precautionary principle to financial stability would likely contribute to a weakening of output legitimacy, by restricting *ex post* accountability to the procedural question of whether a measure is accompanied by scientific risk assessment. While there are rare examples of a stricter standard of evidence being used, there is no guarantee that the application of this principle would overcome the Court's already deferential review of financial stability measures. The implicit danger of this approach is that precaution could give further impetus to both intergovernmentalism in the EMU and the expansion of expert agencies' powers; precaution would provide a stronger legal basis for technocratic decision-making. This conclusion is supported by authors who consider precaution to be entirely self-serving.[46]

At any rate, it would be difficult to apply a precautionary approach to all dimensions of EU financial stability. The principle is specifically designed as a response to cost-benefit analysis in financial regulation, and further research is required on its operational components outside of regulation. In addition, it should be noted that EU financial regulation is increasingly

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[43] *Fedesa* (Case 331/88) ECLI:EU:C:1990:391, paragraph 8.

[44] *Commission v Netherlands* (C-41/02)*,* ECLI:EU:C:2004:762, paragraph. 43.

[45] *Supra* (n 3).

[46] Lucas Bergkamp, 'Understanding the Precautionary Principle (Part I)' [2002] 10 *Environmental Liability* 18, 21.*Cf* Robert V Percival, 'Who's Afraid of the Precautionary Principle?' [2006] 23 *Pace Environmental Law Review* 21, 31.

precautionary. The clearest example is the precautionary recapitalisation for solvent banks under the Bank Recovery and Resolution Directive (BRRD).[47] Therefore, it is unlikely that a precautionary approach would significantly improve the non-economic utility of financial stability policy. Notwithstanding the above criticisms, the precautionary approach highlights some of the particularities of financial stability, and the critical importance of additional *ex ante* and *ex post* safeguards to protect its non-economic utility. The next section delves deeper into the *ex post* side and the role of judicial review in financial stability.

7.3 The role of judicial review in financial stability

This thesis submits that a functionalist interpretation of output legitimacy as performance misrepresents the role of judicial review in correcting some of the challenges identified in previous chapters. To be sure, aligning policy with the non-economic utility and ideology of financial stability is primarily a political and regulatory task. Additionally, there are many dangers associated with judicial empowerment: the most obvious one is the potential appropriation of political power by an unelected body and the entrenchment of dominant economic ideology through the judicial route.[48]

Nevertheless, judicial review is a vital component of output and throughput legitimacy, especially in the European context.[49] Without suggesting that judicial review can solve all the challenges identified in this thesis, the Court's deferential approach in financing assistance and other cases is a direct cause of the misalignment between policy and the teleology of financial stability. Contrary to the view that judicial deference is necessary in times of crisis,

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[47] Art 32.4, BRRD. This empowers resolution authorities to adopt bail-in and debt instruments for solvent banks to remedy capital shortfalls. Paragraph (d) establishes that these measures are precautionary and they can be employed to prevent serious financial disturbances.

[48] On 'judicialisation', see Federico Fabbrini, *European Governance in Europe: Comparative Paradoxes and Constitutional Challenges* (OUP 2016), Chapter 2.

[49] But note the EU has a long history of 'negative integration' through free movement law, which is intrinsically linked to economic functionalism and the subordination of non-economic policy objectives to a market-oriented culture.

this section outlines unique elements of financial stability that exemplify the need for judicial empowerment, as well as the broader connection between legitimacy and judicial review.

7.3.1 Judicial review and legitimacy

The starting point is to emphasise that many of the challenges identified in previous chapters, such as the irreconcilability of financing assistance with the no-bailout clause in Art 125(1) TFEU, are caused by the silence of the Treaties on financial stability. Yet this is a common phenomenon in European integration.[50] It is specifically the Court of Justice's responsibility to interpret the Treaties consistently with an existing body of law, which includes interpretative tools such as the Charter of Fundamental Rights.[51] Judicial empowerment, or the expansion of judicial influence over economic and political affairs, flows from this interpretative role and is an inherent feature of European governance.[52]

One of the common criticisms of judicial activism is that it results in an 'over-constitutionalisation' of EU law, whereby economic and regulatory law is elevated to the highest hierarchical level.[53] There is a link between 'over-constitutionalisation' and technocratic governance in the EMU: for example, the rise of financial stability as a core objective of EU law is used by the Court to justify the delegation of discretionary powers to ESMA and its sister authorities.[54] However, the theory of 'over-constitutionalisation' is contested. Some authors consider that this is an inherent feature of constitutional pluralism,

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[50] In reference to the earlier discussion on environmental protection, this was introduced into EU law through the case law of the Court.

[51] *Infra* (n 117).

[52] See Daniel M Brinks and Abby Blass, 'Rethinking Judicial Empowerment: The New Foundations of Constitutional Justice' [2017] 15(2) *International Journal of Constitutional Law* 296.

[53] Dieter Grimm, 'The Democratic Costs of Constitutionalisation: The European Case' [2015] 21(4) *European Law Journal* 460; Alexander M Bickel, *The Least Dangerous Branch* (1962) 16-17, 'it thwarts the will of representatives of the actual people of the here and now; it exercises control, not in behalf of the prevailing majority, but against it'.

[54] *Short Selling* (C-270/12) ECLI:EU:C:2014:18, paragraph 85.

which should serve to encourage judicial dialogue as a form of democratic legitimacy.[55] More importantly, a distinction must be drawn between areas where the Court assumes the role of an enforcer of economic law, such as the sanctioning regime of the TSCG, and the more traditional interpretative tasks of the Court.[56] In the latter scenario, constitutionalisation flows from the very nature of economic integration; judicial empowerment should not be dismissed outright as a threat to democratic legitimacy.

On the contrary, there is a strong link between judicial review and legitimacy. In the context of English law, Thomas Poole challenges the view that judicial review should be limited to rights protection (triggered when individuals' rights are threatened), arguing instead that judicial review has the broader purpose of fostering the language and culture of legitimacy.[57] Courts generally exercise a gatekeeping function: they filter various substantive and institutional considerations 'to shape a practice of legitimacy and accountability'.[58] Even in technical fields, the role of courts extends beyond rule enforcement because 'the judiciary does not operate in a vacuum: courts are in a dynamic relationship with other bodies involved in normative practice'.[59] In other words, it is specifically the task of the courts to determine what legitimacy and accountability mean in a legal order, even when they choose to defer to the expertise of other bodies. Scott and Sturm describe this as the 'catalyst' role of judicial review and give the example of the CJEU as a body that has historically engaged in dialogue with other actors to shape a culture of legitimacy.[60]

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[55] Gareth Davies, 'Does the Court of Justice Own the Treaties? Interpretative Pluralism as a Solution to Over-Constitutionalisation' [2018] 24(6) *European Law Journal* 358.

[56] Fabbrini (n 48).

[57] Thomas Poole, 'Legitimacy, Rights, and Judicial Review' [2005] 25(4) *Oxford Journal of Legal Studies* 697, 711.

[58] Joanne Scott and Susan Sturm, 'Courts as Catalysts: Rethinking the Judicial Role in New Governance' [2007] 13 *Columbia Journal of European Law* 565.

[59] Ibid, 570.

[60] Ibid, 571. In the context of uncertainty, '[…] the judicial function is to prompt—and create occasions for—normatively motivated inquiry and remediation by relevant non-judicial actors in response to signals of problematic conditions or practices. Law thus operates as a catalyst by facilitating the elaboration and

In relation to financial stability, the 'catalyst' function is best expressed through the concept of 'throughput legitimacy'. It was previously explained that this is subcategory of input and output legitimacy, and the concept is used to spotlight the EU's chronic governance and accountability issues.[61] Thus, the belief that judicial empowerment is a threat to democratic legitimacy ignores the evolving institutional design of the EU, which necessitates extraordinary checks and balances to executive power. For example, the CJEU is a key player in EU competition law, as a countermeasure to the Commission's discretion and extensive enforcement (investigative, prosecutorial, adjudicative) duties.[62] The importance of throughputs can be linked to the complex interplay of normative and empirical sources of legitimacy in global governance, explored in Chapter 2.[63] In this context, Habermas associates legitimacy with the emergence of human rights law.[64] Human rights protection is a good example of how judicial review contributes to output legitimacy, defined by this thesis as a belief (or 'trust') that the decision-making process will deliver appropriate economic and non-economic results.[65]

A further criticism of judicial empowerment is that it favours the dominant political ideology of the time. According to this view, the entrenchment of rights into law through the judicial route insulates political elites from popular pressure and marginalises minority views.[66] More broadly, this alludes to a long-running debate on the political nature of the judiciary. Whether

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implementation of public law norms by other actors, and the productive engagement of normative inquiry among relevant institutional actors'.

