



# University of Reading

## **ECB Monetary Policy and Supervisory Powers: Competing Objectives and Policy Conflicts**

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## **Declaration of original authorship**

‘Declaration: I confirm that this is my own work and the use of all material from other sources has been properly and fully acknowledged.’

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## Abstract

The intertwined relationship between the objectives of banking supervision and monetary policy remained for a long-time part of a rather theoretical debate. It took a major GFC for the policymakers to realise that there were gaps in the existing regulatory and supervisory framework, which subsequently opened the way for the central banks' involvement in both micro- and macro-prudential supervision at international and EU level. Prior to the 2007-2009 financial crisis, the optimal model of central banking governance and institutional framework at both international and EU level, focused on monetary policy objectives. Part of the same orthodoxy was the prominence given to central bank independence and to institutional arrangements focused primarily on inflation targeting. The European Central Bank (ECB), being a creature of its time, was designed as a purely monetary-stability-oriented central bank and was also granted a high level of independence. However, housing monetary policy and banking supervision under the ECB's roof, has radically changed its role and the balance between existing and new powers within the EU banking framework. To this end, this thesis critically examines the centralisation of banking supervision in the EU, by exploring the nexus between monetary policy and banking supervision, and the compatibility of their combination within the existing legislative framework. Having examined the historical context of the debate, recent developments and underlying policy concerns in the pre- and post- Great Financial Crisis (GFC) era, this thesis concludes that the conferral of supervisory tasks on ECB has created a complex system of cooperation between national and supranational level, and between existing and newly established tasks and objectives. This has resulted in stretching the role of ECB beyond its original mandate as set by EU primary law, exceeding the wording of Article 127(6), TFEU. Therefore, drawing on the particular synergies involved, this thesis suggests that the only avenue in transforming the ECB into a truly supranational supervisor with full discretion, is the amendment of the Treaty and the empowered of the ECB with direct supervisory powers.

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## Introduction

### Motivation, contribution and objectives of the thesis

Examining the role of central banks has become a key tool in understanding modern financial markets. Traditionally, maintaining financial stability was a primary objective of central banks. However, the primacy given to central bank independence in the late 1970s and the banks' increasing role in pursuing the goal of price stability, consolidated their place as monetary authorities. This resulted in central banks having a narrow mandate, mainly focused on inflation targeting as the means to achieve price stability.<sup>1</sup> Part of the same orthodoxy was a strict separation between central banks' monetary policy objectives and their responsibility for banking supervision. Yet, even when the mandate of central banks was aiming solely at maintaining stable inflation, they still played a crucial role in the financial stability domain as soon as a financial crisis occurred. As Tommaso Padoa-Schioppa stated, financial stability has been always part of the "genetic code" of central banks.<sup>2</sup> This is to be attributed to the ability of central banks to act as "lender of last resort" and their liquidity management duties, making them a dominant player in preventing and managing systemic banking crises. To this end, central banks are considered to be the best-suited institutions to perform supervision tasks.<sup>3</sup>

The intertwined relationship between the objectives of banking supervision and monetary policy remained for a long time only part of a rather theoretical debate. It took a major GFC for the policymakers to acknowledge the gaps of the existing regulatory and supervisory framework, which in turn, opened the way for the central banks' involvement in

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<sup>1</sup> Angelini, Paolo, Neri, Stefano, Panetta, Fabio, 'Monetary and Macroprudential Policies' (ECB, Working Paper Series No 1449, July 2012) <<https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1449.pdf?b61cbb31d8b42f7c125bde5332c95005>> accessed 14 July 2017.

<sup>2</sup> Padoa-Schioppa, Tommaso, 'Central Banks and Financial Stability: Exploring a Land in Between' (Second ECB Central Banking Conference, "The transformation of the European financial system," Frankfurt am Main, 24 and 25 October 2002), 6 <<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.137.2584&rep=rep1&type=pdf>> accessed 14 July 2017.

<sup>3</sup> Cœuré, Benoît, 'Monetary Policy and Banking Supervision: The history of central banks and the European banking union' (Speech by a Member of the Executive Board of the ECB at the Symposium: "Central Banking: Where Are We Headed?" in honour of Stefan Gerlach's contribution to the Institute for Monetary and Financial Stability, Goethe University, Frankfurt, 7 February 2013) <<http://www.ecb.int/press/key/date/2013/html/sp130207.en.html>> accessed 14 July 2017.

banking supervision. Namely, the financial crisis 2007-2009 or the Great Financial Crisis (Great Financial Crisis) brought the importance of the financial stability mandate of central banks back to the fore and placed emphasis on the need to strengthen macro-prudential supervision and regulation. To this end, macro-prudential supervision attracted attention, especially in the aftermath of the Lehman Brother's collapse in 2008.<sup>4</sup> As a result, policymakers at both national and international levels, laid emphasis on the need for a drastic regulatory change that would strengthen central banks' role in both micro- and macro-prudential supervision, while maintaining at the same time, a balance between the objectives of financial stability and price stability. At EU level, the regulatory response to the financial crisis focused primarily on reshaping the supervisory architecture, while the role of the supranational central bank, i.e. European Central Bank (hereinafter: ECB), was becoming progressively involved in banking oversight.

The ECB, since its establishment by the Maastricht Treaty, was conceived as a pure monetary authority, with its mandate being solely focused on maintaining price stability. This was considered to be adequate in safeguarding the stability of the financial system as a whole. The ECB was designed on the German Bundesbank model of one authority, one objective and one main instrument, which was based on the Tinbergen rule. In addition, in pursuing its mandate, the ECB was given a highly independent status, aiming to shield its functioning from any external interference. Thus, the institutional framework, the governance structure and the legal basis of the ECB's mandate, were all designed in facilitating the functioning of an independent monetary authority that was entrusted with the sole mandate of price stability, attained through an inflation targeting regime and a clear separation between monetary policy and banking supervision objectives. This is evident from the wording of the Treaty provisions, which offer primacy to the price stability mandate and to the bank's independence. As a result, the ECB's role in banking supervision remained limited, while, one could argue that its financial stability mandate was neglected.

Nevertheless, as mentioned above, the GFC challenged the existing conventional view and triggered the need for change in the European Union (hereinafter: EU) regulatory and supervisory frameworks. Starting with the De Larosière Report and the plethora of legislative

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<sup>4</sup> Hofmann, Christian, 'Stabilizing the financial sector' (2012) 8 (4) European Review of Contract Law 426.

reforms to follow, EU financial market regulation and supervision entered an era of change that led to a significant expansion of the ECB's role; an expansion that was moving beyond its envisioned mandate. This stretching of the ECB's mandate reached momentum with the establishment of the first pillar of European Banking Union, the Single Supervisory Mechanism (hereinafter: SSM) in the late 2012, which transformed the ECB into the supranational banking supervision authority for the Eurozone financial institutions. This official assignment of supervisory powers to the ECB, has been appraised as the most significant restructuring of central banking architecture in the EU. Thus, it is hardly surprising that this radical regulatory reform was accompanied by an extremely extensive debate in relation to the controversies, synergies and conflict of interest involved.

This debate has been through a variety of disciplines, which is a result of the complex implications of the ECB's changing responsibilities in various fields, including economic, social, political and legal. In the legal context, where the focus of this thesis lays, one of the most debated topics is whether the newly established supervisory tasks of the ECB are compatible with its monetary policy mandate. This is particularly important given the clear hierarchy provided by Treaty provisions to the ECB's objectives and its exclusion from assuming supervisory tasks when they do not classify as 'specific.'<sup>5</sup> It is therefore questionable how the same Treaty provisions designed to facilitate the functioning of a 'pure' monetary policy authority, provided an adequate legal basis for the subsequent stretching of the ECB's mandate to supervision and how they delineate the exact limits of the 'specificity' of supervisory tasks. In addition, ECB involvement in banking supervision raises fundamental questions regarding its independence and a possible conflict of interest with its existing price stability mandate. This emphasises further the urgent need to address the question of whether the marrying of banking supervision and monetary policy under the ECB's umbrella could be adequately addressed only via considering the possibility of Treaty amendment. Thus, this thesis seeks to examine the changing role of the ECB by addressing the question: "Does the marrying of the objectives of monetary policy and banking supervision under the ECB's umbrella, in its current legislative framework, exceed the wording of EU Treaties provisions?"

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<sup>5</sup> 'Consolidated version of the Treaty on the Functioning of the European Union' [2012] OJ C 326/47 (hereinafter: TFEU) Article 127(6).

In answering this question, this thesis makes a distinct contribution to EU financial regulation and supervision literature by critically examining the evolving role of the ECB, including the legitimacy of its mandate in the context of both the pre- and post-financial crisis regulatory framework. To this end, having highlighted the importance of the topic and laid out the main research question, the aim of this thesis is to critically assess the new role of the ECB in respect to banking supervision, while taking into consideration current developments and the evolution of existing policy frameworks. In particular, the main focus of the thesis is to address the nexus between the respective objectives of monetary policy and banking supervision, while exploring the synergies involved as a result of their combination within the same monetary authority (i.e. the ECB) which operates on a price stability oriented monetary policy regime.

It should be noted that there has been significant coverage in the literature regarding the conflict of interest between monetary policies and banking supervision objectives, especially during the early 1990's, but it involved mainly studies concerned with particular jurisdictions or comparative studies between various jurisdictions, focused on the economic implications. The relevant debate seemed to have faded during the era of central banking independence prominence, to only re-emerge again as a result of the increased involvement of central banks in banking supervision in the aftermath of the GFC. This thesis focuses on the legal perspectives of the debate, while providing a comprehensive analysis of the evolving nature of the ECB's role on pursuing both monetary policy and banking supervision objectives, by identifying at the same time the gaps of a newly formulated regulatory and supervisory architecture that lays at the heart of a unique regional formation, the EU.

The all-around analysis of the changing role of the ECB, adds to the existing literature by identifying the legal constraints arising as a result of the combination of monetary policy and banking supervision objectives under the ECB's remit. The critical analysis of this topic, especially of the legitimacy of the decision to centralise banking supervision at EU level, based on the existing Treaty provisions, offers an original legal point of view. As the topic has significant economic ramifications, the financial issues in conjunction with economic theories are consulted to the extent that help to support the legal argument. An additional contribution of this research can be located on the fact that although there are several publications that analyse the various aspects of banking supervision centralisation at EU level,

the later remains work in progress, with the question of legitimacy and the possibility of Treaty amendment being highly controversial, and barely addressed. Therefore, this thesis aims to enrich the literature in regard to the ECB's involvement in supervision during this most critical period for Europe, when most of the Banking Union project is still 'under construction.' In addition, the ECB, being a creature of its time, represents the greatest illustration of a central banking institutional design that was highly based on the views of a school of macro-economic thought, which for a long period of time influenced the policymaking agenda at national, regional and international level. Thus, the legal considerations of loopholes during the evolution process of the ECB's role, could equally apply to similar monetary policy regimes in other jurisdictions. The areas of study are chiefly based on the EU Law, EU Banking Law and Financial Regulation, and European Common Market Law.

### **Outline method/approach**

The methodical approach of this thesis, builds on the realisation that the recent financial crisis has led to a radical re-evaluation of existing approaches to financial regulation, systemic stability and monetary policy. Methodology can be defined as the 'branch of knowledge' concerned with method, where method is viewed as a special form of procedure or characteristic set of procedures employed (more or less systematically) in an intellectual discipline or field of study as a mode of investigation and inquiry, or of teaching and exposition.<sup>6</sup> Legal research is often described as doctrinal, in the sense that one conducts research into the law and legal concepts.<sup>7</sup>

On the field of this current research, one has to admit that up until 2008, legal theory was only of secondary importance to international financial law. For this reason, a mere doctrinal approach is insufficient in explaining the concepts involved. Neoclassical economic theory, which offered the explanatory background of global financial regulation, was considered to be adequate in informing policy as explained further in this work. Moreover, mainstream debate (meaning research not challenging the bases of global capitalism) was formulated and directed towards answering questions of efficiency and social welfare.

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<sup>6</sup> Fisher, Elizabeth, Lange, Bettina, Scotford, Eloise and Carlarne, Cinnamon, 'Maturity and Methodology: Starting a Debate about Environmental Law Scholarship' (2009) 21 (2) *Journal of Environmental Law* 213, 226.

<sup>7</sup> Manderson, Desmond and Mohr, Richard, 'From Oxymoron to Intersection: An Epidemiology of Legal Research, *Law Text Culture*' (2002) 6 (1) *Law Text Culture* 159, 159.

However, the aftermath of the GFC brought into the surface the so-called: “macro-prudential issues”<sup>8</sup> and raised awareness of what is now understood as systemic risk, calling for global cooperation and coordination. In addressing these themes, a broader involvement of legal theory is needed, as mere neoclassical assumptions no longer suffice.

This research area is highly topical, as there are numerous contemporary changes to the financial sector and new theoretical approaches are being developed. For this reason, this research attempts to provide a holistic assessment of the role of the ECB, by evaluating its role in supervision and monetary policy making. The main framework for analysis is law and economics,<sup>9</sup> articulated on a multi-dimensional level,<sup>10</sup> including European (mainly) and international implications of regulation. The analysis will consider the historical, political and socio-economic implications within these levels, in order to explain the background of legally based policy-making responses. This ‘law and economics’ approach<sup>11</sup> is used in presenting recent developments seeking to tease out the dynamic between legal changes, economic effects, policy reactions.

In discussing regulatory reform therefore, it is imperative to recognise that the regulation of the economy is not just a matter for law and economics. Regulatory interventions, or the lack thereof, can have severe consequences on the political economy of a state and changing popular perceptions of the functions of law can have direct effects on the democratic legitimacy of institutions.<sup>12</sup> For this reason, in conducting this research, a socio-legal approach will be included in analysing national and international institutional settings before and after the crisis. A ‘socio-legal’ methodology,<sup>13</sup> focuses on the links between legal frameworks and the evolution of social and political norms. Legal developments as well as the influence of international financial regulation to the European regulatory framework before and after the crisis are examined both against their socio-economic origins and as to their socio-legal effects.

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<sup>8</sup> Prasad, Eswar, ‘Financial Sector Regulation and Reforms in Emerging Markets: An Overview’ in Kawai, Masahiro and Prasad, Eswar (eds) *Financial Sector Reforms in Emerging Markets* (Brookings Institution Press, Asian Development Bank 2011) 3.

<sup>9</sup> Marciano, Alain (ed), *Law and Economics A Reader* (Routledge 2009).

<sup>10</sup> Palmer, Vernon Valentine, ‘From Leretholi to Lando: Some Examples of Comparative Law Methodology’ (2005) 53 (1) *The American Journal of Comparative Law* 261.

<sup>11</sup> Posner, Richard, *Economic Analysis of Law* (9th edn, Wolters Kluwer Law & Business 2014).

<sup>12</sup> Glinavos, Ioannis, *Redefining the Market-State Relationship* (Routledge 2013) 57.

<sup>13</sup> Perry-Kessaris, Amanda, *Socio-Legal Approaches to International Economic Law* (Routledge 2013).

Despite the fact, that methodologically this research project is mainly focused on law and economics, this does not constitute a limitation. The thesis is informed by the view that the legal apparatus should not be considered as independent from other fields, but rather interconnected with them. This research stems from the belief that the new EU regulatory framework and the reshaping of the ECB's role constitutes a response to the financial turmoil, which involved financial, social and political consequences in a complex interlinked relationship.

### **The structure of the thesis**

This thesis consists of four chapters. Chapter one starts with a presentation of the history of central banking, and the genesis and evolution of the idea of central bank independence. This is followed by an analysis of institutional evolution in Europe and the early years of the process towards integration at EU level. Here, emphasis is placed on the roadmap towards the establishment of European Monetary Union (hereinafter: EMU) and the creation of the European System of Central Banks (hereinafter: ESCB). This chapter also provides a detailed analysis on the independence of the ECB, as established by the provisions of the Treaty, while also examining its relationship to the notions of transparency, openness and accountability. The study of the existing literature on the history of central bank independence at both EU and international levels aims at providing a comprehensive presentation of the topic, by examining its background in a broader context. Lastly, chapter one outlines the main developments towards the consolidated cooperation of banking supervision at international level, by examining the rationale for the creation of the Basel Committee in Banking Supervision (hereinafter: BCBS) and its evolution. This analysis intends to examine the role of international cooperation in reshaping banking supervisory framework through common practices, and their influence at EU level.

Chapter two is dedicated to the theoretical foundation of the separation principle between the objectives of monetary policy and banking supervision. To this end, the second chapter firstly attempts to define the notion of monetary policy and its evolution from the late 19<sup>th</sup> century onwards. Then the analysis focuses on examining the possible trade-offs arising as a result of the combination of monetary policy and banking supervision objectives. Next, the second chapter offers an initial analysis of the ECB's monetary policy function as set by EU law and the bank's role in financial stability. It should be noted that the examination of

the role of the ECB on monetary policy focuses on the legal implications rather than the economic dimension of the debate. This chapter intends to provide the reader with a comprehensive understanding of the ECB's objectives as set by EU primary law, by also examining the rationale and the legal basis of the ECB's mandate.

Chapter three provides a detailed analysis of the evolution of EU financial services, with a particular focus on banking regulation and supervision. This analysis starts by outlining the early regulatory measures of the process of financial services integration, including the main legislative initiatives. The discussion starts with the Lamfalussy Report, which was the last attempt to reshape the EU regulatory and supervisory architecture in the pre-GFC era. The regulatory response to the GFC at EU level, is addressed in the latter part of chapter three, which focuses on the De Larosière Report and the amendments it made to the architecture of EU banking supervision.

The last chapter examines the centralisation of banking supervision at EU level and the transformation of the ECB to a supranational supervisory authority, which brings us to the core subject of the thesis. Thus, the fourth chapter starts with a critical assessment of the genesis of the idea of banking supervision centralisation at EU level and the rationale of choosing ECB as the supervisor for financial institutions in the Eurozone. This is followed by a thorough exploration of the legal basis for the establishment of the SSM and the scope of the ECB's supervisory mandate. Additionally, given the fact that the expansion of ECB's tasks has not eliminated the role of the National Competent Authorities (hereinafter: NCAs), the division of responsibilities between them and the ECB is also closely examined. The next section of chapter four advances a detailed analysis on the operational structure of the SSM, including the role of existing and new bodies. In addition, the discussion moves into analysing the position of the EU supervisory bodies, including the European Banking Authority (hereinafter: EBA), the college of supervisors and the European Systemic Risk Board (hereinafter: ESRB), within the new supervisory framework and their relationship with the ECB. Then, the discussion focuses on the key theme of this thesis, which concerns the separation principle between the ECB's monetary policy and banking supervision objectives and the underlying legal constraints and policy concerns. Lastly, the final part of chapter four examines how the new role of the ECB in banking supervision has influenced its independence, which also constitutes one of the main issues addressed by this thesis.



It should be noted that banking regulation and supervision, especially after the GFC, is subject to a body of legal measures that undergo constant modifications. This is particularly prominent at EU Level, where the ambitious project of Banking Union remains work in progress, aiming at achieving deeper integration of the euro area banking system through the centralising of banking regulation, supervision and resolution. The state of the law as discussed in this thesis is up to date as of July 2017. The theoretical connotations of this work however will resonate far beyond developments in the year of writing.

## Chapter 1: European and International Central Banking

### 1.1 Introduction

Central banks whether acting as the governments' banks and banknotes issuers (in their early years) or operating as politically independent monetary policy authorities (at a later stage), have always played a key role in supporting the financial and monetary system, and industrial development. Indeed, central banks through their monetary policy,<sup>14</sup> can determine and control the money supply, influence inflation rates, unemployment and economic growth, and affect financial stability and currency exchange rates. Moreover, central banks play a prominent role in the supervision of the financial system, either on their own or in cooperation with other institutions. However, central banks' role, objectives and functioning, have changed as a result of an evolving process, which often reflected the prevailing economic conditions.

The most recent example of an event (or a series of events) that triggered major institutional and legal framework changes in central banking is the GFC. In essence, the crisis brought evidence that challenged existing practices and led to rethinking the role and mandate of central banks. If we were to compare the pre- with the post- crisis environment, it seems fair to say that during the pre-crisis era, conventional wisdom required central banks to operate as monetary authorities, independent from political interference (with price stability as their main goal) and with a defined numerical inflation target and regular

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<sup>14</sup> The notion of monetary policy as well as its changing objectives throughout history it is developed further in chapter two.

adjustment of interest rates (usually the short-term interest rate) as their main policy instrument. In the post-crisis environment, major central banks around the world shifted their focus from price stability to financial stability, with the latter regaining attention and a “priority status” within the set of central banks’ goals.

One of the most debated topics before and after the GFC is the notion central bank independence, the roots of which go back to the period of increased inflation during the 1970s. It was, therefore, unavoidable that inflation targeting<sup>15</sup> and central bank independence became parts of the same debate and often considered to be complementary to each other, and the main actors of what became to be accepted as the optimal monetary policy model. It is worth mentioning here that in order to understand the rationale of inflation targeting, it is necessary to explore the historical evolution of monetary policy objectives. This requires a separate analysis, which is extensively developed in chapter two. This chapter focuses instead on the notion of central bank independence at both international and EU level, and the international cooperation in central banking practices at international level.

There is extensive literature regarding the notion of independence, its conceptualisation and optimal models in both legal and economic literature. Hence, the first section (1.1) of this chapter attempts to situate the rationale of the idea of independence and explains how it has evolved throughout the years. In addition, it is comprised of four sub-sections, with the first two (1.1.1 and 1.1.2) offering a brief historical background on the origins of central banking and the idea of central bank independence respectively. This analysis aims at providing the reader with a better understanding of how central banking started, evolved and has been reshaped, adapting to the needs of an increasingly challenging and complex financial environment. In addition, this is an important introduction to any discussion on central banking, as the initial perception and proposed legal framework of the ECB itself, is historically grounded, and thus, its institutional arrangements were highly influenced by the macroeconomic theories of the time. The following sub-section (1.1.3) advances an analysis on the various meanings of central bank independence. The fourth subsection (1.1.4), examines the interaction between independence, and three other fundamental central banking notions: credibility, accountability and transparency. Lastly, the

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<sup>15</sup> Inflation targeting, including its rationale and definition, is discussed in great detail in chapter two.

first section of chapter one closes with an initial discussion on the contemporary debate concerning central bank independence as reshaped in the aftermath of the GFC.

The second section of chapter one (1.2) offers a background analysis on the institutional evolution in Europe and the process of European integration, from its initial inception in 1957, as a vehicle to promote peace and regulate trade, to its development into the multinational institution we know today. Particular attention is paid to the roadmap towards the establishment of European Monetary Union (EMU) and the creation of the European System of Central Banks (ESCB). This analysis is directly related to the main topic of this thesis, which is the changing role of the ECB. To this end, the four subsections of section two discuss the process of European Integration, starting with the aftermath of World War Two (WWII), continuing with an overview of the creation of the European Monetary System (EMS), and moving on to the subsequent adoption of the Maastricht Treaty, as a milestone in the EU history. The next subsection provides an overview of the creation of the ESCB, its evolving institutional framework and the role of the ECB. This aims at narrowing the discussion on providing an analysis regarding the role of the ECB as Europe's supranational monetary policy authority and the guardian of the single currency.

The third section (1.3) of chapter one focuses on the independence of the ECB, as established by the provisions of the EC Treaty. Special emphasis is placed on the ECB's transparency, communication and accountability. This part serves two purposes: firstly, it links to a great extent with the discussion on the idea of central banking independence, as analysed in section one; and secondly, it provides the basis to the discussion in the following chapters, especially in relation to the analysis of the post-crisis regulatory responses and the expansion of ECB's powers beyond its traditional monetary policy tasks and objectives.

A further aspect (discussed in section 1.4) of European integration is its close relationship with international financial institutions, such as the Bank of International Settlements (BIS), which also provided a forum for European monetary cooperation in its early years. With regard to banking regulation and supervision, BIS hosts the Basel Committee in Banking Supervision (BCBS), which represents the international forum providing permanent cooperation on banking supervision. To this end, the last section of this chapter includes a brief overview of the BCBS's creation, role and evolution throughout the years. This section aims at providing an overview of the international perspective of banking supervision under

the BCBS arrangements, exploring the role of international cooperation in reshaping the banking supervisory framework through common practices. This will allow us to better anticipate the discussion in the coming chapters, especially with respect to the rationale of EU initiatives in banking regulation and supervision, which are directly related to or highly influenced by BCBS recommendations.

## 1.2 The idea of central bank independence: A historical analysis

“The only good Central Bank is the one that can say no to politicians.”<sup>16</sup>

### 1.2.1 A brief historical background of the creation of central banking

The history of central banking, begins around the seventeenth century with the establishment of the Swedish Riksbank in 1668, which is considered to be the first institution with the characteristics of a central bank as we know them today.<sup>17</sup> Riksbank was founded initially as a joint stock company with the mandate of lending funds to the government and the function of the clearing house of commerce, and was also the first bank to issue banknotes in Europe in 1661, before it was taken over by the state in 1668.<sup>18</sup> Not far ahead, comes into being the most well-known central bank of that period, the Bank of England (1694), which was established as a joint stock bank to fulfil governments’ needs, in the same line as its

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<sup>16</sup> The Economist, February 10, 1990, 10 as cited in Eijffinger, Sylvester C. W. and De Haan, Jakob, ‘The Political Economy of Central-Bank Independence’ (Princeton University, Special Papers in International Economics No 19, May 1996) <[https://www.princeton.edu/~ies/IES\\_Special\\_Papers/SP19.pdf](https://www.princeton.edu/~ies/IES_Special_Papers/SP19.pdf)> accessed 14 July 2017.

<sup>17</sup> Pohl, Manfred and Freitag, Sabine (eds.), *Handbook on the History of European Banks: European Association for Banking History* (Edward Elgar for the European Association for Banking History E.V. 1994) 989.

<sup>18</sup> Kindleberger, Charles P., *A Financial History of Western Europe* (George Allen & Unwin 1984) 50.

Swedish predecessor.<sup>19</sup> A number of other central banks were founded in the following years with more or less the same purpose. A typical example is the central bank of France, the Banque de France. The latter was founded by Napoleon during 1800s with the aim of counterbalancing the currency in the aftermath of high inflation caused by excessive money printing during the time of French Revolution, and mainly with the purpose of assisting government's financial needs.<sup>20</sup> It is worth mentioning here, that the father of the idea of a state bank in France was John Law in 1714, whose proposal was rejected in 1715, because it was considered that credit conditions were not auspicious. Regardless, Law built its own private bank in 1717, which consisted of two elements: a system operating in public finance and another one involving the introduction of fiat money.<sup>21</sup> In the US, before the establishment of the Federal Reserve System (the Federal Reserve or the Fed, as it is widely known), there were two failed attempts to create a central bank, one during 1791-1811 and the second one during 1816-1836.<sup>22</sup> The establishment of the Fed came in 1913, as a response of several financial panics in 1907 and in an attempt to restore the soundness of the financial system.<sup>23</sup>

From the brief analysis above, it is obvious that the first central banks were created to enhance the financial power of governments. However, their role as government banks, which intended primarily to address government deficits, has evolved into all-powerful financial institutions supporting the banking system as a whole.<sup>24</sup> The Fed is a representative example of the new generation of central banks of the twentieth century, which were founded either to restore monetary stability and the credibility of their currency system in the aftermath of financial distress, or at a later stage, to manage the gold standard. The changing role and objectives of central banks' monetary policy is addressed both in this

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<sup>19</sup> Bordo, Michael D., 'A Brief History of Central Banks' (Federal Reserve Bank of Cleveland Economic Commentary, 12 January 2007) <<https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/2007-economic-commentaries/ec-20071201-a-brief-history-of-central-banks.aspx>> accessed 14 July 2017.

<sup>20</sup> See: Bordo (n 19).

<sup>21</sup> For further reading regarding fiat money and John Law see: Velde, F., *Government Equity and Money: John Law's System in 1720 France* (Princeton University Press 2008).

<sup>22</sup> Cargill, Thomas F. and O'Driscoll, Gerald P. Jr., 'Measuring Central Bank Independence, Policy Implications, and Federal Reserve Independence' (American Economic Association Meeting, San Diego, January 2012) 6.

<sup>23</sup> The Federal Reserve Bank of Minneapolis, 'Born of a panic: Forming the Federal Reserve System' (1988) The Region <<https://www.minneapolisfed.org/publications/the-region/born-of-a-panic-forming-the-fed-system>> accessed 14 July 2017.

<sup>24</sup> 'Issues in the Governance of Central Banks: A report from the Central Bank Governance Group' ((A report from the Central Bank Governance, BIS, May 2009), 19 <<http://www.bis.org/publ/othp04.pdf>> accessed 14 July 2017.

chapter and in chapter two, from two different scopes. Namely, this chapter provides an initial overview of central banks' role, mainly with regard the idea of central bank independence, and chapter two provides a further assessment of central banks' monetary policy changing objectives. It is worth noting that although the importance of central bank independence has been extensively analysed and there is a vast amount of literature about this topic, it is crucial to consider the historical evolution of the notion of independence and how this links to the current debate.

### 1.2.2 The idea of central bank independence in a historical perspective

Although there are several dimensions of central bank independence, the idea of central bank independence is closely linked with government officials' interests and their responses to political pressures. In addition, the entire concept of central bank independence was founded on the presupposition that the state constitutes an institution formed by a diversity of components that cooperate with each other, yet, compete for the predominance of control and power.<sup>25</sup>

From the beginning of the nineteenth century through to the First World War (WWI), government intervention in monetary and trade affairs was rather reserved, and central banks enjoyed a period of a considerable degree of independence.<sup>26</sup> In the years that followed, from the WWI until the 1970s, governmental intervention took over the financial system. As a result, the majority of central banks were nationalised and operated mainly in line with government's economic plans.<sup>27</sup> During this time span, although there was a desire to untangle central banks' operations from the governmental interference (especially right in the aftermath of WWI), the occurrence of Great Depression in 1930 and the Second World War (WWII) shifted the attention of policymakers into stabilising the financial system.<sup>28</sup> An interesting example of shifting attitudes is the Fed, which originally, was granted a high degree of autonomy, it lost it when the US entered the WWI and then, it regained it when the WWI ended, to only lose it again with the participation of the US in WWII.<sup>29</sup> Also, advocates

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<sup>25</sup> Skocpol, Theda, 'Bringing the State Back In: Strategies of Analysis in Current Research' in Evans, Peter B., Rueschemeyer, Dietrich and Skocpol, Theda (eds), *Bringing the State Back In* (Cambridge University Press 1985).

<sup>26</sup> Capie, F., Fischer, S., Goodhart, C. and Schnadt, N. (eds), *The future of central banking: the tercentenary symposium of the Bank of England* (Cambridge University Press 1994) 49.

<sup>27</sup> Capie et al (n 27) 49.

<sup>28</sup> Capie et al (n 27) 51, 53.

<sup>29</sup> Capie et al (n 27) 53.

of central bank independence often point to the hyperinflation experience of Weimar Germany in the early 1920s and the occurrence of Great Depression in the 1930s. To this end, Germany's success in dealing with inflation was attributed to Germany's central bank independent status.<sup>30</sup>

An influential early advocate of central bank independence, was Milton Friedman, who stated that: *"a central bank should be an independent branch of government coordinate with the legislative, executive and judicial branches, and with its actions subject to interpretation by the judiciary."*<sup>31</sup> However, this view gained widespread acceptance after the world experienced the costly consequences of high inflation rates during the 1970s, which was based on both theoretical and empirical grounds.<sup>32</sup> From a theoretical standpoint, the belief that by having an independent central bank a country is more likely to score lower inflation rates is based in three explanatory theories. According to the "public choice" theory, which focused on the relationship between politics and economics, the monetary policymakers are under considerable political pressure to behave in accordance with government's objectives. Therefore, it was argued that a highly independent central bank would reduce the possibility of governmental intervention and would protect the currency from political pressure to finance deficits.<sup>33</sup>

In the same vein, another explanatory theory of the positive effect of central bank independence on inflation, which was developed originally by Sargent and Wallace in 1981, is based on the difference between fiscal and monetary policy.<sup>34</sup> The authors described two

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<sup>30</sup> See:

- Bibow, Jörg, 'A Post Keynesian Perspective on the Rise of Central Bank Independence: A Dubious Success Story in Monetary Economics' (2010) Levy Economics Institute Working Paper No 625, 7-8 <[http://www.levyinstitute.org/pubs/wp\\_625.pdf](http://www.levyinstitute.org/pubs/wp_625.pdf)> accessed 14 July 2017; and
- Canova, Timothy A., 'Black Swans and Black Elephants in Plain Sight: An Empirical Review of Central Bank Independence' (2011) 14 (2) Chapman Law Review 237, 241 <<https://www.chapman.edu/law/files/publications/review-of-central-bank-independence.pdf>> accessed 14 July 2017.

<sup>31</sup> Friedman, M., 'Should there be an Independent Monetary Authority?' in Yeager, Leland B. (ed) *In Search of a Monetary Constitution* (Harvard University Press 1962) 179.

<sup>32</sup> Cukierman, Alex, 'Central Bank Independence and Policy Results: Theory and Evidence' (Lecture prepared for the International Conference on 'Stability and Economic Growth: The Role of the Central Bank in 2006) <<http://www.tau.ac.il/~alexcuk/pdf/theory%20and%20evidence.pdf>> accessed 14 July 2017.

<sup>33</sup> See Buchanan, James M. and Wagner, Richard E., *Democracy in Deficit: The Political Legacy of Lord Keynes* (Vol 8, Academic Press 1977) 117.

<sup>34</sup> Sargent, Thomas J. and Wallace, Neil, 'Some Unpleasant Monetarist Arithmetic' (1981) 5 (3) Federal Reserve Bank of Minneapolis Quarterly Review <<https://www.minneapolisfed.org/research/qr/qr531.pdf>> accessed 14 July 2017.

coordination scenarios, one where fiscal policy dominates over monetary policy, and another where the latter dominates over the former. In the first scenario, the central bank cannot influence the size of government's deficit, while the quality of money in the economy is determined by the economy alone or endogenously, rather than exogenously or autonomously by an external authority such as a central bank.<sup>35</sup> Simply said, if there is a scenario of unsustainable deficits, the central bank might eventually be forced to inflate prices in order to fund the government's deficit. On the contrary, when the central bank is equipped with the power to operate its monetary policy objectives independently, the fiscal authority will be forced to reduce the deficit. In fact, when monetary policy dominates over fiscal policy, the monetary authority: "*permanently control inflation in a monetarist economy, because it is completely free to choose any path for base money.*"<sup>36</sup> In sum, according to this view, central bank independence enhances a central bank's ability to withstand government pressure to finance government deficits via central bank credit.

The prevailing and most influential explanatory theory on the link between central bank independence and inflation is based in the so-called time-inconsistency theory, as it was initially provided by Kydland and Prescott in 1977,<sup>37</sup> later strengthened by Calvo,<sup>38</sup> and further developed by Barro and Gordon.<sup>39</sup> According to the time-inconsistency theory, monetary policymakers when act under political pressure - which often happens before elections - are more likely to foster short-term output gains that eventually will trigger an increase in inflation rates, and as a result, building up in an inflationary bias. Simply put, what usually happens is that shortly before an election, policymakers are systematically tempted to reduce interest rates in order to increase growth and decrease unemployment rates.<sup>40</sup> This, in the short-run may create a promise of low inflation and may also help the governing party to win

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<sup>35</sup> See Moore, Basil J., *Horizontalists and Verticalists: The Macroeconomics of Credit Money* (Cambridge University Press 1988); Kaldor Nicholas, 'The new monetarism' (1970) 97 *Lloyds Bank Review*; Kaldor, Nicholas, *The Scourge of Monetarism* (Oxford University Press 1982); and Harcourt, Geoffrey and Kriesler, Peter (eds), *The Oxford Handbook of Post-Keynesian Economics, Volume 1: Theory and Origins* (Oxford University Press 2013).

<sup>36</sup> Sargent and Wallace (n 35) 2.

<sup>37</sup> Kydland, Finn E. and Prescott, Edward C., 'Rules Rather than Discretion: The Inconsistency of Optimal Plans' (1977) 85 (3) *The Journal of Political Economy* 473.

<sup>38</sup> Calvo, Guillermo A., 'On the Time Consistency of Optimal Policy in a Monetary Economy' (1978) 46 (6) *The Econometric Society* 1411.

<sup>39</sup> Barro, Robert and Gordon, David B., 'Rules, Discretion and Reputation in a Model of Monetary Policy' (1983) *Journal of Monetary Economics* 101.

<sup>40</sup> Alogoskoufis, George S., Lockwood, Ben and Philippopoulos, Apostolis, 'Wage Inflation, Electoral Uncertainty and the Exchange Rate Regime: Theory and UK Evidence' (1992) 102 *The Economic Journal* 1370.



the elections. However, in the long run, this commitment is usually abandoned, and chances are that it will result in increased inflation without any real output gains. Hence, central bank independence was viewed as a means to mitigate an inflationary bias that may arise under a discretionary policy. The main idea of the time-inconsistency theory is that monetary policy should not focus merely on the short-run trade-off between unemployment and inflation by pursuing expansionary policies. This is based on the belief that this practice would raise the expectation of the private sector about inflation, resulting in higher wages and prices; which in turn, would trigger higher inflation rates, without increasing output. In any case, the optimal monetary policy strategy is time-inconsistent since it cannot be consistently followed in the long-run. It should also be mentioned that this is also a problem of credibility, since a central bank's monetary policy is credible only when it does not suffer from the time-inconsistency problem as described above.<sup>41</sup> The discussion about credibility and how it is influenced by central bank independence will be further developed in the last sub-sections of this part.

Barro and Gordon in 1983 took further the reasoning of the time-inconsistency theory, by providing evidence that discretionary monetary policy would bring to the economy a significant inflationary bias, which in turn, would trigger economic instability.<sup>42</sup> Moreover, Rogoff in 1985,<sup>43</sup> argued that economic variables may fluctuate due to changes in economic policies pursued by the central bank. According to Rogoff, the solution to fluctuations in inflation rates and to the time-inconsistency problem is to grant the central bank a considerable independence in pursuing its tasks. Rogoff also argued that inflationary bias can be reduced by having a central bank, which focuses mainly on its price stability,<sup>44</sup> rather than on concerns of the general public. In the same vein, Neumann in 1991,<sup>45</sup> Lohmann in 1992,<sup>46</sup>

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<sup>41</sup> De Sousa, Pedro A. B., 'Independent and Accountable Central Banks and the European Central Bank' (2001) 5 (9) European Integration online Papers (EIoP), 5 <<http://eiop.or.at/eiop/texte/2001-009a.htm>> accessed 14 July 2017.

<sup>42</sup> Barro and Gordon (n 40).

<sup>43</sup> See: Rogoff, K., 'The Optimal Degree of Commitment to an Intermediate Monetary Target' (1985) 100(4) Quarterly Journal of Economics 1169.

<sup>44</sup> Price stability refers to the economic situation where the general price level does not change significantly over time, in a way that there is no significant degree of inflation or deflation involved. This is further explored in chapter two.

<sup>45</sup> Neumann, Manfred J.M., 'Precommitment by Central Bank Independence' (1991) 2 Open Economic Review 95.

<sup>46</sup> Lohmann, S., 'Optimal Commitment in Monetary Policy: Credibility versus Flexibility' (1992) 82 (1) American Economic Review 273.

and Walsh in 1995,<sup>47</sup> suggested that an independent central bank has the capacity to contribute in decreasing inflation rates. These views formed the theoretical foundation of the time-inconsistency theory, which proved to be highly influential and gained widespread acceptance as the main explanatory approach to the notion of central bank independence and its importance; and to the view that inflation was caused by the state's failure to convince the public about its ability to maintain low inflation.<sup>48</sup> A study arguing against the reasoning of the time-inconsistency as the theoretical basis of independence, was developed by McCallum, who considered it misleading and significantly flawed "*by inappropriate interpretive mappings between analytical constructs and real-world institution.*"<sup>49</sup>

However, empirical studies came to bear out the theoretical consensus on central bank independence as the optimal monetary policy model. Namely, in line with the theoretical debate, the empirical studies brought further evidence that there was an inverse correlation between central bank independence over monetary policy and inflation rates. This evidence was originally brought by the empirical study of Bade and Parkin in 1982,<sup>50</sup> who found that the more independent a country's central bank is, the lower the inflation rates are in the economy. From that point onwards, a Pandora's Box was opened, with a number of empirical studies in the late 1980 and early 1990s reaffirming the negative effect of the political interference on central bank operations and inflation rates.<sup>51</sup> This led to the

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<sup>47</sup> Walsh, Carl E., 'Optimal contracts for central bankers' (1995) 85 (1) American Economic Review 150.

<sup>48</sup> See for instance:

- Blinder, Alan, *Central Banking in Theory and Practice* (MIT Press 1998);
- Eijffinger, Sylvester and Schaling, Eric, 'Central bank independence: Theory and Evidence' (1993) Vol. 1993-25 CentER Discussion Paper <<https://pure.uvt.nl/ws/files/1149960/SCWEEES5621912.pdf>> (accessed on 14 July 2017);
- Schaling, Eric, *Institutions and monetary policy: Credibility, flexibility, and Central Bank Independence* (Edward Elgar Publishing Ltd 1995); and
- Cukierman (n 33).

<sup>49</sup> See: McCallum, Bennett T., 'Two fallacies concerning central-bank independence, (1995) 85 (2) American Economic Review 207, 207.

<sup>50</sup> Bade, R. and Parkin, M., 'Central bank laws and monetary policy' (1982) Unpublished Manuscript, University of Western Ontario.

<sup>51</sup> Major contributions are the following:

- Alesina, Alberto, 'Macroeconomics and Politics' in Fischer, Stanley (ed), *NBER Macroeconomics Annual 1988* (vol. 3, MIT Press 1988), 13 <<http://www.nber.org/chapters/c10951.pdf>> accessed 14 July 2017;
- Alesina, Alberto, Mirrlees, James, and Neumann, Manfred J. M., 'Politics and business cycles in industrial democracies' (1989) 4 (8) Economic Policy 55 <<http://homepage.ntu.edu.tw/~kslin/macro2009/Alesina%201989EP.pdf>> accessed 14 July 2017.
- Alesina, Alberto and Summers, Lawrence H., 'Central Bank Independence and Macroeconomic Performances: Some Comparative Evidence' (1993) 25 (2) Journal of Money, Credit and Banking 151

predominance of inflation-targeting as complementary to central bank independence and as such, the second pillar of optimal monetary policy.

In sum, the late 1980s and 1990s were dominated by a broad consensus about the benefits of having a central bank free of government's influence or any other political intervention.<sup>52</sup> This led to a global trend of enhancing central bank independence, which marked a fundamental institutional shift from previous practices. New Zealand and Chile were the first countries to establish independent central banks – in the modern form – in 1989. In the same year, the Delors Report proposed that the projected ESCB should be granted a high degree of independence,<sup>53</sup> something that was highly reflected in the Maastricht Treaty, as will be analysed at the following section. Subsequently, by the mid-1990s the majority of industrialised as well as developed countries, adopted a legal framework for their central banks, designed to ensure a high level of independence and focused on keeping inflation low.<sup>54</sup> However, the practical implementation of the independent central bank model, was

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<http://www.people.fas.harvard.edu/~iversen/PDFfiles/AlesinaSummers1993.pdf>> accessed 14 July 2017;

- Grilli, V., Masciandaro, D. and Tabellini G., 'Political and Monetary Institutions and Public Financial Policies in the Industrial Countries' (1991) 6 (13) *Economic Policy* 341 <http://www.people.fas.harvard.edu/~iversen/PDFfiles/Grillietal1991.pdf>> accessed 14 July 2017;
- Cukierman, Alex, Webb, S.B. and Neyapti, B., 'Measuring the Independence of Central Banks and Its Effect on Policy Outcomes' (1992) 6 (3) *World Bank Economic Review* 353 [https://www.cedeplar.ufmg.br/economia/disciplinas/ecn933a/crocco/Operacao\\_governanca\\_Bancos\\_Centrais/CUKIERMANAWEBBNEYAPTImeas.pdf](https://www.cedeplar.ufmg.br/economia/disciplinas/ecn933a/crocco/Operacao_governanca_Bancos_Centrais/CUKIERMANAWEBBNEYAPTImeas.pdf)> (accessed on 14 July 2017);
- Cukierman, Alex, *Central Bank Strategy, Credibility and Independence* (MIT Press 1992) Chapter 20;
- Cukierman, Alex, 'The Economics of Central Banking' in Wolf Holger (ed) *Macroeconomic Policy and Financial Systems* (The Macmillan Press 1996);
- Cukierman, Alex, 'Central bank independence and monetary policymaking institutions: Past, present and future' (2008) 24 (4) *European Journal of Political Economy* 722;
- Eijffinger and De Haan (n 16);
- Eijffinger, S. C. W., Schaling, E., & Hoeberichts, M. M., 'Central bank independence: A sensitivity analysis' (1998) 14 (1) *European Journal of Political Economy* 73;
- Walsh, Carl E., *Monetary Theory and Policy* (2nd edn, MIT Press 2003); and
- Dincer, Nergiz, N. and Eichengreen, Barry, 'Central Bank Transparency and Independence: Updates and New Measures' (2014) 10 (1) *International Journal of Central Banking* 189.

<sup>52</sup> See: Dincer and Eichengreen (n 52).

<sup>53</sup> 'Report on economic and monetary union' (Committee for the Study of Economic and Monetary Union chaired by Jacques Delors, 1989) (hereinafter: the Delors Report) 22 [http://ec.europa.eu/economy\\_finance/publications/pages/publication6161\\_en.pdf](http://ec.europa.eu/economy_finance/publications/pages/publication6161_en.pdf)> accessed 14 July 2017.

<sup>54</sup> See: Bibow (n 31).

not an immediate process adopted by all the countries instantly, but a continuous process that entailed a number of factors.<sup>55</sup>

The trend of central bank independence was taking place in parallel with significant changes in the international and European arena. The collapse of the Bretton Woods System<sup>56</sup> and later, the European Monetary System, brought an immense need to adopt new effective frameworks able to safeguard price stability in the long run.<sup>57</sup> Furthermore, the highly independent Bundesbank in Germany,<sup>58</sup> and the Swiss National Bank, and the relatively independent Fed, were considered to have been performing well due to their independent status.<sup>59</sup> Notably, Germany scored first in the list of the countries with lower inflation rates after the post-WWII period. Lastly, it is important to note that the rise of the idea of central bank independence also links with a number of institutional and ideational changes of that era, which came as a result 'globalisation' and the predominance of a policy paradigm associated with the 'Washington Consensus.'<sup>60</sup> The latter was promoted by powerful inter-governmental agencies like the International Monetary Fund (IMF) and the World Bank, and involved a number of 'sound policies' which were considered to improve economic performance, including inter alia opening to trade, financial and commercial liberalisation, judicial reform, privatisation of state enterprises, tax reform, deregulation and reduction of entry barriers. Central bank independence, although was not explicitly included in this list, became a crucial part of it.<sup>61</sup>

However, while there seemed to have been a consensus as to the positive effect of central bank independence in inflation performance, there were also those who questioned

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<sup>55</sup> Keefer, Philip, and Stasavage David, 'When Does Delegation Improve Credibility? Central Bank Independence and the Separation of Powers' (1998) Centre for the Study of African Economies Working Paper WPS/98/18 1 <<http://www.csae.ox.ac.uk/workingpapers/pdfs/9818text.PDF>> accessed 14 July 2017.

<sup>56</sup> The Bretton Woods is discussed in detail in chapter two.

<sup>57</sup> Ivanović, Valentina, 'Financial Independence of Central Bank through the Balance Sheet Prism' (2014) 2 Journal of Central Banking Theory and Practice 37, 39 <<ftp://ftp.repec.org/opt/ReDIF/RePEc/cbk/journal/vol3no2-3.pdf>> accessed 14 July 2017.

<sup>58</sup> For more details of German's Deutsche Bundesbank see: Marsh, David, *The Bundesbank: The Bank That Rules Europe* (Heinemann 1993).

<sup>59</sup> Parkin, M., 'Domestic Monetary Institutions and the Deficit' in Buchanan, M., Rowley, C.X. and Tollison, R.D. (eds), *Deficits* (Basil Blackwell 1987); and Alesina and Summers (n 52).

<sup>60</sup> Williamson, John, 'What Washington Means by Policy Reform' in Williamson, John (ed), *Latin American Adjustment: How Much Has Happened?* (Institute for International Economics 1990).

<sup>61</sup> Fischer, Stanley, 'Central-Bank Independence Revisited' (1995) 85 (2) *The American Economic Review* 201, 201.

the notion of central bank independence and advocated in favour of the negative correlation between central bank independence and inflation performance. For instance, Posen claimed that: “...the causal linkage between central bank independence and low inflation is illusory”, and thus, a higher degree of central bank independence may not necessarily decrease inflation rates.<sup>62</sup> In addition, Bibow, argued that the overriding importance given to independence as a means to controlling inflation rates was: “largely a myth nourished by central bankers to attain and maintain their independence.”<sup>63</sup> In the same vein, Canova believed that: “the Weimar hyperinflation had little to do with the structure of the central bank,” and what caused the financial distress it was rather to be seen as: “the country’s inability to service its huge foreign debt rather than any purported political control of the central bank.”<sup>64</sup>

In addition, there were arguments claiming that there was a negative correlation between low inflation and employment levels. To this end, it was believed that the goal of keeping inflation low and the levels of employment high, creates a trade-off between the two goals. To this end, it was argued that as long as the inflation rate target is achieved, governments tend to prioritise the increase of employment levels, usually, above the natural rate, by utilising the temporary trade-off between unemployment and inflation.<sup>65</sup> This came with the realisation that there was no longer a trade-off between inflation and employment, as estimated by the Phillips curve,<sup>66</sup> and thus, inflation was not considered to influence any long-term real outcomes. On the other hand, there were those who believed that this leads to a counterbalancing effect, since the people understand this behaviour and tend to forecast inflation, which in turn, neutralises inflation’s fluctuations influence on the level of employment.<sup>67</sup>

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<sup>62</sup> Posen, Adam, ‘Why Central Bank Independence does not Cause Low Inflation: There is no Institutional Fix for Politics’ in O’Brien R. (ed) *Finance and the International Economy* (Oxford University Press 1993) 41.

On the same view, see also: Forder, James, ‘On the Assessment and Implementation of “Institutional” Remedies’ (1996) 48 (1) *Oxford Economic Papers*, Oxford University Press 39.

<sup>63</sup> Bibow (n 31) 7.

<sup>64</sup> Canova (n 31) 241.

<sup>65</sup> Fuhrer, Jeffrey, C., ‘Central Bank Independence and Inflation Targeting: Monetary Policy Paradigms for the Next Millennium?’ (1997) 1 (2) *New England Economic Review* 19.

<sup>66</sup> In economics, the Phillips curve describes the relationship between rates of unemployment and the relevant rates of inflation in the economy. A further analysis of the Philips Curve is developed in chapter two of this thesis.

<sup>67</sup> This, also, links with the dominance of the time-inconsistency theory.