[61] Viven A Schmidt, Europe's Crisis of Legitimacy: Governing by Rules and Ruling by Numbers in the Eurozone (OUP 2020) 169-173.

[62] José Carlos Laguna de Paz, 'Understanding the Limits of Judicial Review in European Competition Law' [2014] 2(1) *Journal of Antitrust Enforcement* 203.

[63] Jürgen Habermas, Ciaran P Cronin and Pablo de Greiff (eds) *The Inclusion of the Other* (MIT 1998) 183.

[64] Ibid.

[65] This describes integration beyond economic functionalism.

[66] Conor Gearty, 'The Courts in Europe Today: Subverting or Saving Democracy?' in Christina E Parau (ed), *Transnational Networking and Elite Self-Empowerment*: *The Making of the Judiciary in Contemporary Europe and Beyond* (2018).

intentionally or by omission, all judicial decisions entail political consequences. This is even more pronounced in the case of the CJEU, whose jurisdiction is derived from multi-level 'political antagonisms'.[67] For example, in *Pringle* the Court was faced with two impossible options: either invalidating a financing arrangement during the peak of the sovereign debt crisis, or authorising extraordinary assistance on legally ambiguous grounds.[68] Accordingly, this thesis considers challenges to output legitimacy that stem from the reasoning of the Court, not the outcome of its decisions. It is necessary to reconsider the standard of review in financial stability because judicial deference does not imply political neutrality.

It should also be noted that the CJEU's history of negative integration is intrinsically linked to economic functionalism, or the subordination of political and social integration to a market-driven paradigm. The case law on free movement has been instrumental in furthering market liberalisation through principles such as mutual recognition and home-country control. It is conceivable that judicial activism in financial stability will erode output legitimacy by perpetuating a market-oriented culture that overlooks the non-economic utility of this objective. However, the Court can also be seen as a driver of political integration, for example, through its case law on citizenship.[69] Equally, this thesis has demonstrated that judicial deference in financial stability is a major threat to the non-economic utility of financial stability. Therefore, the Court's historical connection to economic functionalism only strengthens the case for revisiting the role and intensity of its review.

Ultimately, the role of the Court of Justice must be assessed in the context of judicial pluralism. There is an evident threat emerging from the deferential review of financial stability measures, that national courts will adopt a more activist stance to compensate for the lack of supranational scrutiny. Indeed, the financial crisis has sparked some of the most

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[67] Renata Mienkowska-Norkiene, 'The Political Impact of the Case Law of the Court of Justice of the European Union' [2021] 17(1) *European Constitutional Law Review* 1, 6.

[68] See Alicia Hinarejos, *The Euro Area Crisis in Constitutional Perspective* (OUP 2015), Chapter 8.

[69] Willem Maas, 'The Origins, Evolution, and Political Objectives of EU Citizenship' [2014] 15(5) *German Law Journal* 797.

notable examples of national judicial resistance to the encroachment of EU law.[70] The most famous example is the *Gauweiler-Weiss* saga in the context of monetary policy, where the German Federal Constitutional Court for the first time ruled a decision of the CJEU as *ultra vires*. Critical to the German court's reasoning was that 'the specific manner in which the CJEU applies the principle of proportionality in the case at hand renders that principle meaningless'.[71] The implications of this judgment on the constitutional integrity and unity of EU law are discussed extensively in the literature.[72] While authors are sceptical of the German court's stance, this challenge is directly connected to the CJEU's level of review. If we consider differences between monetary policy and financial stability, it becomes even more problematic that the CJEU sometimes applies the same standard in both fields.[73] The differences between monetary policy and financial stability are discussed below. Ultimately, the role of judicial review in financial stability depends on the substantive proposals made in the next section.

7.3.2 Judicial review and the teleology of financial stability

In addition to the broader question of whether judicial empowerment impacts positively or negatively on legitimacy, there are grounds to consider judicial review as a vital component of the teleology of financial stability. There are several unique elements of financial stability that necessitate extraordinary *ex post* judicial scrutiny.

Firstly, as the discussion on the precautionary principle shows, *ex post* judicial review acts as a counterweight to the inherent uncertainty and complexity of the financial sector. This challenge extends beyond the concept of 'risk', which is present in all policy areas, and into

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[70] On the Portuguese Courts, see Miguel Poiares Maduro, Leonardo Pierdominici and *António Frada*, 'A Crisis between Crises: Placing the Portuguese Constitutional Jurisprudence of Crisis in Context' [2017] 4(1) *e-Pública* 43 <https://www.e-publica.pt/volumes/v4n1a02.html> accessed 01 July 2020.

[71] BVerfG, Judgment of the Second Senate of 5 May 2020, 2 BvR 859/15, paragraph 127.

[72] See eg, Ana Bobic and Mark Dawson, 'A. Court of Justice Quantitative Easing at the Court of Justice – Doing Whatever it Takes to Save the Euro: Weiss and Others' [2019] 56(4) *CMLR* 1005.

[73] See below discussion on 'margin of appreciation'.

the realm of 'true' uncertainty in the Knightian and Keynesian sense.[74] True uncertainty refers to incomputable problems in the financial sector, which cannot be resolved by scientific progress because new knowledge generates new 'unknown unknowns'.[75] The best example is the emergence of 'shadow banking' as a response to regulatory intervention in traditional banking. More relevant to financial stability, the discretionary use of macroprudential tools complicates the effects of micro-prudential policy and *vice versa*.[76] Accordingly, policy choices cannot be evaluated on an *ex ante*, static basis; course correction over the medium- and long-term becomes key in delivering the intended 'output'. As Scott and Sturm argue:

'In areas of normative uncertainty or complexity, courts prompt and create occasions for normatively motivated and accountable inquiry and remediation by actors involved in new governance processes.'[77]

Second, inherent uncertainty is also the distinguishing factor between financial stability and other technical policy fields, such as monetary policy. This comparison centres on causality. While monetary policy is just as complex and unpredictable as financial stability, it is deployed based on the clear metric of inflation.[78] Financial stability, on the other hand, cannot be quantified until a crisis occurs—if at all.[79] This is intentional, as financial stability is specifically designed as a response to an infinite range of threats to the financial system; the various models that have been developed since the financial crisis acknowledge this limitation.[80] Therefore, while the literature puts forward persuasive arguments for maintaining central bank independence and limiting the influence of the courts in monetary policy, this reasoning does not extend to the review of financial stability. It is precisely the

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[74] *Supra* (n 12).

[75] Ibid.

[76] See Chapter 4. This can be linked to Member State discretion in macroprudential policy.

[77] Scott and Sturm (n 58), 570.

[78] Gundbert Scherf, *Financial Stability Policy in the Euro Zone* (Springer Gabler 2013), 120-130.

[79] *Supra* (n 2).

[80] The most detailed model is presented by Piergiorgio Alessandri *et al*, 'Towards a Framework for Quantifying Systemic Stability' [2009] 5 *International Journal of Central Banking* 47, 53-68.

lack of causality on the *ex ante* front of financial stability that necessitates a stricter review of policy in the *ex post* stage.

Thirdly, judicial review becomes critical because of the fragmentation of financial stability policy in the EU. At its most basic level, fragmentation refers to the complex division of competences in financial stability: there are multiple authorities with overlapping and often conflicting tasks.[81] The differentiated integration of the Banking Union exacerbates this problem further, by generating two "federal" systems (a centralised and decentralised one) operating side by side. Moreover, fragmentation is not simply a question of institutional complexity, but also of structural variation. At the national level, the transposition of EU financial stability tools occurs through various policies, ranging from consumer protection to competition law.[82] Consequently, this complex dynamic points to the elevated importance of *ex post* review in comparison to monetary policy or other expert fields.

Fourthly, there are grounds to consider judicial review to be more effective than political scrutiny in some areas of financial stability policy. As Scherf highlights, politicians do not agree on what financial stability means, let alone how it should be implemented.[83] The underlying challenge of political scrutiny is that financial stability is prone to capture: owing to its connection with economic policy, as well as the huge social costs it entails, financial stability is characterised by intense public and private pressures.[84] This should not be taken to suggest that political institutions should not maintain their leadership role, but rather that the effectiveness of political accountability may sometimes be exaggerated. An example is the European Parliament's review of bodies such as the SSM, whose success ultimately rests on politician's ability to interpret complex statistical models and data.[85] Judicial review of areas

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[81] See generally, Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' [2010] 47(5) *CMLR* 1317.