Moreover, while there was clear evidence in regard to the negative relation between central bank independence and inflation rates, the relation between central bank independence and growth was subject to debate. Namely, while the study of De Long and Summers,<sup>68</sup> found a positive relation between central bank independence and growth, Grilli et al argued about the opposite: *“If central bank independence is on average associated with lower inflation, there is no systematic impact on real output growth, nor on its variability. Thus, having an independent central bank is almost like having a free lunch; there are benefits but no apparent costs in terms of macroeconomic performances”*.<sup>69</sup> Interestingly, although Alesina and Summers, agreed with the argument that central bank independence has a positive effect on price stability and inflation, they also claimed that there is not any significant evidence found, for justifying a fundamental impact on the real economic performance and growth.<sup>70</sup> In addition, Stiglitz, by bringing the example of the East Asian crisis in the late 1990s, argued that “the Washington consensus fail to provide the right framework for understanding either the success of the East Asian economies or their current troubles.”<sup>71</sup> Namely, Stiglitz opined that although controlling inflation is important to macroeconomic stability, should not be considered as the sole component to achieving the latter.<sup>72</sup> Instead, he argued that the excessive focus on inflation may not help to achieving long-run economic growth;<sup>73</sup> and there were also other indicators of macro-instability, such as competition for instance, that should be considered as equally important.

These counter arguments on the benefits of central bank independence, although emphasised the necessity of having central banks free of political influence, raised important questions as to the optimal model of independence, what the notion itself entailed and how to design a legal framework that would accommodate the highest degree of independence. Even the notion of independence itself was questioned by many, since most of the aforementioned studies that provided evidence regarding the correlation of central bank

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<sup>68</sup> De Long Bradford J. and Summers, Lawrence, ‘Equipment Investment and Economic Growth (1991) 106 (2) The Quarterly Journal of Economics 445.

<sup>69</sup> Grilli et al (n 52) 375.

<sup>70</sup> See: Alesina and Summers (n 52).

<sup>71</sup> Stiglitz, Joseph E., ‘More Instruments and Broader Goals: Moving toward the Post-Washington Consensus’ (The 1998 WIDER Annual Lecture, Helsinki, Finland), 3  
<<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.471.9764&rep=rep1&type=pdf>> accessed 14 July 2017.

<sup>72</sup> Stiglitz (n 72) 5.

<sup>73</sup> Stiglitz (n 72) 8.

independence and growth, employment and most importantly inflation, were criticised of focusing on particular ingredients or forms of central bank independence not being universally applied.<sup>74</sup> The debate against the idea of central bank independence has re-emerged again on the post-GFC era and will be further discussed on the last part of this section. Before this, it is essential to examine the various meanings of central bank independence, which have been defined from the aforementioned theoretical models.

### 1.2.3 The various meanings of central bank independence

The notion of central bank independence, was introduced by David Ricardo in 1824.<sup>75</sup> Although Ricardo did not use the term ‘independence,’ he highlighted the dangers that might occur when elected representatives are entrusted to issue paper money. Ricardo also argued against having central banks to directly financing their governments’ deficits. In Ricardo’s words: *“It is said that Government could not be safely entrusted with the power of issuing paper money; that it would most certainly abuse it; and that, on any occasion when it was pressed for money to carry on a war, it would cease to pay coin, on demand, for its notes; and from that moment the currency would become a forced Government paper. There would, I confess, be great danger of this, if Government-that is to say, the Ministers-were themselves to be entrusted with the power of issuing paper money. But I propose to place this trust in the hands of Commissioners, not removable from their official situation but by a vote of one or both Houses of Parliament. I propose also to prevent all intercourse between these Commissioners and Ministers, by forbidding every species of money transaction between them. The Commissioners should never, on any pretence, lend money to Government, nor be in the slightest degree under its control or influence.”*<sup>76</sup>

For Friedman, who was one of the first to discuss the notion of central bank independence as we know it today, central bank independence concerns the relationship between the central bank and the government. He also compared central bank independence

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<sup>74</sup> For a comprehensive analysis of this reasoning see:

Siklos, Pierre L., ‘No Single Definition of Central Bank Independence is Right for All Countries’ (2008) Department of Economics Wilfrid Laurier University and Viessmann European Research Centre <[https://legacy.wlu.ca/documents/29422/CBI\\_03\\_2008.pdf](https://legacy.wlu.ca/documents/29422/CBI_03_2008.pdf)> accessed 14 July 2017.

<sup>75</sup> Ricardo, David, ‘Plan for the Establishment of a National Bank’ reprinted in McCulloch, J.R. (ed), *The Works of David Ricardo. With a Notice of the Life and Writings of the Author* (John Murray 1888) 506.

<sup>76</sup> Ricardo, David, ‘Plan for the Establishment of a National Bank’ reprinted in McCulloch, J.R. (ed), ‘The Works of David Ricardo. With a Notice of the Life and Writings of the Author’ (1888) John Murray, 506 <<http://oll.libertyfund.org/title/1395/83017>> accessed 14 July 2017.

with the relationship between the judiciary and the government. In Friedman's words: "*The device of an independent central bank embodies the very appealing idea that is essential to prevent monetary policy from being day-to-day plaything at the mercy of every whim of the current political authorities*", and: "...a central bank should be an independent branch of government coordinate with legislative, executive, and judicial branches, and with its actions subject to interpretation by the judiciary."<sup>77</sup>

Subsequently, the whole debate about the various meanings of central bank independence and what is more likely to influence more the level of inflation, focused on the difference between "political" and "economic" independence;<sup>78</sup> which were transformed later into "goal" and "instrument" independence respectively.<sup>79</sup> While the definitions used from different authors vary, "goal independence"<sup>80</sup> is considered to entail an institutional framework that guarantees the freedom of a central bank to determine by its own means the final goals of monetary policy.<sup>81</sup> This kind of independence involves the ability of central bank to decide about its own governors, the length of its mandate, whether or not government elected representatives will sit on the board of the bank, whether government authorisation is needed for monetary policy arrangements and whether price stability constitutes an exclusive responsibility of central bank.<sup>82</sup> To this end, it was believed that when the central bank is given a number of goals (for instance: low and stable inflation along with employment level goals), it benefits from the high degree of goal independence, since it may prioritise the

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<sup>77</sup> Friedman, M., 'Should there be an Independent Monetary Authority?' in Yeager, Leland B. (ed), *In Search of a Monetary Constitution* (Harvard University Press 1962) 188.

<sup>78</sup> The definitions political and economic independence were originally given by Grilli et al (n 52).

<sup>79</sup> For the importance and the difference between the meanings of "goal" and "instrument" independence see:

- Debelle, G. and Fischer S., 'How Independent Should a Central Bank Be?' in Fuhrer Jeffrey C. (ed) 'Goals, Guidelines, and Constraints Facing Monetary Policy-makers' (1994) Federal Reserve Bank of Boston Conference Series No. 38, 195; and
- Fischer, Stanley, 'Central-Bank Independence Revisited' (1995) 85 (2) *The American Economic Review* 201.

<sup>80</sup> "Goal independence" is also used as "institutional independence".

<sup>81</sup> Meyer, Laurence H., 'The Politics of Monetary Policy: Balancing Independence and Accountability' (Remarks at the University of Wisconsin, LaCrosse, Wisconsin, 24 October 2000) <<https://www.federalreserve.gov/boarddocs/speeches/2000/20001024.htm>> accessed 14 July 2017.

Lord Bingham, 'Keynote Address' (Liberty conference, London, 6 June 2009) <[www.liberty-human-rights.org.uk/publications/3-articles-and-speeches/index.shtml](http://www.liberty-human-rights.org.uk/publications/3-articles-and-speeches/index.shtml)> accessed 14 July 2017.

<sup>82</sup> See:

- Schobert, Franziska, 'Linking Financial Soundness and Independence of Central Banks - Central and Eastern Europe, Turkey and CIS Countries' (2006) 20 (2) *Research in International Business and Finance* 239, 243; and
- Eijffinger and De Haan (n 16) 2.



tasks in accordance to their importance each time. To the contrary, when a central bank is assigned only the objective of maintaining the price stability, which is often either too broad or very specific, its discretionary autonomy is likely to be rather limited.<sup>83</sup>

In general, “instrument independence” (which is also known as “functional independence” or “operational independence”), involves the ability of central bank to implement instruments or means in pursuit of the monetary policy goals, without political influence.<sup>84</sup> This type of central bank independence is associated with issues such as funding the government’s needs in a direct or indirect way. If a central bank is financing the government’s debt directly by any means or it requires government approval to implement its instruments, it does not enjoy instrument independence. Put differently, instrument independence refers to monetary policymakers’ ability to regulate central bank’s budgets and the distribution of its profits. This is particularly important because negative results, like deficits, may result in troubling scenarios, such as putting into question central bank’s credibility to reach its goals, which in turn, increases central bank’s vulnerability to political pressure.<sup>85</sup>

However, Debelle and Fischer in 1994,<sup>86</sup> and Fischer in 1995,<sup>87</sup> advocated that instrument independence, i.e. the degree to which the central bank is free to choose its monetary policy instruments, is more important than goal independence in defining inflationary performance.<sup>88</sup> In the same vein, Mishkin supported that having a central bank with a legislated mandate and goal dependence is a basic democratic principle, since: *“the public must be able to exercise control over government actions strongly suggests that the goals of monetary policy should be set by the elected government”* and as a result: *“the institutional commitment to price stability should come from the government in the form of an explicit, legislated mandate for the central bank to pursue price stability as its overriding, long-run goal.”*<sup>89</sup> In any case, as it will be extensively discussed in the next sub-section, central

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<sup>83</sup> Eijffinger and De Haan (n 16) 2.

<sup>84</sup> Meyer (n 82).

<sup>85</sup> Archer, David and Moser-Boehm, Paul, ‘Central bank finances’ (BIS, Paper No 71, 2013) 1 <<http://www.bis.org/publ/bppdf/bispap71.pdf>> accessed 14 July 2017.

<sup>86</sup> Debelle and Fischer (n 80).

<sup>87</sup> Fischer (n 80).

<sup>88</sup> Debelle and Fischer (n 80) followed the reasoning of Cukierman (n 52) and Grilli et al (n 52).

<sup>89</sup> Mishkin, Frederic S., ‘Central Banking in a Democratic Society: Implications for Transition Countries’ (1998) 3 (3) Zagreb Journal of Economics 51, 56.

bank independence does not mean lack of accountability, to the contrary, a higher degree of independence must be accompanied by greater accountability and judicial control.

As pointed out earlier, different authors have given various descriptions to the meanings and forms of central bank independence. Namely, Cukierman provided four criteria for determining central bank independence: a) the ability of central bank to appoint and dismiss all of its members, including the members of governing board; b) the freedom of central bank to determine and decide on the goals of its monetary policy mandate; c) price stability as the main goal of monetary policy and d) whether there are lending restrictions imposed to central bank's operation.<sup>90</sup> Later, Eijffinger and De Haan, incorporated two more dimensions into the notion of central bank independence: a) "personnel independence", which relates to the meaning of "goal independence" as described earlier and involves the capacity of central bank to have the final authority for the appointment and dismissal of its members; and b) "financial independence", which refers to central bank's autonomy of any kind of credit relation with the state, either directly or indirectly.<sup>91</sup>

Eijffinger and De Haan, doubted whether "personnel independence" could be achieved, while they also stressed that a central bank that holds the responsibility to provide financial assistance to the government through its own credit, lacks both "financial" and "instrument" independence.<sup>92</sup> In this way, they emphasised that these two types of independence differ from each other, with the latter being broader, because it includes the power of central bank to define interest rates.<sup>93</sup> Lastly, according to Amtenbrink, a central bank enjoys a high degree of instrument/operational independence when holds the right to appoint and dismiss its governing board members on grounds of serious professional misconduct, while dismissal for political reasons classify as restrictive to independence.<sup>94</sup>

There is also the distinction between "de jure" and "de facto" independence.<sup>95</sup> "De jure" or "legal" independence as opposed to "de facto" independence, is enshrined in and

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<sup>90</sup> See: Cukierman (n 52).

<sup>91</sup> Eijffinger and De Haan (n 16).

<sup>92</sup> Eijffinger and De Haan (n 16) 2.

<sup>93</sup> Eijffinger and De Haan (n 16) 2.

<sup>94</sup> Amtenbrink, Fabian, *The Democratic Accountability of Central Banks: A Comparative Study of the European Central Bank* (Hart Publishing 1999) 20.

See also: BIS, May 2009 (n 24) 69.

<sup>95</sup> For the distinction between the "de jure" and "de facto" independence see:

determined by a legal framework that outlines the central bank's functions and the extent of government's authority over them. This kind of independence is protected by law and eliminates short-term political interferences on monetary policy decisions.<sup>96</sup> Cukierman et al. with their study in 1992, provided the components that measure legal independence as following: *"the appointment, dismissal, and term of office of the chief executive officer of the bank-usually the governor; the policy formulation cluster, which concerns the resolution of conflicts between the executive branch and the central bank over monetary policy and the participation of the central bank in the budget process; the objectives of the central bank; and limitations on the ability of the central bank to lend to the public sector; such restrictions limit the volume, maturity, interest rates, and conditions."*<sup>97</sup>

It is worth noting here, that the majority of studies which found a negative association between central bank independence and inflation, they all have in common the reliance on *de jure* indicators of central bank independence.<sup>98</sup> However, the predicted by law standards of independence, may not indicate the real relationship between central banks and governments, which is even more blurry in states where rule of law is less strongly embedded in the political culture. In these cases, as Walsh illustrates it: *"there can be wide gaps between the formal, legal institutional arrangements and their practical impact. This is particularly likely to be the case in many developing economies."*<sup>99</sup>

The difference between the various forms of central bank independence, especially the two major forms: goal/political and instrument/operational independence, is important in order to understand which areas are covered by central bank's autonomous discretion. However, this is not to say that one form exceeds in significance the rest. Although the arguments supporting this view were influential in drawing the line between the two major

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- Cukierman, Alex, 'The Economics of Central Banking' (1996) CentER Discussion Paper <<https://pure.uvt.nl/ws/files/524048/31.pdf>> accessed on 14 July 2017; and
  - Cukierman, Alex, 'Central Bank Independence and Monetary Policymaking Institutions: Past, Present, and Future' (2006b) Central Bank of Chile Working Papers No 360 <<http://si2.bcentral.cl/public/pdf/documentos-trabajo/pdf/dtbc360.pdf>> accessed 14 July 2017.

<sup>96</sup> Koshie, Grace, 'Has the GFC dented central bank independence?' (2013) 24 (2) Quarterly Journal of Central Banking 37.

<sup>97</sup> Cukierman et al (n 52) 356-357.

<sup>98</sup> For the studies that found a negative association between central bank independence and inflation see footnote 30.

<sup>99</sup> Walsh, Carl E., 'Central bank independence' (Prepared for the New Palgrave Dictionary December 2005) 5 <[https://people.ucsc.edu/~walshc/MyPapers/cbi\\_newpalgrave.pdf](https://people.ucsc.edu/~walshc/MyPapers/cbi_newpalgrave.pdf)> accessed 14 July 2017.

forms of central bank independence (goal/political and instrument/operational),<sup>100</sup> they did not gain widespread acceptance. In fact, the most important contributors on the idea of central bank independence,<sup>101</sup> suggested that both forms of central bank independence were equally important and the difference between the two is insignificant in practice, since even when the legal framework is designed to prioritise “instrument independence”, it will also affect the levels of “goal independence.”<sup>102</sup> It is also supported that “de facto” independence is not determined solely by the “de jure independence.” In fact, there are various institutional and non-institutional arrangements that can influence actual central bank independence, such as the degree of central banks’ involvement in open market operations or in exchange rate management.<sup>103</sup>

It is evident from the analysis above, that while central bank independence was growing in prominence from the late 1980s onwards, its evolving meaning and the various dimensions involved, made its evaluation more complicated. As already depicted in the previous subsections, even during this period of time there were a number of studies that had started to challenge the “Washington Consensus” orthodoxy, including central bank independence and inflation targeting policies. However, as a matter of fact a number of empirical studies during the 1990s and the subsequent growing number of countries that had reformed their regulatory framework in order to accommodate a higher degree of independence for their central banks, had offered enough evidence for the emergence of a broadly accepted consensus on the benefits of central bank independence. Thus, the consensus that had developed among policymakers, academics and analysts throughout the world, was that the objectives and targets of monetary policy, should be set by the governments. On the other hand, the de facto management of the monetary policy objectives, should be free from any kind of political interference in order to avoid inflation bias.<sup>104</sup> However, this is not to say that there is a consensus about a perfect kind of central bank independence. A conclusion that could be drawn by the discussion above is rather the

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<sup>100</sup> See: Debelle and Fischer (n 80).

<sup>101</sup> Grilli et al (n 52); Cukierman et al. (n 52); Bade and Parkin (n 51); and Dincer and Eichengreen (n 52).

<sup>102</sup> Bernanke, Ben S. and Mishkin, Frederic S., ‘Inflation Targeting: A New Framework for Monetary Policy?’ (1997) 11 (2) *The Journal of Economic Perspectives* 97, 102.

<sup>103</sup> Ivanović (n 58) 39.

<sup>104</sup> Bernanke, Ben S., ‘Central Bank Independence, Transparency, and Accountability’ (Institute for Monetary and Economic Studies International Conference, Bank of Japan, Tokyo, Japan, 25 May 2010) <<http://www.federalreserve.gov/newsevents/speech/bernanke20100525a.htm>> accessed 14 July 2017.

opposite. There is strong evidence that there is no flawless kind of independence applicable to all countries, since a model of central bank independence that might be efficient for one country, may not work for another.<sup>105</sup>

In addition, the growing prominence of central bank independence along with the advent of inflation targeting began to raise awareness of the importance of transparency and accountability for credibility. Hence, the following subsection aims at defining the notions of credibility, accountability and transparency, while exploring the nexus between them and central bank independence.

#### 1.2.4 The interaction between independence, credibility, transparency and accountability

A conclusion that can be drawn by the discussion on the evolution of central bank independence is that - regardless of its various dimensions - it was considered to be a fundamental component in the pursuit of the price stability, which eventually became the ultimate goal of central banks' monetary policy. However, as the trend in favour of central bank independence was growing, there was also an increasing awareness of the legal and institutional mechanisms that could enhance central bank's performance by also preventing governments infringing on its independence. To this end, as was mentioned earlier in this chapter, central bank independence, although necessary, was not to be seen as a single element able to boost central bank performance on its own. Instead, central bank independence, was considered in conjunction with other components such as increased transparency and accountability for credibility. These central bank components are briefly discussed below, mainly in relation to central bank independence.

##### a) Credibility

Central bank credibility is a peculiar notion, which may sound straightforward at first, although, it is hard to define. Blinder, while highlighting that there was no generally accepted definition for credibility, opined that a central bank is credible if people believe it will do what it says.<sup>106</sup> This practically implies that credibility reflects the ability of central bank to keep its

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<sup>105</sup> See: Siklos (n 75).

<sup>106</sup> Blinder, Alan S., 'Central Bank Credibility: Why Do We Care? How Do We Build It?' (NBER, Working Paper No. 7161, June 1999), 1 <<http://www.nber.org/papers/w7161.pdf>> accessed 14 July 2017.

commitment in fulfilling its monetary policy mandate. However, while the modern form of credibility is critically linked with communication and commitment, its roots are tied up with the history of policy regimes and with the very idea of central banking. In fact, sound central bank policy, regardless of the particular objective of each monetary policy regime, is reflected and to a large extent, interlinked with central bank's credibility and commitment to pursue its objectives. Thus, it is hardly surprising why credibility has been always considered a pivotal component of central bank operations, since a credible monetary authority can greatly enhance the virtues of sound policy.

Although the notion of credibility is older than central bank independence, the issue of whether there is a link between them, as Siklos put it: "*is a recurrent one throughout the twentieth century.*"<sup>107</sup> In the era of inflation targeting and central bank independence, the rationale of credibility, was developed out of neoclassical theories of monetary policy, which are largely based on the theory of rational expectations, as was originally developed by Robert Lucas (1972, 1973, and 1976) and will be further analysed in chapter two.<sup>108</sup> To this end, the advocates of rational expectations theory highlight the importance of credibility<sup>109</sup> in maintaining stable and low inflation, which also finds support in the time-inconsistency literature.<sup>110</sup>

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<sup>107</sup> Siklos, Pierre L., *The Changing Face of Central Banking* (Cambridge University Press 2002) as cited in Bordo, Michael and Siklos, Pierre, 'Central Bank Credibility, Reputation and Inflation Targeting in Historical Perspective' (NBER Working Paper No. 20693, November 2014), 12.

<sup>108</sup> For the theory of rational expectations see:

- Lucas, Robert E., Jr., 'Expectations and the Neutrality of Money, (1972) 4 *Journal of Economic Theory* 103;
- Lucas, Robert E., Jr., 'Some International Evidence on Output-Inflation Tradeoffs' (1973) 63 *American Economic Review* 326;
- Lucas, Robert E., Jr. 'Econometric Policy Evaluation: A Critique' (1976) 1 *Carnegie Rochester Conference Series on Public Policy* 19.

<sup>109</sup> Barro and Gordon (52).

<sup>110</sup> For an early analysis on the time-inconsistency theory see: Kydland and Prescott (n 38) and for a more recent analysis on the importance of credibility see:

- Blinder (n 107);
- Blinder, Alan S., Ehrmann, Michael, Fratzscher, Marcel, De Haan, Jakob and Jansen, David-Jan, 'Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence' (ECB Working Paper Series No 898, 2007) <<https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp898.pdf>> accessed 14 July 2017;
- Issing, Otmar, 'Communication, Transparency, Accountability: Monetary Policy in the Twenty-First Century' *Review* (Federal Reserve Bank of St. Louis *Review* March/April, Part 1, 2005) <<https://files.stlouisfed.org/files/htdocs/publications/review/05/03/part1/Issing.pdf>> accessed 14 July 2017.

The idea behind this, as discussed already, is that when the central bank is viewed to be both committed to and effective at keeping inflation controlled, inflation expectations tend to be anchored. Conversely, when a central bank is viewed as non-credible in pursuing its monetary policy goals, people and the market would be prepared for higher inflation, which will eventually result in firms increasing prices and workers demanding wage increases. This in turn will affect employment levels and output growth.<sup>111</sup> As discussed earlier, according to the time-inconsistency theory, this usually happens when monetary policymakers neglect the medium-term goal of price stability, and focus instead on short-term objectives, usually before elections. This was considered to affect negatively the efficiency and credibility of monetary stability, resulting in adverse consequences for the financial system.<sup>112</sup> The rationale of this reasoning was that the public would soon recognise the risk that monetary policymakers are willing to take in pursuing temporary strategies, which is often incompatible with the long-term economic growth goals. Consequently, as was mentioned in the previous section, central bank independence became not only a necessary prerequisite for successful monetary policy, but also the standard remedy to the time-inconsistency problem and the ultimate means to enhance central bank's credibility.

In terms of what the term entails, Cukierman defines credibility as the “*extent to which the public believes that a shift in policy has taken place when, indeed, such a shift has actually occurred.*”<sup>113</sup> Along similar lines, Cukierman and Meltzer defined the notion of credibility as “*the absolute value of the difference between the policymaker's plan and the public's beliefs*

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- Mishkin, Frederik S., ‘Will Monetary Policy Become More of a Science?’ (NBER Working Paper No 13566, October 2007) <<http://www.nber.org/papers/w13566.pdf>> accessed 14 July 2017); and
  - Walsh, Carl E., ‘The Contribution of Theory to Practice in Monetary Policy: Recent Developments’ in European Central Bank, ‘A Journey from Theory to Practice’ (An ECB colloquium held in honour of Otmar Issing 16-17 March 2006, Frankfurt, 2007), 142 <<https://www.ecb.europa.eu/pub/pdf/other/monetarypolicyjourneytheorypractice2007en.pdf?955e0a69a7c01a3265ab8b19deb448f2>> accessed 14 July 2017.

<sup>111</sup> Mishkin, Frederic S., ‘Monetary Policy Strategy: How Did We Get Here?’ (2006a) 53 (4) *Panaeconomicus*, Savez ekonomista Vojvodine, Novi Sad, Serbia 359 <<http://www.nber.org/papers/w12515.pdf>> accessed 14 July 2017.

<sup>112</sup> Amténbrink, Fabian and Van Duin K., ‘The European Central Bank before the European Parliament: theory and practice after ten years of monetary dialogue’ (2009) 34 *European Law Review* 561.

<sup>113</sup> Cukierman, Alex, ‘Central Bank Behavior and Credibility: Some Recent Theoretical Developments’ (1986) *Federal Reserve Bank of St. Louis Review*, 6 <[https://research.stlouisfed.org/publications/review/86/05/Central\\_May1986.pdf](https://research.stlouisfed.org/publications/review/86/05/Central_May1986.pdf)> accessed 14 July 2017.

about those plans.”<sup>114</sup> Later, Blinder opined that credibility means “*believability and trust*”.<sup>115</sup> Lastly, for Bordo and Siklos: “*a central bank is deemed credible when it delivers, subject to a random error, the implied inflation rate objective conditional on the monetary regime in place.*”<sup>116</sup> Credibility was also one of the main goals of inflation targeting regimes, and it was considered that central banks’ credibility has been improved from the widespread adoption of inflation targeting monetary policy frameworks.<sup>117</sup> Indeed, there is evidence that inflation targeting regimes perform better than non-inflation-targeting frameworks in improving the credibility of central banks.<sup>118</sup> It is worth noting here, that while the importance of credibility is well established, its specific role is difficult to measure.<sup>119</sup>

#### b) Accountability and transparency

As already mentioned, independence does not empower the central bank with an indefinite decisive power, but it is rather to be seen as an effective means to achieve monetary policy objectives. To this end, there are certain limitations to central bank independence, which are usually linked with the notion of accountability and transparency. As Siklos put it: “*with the battle over autonomy seemingly won, there remained the problem that with independence comes with responsibility.*”<sup>120</sup> In fact, although accountability and transparency are considered the reverse side of central bank independence,<sup>121</sup> the latter would have been counterproductive without adequate accountability and transparency. Amtenbrink stressed that independence, transparency and accountability should not be seen in isolation from each other, since they constitute the three pillars of central banking

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<sup>114</sup> Cukierman, Alex and Meltzer, Alan H., ‘A Theory of Ambiguity, Credibility, and Inflation under Discretion and Asymmetric Information’ (1986) 54 (5) *Econometrica* 1099, 1108 <<http://repository.cmu.edu/cgi/viewcontent.cgi?article=1841&context=tepper>> accessed 14 July 2017.

<sup>115</sup> Blinder, Alan S., ‘Central Bank Independence and Credibility During and After a Crisis’ (Federal Reserve Bank of Kansas City Economic Policy Symposium, The Changing Policy Landscape, in Jackson Hole, Wyoming, 1 September 2012) 4 <<https://www.princeton.edu/ceps/workingpapers/229blinder.pdf>> accessed 14 July 2017.

<sup>116</sup> Bordo and Siklos (n 108) 6.

<sup>117</sup> See: Bordo and Siklos (n 108).

<sup>118</sup> Walsh, Carl E., ‘Inflation Targeting: What Have We Learned?’ (2009) 12 (2) *International Finance* 195 <[https://people.ucsc.edu/~walshc/MyPapers/INFI\\_1236.pdf](https://people.ucsc.edu/~walshc/MyPapers/INFI_1236.pdf)> accessed 14 July 2017.

<sup>119</sup> Blinder (n 116) 1.

<sup>120</sup> Siklos, Pierre L., ‘Central Bank Transparency: Another Look’ (2011) *Applied Economics Letters* 18 (10) 929, 929.

<sup>121</sup> Brunner, Karl, *The art of central banking* (Government Policy and Business Working Paper GPB 81-6 University of Rochester Center for Research 1981).



governance.<sup>122</sup> The rationale of this belief is based on the democratic legitimacy of central bank independence itself, which deprives its existence from the notion of accountability. As Briault et al. argued: *“greater accountability has run hand-in-hand with moves towards greater central bank independence: greater accountability is the government's quid pro quo for granting greater central bank autonomy.”*<sup>123</sup>

This also links with the relevant debate on the democratic legitimacy of non-majoritarian institutions, which flourished in light of the increasing number and importance of independent unelected bodies empowered to regulate markets.<sup>124</sup> In essence, the idea that a considerable level of accountability should accompany the operation of independent central banks, was grounded on the potentially anti-democratic implications of delegating responsibility to unelected technocrat. Indeed, it is widely accepted that only elected representatives should be hold decision making powers concerning government income and spending. It follows that when ‘independent’ unelected technocrats are empowered with decision making powers in regard to monetary policy objectives, questions of legitimacy will arise. Majone refers to a system of a ‘non-majoritarian model pf democracy,’ in which governmental institutions are not directly accountable to citizens and democratic legitimacy is achieved through the quality of the decisions made – based on technical expertise.<sup>125</sup> Thus, it was argued that in order to legitimise the role of a central bank within a given constitutional system, a substantial degree of accountability is required to insure against a “democratic

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<sup>122</sup> Amtenbrink, Fabian, ‘The Three Pillars of Central Bank Governance - Towards a Model Central Bank Law or a Code of Good Governance?’ (2005) 5 International Monetary Fund 101 <<https://www.imf.org/external/np/leg/sem/2004/cdmfl/eng/amtenb.pdf>> accessed 14 July 2017.

<sup>123</sup> Briault, Clive B., Haldane, Andrew G. and King, Mervyn A., ‘Independence and Accountability’ (Bank of England Working Paper No 49, 7 <<http://www.bankofengland.co.uk/archive/Documents/historicpubs/workingpapers/1996/wp49.pdf>> accessed 14 July 2017.

<sup>124</sup> See for instance:

- Feldman, Martha S. and Khademian Anne M., ‘To manage is to govern’ (2002) 62 (5) Public Administration Review 541.
- Majone, Giandomenico, ‘Europe's Democratic Deficit: The Question of Standards’ (1998) 4 (1) European Law Journal 5.
- Majone, Giandomenico, ‘The Regulatory State and its Legitimacy Problems’ (1999) 22 (1) West European Politics 1.
- Majone, Giandomenico, ‘Nonmajoritarian Institutions and the Limits of Democratic Governance: A Political Transaction-Cost Approach’ (2001) 157 Journal of Institutional and Theoretical Economics 5.
- Van Kersbergen, K. and Van Waarden F., ‘Governance’ as a bridge between disciplines: Cross-disciplinary inspiration regarding shifts in governance and problems of governability, accountability and legitimacy’ (2004) 43 (2) European Journal of Political Research 143.

<sup>125</sup> Majone, 1998 (n 125).

deficit.”<sup>126</sup> Simply said, the main role of accountability is to ensure appropriate democratic control and good governance of the delegation of monetary policy powers to unelected central bank officials and hence, central banks will be held strictly accountable for their actions. Indeed, the case for central bank democratic accountability is based on the assumption that independent central banks operate within a democratic system featuring a basic division of powers and a system of checks and balances. In a representative democracy, this matter because without accountability there can be no legitimacy, and without the latter the democratic legitimacy of an independent central banks itself will be put in question.

When it comes to defining the notion of accountability, although the latter has gained wide attention during the last ten years,<sup>127</sup> there is no a generally accepted definition as to the limits and the content of the term.<sup>128</sup> According to Tommaso Padoa-Schioppa: *“Accountability means that institutions with the power to affect the lives of people are subject the scrutiny by the elected representatives of the people. As such it is an essential and constituent element of our political order, and indeed this scrutiny is necessary also in those fields- such as central banking-where policy decisions ate consciously removed from the day-to-day influence of the political arena.”*<sup>129</sup> An assessment of what central bank accountability entails, could be done by answering questions such as: for what is the central bank accountable for and by whom, and how the accountability is measured? It comes without saying that the central bank must be, first and foremost, accountable to the general public for its actions. Secondly, the central bank must be also accountable to the state from which it derives its statutory authority.<sup>130</sup>

In general terms, the notion of accountability could be defined as an evaluation of central bank performance, including the achievement of its main goals. In practice, this evaluation practice is made by the government, through a parliamentary committee (banking committee or a specialised group of parliamentary members), ministers of finance,

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<sup>126</sup> Briault et al (n 124) 7.

<sup>127</sup> Lindberg, Staffan I 'Mapping accountability: core concept and subtypes', (2013) 79 (2) International Review of Administrative Sciences 202, 203.

<sup>128</sup> Bovens, Mark, 'Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism' (2010) 33 (5) Journal West European Politics 946.

<sup>129</sup> Padoa-Schioppa, Tommaso, *The Euro and Its Central Bank, Getting United after the Union* (MIT Press 2004) 33.

<sup>130</sup> BIS, May 2009 (n 24) 136.

supervisory board committees or sometimes central banks are obliged to report to the legislature. For instance, the ECB reports to Committees of the EU Parliament and Fed reports to the Congress' banking committees, while the central banks of Poland, Hungary and Czech Republic report to the legislature.

The means to evaluate the achievement of accountability may vary in accordance with the central bank's objectives. This evaluation, however, might prove difficult to conduct, because linking specific - out of many - central bank operations to intended outcomes and then evaluating their performance as to how they influence the accomplishment of central bank's goal, is far from being straightforward. A notable difference is between assessing the accountability with respect to the price stability objective, which is usually easy measure, and evaluating accountability with respect to the financial stability task, which is not easily defined. In fact it takes a high level of expertise for such an evaluation; a hierarchical order of tasks and objective, which should also be explicitly defined; and a clear delegation structure, which specifies the level of involvement and authority of the central bank in decision-making.<sup>131</sup> As it is defined by the IMF Good Transparency Practices: *"the broad modalities of accountability for the conduct of monetary policy and for any other responsibilities assigned to the central bank should be specified in legislation."*<sup>132</sup>

Inevitably, in the era of central bank independence, increased accountability raises the demand for greater transparency. In turn, transparency (especially with regard to monetary policy) facilitates accountability, and as a result increases the effectiveness policy decisions and, in many cases, public welfare. However, historically, central bank reputation was linked to secrecy,<sup>133</sup> while central bank accountability was not necessarily linked to the transparent communication of monetary policy objectives.<sup>134</sup> In fact, prior to the 1990s,

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<sup>131</sup> BIS, May 2009 (n 24) 136.

<sup>132</sup> International Monetary Fund, 'Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles' (1999) item 1.1.5 <<https://www.imf.org/external/np/mae/mft/code/>> accessed 14 July 2017.

<sup>133</sup> See:

- Acheson, K. and Chant, J. F., 'Bureaucratic Theory and the Choice of Central Bank Goals' (1973) 5 (2) Journal of Money, Credit and Banking 639; and
- Dincer, N. Nergiz and Eichengreen, Barry, 'Central Bank Transparency: Where, Why, and with What Effects?' (2007) National Bureau of Economic Research Working Paper No. 13053, 2 <<http://www.nber.org/papers/w13053.pdf>> accessed 14 July 2017.

<sup>134</sup> Paterson, Lea, 'Are central banks different? Lessons from the evaluation community for central bank evaluation functions' (Discussion paper prepared for the biennial conference of the European Evaluation Society,

conventional wisdom held that central bankers should not disclose much information regarding monetary policy tactics.<sup>135</sup> This scenario changed in the era of central bank independence, during which the decisive power of central bank's in choosing its tactics was progressively enhanced. In fact, it was the widespread prominence of central bank independence along with the adoption of explicit inflation targeting,<sup>136</sup> which brought the need for mechanisms that will enable the general public to evaluate whether the central bank is consistent in accomplishing its policy mandate.<sup>137</sup>

A central bank, regardless of being free from political influence, remains a public institution and a public authority that should operate under the scope of its mandate and be committed to accomplish its principal goals within the context of its obligation for the public good.<sup>138</sup> This practically means that the central bank has a duty to explain its activities and tactics. To this end, both clearer definitions of accountability and greater communication with the public, as the means to convincing the latter that the central bank's operations are consistent with a long-term commitment to price stability, became an increasingly important aspect of sound operation.<sup>139</sup> As a result, from the 1990s onwards (which was the beginning of the era of central bank independence), a marked tendency towards a more transparent conduct of monetary policy also developed. It started with the Bank of England, which pioneered the communication of its monetary policy objectives through the Inflation Report

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Maastricht, 29 September 2016) 3 <<http://www.bankofengland.co.uk/about/Documents/ieo/dp0916.pdf>> accessed 14 July 2017.

<sup>135</sup> Blinder et al. (n 116) 2.

<sup>136</sup> See for instance:

- Dincer and Eichengreen (n 52);
- Geraats, P., 'Central Bank Transparency' (2002) 112 (483) *Economic Journal* 532;
- Faust, J. and L. Svensson, 2001, 'Transparency and Credibility: Monetary Policy with Unobservable Goals' (2001) 42 (2) *International Economic Review* 369;
- Blinder, Alan, Goodhart, Charles, Hildebrand, Philipp, Lipton, David and Wyplosz, Charles, 'How Do Central Banks Talk?' (2001) *International Center for Monetary and Banking Studies* <[http://www.icmb.ch/ICMB/Publications\\_files/Geneva%203%20.pdf](http://www.icmb.ch/ICMB/Publications_files/Geneva%203%20.pdf)> accessed 14 July 2017.

<sup>137</sup> Dincer and Eichengreen (n 52) 190.

<sup>138</sup> See: Dincer and Eichengreen (n 52).

<sup>139</sup> See:

- Meade, Ellen E. and Crowe, Christopher, 'Evolution in Central Bank Governance Around the World' (2007) 21 (4) *Journal of Economic Perspectives* 69;
- Blinder et al (n 116);
- Siklos, Pierre L., *The Changing Face of Central Banking: Evolutionary Trends Since World War II* (Cambridge University Press 2002) Chapter 6; and
- ECB, 'Transparency in the monetary policy of the ECB' (ECB Monthly Bulletin, November Issue, 2002) 59-66 <<http://www.ecb.europa.eu/pub/pdf/mobu/mb200211en.pdf>> accessed 14 July 2017.

in February 1993,<sup>140</sup> and was followed by the central banks of New Zealand, Norway, and Sweden.<sup>141</sup> Other countries adopted similar practices and transparency grew in prominence, becoming the new orthodoxy in central banking. Nonetheless, similar to accountability, a definition of transparency, is also difficult to pin down precisely. Lastra defines central bank transparency as the degree to which information on policy tactics are available to the public.<sup>142</sup>

As already emphasised, communication constitutes the key ingredient of transparency and as such there has been an attempt to distinguish between the various types of communication and their respective importance. Namely, Woodford distinguish four types of central bank communication: a) central bank's interpretation of economic conditions, including central bank's view of the outlook for the future, to the extent that this is shaped by factors other than the bank's intentions with regard to policy; b) the content of the policy decisions that are made by the central bank about current operating targets; c) a description of the strategy that guides the central bank's policy decisions in general; and d) statements about the outlook for future policy.<sup>143</sup> Later, Crowe and Meade in their study in 2008, included more dimensions of central bank transparency, such as: a) economic transparency (communication on economic data); b) political transparency (communication on policy objectives); c) procedural transparency (communication on the decision-making process, including the voting procedure); d) policy transparency (communication on the policy decision outcome); and e) operational transparency (communication on the actual implementation of policy).<sup>144</sup>

The rationale for central bank transparency is based on the belief that it reduces uncertainty, and thus shaping market actors' expectations and ensuring the public support

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<sup>140</sup> See: Houben, Aerd C.F.J., *The Evolution of Monetary Policy Strategies in Europe* (Kluwer Academic Publishers 2000) 261.

<sup>141</sup> Dincer and Eichengreen (n 52) 190.

<sup>142</sup> Lastra, Rosa M., 'How much accountability for central banks and supervisors?' (2001) 12 (2) Central Banking Publications 69.

<sup>143</sup> Woodford, Michael, 'Central-Bank Communication and Policy Effectiveness' (Federal Reserve Bank of Kansas City Symposium: "The Greenspan Era: Lessons for the Future" Jackson Hole, Wyoming, 25-27 August 2005) 10 <<http://www.columbia.edu/~mw2230/JHole05.pdf>> accessed 14 July 2017.

<sup>144</sup> Crowe, Christopher and Meade, Ellen E., Central Bank Independence and Transparency: Evolution and Effectiveness" (2008) International Monetary Fund Working Paper WP/08/119 <<https://www.imf.org/external/pubs/ft/wp/2008/wp08119.pdf>> accessed 14 July 2017.

for monetary policy goals.<sup>145</sup> Simply said, when a central bank communicates openly its policy decisions, creates a smooth and predictable business environment, where the market, investors and the general public, are knowledgeable in regard to the outcome of policy decisions and how this outcome will affect them. For instance, Kuttner's study found the Fed's policy of announcing a rationale for monetary actions decreased market volatility and maximised predictability.<sup>146</sup> This is of fundamental importance, especially in times of financial distress, when radical reforms are more likely to be adopted. It follows that when the market and people become informed in advance in regard to central bank strategies, the possibility of efficient monetary policy increases, especially in terms of longer-run interest rates.<sup>147</sup> As Issing - who was Member of the Executive Board of ECB at the time - highlighted: "*when the markets correctly anticipate that a new piece of information will lead to a change in official interest rates they will do much of the work themselves through a change in the term structure.*"<sup>148</sup>

Lastly, transparency is also seen as a tool to foster not only accountability but also the credibility of monetary policy mandate and central banks' consistency to commit to inflation targets.<sup>149</sup> In addition, the increasing trend towards central bank independence in the vast majority of industrialised states, has also strengthened their authority to choose their tools and strategies. It is also suggested that central bank independence increases the willingness of a central bank to communicate its objectives and future plan - hence, central bank transparency - due to the central bank's increased authority and discretionary power over the decision making process.<sup>150</sup> To this end, central bank transparency became a key tool in allowing the public to evaluate whether the commitment of a central bank in pursuing the stated policy mandate is adequately achieved. This links with idea that openness in regard to

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<sup>145</sup> Mishkin, 1998 (n 90) 61.

<sup>146</sup> See: Kuttner, K.N., 'Monetary Policy Surprises and Interest Rates: Evidence from the Fed Funds Futures Market' (2001) 47 (3) Journal of Monetary Economics 523.

<sup>147</sup> See: Dincer and Eichengreen (n 52).

<sup>148</sup> Issing, Otmar, 'The monetary policy of the ECB: stability, transparency, accountability' (Royal Institute of International Affairs, London, 25 October 1999) <[https://www.ecb.europa.eu/press/key/date/1999/html/sp991025\\_1.en.html](https://www.ecb.europa.eu/press/key/date/1999/html/sp991025_1.en.html)> accessed 14 July 2017.

<sup>149</sup> Issing, Otmar, 'The Euro Area and the Single Monetary Policy' (2001) Österreichische Nationalbank Working Paper No. 44.

<sup>150</sup> For this view see: Crowe, Christopher and Meade, Ellen E., 'Central Bank Independence and Transparency: Evolution and Effectiveness' (2008) International Monetary Fund Working Paper WP/08/119 <<https://www.imf.org/external/pubs/ft/wp/2008/wp08119.pdf>> accessed 14 July 2017.

the specific details of how central bank's policy strategy is conducted, is considered to facilitate stable inflation rates, which in turn, increases trust as well as central bank credibility.<sup>151</sup> As Issing emphasised: *"In a democratic society, a high degree of transparency and accountability in monetary policy making reinforces the legitimacy of the central bank and consolidates the public support for its price stability mandate. Moreover, transparency imposes discipline on policy makers and is a means to ensure a general understanding of the monetary policy strategy. In turn, this may add to the credibility, and thereby the effectiveness, of monetary policy, hence facilitating the central bank's effort to attain its statutory objectives."*<sup>152</sup> Therefore, greater transparency, is likely to decrease uncertainty in the market; which in turn, would foster policymakers' role in affecting positively economic growth and stable interest rates.<sup>153</sup>

However, there were also those who argued against excessive transparency and discretionary monetary policy. For instance, Clare and Cortenay, having considered the impact of announcing the minutes of monetary board meetings and the quarterly Inflation Report of Bank of England, concluded that the disclosure of such information led to asset-price volatility.<sup>154</sup> They also added that: *"any improvement in the transparency of monetary policy might bring about a change in the way that both interest rate decisions and other macroeconomic announcements are incorporated into securities prices. And it is possible that changes in the reactions to these two types of announcements may be in opposite directions."*<sup>155</sup> In the same vein, Goodhart<sup>156</sup> and Mishkin<sup>157</sup> argued that increased transparency, especially transparency in respect with policy rates, may complicate the communication with the public, challenge the committee's decision-making process and

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<sup>151</sup> Dincer and Eichengreen (n 52). See also:

International Monetary Fund, 'Supporting Document to the Code of Good Practices on Transparency in Monetary and Financial Policies' (2000) IMF Monetary and Exchange Affairs Department <<https://www.imf.org/external/np/mae/mft/sup/part1.htm>> accessed 14 July 2017.

<sup>152</sup> Issing, 2001(n 150) 12-13.

<sup>153</sup> See: Woodford (n 144).

<sup>154</sup> Clare, Andrew and Courtenay, Roger 'Assessing the Impact of Macroeconomic News Announcements on Securities Prices under Different Monetary Policy Regimes' (2001) Bank of England Working Paper No. 125, 10 <<http://www.bankofengland.co.uk/archive/Documents/historicpubs/workingpapers/2001/wp125.pdf>> accessed 14 July 2017.

<sup>155</sup> Clare and Courtenay (n 155) 7.

<sup>156</sup> Goodhart, Charles A.E., 'Monetary policy transmission lags and the formulation of the policy decision on interest rates' (2001) 83 (4) Federal Reserve Bank of St. Louis Review 165.

<sup>157</sup> Mishkin, Frederic S., 'Can Central Bank Transparency Go Too Far?' (2004) National Bureau of Economic Research Working Paper 10829 <<http://www.nber.org/papers/w10829>> accessed 14 July 2017.

weaken the support towards central bank in achieving their long-run objectives. As Mishkin highlighted: “central bank transparency must always be thought of as a means to an end. Transparency is beneficial when it serves to simplify communication with the public and helps generate support for central banks to conduct monetary policy optimally with an appropriate focus on long-run objectives.”<sup>158</sup> In summary, although transparency has clearly evolved progressively towards a greater degree of “openness,” the relevant literature has not reached consensus on an optimal level of transparency,<sup>159</sup> and the issue of whether transparency is always beneficial, remains elusive and subject to ongoing debate.<sup>160</sup>

All in all, pre-GFC central banking was dominated by a strong tendency towards a higher degree of central bank independence, as the ultimate means to achieving the monetary policy objectives and tasks. Moreover, central bank independence brought the need for enhanced accountability and transparency, which apart from helping to align central banks with democratic principles, are also major contributors to conducting monetary policy successfully. The rationale for greater transparency, as mentioned earlier, is that it ensures the communication and clarity of monetary policy decisions with the public and thus, reduces uncertainty and promotes a better understanding of monetary policy decisions; while the benefit of enhanced accountability is the promotion of a stronger discipline on policymakers. Most importantly, accountability was considered as an important component of the effectiveness of monetary policy and as a necessary counterpart to central bank independence.<sup>161</sup> In simple terms, part of the consensus that led to the prominence of central bank independence, was that the latter was considered be counterproductive without adequate accountability and transparency, since independence requires accountability and

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<sup>158</sup> Mishkin (n 158) 25.

<sup>159</sup> See for instance:

- Cukierman, Alex, ‘Accountability, Credibility, Transparency, and Stabilization in the Eurosystem’ in Wyplosz C. (ed) *The EMU and its Impact on Europe and the World* (Oxford University Press 2001);
- Cruijssen, Carin Van Der and Eijffinger, Sylvester C.W., ‘The Economic Impact of Central Bank Transparency: A Survey’ (2007) Centre for European Policy Research Discussion Paper No. 6070;
- Eijffinger, Sylvester and Geraats, Petra, ‘How transparent are central banks?’ (2006) 22 (1) *European Journal of Political Economy*; and
- Geraats, Petra, ‘Central Bank Transparency’ (2002) 112 (483) *The Economic Journal* 532.

<sup>160</sup> Eijffinger and Geraats (n 160) 6.

<sup>161</sup> Amtenbrink, Fabian and Lastra, Rosa M., ‘Securing Democratic Accountability of Financial Regulatory Agencies-- A Theoretical Framework’ in De Mulder, R.V. (ed) *Mitigating Risk in the Context of Safety and Security. How Relevant is a Rationale Approach?* (Erasmus School of Law & Research School for Safety and Security (OMV) 2008) 115.



accountability entails transparency, and all together were to be complemented by a credible operation.

Therefore, although distinct from one another, the notions of independence, accountability and transparency are highly intertwined in promoting better monetary policy and as such, tend to interrelate and even overlap. As Bordo and Siklos argued: “*autonomy, transparency, accountability, and the monetary policy strategy in place each can influence both the credibility and reputation of the monetary authority.*”<sup>162</sup> The difficulty arises when the three notions, i.e. accountability, credibility and transparency, are combined within the same authority that operates both as the monetary policy and supervision authority. For instance, when it comes to disclosing information in respect with financial supervision and regulation matters, there might be commercial confidential data and information involved in relation to specific financial institutions, which in case of a liquidity problem might cause market disturbances and reputational issues. Thus, there is a major difference between transparency in monetary policy matters, and transparency in financial supervision operations, especially when the two functions are operated by the same institution. In any case, although central banks should have some space of discretion (with prejudice to the particular kinds of transparency each time) in terms of deciding what information should be released or non-released, with the latter being preferably the exception rather than the rule, there might be circumstances that an excessive disclosure of information, especially in times of financial disturbance, may increase the risk of provoking adverse market reactions.

This brings us to the main point of investigation of this thesis (the compatibility of monetary policy and supervisory functions within the same institution) and links to issues of contemporary debate as developed in the post-GFC era. Therefore, the next section of the thesis provides an initial analysis of the challenges brought to the theoretical foundation of what it was considered as conventional wisdom and the legitimacy of existing notions that are pivotal for the smooth operation of major central banks. This is far from being a purely theoretical topic, since the combination of various tasks under the existing regulatory frameworks, has brought the need for the creation of new mechanisms that would insure against negative synergies and conflict of interest between new and existing institutional

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<sup>162</sup> Bordo and Siklos (n 108) 5.

arrangements. It might be that we have entered a new era in central banking, which require cooperation between “conventional” and “new,” or it might be that this cooperation is not feasible and that the “new” has come to dominate over the “conventional.” In a nutshell, “conventional” stands for inflation-targeting independent central banks and “new” stands for a banking supervision focused central bank with the financial stability objective overriding in importance the traditional goal of price stability.

#### 1.2.5 Central bank independence in the aftermath of the Global Financial Crisis: an initial analysis

In a nutshell, prior to the GFC, a consensus had emerged as to the optimal central banking model. This consensus involved regulatory frameworks that were mainly concerned with monetary policy; while, flexible inflation targeting and the objective of price stability were seen as the most appropriate monetary policy framework.<sup>163</sup> Also, from the early 1990s onwards, the most crucial component of central bank governance was considered to be the degree of independence under which the central bank operates, which was seen as crucial in achieving price stability and limiting the inflation bias.<sup>164</sup> The idea behind this, was the belief that the more independence is granted to a central bank, the greater the chances are to conduct effectively its operation in pursuing its goals and objectives. Thus, by the early 2000s many central banks had underwent fundamental changes to their governance in order to accommodate a high degree of independence, and the conduct of monetary policy seemed to had reached what was perceived as its optimal level.<sup>165</sup> With regards to banking supervision, in the majority of developed countries that were following a price-stability-focused monetary policy, their central bank’s role in banking supervision was either a shared responsibility between the central bank and a distinct body or supervision was assigned to a completely separate institution.