[82] Scherf (n 78), Chapter 3. On power concentration, see Alison Lui, Financial Stability and Prudential Regulation: A Comparative Approach to the UK, US, Canada. Australia and Germany (Routledge 2017), 185.

[83] Ibid.

[84] Ibid.

[85] Ibid.

such as financial regulation where political accountability is prone to capture is necessary to ensure output legitimacy.

Finally, the importance of judicial review is connected to the transformative potential of financial stability in EU. While traditional view is that 'judges should not overstep the limits of their competences in order to enforce the limits of other actors' competences',[86] financial stability poses unprecedented challenges to the rule of law and individuals' rights.[87] This argument is aptly presented by Goodhart and Lastra in the context of monetary policy: the authors state that the CJEU exercises the crucial task of 'guarding the guardians' in expert-driven fields.[88] Considering the differences between monetary policy and financial stability explored above, this task becomes even more crucial in financial stability. Overall, there are strong reasons to suggest that judicial review in financial stability is necessary and inherently linked to the goal of minimising the social costs of policy.

7.4 Correcting issues of proportionality and admissibility

Having demonstrated that there is a fundamental link between judicial review and legitimacy, it is necessary to delve deeper into the challenges of proportionality and admissibility, which shape the intensity of judicial review. This section argues that the Court has not developed a consistent methodology for when to exercise judicial deference or not, and to what extent. Thus, the solution lies not in applying a "stricter" standard, but in outlining the purpose of proportionality in financial stability cases.

I propose that the principle of proportionality can act as a balancing mechanism between the economic and non-economic utility of financial stability, and that its application should serve

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[86] Matthias Goldmann, 'Adjudicating Economic? Central Bank Independence and the Appropriate Standard of Judicial Review' [2014] 15(2) *German Law Journal* 265, 270-273.

[87] See eg, Scharpf FW, 'Monetary Union, Fiscal Crisis and the Disabling of Democratic Accountability' in Schäfer A and Streeck W (eds) *Politics in the Age of Austerity* (Polity Press 2014).

[88] Charles Goodhart and Rosa M Lastra, 'Populism and Central Bank Independence' [2018] 29(1)(3) *Open Economies Review* 49.

the purpose of differentiating between social groups affected by financing and other measures. This approach is consistent with the lowest standard of the margin of appreciation, but a stricter approach may be necessary in cases invoking human rights violations. Finally, as regards admissibility, I examine a number of proposals in the literature on how to expand the Court's jurisdiction. I conclude by echoing Goodhart and Lastra's opinion that the CJEU must develop specialised expertise, through training or internal reform, to address the complex issues raised in financial stability cases.

7.4.1 Proportionality as differentiation: minimising social costs

The Court's case law on financial stability is diverse, which reflects the objective's transformative influence in EU law. Two important categories of cases can be highlighted. The first group concerns financing assistance (bailouts and bail-ins), which raise important constitutional questions on the application of human rights and the principle of legitimate expectations.[89] The second group of cases deals with supervisory questions and is more common, but may or may not raise constitutional implications.[90] While these scenarios vary considerably, a common denominator in the case law on financial stability is the principle of proportionality.[91]

On the issue of proportionality, the CJEU has never developed a doctrine of the 'margin of appreciation' observed in other jurisdictions. This doctrine regulates the discretion afforded to the legislator or executive body according to the legal issue at stake. The best example of a consistent methodology on the margin of appreciation is the US Supreme Court's approach, which applies the standard of 'rational basis', 'heightened scrutiny', or 'strict scrutiny' based on the right or measure in question.[92] For example, cases invoking a breach of human rights

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[89] Ledra Advertising (C-8/15) ECLI:EU:C:2016:701; Kotnik (C-526/14) ECLI:EU:C:2016:570.

[90] Eg, *L-Bank* (C-450/17 P) ECLI:EU:C:2019:372.

[91] Beyond their constitutional implications, one of the ways these groups differ is in how financial stability is used.

[92] On this comparison, see Jan Zglinski, 'The Rise of Deference: The Margin of Appreciation and Decentralised Judicial Review in EU Free Movement Law' [2018] 55(5) *CMLR* 1341.

are afforded the higher standard of 'heightened scrutiny'.[93] In EU law, the Court has employed different standards of proportionality review, but there is no clear methodology; in fact, it is common for the CJEU to apply a different standard in cases dealing with the same legal rights.[94]

This lack of a consistent methodology also results in the current situation in financial stability, where the same level of deference can be observed in cases that deal with fundamentally different factual and legal circumstances.[95] Hence, it is counterintuitive to suggest a "stricter" standard of review absent a coherent doctrine of the margin of appreciation. Instead, I outline the purpose of proportionality in the context of financial stability, which can inform various standards of judicial review.

The purpose of proportionality in financial stability

The principle of proportionality provides that Union action must not go 'beyond the degree necessary in the public interest'.[96] The main test for proportionality is derived from *Fedesa*, where the Court lays down a two-step approach: first, the measure must be appropriate to attain its specified objective, and second, the measure must be necessary to attain said objective. A third step of comparing the measure to possible alternatives to determine the least onerous option (proportionality *stricto sensu*) is more uncommon, although it is often discussed in in the literature.[97]

Additionally, the intensity of the Court's proportionality review varies depending on whether the act in question is adopted by an EU institution or a Member State. In most cases, EU institutions are granted wider discretion: the Court examines whether the EU institution's actions were 'manifestly disproportionate' to their 'political responsibilities' under the

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[93] Ibid.

[94] Ibid.

[95] Compare for example *Ledra Advertising* and *L-Bank*.

[96] See Takis Tridimas, 'Proportionality in Community Law: Searching for the Appropriate Standard of Scrutiny' in Evelyn Ellis (ed), *The Principle of Proportionality in the Laws of Europe* (Hart Publishing 1999).

[97] Ibid.

Treaties.[98] Conversely, Member States are given a 'partial' margin of discretion, which 'grants Member States the freedom to make a certain regulatory assessment but stipulates how this assessment ought to be made'.[99] Both tests are informed by the degree of integration in the policy area in question. For example, the Court will be more deferential if an act falls under the exclusive competences of the Union, as *Fedesa* demonstrates.[100]

However, as stated above, there is no consistent methodology on how these tests are applied. Some policy fields are more straightforward than others: for instance, monetary policy in the EMU is an exclusively competence of the ECB and the Court will typically apply the lowest possible standard of review.[101] On the other hand, inconsistencies emerge in shared competences such as free movement law, where the intensity of proportionality can differ between cases dealing with identical measures or legal rights. This challenge becomes even more pronounced in financial stability, which not only falls under shared competences, but is highly fragmented, both vertically (between the EU and Member States) and horizontally (between various authorities and policy areas). For example, the level of harmonisation in micro-prudential policy is significantly higher than in macroprudential policy, and so on.

Nevertheless, the principle of proportionality serves the same purpose in all cases. In constitutional theory, the notion of 'proportionate interference' is akin to 'interference without domination'.[102] It assumes that there can be 'disagreement' about rights, and that policy makers can exceed their freedom.[103] In times of crisis or uncertainty, the link between proportionality and constitutional rights protection acquires even greater significance, as

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[98] *Fedesa* (n 43), page 32.

[99] *Supra* (n 92).

[100] See Wolf Sauter, 'Proportionality in EU Law: A Balancing Act?' [2017] 15 *Cambridge Yearbook of European Legal Studies* 439.

[101] Goodhart and Lastra (n 88).

[102] See Eoin Daly, 'Republicanizing Rights?' in Ester Herlin-Karnell *et al* (eds), *Constitutionalism Justified: Rainer Frost in Discourse* (OUP 2019).

[103] Ibid.

political contestation is heightened.[104] It follows that the main purpose of proportionality is to prevent a misuse of discretionary powers; a task the literature considers to be so significant that there are doubts as to whether courts can be entrusted with the sole responsibility over the application of proportionality.[105] Further, this goal is intimately linked to legitimacy, and the 'catalyst' role of the Courts explored in the previous section.

It should be reiterated that preventing a misuse of discretionary powers is not synonymous with a strict standard of judicial review. Historically, the CJEU has been praised for its willingness to set boundaries to discretionary authority, whilst also deferring to the expertise of the policy maker where necessary. For instance, in risk management cases such as *Commission v Austria*, the Court adopts a reading of proportionality that focuses on transparency and the availability of information as a limit to discretionary powers.[106] By analogy, in *UEAPME*, the Court evaluates the adequacy of the decision-making process with reference to inclusiveness and representation of stakeholder interests.[107] Consequently, judicial deference can be exercised consistently with the goal of establishing boundaries to discretionary power.[108]

Based on the analysis presented in this thesis, the goal of preventing the misuse of discretion is epitomised by the need to pursue both the economic and non-economic utility of financial stability. In other words, it is the purpose of proportionality to filter the 'disagreement' between market and non-market forces, and to deliver an appropriate balance.[109] It has been argued throughout this thesis that the case law of the CJEU in financial stability falls short of this standard, as it overlooks the non-economic utility of financial stability altogether. In many ways, the application of proportionality in cases such as *Ledra Advertising* achieves the

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[104] Sauter (n 100), 444.