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<sup>163</sup> Reichlin, Lucrezia and Baldwin, Richard (eds), ‘Is Inflation Targeting Dead? Central Banking After the Crisis’ (2013) Centre for Economic Policy Research <<http://voxeu.org/sites/default/files/file/P248%20inflation%20targeting%207%20may.pdf>> accessed 14 July 2017.

<sup>164</sup> Masciandaro, Donato and Passarelli, Francesco, ‘Single supervision and resolution rules: Is ECB independence at risk?’ (VOX Centre for Economic Policy Research’s Policy Portal, 2013) <<http://voxeu.org/article/banking-union-ecb-independence-risk>> accessed 14 July 2017.

<sup>165</sup> Goodhart, Charles, ‘The changing role of central banks’ (BIS, Working Papers No 326) 18 <<http://www.bis.org/events/conf100624/goodhartpaper.pdf>> accessed 14 July 2017.

However, we also highlighted that what was considered to be “a consensus” was also highly criticised. Certainly, the topic of central bank independence has regained a vast amount of attention, especially in the aftermath of the GFC, and until today, remains high on the agenda of relevant ongoing debates. This is to be attributed mainly to the fact that during and in the aftermath of the GFC, central banks’ operations have expanded, and their mandate has incorporated tasks beyond the traditional monetary policy objectives.<sup>166</sup> Moreover, policy reforms in the majority of jurisdictions concerning the role of central banks in supervision, monetary policy and the degree of their independence,<sup>167</sup> have brought historic changes, which are comparable to the policy changes that followed Great Depression.<sup>168</sup>

Namely, in the wake of the GFC, there has been an increasing amount of government intervention in economic policy, often, via the central bank. This is particularly prominent in bank bailouts, in an attempt to assist failing financial institutions and to stabilise the financial system.<sup>169</sup> As a result, central bank involvement, either directly or indirectly in the bailout process, blurred the distinction between monetary and fiscal policy.<sup>170</sup> This has radically challenged the banks’ role, by also challenging the principle of inflation targeting, the limits of monetary policy and the extent of their independence.<sup>171</sup> Most importantly, this was reflected in numerous regulatory reforms around the world, which came to reshape the role of central banks, especially, in banking supervision, by challenging the balance between existing and new central banks’ tasks.<sup>172</sup> This links with one of the main aims of this thesis, which tries to shed light on how the new banking supervisory and regulatory framework at EU level has influenced the balance between existing and new ECB responsibilities, and

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<sup>166</sup> Balls, Ed, Howat, James and Stansbury, Anna, ‘Central Bank Independence Revisited: After the financial crisis, what should a model central bank look like?’ (2016) Mossavar-Rahmani Center for Business & Government Associate Working Paper Series No. 67.

<sup>167</sup> See: Cukierman (n 52).

<sup>168</sup> Bordo, Michael D., ‘Rules for a Lender of Last Resort: An Historical Perspective’ (Central Banking in the Next Century: A Policy Conference, Hoover Institution Stanford, California, 29-30 May 2014) <<http://media.hoover.org/sites/default/files/documents/2014BordoLOLR-revised.pdf>> accessed 14 July 2017.

<sup>169</sup> Masciandaro, Donato and Passarelli, Francesco, ‘Bank Bailouts and Redistributive Monetary Policy: Voting on Central Bank Independence’ (BAFFI Center Research Paper Series No. 2013-146, 2013) <<https://ssrn.com/abstract=2370253>> accessed 14 July 2017.

<sup>170</sup> Monetary policy, in general, refers to the actions of central bank in controlling the money supply via factors such as interest rates. Fiscal policy relates to government’s decisions regarding spending and taxation in order to influence aggregate demand in the economy.

<sup>171</sup> Taylor, John B., ‘The Effectiveness of Central Bank Independence vs. Policy Rules’ (2013) 48 (3) Business Economics 155.

<sup>172</sup> Cukierman, Alex, ‘Monetary Policy and Institutions before, during and after the GFC’ (2013) 9(3) Journal of Financial Stability 373.

whether the resulted complex structure adequately complies with the existing Treaty provisions. To this end, central bank independence has been one of the most discussed issues in the debate of changing roles and dynamics of central banks' institutional arrangements at both EU and international level.

The independence of the Bank of England is a recent example of controversy. Jeremy Corbyn, the leader of the Labour Party (the Opposition in the House of Commons), proposed in 2015 the so-called People's Quantitative Easing (PQE) policy, which required the Bank of England (BoE) to print money in order to finance government investment.<sup>173</sup> This was to be done by purchasing bonds issued by the state-owned National Investment Bank.<sup>174</sup> Then this National Investment Bank, would use the money to fund public infrastructure projects, including housing and public transport. This apart from being a highly politically controversial issue, raised questions as to the possible threat that the proposed policies might pose to the independent status of the BoE.

Moreover, in the US, the Senate recently rejected the controversial "Audit the Fed" legislation,<sup>175</sup> proposed by Republican Senator Rand Paul's, who called for tougher audits of the Fed. The legislation aimed at eliminating restrictions in the U.S. Government Accountability Office (GAO) audits of the Fed and mandated that the Fed's credit facilities, securities purchases, and quantitative easing activities to be subject to congressional oversight. In Paul's words: *"nowhere else but in Washington, D.C., would you find an institution with so much unchecked power."*<sup>176</sup> The Obama White House called Paul's proposal "dangerous" and as Jason Furman, Chairman of President Obama's Council of Economic Advisers, highlighted: "Congress shouldn't be telling the Fed what to do with monetary

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<sup>173</sup> See: Bootle Roger, 'What are we to think of Jeremy Corbyn's 'people's QE'?' (The Telegraph 2015) <<http://www.telegraph.co.uk/finance/economics/11862318/What-are-we-to-think-of-Jeremy-Corbyns-peoples-QE.html>> accessed 14 July 2017.

<sup>174</sup> See: Yates, Tony, 'Corbyn's QE for the people jeopardises the Bank of England's independence' (The Guardian, 22 September 2015) <<https://www.theguardian.com/business/economics-blog/2015/sep/22/jeremy-corbyn-qe-for-the-people-jeopardises-bank-of-england-independence>> accessed 14 July 2017.

<sup>175</sup> 'The Federal Reserve Transparency Act of 2015' (S. 2232, 114TH Congress 1<sup>st</sup> Session, 12 January 2016) (commonly referred to as "Audit the Fed") <<https://www.paul.senate.gov/files/documents/GRA15012.pdf>> accessed 14 July 2017.

<sup>176</sup> Transcript of Rand Paul speech in the US 114 Congress, 12 January 2016 <<https://www.paul.senate.gov/news/press/senate-holds-vote-on-sen-rand-pauls-audit-the-fed->> accessed 14 July 2017.

policy.”<sup>177</sup> Also, this raised many questions regarding the independent status of Fed, with Ben Bernake stressing that this would result in a direct involvement of the government in monetary policy decisions, calling into question the Fed’s independence.<sup>178</sup> Lastly, although “Audit the Fed” legislation was rejected in early 2016, Donald Trump expressed support for auditing the Fed, which might result in reviving this topic in the future.<sup>179</sup> It should be noted that in the post-GFC literature, there were also those who supported that the scope of Fed’s independence cannot be viewed as far-reaching. For instance, Wray argues that although the Fed should be insulated from day-to-day political pressures, since it is a “creature of Congress,” created by public law, it is inevitably subject to the will of Congress.<sup>180</sup> Wray also opines that Fed cannot be truly independent from the Treasury either, “because the Fed is the federal government’s bank, with almost all payments made by and to the government running through the Fed. As such, there is no “operational independence” that would allow the Fed to refuse to allow the Treasury to spend appropriated funds. ”<sup>181</sup>

As mentioned earlier, another topic that formed part of the same debate, is a central bank’s involvement in banking supervision. This has raised numerous concerns as to whether the functions of monetary policy and supervision can be exercised in tandem, while maintaining the existing degree of independence. This is particularly problematic in terms of instrument/operational independence, which, when referring to monetary policy, implies a central bank’s ability to decide independently when adjusting its short-term interest rates to achieve its inflation goal; while, when referring to banking supervision, involves decisions such as putting financial institutions under statutory management.<sup>182</sup> In short, when monetary

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<sup>177</sup> Sainato, Michael, ‘What Bernie Sanders’ Vote to Audit the Fed Says About His Devotion to Bipartisanship’ (Observer, 13 January 2016) <<http://observer.com/2016/01/what-bernie-sanders-vote-to-audit-the-fed-says-about-his-devotion-to-bipartisanship/>> accessed 14 July 2017.

See also: Street Chriss, ‘“Audit the Fed” May Finally Pass Congress’ (Breitbart, January 2017) <<http://www.breitbart.com/big-government/2017/01/07/audit-the-fed-pass-congress/>> accessed 14 July 2017.

<sup>178</sup> Garver, Rob, ‘Why the Controversial ‘Audit the Fed’ Bill Is Really a Power Grab’ (The Fiscal Times, 11 January 2016) <<http://www.thefiscaltimes.com/2016/01/11/Why-Controversial-Audit-Fed-Bill-Really-Power-Grab>> accessed 14 July 2017.

<sup>179</sup> Torry Harriet, ‘Republican Lawmakers Revive ‘Audit the Fed’ Legislation’ (The Wall Street Journal, 4 January 2017) <<http://www.wsj.com/articles/republican-lawmakers-revive-audit-the-fed-legislation-1483561810>> accessed 14 July 2017.

<sup>180</sup> Wray, Randall, ‘Central Bank Independence: Myth and Misunderstanding’ (Working Paper No. 791, Levy Economics Institute of Bard College, March 2014).

<sup>181</sup> Wray (n 181).

<sup>182</sup> BIS, May 2009 (n 24) 53.

policy and supervision are conducted by the same authority, i.e. the central bank, they may lead to more elastic monetary policy strategies, in an attempt to prevent a banking crisis. This brings us to the key theme of this thesis, which focused on the synergies involved when a central bank engages in supervision activities, while trying to maintain the same institutional structure, i.e. maintaining independence and staying focused on price stability.

The most representative example of a post-crisis regulatory reform that aimed at marrying banking supervision and monetary policy is the creation of the European Banking Union and the delegation of supervisory powers to ECB, which *inter alia* raised serious questions in relation to ECB's independence. However, in order to evaluate the changing role of the ECB - including its independence - within the new regulatory regime, it is important to examine both the pre- and post-GFC regulatory framework with regards banking regulation and supervision at EU level, and the roadmap towards the creation of Banking Union. This discussion is developed in chapters three and four of this thesis. Prior to this, it is necessary to place the EU integration process in historical perspective, from the initial negotiations and the adoption of the first Treaty, to the establishment of the ESCB. Hence, the following section briefly presents the first steps towards European Cooperation to the adoptions of the Maastricht Treaty. The aim of this discussion is to provide an overview of the basis of the ESCB's legal framework and to explain the rationale of ECB's objectives, independence, and overall role within the EU regulatory framework. This, in turn, will set the ground to our main discussion in relation the latest reforms concerning the ESCB structure and the ECB's new supervisory tasks, which is conducted in the fourth chapter of this thesis.

### 1.3 The roadmap towards European Integration

#### 1.3.1 From the Second World War to the EMS

The history of European integration essentially begins in 1945, when European economies started their recovery from the losses of WWII. The recovery process resulted in a shift towards cooperation over conflict and the desire for economic and political union grew stronger in Western Europe.<sup>183</sup> It was on 19 September 1946 when Winston Churchill, delivered his infamous speech at the University of Zurich about his vision of a 'United States

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<sup>183</sup> Urwin, Derek, W., *The Community of Europe: A History of European Integration since 1945* (2nd rev edn, Adison Wesley Longman 1995).

of Europe,' calling European countries to form a regional organisation in order to promote lasting peace.<sup>184</sup> In the same vein, Robert Schuman, who served as the French Foreign Minister at the time, gave a speech on 9 May 1950 in the Salon de l'Horloge of the Quai d'Orsay in Paris,<sup>185</sup> in which he presented a plan for deeper cooperation that would set up a common Franco-German structure for the production of coal and steel under one common High Authority.<sup>186</sup> Schuman's speech (or declaration as it is widely known), which was highly inspired and for the most part drafted by Jean Monnet, proved to be highly inspirational, to the degree that was considered as the founding act of European integration. Henceforth, 9 May is celebrated as 'Europe Day.' It should be noted that the idea of united Europe was not, however, new. After the WWI, Aristide Briands, who was the French Foreign Minister and President of the Pan-European Union (the latter was founded by the Austrian Count Coudenhove Kalergi founded in 1923), organised and gathered together political figures from various European countries in the first Pan-European Congress in 1926 in Vienna, calling for a federal European Union. These efforts, however, were not successful.

Schuman's declaration, opened negotiations and led to the signature of the Paris Treaty in 18 April 1951,<sup>187</sup> which launched the first step towards a supranational Europe, i.e. the European Community of Steel and Coal (ECSC). In the meantime, there was another Monnet-Schuman European integration attempt – called the European Defence Community (EDC) – involving the creation of a European army, which, however, never came about due to failure in reaching an agreement (mainly because the French National Assembly rejected it in 1954).<sup>188</sup> It is important to clarify here that the author is not referring to an actual supranationalism, as we mean it today. At that stage, the 'supranational' integration had rather the meaning of an inter-governmental cooperation and reciprocal assistance. However, it is widely considered to be the first step toward a supranational Europe because

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<sup>184</sup> 'Winston Churchill's Speech to the academic youth in Zurich 19 September 1946' <[http://www.legalanthology.ch/wp-content/uploads/2014/01/E\\_2.3\\_Churchill\\_Speech-to-the-academic-youth\\_europe-web.pdf](http://www.legalanthology.ch/wp-content/uploads/2014/01/E_2.3_Churchill_Speech-to-the-academic-youth_europe-web.pdf)> accessed 14 July 2017.

<sup>185</sup> See: 'The Schuman Declaration' (9 May 1950) <[https://europa.eu/european-union/about-eu/symbols/europe-day/schuman-declaration\\_en](https://europa.eu/european-union/about-eu/symbols/europe-day/schuman-declaration_en)> accessed 14 July 2017.

<sup>186</sup> 'The European Union explained: The founding fathers of the EU (European Commission 2013) <[http://knjiznica.sabor.hr/pdf/E\\_publicacije/The\\_founding\\_fathers\\_of\\_the\\_EU.pdf](http://knjiznica.sabor.hr/pdf/E_publicacije/The_founding_fathers_of_the_EU.pdf)> accessed 14 July 2017.

<sup>187</sup> 'Treaty constituting the European Coal and Steel Community' [1951] (hereinafter: ECSC Treaty) <<http://www.consilium.europa.eu/uedocs/cmsUpload/Treaty%20constituting%20the%20European%20Coal%20and%20Steel%20Community.pdf>> accessed 14 July 2017.

<sup>188</sup> See: European Commission 2013 (n 187).

firstly, it was the first time that European States (six at that stage) agreed to work towards integration, and secondly, because, its High Authority had a decision making power with binding effect for its Member States.

The ECSC had legal personality and was administered by a High Authority, which was presided by Jean Monnet, a Parliamentary Assembly, a Council of Ministers, a Court of Justice and a Consultative Committee.<sup>189</sup> The founding members of the ECSC were France, Germany, Italy, Luxemburg, Belgium and the Netherlands, and the main goal was the creation of a unity that would ensure long lasting peace, security, financial soundness and stability among the European countries in the aftermath of WWII. However, the founding fathers of this initiative had a forward-looking vision that was beyond the creation of a European setting that would merely facilitate cooperation in coal and steel production. This vision involved the creation of a true 'European Federation.' In Schuman's words: *"The pooling of coal and steel production should immediately provide for the setting up of common foundations for economic development as a first step in the federation of Europe and to open up the longer-term prospect of constructing a federal Europe."*<sup>190</sup> Moreover, this is evident by the Shuman-Monnet proposals for the creation of common institutions, as means to facilitate common proposals, negotiations and decisions in the best interest of the unity as whole, which survived throughout the years and are still in force within the existing EU framework.<sup>191</sup>

The creation of the ECSC paved the road to the Treaties of Rome, which were signed on 25 March 1957, and entered into force on 1 January 1958. The Treaties of Rome established two more Committees: the European Economic Community (EEC)<sup>192</sup> or the "common market", where people, goods and services would move freely among Member States; and the European Atomic Energy Community (widely known as the EURATOM).<sup>193</sup> The

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<sup>189</sup> ECSC Treaty (n 188) Article 7.

<sup>190</sup> The Schuman declaration (n 186).

<sup>191</sup> Noel, Emile in 'Jean Monnet, Proceedings of the Centenary Symposium organised by the Commissions of the European Communities' (Office for Office Publications of the European Communities, 10 November 1989) 48 <<http://aei.pitt.edu/52373/1/A7287.pdf>> accessed 14 July 2017.

<sup>192</sup> Codified Version of the Treaty Establishing the European Community (hereinafter: TEC) [1957] OJ C224/6 <<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:11992E/TXT&from=EN>> accessed 14 July 2017.

<sup>193</sup> Consolidated version of the Treaty Establishing the European Atomic Energy Community (hereinafter: EUROTOM Treaty) [2010] OJ C84 <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:084:0001:0112:EN:PDF>> accessed 14 July 2017.



major difference between the ECSC and the two latter, was that the EEC and EURATOM were concluded with no expiration date,<sup>194</sup> which conferred quasi-constitutional status on them. In the meantime, the other European countries, including: Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom, were reluctant in joining the European Communities and preferred instead to create a separate alliance by establishing the European Free Trade Association (EFTA),<sup>195</sup> which was more of a free trade area union rather than a customs union. Subsequently, the Community of Six, due to its growing economic attractiveness, expanded throughout the years by attracting an increasing number of states.<sup>196</sup> For instance, at a later stage, all the EFTA Member States, applied for an EU Membership. Another significant event that was considered to be the political engine of European integration, is the Franco-German Friendship, which was affirmed in January 1963 with the Joint Declaration of Dr Konrad Adenauer, who served as Chancellor of the Federal Republic of Germany at the time, and the President of the French Republic, Charles de Gaulle.<sup>197</sup>

At the time, the idea of a monetary integration, was not yet part of the European integration process. This happened largely due to the fact that European integration was still at an early stage; and also, because, the Community of the Six, following the international trend, was part of a well-organised global fixed exchange-rate monetary system, i.e. the so-called Bretton Woods System.<sup>198</sup> Accordingly, the authors of the Treaties of Rome did not include the idea of a single currency between the Member States, while the objectives of EEC were developed only to the extent of a customs union and a common agricultural market.<sup>199</sup> It was only in October 1962, when the EU Commission issued a Memorandum (known as the

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<sup>194</sup> See: TEC (n 193) Article 240 and EURATOM Treaty (n 195) Article 208.

<sup>195</sup> 'Consolidated version of the Convention establishing the European Free Trade Association, last amended on 1 July 2013' <<http://www.efta.int/sites/default/files/documents/legal-texts/efta-convention/Vaduz%20Convention%20Agreement.pdf>> accessed 14 July 2017.

See also: EFTA website <<http://www.efta.int/about-efta/history>> accessed 14 July 2017.

<sup>196</sup> Loth, Wilfried, 'Explaining European Integration: The Contribution from Historians' (2008) 14 (1) *Journal of European Integration History* 8, 20 <[http://www.eu-historians.eu/uploads/Dateien/jeih-27-2008\\_1.pdf](http://www.eu-historians.eu/uploads/Dateien/jeih-27-2008_1.pdf)> accessed 14 July 2017.

<sup>197</sup> Baimbridge, Mark J., Mullen, Andrew and Whyman, Philip B., *The political economy of the European social model* (Routledge Studies in the European Economy 2012) 33.

<sup>198</sup> The Bretton Woods System is further analysed in chapter two.

<sup>199</sup> Scheller, Hanspeter K., 'The European Central Bank: History, Role and Functions' (2nd rev edn, ECB Publications 2006) <<http://www.ecb.europa.eu/pub/pdf/other/ecbhistoryrolefunctions2006en.pdf>> accessed 14 July 2017.

Marjolin Memorandum), in which it was stressed that a Single Market requires a single currency and highlighted the link between economic and monetary integration.<sup>200</sup> This led to a series of serious discussion on European monetary integration, which in turn, triggered an intense debate about the creation single currency and further monetary integration at the Community level.<sup>201</sup> Despite the fact that there was no action taken under the scope of the memorandum, the establishment of the Committee of Governors of the central banks of the Member States of the EEC in 1964, proved to be of great importance in fostering the monetary cooperation among the Community central banks and in the final move towards the EMU. In addition, the Committee was responsible for the preparatory process of the first draft Statute of ECB in 1990.<sup>202</sup>

By the late 1960s, European integration was showing signs of effectiveness and positive progress, including: the prompt completion of the transition period towards the establishment of a true customs union; the adoption of a common agricultural policy; and the foundation of a system of own resources.<sup>203</sup> However, although Europe's junior integration steps were marked by successful achievements, at international level, the Bretton Woods system was approaching its collapse. Thus, the last tie to the golden standard was also about to end. This brought the need for a mechanism that would replace it at European level. As a response, the EU Commission officially introduced the new objective of European integration: the EMU. In particular, in 1969, the EU Commission submitted a memorandum to the EU Council (known as the Barre Plan or Barre Memorandum),<sup>204</sup> which aimed at the promotion of economic policy coordination and monetary cooperation among the members of the EEC.<sup>205</sup> As it was stated at the Barre Plan: "*At the present time the Community is an original*

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<sup>200</sup> Commission 'Memorandum and Proposals to the Council on the establishment by stages of economic and monetary union' COM (70) 1250.

<sup>201</sup> Mongelli, Francesco P., 'European Economic and Monetary Integration, and the Optimum Currency Area Theory' (2008) European Commission, Economic Papers No 302, 9 <[http://ec.europa.eu/economy\\_finance/publications/publication12081\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication12081_en.pdf)> accessed 14 July 2017.

<sup>202</sup> Andrews, David, 'The Committee of Central Bank Governors as a source of rules' (2003) 10 (6) Journal of European Public Policy 956.

<sup>203</sup> The Delors Report (n 54) point 1.

<sup>204</sup> Commission 'Memorandum to the Council on the coordination of economic policies and monetary cooperation within the Community' (Bulletin of the European Communities, Supplement No 3/1969) COM (69) 150 (hereinafter: The Barre Plan).

<sup>205</sup> Smits, Rene, *The European Central Bank: Institutional Aspects* (Kluwer Law International 1997).

*and complex entity, consisting of both national and Community elements started from the observation that the Community was “an original and complex economic entity”.*<sup>206</sup>

The Barre Plan was followed by the Werner Report (also known as Werner Plan), which was created after the Heads of State and Government of the European Community (as was the EU originally called) requested the Council to prepare a plan with a view of furthering the European integration through the creation of an economic and monetary union.<sup>207</sup> The Council, in turn created a Committee, which was chaired by the Prime Minister of Luxembourg, Pierre Werner, and provided the aforementioned report (the Werner Report) in October 1970.<sup>208</sup> In March 1971, following Werner Report, the Member States reached an agreement, which was finalised with the establishment of a Community exchange rate system (also known as the currency “snake” or the “snake in the tunnel” system) that came into force in 1972, and by which, the Community Members agreed to peg their currencies to each other.<sup>209</sup> It should be noted that not all the Community Members’ currencies were part of the system. In fact, the “snake” constituted an exchange rate system only among the Deutsche mark, the Dutch guilder, the Belgian and Luxembourg francs and the Danish krone.

Along the same lines, in 1973 another mechanism was introduced as an essential part of the “snake’s” operation: the European Monetary Fund Cooperation (EMFC). Despite the fact that the EMFC was established in order to coordinate the central banks’ cooperation, its operation remained limited in technical tasks.<sup>210</sup> The “snake” was not considered as particularly successful, but it rather raised concerns and politically controversial debates. As we will discuss below, the case of United Kingdom’s (hereinafter UK) participation in the Exchange Rate Mechanism (ERM) is a representative example that the objectives set by the ERM were far from being achieved. Namely, on 16 September 1992, a day that came rapidly

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<sup>206</sup> The Barre Plan (n 205) point 5.

<sup>207</sup> ‘Final Communiqué of the Hague Summit on 1- 2 December 1969 in Hague’ (Bulletin of the European Communities 1-1970) point 8.

<sup>208</sup> ‘Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community’ (Supplement to Bulletin of the European Communities 11-1970) (hereinafter: the Werner Report) <[http://ec.europa.eu/economy\\_finance/publications/publication6142\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication6142_en.pdf)> accessed 14 July 2017.

<sup>209</sup> ‘Resolution of the Council and of the Representatives of the Governments of the Member States of 21 March 1972 on the application of the Resolution of 22 March 1971 on the attainment by stages of economic and monetary union in the Community’ [1972] OJ C 38/3.

<sup>210</sup> For a detailed analysis: Ungerer, Horst, *A Concise History of European Monetary Integration: From EPU to EMU* (Quorum Books 1997).

to be known as Black Wednesday, the UK, struggling to maintain the value of its currency within agreed limit of EMR floating band, was forced to exit from the EMR in less than two years after joining it. The result was a rapid depreciation of pound sterling and an instantaneous loss of credibility. This event also seriously undermined the UK's financial policy and damaged the reputation of the Prime Minister, John Major and his Chancellor, Norman Lamont.<sup>211</sup> After leaving the ERM, however, the UK entered its longest period of continuous economic growth.<sup>212</sup> The UK adopted inflation targets after exiting from EMR in order to restore a nominal anchor and inflation rates.

From the mid-1970s, the initial tendency to create a more consolidated monetary union at Community Level, was weakened and to a high degree, was disorientated due to a number of factors, including: the oil shock of 1973; policy divergence at national level and weak compliance with the currency "snake"; dollar weakness and the economic consequences that followed. Italy withdrew from the 'currency snake' in February 1973; France in January 1974, re-joined in July 1975 and withdrew again in March 1976; Denmark and the United Kingdom became part of it in May 1972 and withdrew in June 1972. Thus, in 1979 the snake was abandoned. Simultaneously, Europe entered a period of high inflation and increased unemployment rates, which gave priority to national initiative and the Community's role was placed in a secondary position.<sup>213</sup>

### 1.3.2 The European Monetary System

Following the period of "currency snake," it was only in 1979 when signs of progress towards furthering monetary integration were initiated again. This initiation came with the establishment of the European Monetary System (EMS), which came into operation in March 1979.<sup>214</sup> The aim was the creation of an area of monetary stability, by encouraging Member

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<sup>211</sup> Toye, Richard and Gottlieb, Julie, *Making Reputations: Power, Persuasion and the Individual in Modern British Politics* (I.B. Tauris 2005).

<sup>212</sup> 'Sir John Major, Conservative 1990 to 1997' <<https://www.gov.uk/government/history/past-prime-ministers/john-major>> accessed 14 July 2017.

<sup>213</sup> See:

- Mongelli (n 202); and
- 'Phase 2: the European Monetary System' (European Commission website) <[http://ec.europa.eu/economy\\_finance/euro/emu/road/ems\\_en.htm](http://ec.europa.eu/economy_finance/euro/emu/road/ems_en.htm)> accessed 14 July 2017.

<sup>214</sup> 'Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System and related matters' [1978] Bulletin of the European Communities No 12/1979 10 (hereinafter: EMS Council Resolution).

States to coordinate their monetary policies at Community level.<sup>215</sup> The EMS involved the creation of a fixed exchange rate mechanism (ERM) that was meant to facilitate the creation of a single market.<sup>216</sup> The main objective of ERM was to enhance the credibility of monetary policy through the reductions of increased inflation with minimum effects on unemployment, through the setup of a stable exchange rates that would promote trade among participating countries. Another mechanism that was adopted within the context of the EMS establishment, was the European Currency Unit (ECU)<sup>217</sup> that was designed to operate as a basket currency.<sup>218</sup> It is worth noting that the establishment of the EMS, including all its supporting mechanisms, was achieved without the need for formal treaty revision.<sup>219</sup>

In contrast with the “snake”, the EMS managed to maintain most of the Member States’ currencies within a single exchange rate system. In addition, it has been considered an improved mechanism due to the introduction of the ECU (the forerunner of the future single currency, the Euro), and the perception of a European Monetary Fund (EMF).<sup>220</sup> The participation in EMS, also, strengthened cooperation and monetary policy coordination among the Member States, and proved to have been a useful tool for countries dealing with high inflation rates, fostering in this way exchange rate stability.<sup>221</sup> The ECU was meant to be at the centre of the system and would be used “*as a means of settlement between EEC monetary authorities.*”<sup>222</sup> However, its role within the EMS remained rather limited in practice, which was attributed to the absence of an anchor for the ECU.<sup>223</sup>

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<sup>215</sup> Conclusions of the Presidency of the European Council resolution on the establishment of the EMS in 5 December 1978, Brussels, point 1 para 2

<sup>216</sup> EMS Council Resolution (n 215) point 3.

<sup>217</sup> EMS Council Resolution (n 215) point 2.2.

<sup>218</sup> Vranken, Martin, ‘The Euro crisis in context: Historical and legal perspectives Journal Articles Refereed’ (2012) Association of Comparative Legislation of the Countries of the Pacific <<http://www.victoria.ac.nz/law/research/publications/about-nzacl/publications/cljpidcp-journals/volume-18,-2012/Vranken.pdf>> accessed 14 July 2017.

<sup>219</sup> Vranken (n 219) 180.

<sup>220</sup> Mourlon-Druol, E., *A Europe Made of Money: the emergence of the European Monetary System* (Cornell University Press 2012).

<sup>221</sup> See:

- Scheller (n 200) 19; and
- Bayoumi, Tamim, ‘International Monetary Fund: The Effect of the ERM on Participating Economies’ (1992) 39 (2) IMF.

<sup>222</sup> Annex to the Conclusions of the Presidency of the European Council (Bremen, 6 and 7 July 1978) point 1.

<sup>223</sup> Scheller (n 200) 20.

The overall satisfactory performance of the EMS in promoting monetary stability, inspired confidence and hope for further European integration. As a result, the Single European Act (SEA) was adopted in 1986,<sup>224</sup> which came into force in 1987 and constituted one of the most important amendments of the Treaty since the establishment of the Common Market in 1968. The aim of the SEA was the creation of a single market among the European Community countries as the first step towards an economic and monetary union.<sup>225</sup> The importance of SEA lays to the fact that it sets the basis of a common financial market between the participating members, and it was the first official attempt to enshrine the plan of an EMU into primarily Community law.<sup>226</sup>

In 1988 the Hanover European Council established a Committee, led by Jacque Delors, the EU Commission's President of that time,<sup>227</sup> in order to study the European economic and monetary union perspective. This produced the so-called the Delors Report in 1989,<sup>228</sup> which introduced a three-stage plan for the establishment of the EMU and emphasised the necessity for a greater coordination at European level in the fields of monetary policy and macroeconomic management.<sup>229</sup> Notably, Delors expressed his vision for a united Europe even beyond a merely economic union, as: "*a frontier free economic and social area on the way to becoming a political union.*"<sup>230</sup> Delors Report followed its predecessor's idea, the Werner plan, and supported that in order for the EMU to be established in the basis of a single currency, it should be administered by the a supranational monetary policy authority: a European System of Central Banks.<sup>231</sup> The SEA led to the first Treaty amendment, including the introduction of Article 102A, which was used later as the legal basis for the establishment EMU.<sup>232</sup> The stages of European financial integration is analysed in detail in chapter two.

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<sup>224</sup> 'Regulation establishing the Single European Act' [1986] OJ L169/1 (hereinafter: SEA).

<sup>225</sup> Dinan, Desmond, *Ever Closer Union: An Introduction to European Integration* (3rd edn, Lynne Rienner Publishers Inc. 2005).

<sup>226</sup> Smits (n 206) 27.

<sup>227</sup> Supplement to Bulletin 11/89 of the European Communities, point 18.

<sup>228</sup> The Delors Report (n 54).

<sup>229</sup> The Delors Report (n 54) point 19.

<sup>230</sup> Dinan, D., *Ever Closer Union: An Introduction to European Integration* (3rd edn, Lynne Rienner Publishers Inc. 2005) 97

<sup>231</sup> The Delors Report (n 54).

<sup>232</sup> Vranken (n 219) 181.

### 1.3.3 The Maastricht Treaty

At the same period of time, there were significant political and historical events taking place in Europe, such as the fall of the Berlin Wall and the collapse of communism in the majority of Central and Eastern Europe countries. Consequently, the need for cooperation at a supranational level was felt more than ever.<sup>233</sup> To this end, following the plan set by Delors Report, the 1989 Strasbourg European Council requested an intergovernmental conference (IGC), in an attempt to identify the necessary amendments of the Treaty able to facilitate the creation of EMU. The work of the intergovernmental congress resulted in the Treaty on European Union (TEU), which was signed on February 1992 in Maastricht and came into force in 1993.<sup>234</sup> The TEU (also known as the Maastricht Treaty) constitutes one of the most important milestones in the history of the EU, establishing defined rules for the forthcoming single currency as well as for a new foreign and security policy framework, within the scope of an increased coordination and cooperation among the Member States in regards with justice and home affairs.<sup>235</sup> As it was stated in the TEU: *“This Treaty marks a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as closely as possible to the citizen.”*<sup>236</sup>

The TEU was an extensive legal document, which was divided into seven titles and included seventeen binding Protocols and thirty-three Declaration attachments.<sup>237</sup> With regards to monetary union, the TEU specified, that in accomplishing the common objective of the EMU, a three stage process - of four years each - should be followed, as it was originally envisaged by the Delors Report.<sup>238</sup> At the same time, and while the agreement of the common goal of the creation of the EMU was reached, the TEU set the so-called “convergence criteria”<sup>239</sup> as a precondition for the Member States in order to become part of the EMU.<sup>240</sup>

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<sup>233</sup> Kaczorowska, Alina, *European Union Law* (2nd edn, Routledge 2011).

<sup>234</sup> Treaty on European Union [1992] OJ C191/1 (hereinafter: TEU) <<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:11992M/TXT&from=EN>> accessed 14 July 2017.

<sup>235</sup> European Union, ‘Towards a single currency: a brief history of EMU’ <[http://europa.eu/legislation\\_summaries/economic\\_and\\_monetary\\_affairs/introducing\\_euro\\_practical\\_aspects/l25007\\_en.htm](http://europa.eu/legislation_summaries/economic_and_monetary_affairs/introducing_euro_practical_aspects/l25007_en.htm)> accessed 14 July 2017.

<sup>236</sup> TEU (n 235) Common Provisions, Article A.

<sup>237</sup> Kaczorowska (n 234) 22.

<sup>238</sup> TEU (n 235) Article 7(1) para 2.

<sup>239</sup> See also: Protocol on the Convergence Criteria annexed to the TEU (n 235).

<sup>240</sup> Artis, Michael J., ‘The Maastricht Road to Monetary Union’ (1992) 30 (3) *Journal of Common Market Studies* 299.

According to Article 140, TEU, the convergence criteria that Member States would have to meet, as a precondition to join the EMU, were: a high degree of price stability; sustainability of the government financial position; the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro; the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels. Most importantly, the Member States, by signing the TEU, were not only committed to institutionalise monetary policy at the Community Level; they also agreed, to transfer their national sovereignty in a new supranational institution, assigned with a mandate of price stability and the power of acting autonomously in deciding and implementing its goals.

The first stage of the EMU's implementation plan, began in 1 July 1990 and was completed in 31 December 1993, when Europe reached a complete liberalisation of capital movements and its Member States became also members of an area of free movement of goods, capital, services, and people (these are also known as the EU's four freedoms). As the process had to move further, and in accordance with Article 109e(1), TEU, the 1<sup>st</sup> of January 1994 was set the official starting date of the second stage, which had to be completed on 31 December 1998.<sup>241</sup> The second stage introduced a new institution, the European Monetary Institute (EMI), which was entrusted with the task of strengthening the cooperation and coordination of monetary policies within the participating countries.<sup>242</sup> As the President of the EMI, Duisenberg, stated: *"the main task of the European Monetary Institute (EMI) has been to translate into a coherent plan, and to implement, the political commitment to*

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<sup>241</sup> Bulletin of the European Communities No 10-1993, point 8.

<sup>242</sup> TEU (n 235) Article 109f.

See also: Protocol on the Statute of the European System of Central Banks and on the European Central Bank (hereinafter: ESCB Statute), Annexed to the Treaty Establishing the European Community [1992] OJ C191/68, as amended by the Treaty of Amsterdam [1997] OJ C340/1, the Treaty of Nice [2001] OJ C80/1, Council Decision 2003/223/EC OJ L83/66 and the Act concerning the conditions of Accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded [2003] OJ L236/33 – unofficial consolidated version <[https://www.ecb.europa.eu/ecb/legal/pdf/en\\_statute\\_2.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/en_statute_2.pdf)> accessed 14 July 2017.

For the latest version of the ESCB Statute see: 'Protocol (No 4) On the Statute of the European System of Central Banks and of the European Central Bank' [2016] OJ C202/230 <[https://www.ecb.europa.eu/ecb/legal/pdf/oj\\_c\\_2016\\_202\\_full\\_en\\_pro4.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/oj_c_2016_202_full_en_pro4.pdf)> accessed 14 July 2017 (hereinafter: ESCB Statute).



*establish a monetary union that the European countries made in signing the Maastricht Treaty.*"<sup>243</sup> EMI, played the role of a transitory institution towards the completion of the EMU project, and became responsible for conducting all actions required for the adoption of the single currency, until the ECB took over.<sup>244</sup> Lastly, the EMI had legal personality and its independence, while not at same level with its successor's (i.e. the ESCB), was granted under Article 8 of EMI Statute.<sup>245</sup> In particular, Article 8 of EMI Statute gave EMI's members the freedom to act according to their own responsibilities, which can be comparable to Article 7, ESCB Statute.<sup>246</sup>

During stage two, various difficulties became evident, which raised doubts as to the feasibility of accomplishing the plan for an economically and monetary united Europe. The ratification process of TEU was, among the rest, an issue that gathered attention, since it proved to be relatively long and not particularly smooth.<sup>247</sup> Another greatly discussed topic, was the establishment of the European System of Central Banks (ESCB), which although was discussed since the publication of the Delors plan and was supposed to be part of the second stage, in practice, it was not achievable. This happened due to the fact that the preparation of transferring national sovereignty in a supranational level, by creating, at the same time, the adequate conditions for the new monetary policy coordination framework, was not straightforward and took longer than expected. Lastly, the role of EMI, whereas pivotal in preparing the ground for the establishment of the ESCB at a later stage, remained to a large extent limited. Notably, decisions regarding monetary policy, were still largely a privilege of the national authorities, while the EMI was not enjoying any decision-making power.<sup>248</sup>

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<sup>243</sup> Duisenberg, Willem Frederik, 'The European Monetary Institute and progress towards monetary union' (speech delivered by President of the European Monetary Institute at the International Banking Seminar on 22 September 1997 in Hong Kong) <<https://www.ecb.europa.eu/press/key/date/1997/html/sp970922.en.html>> accessed 14 July 2017.

<sup>244</sup> See:

- TEU (n 235) Article 109f(2) and (3); and
- 'Treaty establishing the European Community (consolidated version), D. Protocols annexed to the Treaty establishing the European Community Protocol (No 19) on the Statute of the European Monetary Institute' [1992] OJ C 321E/281 (hereinafter: EMI Statute), Articles 2, 4.1 and 4.2.

<sup>245</sup> EMI Statute (n 245).

<sup>246</sup> Smits (n 206) 49.

<sup>247</sup> Andenas, Mads and Kenyon-Slade, Stephen, *EC Financial Market Regulation and Company Law* (Sweet & Maxwell 1993) 233-235.

<sup>248</sup> 'European Monetary Institute' (European Monetary Institute, 1997) <[http://www.ecb.europa.eu/pub/pdf/othemi/pub\\_02en.pdf](http://www.ecb.europa.eu/pub/pdf/othemi/pub_02en.pdf)> accessed 14 July 2017.

The next and final stage in completing the EMU project, started after the Member States had fulfilled the convergence criteria, and was completed with the adoption of the ESCB and ECB on 1 June 1998. The process reached its peak with the introduction of the single currency, the Euro, in 1 January 1999, crowning the vision for EMU's creation. Henceforward, the ESCB, consisting of the ECB and the national central banks (hereinafter: NCBs), is entrusted with the responsibility of implementing the common monetary policy framework.<sup>249</sup> Lastly, it should be noted that the EU Treaties (both the TEU and TEC) underwent two notable amendments, including the Treaty of Amsterdam,<sup>250</sup> which was signed on 2 October 1997 and the Treaty of Lisbon,<sup>251</sup> which was adopted on 13 December 2007 and entered into force on 1 December 2009. The Lisbon Treaty renamed TEC to TFEU (the Treaty on Functioning of the European Union – hereinafter TFEU). In the monetary union area, the Treaty of Lisbon, or aimed at strengthening the decision-making authority of the EU Council for Member States that have joined the single currency.<sup>252</sup>

#### 1.3.4 ESCB Structure

Although the ESCB structure and objectives are subject to further analysis in chapter three, it is important at this stage, to outline some of the main characteristic of its functioning. The ESCB, is composed of the ECB and 28 NCBs of the euro participating and non-participating European countries. The ECB and the NCBs of the 18 countries that have adopted the Euro form the Eurosystem, where the participating Member States have ceded control over monetary policy to the ECB and the latter is responsible for defining and implementing monetary policy. The NCBs differ from the ECB in so that the NCBs constitute bodies with legal personality authorised by the law of each country, whereas the ECB enshrined its legal personality under EU Law. The ESCB does not have its own legal personality, thus, it is governed by the independent decision-making bodies of the ECB. Nevertheless, the ESCB is responsible for promoting and ensuring the values, and the completion of ESCB targets, in accordance with the EU Treaties and the ESCB Statute. The main body of the ECB is the

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<sup>249</sup> See:

- Mongelli (n 202) 15-16; and
- ESCB Statute (n 243).

<sup>250</sup> Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts [1997] OJ C340/01.

<sup>251</sup> TFEU (n 5).

<sup>252</sup> TFEU (n 5) Article 136.

Governing Council, which is entrusted with decision-making powers. The Governing Council includes the Executive Board of ECB and the central bank governors of the Member States, and is empowered with the duty of defining and implementing monetary policy.<sup>253</sup>

Although the objectives of the ESCB and its duties are laid down in Article 127, TFEU, its status within the Community, in comparison with the rest of EU bodies and institutions, remains a puzzled issue. This is partly attributed to the fact that the ESCB consists of internal bodies with separate legal personality and the ESCB is operating under an independent status, enshrined by EU Law. However, at the same time, the ESCB should act within the scope of the common EU objectives while performing its monetary policy's duties. Moreover, as Smits argued: *"the ESCB is part of the Community and as such should act in accordance and cooperation with the rest of Community's Institutions, and has to be treated as subject to the general rules of the Community."*<sup>254</sup> In supporting this argument, Smits refers to Article 5 TEU, considering it applicable to relations between both the institutions and ESCB, and the ESCB and Member States.<sup>255</sup> The question of what powers come under EU jurisdiction is an ongoing topic that has been subject to an extensive controversy.

A good example is a recent case, involving the European Stability Mechanism (ESM), which is a permanent bailout EU agency that provides financial assistance, mainly in the form of loans, to Eurozone Member States' financial institutions when facing difficulties. The case concerned claims against ECB's and EU Commission's role, regarding their involvement in the intervention ESM to assist the two biggest Cypriot banks. The problem started when the claimants had suffered a substantial decrease in the value of their deposits following the forced bank restructure. Thus, the claimants were seeking firstly, the annulment of specific parts of the Memorandum of Understanding on Specific Economic Policy Conditionality concluded between the Republic of Cyprus and the ESM for the restructuring of the banks and compensation from the involvement of the ECB and the EU Commission in the adoption of the MoU. The ECJ rejected the annulment claims, mainly based on the plea that the MoU was adopted by the Republic of Cyprus and the ESM, and since the ESM falls outside the remit

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<sup>253</sup> TEU (n 235) Article 105-109d; and ESCB Statute (n 243). See also: Wrase, Jeffrey M., 'The euro and the European Central Bank' (1999) Business Review, Federal Reserve Bank of Philadelphia 3.

<sup>254</sup> Smits (n 206) 473.

<sup>255</sup> Smits (n 206) 92-100.

of EU law, the legality of its acts cannot be reviewed under Article 263, TFEU.<sup>256</sup> Interestingly, however, the ECJ held that the tasks allocated to the EU Commission by the EU Treaty oblige the latter to ensure that MoUs concluded by the ESM - which is an international body that falls outside of EU remit - are in conformity with EU law.<sup>257</sup> A justification of this view was provided by the Advocate General Wahl, who opined that: *“Given that they were performing tasks outside the framework of the EU, the conduct of the EU institutions criticised by the appellants in the present cases should be viewed mainly through the lens of public international law. Those institutions were in fact acting on behalf of an international organisation (the ESM), whose members are sovereign States, with a view to concluding an international agreement...Under the rules of public international law...the conduct of agents of international organisations is generally imputable to the organisation itself.”*<sup>258</sup> Therefore, this raises an important question, which although exceeds the scope of this analysis, is worth mentioning. Is this reasoning to be considered as the EU Commission has the responsibility to ensure the conformity with EU Law of every MoU conducted?

## 1.4 ECB independence

### 1.4.1 Core elements

The ECB was created in a period, as discussed earlier, when the idea of independence was enjoying widespread acceptance at national, regional and international level. There was a broad consensus that the independence of the guardian of EU's common currency was an important prerequisite in promoting price stability and low inflation. As mentioned earlier, there were also several empirical studies, which provided evidence about the link between central bank independence and low inflation.<sup>259</sup> Following this general trend, the independent status of the ECB was guaranteed even before the ECB started to operate and was subsequently reflected in both the TFEU and the Statute of ESCB. The statutory independence of ECB is enshrined in the EU treaties, forming EU primary law, rather than just secondary legislation.<sup>260</sup> Therefore, amending the independence of the ECB requires

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<sup>256</sup> Joined Cases C-8/15 P to C-10/15 P *Ledra Advertising Ltd and Others v European Commission and European Central Bank* (ECB) [2016] ECR paras 50 and 55 (hereinafter: *Ledra case*).

<sup>257</sup> *Ledra case* (n 257) para 50.

<sup>258</sup> *Ledra case* (n 257) Advocate General Wahl Opinion delivered on 21 April 2016 para 98.

<sup>259</sup> See: section 1.1.2.

<sup>260</sup> See: Kapteyn, P.J.G., McDonnell, A.M. and Mortelmans, K.J.M. (eds), *The Law of the European Union and the European Communities* (4<sup>th</sup> rev edn, Kluwer Law International 2008) 952.

amendment of the TFEU in accordance with Article 48, TEU. The high level of independence granted to the ECB, has raised questions of accountability and legitimacy of its decisions, which is further explored in the following section.

In addition, it was a compulsory precondition for the countries that wanted to join the euro-area, to have completed the process of granting their central bank full institutional independence.<sup>261</sup> In particular, Article 130, TFEU, provides that: *“The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle [of central bank independence] and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.”* Thus, failure to ensure central bank independence would count as a breach of EU law, which would justify bringing an action before the ECJ.<sup>262</sup> For instance, Romania is an example of a new entrant that undertook significant steps to update its banking legislation in order to meet the requirements of joining the Eurozone and strengthening central bank independence was among the main prerequisites.<sup>263</sup>

Having discussed already the main types of central bank independence and their theoretical foundation, the following analysis focuses on the various forms of ECB independence as provided by EU law.

#### A. Institutional Independence

As previously mentioned, institutional independence refers to the ability of the monetary authority to act independently, as a separate, from the other government institutions, legal entity.<sup>264</sup> Within the ESCB, both members of ECB and NCBs should be acting in accordance to their own responsibilities, free of any influence from both national and EU level. Moreover, the members of ECB and NCBs are not obliged, while performing their tasks,

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<sup>261</sup> TEU (n 233) Article 108.

<sup>262</sup> Smaghi, Lorenzo Bini, ‘Central bank independence: from theory to practice’ (Speech by Member of the Executive Board of the ECB at the conference: Good Governance and Effective Partnership, Budapest, Hungarian National Assembly, 19 April 2007) <<https://www.ecb.europa.eu/press/key/date/2007/html/sp070419.en.html#fnid7>> accessed 14 July 2017.

<sup>263</sup> Dragoş, Păun, Zoicas-Ienciu Adrian and Trenca, Ioan, ‘Considerations on Monetary Policy held by the Central Bank to Adopt the Euro’ (2010) 19 (1) Annals of the University of Oradea, Economic Science Series 449, 450.

<sup>264</sup> See also: Smits (n 206) 155.

to seek assistance from any other EU body or the respective governments.<sup>265</sup> Thus, the ECB acts independently when deciding and implementing the policies that fall within the scope of the tasks entrusted to the ESCB under the TFEU and its Statute; while member states and EU institutions, bodies, offices and agencies and the governments shall respect this independence by avoiding to influence the members of the ECB decision making bodies.<sup>266</sup>

## B. Personnel Independence

This type of independence refers to the autonomy of the internal bodies' members of the ECB. In particular, the Governors of the NCBs and members of the Executive Board are granted, at least, a five and eight year office term respectively.<sup>267</sup> However, while the members of the Executive Board term office mandate is not renewable,<sup>268</sup> the governors of the NCBs may be reappointed.<sup>269</sup> Furthermore, the members of the Executive Board are committed to perform their duties in a full-time basis and exclusively, without the possibility to combine it with any other professions.<sup>270</sup> In addition, the members of the Executive Board can be discharged from their duties only if they no longer fulfil the required conditions for the performance of their duties or in case of guilt of a serious misconduct.<sup>271</sup> The same principle apply to the national procedures concerning the dismissal of the NCBs' members, which should be set in respect with the relevant procedures as are underlined in the Statute of ESCB.<sup>272</sup> Lastly, the Governors of NCBs are provided with a minimal office term length of five years.<sup>273</sup>

## C. Functional independence

Functional independence, involves the key powers and tools that should be assigned to the monetary authority which would enable the accomplishment of its main goal, i.e. price stability. In particular, ESCB holds the power to define and implement monetary policy

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<sup>265</sup> TFEU (n 5) Article 130 and ESCB Statute (n 243) Article 7.

<sup>266</sup> TFEU (n 5) Article 130, 282(3) and ESCB Statute (n 243) Article 7.

<sup>267</sup> ESCB Statute (n 243) Articles 14.2 and 11.2.

<sup>268</sup> TFEU (n 5) Article 283(2) and ESCB Statute (n 243) 11.2.

<sup>269</sup> ESCB Statute (n 243) Article 14.

<sup>270</sup> ESCB Statute (n 243) Article 11.2.

<sup>271</sup> ESCB Statute (n 243) Article 11.2.

<sup>272</sup> ESCB Statute (n 243) Article 11.4 and 14.2.