[105] Ibid. Note that 'misuse' in the context of constitutional theory is interpreted broadly; the CJEU adopts a more restrictive definition.

[106] *Commission v Austria* (C-320/03) ECLI:EU:C:2005:684, paragraphs 87-89.

[107] *UEAPME* (T-135/96) ECLI:EU:T:1998:128, paragraph 90.

[108] See also, *Pfizer* (n 34).

[109] Sauter (n 100).

opposite result, of authorising discretionary power in the absence of any safeguards against misuse.[110] In light of the above, it is submitted that the principle of proportionality should acts as a guarantee of differentiation in financial stability.

Differentiation refers to the aim of minimising the social costs of financial stability by distinguishing between the various social groups affected by it, and adjusting policy accordingly. This goal must inform the review of the Court across all standards of the 'margin of discretion': a marginal review should consider whether differentiation is pursued by the relevant policy maker, a partial or strict review can provide more detailed analysis of how this ought to be achieved. Albeit not affecting the intensity of review, this solution can provide a rational basis for determining whether action is 'manifestly disproportionate' to the objective of financial stability, even when the Court decides to exercise restraint. Thus, measures that pursue a 'one-size-fits-all' approach must be considered the primary example of a misuse of discretionary powers, as these fail to account for the social costs of financial stability.

Operational elements of differentiation

In practice, the application of this standard would vary between the two groups of cases identified above. The most important category concerns potential human rights violations in the context of a bail-in or other macroeconomic reforms. In these cases, financial stability is typically used as an 'overriding reason' in the public interest to justify restrictions of the right to property. Accordingly, the key criterion for proportionality in this group of cases should be whether ordinary depositors are differentiated from risk-assuming investors. Thus, in cases such as *Ledra Advertising*, burden-sharing measures would be proportionate to the goal of financial stability if steps were taken to mitigate the losses of ordinary depositors beyond the hierarchy of claims in resolution policy.[111]

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[110] See Chapter 6.

[111] Note that the hierarchy of claims was introduced subsequently.

While this goal is generally consistent with both a soft and a partial standard of the margin of appreciation, there are grounds to suggest that a stricter standard should apply to cases invoking human rights, as is the case in the US.[112] In particular, even if bail-in cases concern the right to property, the example of *Ledra Advertising* demonstrates a significant threat to social equality emerging from a one-size-fits-all application of burden-sharing measures. Limited support for this approach can be found in *Kotnik*. In this case, the Court does not go so far as to differentiate between shareholders (and holders of ordinary debentures) and subordinated creditors as part of its proportionality assessment; however, the distinction between the two was critical in the outcome of the judgment.[113] Moreover, AG Wahl explicitly addresses the proportionality of reorganisation measures and considers the distinction between shareholders and subordinated creditors in his Opinion. Consequently, there is a limited basis for applying differentiation in future cases involving a burden-sharing measures, which would enhance the output legitimacy of financial stability policy.

The second important category of cases concerns supervisory issues, which can raise broader constitutional questions. A good example is the case of *L-Bank*, which concerns the competences of the ECB in the SSM. In this case, the CJEU refused to apply a test of proportionality, stating that proportionality was taken into account by the EU legislature and that the ECB is not required to examine proportionality on a case-by-case basis.[114] This approach is at odds with the aim of differentiation. A more "hands-on" approach can be found in the judgment of the General Court in *Crédit Mutuel Arkéa*: the GC suggested that where there is a choice between several measures, recourse must be had to the least onerous one.[115] This formulation of the proportionality test exemplifies the 'partial' standard of the margin of appreciation and is consistent with the aim of differentiation, as it requires policy makers to take make value judgments on the wider consequences of their actions. *Crédit Mutuel Arkéa* demonstrates that differentiation is not alien to financial regulation, and could form the basis for proportionality assessment.

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[112] *Supra* (n 92).

[113] See Chapter 6.

[114] Opinion of AG Wahl in *Kotnik* (C-526/14) ECLI:EU:C:2016:102, paragraphs 124-130.

[115] See also, *Tercas* (T-98/16) ECLI:EU:T:2019:167.

Ultimately, the precise application of this test will depend on the facts of each case. A final point of note is that differentiation can be derived from the secondary legislation, and the sector-specific principle of proportionality in the CRR/CRD. This principle imposes differentiated obligations on 'small and non-complex' firms, and serves as the basis for additional EU-specific exceptions from Basel. It is specifically intended to minimise the social costs of policy, by reducing the burden of financial stability on key institutions such as public investment banks. It was previously argued that the application of proportionality in the CRR II/CRD V strongly improves the output legitimacy of EU law, by covering key tools and processes of financial stability. Therefore, this sector-specific should provide the inspiration for any future adjustments to the proportionality review of the CJEU, especially in case law dealing with supervisory issues.

7.4.2 (Non)reviewable acts: the issue of admissibility

Beyond the substantive review of policy, the intensity of judicial review is also impaired by the limited admissibility of financial stability measures. This pertains to soft law measures, such as the recommendations of the ESRB in macroprudential policy or the draft technical standards of the ESAs, which fall outside the jurisdiction of the Court due to their non-legally binding nature. A bigger concern is the use of intergovernmental agreements in the euro area, such as the TSCG and the ESM, which fall outside of EU law entirely.[116] As the issue of admissibility has been covered extensively in the literature, the following analysis briefly summarises three possible solutions put forward in the existing research.

Firstly, the literature proposes the maximum harmonisation of macroprudential policy, deposit insurance, and other areas of financial stability that maintain national discretion. While this proposal is not linked directly to the jurisdiction of the CJEU, further harmonisation would reduce the need for soft law instruments and informal decision-making through bodies such as the ESRB. This could also expand the jurisdiction of the Court by bringing areas which remain unharmonised within the scope of EU law. However, maximum harmonisation should not be seen as an automatic correction to the challenges of legitimacy

[116] Note that some hybrid acts include a role for the Court, eg as part of macroeconomic enforcement.

identified in this thesis. This approach could resolve some of the issues in macroprudential policy, such as the overuse of asset-based tools which can limit access to credit and disadvantage vulnerable groups. Further harmonisation would also be beneficial in deposit insurance, due to the importance of protecting depositors against bank failure. Beyond these relatively uncontroversial examples, harmonisation must be assessed on a case-by-case basis, and is just as likely to erode output legitimacy if it is founded on purely market-oriented goals.

Secondly, a number of authors highlight the importance of extending the Court's review to collective acts adopted under international law, but which affect the obligations of the Member States in EU law. There are many examples of this 'hybrid' approach, such as the ESM and TSCG.[117] As Spaventa notes, hybrid acts are becoming a common crisis response tool; most notably during the refugee crisis. Spaventa proposes that, with the exception of acts that have been ratified according to national constitutional requirements, collective acts having a legal effect in EU law must be subject to judicial review. Where EU institutions are part of such acts, the EU could also incur non-contractual liability.[118] Limited support for this proposal can be found in cases such as *Florescu*, examined in Chapter 6.[119] Moreover, Spaventa's solution can be reconciled with Tuori's emphasis on sincere cooperation as a means of extending the jurisdiction of the Court: broadly, this principle considers that there are limits to what Member States can do outside of EU law when their obligations under the Treaties are at risk.[120] There is no doubt that judicial review of hybrid acts would improve the legitimacy of EU law, especially as the full incorporation into EU law of the TSCG and other such instruments appears impossible absent Treaty change.[121]

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[117] Eleanor Spaventa, 'Constitutional Creativity or Constitutional Deception? Acts of the Member States Acting Collectively and Jurisdiction of the Court of Justice' [2021] 58(6) *CMLR* 1697.

[118] There have been many unsuccessful claims on this basis, eg Chrysostomides (C-598/18 P) ECLI:EU:C:2020:1028.

[119] Florescu (C-258/14) ECLI:EU:C:2017:448.

[120] Kaarlo Tuori, *European Constitutionalism* (CUP 2015), Chapter 6.

[121] This is evidenced by the slow incorporation of the TSCG into EU law, which is impossible without Treaty change.

Finally, Goodhart and Lastra propose that many of the challenges in relation to judicial review stem from the lack of expertise and training in technical fields. There are exceptions: for example, the Court has provided complex economic assessment in competition law cases, and this area of law is generally court driven. Therefore, the authors suggest that a precondition for expanding the jurisdiction of the Court is the creation of a specialised chamber and further training of expert judges to take responsibility over complex monetary policy and financial stability cases. This proposal is perhaps the only solution to both admissibility and proportionality issues.

7.5 Conclusion

This chapter explored the role of *ex post* review in aligning policy with the teleology of financial stability. While judicial review is not the only solution to the weak accountability of financial stability reforms, its importance is often dismissed as a potential threat to democratic legitimacy. Against this view, I proposed that judicial review is inherently connected to output legitimacy in this field.

This primarily because of the unique elements of financial stability, that set it apart from other policy areas, such as monetary policy. Firstly, financial stability seeks to regulate a sector that is characterised by inherent uncertainty in the 'Knightian' or 'Keynesian' sense. In other words, judicial review is made necessary due to the many 'unknown unknowns' of the financial system. More specifically, financial stability policy is fragmented between various authorities and between the internal market and the euro area. This challenge is exacerbated by structural variation across the EU, which implies that additional *ex post* safeguards are necessary to ensure an alignment of policy with the teleology of financial stability. Judicial review is, in some ways, more effective than political scrutiny due to the risk of political capture.

In addition, judicial review should not be dismissed outright as a threat to democratic legitimacy. On the one hand, judicial empowerment is seen as contributing to an 'over-constitutionalisation' of economic law, which results in the subordination of social policy goals. The effect of over-constitutionalisation is an entrenchment of dominant economic and

political ideology, and the marginalisation of alternative views. Despite these threats, the current challenge in European governance is not one of over-constitutionalisation, but of agencification; judicial empowerment may be necessary to overcome the threat of technocratic governance. Viewed from this perspective, judicial review is a precondition for output legitimacy in financial stability.

On the substantive question of how to improve the intensity of judicial review, it was explained that the Court has no objective methodology for applying a soft, partial, or strict 'margin of appreciation'. Accordingly, I investigated the purpose of proportionality review in the case law on financial stability. I proposed that proportionality must serve the purpose of differentiation, by distinguishing between social groups affected by policy, which flows from the goal of minimising the social costs of policy. This reasoning can apply to different standards of the margin of appreciation, however, cases invoking human rights breaches may warrant a stricter standard. Ultimately, the precise application of this approach would vary between cases, but there are indications that differentiation is consistent with existing case law.

Final note can be made of the precautionary principle, which introduced the importance of *ex post* review in fields dealing with true uncertainty. This principle is specifically designed as a response to cost-benefit analysis in financial regulation, and would be difficult to apply to all areas of EU financial stability. Further, precaution has a troubled history in EU environmental and public health law, where it is used to rationalise judicial deference. Nevertheless, this dimension warrants further research, especially due to its connection to the non-economic utility of financial stability .

Chapter 8: General Conclusion

Over the last decade, the European Union has navigated crisis after crisis with a measure of success. European integration has continued to advance despite the many challenges faced and compromises made. We are reminded of the repercussions of crisis daily, through the remaining questions surrounding Brexit, the deterioration of public finances that contributed to the COVID-19 pandemic, the rule of law threats in some Member States. Monnet's statement that Europe will be forged in crises rings resonates as poignant and prophetic.

In this time, financial stability emerged as a 'higher' goal of EU law to guide critical policy choices, such as the overhaul of banking regulation and the grant of financing assistance to Eurozone countries. Its influence is truly transformative. Financial stability has served as the legal basis for extraordinary reforms at the national, supranational, and intergovernmental level. It is no exaggeration to say that financial stability remains at the forefront of every crisis, due to the reliance of modern society on finance, public and private.[1] My thesis argues that, despite its influence, there is a flawed understanding of what financial stability entails and what it seeks to achieve, which threatens the legitimacy of EU law. This hypothesis is divided into two further assumptions.

First, I consider the literature's emphasis on the economic definition of this concept to be incomplete. Law cannot and should not seek to define financial stability narrowly, nor should it ignore the wider impacts of policy on society. In light of 'true' uncertainty in the financial system, it is imperative that the objective remains flexible as a system-wide response to an unpredictable range of risks. Equally, financial stability operates within a *sui generis* constitutional order and must be informed by other EU law values and non-economic

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[1] The most recent example is the crisis in Ukraine, which has tested the resilience of credit institutions in some Member States. See eg, Martin Arnold, 'ECB to Oversee Wind-Down of Russian-linked Bank in Cyprus' (Financial Times, 24 March 2022) <www.ft.com/content/b8d1cf4f-5160-4666-aae3-73f9d9ae7c0f> accessed 25 March 2022.

objectives; these prescribe its purpose and its limitations. Therefore, I explore the broad teleology of financial stability in EU law, as distinguished from defining this objective in purely technical or economic terms. My approach seeks to combine various insights in financial regulation and EU constitutional law.

Second, I challenge the notion that the legitimacy of financial stability is derived purely from functionalist performance. The conventional view is that output-driven fields, where expert decision-making excludes democratic participation, derive their legitimacy from performance or necessity. Conversely, I consider 'output' legitimacy to be an empirical concept. Policy is likely to generate negative externalities that undermine the legitimacy of EU law, even if performance is positive. Further, the dissociation of output legitimacy from 'inputs' and 'throughputs' is misleading: acceptance of policy outcomes presupposes a level of trust in the decision-making process. I propose that the teleology of financial stability, and specifically the non-economic utility of this objective, is critical in evaluating legitimacy.

In this general conclusion, I summarise my findings in relation to the teleology and legitimacy of financial stability. The first two chapters of this thesis (Chapters 2, 3) focus on the theoretical foundations of my research, the concepts of financial stability and legitimacy. The following three chapters (Chapters 4, 5, 6) serve as case studies into various dimensions of EU financial stability: bank regulation and resolution, institutional reforms, fiscal and financing measures in the EMU. My final chapter (Chapter 7) examines the role of judicial review in realigning policy with the teleology of financial stability. I conclude by identifying the contributions and limitations of the present work, as well as potential areas for future research.

8.1 Summary of findings

The starting point for any investigation into financial stability is to define a concept that is, by its very nature, undefinable. Owing to the many 'unknown unknowns' of the financial sector and the intentionally flexible scope of financial stability to account for novel threats, the objective is often described as the opposite of instability. Interpreted in the negative, there are very few limits to the application of financial stability in law. It should also be noted that by virtue of financial stability being an expert field, the traditional role of political and judicial

institutions in determining the EU's political objectives is significantly reduced. The literature seeks to overcome the elusiveness of financial stability by associating the concept with (i) the 'prevention, mitigation, and management of systemic risk', (ii) the theory of 'global public goods'.

The former is important in acknowledging the endogenous nature of risk, which necessitates the intensification of regulation and supervision.[2] This definition is also helpful in identifying the normative instruments that make up crisis prevention and management: micro- and macroprudential policy, bank recovery and resolution, deposit insurance, and lender-of-last-resort policies (which also include burden-sharing).[3] The list is not exhaustive; these instruments are expected to change as our understanding of the concept evolves in response to new threats. For example, emphasis on 'systemic risk' is a direct reaction to the shortcomings of micro-prudential supervision leading up to collapse of Lehman Brothers, and does not explain the legal innovations in the euro area following the sovereign debt crisis.

The latter approach, of conceptualising financial stability as a 'global public good', centres on the need for public interference with the market and for international cooperation.[4] As the dominant narrative in the literature, this theory provides a conceptual basis for supranational action during the crisis. However, it does little to delineate the scope of this objective. Moreover, while the terminology of public goods conveys a market-oriented rationale that underemphasises the connection between financial stability and social policy.[5] Financial stability is typically perceived as a prerequisite for economic growth, which is an

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[2] Endogeneity refers to the inherent fragility of the financial system, which generates risks as part of its ordinary functioning. See generally, Rosa M Lastra, 'Systemic Risk, SIFIs and Financial Stability' [2011] 6(2) *Capital Markets Law Journal* 197, 207.

[3] Ibid; Gianni Lo Schiavo G, The Role of Financial Stability in EU Law and Policy (Wolters Kluwer 2017) 53.

[4] Joseph Stiglitz *et al*, 'Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International and Monetary and Financial System' (UN 2009) 51 <www.un.org/en/ga/econcrisissummit/docs/FinalReport_CoE.pdf > accessed 16 September 2021.