<sup>273</sup> ESCB Statute (n 243) Article 14.2.

exclusively,<sup>274</sup> and is also, the responsible body for banknote issuance.<sup>275</sup> Moreover, the ECB holds the exclusive power of controlling the share capital and foreign reserve assets when they fall within the scope of the ESCB Statute.<sup>276</sup> The ECB power is limited in granting loans or any other type of credit facilities or debt instruments in favour of any EU or national: *“institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States.”*<sup>277</sup> The only exception to this rule is the case of publicly owned credit institutions, which, enjoy the same privileges as private credit institutions.<sup>278</sup> This aims to avoid scenarios that would facilitate the ECB strategies and operations to being influenced by important creditors-members of Eurozone’s associations and arrangements.<sup>279</sup>

Lastly, the ECB is assigned regulatory powers to impose binding and non-binding legal acts with the status of secondary EU Law, including decisions, recommendations and opinions.<sup>280</sup> Furthermore, another instrument attached to the powers of the ECB is the ability to levy penalty interest and to impose other sanctions with comparable effect against Member States’ credit institutions, in case they fail to comply with the required minimum reserves.<sup>281</sup> It is important to re-emphasise that these regulatory powers assigned to the ECB by primary EU Law, equate the ECB’s regulatory competences with the rest EU institutions. Thus, this results in significant power given to unelected officials to produce binding legislation. Hence, it is clear where the rationale of this effort to shield ECB’s independence by means of primary EU law, finds its basis.

#### D. Financial independence

As discussed earlier, financial independence is related to the autonomy of central banks to cover and organise the funding of their operations and activities. At EU level, the ECB has the exclusive power to issue the euro and to manage its finances.<sup>282</sup> Also, the monetary

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<sup>274</sup> TFEU (n 5) Article 127(2) and ESCB Statute (n 243) Article 3.1.

<sup>275</sup> TFEU (n 5) Article 128(1) and ESCB Statute (n 243) Article 16.

<sup>276</sup> ESCB Statute (n 243) Article 30.1.

<sup>277</sup> TFEU (n 5) Article 123(1).

<sup>278</sup> TFEU (n 5) Article 123(2).

<sup>279</sup> See: ESCB Statute (n 243) Article 34.

<sup>280</sup> TFEU (n 5) Article 132 and ESCB Statute (n 243) Article 34.

<sup>281</sup> ESCB Statute (n 243) Article 19.

<sup>282</sup> TFEU (n 5) Article 282.

income, which is the income accruing to the NCBs in the performance of ESCB's operations, is divided among all the NCBs at the end of each financial year.<sup>283</sup> This procedure of allocating the monetary income in an annual basis, is set by Article 32, ESCB Statute, in order to protect the monetary income to become subject to political interference. Lastly, there are external auditors, appointed by the Governing Council and approved by the EU Council, with the task to examine the books and accounts of both the ECB and NCBs.<sup>284</sup>

#### 1.4.2 Transparency, Communication and Accountability of the ECB

As mentioned earlier in this chapter, the ECB operational structure and institutional framework was highly based on the German Bundesbank model of central banking.<sup>285</sup> The justification of the success of this model, was the Bundesbank performed exceptionally well in maintaining inflation low during the early 1970s when the Bretton Woods System collapsed. Thus, the ECB as a creature of its time, enjoys a highly independent status and a wide discretionary space to use its instruments in pursuing the assigned tasks and objectives. In fact, since the drafting of the Maastricht Treaty, the ECB – which is not an EU institution within the meaning of Article 13, TEU – the power to adopt regulations that become EU and national law (of the Member States) without requiring the involvement of national parliament, the EU Parliament of other EU institutions.<sup>286</sup>

In addition, it has been repeatedly argued that the ECB is more independent than the Bundesbank,<sup>287</sup> with some even claiming that *“the European Central Bank has been endowed with greater powers than any other non-majoritarian Community institution to date.”*<sup>288</sup> Indeed, since the independence of the ECB, is enshrined by EU Law, it has a stronger legal basis from that of Bundesbank. To this end, the Bundestag, the German Parliament, has the power to change the statute of the central bank (i.e. the Bundesbank), which is also

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<sup>283</sup> ESCB Statute (n 243) Article 32.

<sup>284</sup> TFEU (n 5) Article 287 and ESCB Statute (n 243) Article 27.

<sup>285</sup> Bibow (n 31) 6.

<sup>286</sup> Majone, 1998 (n 125) 15.

<sup>287</sup> See:

- Majone, 1998 (n 125) 15.
- Verdun, Amy, 'The Institutional Design of EMU: A Democratic Deficit?' (1998) 18 (2) Journal of Public Policy 107, 108.

<sup>288</sup> Brentford, Philip, 'Constitutional Aspects of the Independence of the European Central Bank' (1998) 47 (1) International and Comparative Law Quarterly 75, 106.



embedded in a system of political checks and balances. The European Parliament, on the other hand, cannot modify the ECB's status, objectives and overall mandate.<sup>289</sup> This practically implies that the institutional framework of the ECB is much more immune to changes, in comparison to relevant institutions at national level.<sup>290</sup> In essence, the ECB's independent status can be modified only through Treaty amendment, which requires unanimous consent of the Member States and ratification at national level.<sup>291</sup> As analysed already, such a high degree of independence assigned to an institution that falls outside the scope of direct parliamentary control seems to pose the potential of a 'democratic deficit,' raising issues of accountability. Hence, the relevant literature on the 'democratic deficit' in the EU, refers to the lack of democratic control of the ECB decisions, which are not subject to scrutiny by neither national nor the European parliaments.<sup>292</sup> For instance, according to Begg and Green, the ECB is "to independent' since it enjoys both instrument and goal independence and hence, "there will be a substantial and widely perceived democratic deficit which will undermine the credibility of European economic institutions when adverse economic circumstances arise.<sup>293</sup> A counter argument to the advocates of ECB's 'democratic deficit,' is that the Treaty setting the legal basis of the ECB has been agreed, initially by 15 and subsequently by 28 national governments, and ratified by the relevant national parliaments.

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<sup>289</sup> Verdun (n 288).

<sup>290</sup> For the advocates of this view see:

- Brentford (n 289) 109;
- De Haan, Jakob, 'The European Central Bank: Independence, accountability and strategy: A review' (1997) 93 (3-4) *Public Choice* 395, 417;
- Heisenberg, Dorothee and Richmond, Amy, 'Supranational institution-building in the European Union: a comparison of the European Court of Justice and the European Central Bank' (2011) 9 (2) *Journal of European Public Policy* 201, 211-212; and
- Verdun (287) 108.

<sup>291</sup> Majone, 1998 (n 125) 15.

<sup>292</sup> For an early analysis on the democratic deficit debate see:

- Boyce, Brigitte, 'The Democratic Deficit of the European Community' (1993) 44 (4) *Parliamentary Affairs* 458;
- Lodge, Juliet, 'Transparency and Democratic Legitimacy' (1994) 32 (3) *Journal of Common Market Studies* 343;
- Scharpf, Fritz W., 'Economic Integration, Democracy and the Welfare State' (1997) 4 (1) *Journal of European Public Policy* 18; and
- Schmidt, Vivien, 'European Integration and Democracy: the Differences among Member States' (1997) 4 (1) *Journal of European Public Policy* 128.

<sup>293</sup> Begg, Ian and Green, David, 'The political economy of the European Central Bank' in Arestis, Philip and Sawyer, Malcolm C. (eds), *The Political Economy of Central Banking* (Edward Elgar 1998) 122, 134.

It should, however, be noted that the approval of the Treaty was subject to a take-it-or leave it vote on the entire content of the document.<sup>294</sup>

In a democratic society, the independence of a decision-making body cannot be regarded in isolation from its mandate. Thus, central bank independence is not to be viewed as an end in itself, but as a tool in pursuing objectives that are set by law. In fact, as we saw earlier, central bank independence needs to be complemented or perhaps, counterbalanced by accountability, credibility and transparency. The meaning of each of these notions has been largely covered, including how they affect and interact with one another. Therefore, it is hardly surprising that the same principles, arguments and empirical evidence come into play in regard to the institutional arrangements of the ESCB. To this end, the commitment of the ECB to the principle of openness, transparency and accountability has been repeatedly emphasised by both the ECB in its annual Reports and its official in various public speeches. For instance, in the annual Report of 1999, the ECB highlighted that: *“The ECB is committed to the principles of openness, transparency and accountability.”*<sup>295</sup> Additionally, Otmar Issing, who served as a members of the Executive Board, stated that: *“the ECB is both accountable and transparent”* and it *“...has a mandate determined by the Treaty, which stipulates how it should be accountable to the public at large.”*<sup>296</sup> Similarly, Wim Duisenberg, highlighted that: the European Central Bank is fully independent, but also fully accountable to Parliament, Ministers and the public.<sup>297</sup> Tommaso Padoa-Schioppa, who was another members of the Executive Board, explained that: *“the ECB fulfils its accountability obligation, inter alia, by way of comprehensive dialogue with political bodies,”* including the EU Parliament - which is: *“the institution of Europe's democratically elected representatives, which represents the interests of the peoples of Europe”* - and other EU bodies that the bodies that play a role in the

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<sup>294</sup> Buiter, Wilhelm H., ‘Alice in Euroland’ (CEPR Policy Paper No. 1, 1999), 4 <[http://ac.els-cdn.com/S0165188914002127/1-s2.0-S0165188914002127-main.pdf?\\_tid=fae42f60-69b6-11e7-9caf-00000aab0f27&acdnat=1500162207\\_541f393e845bef872b738321ce7be08a](http://ac.els-cdn.com/S0165188914002127/1-s2.0-S0165188914002127-main.pdf?_tid=fae42f60-69b6-11e7-9caf-00000aab0f27&acdnat=1500162207_541f393e845bef872b738321ce7be08a)> accessed 14 July 2017.

<sup>295</sup> ‘Annual Report 1999’ (ECB, Frankfurt am Main, 2000a), 128 <<https://www.ecb.europa.eu/pub/pdf/annrep/ar1999en.pdf?2f98b3509c69c370be35b1ebf0424447>> accessed 14 July 2017.

<sup>296</sup> Issing, Otmar, ‘The ECB and its watchers’ (Speech by Professor Otmar Issing, at the ECB Watchers Conference on 17 June 1999, in Frankfurt, Germany) <<https://www.ecb.europa.eu/press/key/date/1999/html/sp990617.en.html#fn19>> accessed 14 July 2017.

<sup>297</sup> Duisenberg, Wim, ‘Introductory statement at the Hearing before the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 20 June 2000’ <<https://www.ecb.europa.eu/press/key/date/2000/html/sp000620.en.html>> accessed 14 July 2017.

European political process (e.g. the Council of Ministers, the EU Commission, the Economic and Social Committee etc.). Padoa-Schioppa also added that: *“at the national level, the National Central Banks relate to their national parliaments and entertain links of communication with their national governments.”*<sup>298</sup>

In addition, the decisions of ECB are subject to judicial control by the Court of Justice. Namely, according to Article 263, TFEU: *“Should the European Parliament, the European Council, the Council, the Commission or the European Central Bank, in infringement of the Treaties, fail to act, the Member States and the other institutions of the Union may bring an action before the Court of Justice of the European Union to have the infringement established.”*<sup>299</sup> The wording of this Article indicates that in terms of the legality of its actions, the ECB is treated identically the same as the EU Commission and the other EU institutions and it is subject to the general principle of EU law.<sup>300</sup> A fact that has been also confirmed by the ECJ in its judgment in the so-called “OLAF case.” Namely, the ECJ while examining the constitutional nature of the ECB and the scope of its independence, highlighted that that *“the ECB, pursuant to the EC Treaty, falls squarely within the Community framework.”*<sup>301</sup>

As far as transparency is concerned, the ECB is required to publish: reports on the activities of the ESCB at least quarterly; a weekly consolidated financial statement of the ESCB; and annual reports on the activities of the ESCB and monetary policy operations to the EU Parliament, the EU Council and the EU Commission.<sup>302</sup> Also, subject to EU Parliament’s request, the President of the European Central Bank and the other members of the Executive Board, may be heard by the competent committees of the EU Parliament.<sup>303</sup> With the adoption of the euro in 1999, the ECB has made use of all the aforementioned communication tools. In addition, the ECB adopted a Decision in March 2004, aiming to grant public access to

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<sup>298</sup> Padoa-Schioppa, Tommaso, ‘An institutional glossary of the Eurosystem’ (Article at the conference on “The Constitution of the Eurosystem: the Views of the EP and the ECB”, 8 March 2000) <[https://www.ecb.europa.eu/press/key/date/2000/html/sp000308\\_1.en.html](https://www.ecb.europa.eu/press/key/date/2000/html/sp000308_1.en.html)> accessed 14 July 2017.

<sup>299</sup> TFEU (n 5) Article 263 (ex-Article 230 TEC) and ESCB Statute (n 243) Article 35.1.

<sup>300</sup> Fernandez, Martin, J.M., ‘The Competition Rules of the EC Treaty and the European System of Central Banks’ (2001) European Competition Law Review 51.

<sup>301</sup> Case C-11/00 Commission v European Central Bank [2003] ECR I-7147, para 92 (hereinafter: OLAF case). For a thorough analysis of the OLAF case see: Goebel, Roger J., ‘Court of Justice Oversight Over the European Central Bank: Delimiting the ECB’s Constitutional Autonomy and Independence in the OLAF Judgment’ (2005) 29 (4) Fordham International Law Journal 609.

<sup>302</sup> TFEU (n 5) Article 284(3) and ESCB Statute (n 243) Article 15 ESCB.

<sup>303</sup> TFEU (n 5) Article 284(3) para 2.

documents drawn up by it, but also to documents received by it, with the view to increase openness of its decisions.<sup>304</sup> All these combined, aim at enhancing transparency, with the view to also foster both the accountability and credibility of the ECB's monetary policy.<sup>305</sup>

To this end, in fulfilling its transparency and accountability commitments, the ECB also holds press conferences by its President and Vice-President immediately after the first Governing Council meeting of the month, which includes a question and answer session that is open to various media representatives from inside and outside the Euro-area. In addition, the transcripts of the press conferences are made available on ECB's website. This is followed by the publication of a Monthly Bulletin, usually one week after the Governing Council's meeting, which contains detailed and comprehensive evaluation of the economic environment, long-term development plans and detailed explanation on monetary policy decisions. Moreover, the President of the ECB is invited four times a year before the Parliament's Committee on Economic and Monetary Affairs, which are open to the public and involve questions addressed directly to the ECB President by the Members of the Committee. The other ECB officials are also engaged to public speeches, interviews and participation to the aforementioned Committee. Lastly, the ECB publishes regularly Working Paper and Occasional Paper Series and statistical data.<sup>306</sup>

On the negative side, although the EU Treaties and ESCB Statute seem to have created a legal framework with a number of provisions aiming to ensure the transparency of ESCB's actions, serious doubts have been raised as to its effectiveness.<sup>307</sup> For instance, it has been supported that the existing framework lacks the legally binding mechanisms to assure the

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<sup>304</sup> 'Decision of the European Central Bank of 4 March 2004 on public access to European Central Bank documents' [2004] OJ L 80/42, as amended by:

- 'Decision of the ECB of 9 May 2011 amending Decision ECB/2004/3 on public access to ECB documents' [2011] OJ L 158/37.
- 'Decision (EU) 2015/529 of the ECB of 21 January 2015 amending Decision ECB/2004/3 on public access to documents' [2015] OJ 84/64.

<sup>305</sup> See: Christodoulou, Phoebus, 'The Issue of the Democratic Legitimacy of the Eurosystem – A Sketch' in Amicorum, Liber and Garavelli, Paolo Z., *Legal Aspects of the European System of Central Banks* (European Central Bank 2005) 179, 185-186 <<https://www.ecb.europa.eu/pub/pdf/other/legalaspectsescben.pdf>> accessed 14 July 2017.

<sup>306</sup> 'The Monetary Policy of the ECB 2004' (ECB, 2004a) 68-71 <<https://www.ecb.europa.eu/pub/pdf/other/monetarypolicy2004en.pdf>> accessed 14 July 2017.

<sup>307</sup> See:

- Buiter (295); and
- Issing, Otmar, *The Eurosystem: Transparent and Accountable, or Willem in Euroland* (CEPR Policy Paper No. 2, 1999).

accountability of the ECB, while the existing provisions provide only for information exchange communication between the ECB and EU institutions.<sup>308</sup> Indeed, there are no legally binding mechanisms that would provide for evaluation procedures in case of misconduct, for instance, by the ECB governors. As previously mentioned, the EU Parliament holds the power to call the President of the European Central Bank and the other members of the Executive Board to be heard in front of the competent committees of the EU Parliament, which however, does not constitute a legally binding procedure.<sup>309</sup> Furthermore, while the ECB regularly publishes its monthly and annual reports, the minutes of Governing Council's regular meetings are not disclosed. This is considerably different than the practice of other central banks, such as the Fed for instance, which publishes the minutes of Fed's Open Market Committee (FOMC) meetings.

In the wake of GFC, greater emphasis was put on enhancing the communication, transparency and accountability of the ECB, including new mechanisms that aim at strengthening the role of the ECB at both traditional and new task. However, concerns regarding the ECB's monetary policy decisions, have only deepened. For example, the ECB's Emergency Liquidity Assistance (ELA) guidelines, which do not exceed a two pages document, cannot be considered as particularly comprehensive, given also the importance of ELA in economies that are still experiencing a great hardship, such as Greece.<sup>310</sup> In addition, in 2015 the ECB, repeatedly, decided to limit the ceiling on ELA for Greece's banks, without, however, publicly announcing the relevant decisions. With the advent of the Banking Union, and the ability of the ECB to both supervise Eurozone financial institutions and decide on monetary policy objectives, a debate on the ECB's transparency has ensued, largely questioning the legitimacy of its decision-making role. This is particularly problematic, especially given the fact

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<sup>308</sup> See:

- Gormley, Laurence and De Haan, Jakob, 'The Democratic Deficit of the European Central Bank' (1996) 21 (2) *European Law Review* 95;
- Lastra, Rosa, 'The Independence of the European System of Central Banks' (1992) 33 (2) *Harvard International Law Journal* 475, 476–482;
- Lastra, Rosa, 'Central Banking and Banking Regulation' (1996) *Financial Market Group*, London School of Economics, Special Paper No. 127; and
- Smits (n 206).

<sup>309</sup> Amtenbrink (n 95) 568-569.

<sup>310</sup> Murphy, Paul, 'About that ELA rulebook (all two pages)' (FT April 16, 2015) <<https://ftalphaville.ft.com/2015/04/16/2126775/about-that-ela-rulebook-all-two-pages/>> accessed 14 July 2017.

that the Treaty remains silent as to the possibility for the ECB's independence to be overridden by the delectedated representatives in times of a financial distress. This is examined in the last chapter of the thesis, following the legal analysis of the first pillar of the Banking Union, i.e. the Single Supervisory Mechanism (SSM).

The next chapter moves the discussion from the EU to the international level. At this domain, the Basel Committee in Banking Supervision (BCBS) constitutes the main international institution that sets standards for prudential regulation of financial institutions. As such, the analysis of its role and purpose aims to provide context on the evolution of banking supervision and regulation, at both international and EU level. Hence, reference is made throughout the thesis to the implementation of BCBS's main legislation at EU level. It should be noted that this exploration does not intent to provide a comprehensive analysis of the broader subject of the BCBS rules and their role on EU banking regulation, but it rather aims to provide context to the discussion on EU banking framework, by staying focused to the core idea of this thesis that is banking regulation and supervision at EU level.

## 1.5 Basel Committee in Banking Supervision

### 1.5.1 Creation and early years

In the aftermath of WWII, as barriers of exchange control and other restrictions to the free movement of financial services were slowly diminished, financial intermediation entered an era of increasing interconnection. However, while financial markets and intermediation became international, regulation remained at domestic level. This realisation along with the collapse of the Bretton Woods system of fixed exchange rates in 1971/72 and the oil crisis in 1973/74, led to the establishment of what became latter known as the Basel Committee on Banking Supervision (BCBS).<sup>311</sup> In addition, there were a number of highly publicised failures of international financial institutions in the early 1970s that highlighted the need for international convergence of regulatory standards. Namely, in June 1974, the privately owned German bank, Bankhaus Herstatt, went bankrupt after the West Germany's Federal Banking

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<sup>311</sup> Kapstein E.B., *Governing the global economy, international finance and the state* (Harvard University Press 1994).

Supervisory Office intervention, which called for bank's liquidation due to its problematic operation. The bank's foreign exchange operation exceeded three times the value of its capital. The consequences of that incident were not limited within Germany's financial market, but affected banks outside Germany and spread worldwide.<sup>312</sup> The collapse of Bankhaus Herstatt, was followed by the closure of the British-Israel Bank of London in July 1974,<sup>313</sup> and the failure of Franklin National Bank in the United States (hereinafter: US) in 1975,<sup>314</sup> which were accompanied with global repercussions.<sup>315</sup> To this end, the realisation that the breakdown of a middle-sized bank could have serious consequences with a cross-border dimension, was the cornerstone that led to the genesis of a long-term cooperation and coordination at global level among the banking supervisory governors of national central banks.<sup>316</sup>

As a result of these events, and in an attempt to regain control on their central banks and to enhance cooperation in banking supervision, the central bank governors of the Group of Ten or G10 countries (G10 refers to the group of countries that were signatories to the General Arrangements to Borrow (GAB), which was set to enable the International Monetary Fund (IMF) to borrow specified amounts of currencies in order to increase its lending ability),<sup>317</sup> met in Basel, Switzerland in January 1975, and established the Standing Committee on Banking Regulation and Supervisory Practices (CBRSP-the forerunner of Basel Committee on Banking Supervision) at the Bank for International Settlements (BIS). As was stated at the first CBRSP meeting in February 1975, the Committee's main objective was: *"...to help ensure bank solvency and liquidity"*, and *"...to give particular attention to the need for an early warning system."*<sup>318</sup> The aim of the BCBS's establishment, was not the creation of a

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<sup>312</sup> For more on the Bankhaus Herstatt collapse see: Schenk, Catherine R., 'Summer in the City: Banking Failures of 1974 and the Development of International Banking Supervision' (2014) 129 (540) *The English Historical Review* 1129 <<http://eprints.gla.ac.uk/96034/1/96034.pdf>> accessed 14 July 2017.

<sup>313</sup> For more on British-Israel Bank of London see: Lawrence, Lee, L.C., 'The Basel Accords as Soft Law: Strengthening International Banking Supervision' (1998) 39 (1) *Virginia Journal of International Law* 1.

<sup>314</sup> Alford, Duncan, E., 'Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?' (2005) 28 (2) *Boston College International and Comparative Law Review* 237, 241-42.

<sup>315</sup> Bilali, Genci and Felsenfeld, Carl, 'The Role of the Bank for International Settlements in Shaping the World Financial System' (2004) 25 (3) *University of Pennsylvania Journal of International Economic Law* 945, 977-78.

<sup>316</sup> Crockett, Andrew, 'Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability' (Remarks by Mr Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, before the Eleventh International Conference of Banking Supervisors, held in Basel, 20-21 September 2000) <<http://www.bis.org/review/r000922b.pdf>> accessed 14 July 2017.

<sup>317</sup> See: BIS website <<https://www.bis.org/list/g10publications/>> accessed 14 July 2017.

<sup>318</sup> 'Informal record of the first meeting of the CBRSP' (BIS Archive 1.3a (3) 18, BS/75/5, 6-7 February 1975).

supranational body, responsible to supervise banks worldwide, but it was rather an attempt to promote general supervisory standards, rules and guidelines at international level. As the Director of Supervision of the Bank of England (chairing in 1984 the BCBS), Peter Cooke, stated: *“The Committee does not undertake a formal supranational supervisory role....it formulates and recommends broad supervisory principles and guidelines of best practices in the hope and expectation that individual authorities will take steps to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems”*.<sup>319</sup>

The first goal set by the BCBS, was to define the responsibilities of home and host country supervisors in regard to the subsidiaries and branches of foreign banks; a goal that was, accomplished at a later stage by the so-called Basel Concordat.<sup>320</sup> The latter *“sets out the principles for sharing supervisory responsibility for banks' foreign branches, subsidiaries and joint ventures between host and parent (or home) supervisory authorities.”*<sup>321</sup> The Basel Concordat met widespread acceptance, and was gradually implemented by many countries.<sup>322</sup> In May 1983, the Basel Concordat was replaced by the ‘Principles for the Supervision of Banks' Foreign Establishments.’<sup>323</sup> The latter, focused on consolidated supervision and was in the form of recommended guidelines for best practice. At the same time, at EU Level, highly influenced by the BCBS’s guidelines, the first Directive on consolidated supervision was adopted.<sup>324</sup> This was followed by a Supplement in April 1990, aiming to improve the cross-border flow of prudential information between banking supervisors.<sup>325</sup> The Basel Concordat underwent another change in June 1992, when it was

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<sup>319</sup> Gordon, Kenneth J., ‘Risk-Based Capital Requirements: The Proper Approach to Safe and Sound Banking?’ (1991) Annual Review Banking Law 491, 493.

<sup>320</sup> ‘Report on the supervision of banks' foreign establishments – Concordat’ (BCBS, September 1975) <<http://www.bis.org/publ/bcbs00a.pdf>> accessed 14 July 2017.

<sup>321</sup> ‘A brief history of the Basel Committee’ (BCBS, November 2015) 1-2 <<http://www.bis.org/bcbs/history.pdf>> accessed 14 July 2017.

<sup>322</sup> Goodhart, Charles, *The Basel Committee on Banking Supervision: A History of the Early Years 1974–1997* (Cambridge University Press 2011) 103.

<sup>323</sup> ‘Principles for the Supervision of Banks' Foreign Establishments’ (BCBS, May 1983) <<http://www.bis.org/publ/bcbsc312.pdf>> accessed 14 July 2017.

<sup>324</sup> ‘Council Directive 83/350/EEC of 13 June 1983 on the supervision of credit institutions on a consolidated basis’ [1983] OJ L 193/18.

<sup>325</sup> ‘Exchanges of information between supervisors of participants in the financial markets’ (BCBS, April 1990) <<http://www.bis.org/publ/bcbs07a.pdf>> accessed 14 July 2017.



reformulated in a new document, known as the Minimum Standards, which was published in July 1992.<sup>326</sup>

The BCBS since the very beginning of its establishment produced a vast amount of publications, aiming to outline the rules under which banking supervision should be conducted.<sup>327</sup> However, the decisions of the BCBS are based on consensus and are not taken by voting. Indeed, the BCBS defines itself as an advisory committee rather than an executive committee, with its role being mainly focused on providing recommendations and guidelines to the central bank governors on best regulatory practice, which are, however, not legally binding. This practically means that the BCBS produces soft law and each governor has to present those regulatory guidelines to their respective countries, subject to domestic law implementation.<sup>328</sup>

Although the BCBS has no legal enforcement power itself, it encourages Member States to implement its decisions. The issue of implementation was stressed since the first revision of the Basel Concordat in 1983 in form of the following suggestions: *“The implementation of the second basic principle, namely that the supervision of all foreign banking establishments should be adequate, requires the positive participation of both host and parent authorities.”*<sup>329</sup> In addition, the BCBS established a sub-group to consider the adequate implementation of the revised Basel Concordat.<sup>330</sup> Reference to the need of sufficient implementation was also made at a document published in 1992, the Minimum Standards, as following: *“members of the Committee now recognise that there needs to be a greater effort to ensure that these principles can be applied in practice.”*<sup>331</sup> Interestingly, despite the fact that the BCBS regulatory guidelines are not legally binding and the system operates based on a highly consensual manner, its recommendations and guidelines have enjoyed global acceptance and have been increasingly implemented by many countries.<sup>332</sup> In

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<sup>326</sup> ‘Minimum Standards for the Supervision of International Banking Groups and Their Cross-border Establishments’ (BCBS, July 1992) <<http://www.bis.org/publ/bcbsc314.pdf>> accessed 14 July 2017.

<sup>327</sup> Blair, N. W. J. L., Allison, Austin, Morton, Guy, Palemer, Keith, Richards-Carpenter, Peter and Walker, George (eds), *Banking and Financial Services Regulation* (3rd rev edn, LexisNexis UK) 652-663.

<sup>328</sup> Goodhart (n 323) 110.

<sup>329</sup> BCBS, May 1983 (n 324).

<sup>330</sup> Goodhart (n 323) 110.

<sup>331</sup> BCBS July 1992 (n 327).

<sup>332</sup> Goodhart (n 323) 103.

fact, the success of its implementation has been commonly referred to as a good example of 'soft law' with considerably broad influence worldwide.<sup>333</sup>

Over time, the BCBS developed into a forum where the central bank governors meet on a regular basis to discuss on international supervisory matters, with the view to develop supervisory regulation, to foster financial stability and to ensure the soundness of international financial markets. The long-term goal of the process towards fostering a closer international cooperation and setting the international minimum standards in prudential supervision, was the creation of a financial system, able to detect upcoming risks and prevent them affecting international financial stability.<sup>334</sup>

### 1.5.2 Basel Capital Accord: Basel I and II

The initial objective of the BCBS was to ensure that all financial institutions with international activity were subject to sufficient and consistent supervision across borders. However, this objective was stretched after the experience of the early 1980s, which was characterised by falling capital ratios and the crises in Latin America.<sup>335</sup> This raised concerns and shifted attention to capital adequacy, while it became clear that the BCBS could not focus merely on supervisory issues, but also in strengthening banking regulation. Before analysing the Basel Capital Accord, which was adopted as a result of this realisation, it is important to define the meaning of bank capital and why it is subject to regulation. Bank capital implies: *"the bank's financing that comes from shareholder funds, subordinated debt, certain types of reserves, and hybrid debt/equity instruments,"*<sup>336</sup> while: *"bank capital regulations were introduced in order to redress the natural tendency of banks to hold insufficient capital."*<sup>337</sup>

Bank capital has an essential role, especially in times of financial distress, due to the increased liquidity risks that might arise as a result of capital inadequacy. Thus, there was an emphasis paid on the importance of maintaining an adequate capital - which usually is

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<sup>333</sup> Ellinger, E.P., Lomnicka, E. and Hare, C., *Ellinger's Modern Banking Law* (5th edn Oxford University Press 2010) 77.

<sup>334</sup> Kapstein (n 312) 44-62

<sup>335</sup> BCBS May 1983 (n 324) 2.

<sup>336</sup> 'Banking Supervision and Regulation' (House of Lords, Select Committee on Economic Affairs, 2nd Report of Session 2008–09) 48 <<https://www.publications.parliament.uk/pa/ld200809/ldselect/ldeconaf/101/101i.pdf>> accessed 14 July 2017.

<sup>337</sup> House of Lords (n 337) 51.

expressed as a ratio of capital to a bank's asset, and capital 'buffers' - that reflect the amount of capital that is required to cover banks' risks.<sup>338</sup> Simply said, bank capital regulation is necessary since the banks are exposed to liquidity risks, which in times of instability tend to increase. Thus, the higher exposure to liquidity risk, the greater the need for a financial institution to maintain a higher amount of bank capital in order to retain its solvency and overall stability. A very recent example of how inadequate level of capital can affect the entire reputation of a financial institution is the case Deutsche Bank, which is Germany's biggest lender and a significant global investment bank. Deutsche Bank from 2014 onwards faced serious difficulties as a result of a number of fines imposed from the US regulators, strict new rules on bank capital and a fragile European economy. These scenarios affected its shares that hit record lows and were worth barely an eighth of what they were in 2007, prior to the advent of the GFC.<sup>339</sup> Deutsche Bank's position was also worsen after the Referendum in the UK in favour of Brexit, since it has a very strong presence in the City of London. In addition, following the failure of its US subsidiary failure to pass the annual stress test, the IMF in its Report, in June 2017 named the world's riskiest bank and "*the most important net contributor to systemic risks in the global banking system.*"<sup>340</sup> On the positive side, in April 2017 Deutsche Bank has successfully completed the capital increase from authorised capital against cash contributions it announced on 5 March 2017.<sup>341</sup>

Back to the 1980s, the widespread effects of the Latin American debt crisis brought evidence that capital ratios of internationally active financial institutions were influenced

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<sup>338</sup> Bank of England, 'Supplement to the December 2015 Financial Stability Report: The framework of capital requirements for UK banks' <<http://www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrsupp.pdf>> accessed 14 July 2017. See also: Reinicke, W.H. *Banking, Politics and Global Finance: American Commercial Banks and Regulatory Change, 1980-1990* (Edward Elgar 1995).

<sup>339</sup> 'Deutsche Bank: A floundering titan. Germany's banking champion has neither a proper business model nor a mission' (The Economist, 16 July 2016) <<https://www.economist.com/news/leaders/21702195-germanys-banking-champion-has-neither-proper-business-model-nor-mission-floundering-titan>> accessed 14 July 2017.

<sup>340</sup> Kottasova, Ivana, 'The world's riskiest bank is in trouble' (CNN, 27 July 2016) <<http://money.cnn.com/2016/07/27/news/companies/deutsche-bank-profit-slump/index.html>> accessed 14 July 2017.

<sup>341</sup> See:

- 'Blues in a different key: Deutsche Bank raises capital, and changes course. A troubled bank hopes to turn the page' (The Economist, 9 March 2017) <<https://www.economist.com/news/finance-and-economics/21718512-troubled-bank-hopes-turn-page-deutsche-bank-raises-capital-and-changes>> accessed 14 July 2017; and
- 'Deutsche Bank close to \$8.5 billion stock sale' (Marketwatch, 6 April 2017) <<http://www.marketwatch.com/story/deutsche-bank-close-to-85-billion-stock-sale-2017-04-06>> accessed 14 July 2017.

negatively when there was a scenario of increasing international risks.<sup>342</sup> As a result, the BCBS came to the conclusion that there was a need to establish minimum requirements of capital adequacy. This led to the adoption of the first Basel Capital Accord (hereinafter Basel I) in 1988,<sup>343</sup> which implied specific measures that aimed to reduce institutional credit risk with two fundamental objectives: *“firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and secondly that the framework should be in fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks.”*<sup>344</sup> Additionally, Basel I required the supervisory authorities of the host and home country, to share data and information, as well as national rules regarding the respective responsibilities over branches and subsidiaries. Also, Basel I introduced the minimum capital adequacy ratio, initially as a ratio of bank capital to risk-weighted assets for credit risk only, which was set at 8% and was to be adopted by 1992.<sup>345</sup> Simultaneously, at European level, Basel I was adopted in two Directives in 1989.<sup>346</sup>

Basel I, since its establishment was designed as an evolutionary framework, so future updates were part of the agenda in order to keep pace with the financial sector that was constantly developing and changing. Thus, in November 1991,<sup>347</sup> its first amendment took place, intending to redefine with greater precision general provisions on the general loan-loss reserves that could be part of capital adequacy calculation.<sup>348</sup> In April 1995, Basel I underwent another amendment, focusing on the effects of netting in the calculation of the add-ons for potential exposure.<sup>349</sup> Lastly, in 1996, BCBS issued another amendment of Basel

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<sup>342</sup> ‘History of the Basel Committee’ (BIS website) <<http://www.bis.org/bcbs/history.htm>> accessed 14 July 2017.

<sup>343</sup> ‘International Convergence of Capital Measurement and Capital Standards’ (BCBS July 1988) (hereinafter: Basel I) <<http://www.bis.org/publ/bcbs04a.pdf>> accessed 14 July 2017.

<sup>344</sup> Basel I (n 344) at 3.

<sup>345</sup> Basel I (n 344) at 44, 45.

<sup>346</sup> See:

- ‘Council Directive 89/299/EEC of 17 April 1989 on the Own Funds of Credit Institutions’ [1989] OJ L 124/16 (hereinafter: Own Funds Directive); and
- ‘Council Directive 89/647/EEC of 18 December 1989 on a Solvency Ratio for Credit Institutions’ [1989] OJ L 386/14 (hereinafter: Solvency Ratio Directive).

<sup>347</sup> ‘Amendment of the Basle Capital Accord in respect of the inclusion of general provisions/general loan-loss reserves in capital’ (BCBS, November 1991) <<http://www.bis.org/publ/bcbs09.pdf>> accessed 14 July 2017.

<sup>348</sup> BIS website (n 343).

<sup>349</sup> ‘Basle Capital Accord: The treatment of potential exposure for off-balance-sheet items’ (BCBS, April 1995) <<http://www.bis.org/publ/bcbs18.pdf>> accessed 14 July 2017.

I, in order to incorporate capital requirements for market risks in addition to the existing capital requirements for credit risks.<sup>350</sup>

In June 1999, the Committee issued a proposal for a new capital adequacy framework that was intended to replace the 1988 Accord.<sup>351</sup> This led to the adoption of the Revised International Capital Framework in June 2004,<sup>352</sup> widely known as Basel II. Basel II, from the outset, was designed to provide more flexibility in terms of minimum capital requirements, by also, highlighting the need to define an effective prudential supervisory framework. This, in turn, would enable the sufficient supervision of minimum capital requirements implementation.<sup>353</sup> Basel II launched a new proposal that was based on three main measurements: minimum capital requirements, a supervisory review and a market discipline (the so-called three pillars).<sup>354</sup> The third pillar on market discipline, was set to support the capital framework as to the market risk occurring as a result of banks' exposure to foreign exchange, traded debt securities, equities, commodities and options.<sup>355</sup> The innovative part of this amendment was that large banks, while calculating their market risk capital requirements, would use an internal-rating based model in order to improve their own risk system and small banks would use risk-weighted assets for the same purpose. Internal-rating based models will, practically, allow large banks to use their own credit risk models to generate key inputs into the formulas that determine the capital reserves they must hold.<sup>356</sup> Lastly, the internal rating-based model is also subject to ongoing supervision as to whether it fulfils certain criteria, with the view of assessing risk exposures of financial institutions.<sup>357</sup>

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<sup>350</sup> 'Amendment to the capital accord to incorporate market risks' (BCBS, January 1996) <<http://www.bis.org/publ/bcbs24.pdf>> accessed 14 July 2017.

<sup>351</sup> 'A new capital adequacy framework' (BCBS, June 1999) <<http://www.bis.org/publ/bcbs50.pdf>> accessed 14 July 2017.

<sup>352</sup> 'International Convergence of Capital Measurement and Capital Standards A Revised Framework' (BCBS June 2004) <<http://www.bis.org/publ/bcbs107.pdf>> (hereinafter: Basel II) accessed 14 July 2017.

<sup>353</sup> Ojo, Marianne, 'Risk management by the Basel Committee: evaluating progress made from the 1988 Basel Accord to recent developments' (2010) 18 (4) *Journal of Financial Regulation and Compliance*.

<sup>354</sup> Sappideen, Razeen, 'The regulation of credit, market and operational risk managements under the Basel Accord' (2004) 1 *Journal of Business Law* 59.

<sup>355</sup> BIS website (n 343).

<sup>356</sup> Tarullo, Daniel K. *Banking on Basel: The future of the international Financial Regulation* (Peterson Institute for International Economies 2008) 104-113.

<sup>357</sup> Basel II (n 353) 765.

At EU level, one month after Basel II was published, the EU Commission issued a proposal,<sup>358</sup> which was subsequently adopted on 14 June 2006 in form of two Directives. The first Directive amended the existing Banking Directive of 2000,<sup>359</sup> while the second one amended the existing Capital Adequacy Directive (also known as the Capital Requirements Directive Package or CRD I).<sup>360</sup> It is worth mentioning that CRD I was published on 30 June 2006 and entered into force on 20 July 2006, involving almost 600 amendments.<sup>361</sup> CRD I reflects, to a great extent, Basel II rules, while it differs from the latter as to its legal nature. Thus, as mentioned already, while BCBS produces are soft law, subject to a voluntary transposition into nation law, EU Directives are legally binding for all EU Member States.<sup>362</sup>

Basel II took five years to be published and more than nine years to come into force. In addition, during the process of Basel II implementation, a great debate developed as to the effectiveness of the new framework. This was also reflected to the reluctance of the Member States to transpose it into national law, which was fairly evident if compared with the wide acceptability of its forerunner. In general, Basel II was considered not to be adding any substantial changes to the original Capital Record of 1988, i.e. Basel I, especially, regarding the minimum capital requirements.<sup>363</sup> These concerns came to be emphasised by the advent of the GFC, which shed light on the importance of liquidity standards. Thus, although the loopholes and deficiencies of Basel II, had become apparent even before the eruption of the

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<sup>358</sup> Commission, 'Proposal for Directives of the European Parliament and of the Council Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions' COM (2004) 486 final.

<sup>359</sup> 'Council Directive 2000/12/EC of the of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions' [2000] OJ L 126/1.

<sup>360</sup> 'Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions [1993] OJ L141 as it was amended by Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 92/49/EEC and 93/6/EEC and Directives 94/19/EC, 98/78/EC, 2000/12/EC, 2001/34/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees' [2005] OJ L 79/9.

<sup>361</sup> See:

- 'Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions' [2006] OJ L 177/1; and
- 'Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions' [2006] OJ L 177/201.

<sup>362</sup> Dierick, Frank; Pires, Fatima, Scheicher, Martin and Spitze, Gereon K., 'The New BASEL Capital Framework and Its Implementation in the European Union' (ECB Occasional Paper Series No. 42, December 2005) 20 <<https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp42.pdf?819df1d197f718a070e14b8418e98aac>> accessed 14 July 2017.

<sup>363</sup> For a complete analysis see: Barfield R. *A practitioner's guide to Basel III and Beyond* (Sweet & Maxwell 2011) 54-56.

GFC, the latter opened a new round of discussions concerning Basel II amendments.<sup>364</sup> Notably, the revision version of the “Principles for sound liquidity risk management and supervision,”<sup>365</sup> came about in the same month that Lehman Brothers collapsed.<sup>366</sup> Some even advocated that Basel II was among the reasons that led to the GFC since it encouraged self-regulation by allowing banks to use their own estimates when calculating capital adequacy.<sup>367</sup> Ultimately, it was recognised that a more comprehensive overhaul of the Basel II rules was needed, which was reflected in a series of amendments that are discussed in the following section.

### 1.5.3 Basel III

Basel III comprises a comprehensive set of reform measures that were brought as an immediate response to the aforementioned realisation that Basel II needed reconsideration, and with the vision to strengthen regulation, supervision and risk management of the banking sector in light of the GFC. However, while complex negotiations towards the adoption of Basel III were taking place, the BSBS, in July 2009 released a revision of the existing framework (i.e. Basel II) as a quick fix of market risks. This is known as Basel 2.5, which was drafted with the view to address the growing concern over banks' capital requirements, especially regarding banks' exposure to risky credit derivatives.<sup>368</sup> Thus, Basel 2.5 measures, while maintained the main features of Basel II, targeted to strengthen the capital base, by increasing the capital requirements.<sup>369</sup> Basel 2.5 was criticised on similar grounds as Basel II, resulting in its update on 14 January 2016, when BCBS issued a revised framework for market risk capital requirements - also known as the fundamental review of the trading book (FRTB) - which will take effect on 1 January 2019.<sup>370</sup> At EU level, Basel 2.5

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<sup>364</sup> Leonard Ng, ‘Changes to Basel II and the EU Capital Requirements Directive: Implications for Securitisation’ (2010) 25 *Journal of International Banking Law and Regulation*, 265-74.

<sup>365</sup> ‘Principles for Sound Liquidity Risk Management and Supervision’ (BCBS, September 2008) <<http://www.bis.org/publ/bcbs144.pdf>> accessed 14 July 2017.

<sup>366</sup> BIS website (n 343).

<sup>367</sup> Hull, John C., *Risk Management and Financial Institutions* (2<sup>nd</sup> edn Pearson 2009) 285. See also: Moosa, Imad A., *Good Regulation, Bad Regulation: The Anatomy of Financial Regulation* (Palgrave Macmillan 2015) 106-120.

<sup>368</sup> See: ‘Revisions to the Basel II market risk framework’ (BCBS, July 2009) <<http://www.bis.org/publ/bcbs158.pdf>> (hereinafter: Basel II.5) accessed 14 July 2017.

<sup>369</sup> Sum, Katarzyna, *Post-Crisis Banking Regulation in the European Union: Opportunities and Threats* (1<sup>st</sup> edn, Palgrave Macmillan 2016) 44.

<sup>370</sup> ‘Standards: Minimum capital requirements for market risk’ (BCBS, January 2016) <<http://www.bis.org/bcbs/publ/d352.pdf>> accessed 14 July 2017.



was implemented in a Directive,<sup>371</sup> which was later amended accordingly to keep up with the relevant revisions as set by BCBS.

Meanwhile, after a series of protracted negotiations, the Group of Governors and Heads of Supervision of the BCBS, had announced on 12 September 2010, that they had reached an agreement on the strengthening of existing capital requirements, while emphasising that the three-pillar structure of Basel II would remain unchanged.<sup>372</sup> In December 2010, the first Basel III rules text was issued,<sup>373</sup> which was subsequently revised in July 2011,<sup>374</sup> introducing minor amendments on the credit valuation adjustment (CVA). Credit valuation adjustment (CVA), as defined at BIS website, is: *“the risk of loss caused by changes in the credit spread of a counterparty due to changes in its credit quality (also referred to as the market value of counterparty credit risk).”*<sup>375</sup> As it was stated at Basel III introductory note: *“The Committee’s comprehensive reform package addresses the lessons of the financial crisis. Through its reform package, the Committee also aims to improve risk management and governance as well as strengthen banks’ transparency and disclosures. Moreover, the reform package includes the Committee’s efforts to strengthen the resolution of systemically significant cross-border banks.”*<sup>376</sup>

Basel III brought a series innovative measures, mainly at Pillar I of Basel II, including *inter alia*: extensions in capital requirements; a non-risk based leverage ratio and two liquidity ratios. In particular, Basel III brought changes in respect with liquidity risk management by issuing a separate document on this matter.<sup>377</sup> The latter introduced two

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<sup>371</sup> ‘Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies’ [2010] OJ L 329/3 (hereinafter: CRD III).

<sup>372</sup> ‘Group of Governors and Heads of Supervision announces higher global minimum capital standards’ (Press Release, BCBS, 12 September 2010) <<http://www.bis.org/press/p100912.pdf>> accessed 14 July 2017.

<sup>373</sup> ‘Basel III: A global regulatory framework for more resilient banks and banking systems’ (BCBS, December 2010) (hereinafter: Basel III) <[http://www.bis.org/publ/bcbs189\\_dec2010.pdf](http://www.bis.org/publ/bcbs189_dec2010.pdf)> accessed 14 July 2017.

<sup>374</sup> ‘Basel III: A global regulatory framework for more resilient banks and banking systems’ (revised version BCBS June 2011) (hereinafter: Basel III Revised Version) <<http://www.bis.org/publ/bcbs189.pdf>> accessed 14 July 2017.

<sup>375</sup> BIS website <<http://www.bis.org/publ/bcbs189.htm>> accessed 14 July 2017.

<sup>376</sup> Basel III (n 374) at 2.

<sup>377</sup> ‘Basel III: International framework for liquidity risk measurement, standards and monitoring’ (BCBS, December 2010) <<http://www.bis.org/publ/bcbs188.pdf>> accessed 14 July 2017, as it was revised by ‘Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools’ (BCBS, January 2013) <<http://www.bis.org/publ/bcbs238.pdf>> accessed 14 July 2017 and ‘Basel III: the net stable funding ratio’ (BCBS October 2014) <<http://www.bis.org/bcbs/publ/d295.pdf>> accessed 14 July 2017.



liquidity ratios: liquidity coverage ratio (LCR), aiming to promote short-term resilience of the liquidity risk profile of banks, by ensuring that they have sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days;<sup>378</sup> and the net stable funding ratio (NSFR), designed to address medium and long-term problems arising from illiquidity.<sup>379</sup> The specific standards and timelines for the implementation of the LCR were sets out by a new document issued in January 2013.<sup>380</sup>

Furthermore, Basel III launched the notion of capital conservation buffer, “*which is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred.*”<sup>381</sup> To this end, Basel III included a macro-prudential approach, by invoking an added requirement for banks to maintain a specific capital conservation buffer of 2.5 percent of common equity,<sup>382</sup> while in times of crisis this buffer could be decreased as a counterbalance to the damages. Depending on the circumstances of each case, the national authorities would be entitled for a further buffer of 0 to 2.5 percent.<sup>383</sup> Furthermore, Basel III introduced a new capital adequacy framework, aiming to strengthen the quality of the minimum capital requirements, by increasing it to 4.5 percent (compared to the 2 percent of Basel II) and the Tier 1 capital ratio was to be increased from 4 to 6 percent, while both shall be maintained at all times.<sup>384</sup>

In the context of macro-prudential supervision and additionally to capital buffers requirements, Basel III, addressed the issue of systemic risk. To this end, Basel III highlighted the need to strengthening the resolution for the systematically important financial institutions, which were to maintain their loss absorbing capacity beyond the minimum standards.<sup>385</sup> Initially, the process of regulating systematically important banks was to be further developed, subject to the close cooperation of BCBS and the Financial Stability Board

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<sup>378</sup> BCBS, December 2010 (n 378) at 15.

<sup>379</sup> BCBS, December 2010 (n 378) at 119.

<sup>380</sup> BCBS January 2013 (n 378) at 1.

<sup>381</sup> Basel III (n 374) at 122.

<sup>382</sup> Basel III (n 374) at 50.

<sup>383</sup> Basel III (n 374) at 139. See also: Co-Pierre, G., ‘Basel III and Systemic Risk Regulation - What Way Forward?’ (2011) Working Papers on Global Financial Markets No 17 <[http://pubdb.wiwi.uni-jena.de/pdf/wp\\_hlj17-2011.pdf](http://pubdb.wiwi.uni-jena.de/pdf/wp_hlj17-2011.pdf)> accessed 14 July 2017.

<sup>384</sup> Basel III (n 374) at 50.

<sup>385</sup> Basel III (n 374) at 32.

(FSB).<sup>386</sup> This was regulated at a later stage, when the BCBS in November 2011, issued the assessment methodology for global systemically important banks,<sup>387</sup> which was later revised in July 2013.<sup>388</sup> Lastly, another important innovation brought by Basel III was the introduction of the leverage ratio requirements, in an attempt to constrain leverage, model risk and measurement error. Thus, leverage ratio intended to supplement the risk-weighted measure with a simple, transparent and independent measure, which was deemed necessary due to the realisation that leverage ratio was considered to be one of the underlying features that led to the GFC.<sup>389</sup> Within the context of Basel III have been issued a number of documents aiming to address various aspects of banking supervision, including the establishment of standards for: liquidity coverage;<sup>390</sup> stable funding;<sup>391</sup> leverage ratio,<sup>392</sup> extended disclosure requirements;<sup>393</sup>

Most importantly, as Walter argues, what differentiates Basel III from its forerunners, apart from its comprehensive scope, is that: *“it combines micro- and macro-prudential reforms to address both institution and system level risks.”*<sup>394</sup> This is particularly important given that one of the elements of banking regulation that was considered to have had a negative effect during the GFC, was the extensive focus on micro-prudential supervision, which concerns the welfare of individual financial institutions; while the macro-prudential aspect seemed to have been neglected. When the latest financial crisis proved to have severe effects to the global economy as a whole and not only to particular financial institutions, the

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<sup>386</sup> Basel III (n 374) at 32. Also, for an early detailed analysis of Basel III see: Cannata, F. and Quagliariello, M. *Basel III and Beyond: A Guide to Banking after the Crisis* (Risk Books 2011)

<sup>387</sup> ‘Global systemically important banks: Assessment methodology and the additional loss absorbency requirement - final document’ (BCBS, November 2011) <<http://www.bis.org/publ/bcbs207.pdf>> accessed 14 July 2017.