[5] Some authors interpret financial stabiltiy as a commoditiy intended to advance 'private aspirations and utility', in Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation* (Routledge 2014) 4, 413-469.

oversimplification of what this objective seeks to achieve and the potential externalities it generates. Therefore, is necessary to look at the broader teleology of financial stability, with view to identifying its true outcomes as well as its boundaries in law. This is a vital step in evaluating output legitimacy.

Theoretical foundations: teleology & legitimacy of financial stability

A teleological interpretation of financial stability focuses on what this objective tries to achieve, conceptually and legally. From a conceptual standpoint, financial stability is a precondition for both economic and social policy objectives, which can be explained by the importance of the financial system in modern society. Legally, the foundational status of financial stability in EU law is derived from its connection to the core objectives listed in Art 3 TEU, which include economic growth, a social market economy, and solidarity.[6]

The literature generally accepts the positive relationship between financial stability and social development: instability is perceived as a cause of unemployment, homelessness, physical and mental health issues, social inequality. However, the theories of systemic risk and public goods overlook the negative relationship between financial stability and social policy: financial stability measures generate huge social costs, for example, by restricting credit availability and amplifying social stratification. On an operational level, the above teleology requires a balancing of the economic and non-economic sides of financial stability. I argue that policy must actively seek to minimise social costs through a flexible or differentiated application prudential and other tools.

The second component of the teleology of financial stability is an ideological shift implicit in the proliferation of macroprudential regulation and other post-crisis reforms.[7] The literature

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[6] The EU Treaties are silent on financial stability, and in fact appear to suggest its subordination to price stability in the EMU. See eg, Article 127(5) TFEU.

[7] For a discussion of the broader ideology of the European Union, see Jason Glynos, Robin Klimecki and Hugh Willmott, 'Cooling Out the Marks: The Ideology and Politics of the Financial Crisis' [2012] 5(3) Journal of Cultural Economy 297; Benjamin Farrand and Marco Rizzi, There is No (Legal) Alternative:

often presents Maastricht as the end of economic functionalism in European integration, due to the introduction EU citizenship and the single currency. Yet the single monetary policy encouraged laissez-faire policies in the financial market leading up to the financial crisis. The transformative influence of financial stability can be seen as a correction of this failure: financial stability establishes significant limits to market integration and, in many ways, qualifies the principles of market equality and market freedom. It is suggested that policy must comply with this ideological evolution of the European financial market to be considered legitimate.

This is supported by analysis of the concept of output legitimacy. Generally, the wider literature on European constitutionalism converges of the issue of legitimacy as a major challenge linked to the financial crisis.[8] Nevertheless, there is a misconception that output legitimacy is synonymous with performance or effectiveness; in other words, that financial stability policy derives legitimacy in the normative sense by contributing to crisis prevention and management. This conceptualisation is inconsistent with the complex interplay of normative and empirical sources of legitimacy in European and global governance. Against this view, my thesis defines output legitimacy as support in a "project", informed by its democratic characteristics and other considerations, and which extends beyond the economic outputs of policy.[9] Consistently with this definition, the non-economic utility and ideology of financial stability are key to evaluating output legitimacy.

Codifying Economic Ideologic Into Law' in Eva Nanopoulos and Fotis Vergis (eds), The Crisis Beyond the Euro-Crisis: The Euro-Crisis as a Multi-Dimensional Systemic Crisis of the EU (CUP 2019).

[8] See eg, Kaarlo Tuori, *European Constitutionalism* (CUP 2015) Chapters 5 & 6; Joseph H H Weiler, 'In the Face of Crisis: Input Legitimacy, Output Legitimacy and the Political Messianism of European Integration' [2012] 34(7) *Journal of European Integration* 825.

[9] This is consistent with Scharpf's definition of output legitimacy, which incoroporates input and other considerations such as the connection between economic policy and social welfare. See Fritz W Scharpf, 'Monetary Union, Fiscal Crisis and the Disabling of Democratic Accountability' in Armin Schäfer and Wolfgang Streeck (eds) *Politics in the Age of Austerity* (Polity Press 2014).

Note can also be made of throughput legitimacy.[10] This concept highlights issues of process, such as governance, accountability, and transparency. While some authors present this as a separate type of legitimacy, I explain that throughputs are a necessary operational element of financial stability and relevant to assessing output legitimacy. Relevant to the goal of minimising social costs is the need for *ex post* accountability over the medium- and long-term, as the effects of financial stability are inherently unpredictable and prone to regulatory capture. Therefore, the throughput dimension can be seen as a further operational element of the teleology of financial stability.

Policy implications: substantive tools, institutional reform, fiscal & financing measures

On the basis that output legitimacy is not solely a question of functionalist performance, but is instead determined by the extent to which policy is aligned with the teleology of financial stability, this thesis investigates a range of reforms connected to this objective. Three areas are distinguished: prudential and resolution policy in the banking sector, the institutional reforms of the ESFS and the Banking Union, and extraordinary fiscal and financing measures in the EMU.

The reform of financial regulation and supervision, as well as bank recovery and resolution, largely coincides with the teleology explored previously. First, there is a clear ideological shift in regulation as a result of financial stability emerging as a supranational objective. The new CRR/CRD rules impose extensive capital, liquidity, corporate governance, and other requirements on credit institutions operating in the EU. Equally, the BRRD establishes comprehensive recovery planning, early intervention, and resolution procedures for ailing banks. This framework represents an unprecedented shift away from market access and liberalisation in the internal market. From an ideological viewpoint, financial stability qualifies the goal of market integration, which can only be seen as enhancing output legitimacy.

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[10] Vivien A Schmidt, Europe's Crisis of Legitimacy: Governing by Rules and Ruling by Numbers in the Eurozone (OUP 2020) 25-55.

More importantly, the second wave of reforms in this area (CRR II/CRD V & BRRD II) takes significant steps in correcting the initial one-size-fits-all transposition of Basel rules, which contradicted the teleology of financial stability. For example, the application of capital and other requirements to all credit institutions irrespective of size or risk profile created put SMEs at a disadvantage. SMEs are not important in pursuing various social policy goals, but they are also better positioned to contribute to financial stability than systemic institutions.[11] The new rules are based on the sector-specific principle of proportionality, which allows differentiation between firms based on their size and complexity. The application of proportionality is a positive step towards minimising the social costs of policy and sets an example of how policy can be aligned with the non-economic utility of financial stability. There are other examples of differentiation in the new regime, such as a range of EU-specific exceptions from Basel.[12] It should be noted that this framework introduces equal pay and other corporate governance rules that extend beyond a purely economic rationale.

While the assessment of prudential and resolution tools is overall positive, challenges remain in macroprudential policy, the main means of operationalising financial stability. The biggest challenge is that asset-based tools are not harmonised. These instruments, which alter the conditions of loans as opposed to bank capital, are popular due to their direct and immediate impact on financial stability.[13] However, they can exacerbate social inequality by restricting the availability of credit to the unemployed, first-time home buyers, and other vulnerable social groups. Additionally, Member States enjoy considerable discretion in setting macroprudential buffers, especially the systemic risk buffer.[14] Further harmonisation in this area would certainly improve output legitimacy, both in the narrow sense as performance and

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[11] For example, smaller credit institutions are better at screening clients and tend to engage in fewer speculative activities.

[12] For example, leverage ratio exceptions to protect public investment.

[13] Anat Keller, 'The Possible Distributional Effect of the Loan-to-value Ratio and its Use as a Macro-Prudential Tool by the European Systemic Risk Board' (2013) 28(7) *Journal of International Banking Law Review* 266.

[14] Note recent improvements. These are explored in Chapter 4.

in relation to the non-economic dimension.[15] Other challenges identified in this area include the use of voluntary (and mandatory) reciprocity in cross-border situations, and the bail-in tool as part of the EU's bank resolution policy.[16] These should be seen as opportunities for future reform, but they do not invalidate the significant improvements made by the CRR II/CRD V and BRRD II.

Institutional reforms are more concerning. The key issue in relation to the ESFS and the Banking Union is the 'agencification' of EU law, a topic exhaustively covered in the literature, but mainly from the perspective of legality. In terms of legitimacy, the emergence of expert financial stability agencies with extensive (hard law and soft law) powers could be consistent with the ideological shift explained above. However, contrary to substantive reforms that establish an entirely new toolkit of measures which qualify market integration, the creation of expert agencies replaces national competences and restricts supranational political leadership in financial stability. As such, these vertical and horizontal shifts in power perpetuate the economic functionalism of integration, and defy the ideological change discussed previously.[17] This can also be linked to the throughput dimension: agencification diminishes the scope for cross-institutional accountability, which impairs the EU's ability to balance the economic and non-economic dimensions of financial stability.

Beyond agencification as an overarching challenge, inconsistencies between policy and teleology can be observed in relation to individual agencies. For example, the many compromises in the Banking Union have resulted in a system that supports the economic side of financial stability, mainly through SSM supervision, but which lacks essential operational

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[15] While harmonisation may also restrict Member States ability to minimise social costs, the current challenge is that these tools can be overused due to their granular nature.

[16] On bail-ins generally, see Emilios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-ins' [2015] 1(1) *Journal of Financial Regulation* 3.

[17] Michelle Everson, 'Banking on Union: EU Governance Between Risk and Uncertainty' in Mark Dawson, Henrik Enderlein and Christian Joerges C (eds) *Beyond the Crisis The Governance of Europe's Economic, Political and Legal Transformation* (OUP 2015).

elements of non-economic utility, such as deposit insurance. The Banking Union also complicates the governance and performance of the European Supervisory Authorities, which have a positive track record notwithstanding the broader criticism of agencification. For example, the EBA has been instrumental in introduction of proportionality in the CRR II/CRD V, a vital step in minimising the social costs of policy. Differentiated integration in the euro area significantly limits this agency's potential.[18]

Further, I examine challenges facing the ESRB, such as its vague mandate, its operational reliance on the ECB, and the weak political scrutiny of this body. While the ESRB may not be as significant from a constitutional perspective as the Banking Union or the ESAs, its expert role in macroprudential policy implies an immediate connection to financial stability. In sum, the institutional dimension is concerning, and future reforms should prioritise expanding crisis management and political accountability; both are intimately tied to the non-economic utility of financial stability.

The final case study investigates the output legitimacy of fiscal and financing measures in the EMU. As regards fiscal reform, it should be noted that fiscal sustainability is not synonymous with financial stability, but there is a strong, two-way interaction between the two.[19] My analysis of fiscal measures is mainly intended to set the scene for evaluating financing assistance, but brief observations can be made. There is a distinct threat to accountability emerging from the intergovernmentalism of fiscal reform and other developments, such as the use of "reverse" qualified majority voting in key macroeconomic procedures.[20] Other challenges include the rigidity of the current surveillance model, which generates inequalities

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[18] On differentiated integration, see Alexander C G Stubb, 'A Categorization of Differentiated Integration' [1996] 34(2) *Journal of Common Market Studies* 283.

[19] See Virgilijus Rutkauskas, 'Financial Stability, Fiscal Sustainability and Changes in Debt Structure After Economic Downturn' [2015] 94(3) *Ekonomika* 70.

[20] See Chapter 6.

and other asymmetric effects.[21] These challenges impact on the output legitimacy of financial stability, directly or indirectly. For instance, the emphasis on fiscal consolidation impedes the goal of minimising social costs, as the COVID-19 pandemic and the (temporary) suspension of budgetary limits has shown.[22]

The most problematic area of EU financial stability is financing assistance in the euro area, and specifically the case law of the Court on bailouts and bail-ins. In *Pringle*, the Court puts forward an interpretation of financial stability as a 'higher' objective of EU law to reconcile international law financing assistance with the "no-bailout" clause in Art 125(1) TFEU.[23] In addition, the Court suggests that this type of financial stability measure is only compatible with EU law if accompanied by 'strict conditionality', or far-reaching austerity reforms aimed at safeguarding the objective of budgetary discipline in the Treaties. Both aspects of this judgment are incompatible with the teleology of financial stability. First, the higher-order status of financial stability denotes a subordination of other objectives to the functionalist rationale of preventing the next crisis, which ignores the need to minimise the social costs of financial stability. Second, by attaching strict conditionality to the 'higher' goal of financial stability, the Court achieves a constitutionalisation of austerity which prevents any balancing of the economic and non-economic sides of financial stability. The reasoning of the Court in *Pringle* poses a major threat to output legitimacy.

Even more alarming is the ensuing case law on financing assistance. The most important case is *Ledra Advertising*, examining the legality of the Cypriot bail-in.[24] This judgment is widely praised for extending the application of the Charter of Fundamental Rights to the

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[21] Alicia Hinarejos, 'Fiscal Federalism in the European Union: Evolution and Future Choices for EMU' [2013] 50(6) *Common Market Law Review* 1621; Federico Fabbrini, 'The Fiscal Compact, the "Golden Rule," and the Paradox of European Federalism' [2013] 36(1) *Boston College International & Comparative Law Rev* 1.

[22] Note the EU's response to suspend budgetary limits (twice), and to authorise an enormous support package.

[23] *Pringle* (C-370/12) ECLI:EU:C:2012:756, paragraph 135.

[24] *Ledra Advertising* (C-8/15) ECLI:EU:C:2016:701.

participation of EU institutions in international agreements.[25] However, the novelty of this case is strongly exaggerated; beyond the issue of admissibility, the substantive review of financial stability measures in *Ledra* is exceedingly deferential. In particular, the Court's application of proportionality and human rights is intertwined, and centres on the urgency of the crisis and the expertise of the ECB and the Commission. While judicial deference is generally the norm in times of crisis, it is especially concerning that the Court fails to distinguish between types of individuals affected by the bail-in, as it had in previous case law.[26] The failure to differentiate between ordinary depositors, whose life-savings, pensions, and estates were trimmed, and risk-assuming investors who have the resources and know-how to spread their losses, is totally at odds with the teleology of financial stability. *Ledra* supports a version of financial stability that is virtually unlimited and exclusively predicated on economic performance.

This finding extends to subsequent case law. The conventional view is that the Court has gradually expanded its jurisdiction to review different types of bailout measures. I have explained that *Florescu*, the main example used in the literature, is an exceptional judgment which does not extend to post-crisis financial stability measures. Indeed, *Florescu* concerned macroeconomic reforms pursued *within* EU law, and preceding the Treaty of Lisbon. On the contrary, judgments such as *Chrysostomides*, which confirms that the 'informal' role of the Eurogroup in financing assistance is not subject to judicial review, further demonstrate the Court's reluctance to exercise meaningful accountability in the field of financial stability. As *ex post* accountability is a vital operational element of the teleology explored in this thesis, the case law represents the biggest threat to output legitimacy in the field of financial stability.

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[25] For a nuanced perspective, see Alicia Hinarejos, 'Bailouts, Borrowed Institutions, and Judicial Review: Ledra Advertising' (EU Law Analysis, 2016) <eulawanalysis.blogspot.co.uk/2016/09/bailouts-borrowed-institutions-and.html> accessed 23 April 2020.

[26] Eg, *Kotnik* (C-526/14) ECLI:EU:C:2016:570.

Aligning policy and teleology: precaution and the role of judicial review

While the main aim of this dissertation was to provide a conceptualisation of financial stability and output legitimacy that extends beyond the dominant economic narrative in European law, I briefly examine solutions to the challenges identified above. The emphasis of these proposals is on the role and intensity of judicial review in financial stability, but the precautionary principle is also addressed as an emerging orthodoxy in the literature on the non-economic effects of financial stability. It should be emphasised that these are not the only possible ways to align policy with the teleology of financial stability. In particular, many of the issues identified in relation to the institutional dimension can only be resolved with political accountability.

Starting with the precautionary principle, this approach is mainly used in environmental and public health regulation, which similarly to financial stability deal with inherent uncertainty and complexity. Authors, mainly in the US, put forward the precautionary principle as an alternative to 'cost-benefit' analysis in financial regulation and supervision; it is believed that the precautionary approach can capture the unquantifiable effects of policy on human life.[27] Broadly, the principle authorises pre-emptive action even when scientific evidence is incomplete, but it imposes additional *ex ante* and *ex post* conditions to minimise social costs and ensure effectiveness over the long-term.

My overall finding is that the precautionary principle cannot resolve the challenges of financial stability in EU law. First, the principle is specifically designed to correct issues in regulation, but this is the least problematic area of EU financial stability. Further, it is difficult to conceive of a version of precaution that would address institutional and constitutional challenges in the euro area. Second, the use of the precautionary principle in other areas of EU law is considered exceedingly deferential and ineffective. Nevertheless, analysis of the precautionary principle reveals the importance of *ex post* review in other fields

[27] For a rare EU perspective, see Aerdt Houben, 'Aligning Macro- and Microprudential Supervision' in Joanne A Kellermann, Jakob de Haan and Femke de Vries (eds), *Financial Supervision in the 21st Century* (Springer 2013), 209.

dealing with Knightian uncertainty. Similarly to environmental and public health regulation, the task of balancing the economic and non-economic sides of financial stability should be perceived as an ongoing process.