<sup>388</sup> ‘Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement’ (BCBS, July 2013) <<http://www.bis.org/publ/bcbs255.pdf>> accessed 14 July 2017.

<sup>389</sup> Basel III (n 374) at 16.

<sup>390</sup> ‘Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools’ (BCBS, January 2013) <<http://www.bis.org/publ/bcbs238.pdf>> accessed 14 July 2017.

<sup>391</sup> ‘Basel III: The Net Stable Funding Ratio’ (BCBS, October 2014) <<http://www.bis.org/bcbs/publ/d295.pdf>> accessed 14 July 2017.

<sup>392</sup> ‘Basel III leverage ratio framework and disclosure requirements’ (BCBS, January 2014) <<http://www.bis.org/publ/bcbs270.pdf>> accessed 14 July 2017.

<sup>393</sup> ‘Standards: Pillar 3 disclosure requirements – consolidated and enhanced framework’ (BCBS, March 2017) <<http://www.bis.org/bcbs/publ/d400.pdf>> accessed 14 July 2017.

<sup>394</sup> Walter, Stefan ‘Basel III: Stronger Banks and a More Resilient Financial System’ (Conference on Basel III, Financial Stability Institute, 6 April Basel) 3 <<http://www.bis.org/speeches/sp110406.pdf>> accessed 14 July 2017. See also: Baker, Andrew, ‘The gradual transformation? The incremental dynamics of macroprudential regulation’ (2013) 7 (4) Regulation and Governance 417, 426- 28.

ultimate response was to adjust banking regulation in a way that would marry both micro- and macro-prudential supervision. Chapter two provides the definition of these notions as well as the relevant discussion on the recent debate in relation to their changing role and interaction.

Nonetheless, Basel III has been subject to criticism, mainly because it is considered to have been following the same pattern as Basel II. As Ambler pointed out in 2011: *“since Basel III follows the same approach as Basel II, albeit with a higher threshold, we should not be too confident that it will assure financial stability.”*<sup>395</sup> Thus, it is sensible to assume that another revision is on the way. In fact, although Basel III has not been fully implemented yet by many countries,<sup>396</sup> discussion on the perspective of ‘Basel IV’ have been circulating around for the last 4-5 years.<sup>397</sup> ‘Basel IV’ is not a formal name adopted by the BCBS, but it was rather a term increasingly used by the financial industry, after KPMG made reference to ‘Basel IV’ in order to describe the work of the BCBS on the revised standards of Basel III. Some others make reference to ‘Basel IV’ to indicate the new measures adopted in the context of Basel III. However, there is no official announcement as to the stance of BCBS regarding ‘Basel IV’. As mentioned earlier, one thing is for certain, Basel rules are designed to be revised in accordance with the needs of the evolving financial markets.

At EU level, Basel III has been implemented largely through the issuing of a Directive (Capital Requirements Directive IV - CRD IV)<sup>398</sup> and a Regulation (Capital Requirements

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<sup>395</sup> Ambler, Tim, ‘How Basel III Threatens Small Businesses’ (Adam Smith Institute Briefing Paper 2011) <<https://static1.squarespace.com/static/56eddde762cd9413e151ac92/t/5880c5009de4bb45fd8c71fc/1484834052752/How+Basel+III+threatens+small+businesses+by+Tim+Ambler.pdf>> accessed 14 July 2017.

<sup>396</sup> See: ‘Twelfth progress report on adoption of the Basel regulatory framework’ (BCBS, April 2017) <<http://www.bis.org/bcbs/publ/d404.pdf>> accessed 14 July 2017.

<sup>397</sup> See for instance:

- ‘Basel 4 – Emerging from the mist?’ (KPMG, September 2013) <<https://assets.kpmg.com/content/dam/kpmg/pdf/2013/09/emerging-from-the-mist.pdf>> accessed 14 July 2017;
- ‘Basel 4 revisited: The fog begins to clear’ (KPMG, September 2015) <<https://assets.kpmg.com/content/dam/kpmg/pdf/2015/10/basel-4-report-concepts.pdf>> accessed on 14 July 2017; and
- ‘The world awaits: Basel 4 near completion’ (KPMG, December 2016) <<https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/12/world-awaits-basel-4-nears-completion.pdf>> accessed 14 July 2017.

<sup>398</sup> ‘Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC’ [2013] OJ L 176/338. See also its Corrigendum:

Regulation-CRR)<sup>399</sup> in 2013, which took effect in 1 January 2014 with some of the provisions to have been phased in between 2014-2019.<sup>400</sup> Special role in the implementation of regulation pertaining Basel rules is played by the European Banking Authority (EBA). The EBA contributes to the establishment of joint regulatory and supervisory standards in practice in the European Union by issuing opinions, developing guidelines and recommendations and drafting regulatory and implementing technical standards.

#### 1.5.4 Core principles for effective Banking Supervision

Following the analysis in the previous subsections, it is clear by now that the BCBS has focused its work throughout the years on strengthening the regulatory framework by setting minimum standards for adequate capitalisation for credit institutions at global level. However, the importance of effective supervision, apart from being the initial aim of BCBS establishment, was always part of the agenda,<sup>401</sup> since “*changing the rules alone cannot make the financial system safe. The judgment of banking supervision is crucial*”.<sup>402</sup> This was the rationale behind the introduction of the Core Principles for Effective Banking Supervision by the BCBS in September 1997.<sup>403</sup> The main objective of the latter was to set global standards

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‘Corrigendum to Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC’ [2013] OJ L 208/73.

<sup>399</sup> ‘Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012’ [2013] OJ L176/1.

See also its two Corrigendum:

- ‘Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012’ [2013] OJ L 321/6;
- ‘Corrigendum to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012’ [2013] OJ L 208/68.

<sup>400</sup> For a detailed analysis of Basel III implementation at EU level see: Atik, Jeffery ‘EU Implementation of BASEL III in the Shadow of Euro Crisis’ (2013-2014) 33 Review of Banking & Financial Law 283 <[https://www.bu.edu/rbfl/files/2014/03/RBFL-V.-33\\_1\\_Atik.pdf](https://www.bu.edu/rbfl/files/2014/03/RBFL-V.-33_1_Atik.pdf)> accessed 14 July 2017.

<sup>401</sup> Douglas, Arner, W. *Financial stability, economic growth, and the role of law* (Cambridge University Press 2007) 202-204.

<sup>402</sup> Zamil, Raihan, S., ‘Judgment Day’ (2010) 47 (3) IMF Finance and Development <<http://www.imf.org/external/pubs/ft/fandd/2010/09/pdf/zamil.pdf>> accessed 14 July 2017.

<sup>403</sup> ‘Core principles for effective banking supervision’ (BCBS, September 1997) <<http://www.bis.org/publ/bcbs30a.pdf>> accessed 14 July 2017.

for prudential banking supervision. This underwent revision in October 2006,<sup>404</sup> and the BCBS issued consultative document in December 2011,<sup>405</sup> as a basis for its revision in September 2012.<sup>406</sup> It is noteworthy that the Core Principles for Effective Banking Supervision, since their introduction has been positively received and implemented by many developed nations, while emerging markets and transition economies to a more limited degree.<sup>407</sup>

At EU level, banking supervision remained for many years at national level,<sup>408</sup> while the relevant legislation at domestic level worldwide has been highly influenced by the Core Principles for effective Banking Supervision.<sup>409</sup> Similarly, the Core Principles Rules have been highly influential at EU level. For instance, since the early stage of EU monetary integration, this is evident from the rules included at some of the Services Action Plan Directives and Regulation, including the Regulation on the application of international accounting standards,<sup>410</sup> and the Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.<sup>411</sup> In the years to follow, the EU slowly developed its own supervisory framework, which again has been influenced by the Core Principles. A representative example is central bank independence, which was generously granted to the ECB, even after the ECB assumed supervisory responsibilities. A full analysis of the effect of Core Principles in the EU, goes beyond the scope of this thesis. Hence, this basic analysis aimed to provide context to the discussion to follow in chapter three with respect to the evolution of the supervisory framework in the EU, rather

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<sup>404</sup> 'Core Principles for Effective Banking Supervision - final document' (BCBS, October 2006) <<http://www.bis.org/publ/bcbs129.pdf>> accessed 14 July 2017.

See also its added document: 'Core Principles Methodology' (BCBS, October 2006) <<http://www.bis.org/publ/bcbs130.pdf>> accessed 14 July 2017.

<sup>405</sup> 'Consultative Document Core Principles for Effective Banking Supervision Issued for comment by 20 March 2012' (BCBS, December 2011) <<http://www.bis.org/publ/bcbs213.pdf>> accessed 14 July 2017.

<sup>406</sup> 'Core Principles for Effective Banking Supervision' (BCBS September, 2012) <<http://www.bis.org/publ/bcbs230.pdf>> accessed 14 July 2017.

<sup>407</sup> Alford (n 315) 269.

<sup>408</sup> Barfield, Richard (ed), *A practitioner's guide to Basel III and Beyond* (Thomson Reuters UK Limited 2011) 471-474.

<sup>409</sup> See: Ellinger et al (n 334).

<sup>410</sup> 'Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards' [2002] OJ L 243/1.

<sup>411</sup> 'Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council' [2002] OJ L 35/1.

than providing a comprehensive analysis of the relationship between BCBS rules and EU banking legislation.

## 1.6 Concluding Remarks

This chapter provided an initial analysis of the purpose and conceptual framing of central banking, with a particular focus on the idea of central bank independence. This aimed to set the ground for the discussion to follow in the succeeding chapters, which primarily intend to examine the compatibility of monetary policy and banking supervision tasks, under the existing Treaty provisions, in light of the decision to assign supervisory powers to the ECB. Section one, after providing an overview of the idea of central bank independence and its links with the notions of credibility, transparency and accountability, stressed their relevance to the recent debate, concerning the conferral of supervisory powers to central banks, which, as aforesaid, lies at the heart of this thesis. In addition, section four, narrowed down the discussion on the independence of the ECB in light of EU Treaty provisions.

The chapter then described the historical background of the process of European integration, which aimed at explaining its rationale and its development through a process of gradual evolution that has been characterised by an increased trend of further harmonisation of rules and practices. Also, although the adoption EU Treaty provisions, goes back to the early 1990s, they still provide the legal basis of the ECB's operation and guarantee the legitimacy of its actions, by also offering the base for any future amendments. Thus, looking back in history is an integral part of understanding existing regulatory arrangements as well as their potential for future changes. The last section, analysed the BCBS initiatives and their role in setting minimum standards for supervisory and regulatory practices. It should be noted that there is a broad literature regarding the BCBS rules and their implementation at EU level. However, a full analysis of this subject goes beyond the scope of this thesis. Hence, the discussion remains limited to the provision of a basic analysis of the BCBS, including: a brief overview of its creation; the rationale of its role and purpose; the main legislative initiatives and their influence at EU level. This chapter has offered the background needed to allow us to proceed to an investigation of the interaction of monetary policy and bank regulation in the following chapter two.

## Chapter 2: The interaction between monetary policy and bank regulation

### 2.1 Introduction

As discussed in the previous chapter, on 1 January 1999 the ECB assumed responsibility for monetary policy in the Eurozone. The Eurozone represents (as of 2016) the second largest economy in the world - measured in nominal terms and according to purchasing power parity (PPP) - after the US;<sup>412</sup> and (as of 2014) the largest economy in the world - measured in terms of the goods and services it produces (GDP).<sup>413</sup> Almost eighteen years on, the ECB enjoys a high degree of credibility worldwide for its effective monetary policy, focused primarily on maintaining price stability. The journey towards the creation of the EMU, the establishment of the ECB and the introduction of the euro has been already outlined in chapter one. Chapter one, also touched upon the notion of price stability as the main objective of the ESCB. Thus, this chapter analyses in detail what the notion of price stability entails, by also explaining its rationale and how it came to be established as the key goal of the ESCB.

The monetary policy framework of the ECB, similarly to its overall institutional framework, is based on historical experience and the parallel evolution of macroeconomic thought. Thus, the ECB's monetary policy model is built upon two important underlining principles: the sole mandate of the monetary authority to maintain price stability and a high degree of independence in pursuing its mandate. The second principle has been already discussed in detail in chapter one and is also subject to discussion in chapter four, as part of the analysis regarding the new responsibilities of the ECB in the supervisory domain. Thus, this chapter aims firstly, to explore the role of ECB in maintaining price stability as set by the provisions of EU law, including the its rationale, evolution and changing nature. However, as

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<sup>412</sup> See: 'Report for Selected Country Groups and Subjects' (IMF, October 2016) <<http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=56&pr.y=8&sy=2016&ey=2016&scsm=1&ssd=1&sort=country&ds=.&br=1&c=001,998&s=NGDPD&grp=1&a=1#download>> accessed 14 July 2017. See also: 'The Monetary Policy of the ECB' (ECB, 2011) 9 <<https://www.ecb.europa.eu/pub/pdf/other/monetarypolicy2011en.pdf>> accessed 14 July 2017.

<sup>413</sup> EU official website <[https://europa.eu/european-union/about-eu/figures/economy\\_en](https://europa.eu/european-union/about-eu/figures/economy_en)> accessed 14 July 2017.

briefly discussed in chapter one, in the aftermath of the GFC, the role of ECB has been changing radically. This change has been mainly influenced by a plethora of post-crisis regulatory measures aimed at strengthening the ECB's supervisory role by enhancing its financial stability mandate. At the same time, there is no intention to change the original institutional framework of the ECB and its traditional role in maintaining price stability through inflation targeting goals.

To this end, although, monetary policy and financial stability are two sides of the same coin, their incorporation within an existing institutional framework is not straightforward, but it rather raises a number of questions regarding potential synergies that remain subject to an ongoing debate. With the introduction of the Banking Union 'project' at EU level, and the establishment of its first pillar (i.e. the SSM), which facilitated the transfer supervisory powers from national to EU level, this debate has been only intensified. However, before analysing the regulatory measures that paved the way towards the creation of the Banking Union, it is important to discuss the rationale of price stability, as the main objective of monetary stability, and its interaction with the Bank's financial stability function.

This chapter is divided into two parts. The first part is comprised of three sub-sections, with the first one (2.1.1) aiming to explore the meaning of monetary policy, its evolution at international level from the late 19<sup>th</sup> century to the modern era. The second sub-section (2.1.2) examines the interaction between monetary policy and financial supervision, which is followed (in 2.1.3) by an investigation of the potential trade-offs between price stability (as the main objective of monetary policy) and financial stability (as the fundamental aim of financial supervision). The second part of this chapter is divided into two sub-sections, with the first (2.2.1) aimed at exploring the ECB's monetary policy function as set by EU law and the second (2.2.2) examining the Bank's role in financial stability.

This chapter starts by mapping the concept of monetary policy and its evolving role towards what has come to be established as "the optimal model" or more precisely, the desired monetary policy framework. This outline sets the ground for the subsequent analysis of the changing role of monetary policy in the aftermath of the GFC. In fact, there is evidence generated by the GFC that challenged the conventional wisdom on a monetary policy role



focused primarily on maintaining price stability. This discussion also links with the debate against the notion of central bank independence both in the pre- and post- crisis era.

## 2.2 The broader monetary and financial framework

### 2.1.1 Monetary policy: is there an optimal institutional model?

*“Having looked at monetary policy from both sides now, I can testify that central banking in practice is much art as science. Nonetheless, while practising this dark art, I have always found the science quite useful.”*<sup>414</sup>

Generally speaking, monetary policy comprises the rules and actions adopted by central banks to achieve their objectives, which usually concern controlling the money supply and interest rates. According to Friedman, monetary policy, together with fiscal policy, constitute: *“the two principal means by which government authorities in a market economy regularly influence the pace and direction of overall economic activity, importantly including not only the level of aggregate output and employment but also the general rate at which prices rise or fall.”*<sup>415</sup> The US’s Fed defines its monetary policy as: *“the actions undertaken by a central bank, such as the Federal Reserve, to influence the availability and cost of money and credit to help promote national economic goals,”* with maximum employment, stable prices, and moderate long-term interest rates, being set as the statutory objectives for monetary policy.<sup>416</sup> The ECB does not provide an explicit definition for monetary policy, but it specifically outlines its main objective, which is to maintain price stability.<sup>417</sup>

As one can notice, the views as to what is defined as monetary policy and how it should be conducted varies. In fact, there will always be some a grey area in macroeconomic debates when it comes to determining a generally accepted definition for “monetary policy” and the

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<sup>414</sup> Blinder Alan S., ‘What Central Bankers Can Learn From Academics- And Vice-Versa’ (1997) 11 (2) Journal of Economic Perspectives 3, 17.

<sup>415</sup> Friedman, Milton, ‘Monetary Policy’ in Smelser, Neil J. and Bates, Paul B, (eds.) *International Encyclopedia of the Social & Behavioral Sciences* (Elsevier 2001) 9976.

<sup>416</sup> See the definition at Fed’s website: <<https://www.federalreserve.gov/monetarypolicy/fomc.htm>> accessed 14 July 2017.

<sup>417</sup> See: ECB’s website: <<https://www.ecb.europa.eu/home/html/index.en.html>> accessed 14 July 2017.

meaning of “money”. This happens due to a combination of evolving views in macroeconomic theory and the various interpretations given to monetary history. However, if we look at the discussion about monetary policy prior to the GFC, we could talk about almost optimal monetary policy models – or generally accepted as optimal – and well-functioned institutional arrangements, which were primarily based on inflation targeting policies.

Similarly to the vagueness of the meaning of monetary policy, there is also, no generally accepted definition for inflation targeting.<sup>418</sup> The rationale for the widespread choice of targeting inflation regime from many central banks around the world, dates back to a period when inflation rates increased rapidly, i.e. in the 1970s (in the advanced economies) and in the 1980s (in emerging economies).<sup>419</sup> This increase in inflation brought evidence that challenged the existing monetary policy regimes (which were not inflation-driven) and their respective explanatory macroeconomic theories. As a result, by the 1990s many countries had started to either adopt or considering adopting inflation targeting goals. To this end, and in order to understand how the world came to accept inflation targeting as the optimal monetary policy framework, it is important to briefly analyse the roadmap towards inflation targeting prevalence, including the historical milestones and the evolution of macroeconomic thought. However, since there is an extensive literature on the historical evolution of monetary policy and a large body of it, is dedicated on inflation targeting, the analysis to follow will focus only on the major events that led to inflation targeting predominance.

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<sup>418</sup> For various (recent) definitions regarding the meaning of inflation targeting see:

- Debelle, Guy, Masson, Paul, Savastano, Miguel, and Sharma, Sunil, ‘Inflation Targeting as a Framework for Monetary Policy’ (IMF, October 1998), 2 <<http://www.imf.org/external/pubs/ft/issues/issues15/index.htm>> accessed 14 July 2017;
- Svensson, Lars E. O., ‘Inflation Targeting as a Monetary Policy Rule’ (NBER, Seminar Paper No. 6790, 1998) 13 <<http://www.nber.org/papers/w6790.pdf>> accessed 14 July 2017;
- Batini, Nicoletta, Kuttner, Kenneth, and Laxton, Douglas, ‘Does Inflation Targeting Work in Emerging Markets’ (IMF World Economic Outlook, September 2005) 161, 161 <<https://www.imf.org/external/pubs/ft/weo/2005/02/pdf/chapter4.pdf>> accessed 14 July 2017;
- Bernanke, Ben S. and Woodford, Michael (eds.), *The Inflation Targeting Debate* (The University of Chicago Press 2005) 1; and
- Hammond, Gill, ‘State of the art of inflation targeting’ (Handbook No. 29, Centre for Central Banking Studies February, Bank of England, 2012) 5 <<http://www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ccbshb29.pdf>> accessed 14 July 2017.

<sup>419</sup> Eichengreen, Barry, El-Erian, Mohamed, Fraga, Arminio, Ito, Takatoshi, Pisani-Ferry, Jean, Prasad, Eswar, Rajan, Raghuram, Ramos, Maria, Reinhart, Carmen, Rey, Helene, Rodrik, Dani, Rogoff, Kenneth, Song Shin, Hyun, Velasco, Andres, Weder di Mauro, Beatrice and Yu, Yongding, ‘Rethinking Central Banking’ (Bruegel, Report of the Committee on International Economic and Policy Reform, September 2011), 1 <[http://bruegel.org/wp-content/uploads/imported/publications/Rethinking\\_Central\\_Banking\\_web.pdf](http://bruegel.org/wp-content/uploads/imported/publications/Rethinking_Central_Banking_web.pdf)> accessed 14 July 2017.

It should be noted that the term “monetary regimes” is used here to describe the set of rules governing the institutions (in most of the cases central banks), which finally determine the amount of money supplied. Historically, monetary policy regimes could be divided as following: a) the classical gold standard (1870-1914); b) interwar gold exchange standard (1925-1939); c) the fixed and floating exchanges rates during the Bretton Woods system (1944-1971); and d) the present fiat money system.<sup>420</sup>

During the classical gold standard era, the majority of countries adhered to the principle of convertibility, where the standard unit of domestic currency was a fixed quantity of silver or gold or was linked to a fixed quantity of silver or gold.<sup>421</sup> The obvious advantage of the gold standard was that a fixed asset backed the value of paper money. Each country had discretion to define the gold equivalent of its currency, and as a result would print as much money as the size of its gold reserve.<sup>422</sup> Monetary policy, during that time, was focused on preventing price inflation by the excessive issue of paper currency, which is also believed to explain the low inflation rates of this period.<sup>423</sup> Another benefit of the classical gold standards was that it was based upon an automatic self-regulating mechanism of balance of payments, wherein a country that had a balance of payment imbalance at the fixed exchange rate, would be subject to an automatic adjustment process to correct the imbalance.<sup>424</sup>

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<sup>420</sup> For more on the monetary regimes and a detailed historical background analysis see: Bordo, Michael, ‘The Gold Standard, Bretton Woods and Other Monetary Regimes: A Historical Appraisal’ (Federal Reserve Bank of ST. Louis Review, March/Prill 1993a) <[https://research.stlouisfed.org/publications/review/93/03/Gold\\_Mar\\_Apr1993.pdf](https://research.stlouisfed.org/publications/review/93/03/Gold_Mar_Apr1993.pdf)> accessed 14 July 2017. See also:

- Bordo, Michael and Jonung, Lars, ‘A Return to the Convertibility Principle? Monetary and Fiscal Regimes in Historical Perspective: The international evidence’ (EU Commission, Economic Paper No 159, September 2001) <[http://ec.europa.eu/economy\\_finance/publications/publication876\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication876_en.pdf)> accessed 14 July 2017; and
- Issing, Otmar, ‘The Development of Monetary Policy in the 20th Century – Some Reflections’ (Colloquium at the National Bank of Belgium, Brussels, 29 April 2010) <<https://www.imf.org/external/np/seminars/eng/2011/res/pdf/oi2.pdf>> accessed 14 July 2017.

<sup>421</sup> See: Bordo, Michael D. and Schwartz, Anna J. (eds), *A Retrospective on the Classical Gold Standard, 1821-1931* (The University of Chicago Press 1984).

<sup>422</sup> Sawyer, Charles W. and Sprinkle, Richard L., *Applied International Economics* (4<sup>th</sup> edn. Routledge 2015).

<sup>423</sup> Bernholz, Peter, *Monetary Regimes and Inflation: History, Economic and Political Relationships* (Edward Elgar Publishing 2003) 14. See also: Bordo, Michael D. and MacDonald, Ronald, ‘Violations of the ‘Rules of the Game’ and the Credibility of the Classical Gold Standard, 1880-1914’ (NBER, Working Paper No. 6615, July 1997) <<http://www.nber.org/papers/w6115.pdf>> accessed 14 July 2017.

<sup>424</sup> Sawyer and Richard (n 423) 469.

Despite these advantages, the gold standards had certain limitations. Namely, the convertibility of the currency was limiting for monetary policy to the extent that the only goal was to defend the external value of the currency. This happened mainly because it was the availability of silver or gold reserves and the marginal cost of their production that determined the stock of money. The reserves of gold or silver, in turn, and by default the money supply, depended on natural discoveries. Economic growth, however, depends on the availability of credit, and an artificial restriction on expanding the money supply (like the gold standard) creates a continuous break against the expansion of economic activity.<sup>425</sup> With the outbreak of WWI in 1914, the gold standard was abandoned, to only return during the interwar period (by the late 1920s) as an evolved version, the so-called gold exchange standard. Finally, in 1931, when the UK decided to abandon the gold standard, its era came to an end.<sup>426</sup> Notably, many major central banks were established during the gold standard era, including the Banque Nationale de Belgique in 1850; the German Reichsbank in 1876; the Bank of Japan, which was the first central bank outside Europe, in 1882; and the US's Fed was created in 1913.

After WWI there was a continuous effort to restore the gold value of currencies, a stance that shifted radically in the 1930s during the Great Depression.<sup>427</sup> Indeed, the collapse of the gold standard coincided with the occurrence of Great Depression, which represents one of the darkest eras of central banking.<sup>428</sup> There is some literature supporting the idea that there is a link between the distortions caused by the golden standard and the Great Depression. For instance, Temin attributed the Great Depression to the structural pitfalls of the exchange gold standard during the interwar period and the respective ineffective policy

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<sup>425</sup> Burda, Michael and Wyplosz, Charles, *Macroeconomics: A European Text* (Oxford University Press 2017) 513-514.

<sup>426</sup> Bordo, Michael D. 'The Classical Gold Standard: Some Lessons for Today' (Federal Reserve Bank of St. Louis Review, May 1981), 7  
<[https://files.stlouisfed.org/files/htdocs/publications/review/81/05/Classical\\_May1981.pdf](https://files.stlouisfed.org/files/htdocs/publications/review/81/05/Classical_May1981.pdf)> accessed 14 July 2017.

For an detailed analysis of the golden standard and the reasons that led to its collapse see also:

- Bordo, 1993a (n 421); and
- Eichengreen, Barry, *Golden Fetters: The Gold Standard and the Great Depression 1919-1939* (Oxford University Press 1992).

<sup>427</sup> Schenk, Catherine and Straumann, Tobias (2014), 'International Monetary Policy Regimes: Historical Perspectives' (Norges Bank Conference: 'Of the Uses of Central Banks: Lessons from History', Oslo, 5-6 June 2014) 7 <[http://www.norges-bank.no/pages/100044/05\\_Schenk\\_and\\_Straumann2014.pdf](http://www.norges-bank.no/pages/100044/05_Schenk_and_Straumann2014.pdf)> accessed 14 July 2017.

<sup>428</sup> Goodhart (n 166) 5.

responses.<sup>429</sup> In the same vein, Eichengreen and Sachs, argued that the countries that abandoned the gold standard, revived from the Great Depression at a faster pace in comparison to those that decided to adhere the gold standard for longer.<sup>430</sup>

Undeniably, the Great Depression had a major influence on the development of macroeconomic thought of that time. In fact, the implications of the Great Depression and the exploration of its underlying reasons are still subject to ongoing research, and continue to influence macroeconomic thought.<sup>431</sup> As former chair of the Fed, Ben Bernanke typically stated: *“to understand the great depression is the Holy Grail of macroeconomics.”*<sup>432</sup> Notably, it was during that period of severe worldwide economic downfall that a window to a new macroeconomic thought opened. This was particularly important, since what was then acknowledged as conventional economic wisdom, proved to be insufficient in dealing with the challenges brought by the Great Depression. In the period prior to the Great Depression, economic thought was highly influenced by classical economics, which represent the school of economic thought exemplified by Adam Smith's writings in the 18th century, and David Ricardo, John Stuart Mill and Thomas Robert Malthus's works during the end of the 18th century and early years of the 19th century.

A new order in macroeconomic thought, pioneered by the British economist, John Maynard Keynes (considered as the father of modern macroeconomics) came into prominence in an attempt to provide answers as to what led to Great Depression and to offer possible solutions in showing the way out of it. Keynes' theory shifted macroeconomic thought from aggregate supply to aggregate demand, and its advocates argued that the huge fall in aggregate demand ultimately led to the double-digit unemployment rates in the US during the 1930s, and subsequently, to deflationary spiral of the Great Depression. The core idea of Keynesianism is that the impact of changes in the level of borrowing interest rates over spending in the economy, outweighs in importance the respective impact of changes over the money supply. Simply said, when there is evidence that a country's economy is close

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<sup>429</sup> See: Temin, Peter, *Lessons from the Great Depression* (The MIT Press 1991).

<sup>430</sup> Eichengreen, Barry and Sachs, Jeffrey, 'Exchange Rates and Economic Recovery in the 1930s' (1985) 45 (4) *The Journal of Economic History* 925.

<sup>431</sup> Bernanke, Ben S., 'The Macroeconomics of the Great Depression: A Comparative Approach' (1995) 27 (1) *Journal of Money, Credit and Banking* 1, 1.

<sup>432</sup> Bernanke (n 432) 1.

to distress, the central bank must drive down its interest rates in order to allow banks and people to borrow cheaply, which will ultimately allow them to spend more.<sup>433</sup>

As mentioned before, Keynesians believed that inadequate monetary policy led to a severe economic meltdown. In addition, monetary policy, although necessary, was considered to be insufficient to boost the economy and increase investment flows on its own. To this end, Keynesian advocates viewed fiscal policy and thus, government intervention, as the only possible solution in terminating a financial distress.<sup>434</sup> Notably, Keynes highlighted the need for a stabilising system and emphasised “*the importance of rule-based regimes to stabilise business expectations.*”<sup>435</sup> In addition, Keynes viewed the role of the central bank as a governmental organ and an instrument of public policy, which would ensure state control over the currency and all the issues related to it.<sup>436</sup>

Keynesian theories proved to be determinant in the post-war negotiations for international cooperation, especially in the establishment of the new monetary regime in 1944, i.e. the Bretton Woods System. The latter represented the settlement of lasting peace after WWII and an attempt to learn from the lessons of Great Depression,<sup>437</sup> by incorporating both the benefits of a fixed system (i.e. stability of exchange rates) and the freedom of a floating rate system (i.e. monetary and fiscal independence).<sup>438</sup> In a nutshell, Bretton Woods was a fixed exchange rate international monetary system, during which the world enjoyed two decades of growth, low unemployment rates and stable low inflation.<sup>439</sup> This perhaps explains, the reasons why Keynesian theory came to be established as the best explanatory

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<sup>433</sup> See:

- Keynes, John M., *A tract on monetary reform* (Macmillan and Co. Ltd 1923);
- Keynes, John M., *A Treatise on Money* (Macmillan and Co. Ltd. 1930); and
- Keynes, John M., *The General Theory of Employment, Interest, and Prices* (Macmillan and Co. Ltd. 1936).

<sup>434</sup> Mishkin, Frederic S., ‘Monetary Policy Strategy: Lessons from the Crisis’ (NBER, Working Paper No. 1675, February 2011), 3 <<http://www.nber.org/papers/w16755.pdf>> accessed 14 July 2017.

<sup>435</sup> See: ‘Ideas and the world’ (The Economist, 23 November, 2000) <<http://www.economist.com/node/431717>> accessed 14 July 2017.

<sup>436</sup> Bibow, Jörg, ‘At the Crossroads: The Euro and Its Central Bank Guardian (and Savior?)’ (Levy Economics Institute of Bard College, Working Paper No. 738, November 2012), 3 <[http://www.levyinstitute.org/pubs/wp\\_738.pdf](http://www.levyinstitute.org/pubs/wp_738.pdf)> accessed 14 July 2017.

<sup>437</sup> James, Harold, ‘The multiple contexts of Bretton Woods’ (2012) 28 (3) Oxford Review of Economic Policy 411, 414.

<sup>438</sup> Bordo 1993a (n 421) 7.

<sup>439</sup> For a detailed analysis on the Bretton Woods System see: Bordo, Michael D., ‘The Bretton Woods International Monetary System. An Historical Overview’ (NBER, Working Paper No. 4033, March 1992) <<http://www.nber.org/papers/w4033.pdf>> accessed 14 July 2017.

theory of fluctuations in economic activity, and as a result, many countries pursued domestic stabilisation policies, mainly focused on the goal of full employment.<sup>440</sup>

It should be noted here, that the Bretton Woods System was not consistently a fixed rate exchange system throughout its duration. Originally, it was designed as a flexible exchange rate monetary system, which evolved into an international fixed exchange rate monetary system. Bordo divides Bretton Woods into two sub-periods: the pre-convertible phase (from 1946 to 1958) and the convertible phase (between 1959 until 1970). As Bordo explained in relation to the two periods: *“the comparison also relates to the theoretical issues raised by the perennial debate over fixed versus flexible exchange rates.”*<sup>441</sup> In short, in the post-WWII, monetary policy period was not given equal importance as fiscal policy in terms of its ability to deliver the intended macroeconomic goals. Hence, the role of price stability was arguably completely neglected. In fact, monetary policy decisions at the time – most notably, the implementation of stabilisation policies in the US – were influenced by the assumption that there was a trade-off between unemployment and inflation.<sup>442</sup>

This assumption was based on the Phillips curve theory, according to which unemployment could be addressed by increasing inflation rates, hence, through expansionary monetary policy approaches.<sup>443</sup> A central bank pursues an expansionary monetary policy when it uses its own tools to stimulate the economy, mainly by keeping interest rates low, which expands the money supply and increases aggregate demand in order to boost the economy.<sup>444</sup> It should be noted that the Phillips curve, was originally based on economic theories of the late 18th century and further developed by empirical studies regarding money wage growth and unemployment during the 19th century. However, according to Humphrey, it was not until 1958 that modern Phillips curve analysis begun, with the publication of

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<sup>440</sup> Bordo and Jonung (n 421) 30.

<sup>441</sup> Bordo 1993a (n 421) 5.

<sup>442</sup> Romer, Christina D. and Romer, David H. ‘The Evolution of Economic Understanding and Post-war Stabilization Policy’ (NBER, Working Paper 9274, October 2002) <<http://www.nber.org/papers/w9274.pdf>> accessed 2017.

<sup>443</sup> For an early analysis of the Phillips Curve see: Humphrey, Thomas M., ‘The Evolution and Policy Implications of Phillips Curve Analysis’ (1985) 71 (2) Economic Review 3, 3.

<sup>444</sup> See: Baumol, William J. and Blinder, Alan S., *Macroeconomics Principles and Policy* (11<sup>th</sup> edn, South-Western Cengage Learning 2009) Chapter 13.

Phillips's famous paper, where he argued that there was an inverse correlation between the rate of change in money wages and unemployment.<sup>445</sup>

The Phillips curve, was later extended to the relation between inflation and unemployment, depicting that there was evidence of this inverse trade-off between them. Samuelson and Solow in 1960 discussed the long-run trade-off between employment and inflation, and whether one of the goals has to be prioritised over the other.<sup>446</sup> This approach started from being very influential in adopting expansionary policies in the early 1960s in the US, to become highly criticised during and in the aftermath of Great Inflation (see below); and thus, leading to alternative theories to the Phillips curve analysis.

Nonetheless, the collapse of the Bretton Woods System (between 1968 and 1971) brought an end to monetary regimes based on the "convertibility principle," and broke the last link of money with gold. As a result, the world's major currencies were left completely unanchored, which was followed by a period of increased inflation that brought new evidence that questioned both Keynesian theories and the Phillips curve view of inflation. In fact, the Phillips curve theory along with the low estimate of the natural rate of unemployment, are often blamed for the occurrence of the inflationary gap in the years to follow.<sup>447</sup> As discussed in Chapter one, there was a vast amount of arguments supporting that there was a negative correlation between low inflation and employment levels. The notion of an inflationary gap was originated by Keynes in 1940, in an attempt to analyse and calculate the main determinants that cause an inflationary rise of prices, i.e. the pressure of inflation.<sup>448</sup> Keynes defined inflationary gap as: "*an excess of planned expenditure over the available output at full employment*,"<sup>449</sup> and considered it to be the main cause of inflation. Thus, according to this view, inflationary gap is created when in an economy, aggregate demand exceeds the

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<sup>445</sup> Phillips, William A., 'The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957' (1958) 25 (100) *Economica* 283.

<sup>446</sup> Samuelson, Paul A. and Solow, Robert M., 'Analytical Aspects of Anti-Inflation Policy' (1960) 50 (2) *American Economic Review*, Papers and Proceedings 177.

<sup>447</sup> Goodfriend, Marvin, 'How the World Achieved Consensus on Monetary Policy' (NBER Working Paper No. 13580, November 2007), 4 <<http://www.nber.org/papers/w13580.pdf>> accessed July 2017.

See also: Orphanides, Athanasios, 'Monetary Policy Rules and the Great Inflation' (2002) 84 (4) *The American Economic Review* 569.

<sup>448</sup> Keynes, Maynard J., *How to pay for the war: a radical plan for the Chancellor of the Exchequer* (1<sup>st</sup> edn, Macmillan 1940).

<sup>449</sup> Keynes (n 449) as quoted in Kennedy, Maria J., *Macroeconomic Theory* (Prentice-Hall of India Pvt. Ltd 2011) 234.



aggregate value of output at the full employment level. However, the inflationary gap constitutes a highly controversial notion that has been subject to extensive criticism,<sup>450</sup> which exceeds the scope of this analysis.

The breakdown of Bretton Woods, was combined with a rapid increase of inflation in many countries around the world.<sup>451</sup> This period is also known as the Great Inflation or Inflation Depression, which involved two decades of high inflation; four economic recessions; two severe energy and oil crises; a rapid rise in public debts in the 1970s and in particular, in the 1980s; and the unprecedented peacetime implementation of wage and price controls.<sup>452</sup> During the Great Inflation, which according to Samuelson begins from the late 1960s and lasts until the early 1980s,<sup>453</sup> inflation rates in the US reached their 20th century peak, by exceeding 10%.<sup>454</sup> In addition, the annual inflation rates soared to over 10% during the 1970s across OECD countries, with a few exceptions (Germany and Switzerland),<sup>455</sup> and in 1975 the United Kingdom recorded a peak in inflation of 25%.<sup>456</sup> Siegel describes the Great Inflation period as the greatest failure of American macroeconomic policy during the post-war period,<sup>457</sup> which, however, did not remain only a US- related event, but was transmitted quickly to other countries and in many cases with an amplifying effect.

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<sup>450</sup> See inter alia:

- Friedman, Milton, 'Discussions on the inflationary gap by Walter Salant' (1942) 32 (2) American Economic Review 314;
- Salant, Walter S., 'The inflationary gap, meaning and significance for policy making' (1942) 32 (2) Economic Review 308; and
- Hansen, Bent, *A Study in the Theory of Inflation* (Allen & Unwin 1953).

<sup>451</sup> For a detailed analysis of this approach see for instance:

- Bordo and Schwartz (n 422); and
- Barro, Robert J., 'United States Inflation and the Choice of a Monetary Standard' in Hall, Robert E. (ed.) *Inflation: Causes and Effect* (University of Chicago Press 1982).

<sup>452</sup> See: Bordo and Jonung (n 421).

<sup>453</sup> See: Samuelson, Robert J., *The Great Inflation and Its Aftermath: The Past and Future of American Affluence* (Random House 2008).

<sup>454</sup> Collard, Fabrice and Dellas, Harris, 'The Great Inflation of the 1970s' (Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 799., 2004) <<http://www.federalreserve.gov/pubs/ifdp/2004/799/ifdp799.pdf>> accessed July 2017.

<sup>455</sup> 'The "Great Inflation": Lessons for monetary policy' (ECB, Monthly Bulletin, May 2010) 99 <[https://www.ecb.europa.eu/pub/pdf/other/mb201005en\\_pp99-110en.pdf?023022965966d570be586b1dc46e84b6](https://www.ecb.europa.eu/pub/pdf/other/mb201005en_pp99-110en.pdf?023022965966d570be586b1dc46e84b6)> accessed July 2017.

<sup>456</sup> Nelson, Edward, 'The Great Inflation of the Seventies: What Really Happened?' (Federal Reserve Bank of ST. Louis, Working Paper 2004-001, January 2004), 4 <<https://research.stlouisfed.org/wp/2004/2004-001.pdf>> accessed July 2017.

<sup>457</sup> Siegel, Jeremy J., *Stocks for the Long Run: A Guide to Selecting Markets for Long-Term Growth* (2<sup>nd</sup> edn. Irwin Professional Publishing).

Interestingly, the discussion regarding the reasons that led to Great Inflation, were brought to the surface again during the GFC. This, in turn, led to reopening the debate about monetary policy, inflation, central bank independence and supervisory regimes. For instance, Samuelson, highlighted the existence of parallels between the Great Inflation and this the GFC, which made the former a point of comparison and a source of learning for the current policy responses.<sup>458</sup> Back to the 1970s, Great Inflation significantly influenced change in macroeconomic thought, which happened as a result of the realisation that the acute changes in real GDP and in price levels could not be explained anymore by the aggregate demand of Keynesian economics. Also, higher inflation did not bring about higher employment or faster growth, as it was expected. In fact, monetary policy strategies aimed at reaching and maintaining full employment by increasing aggregate demand, had rather the opposite effect since they created inflationary pressures.<sup>459</sup> Lastly, the Keynesian idea that monetary policy should not be concerned about inflation, since there were other factors to be considered as more important in influencing inflation (such as fiscal deficits, commodity price shocks, aggressive labour unions etc.), proved also to be insufficient in explaining the changing parameters of the economy.

As a result, Keynes's fiscal and monetary policy theories that had won widespread acceptance by the majority of governments around the world during the 1960s, were no longer sufficient to address the challenges brought by the upward trend in inflation rates during the 1970s and after.<sup>460</sup> This in turn, brought increased scepticism as to the role of monetary authority and monetary policy strategies. Thus, by the late 1960s, against what had become the Keynesian orthodoxy stood the monetarist theory, espoused by Milton Friedman, Karl Brunner, and Allan Meltzer.<sup>461</sup> The main point of disagreement in the debate between Keynesian and Monetarist economists, was primarily the effectiveness of policy instruments.

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<sup>458</sup> See: Samuelson (n 454).

<sup>459</sup> Bordo and Jonung (n 421) 30.

<sup>460</sup> For a detailed analysis on the experiences of the 1970s see: Mishkin (n 112) and Mishkin (n 435).

<sup>461</sup> The original theory can be found at the following:

- Friedman, Milton, and Meiselman, David, 'The Relative Stability of Monetary Velocity and the Investment Multiplier in the United States, 1897-1958' in Commission on Money and Credit, *Stabilization Policies* (Prentice-Hall 1963) 165;
- Friedman, Milton, and Schwartz, Anna J., *Monetary History of the United States, 1867-1960* (Princeton University Press 1963a); and
- Friedman, Milton, and Schwartz, Anna J. 'Money and Business Cycles' (1963b) 45 (1) Review of Economics and Statistics 32.

Keynesians were insisting on the effectiveness of fiscal policies, and monetarists were supporting that monetary policy alone could control inflation without the need for fiscal policies, suggesting that aggregate demand was not affected by fiscal policies but rather by the money component.<sup>462</sup>

Monetarists, also, argued that increased employment and economic growth could be achieved only by stable price levels.<sup>463</sup> Pioneer monetarists such as Milton Friedman<sup>464</sup> and Edmund Phelps,<sup>465</sup> insisted that there was no long-run trade-off between inflation and unemployment (as the Phillips curve suggested originally), and the economy would experience some natural rate of unemployment in the long-run despite the level of inflation.<sup>466</sup> They supported, that, on the contrary, by mobilising monetary policy to foster employment and economic growth, inflation rates would rise. As Friedman stated: *“Inflation is always and everywhere a monetary phenomenon”*, a famous dictum that had a major impact on macroeconomic theory during the 1960s and onwards, since it proved to be true in its prediction during the subsequent inflationary rise. In the words of Friedman: *“The simultaneous decline in unemployment and inflation produced orgies of self-congratulation by the powers that be. However, this happy state proved short-lived as inflation once again started to accelerate. Needless to say, the political Establishment tried to prolong the happy glow by attributing the acceleration of inflation to special events—bad weather, food shortages, labour union intransigence, corporate greed, the OPEC cartel, or any straw at which they could grasp. Never any sign of mea culpa.”*<sup>467</sup>

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<sup>462</sup> Issing, Otmar, ‘The role of fiscal and monetary policies in the stabilisation of the Phelps, Edmund S., ‘Money-Wage Dynamics and Labor-Market Equilibrium’ (1968) 76 (4) Journal of Political Economy 687.economic cycle’ (Speech by a Member of Executive Board of the ECB at the International Conference: ‘Stability and Economic Growth: The Role of the Central Bank,’ Mexico City, 14 November 2005) <<https://www.ecb.europa.eu/press/key/date/2005/html/sp051114.en.html>> accessed 14 July 2017.

<sup>463</sup> Mishkin, Frederic S., *Monetary Policy Strategy* (MIT Press 2007) 3.

<sup>464</sup> Friedman, Milton, ‘The Role of Monetary Policy’ (1968) 58 (1) The American Economic Review 1.

<sup>465</sup> Phelps, Edmund S., ‘Money-Wage Dynamics and Labor-Market Equilibrium’ (1968) 76 (4) Journal of Political Economy 687.

<sup>466</sup> McNees, Stephen K., ‘An empirical assessment of “new theories” of inflation and unemployment’ (Proceedings of a Conference Held at Edgartown, Massachusetts, June 1978: “After the Phillips Curve: Persistence of High Inflation and High Unemployment,” Federal Reserve Bank of Boston Conference Series, No. 19), 29 <<https://paulromer.net/wp-content/uploads/2015/08/After-the-Phillips-Curve-Lucas-Sargent.pdf>> accessed 14 July 2017.

<sup>467</sup> Friedman, Milton, ‘Inflationary Recession’ (Newsweek, October 17, 1966) 92.

By early 1973 the major currencies were floating against one another, and inflation had started to become the main target of monetary policy agendas, influencing relevant policy decisions.<sup>468</sup> By that time monetarist theories had become widely acknowledged and policymakers around the world came to realise firstly, the importance of monetary policy in controlling inflation and the role of aggregate supply, in the long and the short run; secondly, the risky costs of inflation; thirdly, the inability of expansionary monetary policy to keep unemployment rates low in the long-run; and the value of a strong nominal anchor. Thus, by the mid-1970s, a large number of central banks in industrialised countries adopted monetary targeting frameworks or a "managed floating" system, including Germany first in 1974; the US, Switzerland, Canada and Italy in 1975; and the UK, France and Australia in 1976.<sup>469</sup>

Monetary targeting frameworks were an intermediate exchange-rate regime between pegged and freely floating rates, which recognised acceptable exchange rates while allowed their flexibility within certain bands.<sup>470</sup> Also, monetary targeting systems involved pre-announced monetary targets, which aimed at stabilising the economy, by focusing at the goal of price stability in order to promote growth and decrease the levels of unemployment.<sup>471</sup> However, as Mishkin opined: "*the instability of the relationship between monetary aggregates and goal variables (inflation and nominal income) make monetary targeting problematic*", and thus, the relationship between monetary aggregates and inflation, which resulted in the abandonment of monetary targeting.<sup>472</sup>

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<sup>468</sup> Cobham, David, 'From Bretton Woods to inflation targeting: financial change and monetary policy evolution in Europe' in: Boughzala, Mongi and Cobham, David (eds.) *Inflation Targeting in MENA Countries: An Unfinished Journey* (Palgrave Macmillan 2011) 171, 175.

<sup>469</sup> See: Bernanke, Ben S. and Mishkin, Frederic S., 'Central Bank Behaviour and the Strategy of Monetary Policy: Observations from Six Industrialized Countries' (NBER Macroeconomics Annual 1992, vol. 7, Reprinted with permission of MIT Press) 183 <<http://www.nber.org/chapters/c10993.pdf>> accessed 14 July 2017.

See also: Mishkin, Frederic S., 'International experiences with different monetary policy regimes' (1999) 43 (3) *Journal of Monetary Economics* 576.

<sup>470</sup> For a comprehensive analysis on monetary targeting regime see: Tosini, Paula A., 'Leaning against the wind: A Standard for Managed Floating' (Essays in International Finance no. 126, International Finance Section Department of Economics, Princeton University, December 1977) <[https://www.princeton.edu/~ies/IES\\_Essays/E126.pdf](https://www.princeton.edu/~ies/IES_Essays/E126.pdf)> accessed 14 July 2017.

<sup>471</sup> Cobham (n 469) 175. See also: Mishkin (n 464).

<sup>472</sup> Mishkin, Frederic S., 'From Monetary Targeting to Inflation Targeting: Lessons from the Industrialized Countries' (Prepared for the Bank of Mexico Conference: "Stabilization and Monetary Policy: The International Experience," Mexico City, November 14-15, 2000), 8 <<https://www0.gsb.columbia.edu/faculty/fmishkin/PDFpapers/00BOMEX.pdf>> accessed 14 July 2017.

In addition, during this period of uncertainty (i.e. the Great Inflation), there were significant developments taking place in central banking theories, which were mainly derived from assessing inflation costs on the economy. As was mentioned earlier, Keynesian economists focused their analysis on aggregate demand, while monetarist economists included in their analysis the individuals' maximising behaviour regarding money demand. However, neither of them incorporated in their analysis the role of individual decisions that affect both aggregate demand and supply, which was exactly what was coming next as a new approach to macroeconomics.

This new school of macroeconomic thought was based on the analysis of behaviour and individuals' maximising choices, while focusing on the long-run aggregate supply and the economy's ability to reach this level of output quickly. Robert Lucas,<sup>473</sup> one of the most important advocates of this idea, took Friedman's reasoning a step further and developed the rational expectations theory, arguing that the public's and the markets' expectations of monetary authority decisions were able to influence significantly more than one sector of economic activity.<sup>474</sup> Mishkin argues that, as a result of this realisation, "*....the systematic component of policymakers' actions--i.e., the component that can be anticipated--plays a crucial role in the conduct of monetary policy*".<sup>475</sup> Also, the theory of rational expectations provided a comprehensive and feasible analysis as to why there is no longer a long-run trade-off between inflation and unemployment, by arguing that a decrease in unemployment rates lower than the natural rate would eventually result in increased inflation rates.<sup>476</sup>

This explanation of inflation is also linked with the notion of central bank independence and with the idea that political pressure might affect central banks' expansionary policies and output goals. To this end, elected officials, either in order to win

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<sup>473</sup> See:

- Lucas, Robert E., 'Expectations and the Neutrality of Money' (1972) 4 (2) *Journal of Economic Theory* 103;
- Lucas, Robert E., 'Some International Evidence on Output-Inflation Trade-offs' (1973) 63 (3) *American Economic Review* 326-34; and
- Lucas, Robert E., 'Econometric Policy Evaluation: A Critique' (Carnegie-Rochester Conference Series on Public Policy Vol. 1976) 19.

<sup>474</sup> Mishkin (n 111).

<sup>475</sup> Mishkin (n 111) 7.

<sup>476</sup> Mishkin (n 473) 3. There is also more recent literature on the rational expectation theory. See: Blinder (n 107) and Walsh (n 119).

the favour of the electorate or due to misevaluation of short-run economic expansion, may be tempted to act according to short-term goals and as a result, to neglect the long-term consequences of expansionary policies. It is at this point that the discussion on central bank independence and its evolution into the optimal model for central banking governance become relevant, as explained in chapter one.

The rational expectations theory has also influenced the general understanding of monetary policy strategy, and most importantly: *“made clearer the need for use of a nominal anchor, a nominal variable such as the inflation rate or the money supply, which ties down the price level to achieve price stability,”*<sup>477</sup> by also depicting the time-inconsistency problem, which has been already examined in chapter one. The notion of time-inconsistency has influenced subsequent research, leading to key findings regarding central banks’ institutional design and the significance of pursuing institutional means to keep inflation low, and most importantly, the contribution of an independent central bank at maintaining the inflation low.<sup>478</sup>

Friedman’s concept, that there is no long-run trade-off between output and inflation, and the time-inconsistency problem, as depicted by Kydland and Prescott, constituted to a large extent the basis of what subsequently became known as the inflation targeting regime, which proved to be both a popular and durable monetary policy regime.<sup>479</sup> However, before the world came into a consensus about the benefits of an inflation targeting framework, there was another important momentum in the history of monetary policy that influenced that belief, which had also even the debate between Monetarist and Keynesians. This happened in August 1979 in the US, when Paul Volcker became Chairman of the Fed Board, whose policy measures and implications have been subject of a great body of literature.<sup>480</sup> Volcker aimed at fighting inflation at any cost and focused on the goal of price stability, appraising it as the only possible mean to restore inflation expectations and re-establish economic stability and

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<sup>477</sup> Mishkin, Frederic S., ‘Inflation Targeting: True Progress or Repackaging of an Old Idea?’ (University of Columbia Working Paper, February 2006), 4  
<<https://www0.gsb.columbia.edu/faculty/fmishkin/papers/05snb.pdf>> accessed 14 July 2017.

<sup>478</sup> Mishkin (n 473) 8.

<sup>479</sup> Andersen, Barnebeck T., Malchow-Moller, Nikolaj and Jens, Nordvig, ‘Inflation-Targeting, Flexible Exchange Rates and Macroeconomic Performance since the Great Recession’ (CEPS Working Document No. 394, March 2014) <[http://aei.pitt.edu/50256/1/WD394 Andersen et al Inflation Targeting.pdf](http://aei.pitt.edu/50256/1/WD394_Andersen_et_al_Inflation_Targeting.pdf)> accessed 14 July 2017.

<sup>480</sup> Goodfriend, Marvin and King, Robert G., ‘The incredible Volcker disinflation’ (2005) 52 (5) Journal of Monetary Economics 981 <<http://www.bu.edu/econ/files/2011/01/GKcr2005.pdf>> accessed 14 July 2017.

growth.<sup>481</sup> In addition, Volcker announced that the policy instrument of Fed would be to target reserve growth rather than the Fed's funds rate. The early years of Volcker's attempt to bringing inflation down, by increasing short-term interest rates, depressed economic activity, raised unemployment levels and caused two severe recessions in the early 1980s.<sup>482</sup> In simple terms, a recession is defined as two consecutive quarters of falling gdp. Despite the negative consequences, Volcker continued persistently taking radical steps to rein in runaway inflation and insisted in his inflation-fighting strategy by combining higher interest rates and even slower reserve growth. In Volcker's own words: *"My basic philosophy is over time we have no choice but to deal with the inflationary situation because over time inflation and the unemployment rate go together... isn't that the lesson of the 1970s?"*<sup>483</sup>

Volcker's monetary policy was highly influenced by the monetarist approach, hence, he believed that monetary policy could fight inflation on a permanent basis, without the need for fiscal policies or control over wages, prices and credit. However, while that resulted in increased unemployment in the short-run, the actual unemployment rates were not close to those predicted by the Keynesian theories. Thus, Volcker believed that a vigorous rise in short-term interest rates could decrease inflation expectations and help to restore moderate inflation rates without causing a recession.<sup>484</sup> Indeed, over time inflation rates in the US showed a slow but steady downward trend, although unemployment high rates persisted. However, over time, the downward trend in inflation resulted in increasing the Fed's

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<sup>481</sup> On Volcker's policy its impact on the macroeconomic thinking see:

- Goodfriend and King (n 481);
- Hetzel, Robert, 'What is the Monetary Standard, Or, How Did the Volcker Greenspan Fed Tame Inflation' (2008) 94 (2) Federal Reserve Bank of Richmond Economic Quarterly 147 <[https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic\\_quarterly/2008/spring/pdf/hetzel.pdf](https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_quarterly/2008/spring/pdf/hetzel.pdf)> accessed 14 July 2017.
- Lindsey, David E., Orphanides, Athanasios and Rasche, Robert H., 'The Reform of 1979: How It Happened and Why' (Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2005) <<https://www.federalreserve.gov/pubs/feds/2005/200502/200502pap.pdf>> accessed 14 July 2017.
- Orphanides, Athanasios and Williams, John C., 'The Decline of Activist Stabilization Policy: Natural Rate Misperceptions, Learning, and Expectations' (Board of Governors of the Federal Reserve System, International Finance Discussion Papers Number 804, April 2004) <<http://www.federalreserve.gov/pubs/ifdp/2004/804/ifdp804.pdf>> accessed 14 July 2017.

<sup>482</sup> See: Goodfriend and King (n 481).

<sup>483</sup> Meltzer, Allan H., *A History of the Federal Reserve: Volume 2, Book 2, 1970-1986* (University of Chicago Press 2010) 1034.

<sup>484</sup> Goodfriend and King (n 481) 12.

credibility, which slowly brought a decline in unemployment rates and an overall increase in economic growth, and finally brought inflation rates in the desired level. Subsequently, the Fed's monetary policy strategy, under Alan Greenspan's leadership, who was the successor to Volcker, managed to achieve an inflation rate below 2 percent until the early 2000s, which was considered by Greenspan as "effective price stability." At the same period of time, the low inflation rates in the US were combined with improved inflation rates worldwide.<sup>485</sup> Volker's remarkable forward-thinking approach and its perceived successful outcomes in the US economy constituted the basis of the new consensus in monetary policy theory.<sup>486</sup> As Blinder argued, a great lesson Volker taught us is that: "...tight monetary policy can bring inflation down at substantial, but not devastating, cost" and "...money-supply targeting can be hazardous to a nation's health."<sup>487</sup>

As the recession in the US came to an end by 1982, the economy started expanding, not only for the US but at a global scale. In the years to follow, recessions occurred, but they did not last long, and they were not severe. Notably, in the US, after the Volcker recession era and before the GFC, the economy has experienced only two recessions, one in 1990 and another in 2001.<sup>488</sup> Those years from 1984 to 2007 are also known as the Great Moderation, a term first used by Ben Bernanke in his speech in February 2004.<sup>489</sup> Notably, Great Moderation was dominated by low real GDP volatility and low interest rates. Interestingly, although there is no consensus about the components that ultimately led to this positive outcome, monetary policy is often cited as a contributing factor.<sup>490</sup> Bernanke attributed the Great Moderation to improved monetary policy, by arguing that: "*the historical pattern of changes in the volatilities of output growth and inflation gives some credence to the idea that*

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<sup>485</sup> Goodfriend (n 448) 8-12.

<sup>486</sup> For a thorough analysis on how the consensus on monetary policy was reached see: Goodfriend (n 448).

<sup>487</sup> Blinder, Alan, 'What Have We Learned since October 1979?' (CEPS Working Paper No. 105, April 2005), 4 <<http://www.princeton.edu/ceps/workingpapers/105blinder.pdf>> accessed 14 July 2017.

<sup>488</sup> For a detailed overview see: Romer, Christina D., 'Macroeconomic policy in the 1960s: The Causes and Consequences of a Mistaken Revolution' (Economic History Association Annual Meeting, September 2007) <<http://eml.berkeley.edu/~cromer/Lectures/MacroPolicy.pdf>> accessed 14 July 2017.

<sup>489</sup> Bernanke, Ben S., 'The Great Moderation' (Remarks made at the meeting of the Eastern Economic Association, Washington, DC, 20 February 2004) <<http://www.federalreserve.gov/boarddocs/speeches/2004/20040220/>> accessed 14 July 2017.

<sup>490</sup> Danthine, Jean-Pierre, 'Reconciling price and financial stability' (Speech by Member of the Governing Board of the Swiss National Bank, at the University of Zurich, Zurich, 24 January 2012) 3 <<http://www.bis.org/review/r120215d.pdf>> accessed 14 July 2017.



*better monetary policy may have been a major contributor to increased economic stability.*"<sup>491</sup> To this end, it is believed that among the factors that contributed to that positive scenario, was the consensus achieved on the factors that were likely to lead to inflation as well as the rise of central bank independence. In fact, economists and policymakers believed that macroeconomic theory in conjunction with monetary policy were the key to success; an approach that includes elements of Keynesianism, Monetarism, and neoclassical economics.<sup>492</sup> Neoclassical economics originate in the work of Alfred Marshall, who explained, back in 1890, prices such as the intersection of supply and demand curves.<sup>493</sup> Since then, neoclassical economics had attracted many important economists (including, *inter alia*: George Stigler, Paul Samuelson and Milton Friedman), but have been also subject to extensive criticism.<sup>494</sup> Nowadays, the term neoclassical economics is used to make reference to mainstream economic models that relate to the determination of prices, outputs, and income distribution in markets to supply and demand.<sup>495</sup>

As a result of this incorporation of ideas, a new school of macroeconomic thought was about to evolve: the new Keynesian school, which emerged as the preferred approach to modern macroeconomic analysis.<sup>496</sup> An important development during the Great Moderation was that both economists and policymakers valued the importance of communication and transparency of central banks in achieving effectively their monetary policy goals.<sup>497</sup> All in all, Friedman's famous quote: "*inflation is always and everywhere a monetary phenomenon*", gained widespread acceptance among economists and remains influential until today.<sup>498</sup> Other components of monetary policy that came to be widely accepted as principle rules for a successful monetary policy was what Fed's monetary policy under Greenspan's leadership

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<sup>491</sup> See: Bernanke (n 490).

<sup>492</sup> For an extensive analysis on the Great Moderation see: McConnell, Margaret M. and Perez-Quiros, Gabriel, 'Output Fluctuations in the United States: What Has Changed Since the Early 1980s?' (2000) 90 (5) American Economic Review 1464.

<sup>493</sup> Marshall, Alfred, *Principles of Economics* (Palgrave Macmillan 1890).

<sup>494</sup> Morgan, Jamie (ed), *What is Neoclassical Economics?: Debating the Origins, Meaning and Significance* (1<sup>st</sup> edn, Routledge 2015) 1.

<sup>495</sup> Sullivan, Larry E., *The SAGE Glossary of the Social and Behavioral Sciences* (1<sup>st</sup> edn, SAGE Publications Inc. 2009).

<sup>496</sup> Goodfried (n 448) 21-22.

<sup>497</sup> See: Woodford, Michael, 'Central Bank Communication and Policy Effectiveness' Central Bank Communication and Policy Effectiveness' (NBER Working Paper No. 11948, 2005) <<http://www.nber.org/papers/w11948.pdf>> accessed 14 July 2017.

<sup>498</sup> Mishkin, Frederic S., *The Economics of Money, Banking, and Financial Markets* (9<sup>th</sup> edn Addison-Wesley 2010).

taught us, i.e. the ability of monetary policy to control and maintain low inflation along with low unemployment rates, and with infrequent, mild recessions.<sup>499</sup> However, it should be noted that Greenspan's monetary policy came into question in 2007, when the housing bubble in the US signalled the biggest (finance generated) recession in history. This led many observers to blame Greenspan's loose monetary policy for the expansion of the housing bubble and the negative effect of lowering interest rates.<sup>500</sup>

Evolution in macroeconomic theory in conjunction with empirical and historical evidence (the high costs of inflation, as discussed earlier), and the Fed's successful monetary policy strategy under Volcker,<sup>501</sup> led to the evolution of inflation targeting from money targeting to a monetary policy focused on the goal of price stability.<sup>502</sup> As mentioned already in chapter one, during the early 1990s, inflation targeting regimes became a global trend. New Zealand was the very first country to have adopted an inflation targeting regime in 1989;<sup>503</sup> which was followed by Canada in 1991; the UK in 1992; and Australia and Sweden in 1993.<sup>504</sup> Despite its widespread acceptance, the actual implementation of inflation targeting has been customised in various ways, with some countries announcing an explicit numerical inflation target (the prevalent trend) and with some of them to have followed implicit inflation targeting<sup>505</sup>

If we try to define a general meaning of inflation targeting – including questions such as: what does it entail? Which are the general characteristics applied to inflation targeting regimes, if any? – the approaches vary. For instance, according to King: *“An inflation-targeting framework combines two distinct elements: (a) a precise numerical target for inflation in the*

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<sup>499</sup> See: Goodfriend (n 448).

<sup>500</sup> See:

- Henderson, David, 'Did the Fed Cause the Housing Bubble?' (WSJ, 27 March 2009) <<https://www.wsj.com/articles/SB123811225716453243>> accessed 14 July 2017.
- Sherman, Matthew 'A Short History of Financial Deregulation in the United States' (CEPR, July 2009) <<http://cepr.net/documents/publications/dereg-timeline-2009-07.pdf>> accessed 14 July 2017.

<sup>501</sup> Goodfriend (n 448) 15.

<sup>502</sup> Mishkin (n 478) 13.

<sup>503</sup> See: Mishkin, 2007 (n 464) 13; and Goodhart, Charles A.E., 'The Future of Central Banking' (LSE Financial Markets Group Special Paper Series No 162, September 2005) <<http://www.lse.ac.uk/fmg/documents/specialPapers/2005/sp162.pdf>> accessed 14 July 2017.

<sup>504</sup> Leiderman, Leonardo and Svensson, Lars E. O., *Inflation Targets* (Centre for Economic Policy Research 1995). See also: Cobham, David, 'The past, present and future of central banking' (Heriot-Watt University Economics Discussion Papers No. 2012-05, November 2012) <[https://www.hw.ac.uk/schools/social-sciences/documents/research/HW\\_DP\\_2012\\_05.pdf](https://www.hw.ac.uk/schools/social-sciences/documents/research/HW_DP_2012_05.pdf)> accessed 14 July 2017.

<sup>505</sup> Goodfriend (n 448) 16.

medium term and (b) a response to economic shocks in the short term. The inflation target provides a rule-like framework on which the private sector can anchor its expectations about future inflation".<sup>506</sup> Moreover, as Munchau stated: "The purpose of inflation targets is to provide a nominal anchor for inflationary expectations."<sup>507</sup> According to Kahn, inflation targeting involves the explicit announcement that inflation constitutes the main target of monetary policy, and when there is a need to prioritise macroeconomic targets, (for instance: if there is a choice between unemployment and inflation, inflation should prevail).<sup>508</sup>

Lastly, according to Bernanke: "*Inflation targeting is a framework for monetary policy characterised by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank's accountability for attaining those objectives.*"<sup>509</sup> It should be noted that inflation targeting is perceived differently in terms of its institutional arrangements. Regardless of its various forms, however, the overall performance of inflation targeting regimes is considered as generally successful.<sup>510</sup> A recent example is the GFC, which brought evidence suggesting that central banks with inflation targeting frameworks performed better than the rest.<sup>511</sup>

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<sup>506</sup> King, Marvin, 'Monetary Policy: Practice Ahead of theory' (Speech by the Governor of the Bank of England at the Cass Business School, City University, 17 May 2005, London) <[www.bankofengland.co.uk/publications/speeches/2005/speech245.pdf](http://www.bankofengland.co.uk/publications/speeches/2005/speech245.pdf)> accessed 14 July 2017.

<sup>507</sup> Munchau, Wolfgang, 'The Beginning of the End for Inflation Targeting' (FT, 5 June 2006) <<https://www.ft.com/content/0e22c72e-f3e6-11da-9dab-0000779e2340?mhq5j=e3>> accessed 14 July 2017.

<sup>508</sup> Kahn, George and Parrish, Klara, 'Conducting Monetary Policy with Inflation Targets' (Federal Reserve Bank of Kansas City, Third Quarter Economic Review) <<https://www.kansascityfed.org/publicat/econrev/PDF/3q98kahn.pdf>> accessed 14 July 2017.

<sup>509</sup> Bernanke, Ben S., Laubach, Thomas, Mishkin, Frederic S. and Posen, Adam S., *Inflation Targeting: Lessons from the International Experience* (Princeton University Press 1999), 4.

<sup>510</sup> Roger, Scott and Stone, Mark, 'On Target? :The International Experience with Achieving Inflation Targets' (IMF, Working Paper No. 05/163, August 2005) <<http://www.imf.org/external/pubs/ft/wp/2005/wp05163.pdf>> accessed 14 July 2017.

<sup>511</sup> See:

- De Carvalho Filho, Irineu, 'Inflation Targeting and the Crisis: An Empirical Assessment' (IMF, Working Paper WP/10/45, February 2010) <<https://www.imf.org/external/pubs/ft/wp/2010/wp1045.pdf>> accessed 14 July 2017; and
- Olafsson, Thorvardur Tjörvi and Pétursson, Thórarinn G., 'Weathering the financial storm: the importance of fundamentals and flexibility' (Central Bank of Iceland, Working Paper No. 51, October 2010) <<http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8138>> accessed 14 July 2017.

One of the most typical and economically important central banking systems that follow an explicit inflation targeting strategy is the Eurosystem, which, as already highlighted, comprises the ECB and NCBs of the EU Member States that have joined the Euro. Although the Eurosystem does not deem to have a monetary policy strategy solely focused on inflation targeting, since it also controls money growth rates; yet its independent status, the importance of transparent communication and most importantly, the explicit definition of price stability, qualify its monetary policy as inflation targeting. As it could be concluded by the analysis above, central banking regulation has always taken shape through periods of uncertainty and after legislative interventions responding to crises. Thus, one lesson that could be drawn throughout this evolving process, is the that there are no optimal models to guarantee the long-term soundness of a financial system. The following section discusses the interaction between monetary policy and financial supervision when combined within the same authority.

### 2.1.2 Monetary policy and financial supervision

Central bank's structure and position, unavoidably, influences both monetary policy and banking supervision. Even though the two notions are substantially different, including the overall motive, intent, the nature of decisions, the information needed to perform respective tasks, implementation and the qualifications of the staff needed,<sup>512</sup> they are, at the same time, closely interlinked and have the ability to influence each other's performance. Historically, governmental structures of monetary policy and banking supervision management were divided into two distinct categories, which were based on two models. Firstly, the English model, where the central bank was responsible for both monetary policy and banking supervision, and secondly, the German model, where there was a clear separation or a 'Chinese Wall' between these two functions.<sup>513</sup> Before exploring the nexus between monetary policy and banking supervision, which constitutes the main theme of this thesis, it is important to examine the evolution of their objectives in light of the GFC. Having presented the history of monetary policy, this section aims to examine changing attitudes

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<sup>512</sup> Beck, Thorsten and Gros, Daniel, 'Monetary Policy and Banking Supervision: Coordination instead of separation' (CEPS No. 286, 12 December 2012), 3.

<sup>513</sup> Haubrich, Joseph G., 'Combining Bank Supervision and Monetary Policy' (Federal Reserve Bank of Cleveland, Economic Commentary, November 1996) <<https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/1996-economic-commentaries/ec-19961101-combining-bank-supervision-and-monetary-policy.aspx>> accessed 14 July 2017.

towards the existing monetary policy regimes in a way that would incorporate financial stability objectives.

As discussed in great detail above, prior to the GFC, macroeconomic thought had reached consensus on an 'optimal' model of monetary policy. This involved monetary policy strategies designed to maintaining price stability, mainly obtained through inflation targeting (explicit or implicit), as the best way to stabilise both macro-economy and the financial system as whole.<sup>514</sup> As Schwartz advocated in the late 1980s: *"a central bank that was able to maintain price stability would also incidentally minimize the need for lender of-last-resort intervention,"*<sup>515</sup> since price level instability, i.e. fluctuations in inflation, triggers or exacerbates financial disturbances. The same belief remained dominant until recently, with most of the pre-GFC literature suggesting that monetary policy focused on promoting stable and low inflation (i.e. price stability), was able to maintain financial stability.<sup>516</sup> This approach was also backed by empirical evidence. For instance, Bordo et al. highlighted in their study that: *"our results indicate that a monetary regime that produces aggregate price stability will, as a by-product, tend to promote stability of the financial system."*<sup>517</sup>

However, even before the occurrence of the GFC, there were those who predicted the insufficiency of price-stability-oriented monetary policy regimes to achieving simultaneously their financial stability goals. For instance, White, while agreeing that the price stability goal is of great importance, argued at the same time that: *"achieving near-term price stability might sometimes not be sufficient to avoid serious macroeconomic downturns in the medium*

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<sup>514</sup> Blanchard, Olivier, Dell'Ariccia, Giovanni and Mauro, Paolo, 'Rethinking Macroeconomic Policy' (IMF Staff Position Note 10/03, 12 February 2010) <<https://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf>> accessed 14 July 2017.

<sup>515</sup> Schwartz, Anna J., 'Financial Stability and the Federal Safety Net' in: Haraf, William S. and Kushneider, Rose M. (eds.) *Restructuring Banking and Financial Services in America* (American Enterprise Institute for Public Policy Research 1988) 53. See also: Schwartz, Anna J., 'Why financial stability depends on price stability' (1995) 15 (4) *Economic Affairs* 21.

<sup>516</sup> For studies supporting the conventional view see:

- Bordo, Michael D., and Wheelock, David C., 'Price Stability and Financial Stability: the Historical Record' (Federal Reserve Bank of Saint Louis Review, No. 80September/October 1988) 41 (1998) <<https://research.stlouisfed.org/publications/review/98/09/9809dw.pdf>> accessed 14 July 2017;
- Bordo, Michael D., Dueker, Michael J. and Wheelock, David C., 'Aggregate Price Shocks and Financial Instability: An Historical Analysis Wheelock' (NBER Working Paper No. 7652, April 2000) <<http://www.nber.org/papers/w7652.pdf>> accessed 14 July 2017; and
- Bernanke, Ben S., Gertler, Mark and Gilchrist, Simon, 'The Financial Accelerator in a Quantitative Business Cycle Framework' in Taylor, John B. and Woodford, Michael (eds.), *Handbook of Macroeconomics* (1<sup>st</sup> edn, vol. 1, North-Holland) Chapter 12.

<sup>517</sup> Bordo et al., 2000 (n 517) 27.

term.”<sup>518</sup> In the same line, Borio and Lowe, although supporting the view that stable inflation promotes financial stability, they also advocated that: “*financial imbalances can and do build up in periods of disinflation or in a low inflation environment*”, and thus: “*achieving monetary and financial stability requires that appropriate anchors be put in place in both spheres*”, which requires: “*co-operation between monetary and prudential authorities.*”<sup>519</sup> An opposing view to the conventional wisdom was that of Leijonhufvud who stated in 2007: “*I have a number of reservations concerning this fashionable policy doctrine. In particular, I maintain that stabilising the consumer price index (or its rate of growth) does not guarantee stability of the financial system. Moreover, under certain conditions, concentrating on year-to-year monetary stability, in the sense of keeping to a CPI inflation target, can lead you to follow policies that are inimical to financial stability over the longer run.*”<sup>520</sup>

These concerns became relevant in the GFC era, when its complex consequences and the enormous costs of the unstable financial environment, brought evidence regarding the shortcomings of the existing monetary policy framework. The inflation-targeting-focused monetary policies proved to be unable to deliver the goal of price stability, and subsequently ensure the soundness of the financial system as a whole. In addition, the focus on the sole mandate of price stability appeared to pose a high risk to financial stability, and this in turn, created severe risks for price stability itself. For instance, Carney advocated that: “*Price stability is a necessary, but not sufficient, condition for the stabilization of economic activity, and it must be supplemented by a robust macro-prudential regulatory framework,*”<sup>521</sup> while White added that: “*price stability was not enough to ensure high, sustained growth.*”<sup>522</sup> Thus, the overriding importance of maintaining price stability was reconsidered when general financial instability appeared to be outweighing the sole mandate of price stability. As Crockett opined: “*... since the 1980s inflation has been largely conquered, and yet financial instability has, if anything, intensified...*” adding that: “*... the pursuit of price stability can*

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<sup>518</sup> White, William R., ‘Is Price Stability Enough?’ (BIS Working Paper No. 205, April 2006), 5 <<http://www.bis.org/publ/work205.pdf>> accessed 14 July 2017.

<sup>519</sup> Borio, Claudio and Lowe, Philip, ‘Asset prices, financial and monetary stability: exploring the nexus’ (BIS Working Papers No 114, July 2002), 1 <<http://www.bis.org/publ/work114.pdf>> accessed 14 July 2017.

<sup>520</sup> Leijonhufvud, Axel, ‘Monetary and Financial Stability’ (CEPR, Policy Insight No. 14, October 2007), 1 <[http://www.cepr.org/sites/default/files/policy\\_insights/PolicyInsight14.pdf](http://www.cepr.org/sites/default/files/policy_insights/PolicyInsight14.pdf)> accessed 14 July 2017.

<sup>521</sup> Carney, Mark, ‘Some Considerations on Using Monetary Policy to Stabilize Economic Activity’ (Remarks by the Governor of the Bank of Canada, to a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 22 August 2009), 7 <<http://www.bis.org/review/r090826a.pdf>> accessed 14 July 2017.

<sup>522</sup> See: White (n 519).

*sometimes allow financial imbalances to arise inadvertently, and can sow the seeds of subsequent instability.*"<sup>523</sup>

To this end, many observers also attributed the occurrence of the GFC to loose monetary policy practices, and raised questions about the future of monetary policy and its linkages with financial stability, bringing a great deal of attention towards strengthening the role of central bank in financial stability, through appropriate mechanism that would mitigate systemic risk.<sup>524</sup> For instance, De Grauwe, argued that the GFC "*unveiled the fallacy of this hands-off view,*" meaning the inflation targeting orthodoxy.<sup>525</sup> Others considered the rationale of inflation-targeting strategies itself misleading, since even when inflation-targeting policies were appropriately applied, low interest rates for extended periods might have led financial institutions to excessive risk-taking practices. For instance, Taylor found that the policy decisions of Fed, under Greenspan's lead, to significantly decrease interest rates, before the emergence of the GFC, had a major impact to triggering its occurrence.<sup>526</sup> According to Taylor, there is was link between the expansionary monetary policy decisions (especially in US) and the emergence of financial crisis, which he attributed to the inappropriate application of inflation-targeting polices.<sup>527</sup> Taylor also believes that that there was a possible correlation between the increase of interest rates in the US and the similar policies adopted by the ECB at the same period of time.

Taylor's reasoning on the pitfalls of monetary policy decision that led to the GFC, was mainly focused what is known as the "Taylor Rule." The Taylor Rule was created by John Taylor in 1993 in an attempt to explain the interest rate decisions of the Fed's Open Market Committee at the time. The Taylor Rule uses a method that describes how central banks should set short-term interest rates, as the instrument of monetary policy, in order to deliver

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<sup>523</sup> Crockett, Andrew, 'Monetary policy and financial stability' (Speech the General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, given at the Fourth HKMA Distinguished Lecture, held in Hong Kong, 13 February 2001), 3 <<http://www.bis.org/review/r010216b.pdf>> accessed 14 July 2017.

<sup>524</sup> See: Taylor, John B., 'The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong' (NBER Working Paper No. 14631, January 2009) <<http://www.nber.org/papers/w14631.pdf>> accessed 14 July 2017.

<sup>525</sup> De Grauwe, Paul, 'There is more to central banking than inflation targeting' (VOX Centre for Economic Policy Research's Policy Portal, 14 November 2007) <<http://voxeu.org/article/subprime-crisis-time-inflation-targeting-rethink>> accessed 14 July 2017.

<sup>526</sup> Taylor (n 525).

<sup>527</sup> Taylor (n 525).



both short- and long-term objectives in a changing economic environment. In short, the Taylor Rule suggests increasing interest rates when inflation rates exceed their target or when the levels of employment are higher than expected; and to lower them in the contrary scenarios.<sup>528</sup> The Taylor Rule has revolutionised the way many central banking policymakers deal with monetary policy and came to be widely influential because it is easy to use in diverse monetary policy regimes, including regimes that have a dual mandate (embedding both price stability and financial stability), and regimes that are solely focused on price stability goals.<sup>529</sup> Notably, with regards to the GFC, Taylor argued that despite the fact that the price stability goal was met, excessive monetary policy decisions of the Fed, which deviated from what the Taylor Rule prescribes, resulted subsequently in poor inflation rates.<sup>530</sup> A counter argument regarding the reasons that led to the crisis, is that there were not inefficient monetary policy decisions that triggered it, but rather regulatory and supervisory failures, in combination with some special circumstances.<sup>531</sup>

However, the consensus that prevailed regarding ‘optimal’ monetary policy models and thus, the evolution of monetary policy, did not equally apply to banking supervision. During the pre-GFC era, while the primary and often sole mandate of monetary policy was price stability, financial stability was the realm of prudential supervision, which was usually conducted by a body separate from the central bank. In addition, as previously mentioned before, the financial stability of the while system was considered to be maintained by mitigating the risks to individual financial institutions, i.e. micro-prudential supervision. In order to understand the subsequent change in the aforementioned framework, it is important here to define firstly, the difference between supervision and regulation and secondly, the notions of micro- and macro-prudential supervision. Simply said, banking regulation refers to rule-making, i.e. the legislation that sets the rules for acceptable behaviour and conduct for financial institutions. Banking supervision refers to the enforcement of legislation and thus,

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<sup>528</sup> Taylor, John B., ‘Discretion versus policy rules in practice’ (1993) 39 Carnegie-Rochester Conference Series on Public Policy 195.

<sup>529</sup> See: Kahn, George A., ‘The Taylor Rule and the Practice of Central Banking’ in Koeing, Evan F., Leeson, Robert and Kahn, George (eds) *The Taylor Rule and the Transformation of Monetary Policy* (Hoover Institutions Press Publications 2012) 63.

<sup>530</sup> Taylor (n 529).

<sup>531</sup> Svensson, Lars E. O., ‘Monetary policy after the crisis’ (Speech at the conference: “Asia’s role in the post-crisis global economy,” held at Federal Reserve Bank of San Francisco, 29 November 2011) <<http://www.bis.org/review/r111201a.pdf>> accessed 14 July 2017.



the oversight of financial institutions' behaviour. Despite of their distinct features, regulation and supervision are often used interchangeably, since their supervisors are also assigned rule-making powers.<sup>532</sup>

As already mentioned in chapter one, the micro-prudential dimension of supervision aims at mitigating risks to individual financial institutions and thus, it is primarily concerned with the soundness of individual financial institutions. Macro-prudential supervision, on the contrary, considers the systemic implications, i.e. systemic risk, of the collective behaviour of financial firms, aiming to prevent the build-up of financial imbalances.<sup>533</sup> As Crockett pointed out: *"the macro-prudential objective can be defined as limiting the costs to the economy from financial distress, including those that arise from any moral hazard induced by the policies pursued. One could think of this objective as limiting the likelihood of the failure, and corresponding costs, of significant portions of the financial system. This is often loosely referred to as limiting 'systemic risk' ...while.... "the micro-prudential objective can be seen as limiting the likelihood of failure of individual institutions."*<sup>534</sup>

As noted by Borio and White: *"In a nutshell, a 'macro-prudential' orientation would stress the system-wide perspective of risk in terms of objectives and the way of achieving them. It would be less concerned with the failure of individual institutions per se and more with the macroeconomic costs of financial distress as the ultimate metric to choose policies. And it would fully recognise how financial distress of this type tends to arise from common exposures and the mutual interaction between the financial and real economy, with the evolution of risk being in part endogenous with respect to the collective behaviour of financial players."*<sup>535</sup> Thus, macro-prudential supervision focuses mainly on systemic risk implications, rather than an individual bank's risks. The systemic risk phenomenon, while it was known even before the latest crisis, was highly underestimated. Blinder defines systemic risk as: *"one*

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<sup>532</sup> Lastra, Rosa M., 'The Governance Structure for Financial Supervision and Regulation in Europe' (2003) 10 (1) Columbia Journal of European Law 49.

<sup>533</sup> Papademos, Lucas, 'Financial stability and macro-prudential supervision: objectives, instruments and the role of the ECB' (Speech the Vice-President of the ECB, at the conference: "The ECB and Its Watchers XI", Frankfurt, 4 September 2009) <[https://www.ecb.europa.eu/press/key/date/2009/html/sp090904\\_3.en.html#fnid6](https://www.ecb.europa.eu/press/key/date/2009/html/sp090904_3.en.html#fnid6)> accessed 14 July 2017.

<sup>534</sup> Crockett (n 317).

<sup>535</sup> Borio, Claudio and White, William, 'Whither monetary and financial stability? The implications of evolving policy regimes' (BIS Working Papers No 147, February 2004), 26 <<http://www.bis.org/publ/work147.pdf>> accessed 14 July 2017.

*that is either large enough in size or broad enough in scope that, if things go wrong, it can damage a significant portion of the financial system.*"<sup>536</sup> Also, a definition of what systemic risk entails, was provided by the IMF, BIS and FSB on the report to the G-20 Finance Ministers and Governors (2009): "*a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.*"<sup>537</sup>

It should be mentioned that while macro-prudential supervision became accepted as necessary in the course of the GFC, it has a long pedigree. Early discussion on systemic risk can be traced to the mid-1970s, when Bankhaus Herstatt collapsed (in 1974). As discussed already in chapter one, despite of its small size, the collapse of Bankhaus Herstatt generated significant losses and caused chaos in the international financial markets, since it was heavily involved in foreign exchange transactions.<sup>538</sup> As a result, what became evident was that the banking system had entered the era of globalisation, creating a complex system of interlinked dynamics that had the potential to trigger systemic risks. On the other hand, what subsequently proved to be highly problematic is that regulation and supervision of the financial system had remained national, subject to national authorities and domestic legislation. This triggered an increased awareness at both national and international level, and resulted in the establishment of BCBS, which, as analysed already, is often linked with the Bankhaus Herstatt failure and the attempt to create greater cooperation at international level through mutual standards in regulations and supervision.<sup>539</sup>

The most prominent element when discussing the macro-prudential aspect of central banks' objectives, is financial stability. Financial stability constituted the initial motivation for

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<sup>536</sup> Blinder, Alan, 'How Central Should the Central Bank Be?' (2010) 48 (1) Journal of Economic Literature 123, 125.

<sup>537</sup> 'Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations' (IMF, BIS, FSB Report to the G-20 Finance Ministers and Governors, Washington and Basel, November, 2009), 2 <<https://www.imf.org/external/np/g20/pdf/100109.pdf>> accessed 14 July 2017.

For a thorough analysis on systemic risk and its implications see: Smaga, Paweł, 'The Concept of Systemic Risk' (LSE, Science, Systemic Risk Centre (SRC), Special Paper No. 5, August 2014) <<http://eprints.lse.ac.uk/61214/1/sp-5.pdf>> accessed 14 July 2017.

<sup>538</sup> Schenk (n 428).

<sup>539</sup> Wood, Duncan R., *Governing Global Banking: The Basel Committee and the Politics of Financial Globalisation* (Ashgate Publishing 2005) 48-50.

setting up central banks,<sup>540</sup> and thus, has historically been part of the dual mandate of central banks (involving both price stability and financial stability objectives).<sup>541</sup> However, there is no consensus as to what exactly constitutes “financial stability,” and the adequate mechanisms and tools needed to foster financial stability, remain until today a highly debated issue. Indeed, as Lastra argued, the goal of financial stability is difficult to be defined since it constitutes a multidimensional notion (national, regional and international) and involves a variety of instruments that are likely to assist in its accomplishment.<sup>542</sup> Moreover, Lastra suggested that in order to maintain financial stability, there should be measures implemented which would go beyond the national borders. As Lastra describes it: *“Like a tsunami that does not respect national boundaries, episodes of financial instability have a trans-national dimension, thus requiring a trans-national solution.”*<sup>543</sup> Crockett, instead of defining financial stability, preferred to describe the negative scenario of financial instability, with the latter being an: *“economic performance that is potentially impaired by fluctuations in the price of financial assets, or in the ability of financial intermediaries to meet their contractual obligations.”*<sup>544</sup>

At EU level, although the term financial stability is not clear and it is not explicitly defined in EU primary law (with the exception of the mention in Article 127(5), TFEU) the ECB has explained that financial stability constitutes: *“a condition in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.”*<sup>545</sup> To this regard, Lastra opined that financial

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<sup>540</sup> Brunnermeier, Markus K. ‘Macropprudential Regulation: Optimizing the currency Area’ in ECB, *The great financial crisis: lessons for monetary policy* (An ECB Colloquium held in honour of Lucas Papademos, 20–21 May 2010) 29, 29.

<sup>541</sup> See: Goodhart, Charles, *The Evolution of Central Banks* (MIT Press 1988).

<sup>542</sup> Lastra, Rosa M., ‘Central Bank Independence and Financial Stability’ (Estabilidad Financiera, No. 18, Banco de España, 2010) 51, 59  
<<https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/10/May/Fic/ref0318.pdf>> accessed 14 July 2017.

<sup>543</sup> Lastra (n 543) 60.

<sup>544</sup> Crockett, Andrew, ‘The theory and practice of financial stability’ (Princeton University, Department of Economics, Essays in International Finance, No. 203, 1997), 2  
<[https://www.princeton.edu/~ies/IES\\_Essays/E203.pdf](https://www.princeton.edu/~ies/IES_Essays/E203.pdf)> accessed 14 July 2017.

<sup>545</sup> ‘Financial Stability Review’ (ECB, June 2009), 9  
<<https://www.ecb.europa.eu/pub/pdf/other/financialstabilityreview200906en.pdf?80524324b2777945e406ac541792fc72>> accessed 14 July 2017.

stability in Europe constitutes an evolving concept, which concerns various components and orientates the functioning of the European financial architecture.<sup>546</sup> According to the 2014 Financial Stability Review of the ECB, *“Capturing the complex notion of financial stability is not straightforward; the ECB defines it as a condition in which the financial system – intermediaries, markets and market infrastructures – can withstand shocks without major disruption in financial intermediation and in the effective allocation of savings to productive investment.”*<sup>547</sup> As it could be noticed, financial stability is a complex and elusive notion, and the absence of a concrete definition makes it harder to analyse the relationship between financial stability and monetary policy.<sup>548</sup> One thing its definite, financial stability has always constituted a goal that was directly associated with the very nature and purpose of central banks. As Tommaso Padoa-Schioppa described: *“The role of central banks in financial stability was thus part of their genetic code.”*<sup>549</sup>

In the run-up to the 2007 crisis, financial stability risks grew. This was attributed to the prevalent approach to financial stability, according to which the system as a whole can be maintained robust by safeguarding the soundness of individual financial institutions, i.e. micro-prudential supervision. As discussed already in chapter one, this was the dominant view supported in both Basel I and II, which has been, however, subject to a wide criticism. For instance, Brunnermeier supported that this view represents a fallacy of composition in practice, arguing that: *“in trying to make themselves safer, banks, and other highly leveraged financial intermediates, can behave in a way that collectively undermines the system. Selling an asset when perceived risk increases, is a prudential response from the perspective of an individual bank. But if many banks acts in this way, the asset price will collapse, forcing institutions to take yet further steps to rectify the situation. Such responses by banks lead to generalised declines in asset price, and to enhanced correlations and volatility is asset*

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<sup>546</sup> Lastra Rosa M., *Legal Foundations of International Monetary Stability* (Oxford University Press 2006) 92-93.

<sup>547</sup> ‘Financial Stability Review’ (ECB, May 2014), 5

<<https://www.ecb.europa.eu/pub/pdf/other/financialstabilityreview201405en.pdf>> accessed 14 July 2017.

<sup>548</sup> Issing, Otmar, ‘Monetary and Financial Stability: Is there a Trade-off?’ (Speech of the Member of the Executive Board of the European Central Bank at the Conference on: Monetary Stability, Financial Stability and the Business Cycle,” Bank for International Settlements, Basle, March 28-29, 2003) <<http://www.ecb.europa.eu/press/key/date/2003/html/sp030329.en.html#fn8>> accessed 14 July 2017.

<sup>549</sup> Padoa-Schioppa, Tommaso, ‘Central Banks and Financial Stability: Exploring a Land in Between’ (Second ECB Central Banking Conference on: “The Transformation of the European Financial,” System Policy Panel Introductory Paper, Frankfurt am Main, 24 and 25 October 2002), 6 <<https://www.ecb.europa.eu/events/pdf/conferences/tps.pdf>> accessed 14 July 2017.

*markets. Risk is endogenous to bank behaviour.*"<sup>550</sup> Indeed, the GFC reaffirmed the aforementioned concerns, by bringing evidence that the whole system behaves differently than its individual components and the build-up of financial imbalances have contagious effects to the global financial system as whole, creating the known as domino effect i.e. the failure of one institutions infected the whole financial system. Perhaps, it was the excessive focus on the individual elements/problems that prevented policymakers from seeing the bigger picture and the threat that such a narrow view might bring to financial stability, with the latter being taken somewhat for granted. Thus, the need to focus on the macro-prudential policies in order to safeguard the financial system as whole, gained widespread acceptance.<sup>551</sup>

It should be stressed, that despite the facts that financial stability and systemic risk implications have been linked with macro-prudential supervision, yet, by targeting solely the macro-prudential dimension of supervision and regulation might not prove to be sufficient in a long-term basis. In fact, it is believed that macro-prudential measures, while essential, should be incorporated with effective monetary policy measures, strong fiscal policies and consistent micro-prudential supervision, all in a way that they will complement each other.<sup>552</sup> However, the incorporation of all these objectives under the same institution might create risks that could raise questions regarding their interaction and their optimal institutional marrying. The most prominent concern that was raised in this regard, stressed the issue of interactions between monetary and macro-prudential policies, and more precisely, the interconnectedness or perhaps, competitiveness between their respective goals of price and financial stability.<sup>553</sup> This discussion is also highly relevant to the main idea of this thesis -the recently assumed supervisory powers by the ECB with the advent of Banking Union- and the relevant debate on the compatibility of this broader mandate with the existing Treaty provisions, which is developed in chapter four.

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<sup>550</sup> Brunnermeier, Markus, Crockett, Andrew, Goodhart, Charles, Persaud, Avinash D. and Shin, Hyun, 'The Fundamental Principles of Financial Regulation' (Geneva Reports on the World Economy 11, CEPR 2009), 15 <<https://www.princeton.edu/~markus/research/papers/Geneva11.pdf>> accessed 14 July 2017.

<sup>551</sup> Orphanides, Athanasios, 'Monetary Policy Lessons from the Crisis' (CEPR Discussion Paper No. DP7891, June 2010), 23.

<sup>552</sup> Caruana, Jaime, 'Systemic risk: how to deal with it?' (BIS, February 2010) <<http://www.bis.org/publ/othp08.htm#P1>> accessed 14 July 2017.

<sup>553</sup> See: 'The Interaction of Monetary and Macroprudential Policies' (IMF, January 29 2013) <<https://www.imf.org/external/np/pp/eng/2013/012913.pdf>> accessed 14 July 2017.

To summarise the points made throughout this section, the experience of the GFC apart from shedding light on the loopholes of monetary policy instruments, it also brought financial stability to the centre of the policy agenda. In addition, the intertwined relationship between the goals of financial stability and price stability, triggered discussion on the possibility of returning central banks to their roots by re-assuming a broad mandate.<sup>554</sup> The debate that followed the 2007 crisis, stressed the need for fostering the macro-prudential dimension of financial stability, which seemed to have been relatively ignored earlier. As already discussed, until then, policymakers were focused more on the traditional micro-prudential dimension of regulation. Yet, this narrow focus on the safety and soundness of individual institutions proved to be insufficient to secure systemic stability, since important systemic risk implications seemed to have been disregarded or even triggered negatively by some aspects of the micro-prudential approach.<sup>555</sup>

In light of this realisation, many governments adopted regulatory responses, including a plethora of legislative proposals and reforms, which aimed at reshaping macro-economic policies in a way that would create a bridge between monetary policy and financial stability. Banking supervision reforms came into prominence, aiming to strengthen the macro-prudential dimension and to tackle the systemic risk problem. At international level, a good example was the introduction of the Dodd-Frank Act in 2010, in the US, which has been considered to be the most extensive financial regulatory reform in the US since the Great Depression, by bringing a considerable increase of the supervisory powers of Fed.<sup>556</sup> In Germany, the governing coalition parties, proposed in late 2010 to dismantle the single supervisory authority (the Federal Financial Supervisory Authority-BaFin) and to assign its responsibilities to the Bundesbank, which shared supervisory duties with BaFin prior to the GFC.<sup>557</sup> In the same line, in 2010, the UK introduced a new banking reform, which empowered

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<sup>554</sup> See: Goodhart (n 157).

<sup>555</sup> De Nicolò, Gianni, Favara, Giovanni and Ratnovski, Lev, 'Externalities and Macroprudential Policy' (IMF, Staff Discussion Note, SDN/12/05, June 2012), 4 <<https://www.imf.org/external/pubs/ft/sdn/2012/sdn1205.pdf>> accessed 14 July 2017.

<sup>556</sup> See: Liedtke, Patrick M. and Monkiewicz, Jan. (eds.), *The Future of Insurance Regulation and Supervision: A Global Perspective* (Palgrave Macmillan 2011).

<sup>557</sup> Handke, Stefan and Zimmermann, Hubert, 'Institutional Change in German Financial Regulation' in Mayntz, Renate (ed.), *Crisis and Control: Institutional Change in Financial Market Regulation* (vol. 75, Publication Series of the Max Planck Institute for the Study of Societies) 131.

the Bank of England with supervisory powers.<sup>558</sup> Also in 2010, Ireland's Central Bank Reform Act,<sup>559</sup> established a new single unitary body- the Central Bank of Ireland - in order to undertake both central banking and supervisory duties; replacing the Boards of the Central Bank and Irish Financial Services Regulatory Authority. The Basel III Accord, as discussed already, envisages a stricter capital regulation, including the launching of new parameters, such as liquidity requirements.<sup>560</sup>

At European level, financial regulation and supervision has been also subject to historic changes. The ECB assumed supervisory powers in November 2014, transforming from a purely monetary agency to the key supervisory authority for credit institutions in the Eurozone. The roadmap towards to adoption of this decision and the creation of Banking Union's first pillar, i.e. the Single Supervisory Mechanism (SSM) is discussed in detail in the following chapter, while chapter four provides an in-depth legal analysis of the new supervisory powers of ECB under new and existing provisions.

To this end, among the issues that arose during the GFC, was whether to assign supervisory task to the central bank and whether financial and price stability are a dual or a duelling mandate? However, this topic, is not new, since it has been linked with the very existence of central banking, and with the traditional role of the central bank as the government's bank.<sup>561</sup> The following section critically examines the combination of monetary policy and banking supervision objectives under the central bank's remit.

### 2.1.3 Is there a dichotomy between financial stability and price stability objectives?

The literature regarding the interaction between financial and price stability goals, and the potential trade-offs of their combination under the same authority, has been booming in the aftermath of the GFC. However, the following discussion is mainly focused on the legal

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<sup>558</sup> Dalla Pellegrina, L., Masciandaro, D. and Vega Pansini, R., 'New Advantages of Tying One's Hands: Banking Supervision, Monetary policy and Central Bank Independence' in Eijffinger, Sylvester and Masciandaro, Donato (eds.) *Handbook of Central Banking, Financial Regulation and Supervision: After the Crisis* (Edward Elgar Publishing 2011), 208-209.

<sup>559</sup> Central Bank of Ireland Reform Act [2010] <<http://www.irishstatutebook.ie/eli/2010/act/23/enacted/en/pdf>> accessed 14 July 2017.

<sup>560</sup> De Nicolò et al. (n 556) 4. See also: Kern, Alexander, 'Which Future Model for Europe?' (Commissioned Report, European Parliament's Special Committee on the Financial, Economic and Social Crisis, Feb 2010), 6 <[http://www.europarl.europa.eu/document/activities/cont/201103/20110324ATT16356/20110324ATT16356\\_EN.pdf](http://www.europarl.europa.eu/document/activities/cont/201103/20110324ATT16356/20110324ATT16356_EN.pdf)> accessed 14 July 2017.

<sup>561</sup> See: Goodhart (n 157).



dimension of the relevant debate, whereas the economic synergies involved are discussed only to the extent that they contribute to the legal domain. This discussion serves the main topic of this thesis, which aims at exploring the recent broadening of the ECB's mandate, involving the marrying of monetary stability and banking supervision, and its compatibility with the existing legal environment. Thus, the examination of the nexus between their main objectives, i.e. price stability and financial stability respectively, aims at stressing both the advantages and disadvantages of their combination under central bank's remit, as developed by the literature prior and post the GFC era.

As discussed already, according to the convention view, a successful monetary policy is the one that focuses mainly on price stability, while financial variables over and above their effects on inflation were considered irrelevant. Thus, maintaining price stability through an inflation targeting policy was considered adequate in maintaining at the same time financial stability.<sup>562</sup> As emphasised in the previous section of this chapter, the roots of these findings go back to the predominance of inflation targeting regimes and the belief that monetary policy, which credibly preserves price stability, is also able to promote financial stability. In line with this doctrine, was also the belief that there is an increased likelihood of policy trade-offs when particular financial imbalances occur, and the central bank tries to achieve both objectives simultaneously, i.e. preserving price stability and safeguarding financial stability. This view was also backed by early empirical studies, suggesting that there is a possibility of a conflict of interest when the functions of banking supervision and monetary policy are combined.<sup>563</sup> However, it is worth noting that Goodhart and Schoenmaker, who were the early advocates of this view, while suggested that the two functions should be separated, since there was historical evidence supporting the benefits of their separation; they also, argued that both arguments in favour of their combination or separation, were lacking, and

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<sup>562</sup> Orphanides (n 552) 23.

See also: George, Esther, , L., 'Monetary and Macroprudential Policy: Complements, not Substitutes' (Speech at Asia-Pacific High-Level Meeting, Financial Stability Institute/Bank for International Settlements, Manila, Philippines, 10 February 2015), 2 <<https://www.kansascityfed.org/publicat/speeches/2015-George-Manila-BIS-02-10.pdf>> accessed 14 July 2017.

<sup>563</sup> See:

- Di Giorgio, Giorgio and Di Noia, Carmine, 'Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?' (1999) 2 (3) *International Finance* 361; and
- Goodhart, Charles and Schoenmaker, Dirk, 'Should the functions of monetary policy and banking supervision be separated?' (1995) 47 (4) *Oxford Economic Papers* 539.



anyways the involvement of the central bank in supervisory issues is unavoidable due to its unique role as the lender of last resort when needed.<sup>564</sup>

Highly influenced by this view, the majority of inflation-targeting central banks around the world were operating under the so-called “separation principle,” with the goals of price stability and financial stability being strictly disconnected from one another, which practically led to the separation of monetary policy from supervision and regulation. The separation of the two objectives is based on the so-called Tinbergen Rule, first formulated by Tinbergen, in early 1952.<sup>565</sup> In a nutshell, the Tinbergen Rule implies that there should be some consistency between instruments and objectives, i.e. at least one separate policy instrument for each policy objective.<sup>566</sup> Thus, since, in accordance to the Tinbergen Rule, addressing two targets/objectives with only one instrument is not feasible, monetary policy cannot deal with both price stability and financial stability at the same time, since an authority with more than one objectives will tend to misapply its own resources and might disregard one of them or more.<sup>567</sup> It follows that although, monetary policy can adequately pursue its price stability objective with the instrument of interest rates, yet, the same instrument cannot be used to pursue the objective of financial stability.<sup>568</sup> Therefore, the two policies can be complementary to each other only in case their respective objectives are to be equally targeted and achieved.<sup>569</sup> This practically means that if there are more than one policy objectives, there should be available an equal number of independent policy instruments.