The above argument leads to my main findings on the role and intensity of judicial review in financial stability. The traditional view is that judicial review ought to be deferential in times of crisis, especially in technical policy fields. This can be linked to the operational independence of expert agencies, who must be insulated from judicial and other pressures. Additionally, judicial empowerment entails many dangers and can be seen as antithetical to democratic (input) legitimacy. A strand of the literature considers that judicial review results in an 'over-constitutionalisation' of law, which entrenches dominant economic and political ideology.[28] Certainly, the case law of the CJEU is intimately tied to the economic functionalism of European integration. Without dismissing these dangers or proposing that judicial review can ever replace political inputs and throughputs, I challenge the logic of judicial deference in financial stability, on the following grounds.

From a constitutional perspective, courts act as 'catalysts' by fostering the language and practice of legitimacy.[29] Importantly, the key challenge in financial stability is one of executive and technocratic dominance; in this context, the Court acts as a 'guardian' of democratic legitimacy.[30] Moreover, judicial deference is inconsistent with the teleology of financial stability. This is not only because of the inherent uncertainty of the financial sector, which as discussed in relation to the precautionary principle necessitates additional 'throughputs', but also because of structural variation and other unique challenges in this field. In some ways, judicial review may be more vital than political accountability, due to

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[28] Dieter Grimm, 'The Democratic Costs of Constitutionalisation: The European Case' [2015] 21(4) *European Law Journal* 460.

[29] Joanne Scott and Susan Sturm, 'Courts as Catalysts: Rethinking the Judicial Role in New Governance' [2007] 13 *Columbia Journal of European Law* 565.

[30] See, on central banks and the argument of 'guarding the guardians', Charles Goodhart and Rosa M Lastra, 'Populism and Central Bank Independence' [2018] 29(1)(3) *Open Economies Review* 49.

the contested politics of financial stability and its potential for regulatory capture.[31] Ultimately, the rise of financial stability in EU law has brought about transformative change, which must be met with extraordinary scrutiny.

Therefore, my proposals focus on the application of proportionality in the Court's case law. Owing to the lack of a doctrine of the 'margin of appreciation' in European law, I examine what proportionality should seek to achieve, as opposed to proposing a "stricter" standard. It is suggested that the general principle of proportionality could draw inspiration from the sector-specific version of proportionality used in prudential policy, which aims to reduce the social costs of financial stability by differentiating between different groups affected by policy. Accordingly, the application of proportionality in the case law of the Court should acts a guarantee of differentiation by policy makers.[32] Support for this approach can be found in exceptional cases, such as *Kotnik*, where the Court distinguishes between ordinary depositors and risk-assuming investors in assessing the proportionality of burden-sharing. This approach is consistent with both a 'soft' and 'partial' margin of appreciation in financial stability, however, cases invoking breaches of human rights may warrant a more intensive standard of review.[33]

A final issue is admissibility. Currently, the jurisdiction of the CJEU is limited due to the intergovernmentalism of the ESM and other measures, as well as the excessive reliance on soft law instruments in the ESFS (and in fiscal policy). In response to this challenge, the literature offers a number of solutions. In particular, I highlight Spaventa's proposal that "hybrid" acts lacking primary law status must be subject to the review of the Court regarding

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[31] Gundbert Scherf, *Financial Stability Policy in the Euro Zone* (Springer Gabler 2013) 120-130.

[32] This can also be linked to the concerns expressed by the German Federal Constitutional Court in the *Weiss* case, which centre around the CJEU's application of proportionality. BVerfG, Judgment of the Second Senate of 5 May 2020, 2 BvR 859/15.

[33] For an overview of the doctrine of the margin of appreciation, see Jan Zglinski, 'The Rise of Deference: The Margin of Appreciation and Decentralised Judicial Review in EU Free Movement Law' [2018] 55(5) *CMLR* 1341.

their compatibility with the Charter of Fundamental Rights.[34] In addition, further harmonisation in macroprudential policy, deposit insurance, and other areas would expand the jurisdiction of the CJEU, but substantive harmonisation must be consistent with the ideology and non-economic utility of financial stability.

8.2 Contributions, limitations, proposals for future research

This research makes several contributions to the scholarship. From a conceptual standpoint, it provides a holistic account of financial stability in EU law which bridges the gap between the literature on financial regulation and public law. With view to overcoming the elusive nature of financial stability, I put forward a teleology (as distinguished from a narrow definition) that incorporates the ideological and non-economic characteristics of a transformative objective. These are underexplored in the literature due to the technical nature of financial stability and the justifiable emphasis on the constitutionality of legal innovations in the euro area. Specifically, a teleological approach challenges the paradigm of economic functionalism, or the chronic subordination of non-economic goals to a market-oriented logic; these insights can be applied to other areas of EU law. From a policy perspective, this teleology is used to evaluate recent and incredibly complex instruments, such as the CRR II/CRD V and BRRD II; the literature on these reforms is very limited.

In addition, this thesis provides a conceptualisation of output legitimacy that extends beyond the dangerous notion that performance or necessity alone can justify extraordinary constitutional change. This can be linked to a phenomenon identified by many authors in the context of the financial crisis, but which is commonly expressed through diverse and conflicting terminology: examples include ‘political messianism’, ‘executive federalism’, ‘authoritarian managerialism’. My definition of output legitimacy offers the advantage of a neutral approach that does not treat technocratic governance as exceptional, but which still captures the many challenges emerging from this phenomenon.

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[34] Eleanor Spaventa, ‘Constitutional Creativity or Constitutional Deception? Acts of the Member States Acting Collectively and Jurisdiction of the Court of Justice’ [2021] 58(6) *CMLR* 1697.

As part of this conceptualisation, I challenge further misconceptions on the role of judicial review in technical policy fields. Whereas the literature covers regulatory and political solutions to Europe's perceived crisis of legitimacy, judicial review is often dismissed as a potential threat to democratic legitimacy and the operational independence of expert policy makers. However, I demonstrate that judicial review is intrinsically connected to output and throughput legitimacy, and a vital operational component of the teleology of financial stability. Further proposals are made on the meaning and application of proportionality in this field.

The limitations of this research are as follows. First, while the crisis theme is prevalent in my writing, I do not presume to understand the full intricacies of each crisis that has occurred in the last decade. The COVID-19 pandemic is referenced only in relation to specific prudential and fiscal measures that showcase the success or failure of financial stability reforms. Equally, the origins of the financial crisis and the global shift towards financial stability are only briefly addressed in the context of prudential policy. The actions of international and national actors during the financial crisis are beyond the scope of this research, with very few exceptions (such as the Basel Committee).

Second, the focus of this dissertation is exclusively on financial stability in EU law. There is an abundance of literature on the economic and political dimension of financial stability; while the insights of important authors such as Keynes and Minsky are addressed, analysis of the economic and political dimension is not intended to be comprehensive. For example, I do not explore social pluralism, an important concept that can be tied to the non-economic utility of financial stability. In addition, the foundations of the concept of legitimacy in political philosophy are only briefly mentioned.

Third, due to the wide scope and flexible definition of financial stability, my dissertation adopts a broad perspective that touches on many areas of European law and policy. Some of these topics warrant further examination: the precautionary principle is a good example. Importantly, I do not elaborate on the overall economic and political ideology of the European Union beyond the narrow shift away from laissez-faire liberalism in the financial market. Moreover, my thesis does not seek to answer broader questions on the role of

political accountability, or on the many constitutional challenges in the EMU. The ideological and constitutional dimensions are exhaustively covered in the existing scholarship.

Finally, the present research offers opportunities for further research into the evolution of financial stability in EU law and in other jurisdictions. Perhaps the most urgent line of enquiry concerns the impact of the COVID-19 pandemic and the crisis in Ukraine on prudential and other policies. This can also encompass the incremental incorporation of intergovernmental agreements (such as the Fiscal Compact) into EU law, as well as efforts to complete the Banking Union and the Capital Markets Union. Primarily, there is a need for a detailed investigation into the relationship between financial stability and market integration. It would also be worthwhile to conduct comparative analysis of the teleology of financial stability in the UK, the US, and internationally.

It has been demonstrated that there is an incomplete understanding of both financial stability and output legitimacy, which threatens the legitimacy of EU law. To the effect of improving output legitimacy, this thesis has argued in favour of a teleological interpretation of financial stability that incorporates ideological and non-economic considerations. On an operational level, this teleology supports differentiation between the social groups affected by policy and a level of judicial empowerment to protect such differentiation. Ultimately, the response to the challenge of output legitimacy must encompass regulatory and political solutions.

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