The advocates of the “separation principle” also argue that the two objectives shall be pursued with different policy instruments. For instance, Bernanke believed that financial stability should be pursued by regulation and supervision, whereas monetary policy is better

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<sup>564</sup> Goodhart and Schoenmaker (n 541) 556.

<sup>565</sup> Tinbergen, John, *On the Theory of Economic Policy* (2nd edn., North-Holland 1952).

<sup>566</sup> Schoenmaker, Dirk, ‘The Role of Central Banks in Financial Stability’ in Caprio, Gerard (ed.), *En The Encyclopedia of Financial Globalization* (Elsevier 2011) 22.

<sup>567</sup> See: Abrams, Richard and Taylor, Michael, ‘Issues in the Unification of Financial Sector Supervision’ in Enoch, Charles, Marston, David and Taylor, Michael (eds.) *Building Strong Banks* (IMF 2002) 146.

<sup>568</sup> See:

- De Gregorio, Jose, ‘Recent challenges of inflation targeting’ (BIS, Papers No. 51, March 2010) 9, 10 <<http://www.bis.org/publ/bppdf/bispap51c.pdf>> accessed 14 July 2017; and
- Goodhart, Charles, ‘Central banks’ function to maintain financial stability: An uncompleted task’ (VOX Centre for Economic Policy Research’s Policy Portal, 24 June 2008) <<http://voxeu.org/article/two-goals-one-instrument-how-can-central-banks-tackle-financial-crises>> accessed 14 July 2017.

<sup>569</sup> Agénor, Pierre-Richard and Pereira da Silva, Luiz A., ‘Macroeconomic Stability, Financial Stability, and Monetary Policy Rules’ (2012) 15 (2) *Journal of International Finance* 205, 219.

suited to aim at stability growth and inflation.<sup>570</sup> Similarly, Svensson argued that: *“each policy can be conducted separately, with different objectives and different instruments. This is regardless of whether the central bank is in charge of both monetary policy and financial-stability policy or whether the central bank is in charge of monetary policy only and there is a separate authority in charge of financial-stability policy.”*<sup>571</sup> A counter argument to this belief, supports that the Tinbergen rule does not work in practice since *“interest rates affect financial stability and, hence, real activity” ...while...“macroprudential tools impact credit growth and external imbalances with consequences for macroeconomic and price stability;”* and lastly, *“rather than viewing the allocation problem as having a corner solution where one instrument is devoted entirely to one objective, the macro-stabilization exercise must be viewed as a joint optimization problem where monetary and regulatory policies are used in concert in pursuit of both objectives.”*<sup>572</sup>

For those who argue against the dual mandate for central banks, a major problem when it comes to the incorporation of price stability and financial stability objectives, rests on the fact that they constitute two completely different notions that serve opposite purposes. In addition, price stability, since it reflects real shocks, is more predictable and can be explicitly determined, whereas financial vulnerabilities are not easily determined, because they are often based on legal interpretations and tend to take shape over time. Sometimes, they can even retain their negative effect for longer than predicted.<sup>573</sup> For instance, Svensson while recognised some commonalities between financial stability and monetary policy, highlighted

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<sup>570</sup> Bernanke, Ben S., ‘Causes of the Recent Financial and Economic Crisis’ (Testimony before the Financial Crisis Inquiry Commission, Washington, 2 September 2010 Statement by Ben S. Bernanke Chairman Board of Governors of the Federal Reserve System before the Financial Crisis Inquiry Commission Washington, D.C. September 2, 2010) <<https://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm>> accessed 14 July 2017.

See also: Bernanke, Ben S., ‘The Federal Reserve and the financial crisis’ (The Federal Reserve and the Financial Crisis Origins and Mission of the Federal Reserve, Lecture 1, George Washington University School of Business March 20, 2012) <<https://www.federalreserve.gov/mediacenter/files/chairman-bernanke-lecture1-20120320.pdf>> accessed 14 July 2017.

<sup>571</sup> Svensson, Lars E. O., ‘Comment on Michael Woodford: Inflation Targeting and financial stability’ (2012) 1 Sveriges Riksbank Economic Review 33, 37 <[http://www.riksbank.se/Documents/Rapporter/POV/2012/rap\\_pov\\_artikel\\_2\\_120210\\_eng.pdf](http://www.riksbank.se/Documents/Rapporter/POV/2012/rap_pov_artikel_2_120210_eng.pdf)> accessed 14 July 2017. See also: Svensson, Lars E. O., ‘Monetary policy after the financial crisis’ (Speech the Deputy Governor of the Sveriges Riksbank, at the Second International Journal of Central Banking (IJCB) Fall Conference, Tokyo, 17 September 2010) <<http://www.bis.org/review/r100920c.pdf>> accessed 14 July 2017.

<sup>572</sup> Eichengreen (n 427) 7.

<sup>573</sup> Cihak, Martin, ‘Price Stability, Financial Stability, and Central Bank Independence’ (Speech at 38th Economics Conference at the Oesterreichische Nationalbank, Vienna, 2010), 46.

at the same time that they constitute two distinct notions, with different objectives, instruments and responsible authorities. Indeed, price stability is the primary objective of monetary policy, whereas financial stability is the main goal of macro-prudential policies/supervision.<sup>574</sup> Thus, for monetary policy the situation is more straightforward – one objective-one instrument (price stability-monetary policy) – whereas for financial stability, although it primarily involves one objective, the necessary instruments are many (among the rest: supervision, resolution and lender of last resort).<sup>575</sup>

Indeed, the instruments used by monetary policy in achieving its goals, are considerably different when compared to financial stability instruments. In normal times, monetary policy operates through policy interest rates and communication, including a publicly- announced policy-rate strategy and a forecast of inflation, and the real economy. In times of instability, emergency mechanisms might be applied, such as fixed-rate loans at longer maturities, asset purchases and foreign-exchange intervention to prevent currency appreciation. On the other hand, financial stability operates through instruments such as micro- and macro- supervision, regulation and financial stability reports. These instruments, should be activated in a timely manner in order to address early warnings of a potential financial crisis, by also analysing and predicting possible gaps that might lead to financial instability. In times of instability, the available tools are: lender of last resort mechanisms, special resolution mechanisms for financial institutions in danger, government capital injections, risk management and so forth. As highlighted by Garicano and Lastra, *“in an environment with multiple tasks that are observable with different difficulty, the setting of clear performance criteria in the tasks that are easily measurable deflects agents’ efforts away from the tasks that may be valuable but are more difficult to measure.”*<sup>576</sup>

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<sup>574</sup> Boeckx, J., Ilbas, P., Kasongo Kashama, M., De Sola Perea, M. and Van Nieuwenhuyze, Ch., ‘Interactions between monetary and macroprudential policies’ (2015) 2 Economic Review 7, 8.

<sup>575</sup> Lastra (n 547) 66.

<sup>576</sup> Garicano, Luis and Lastra, Rosa, ‘Towards a New Architecture for Financial Stability: Seven Principles’ (LSE, Centre for Economic Performance, Discussion Paper No. 990, July 2010), 9 <<http://cep.lse.ac.uk/pubs/download/dp0990.pdf>> accessed 14 July 2017. See also:

- Holmstrom, Bengt and Milgrom, Paul, ‘Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design’ (1991) 7 Journal of Law, Economics, & Organization 24; and
- Holmstrom, Bengt and Milgrom, Paul, ‘The Firm as an Incentive System’ (1994) 84 (4) American Economic Review 972.

Another argument that has been used to lay emphasis to the incompatibility between financial and price stability objectives is the risk of undermining central bank independence; a belief that is highly based on the time-inconsistency problem. For instance, a recent study by Ueda and Valencia, based on the time-inconsistency problem, found that that a dual-mandate central bank is not socially optimal, whilst, *“the separation of objectives achieves the social optimum as long as policy is conducted by politically independent institutions.”*<sup>577</sup> Hence, the time-inconsistency problem arises when the two objectives are combined, often due to loose monetary policy in an attempt to preserve simultaneously financial stability. As a result, as Smets argues, when there is no clear separation between the two domains, i.e. monetary policy and macro-prudential supervision and regulation, and macro-prudential policy is not explicitly defined, and it becomes subject to political interference, there is a greater possibility for the creation of a larger inflation bias than the one that would result from the time-inconsistency problem.<sup>578</sup> Furthermore, it is argued that the combination of these two objectives might pose a serious risks to both independence and accountability of central banks. Although this issue is thoroughly examined at the last chapter of the thesis, when discussing the ECB’s independence, it is worth mentioning its relevance with the aforementioned reasoning. To this end, as central banks’ mandate expands to financial stability objectives, their operation also expands into areas that are highly political. Recent examples range from the involvement of central banks into housing policy to the conduct of gigantic bail-out operations. In addition, in case of a bank collapse within a financial system where the central bank is assigned a dual mandate, it is presumed that its public reputation might be threatened not only in regard to the supervisory tasks, but also in relation to its monetary policy credibility.<sup>579</sup>

Notably, both those in favour and against a dual mandate for central banks, suggest that when a central bank – which is explicitly mandated to safeguard price stability via inflation targeting – assumes macro-prudential supervisory powers, it poses a high risk to its

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<sup>577</sup> Ueda, Kenichi and Valencia, Fabián, ‘Central Bank Independence and Macroprudential Regulation’ (IMF, Working Paper WP/12/10, April 2012) <<https://www.imf.org/external/pubs/ft/wp/2012/wp12101.pdf>> accessed 14 July 2017.

<sup>578</sup> Smets, Frank, ‘Financial Stability and Monetary Policy: How Closely Interlinked?’ (International Journal of Central Banking June 2014) 263 <<http://www.ijcb.org/journal/ijcb14q2a11.pdf>> accessed 14 July 2017.

<sup>579</sup> Garicano and Lastra (n 580) 9.

independence, which in turn will put in danger the main mandate of price stability.<sup>580</sup> This belief seems to be largely justified, since there are obvious incentives as to why a central bank might come under increased political pressure when acting as a supervisor, in comparison with the scenario when its role is solely focused on price stability targets. Simply said, financial institutions are the subjects of central banks' decisions and thus, directly affected by the outcome of changes in policy. As a result, a financial institution will be driven to use all available means in order to influence central bankers in avoiding the application of restrictive macro-prudential tools, especially during a credit bubble.<sup>581</sup>

A good example, as pointed out by Mishkin, is the case of Basel III Accord, which proved that political interference during both its negotiation process and implementation stage, may indeed place significant constraints on the adoption of adequate macro-prudential decisions. Namely, according to press reports, various complaints originated by the German Landesbanken, during the negotiation of Basel III, resulted in the adoption of weaker capital standards. In addition, its implementation was put off for 10 years, while systemic risk measures were largely neglected, including higher capital requirements on systemically important banks.<sup>582</sup> This explains, as discussed in chapter one, the criticism against Basel III based on the realisation that was bringing nothing new to his predecessor, i.e. Basel II. This also explains the reluctant and highly selective attitude towards the implementation of Basel III at EU level, which was surprisingly different from the traditional receptive approach.

There are, however, a number of advantages when combining the financial and price stability objectives under central bank's roof. Firstly, it promotes better information exchange and cooperation. This proved to be particularly important during the GFC, when it was depicted that monetary policy influences both inflation rates and the price of risk taking. It is therefore necessary, as Garicano and Lastra argued, that *“those in charge of monetary policy need to know the amount of risk and instability in the system”* and, *“the absence of stable prices harms the stability of the financial system, while financial fragility in turn, negatively*

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<sup>580</sup> Goodhart, Charles, 'The Organisational Structure of Banking Supervision' (FSI, Occasional Paper No. 1, November 2000 Basel) <<http://www.bis.org/fsi/fsipapers01.pdf>> accessed 14 July 2017.

<sup>581</sup> Mishkin, Frederic S., 'How should central banks respond to asset-price bubbles? The lean versus clean debate' (Banque de Réserve d'Australie, Bulletin, June Quarter 2011) 59, 65 <<http://www.rba.gov.au/publications/bulletin/2011/jun/pdf/bu-0611-8.pdf>> accessed 14 July 2017.

<sup>582</sup> Mishkin (n 585) 65.

*affects monetary stability.*<sup>583</sup> This enhanced communication is also likely to foster the coordination between the two domains (i.e. monetary policy and banking supervision), which in turn, is likely to help efficiency. In addition, since the majority of price-stability-oriented central banks have been granted a high degree of independence, which is often established under constitutional law, this can contribute to shield supervision from political interference.<sup>584</sup> Lastly, the role of central banks to act as lender of last resort, which involves the provision of immediate liquidity to the banking system, provides them with enhanced tools in dealing with financial imbalances. Indeed, the role of lender of last resort, entails obvious advantages in times of instability in avoiding systemic problems, since it assures immediate circulating of the relevant information and prompt decision making.<sup>585</sup>

As repeatedly emphasised, the GFC, has decisively changed attitudes towards the conventional view, with many arguing about the need to include financial stability among the set of central banks' objectives. As Papademos argued: *"...price stability and financial stability complement and mutually reinforce one another"*, adding that: *"monetary policy that credibly preserves price stability promotes financial stability"*, whereas: *"a stable financial system enhances the effectiveness of monetary policy."*<sup>586</sup> This is closely related with the ever growing literature in favour the enlargement of monetary policy mandate to include financial stability objectives, which is also known as "leaning against the wind."<sup>587</sup> In June 2005, Jean-Claude

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<sup>583</sup> Garicano and Lastra (n 577) 9.

<sup>584</sup> Abrams and Taylor (n 571) 166.

<sup>585</sup> Beaufort Wijnholds, J. Onno de and Hoogduin, Lex, 'Central Bank Autonomy: Policy Issues' in Beaufort Wijnholds, J. Onno de, Eijffinger, Sylvester C.W., Hoogduin, Lex H. (eds.), *A Framework for Monetary Stability* (Springer Science+Business Media 1994) 75, 78.

<sup>586</sup> See: Papademos (n 535).

<sup>587</sup> For a recent analysis on "leaning against the wind" see:

- Smets (n 579);
- 'The Tradeoffs in Leaning Against the Wind' – Conference Draft – Gourio, Francois, Kashyap, Anil K and Sim, Jae (IMF, 28 October 2016)  
<[https://www.imf.org/external/np/res/seminars/2016/arc/pdf/Kashyap\\_et\\_al\\_Session1.pdf](https://www.imf.org/external/np/res/seminars/2016/arc/pdf/Kashyap_et_al_Session1.pdf)>  
accessed 14 July 2017;
- French, Kenneth R., Baily, Martin N., Campbell, John Y., Cochrane, John H., Diamond, Douglas W., Duffie, Darrell, Kashyap, Anil K., Mishkin, Frederic S., Rajan, Raghuram G., Scharfstein, David S., Shiller, Robert J., Shin, Hyun Song, Slaughter, Matthew J., Stein, Jeremy C. and Stulz, René M., *The Squam Lake Report Fixing the Financial System* (Princeton University Press 2010) 28;
- Svensson, Lars E.O., 'Cost-Benefit Analysis of Leaning Against the Wind' (NBER Working Paper No. 21902, January 2016); and
- Gambacorta, Leonardo and Signoretti, Federico M., 'Should monetary policy lean against the wind?' (BIS Working Papers No 418, An analysis based on a DSGE model with banking, July 2013)  
<<http://www.bis.org/publ/work418.pdf>> accessed 14 July 2017.

Trichet, President of the ECB at the time, defined “leaning against the wind” as: “*a tendency to cautiously raise interest rates even beyond the level necessary to maintain price stability over the short to medium term when a potentially detrimental asset price boom is identified.*”<sup>588</sup> However, the most controversial part of this debate, is the question as to whether the central bank is the most appropriate body to pursue both the financial and price stability objectives in an effective manner and most importantly, under which institutional framework? This has become highly relevant in the aftermath of the GFC, since many central banks are getting involved in both price stability and financial stability functions, either directly or indirectly via an independent body.<sup>589</sup>

In this context, the literature post-2007 has converged on the view that financial stability policy, macro-prudential regulation and monetary policy are highly interlinked, and necessary to each other. This is based on the presumption that the inadequate performance of one may have negative impact on the other and as Mishkin argued: “*the dichotomy between monetary and financial stability policy is a false one.*”<sup>590</sup> Similarly, Bernake supported the complementary relationship between the two objectives, by highlighting at the same time how “*monetary policy, financial supervision, and lender-of-last-resort policies all benefit from the sharing of information and expertise.*”<sup>591</sup> In addition, Lastra by bringing the example of Northern Rocks collapse and the Bank of England role, argued that the best placed institution to act as the chair of the body responsible for financial stability, should be the central bank.<sup>592</sup>

It should also be noted that central banks, regardless of whether are formally assigned supervision objectives, cannot be isolated from responsibilities concerning macro-prudential risks. Here becomes relevant the, relatively recent, case of Bank of England, which after the collapse of Northern Rock was blamed for the failure, regardless of its supervisory role and oversight implication in general. It should be noted that the Bank of England was given a statutory objective to contribute to financial stability in the Banking Act 2009, which was in

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<sup>588</sup> Trichet, Jean-Claude, ‘Asset price bubbles and monetary policy’ (Speech by President of the ECB, Mas lecture, Singapore, 8 June 2005) <<https://www.ecb.europa.eu/press/key/date/2005/html/sp050608.en.html>> accessed 14 July 2017.

<sup>589</sup> Lastra (n 533).

<sup>590</sup> Mishkin, 2007 (n 464) 46.

<sup>591</sup> Bernanke, Ben S., ‘The Effects of the Great Recession on Central Bank Doctrine and Practice’ (Speech at the Federal Reserve Bank of Boston 56th Economic Conference, Boston, Massachusetts, 18 October 2011) <<https://www.federalreserve.gov/newsevents/speech/bernanke20111018a.htm>> accessed 14 July 2017.

<sup>592</sup> Lastra (n 533) 60.

the aftermath of Northern Rock's collapse.<sup>593</sup> Indeed, a central bank, despite of being or not formally assigned supervisory powers (or not), due to its role as the provider of liquidity when acting as the lender of last resort, will have the final word and will eventually get involved regardless. It is therefore, more sustainable for a central bank to be institutionally designed with macro-prudential tools in order to make full use of its available information and resources, both in terms of prevention and subsequently, in case of emergency if there is the need. This also links with the discussion developed in chapter one, where it is argued that central bank independence, while constitutes an important component for effective monetary policy, it should not be considered as an end in itself. To this end, as Lastra argued: *"Central bank independence is not absolute, but relative. Central bank independence has an instrumental nature, as a means to achieve a goal, namely price stability, a goal which is desirable for the economic running of the state and for the welfare of society."*<sup>594</sup>

In conclusion, the main lesson to be drawn from historical experience and the relevant macroeconomic theories developed as a response, is that the central bank's monetary policy goal of price stability, while essential, cannot be seen in isolation from the objective of financial stability. As the experience of the GFC depicted, the two objectives are highly intertwined and the performance of one affect the other. The problem arises when the two objectives are to be performed exclusively by the central bank. On the one hand, when one objective is addressed with only one instrument, the central bank will be highly rule-based but still in line with the Tinbergen Rule and the time-inconsistence theory. This, however, when the objective of price stability is pursued by monetary policy instruments, might lead to neglecting macro-prudential implications, posing a great risk to financial stability goals, as discussed already. On the other hand, if the two objectives are combined, questions regarding central bank independence may arise, or even conflicts of interests between the two objectives, which in turn, might pose risks to the main objective of price stability itself.

However, as became apparent during the GFC, the financial stability goal cannot be seen as detached from the set of central banks' objectives. A central bank should be able to

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<sup>593</sup> For a detailed analysis see: Bruni, Franco and Llewellyn, David T. (eds.), *The Failure of Northern Rock: A Multi-Dimensional Case Study* (SUERF 2009) <[https://www.suerf.org/docx/s\\_5d6646aad9bcc0be55b2c82f69750387\\_2141\\_suerf.pdf](https://www.suerf.org/docx/s_5d6646aad9bcc0be55b2c82f69750387_2141_suerf.pdf)> accessed 14 July 2017.

<sup>594</sup> Lastra (n 533) 53.



use all its resources and tools to: firstly, if not prevent, at least, minimise the robustness of future financial disturbances; and secondly, to tackle the occurrence of financial distress. Most importantly, the role of central banks in financial stability is unavoidable, regardless of whether or not they are officially assigned supervisory responsibilities. This is linked with central banks' traditional role as lenders of last resort, which ultimately link their tasks to supervisory duties. Thus, it would be particularly valuable for both functions of central bank, if the conduct of monetary policy becomes informed by consideration drawn by the central bank's analysis of financial stability, and *vice versa*. This would enable the central bank to act appropriately both in times of stability and in times of financial distress. The problem is, however, how to combine the two functions simultaneously, by avoiding or reducing organisational costs, which, can become a significant concern.

## 2.3 The price and financial stability objectives of the ECB

### 2.3.1 Monetary policy and the price stability objective

The creation of the EMU on 1 January 1999 and the establishment of the ESCB, introduced a new era for European central banking that one could call highly experimental, due to the limited theoretical backing for the endeavour and the lack of any direct precedent. Simultaneously, the introduction of the ECB as a new supranational and independent legal entity, founded on primarily EU law, marked an historical change to the constitutional balance within the EU.<sup>595</sup> Since the entry into force of the Treaty of Lisbon on 1 December 2009, the ECB constitutes an EU institution with its own legal personality.<sup>596</sup> The ECB along with the NCBs form the ESCB,<sup>597</sup> within which lies the Eurosystem or the Eurozone. Apart from the EU primary law, which is the applicable law to the ESCB (Articles 127–142 and Articles 282–284 TFEU, Article 13, TEU and the Protocol on the Statute of the European System of Central Banks and the European Central Bank, ESCB Statute), there is also secondary EU law related to the ESCB, including: ECB regulations, decisions, recommendations and opinions; and the

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<sup>595</sup> See: Zilioli Chiara and Selmayr, Martin, *The Law of the European Central Bank* (Hart Publishing 2001).

<sup>596</sup> See: ECB website: <<http://www.ecb.europa.eu/home/glossary/html/glosse.en.html#190>> accessed 14 July 2017.

<sup>597</sup> TFEU (n 5) Article 282(1).

guidelines and instructions of the ESCB; the EU Council regulations on the euro, minimum reserves, statistical information gathering, sanctions.<sup>598</sup> Lastly, the specific division of responsibilities within the ESCB are defined in the ESCB statute. The Governing Council and the Executive Board are the governing bodies of the ECB. The Executive Board is comprised of President, the Vice-President and four board members, and it is responsible to execute the decisions of the Governing Council. The latter is consisted of the members of the Executive Board and the 12 governors of the NCBs, and it is responsible for implementation of monetary policy for the euro area.

According to Article 127(2) TFEU: *“the primary objective of the European System of Central Banks shall be to maintain price stability.”* As extensively discussed in chapter one, according to Article 130, TFEU, the ECB in pursuing its mandate, acts in full independence from any EU institution, body, office and agency, and from the governments of Member States.<sup>599</sup> Thus, the wording of Article 130, TFEU, explicitly forbids the Members of the ESCB’s Governing Council from taking instructions from any national or EU body, establishing a high level of not only instrument independence but also goal independence, i.e. it is up to the Bank’s discretion to decide the definition of price stability and the means to achieving it.

It is evident, therefore, that the TFEU, sets a clear hierarchy in the objectives of ECB by assigning an overriding importance to the maintenance of price stability, i.e. the control of inflation. The ECB’s price stability mandate and its operational structure, i.e. one institution (the central bank) - one objective (price stability) one instrument (monetary policy), was highly influenced by the German Bundesbank Model of central banking,<sup>600</sup> which performed exceptionally well in maintaining inflation low during the early 1970s when the Bretton Woods System collapsed. However, although the institutional framework of the ECB is based on the Bundesbank model, its primary mandate of maintaining price stability is incorporated in EU primary law, whereas the price stability mandate of Bundesbank is based on its statute. The latter makes the Bundesbanks’ mandate changing process substantially more flexible

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<sup>598</sup> Lastra, Rosa M. and Louis, Jean-Victor, ‘European Economic and Monetary Union: History, Trends, and Prospects’ (2013) Yearbook of European Law 2013 1, 73.

<sup>599</sup> TFEU (n 5) Article 130.

<sup>600</sup> Bibow (n 437) 6.

than the process of a Treaty change.<sup>601</sup> To this end, both the ECB's mandate of price stability and status are enshrined in the TFEU, i.e. in the constitutional charter of the EU, governed by the rule of law. As the ECJ found, the EU is: "...a Community based on the rule of law, inasmuch as neither its Member States nor its institutions can avoid a review of the question whether the measures adopted by them are in conformity with the basic constitutional charter, the Treaty."<sup>602</sup> In addition the ESCB Statute, is a protocol to the TEU and thus, any amendment to the Treaty provisions or its protocol would require undergoing a more complex process ratification at national level. Simply said, any state can amend their national laws, including those that define the legal basis and objectives of their central banks.

This also links with the discussion developed in chapter one regarding the independence of ECB, which is also based on the model of Bundesbank's independence. However, since the independence of the ECB, as highlighted in chapter one, is enshrined by EU Law, it has a stronger legal basis from that of Bundesbank. The Bundestag, the German Parliament, has the power to change the statute of the central bank (i.e. the Bundesbank), which is also embedded in a system of political checks and balances. The EU Parliament, on the other hand, cannot modify the ECB's status, objectives and overall mandate.<sup>603</sup> In essence, a decision to change the ECB's independence or price stability mandate would depend upon a Treaty amendment, which requires unanimous consent of the Member States and ratification at national level.<sup>604</sup>

However, the choice of price stability as the optimal monetary policy objective of the ESCB was not regarded as a 'imperative,' but it rather came as a result of long discussions and

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<sup>601</sup> Kenen, Peter, *Economic and Monetary Union in Europe: Moving Beyond Maastricht* (Cambridge University Press 1995) 42.

<sup>602</sup> *Case 294/83 Parti écologiste, 'Les Verts' v. European Parliament* [1986] ECR 1986, para.23.

Relevant statements could be found at:

- Opinion 1/76, 'On the Draft Agreement establishing a European laying-up fund for inland waterway vessels' pursuant to Article 228 (1) of the EEC Treaty [1977 ECR I-741], at para. 12 ("internal constitution of the Community"); Opinion of the Court of 26 April 1977.
- Case C-314/91, *Beate Weber v European Parliament* [1993] ECR I-1093, para. 8;
- Case C-2/88, *Imm. Zwartfeld and Others* [1990] ECR I-3365, para. 16;
- Opinion 1/91, "On Draft agreement between the Community, on the one hand, and the countries of the European Free Trade Association, on the other, relating to the creation of the European Economic Area [1991] ECR I-6079, para. 21.

<sup>603</sup> Verdun, Amy, 'The Institutional Design of EMU: A Democratic Deficit?' (1998) 18 (2) *Journal of Public Policy* 107, 108.

<sup>604</sup> Majone, 1998 (n 125) 15.

negotiations among the Member States.<sup>605</sup> The two dominant components that contributed directly in the final consensual outcome were: firstly, the political background, with Germany playing a key role in the negotiation process of establishing a supranational monetary authority (i.e. the ECB) based on “Bundesbank inspired model”; and secondly, the general international trend in central banking theories during the time of ECB’s establishment.<sup>606</sup> As it was thoroughly analysed, at the time of ECB’s establishment there was a widespread consensus about the optimal model of monetary policy, i.e. primarily focused on the sole mandate of price stability, achieved through inflation targeting and a highly independent status.<sup>607</sup> Issing et al. develop a comprehensive analysis on how the ECB’s institutional design and monetary policy framework reflect the consensus of macroeconomic theory of their time.<sup>608</sup> Consequently, the ECB was designed to be fully committed to the primary objective of price stability, while enjoying a high degree of independence in pursuing this objective, free from any political influence.

Apart from the sole mandate of price stability, there are also other tasks entrusted to the ECB, which are also defined by Article 127(2) of the TFEU and are reproduced in Article 3(1) of the ESCB Statute as following: a) to define and implement the monetary policy of the Union, b) to conduct foreign-exchange operations consistent with the provisions of Article 219, c) to hold and manage the official foreign reserves of the Member States, d) to promote the smooth operation of payment systems.<sup>609</sup> These tasks have been defined as non-basis tasks and as Lastra specified: “*There are four other ‘non-basic’ tasks (i.e., not included under the umbrella of ‘basic tasks’): (1) issue of banknotes, (2) contribution to financial stability, (3)*

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<sup>605</sup> For a detailed analysis on the price stability focused monetary policy of the ECB see:

- Issing, Otmar, *The Birth of the Euro* (Cambridge University Press 2008);
- Issing, Otmar, Gaspar, Vitor, Angeloni Ignazio and Tristani, Oreste Tristan (eds.), *Monetary policy in the euro area – Strategy and decision making at the European Central Bank* (Cambridge University Press 2001);
- ‘The stability-oriented monetary policy of the Eurosystem’ (ECB, Monthly Bulletin January 1999) 39 <<https://www.ecb.europa.eu/pub/pdf/mobu/mb199901en.pdf>> accessed 14 July 2017.
- ‘The Two Pillars of the ECB’s Monetary Policy Strategy’ (ECB, Monthly Bulletin November 2000b), 37 <[https://www.ecb.europa.eu/pub/pdf/other/pp37\\_48\\_mb200011en.pdf](https://www.ecb.europa.eu/pub/pdf/other/pp37_48_mb200011en.pdf)> accessed 14 July 2017; and
- ‘The Monetary Policy of the ECB’ (ECB, 2004b) <<https://www.ecb.europa.eu/pub/pdf/other/monetarypolicy2004en.pdf>> (accessed 14 July 2017;

<sup>606</sup> Issing, Otmar, ‘In Search of Monetary Stability: The Evolution of Monetary Policy,’ (BIS Working Papers No. 273, March 2009) <<http://www.bis.org/publ/work273.pdf>> accessed 14 July 2017.

<sup>607</sup> Svensson, Lars E.O., ‘Price Stability as a Target for Monetary Policy: Defining and Maintaining Price Stability’ (NBER Working Papers No. 7276, August 1999) <<http://www.bis.org/publ/work273.pdf>> accessed 14 July 2017.

<sup>608</sup> See: Issing et al. (n 609).

<sup>609</sup> TFEU (n 5) Article 127(2) and ESCB Statute (n 243) Article 3(1).

*advisory functions and collection of statistical information and, (4) international co-operation and 'external operations.'*"<sup>610</sup>

Furthermore, the second sentence of Article 127(2), TFEU, further specifies that: *"without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119."* Article 127(4), TFEU, outlines the advisory role of the ECB towards both the Union and national authorities, as regard issues concerning its competences as laid down by the Treaty. The wording of the aforementioned provisions, while referring at responsibilities outside of ECB's "basis tasks," somewhat extend the role of ECB beyond the sole mandate of price stability.

However, the key objective of the ECB is clearly defined by the EU Treaty as the guardian of price stability in the euro area. The numerical definition of price stability is not included in the wording of the relevant provisions. In fact, the numerical definition of price stability was set by the ECB's Governing Council, and was to be maintained at levels below, but close to 2% over the medium term and is measured by the Harmonised Index of Consumer Prices (HICP).<sup>611</sup> In particular, the Governing Council of the ECB, acting within the context of the Treaty provisions as an independent authority, announced in October 1998, the explicit quantitative definition of price stability as following: *"Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%."*<sup>612</sup> It should be noted that prior the Governing Council's definition, EMI - the ECB's forerunner - in its 1994 Annual Report, stated that price stability is translated to inflation level close to 2% or less.<sup>613</sup>

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<sup>610</sup> Lastra, Rosa M., 'The evolution of the European Central Bank' (Queen Mary University of London, School of Law Legal Studies Research Paper No. 99/2012, March 2012), 7 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2020545](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2020545)> accessed 14 July 2017.

<sup>611</sup> See: Issing et al. (n 609).

<sup>612</sup> 'A stability-oriented monetary policy strategy for the ESCB' (ECB Press Release, 13 October 1998) <[https://www.ecb.europa.eu/press/pr/date/1998/html/pr981013\\_1.en.html](https://www.ecb.europa.eu/press/pr/date/1998/html/pr981013_1.en.html)> accessed 14 July 2017.

<sup>613</sup> See: 'Annual Report 1994' (EMI, April 1995), 50 <<https://www.ecb.europa.eu/pub/pdf/annrep/ar1994en.pdf?2f7b090108a9f610108797426c0cba75>> accessed 14 July 2017.

This decision of the Governing Council to publicly announce the numerical definition of price stability, derived from a strategic reasoning. Foremost, by explicitly defining the goal of price stability, the Governing Council aimed at helping the general public understand the monetary policy strategy and thus, making the latter more transparent. Furthermore, the explicit definition of price stability meant to promote the accountability of the ECB, enabling the public to know exactly what to expect from the European monetary authority. In case of any inconsistency in terms of maintaining its price stability objectives, the ECB would then be obliged to provide an explanation and an ultimate remedy. Also, the quantitative definition of price stability delivers guidance to the public for building expectations of future price developments.<sup>614</sup> This also links to the discussion developed in chapter one about ECB's transparency, and how this is directly related to its independent status. In the context of this discussing, it was also stressed that there were several concerns developed in relation to the wide discretion of the ECB in interpreting and defining its price stability mandate, which raises legitimacy and accountability questions regarding the operation of the ECB.

In sum, the monetary policy strategy of the ECB follows an inflation targeting model, which incorporates other macroeconomic variables besides money in analysing the possible risks to price stability. This means that the ECB's monetary policy is not entirely focused on a forecast inflation figure, but thoroughly considers the underlining sources of these risks.<sup>615</sup> As discussed already, the history has depicted that despite the efforts of different economic theories and various policy-making decisions, the occurrence of inflation or deflation has always been part of the story. Furthermore, the precise acceptable level of inflation constitutes a peculiar issue, which is highly dependent on the actual economic circumstances. However, before the emergence of the GFC, flexible inflation targeting was considered to be the most appropriate framework for monetary policy, which also involved its separation from the function of fiscal policy and a numerical definition of 0-3% level of inflation as the generally accepted safe for the economy.

The ECB, since its establishment, has been considered to have performed remarkably well in delivering its objective and has gained a strong reputation as the guardian of price

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<sup>614</sup> ECB, 2004b (n 609) 51.

<sup>615</sup> For a comprehensive analysis of the monetary policy strategy (including both economic and monetary analysis) of the ECB and the rationale behind the inflation targeting model see: ECB, 2004b (n 609) 55-66.

stability in the euro area, with inflation expectations appearing well anchored.<sup>616</sup> Indeed, the average actual inflation rate for many years before the outbreak of the GFC was very close to the two percent annual target, with minor fluctuations, and long-term inflation targets were at the same level.<sup>617</sup> According to Stefan Collignon, who was entrusted the task of assessing the ECB's performance under president Jean- Claude Trichet: *"The ECB was remarkably successful in achieving price stability. Except for the peak in energy and food prices in 2006/7, actual and core inflation as well as inflation expectations measured by inflation-indexed OATi bonds were stable and close to the ECB target below 2 per cent."*<sup>618</sup> Also Lopez and Papell found that: *"euro area inflation is very close to 2% for most of the Euro period with the exception of the 2008 financial crisis..."*, although they highlighted that: *"....at the country level, Ireland, Greece, and Spain relax their efforts shortly after the adoption of the single currency, ending up with noticeably higher inflation rates than the other Euro countries, placing them in a strong disadvantage in term of price competitiveness and susceptible to current account deficits and bubbles (real estate: Spain, Ireland, public debt: Greece)."*<sup>619</sup>

#### 2.2.2 ECB's role in financial stability: Pre-GFC

It is evident from the analysis above that, at EU level, there was a clear hierarchy of objectives for the ECB, with the task of price stability being the key, if not the sole objective of the ECB. In addition, the original legislative framework of the EMU did not consider financial instability as a significant risk. This, however, does not imply that financial stability was not included among the tasks of ECB. Firstly, ECB, as discussed in the previous section, provides a definition for price, which has been outlined by the ECB: *"as a condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are*

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<sup>616</sup> Orphanides (n 552) 1.

<sup>617</sup> 'The importance of macroprudential policy for monetary policy' (Deutsche Bundesbank, Monthly Report, March 2015) 39, 41  
<[https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly\\_Report\\_Articles/2015/2015\\_03\\_importance.pdf?\\_\\_blob=publicationFile](https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2015/2015_03_importance.pdf?__blob=publicationFile)> accessed 14 July 2017.

<sup>618</sup> Collignon, Stefan 'European Monetary Policy under Jean-Claude Trichet' (shorter version of the draft paper) <[http://eprints.lse.ac.uk/39425/1/blogs\\_lse\\_ac\\_uk-Despite\\_past\\_criticisms\\_the\\_European\\_Central\\_Bank\\_has\\_prevented\\_a\\_meltdown\\_of\\_EU\\_banks\\_and\\_helped\\_to\\_.pdf](http://eprints.lse.ac.uk/39425/1/blogs_lse_ac_uk-Despite_past_criticisms_the_European_Central_Bank_has_prevented_a_meltdown_of_EU_banks_and_helped_to_.pdf)> accessed 14 July 2017.

<sup>619</sup> Lopez, Claude and Papell, David H., 'Convergence of Euro Area Inflation Rates' (2012) 31 (6) Journal of International Money and Finance 1440, 1443.

*severe enough to significantly impair the allocation of savings to profitable investment opportunities.*<sup>620</sup> Secondly, Article 127(5) of the TFEU specifies that the ECB/ESCB: “*shall contribute to the stability of the financial system*” and the Eurosystem’s Mission Statement states that: “*we aim to safeguard financial stability.*”<sup>621</sup>

However, Articles 2-6, ESCB Statute, explicitly outline the objectives (Article 2), the tasks (Article 3-5) and the functions in international cooperation (Article 6) of the ECB, but do not include financial stability among the core objectives of the ECB. The content of Article 2, which highlights the principle objective of ECB, was originally proposed by the Committee of Governors of the Central Banks (the “Committee of Governors”) of the EEC, in the draft text for the Statute of the ESCB (“the Statute”) and is highly based on this proposal, with minor changes. The Governing Council of the ECB in its press release of October 1998, did not include any additional objectives of the ECB, but rather highlighted the sole mandate of the ECB in its primary and strictly focused commitment to maintain price stability. The Governing Council of ECB at the announcement specified that: “*...the ESCB’s monetary policy strategy will focus strictly on this objective.*”<sup>622</sup> By this statement, the Governing Council seems to have went against the wording of the Treaty provisions, since not only has given priority to the mandate of price stability but also, has considered it as the single objective of the ECB (see the wording: “strictly”). Yet, since the wording of Article 127, TFEU includes additional tasks to the ECB, this emphasises that the EU does not follow a sole economic policy, but incorporates a number of objectives that are mutually interconnected and co-dependent on each other.

As a result, despite the fact that the importance of financial stability in pursuing price stability was well-recognised, clearly mentioned and desirable, there was no clear mandate as to the means and scope of its protection. In fact, a clear distinction or a ‘Chinese Wall’ between monetary policy and financial stability policy was largely retained in terms of institutional arrangements and policy mechanisms. Again, this strategy, similar to the price stability mandate, was a result of macroeconomic theories developed at the time of the ECB’s

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<sup>620</sup> ECB, 2009 (n 546) 9.

<sup>621</sup> Papademos, Lucas, ‘Price stability, financial stability and efficiency, and monetary policy’ (Speech by Vice President of the ECB at the Third conference of the Monetary Stability Foundation on “Challenges to the financial system – ageing and low growth” Frankfurt am Main, 7 July 2006) <<https://www.ecb.europa.eu/press/key/date/2006/html/sp060707.en.html>> accessed 14 July 2017.

<sup>622</sup> See: ECB, 1998 (n 616).



establishment, which supported the idea that central banks should be focusing in maintaining price stability, something that was considered to be enough in lessening both the incidence and the severity of financial instability, and to safeguard the financial system and the economy as a whole. Moreover, empirical studies based on the historical evidence of some developed countries such as the UK, the US, Canada and Japan, also supported the idea that in most of the cases when central banks failed to deliver their mandate for price stability, there was a severe negative effect on financial stability.<sup>623</sup> As George stated: *“after many years of financial market stability in advanced economies, policymakers seemed to have reason to view monetary policy as appropriately focused on macroeconomic objectives.”*<sup>624</sup> As discussed above, a wide consensus has emerged in the post-GFC that the objectives of financial and price stability are strongly intertwined. This has resulted in an increasing number of regulatory responses around the world aiming at reshaping their financial regulatory environment in a way that would accommodate both financial stability and monetary policy objectives within the set of central banks’ mandate.

Similarly, while the ECB was originally designed to serve as a pure monetary authority, there were a series of events that triggered the process of broadening the ECB’s mandate towards its increasing involvement in banking supervision. This process started with the Lamfalussy Report in 2004, which was followed by the De Larosière Report in 2009, leading to the creation of the ESRB (in 2011), which was entrusted with the macro-prudential oversight of the euro area banks. The analysis of the aforementioned process is subject to the following chapter, which examines the roadmap towards the creation of the first pillar of the European Banking Union, i.e. the SSM, by outlining the main regulatory reforms that the EU financial regulation underwent in light of the GFC. This reformative process reached momentum in November 2014, when the ECB became the single supervisor of the euro area, assuming regulatory and supervisory responsibilities through the newly established SSM. It should be noted that the idea of empowering the ECB with supervisory tasks is not a new proposal or an emergency response to the financial crisis. It is rather the opposite, since it has been repeatedly considered and officially proposed in the past, but the politics of the legislative process at EU level slowed down the achievement of this goal. However, the

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<sup>623</sup> See: Bordo and Wheelock (n 517).

<sup>624</sup> George (n 566) 2.

implementation of the relevant decision and has reopened both old and new debates concerning potential policy trade-offs and incompatibility of new and existing objectives.

Since its establishment the ECB has played a crucial role in the European arena, and its role has been evolving during the last years, becoming increasingly prominent especially, during the GFC. The main task of the ECB, including its additional duties came to be enlarged in light of its recent involvement in supervisory matters. Times have changed for central banking, and the price-stability-focused monetary authorities have been replaced by financial-stability-oriented ones. Likewise, the ECB, as a creature of its time, although maintaining its price stability mandate, has shifted its emphasis towards the objective of financial stability.<sup>625</sup>

## 2.4 Conclusion

This chapter provided an analysis on the evolution of monetary policy and the theoretical foundation for the prevalence of inflation targeting regimes. However, the occurrence of the GFC and its far-reaching consequences, have shaken up the macroeconomic policy framework that appeared to have been adequately stabilising the economy during the Great Moderation era. Thus, the evidence brought by the GFC experience, has challenged the conventional views on how monetary policy should be conducted, as the excessive focus of central banks on the price stability objective proved to be inadequate in maintaining financial stability, which in turn, led to negative consequences in price stability. These findings placed emphasis on the macro-prudential regulatory and supervisory domain, and the relationship of the latter with the monetary policy and micro-prudential supervision. As a result, central banking, at national, international and EU level, became subject to a plethora of regulatory responses aiming to broadening the mandate of central banks, by combining monetary policy, macro-prudential and micro-prudential supervision under the same roof.

At the same time and while searching for the optimal institutional design to facilitate the marrying of monetary policy and banking supervision, a number of concerns were raised

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<sup>625</sup> Buiter, Willem H., 'Unemployment and inflation in the Eurozone: why has demand management failed so badly?' (ECB Forum on Central Banking, May 2015) <<http://willembuiter.com/sintra.pdf>> accessed 14 July 2017.

as to their compatibility and the 'side effects' that this combination may entail. The 'conflict of interest' issue was supported by a large part of the literature, while the time-inconsistency problem and the Tinbergen Rule constituted the theoretical basis of views against central banks assuming dual mandates. In addition, both those against and in favour, stressed that the combination of financial and monetary stability may undermine central bank independence. This may prove to be particularly problematic, especially when combining macro-prudential and monetary policy objectives. Hence, a strict separation between the two is to be maintained, while the tasks and responsibilities of each domain would have to be clearly defined.

At EU level, the process towards further financial integration, harmonisation of rules and greater cooperation between national and EU institutions had already started before the GFC period. However, the major changes in financial services regulation and supervision came to be introduced as "emergency" measures, intended to provide immediate solutions during the GFC in order to prevent further damage to the financial system. Thus, layers upon layers of regulation started to build on existing structures, combining present and new laws in a complex structure of cooperation between national and supranational institutions and structures. This created a unique momentum for EU financial integration, expressed in the Banking Union project. However, before analysing in detail the legal implications of this decision and its compatibility with existing EU law provisions, it is of fundamental importance to outline the roadmap towards its creation in the following chapter

## Chapter 3: European Banking Regulation and Supervision: from Fragmentation to Integration

*“The road Western Europe took from the end of World War II to its current state has been one with lots of steep and sometimes blind curves, with harsh speed limits and frequent detours. But still it has been one that attracted more and more traffic.”<sup>626</sup>*

### 3.1 Introduction

The last three decades have witnessed increased financial integration, at national, regional and international level as a result of the growing trade in financial services and technological advances. This process, as discussed in chapter one, has spurred the creation, of an international framework of regulatory and supervisory standards. At EU level, the concept of financial services integration has been at the core of policymaking since the early stages of the EU integration. From the Treaties of Rome to the Maastricht Treaty and the introduction of the euro, Europe has moved slowly but progressively towards a single market for financial services. It should be noted that financial integration is comprised of three parts, including banking, insurance and securities integration. As this thesis focuses on banking regulation, with particular emphasis on prudential supervision, the analysis centres on the relevant literature concerning banking services integration. Having said this, banking services unification, while at the heart of the EU financial services, remained highly fragmented for years, which was considered to be in contradiction with the growing globalisation of financial markets.

The hit of the GFC created political momentum for regulatory change and innovative amendments at both international and European level, bringing calls for tighter integration and stronger cooperation. Having discussed the roadmap towards the creation of the Euro, including the establishment of ESCB and its core objectives, in chapter one, this chapter moves into the main theme of this thesis, which concerns the centralisation of banking

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<sup>626</sup> Koop, Michael J. and Siebert, Horst, ‘Institutional competition versus centralization: Quo vadis Europe?’ (Kiel Working Paper, No. 548, 1993), 1 <<https://www.econstor.eu/bitstream/10419/773/1/126396450.pdf>> accessed 14 July 2017.

supervision and regulation at EU level. To this end, although the substantial discussions that led to centralisation of regulation and supervision at EU level, occurred mainly after the outbreak of Great Depression, the rationale of its idea finds its roots back to the foundation of the EU. Therefore, in order to understand the EU regulatory reforms implemented after the outbreak of the GFC, it is crucial to examine their underpinnings. This chapter starts with tracing the evolution of EU financial services integration, by outlining the main regulatory initiatives. The analysis then focuses on the initial steps towards strengthening regulation and supervision at EU level, including the Lamfalussy Report, its impact on reshaping the EU regulatory and supervisory architecture, and its main pitfalls. This sets the ground for the third part of this chapter, which examines the EU regulatory response in the aftermath of the GFC, primarily focused on reshaping the EU banking supervision through a continuous process of legislative initiatives. It should be noted that this thesis focuses on the legal implications of the GFC, while the economic factors involved are not thoroughly examined as they exceed the scope of this analysis.

At the heart of the EU regulatory response to the financial crisis was the De Larosière Report, which signalled the start of the most important financial integration project in the history of the EU. Hence, the following analysis places particular emphasis on the supervisory architecture, centred by the European System of Financial Supervisor (ESFS), as crystallised by the De Larosière Report and the applicable legislative acts. The main aim of this analysis is to examine the functioning of the ESFS, by observing its institutional operation and exploring the salient features that provided the basis for the ultimate decision of centralising banking supervision at EU level. It should be noted, that the discussion touches upon the Capital Requirements Directive amendments, but only to the extent that it contributes to the analysis of the legal framework of EU banking regulation and supervision.

### 3.2 The historical evolution of EU banking services integration

Financial integration constituted one of the main objectives of the EU policymakers from the initial idea of creating a European Single Market to the first efforts of its implementation. It is worth mentioning that the European Single Market (also known as common market or internal market) rests on four pillars: the free movement of goods, persons, services and capital between Member States; and it is defined by the EU Commission

website as following: *“the Single Market refers to the EU as one territory without any internal borders or other regulatory obstacles to the free movement of goods and services. A functioning Single Market stimulates competition and trade, improves efficiency, raises quality, and helps cut prices. The European Single Market is one of the EU’s greatest achievements. It has fuelled economic growth and made the everyday life of European businesses and consumers easier.”*<sup>627</sup>

The starting point and the foundation of the subsequent regulatory response is the Treaty of Rome of 1957,<sup>628</sup> which laid down the legal foundation for the creation of a Single Market in Europe and it also introduced the fundamental EU principles (or 'four freedoms'), including the free movement of capital, goods, services and people. Nevertheless, the meaning of financial integration in the 1950s was far from what we anticipate today as financial integration. In fact, the main goal of the Treaty of Rome was to transform the highly segmented Member States’ domestic markets into a single unified market, whilst financial integration meant primarily, the elimination of trade barriers and the creation of a customs union.<sup>629</sup> The actual achievement of this goal was accomplished by the recognition of the right of establishment and the coordination of national legislation.<sup>630</sup> The relevant provisions on the right of establishment and the free movement of services were also supported by a General Programme for the abolition of restrictions on freedom of establishment<sup>631</sup> and free movement to provide services,<sup>632</sup> which resulted subsequently into a Council Directive.<sup>633</sup> In sum, during the 1950s, the six founding countries that established the ECSC, created two distinct paths to financial integration. The first path, as analysed in chapter one, involved the

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<sup>627</sup> See: EU Commission Website <[https://ec.europa.eu/growth/single-market\\_en](https://ec.europa.eu/growth/single-market_en)> accessed 14 July 2017.

<sup>628</sup> TEC (n 193).

<sup>629</sup> Egan, Michelle P., *Constructing a European Market: Standards, Regulation, and Governance* (Oxford University Press 2001) 1.

<sup>630</sup> Dermine, Jean, ‘European Banking, Past, Present and Future’ (Second ECB Central Banking Conference, Frankfurt, 24-25 October 2002) <[https://www.ecb.europa.eu/events/pdf/conferences/dermine\\_comp.pdf](https://www.ecb.europa.eu/events/pdf/conferences/dermine_comp.pdf)> accessed 14 July 2017.

<sup>631</sup> General Programme for the abolition of restrictions on freedom of establishment [1962] OJ 2/36 (English Special Edition: Series II Volume IX, 7).

<sup>632</sup> General Programme for the abolition of restrictions on freedom to provide services [1962] OJ 2/32 (English Special Edition: Series II Volume IX, 3-6).

<sup>633</sup> ‘First Council Directive 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions’ [1973] OJ L 194/1.

creation of EEC and abolition of obstacles for the free movement of goods mainly in agriculture products, whereas monetary integration remained undeveloped at EU level.

Although there is no a generally accepted or explicit definition to address the notion of financial integration, the modern perception of what financial integration entails, focuses on a more holistic approach.<sup>634</sup> Simply put, financial integration could be defined as the situation where financial markets in regional or global level are closely connected with each other. At EU level, the ECB has defined financial integration as the situation whereby all the potential participant in a market of a given set of financial instruments or services are: “(i) subject to a single set of rules when they decide to deal with those financial instruments or services, (ii) have equal access to this set of financial instruments or services, and (iii) are treated equally when they operate in the market.”<sup>635</sup> Also, the ECB highlighted that financial integration constitutes a key component for the smooth conduct of monetary policy, the general economic policy of the EU and the promotion of financial stability.<sup>636</sup>

European financial systems are mainly bank-based, which is evident by the fact that stock and bond markets provide a relatively modest share of the financing to the private sector in the majority of the Member States.<sup>637</sup> Therefore, the implementation of common rules on banking regulation and supervision, as already highlighted, was always an integral part of the financial integration process. Hence, it is hardly surprising that the four freedoms (i.e. free movement of capital, people, goods and services) introduced by the Treaty of Rome, constituted the basis for the adoption of the subsequent free movement of banking services and the right for establishment for financial institutions. Additionally, during the early 1960s, banking regulation and supervision were subject to an active debate at EU level. An early instance of the attempt to address the integration of financial regulation and supervision at

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<sup>634</sup> Di Gennaro, Luca, ‘What exactly is financial integration? A household approach,’ in Marques, Helena, Soukiazis, Elias and Cerqueira, Pedro (eds), *Perspectives on Integration and Globalisation* (Deutsche Nationalbibliothek 2008) 148.

<sup>635</sup> ‘Financial integration in Europe’ (ECB, March 2007) 5 <<http://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope200703en.pdf?560fd6751ed5d9dce1609c35e594616d>> accessed 14 July 2017.

<sup>636</sup> ECB, March 2007 (n 639) 6.

<sup>637</sup> See: Enoch, Charles, Everaert, Luc, Tressel, Thierry, Zhou, Jian-Ping (eds) *From Fragmentation to Integration in Europe* (International Monetary Fund 2014) 55-56.

EU level was the Report of a Group of Experts (commonly known as Segre Report),<sup>638</sup> which was appointed by the EEC Commission in 1966 to study the process of establishment of a European Capital Market.<sup>639</sup> Segre Report examined all aspects of capital markets and called for implementation of common rules and practices in banking regulation and supervision, by also highlighting the need for *“certain adjustments in the way economic policies of Member States are applied.”*<sup>640</sup> It should be noted here that Segre Report, although chaired by Claudio Segre, who was a representative of the EEC Commission, did not represent an official Commission Policy. It rather constituted a study created with the aim to give an overall view of the objectives, methods and implications of the establishment of a European Capital Market. Also, as it was stated by the EEC Commission, the Segre Report: *“was commissioned because of the difficulties encountered in the efforts to make further progress through directives based on Article 67”* and it *“formed the basis for discussions among the Common Market’s six members (at the time) measures on measures to be taken.”*<sup>641</sup>

The EEC Commission’s response to Segre Report, was a series of working documents, aiming at producing a Directive that would promote harmonisation of banking regulation and supervision. These attempts resulted in a draft Directive proposed by the Commission in 1972, which introduced the ambitious idea of creating a Single Banking Market at one stroke; where the financial institutions would be regulated by the home state rather than the host state authorities and the national authorities would have to closely cooperate.<sup>642</sup> Europe, still at a premature stage of banking integration, did not welcome the idea of centralising banking regulation and supervision at European level. As a result, the Commission withdrew the draft Directive, while it became evident that the creation of a fully-fledged single banking market

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<sup>638</sup> Segre, Claudio, ‘The development of a European capital market’ (1966) Report of a Group of Experts appointed by the EEC Commission, EU Commission Working Document (hereinafter: Segre Report) <[http://aei.pitt.edu/31823/1/Dev\\_Eur\\_Cap\\_Mkt\\_1966.pdf](http://aei.pitt.edu/31823/1/Dev_Eur_Cap_Mkt_1966.pdf)> accessed 14 July 2017.

See also: Maes, Ivo, *Half a Century of European Financial Integration: From the Rome Treaty to the 21st Century* (Brussels: Mercatorfonds 2007) 29-31.

<sup>639</sup> On Commission’s response on Segre Report see:

- ‘EEC Realised study on Unified Capital Market’ (Commission, Press Release, 24 January 1967) <[http://aei.pitt.edu/54688/1/Press\\_Release\\_1.24.67.pdf](http://aei.pitt.edu/54688/1/Press_Release_1.24.67.pdf)> accessed 14 July 2017; and
- ‘Information Memo P-36/67’ (Commission, June 1967) <[http://aei.pitt.edu/29848/1/P\\_36\\_67.pdf](http://aei.pitt.edu/29848/1/P_36_67.pdf)> accessed 14 July 2017.

<sup>640</sup> Commission, June 1967 (n 643).

<sup>641</sup> Commission, June 1967 (n 643).

<sup>642</sup> Story, Jonathan, and Walter, Ingo, *Political Economy of Financial Integration in Europe: The Battle of the Systems* (The MIT Press 1997) 14.



would require more time and a step-by-step approach.<sup>643</sup> What came into being instead, was the Council Directive of 1973,<sup>644</sup> which required the Member States to comply with the national treatment principle, which entailed an obligation for equal regulatory and supervisory treatment of both foreign and domestic financial institutions.<sup>645</sup>

Notably, by 1973, discriminatory restrictions on freedom of establishment and freedom to provide services were strictly prohibited among EU Member States. In addition, an ambitious transitional period of twelve year to the fully establishment of the Single Market (to be completed by 1969) was set by the Treaty of Rome.<sup>646</sup> Therefore, one would expect that Europe was moving fast towards tighter integration. However, a truly unified single market for banking services in Europe was still an aspirational objective. In fact, capital controls, major disparities and a general lack of coordination in both banking regulation and supervision among Member States persisted for many years to follow,<sup>647</sup> while regulation continued to be narrowly defined by national boundaries. There are a number of factors that may potentially explain this rather slow progress. Among the rest, it was believed that the process toward harmonisation of rules throughout Europe could have been easier through a positive integration approach, whereas the Treaty of Rome took a rather negative integration approach that involved strategies such as the prohibition of discrimination of foreign goods, services and so forth.<sup>648</sup> Also, strict customs and capital remained a necessity due to different domestic laws and regulations in areas such as food safety and hygiene.<sup>649</sup>

In summary, although the adoption of common rules in banking practices has been part of the European policymaking agenda long before their introduction, the Member States were reluctant in unifying and centralising their practices in banking matters. This explains why the early banking measures came in the legislative form of Directive, which entails a

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<sup>643</sup> Dragomir, Larisa, *European Prudential Banking Regulation and Supervision: The Legal Dimension* (Reissue edition, Routledge 2012) 67.

<sup>644</sup> Directive 73/183/EEC (n 637).

<sup>645</sup> Dermine (n 634) 6.

<sup>646</sup> TEC (n 193) Article 8(1).

<sup>647</sup> Dermine (n 634) 6.

<sup>648</sup> Barnard, Catherine and Scott, Joanne (eds), *The Law of the Single European Market: Unpacking the Premises* (2nd edn, Hart Publishing 2002) 3.

<sup>649</sup> 'Historical events in the European integration process (1945–2014)' (Centre Virtuel de la Connaissance sur l'Europe) <<http://www.cvce.eu/en/recherche/unit-content/-/unit/02bb76df-d066-4c08-a58a-d4686a3e68ff/fc955c85-4a39-4187-9ae7-935d67d1656b>> accessed 14 July 2017.

certain level of flexibility.<sup>650</sup> The choice of Directives was specified in a number of occasions, including the declaration on Article 101a, TEC in the context of the SEA, in which it was defined that: “*the Commission shall give precedence to the use of the instrument of a directive.*”<sup>651</sup> Also, in the Treaty of Amsterdam it was specified that: “*directives should be preferred to regulations and framework directives to detailed measures.*”<sup>652</sup> This clearly indicates a willingness to leave some space of discretion at national level, since Directives are not directly applicable and are binding only as to the result to be achieved, allowing the Member States to retain discretion of choice as to the actual form and methods for their implementation in accordance to their local conditions.<sup>653</sup> The stringency of Directives was even considered to have been “*watered down to make them politically acceptable.*”<sup>654</sup> However, it is worth stressing that according to the ECJ there might be cases where Directives are directly applicable.<sup>655</sup> For instance, in Van Duyn Case in 1974, the ECJ held that Directives can have a directly applicable effect.<sup>656</sup> On the other hand, Regulations have general application and binding power in their entirety, and are also directly applicable in all Member States.<sup>657</sup> However, the use of Directives and their inconsistent implementation in a rapidly changing financial market was considered as one of the reasons that weakened financial integration.<sup>658</sup>

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<sup>650</sup> Norton, Joseph J., ‘The European Community Banking Law, Paradigm: A Paradox in Bank Regulation and Supervision - Reflections on the E. C. Second Banking Directive’ in Norton, Joseph J., Cheng, Chia-Jui and Fletcher I. (eds) *International Banking Regulation and Supervision: Change and Transformation in the 1990s* (Kluwer Law International 1994).

<sup>651</sup> SEA (n 225).

<sup>652</sup> ‘Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts’ [1997] OJ C 340/1, recital 6.

<sup>653</sup> TFEU (n 5) Article 288 (ex-Article 249 TEC).

<sup>654</sup> Pelkmans, Jacques, *Market integration in the European Community* (Martinus Nijhoff Publishers 1984) 183.

<sup>655</sup> For more on the direct effect of Directives see:

- Hartley T. C., *The Foundations of European Union Law* (7<sup>th</sup> edn, Oxford University Press 2010) 218-255
- Schütze, Robert, *European Union Law* (Cambridge University Press 2015) 95-103; and
- Wyatt, Derrick, ‘The Direct Applicability of Regulations and Directives’ (1977) 36 (2) *The Cambridge Law Journal*.

<sup>656</sup> Case C-41/74 *Yvonne Van Duyn v. Home Office* [1974] ECR 1337.

<sup>657</sup> TFEU (n 5) Article 288 (ex-Article 249 TEC).

<sup>658</sup> See:

- Kalemli-Ozcan, Sebnem, Papaioannou, Elias and Peydró, José-Luis, ‘What lies beneath the euro's effect on financial integration? Currency risk, legal harmonization, or trade?’ (ECB Working Paper No 1216, June 2010)  
<<https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1216.pdf?a7527dddb97762eb88042775ee22c4dc>> accessed 14 July 2017.
- Grossman, Emiliano, and Leblond, Patrick, ‘European Financial Integration: Finally the Great Leap Forward?’ (2011) 49 (2) *Journal of Common Market Studies* 413.

Despite the choice of legal instrument (Directives over Regulations) as the means to harmonise rules and practices among Member states, the process towards the completion of a Single Market for banking services was rather slow. As Gaul argued, the banking industry is heavily regulated, thus, the liberalisation of trade and cross-border investment of banking services might prove to being extremely challenging.<sup>659</sup> Hence, national peculiarities and divergent regulatory practices persisted, while the fragmentation of European financial markets remained the rule. This was highly contradictory with the increasing expansion of cross-border banking activity internationally, and the growing size and importance of major European banks.<sup>660</sup> This slow progress was also linked with international events that were taking place in a parallel pace. Namely, the two severe oil crises and the collapse of the Bretton Woods system, found Europe of the late 1970s under the largest macroeconomic instability, with increased inflation and unemployment rates.<sup>661</sup> Notably, the period from 1970-1985 is known as “Eurosclerosis,” which represents the years of European stagnation and was characterised by a lack of desire on part of the Member States to furthering the integration process.<sup>662</sup>

The shifting point came during the late 1970s, with the emergence of a positive attitude and an increasing willingness of the Member States to cooperate at European level. This trend was illustrated in numerous legislative measures that followed, aiming to facilitate further financial integration and to promote a higher level of harmonisation in banking regulation and supervision. The key initiatives that significantly contributed throughout this process from the late 1970s until the hit of the GFC, were, in chronological order, the following:

1. The First Banking Directive,<sup>663</sup> was adopted in 1977 after twelve years of negotiations,<sup>664</sup> constituting the first major step towards the creation of Single Market in banking services.<sup>665</sup>

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<sup>659</sup> Gaul, Jordi, ‘The integration of EU banking markets’ (2004) CEPR Working paper No 4212, 2.

<sup>660</sup> Enoch et al (n 641) 57.

<sup>661</sup> Weiss, Friedl and Kaupa, Clemens, *European Union Internal Market* (Cambridge University Press 2014) 7-8.

<sup>662</sup> Kaczorowska (n 234) 13.

<sup>663</sup> ‘First Council Directive 77/780/EEC of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-Up and Pursuit of the Business of Credit Institutions’ [1977] OJ L 322/30 (hereinafter: First Banking Directive).

<sup>664</sup> De Meester, Bart, *Liberalization of Trade in Banking Services: An International and European Perspective* (Cambridge University Press 2014) 270.

<sup>665</sup> Mohamed, Sideek, *European Community Law on the Free Movement of Capital and EMU* (Brill 1999) 189.

The main aim was to create: “a system whereby credit institutions having their head office in one of the Member States are exempt from any national authorisation requirement when setting up branches in other Member States.”<sup>666</sup> The legal basis of the First Banking Directive was Article 57(2) of TEC (now Article 53, TFEU) and provided for elimination of trade barriers and coordination in banking supervision. Closer cooperation was to be promoted through a newly established Bank Advisory Committee, which would be composed of three representatives of central banks, NCAs and finance ministers from each Member State as well as of three representatives from the Commission.<sup>667</sup>

However, the First Banking Directive was not ground-breaking, in a sense that it did not provide with any innovative harmonisation tools exceeding the scope and effect of the four EU freedoms.<sup>668</sup> In fact the aim was to facilitate the extension of the four EU freedoms as set by the Treaty of Rome. Credit institutions were still required to obtain authorisation before commencing their activities, subject to the host’s state national regulation and supervision legislation.<sup>669</sup> Moreover, the First Banking Directive did not require the Member States to recognise authorisation licences obtained in another Member State, which posed serious branching restrictions and constrains in cross-border activity.<sup>670</sup> As it was stated from the ECJ in 1995: “*The First Banking Directive was no more than a first step, however, towards the mutual recognition by Member States of authorizations issued by each of them to credit institutions.*”<sup>671</sup> The only exception to the entry authorisation rule was that authorisation was to be evaluated on the basis of the economic needs of the market.<sup>672</sup>

2. The White Paper from the EU Commission in 1985<sup>673</sup> laid down the program and timetable for the completion of a Single Market for Europe,<sup>674</sup> and it is considered one of the most important milestones of European integration. As it was stated in 1985 at the monthly Bulletin

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<sup>666</sup> First Banking Directive (n 667) pmb. recital 10.

<sup>667</sup> First Banking Directive (n 667) Article 11.

<sup>668</sup> De Meester (n 668) 270.

<sup>669</sup> First Banking Directive (n 667) Article 3 (1) (2).

<sup>670</sup> Matthews, Barbara C., ‘The Second Banking Directive: Conflicts, Choices, and Long-Term Goals’ (1992) 2 (1) Duke Journal of Comparative & International Law.

<sup>671</sup> Case C-222/95 *Societe civile immobiliere Parodi v. Banque H. Albert de Bary et Cie* [1997] ECR I-03899, para 24.

<sup>672</sup> First Banking Directive (n 667) Article 3.

<sup>673</sup> Commission, ‘Completing the Internal Market’ COM (85) 310 final (hereinafter: White Paper).

<sup>674</sup> White Paper (n 677) paras 1-3.

of the European Communities, the White Paper: *“was the first priority of the present Commission, and was perhaps the major achievement required of the Commission during its term of office; if the programme succeeded, it would fundamentally alter the face of Europe.”*<sup>675</sup> The main objective of completing a Single Market for Europe, was illustrated in over 300 legislative proposals, including measures to eliminate a series of physical, technical and fiscal non-tariff barriers. The White Paper developed a “new approach” and a “new strategy” towards the completion of the Single Market. The “new approach” raised the question of how true harmonisation could be accomplished. On the other hand, the “new strategy” entailed a process of choosing between the principles of harmonisation and mutual recognition.<sup>676</sup> This is not to say that the principle of mutual recognition replaced the principle of harmonisation, but it was rather that the former was to be applied in case the latter was not deemed necessary. Harmonisation, for instance, was considered to be still necessary in areas such as safety, public health, environmental, consumer protection and so forth. In fact, the principle of harmonisation was regarded as *“the cornerstone of Community action in the first 25 years”* and as a principle that *“has produced unprecedented progress in the creation of common rules on a Community-wide basis.”*<sup>677</sup> However, the Commission acknowledged the fact that the harmonisation principle had proven to be, in many respects, impractical and cumbersome in furthering European integration towards the creation of a truly unified Single Market by 1992.<sup>678</sup> As Leleux was arguing in the late 1960s: *“Harmonization presents very great difficulties when the actions of the authorities in the various countries are based on different ideas, and even if harmonization is achieved, the disadvantages of having parallel but multiple procedures that have to be gone through are obvious.”*<sup>679</sup>

In the context of banking regulation, the White Paper set out three main principles: mutual recognition of financial standards,<sup>680</sup> according to which the member states should recognise and trust each other’s regulatory regimes and practices,<sup>681</sup> minimum

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<sup>675</sup> ‘The completion of the internal market by 1992’ (Volume 18, No 6, EC Bulletin, 1985) 18.

<sup>676</sup> White Paper (n 677) 58, 61, 65, 77, 79.

<sup>677</sup> White Paper (n 677) para 61.

<sup>678</sup> White Paper (n 677) paras 61 and 67-68.

<sup>679</sup> Leleux, Paul, ‘Corporation Law in the U.S. and in the EEC’ (1967-1968) 133 *Common Market Law Review*.

<sup>680</sup> For an extensive analysis of the principle of mutual recognition see: Janssens, Christine, *The Principle of Mutual Recognition in EU Law* (Oxford University Press 2013).

<sup>681</sup> Zavvos, George, ‘Banking Integration in the European Community’ (1989) 9 (3) *Northwestern Journal of International Law & Business*, 573-574.

harmonisation, which aimed in setting minimum standards to be adopted at national level by the Member States (i.e. elimination of barriers); and the principle of home country control, according to which financial institutions were to be supervised by the home state.<sup>682</sup> Originally these principles were explicitly based on the landmark ruling of ECJ in Cassis de Dijon,<sup>683</sup> which drew on the reasoning of Dassonville case.<sup>684</sup>

In the Cassis de Dijon, it was found that Germany could not prohibit the import of liquor from France, where it was legally manufactured and sold, on the basis that the alcoholic content was too low to be considered as liquor under German national legislation. In the Dassonville ruling in 1974 it was held *inter alia* that all measures having effects equivalent to quantitative restrictions on trade between Member States were prohibited in accordance to Article 34, TFEU. This was also known as the ‘Dassonville formula,’ which accorded a wide definition to measures having equivalent effect to quantitative restrictions and paved the way for future very broad interpretations. However, despite the fact that both Cassis de Dijon and Dassonville cases were related only to the free movement of goods, their reasoning was followed in the White Paper, where it was highlighted that: “...*the general principle should be approved that, if a product is lawfully manufactured in one Member State, there is no reason why it should not be sold freely throughout the Community...What is true for goods, is also true for services and people.*”<sup>685</sup> The same principles were considered to be also applicable to

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<sup>682</sup> White Paper (n 677) paras 101-103. The principle of home country control was also included in:

- First Banking Directive (n 667) 16;
- ‘Second Council Directive 89/646/EEC of 15 December 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC’ [1989] OJ L386/1, 1 (hereinafter: Second Banking Directive); and
- ‘Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions’ [2000] OJ L 126/1, 1 (hereinafter: Codified Banking Directive).

See also the following ruling: Case C-222/02 Peter Paul, Cornelia Sonnen-Lütte and Christel Mörkens v Bundesrepublik Deutschland [2004] ECR I – 9460.

<sup>683</sup> Case C-120/78 *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein* [1979] ECR 1979-00649 (hereinafter: Cassis de Dijon). For a detailed analysis of the ruling of Cassis de Dijon see: Pelkmans, Jacques, ‘The New Approach to Technical Harmonization and Standardization’ (1987) 25 (3) *Journal of Common Market Studies*, 249.

<sup>684</sup> Case C-8/74 *Procureur du Roi v Benoît and Gustave Dassonville* [1974] ECR 1974 -00837 (hereinafter: Dassonville case).

For an analysis on the Dassonville case see: Pelkmans, Jacques, ‘Mutual Recognition in Goods and Services: An Economic Perspective’ (European Network of Economic Policy Research Institutes, Working Paper No. 16, 2003) 5 <[http://aei.pitt.edu/1852/1/ENEPR1\\_WP16.pdf](http://aei.pitt.edu/1852/1/ENEPR1_WP16.pdf)> accessed 14 July 2017.

<sup>685</sup> White Paper (n 677) para 58.

the free movement of financial services, for which specific reference was made.<sup>686</sup> It is worth noting that these three principles did not obtain a legal basis in the Treaty, but could only be identified in secondary EU law.<sup>687</sup>

In general, the White Paper was welcomed and well-received, by most of the Member States, apart from Denmark, Greece and the UK that expressed their opposition. This led to Intergovernmental Conferences held in Luxemburg and Brussels during late 1985 that resulted in the adoption of the SEA in 1986,<sup>688</sup> which introduced the most important amendments of the Treaties since their adoption.<sup>689</sup>

3. The Second Banking Directive, was a key legislative act towards the creation of a single banking market for Europe, which was proposed by the EU Commission in 1987<sup>690</sup> and finally adopted by the EU Council in 1989.<sup>691</sup> The Second Banking Directive was considered to be: *“the essential instrument for the achievement of the internal market, a course determined by the Single European Act and set out in timetable form in the Commission's White Paper, from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions.”*<sup>692</sup> It is important to note that while the Second Banking Directive amended, to a great extent, the First Banking Directive, the latter was still applicable.

The Second Banking Directive was highly based on the principles set by the White Paper, including minimum harmonisation, mutual recognition and home country control. One of the most innovative aspects of the Second Banking Directive was the introduction of the ‘single banking licence,’ which provided for free movement of financial services and the right to establish local branches on the basis of the home state’s authorisation.<sup>693</sup> The ‘single banking licence’ came to change dramatically the dynamics in the EU financial services

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<sup>686</sup> White Paper (n 677) para 102.

<sup>687</sup> Dragomir (n 647) 74.

<sup>688</sup> SEA (n 225).

<sup>689</sup> On the Single European Act see: Kaczorowska (n 234) 16-19.

<sup>690</sup> Commission, ‘Proposal for a Second Banking Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC’ COM (87) 715 final.

<sup>691</sup> Second Banking Directive (n 686).

<sup>692</sup> Second Banking Directive (n 686) pmb. recital 5.

<sup>693</sup> Second Banking Directive (n 686) Article 23.

market, by allowing a financial institution that had obtain authorisation, in a Member States to freely operate in any other Member State without entry authorisation and only subject to notification requirements.<sup>694</sup> The single banking licence is also known as the principle of freedom of establishment or the ‘passporting principle’. It is worth mentioning that the meaning of ‘authorisation’ was defined by Article 1, First Banking Directive, as: “*an instrument issued in any form by the authorities by which the right to carry on the business of a credit institution is granted;*” and it was also adopted in an identical manner by the Second Banking Directive, as explicitly defined in Article 1(2). The main objective of the ‘single banking licence’ was to strengthen the cross-border financial activity by enabling the easy establishment of the financial institutions across Member States and by limiting at the same time the barriers at national level.<sup>695</sup>

The rationale of the ‘single banking licence’ was based on the model of the ‘universal bank’ and the mutual recognition of national licences.<sup>696</sup> This ended the tradition of host-state control over branches and enabled the open operation of banking services throughout Europe based on home state authorisation. Furthermore, it is widely acknowledged that the establishment of the ‘single banking licence’ resulted in an extensive increase of cross-border banking activity across Europe, which was intensified by a growing number of cross-border mergers and acquisitions.<sup>697</sup> Yet, this was not an immediate process but it rather took shape over the years and in accordance to the domestic law of each country, the type of institution’s activity, and the cooperation ability of the particular institution.<sup>698</sup>

The slow pace of this process is to be partly attributed to the fact that, the ‘single banking licence’ while it was based on the model of ‘universal bank,’ did not create a uniform body of banking law for Europe, but only a mere obligation of the Member States to mutually

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<sup>694</sup> Second Banking Directive (n 686) Article 6 and Article 18 (1). For the notification requirement see: Second Banking Directive (n 686) Article 19 and 20.

<sup>695</sup> Dixon, Rod, *Banking in Europe: The Single Market* (Routledge 1992) 58-62.

<sup>696</sup> For a detailed analysis on the single banking licence see:

Gruson, Michael and Feuring, Wolfgang, ‘A European Community Banking Law: The Second Banking and Related Directives’ in Cranston, Ross (ed) *The Single Market and the Law of Banking Hardcover* (2<sup>nd</sup> rev edn, LLP Professional Publishing 1995).

<sup>697</sup> Dermine, Jean, ‘European Banking Integration: Don’t Put the Cart before the Horse’ (INSEAD, Fontainebleau, 17 September 2005), 9 <<http://faculty.insead.edu/jean-dermine/documents/Chicago2005DermineDraftII.pdf>> accessed 14 July 2017.

<sup>698</sup> Lastra, Rosa Maria, *Central Banking and Banking Regulation* (Financial Market Group-London School of Economics and Political Sciences 1996) 225-228.



recognise the laws and licences from other Member States.<sup>699</sup> There were still divergences on national laws and licenses and most importantly, fundamental limitation on the freedom of establishment, with the host country retaining a significant degree of control over financial institutions operating within its territory. This was also envisaged by the White Paper, which explicitly suggested that national laws and licenses would remain divergent, whereas supervisory standards were to be harmonised at national level and thus, driven by the home country control principle.<sup>700</sup> Thus, foreign financial institutions would still remain subject to host country's capital requirements and other financial regulation measures. Moreover, the 'single banking licence' was not applicable to subsidiaries, which were subject to licencing requirements and prudential supervision rules of the competent authority of the host state.<sup>701</sup> The main right granted to financial institutions or banking group in the host state, was that their subsidiaries were subject to the same laws and principles applicable to the domestic financial institutions, which was also based on the principles of non-discrimination, proportionality and necessity.<sup>702</sup>

With regards to banking supervision, the Second Banking Directive provided that it would be subject to the principles of home country control and mutual recognition.<sup>703</sup> This practically meant that supervision remained a responsibility of the competent authorities of the home state. Namely, the host state was responsible to supervise the liquidity requirement of banks, in close cooperation with the competent authorities of the home state.<sup>704</sup> Also, the establishment of subsidiaries to the host state was forbidden and the host country could oblige a financial institution or an investment firm to comply with regulatory provisions that were adopted in the interest of the general good.<sup>705</sup> These two principles remained for a long time at the heart of EU policymaking towards the completion of a single market for financial

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<sup>699</sup> Gruson, Michael and Nikowitz, Werner, 'The Second Banking Directive of the European Economic Community and Its Importance for Non-EEC Banks' (1988) 12 (2) *Fordham International Law Journal* 205, 210-211.

<sup>700</sup> See: White Paper (n 677) paras 101-103.

<sup>701</sup> De Haan, Jakob, Oosterloo, Sander and Schoemaker, Dirk. (2009) *European Financial Markets and Institutions* (Cambridge University Press 2009) 48.

<sup>702</sup> For the interpretation of the principle of proportionality and the necessity of its application to the subsidiaries at the host states, see the following ruling of the ECJ: Case C-442/02 *Caixa-Bank France v. Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-08961. See also: Emiliou, Nicholas, *The Principle of Proportionality in European Law, A Comparative Study* (1<sup>st</sup> edn, Kluwer Law International 1996).

<sup>703</sup> Second Banking Directive (n 686) Articles 13 and 15

<sup>704</sup> Second Banking Directive (n 686) Article 14.

<sup>705</sup> Second Banking Directive (n 686) Article 19 (4) and Article 21 (5) (11).

services.<sup>706</sup> As mentioned earlier, the principle of harmonisation was only applicable on those components of prudential regulation where convergence was considered to be vital. More substantial harmonisation requirements came with the adoption of two more Directives in 1989: the Own Funds Directive<sup>707</sup> and the Solvency Ratio Directive.<sup>708</sup> These Directives, drawing largely on the provisions of Basel I on international banking capital adequacy,<sup>709</sup> introduced a minimum ratio of 8% of eligible capital to weighted risk assets. The Second Banking Directive, Own Funds Directive and Solvency Directives – also known as the minimum package – set the scene for the creation of a Single EU banking market, starting with the entry into force of the Second Banking Directive on 1 January 1993 onwards.<sup>710</sup> It is also worth mentioning that at the same period of time, the EU banking legislation framework was enriched by two more directives: the Large Exposures Directive,<sup>711</sup> and the Consolidated Banking Directive.<sup>712</sup>

3. The Maastricht Treaty, which has been of central importance for furthering the integration of financial regulation and supervision at EU level. Although “*full integration of banking and other financial markets*,”<sup>713</sup> was envisaged earlier by the Delors Report, the Maastricht Treaty provided the mechanisms for its practical implementation, including the introduction of the euro and the legal basis for the ESCB. The era after the Maastricht Treaty was characterised by a prominent priority given to the financial markets integration and the full liberalisation of the movement of capital. Furthermore, as already stressed, banking integration took place in parallel with international developments, especially with the growing attempt of the BCBS to set harmonisation rules and convergence of prudential standards at international level. Thus, the BCBS initiatives, as discussed in chapter one, have also contributed in triggering the need for further harmonisation, convergence of practices and the centralisation of rules at EU level.

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<sup>706</sup> De Meester (n 668) 273.

<sup>707</sup> Own Funds Directive (n 347).

<sup>708</sup> Solvency Ratio Directive (n 347).

<sup>709</sup> Basel I (n 344).

<sup>710</sup> Clarotti, Paolo, ‘The implementation of Second Banking Directive’ in Wymeersch, Eddy (ed) *Further Perspective in Financial Integration in Europe: Reports Presented at the Brussels meeting of the International Faculty for Corporate Market Law and Securities Regulations 26 – 30 April 1993* (De Gruyter 1994) 49.

<sup>711</sup> ‘Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions’ [1992] OJ L 29/1 (hereinafter: Large Exposures Directive).

<sup>712</sup> ‘Council Directive 92/30/EEC of 6 April 1992 on the Supervision of Credit Institutions on a Consolidated Basis’ [1992] OJ L 110/52.

<sup>713</sup> The Delors Report (n 54) para 22.

In addition, as we mentioned, in chapter one the guidelines of the BCBS have been influential into reshaping EU banking regulation. However, as already analysed, the overall process towards furthering financial integration at EU level was rather slow and dominated by the principle of home country control. It was only after the completion of the internal market in 1992 that discussions on changing some aspects of the home country control started to emerge.

As mentioned in chapter one and two, the Maastricht Treaty explicitly defined the objective of ECB, by providing a clear priority to its price stability mandate. However, this is not to say that regulation and supervision were not envisaged within the ECB's set of objectives. In fact, there was a direct reference in Article 105(6) of Maastricht treaty (current: Article 127, TFEU), leaving a window open to the possibility of granting supervisory powers to the ECB. As we will discuss in detail in chapter four, it was indeed, Article 127, TFEU that would serve, at a later stage, as the legal basis for the centralisation of banking supervision at EU level.

4. Another key component of banking markets' integration was the Financial Services Action Plan (FSAP). The FSAP was created in May 1999 and contained a number of measures aiming to establish a fully-fledged European banking and capital market.<sup>714</sup> The process towards the creation of FSAP started with the European Council held in Cardiff in 1998 that called the EU Commission to create a framework for action in order: *"to improve the single market in financial services, in particular examining the effectiveness of implementation of current legislation and identifying weaknesses which may require amending legislation."*<sup>715</sup> The EU Commission as a response, adopted a framework for action,<sup>716</sup> which was welcomed by the EU Council held in Vienna in December 1998. As it was stated by the EU Council: *"It therefore welcomes the Commission's initiative for a framework for action and the establishment of a High-Level Group. It asks for a Council report to the European Council in Cologne on the*

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<sup>714</sup> Commission, 'Financial Services: Implementing the Framework for Financial Services Markets: Action Plan' (Communication) COM (1999) 232 final (hereinafter: FSAP) <<http://eur-lex.europa.eu/legal-content/PL/TXT/?uri=uriserv:l24210>> accessed 14 July 2017.

<sup>715</sup> 'Presidency Conclusions of Cardiff European Council on 15 and 16 June 1998' para. 17 <[http://www.europarl.europa.eu/summits/car2\\_en.htm?textMode=on](http://www.europarl.europa.eu/summits/car2_en.htm?textMode=on)> accessed 14 July 2017.

<sup>716</sup> Commission, 'Financial Services: Building a Framework of Action' (Communication) COM (98) 625 final.

*necessary steps towards a single financial market. It also underlines the necessity of maintaining a high level of consumer protection.”*<sup>717</sup>

Furthermore, the FSAP was approved by the Lisbon European Council in 2000, in which it was stressed that there was a need to undertake all the steps necessary for the implementation of FSAP by 2005.<sup>718</sup> One of the core objectives of the FSAP, was to strengthen further the integration of financial markets and the abolitions of the remaining barriers in all financial services across Europe, without focusing explicitly on a particular market (such as banking for instance).<sup>719</sup> For the accomplishment of this objective, the FSAP provided a timetable for specific measures to achieve three strategic objectives, including: a) a single market in wholesale financial services; b) open and secure retail markets and c) stronger rules on prudential supervision.<sup>720</sup>

As a result of these legislative acts altogether, the process of financial markets integration expanded, and the EU regulatory framework progressively started to take shape on the basis of convergent standards and harmonised rules. This in turn, led to the creation of a highly interlinked system, which apart from changing rapidly, had started to show signs of dependency, influence and interconnection, and had the potential to develop risks with widespread cross-border effects. The harmonisation process in regard to supervision, was still at an infant stage, since the Member States retained the power to regulate the operation of financial institutions, while the NCAs were responsible for the supervision of banks across the EU.<sup>721</sup> This was to be attributed to the prevalence of mutual recognition and home country control principles, which seemed to have been lacking the ability to facilitate further integration towards the creation of a fully-integrated banking market.<sup>722</sup>

This reluctant approach towards regulatory harmonisation became subject to criticism, with many arguing that the extensive freedom given to the NCAs, would eventually

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<sup>717</sup> See: ‘Presidency Conclusion of Vienna European Council on 11 and 12 December 1998’ para. 51 <[http://www.europarl.europa.eu/summits/wie1\\_en.htm](http://www.europarl.europa.eu/summits/wie1_en.htm)> accessed 14 July 2017.

<sup>718</sup> ‘Presidency Conclusions of Lisbon European Council on 24 and 24 March 2000’ para. 21 <[http://www.europarl.europa.eu/summits/lis1\\_en.htm](http://www.europarl.europa.eu/summits/lis1_en.htm)> accessed 14 July 2017.

<sup>719</sup> ECOFIN, 2283rd Council meeting in Brussels, 17 July 2000 <[http://europa.eu/rapid/press-release\\_PRES-00-263\\_en.htm?locale=en](http://europa.eu/rapid/press-release_PRES-00-263_en.htm?locale=en)> accessed 14 July 2017.

<sup>720</sup> FSAP (n 718) summary.

<sup>721</sup> ‘European Monetary Union and Banking Supervision’ (ECB, Monthly Bulletin 2000c) 49.

<sup>722</sup> Kenen (n 605) 32-35.

lead to divergences between national laws and therefore, to inconsistent application of EU law. Notably, it was as early as in the 1990s that some observers went a step further by arguing that the only way to promote greater cooperation at EU level would be to centralise supervision at a supranational level.<sup>723</sup> This belief was remarkably summarised by Folkerts-Landau and Garber, who argued that the ECB should assume supervisory responsibilities. Their reasoning was based in two arguments: firstly, the ECB, being granted a highly independent status and its own resources, was the best suited body to assess the solvency of potential borrowers by protecting at the same time its own resources; and secondly, the ECB would be more likely to retain the expertise and information necessary to conduct liquidity support operations.<sup>724</sup> However, banking integration was still at an early stage, and the idea of centralisation was still illusive and politically unreachable.

### 3.3 The Lamfalussy Report

The period to follow the FSAP was dominated by new regulatory initiatives in banking, which aimed at developing and implementing new mechanisms that would facilitate and achieve a truly united Europe for financial services.<sup>725</sup> Another initiative, which was not part of the FSAP, but significantly simplified the EU banking framework,<sup>726</sup> by consolidating a number of directives,<sup>727</sup> was the Codified Banking Directive of 2000.<sup>728</sup> Meanwhile, financial markets were becoming more unified and integrated, as opposed to banking supervision and

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<sup>723</sup> Among the rest see: Kenen (n 605) and Eichengreen, Barry, *Should the Maastricht Treaty be Saved?* (Princeton University in International Economics 1992) 42-47.

<sup>724</sup> Folkerts-Landau, David and Garber, Peter M., 'The European Central Bank: A Bank or a Monetary Policy Rule' (NBER Working Paper, No. 4016, 1992) 29-30 <<http://www.nber.org/papers/w4016.pdf>> accessed 14 July 2017. See also:

- Schoenmaker, Dirk, 'Banking Supervision and Lender of Last Resort in EMU' in Andenas, M., Gormley, L., Hadjiemmanuil, C. and Harden, I. (eds) *European Economic and Monetary Union: The Institutional Framework*, Kluwer International 1997).
- Vives, Xavier, 'Restructuring Financial Regulation in the European Monetary Union' (2001) 19 (1) *Journal of Financial Services Research* <<http://blog.iese.edu/xvives/files/2011/09/100.pdf>> accessed 14 July 2017.
- Goodhart, Charles and Schoenmaker, Dirk, 'Fiscal Burden Sharing in Cross-Border Banking Crises' (2009) 5 (1) *International Journal of Central Banking*.

<sup>725</sup> De Meester (n 668) 276.

<sup>726</sup> De Meester (n 668) 277.

<sup>727</sup> Among the rest: the Codified Banking Directive included the First Banking Directive (n 664); Second Banking Directive (n 686); Own Funds Directive (n 347); Solvency Ratio Directive (n 347); Large Exposures Directive (n 715); and the Consolidated Banking Directive (n 716).

<sup>728</sup> Codified Banking Directive (n 686).

regulation which remained highly fragmented and still concentrated at national level.<sup>729</sup> Therefore, there emerged the need for banking integration to move beyond harmonisation, combined with a more active interventionist attitude towards regulation and supervision. As a response to this realisation and with the view to reduce market fragmentation, an independent and highly specialised Committee was established by the ECOFIN of Brussels in July 2000.<sup>730</sup> The main objective of the Committee was to follow up on the framework set by the FSAP and facilitate the practical implementation of the relevant European rules, in order to enhance the effectiveness of the regulatory and supervisory architecture.<sup>731</sup> It is worth noting here, that prudential supervision was explicitly excluded by the set of tasks of the Committee.<sup>732</sup>

The Committee of Wise Men produced a Report, which is known as the Lamfalussy Report,<sup>733</sup> and is named after the name of Alexandre Lamfalussy, who chaired the Committee. It is worth mentioning that Lamfalussy was the former president of the European Monetary Institute and member of the Segre' Committee on the development of a European capital market. The Lamfalussy Report introduced a new perspective to EU financial regulation. The process was initially introduced in 2001, in securities and expanded to banking, insurance and investment services four years later. The initial Lamfalussy Report concluded that the existing EU regulatory framework was *"too slow, too rigid, complex and ill-adapted to the pace of global financial market change."*<sup>734</sup> Moreover, it was argued that the existing regulatory framework was incomplete in terms of coverage, but was also lacking the capacity to ensure the consistent application of EU law.<sup>735</sup> To this end, the slow transmission process of EU law to national legislation, was considered as the greatest obstacle on the way towards a unified internal market for financial services.<sup>736</sup> This was attributed to the choice of Directives instead

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<sup>729</sup>Alford, Duncan, '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, 396.

<sup>730</sup> ECOFIN Meeting, July 2000 (n 723).

<sup>731</sup> Dardac, Nicolae and Georgescu, Elena, 'Lamfalussy Architecture - A Model for Consolidating the Financial Markets' Supervision' (2008) 8 (525) Theoretical and Applied Economics 63.

<sup>732</sup> ECOFIN Meeting, July 2000 (n 723).

<sup>733</sup> 'Committee of Wise Man on the Regulation of European Security Markets' Final Report, Brussels, 15 February 2001 (hereinafter: the Lamfalussy Report) <[http://ec.europa.eu/internal\\_market/securities/docs/lamfalussy/wisemen/final-report-wise-men\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf)> accessed 14 July 2017.

<sup>734</sup> The Lamfalussy Report (n 738) 7.

<sup>735</sup> The Lamfalussy Report (n 738) 7, 10 and 18.

<sup>736</sup> The Lamfalussy Report (n 738) 13.

of Regulations,<sup>737</sup> which was believed to have offered excessive regulatory space to Member States, resulting in uneven transposition and different interpretations of EU law; while Directives required at least 18 months for transposition at national level.<sup>738</sup> As a solution, the Lamfalussy Report proposed a fast-traced procedure, which as defined by the Report: *“involves early adoption of an act after first reading in the European Parliament – by ensuring prior consultation and agreement with the Council of Ministers and the Commission,”* and also recommended that: *“...more use should be made of Regulations, rather than Directives.”*<sup>739</sup>

Most importantly, the Lamfalussy Report, in an attempt to facilitate an adequate regulatory framework for the creation of a truly integrated financial services market, proposed a novel four levels governance mechanism (known as the Lamfalussy process).<sup>740</sup> The Lamfalussy process through its four levels mechanism, provided a framework for timely decision-making, with the view to speeding up the EU response to market change, and to improving the flexibility and quality of EU financial regulation.<sup>741</sup> In short, Level 1 referred at the initial stage of the legislation process, whereby the adoption of legislative acts was made through the normal EU decision-making procedure, which implies that framework legislation is adopted by the EU Council and Parliament under the co-decision procedure following the EU Commission’s proposal as specified in Article 251, TFEU.<sup>742</sup> Level 2 was designed to supplement the Level 1 framework by implementing detailed rules and technical standards<sup>743</sup> subject to ‘comitology.’<sup>744</sup> The Lamfalussy Report defined “comitology” as: *“the delegation of implementing powers by the Council to the Commission for the execution of EU legislation.”*<sup>745</sup> It should be noted here that ‘comitology’ has been established by a Council Decision in 1999, while the Lisbon Treaty introduced modifications to the co-decision procedure and the

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<sup>737</sup> The Lamfalussy Report (n 738) 14.

<sup>738</sup> The Lamfalussy Report (n 738) 14 and 21.

<sup>739</sup> The Lamfalussy Report (n 738) 21.

<sup>740</sup> The Lamfalussy Report (n 738) 19.

<sup>741</sup> Smits, René, *The European Central Bank in the European Constitutional Order* (Eleven International Publishing 2003) 48-49.

<sup>742</sup> The Lamfalussy Report (n 738) 22- 27. See also: Lannoo, Karel and Levin, Mattias, ‘Securities Market Regulation in the EU: Everything you always wanted to know about the Lamfalussy procedure’ (2004) CEPS Research Report in Finance and Banking No. 33.

<sup>743</sup> The Lamfalussy Report (n 738) 28-36.

<sup>744</sup> For more details on the comitology procedure see: Gualandri, Elisabetta and Grasso Giovanni, Alessandro, ‘Towards a new Approach to Regulation and Supervision in the EU: Post-FSAP and Comitology’ (2006) Munich Personal RePEc Archive Paper No. 1780 <[https://mpr.ub.uni-muenchen.de/1780/1/MPRA\\_paper\\_1780.pdf](https://mpr.ub.uni-muenchen.de/1780/1/MPRA_paper_1780.pdf)> accessed 14 July 2017.

<sup>745</sup> The Lamfalussy Report (n 738) 112.

comitology. Namely, the new comitology procedure implied that the EU Commission could adopt delegated legislative acts in accordance to Article 290, TFEU or implementing legislative acts pursuant to Article 291, TFEU, which are both binding for the Member States.<sup>746</sup> Level 3 aimed to create an environment of cooperation among EU national securities regulators with the view to ensure the uniform transposition of EU legislation at national level, as adopted at Level 1 and 2.<sup>747</sup> Lastly, Level 4 intended to strengthen the enforcement of EU law, especially, by increasing the power of the EU Commission to undertake enforcement actions for any failure to implement or inconsistent implementation of EU law.<sup>748</sup>

In the context of Level 2, the Lamfalussy Report recommended the establishment of two new Committees: the European Securities Committee (ESC) and the European Securities Regulators Committee (CESR or ESRC), with first one, intended to have a regulatory function and the second one, designed to have an advisory character.<sup>749</sup> The two Committees (CESR and ESC) were adopted by two decisions of the EU Commission in June 2001.<sup>750</sup> An important innovation that differentiated the Lamfalussy Report from previous Commission initiatives, was the cooperative endeavour between the Commission and the security markets' national representatives through their participation in the ESC. In particular, the ESC was composed of representatives of the Member States and chaired by a representative of the Commission,<sup>751</sup> and both the Commission and ESC, would have to work together in proposing, outlining and finally deciding on the application of technical details of Level 1 measures.

Furthermore, Level 1 legislative process was complemented by a transparent consultation procedure, which was to be conducted before the EU Commission's proposal for

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<sup>746</sup> 'Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission' [1999] OJ L184/23, as amended by 'Council Decision 2006/512/EC of 17 July 2006 amending Decision 1999/468/EC laying down the procedures for the exercise of implementing powers conferred on the Commission' [2006] OJ L 200/11 and 'Council Regulation (EU) No 182/2011 of the European Parliament and of the Council of 16 February 2011 laying down the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers' [2011] OJ L55/13.

<sup>747</sup> The Lamfalussy Report (n 738) 37.

<sup>748</sup> The Lamfalussy Report (n 738) 40-41.

<sup>749</sup> The Lamfalussy Report (n 738) 28.

<sup>750</sup> Commission's decision on the implementation of CESR and ESC are the following:

- Commission, 'Decision 2001/527/EC of 6 June 2001 establishing the Committee of European Securities Regulators' [2001] OJ L 191/43;
- Commission, 'Decision 2001/528/EC of 6 June 2001 establishing the European Securities Committee' [2001] OJ L 191/45.

<sup>751</sup> Commission Decision 2001/528/EC (n 755) Article 3.



legislation and subject to its recommendation. The process was open to the participation and involvement of market participants, end-users (issuers and consumers), Member States and their regulators, the EU Parliament and Level 2 Committees.<sup>752</sup> This was a pioneering feature of the Lamfalussy Process since it provided the EU Commission with the opportunity to take advantage of the specific technical expertise of all interested parties prior to forming its final view for the drafting of the proposal. In addition, the Lamfalussy Report recommended regular monitoring and reporting to the EU Council, Commission, Parliament and the public, of both the procedure and the progress towards creating an integrated financial market.<sup>753</sup> As a response, the EU Council, the EU Parliament, the EU Commission and the ECOFIN set up an Interinstitutional Monitoring Group (IIMG) in 2002, which drafted the relevant reports and published them in an annual basis.<sup>754</sup> The IIMG was mandated by the EU Parliament, the EU Council of Finance Ministers and the EU Commission and was composed of six independent experts, two of which were nominated by each Institution.<sup>755</sup>

With regards to the ESC, this was designed to serve at multiple levels. Firstly, the ESC would have an advisory role to the EU Commission in Level 1 legislative initiatives;<sup>756</sup> secondly, it would advise the EU Commission on matters of Level 2 regarding the CESR;<sup>757</sup> and lastly, at Level 2 the ESC would act as a regulatory comitology committee advising the EU Commission when taking decisions on implementing measures under Article 202, TEC.<sup>758</sup> Likewise, the CESR would operate in two Levels: in Level 2 would have a general advisory role for the EU Commission,<sup>759</sup> and in Level 3 would ensure the implementation and consistent application of EU law by NCAs.<sup>760</sup> At Level 3, the CESR fulfilled this role by producing guidance, recommendations and standards, including: administrative guidelines, interpretation

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<sup>752</sup> The Lamfalussy Report (n 738) 25.

<sup>753</sup> The Lamfalussy Report (n 738) 40-45.

<sup>754</sup> See the first interim Report of IIMG: IIMG 'First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe (The Lamfalussy Process)' (Inter-Institutional Monitoring Group, Brussels, May 2003) (hereinafter: IIMG First Interim Report) <[http://ec.europa.eu/internal\\_market/securities/docs/monitoring/first-report/2003-05-monitoring-summary\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/monitoring/first-report/2003-05-monitoring-summary_en.pdf)> accessed 14 July 2017.

<sup>755</sup> 'Financial Markets: Inter-institutional Monitoring Group for securities markets publishes first report' (Brussels, 8th May 2003 IP/03/650).

<sup>756</sup> Commission Decision 2001/528/EC (n 755) Article 2.

<sup>757</sup> The Lamfalussy Report (n 738) 29.

<sup>758</sup> See: The Lamfalussy Report (n 738) 29; and Commission Decision 2001/528/EC (n 755) pmb. recital 11.

<sup>759</sup> See: The Lamfalussy Report (n 738) 31; and Commission Decision 2001/527/EC (n 755) pmb. recital 6, 8 and Article 2.

<sup>760</sup> See: The Lamfalussy Report (n 738) 31; and Commission Decision 2001/527/EC (n 755) pmb. recital 9.

recommendations, common standards, peer reviews and comparisons of regulatory practice. These guidance, recommendations and standards were intended to address issues that were not covered by EU law, provided were consistent with the legislation adopted at Level 1 and 2. In addition, they had a non-binding character and the Member States would apply them at national level on a voluntary basis.<sup>761</sup> In sum, the new framework, facilitated a two levels legislation process, whereby the first one involved the preparation and creation of regulation (Level 1 and 2), whilst the second one involved the drafting of technical details, by special Committees consisting of national representatives, for implementing the regulation (Level 3 and 4).<sup>762</sup> Lastly, CESR was composed of high-level representatives from the national public authorities competent in the field of securities.<sup>763</sup>

Due to the imminent need to cope with fast changing financial markets as well as with the EU enlargement,<sup>764</sup> in the informal ECOFIN meeting in Oviedo on 11 April 2002 it was decided *inter alia* that further steps should be undertaken in order to: “ensure that the EU has appropriate structures in place for financial regulation and supervision in a rapidly-changing financial environment.”<sup>765</sup> Furthermore, the Brussel’s ECOFIN in May 2002 invited the Economic and Financial Committee (EFC) to draft a report on financial stability, supervision and integration.<sup>766</sup> The EFC would act as an EU Committee, in accordance with Article 134, TFEU (ex-Article, 114 TEC), and operate in an advisory capacity, with the aim to promote policy coordination among the Member States for the functioning of the internal market. The final EFC report<sup>767</sup> was included in Brussel’s ECOFIN meeting on 3 December

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<sup>761</sup> See also: ‘Role of CERS at ‘Level 3’ under the Lamfalussy Process’ (CESR Consultation Paper, CESR/04-527, April 2004) <[https://www.esma.europa.eu/sites/default/files/library/2015/11/04\\_104b.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/04_104b.pdf)> accessed 14 July 2017.

<sup>762</sup> Valiante, Diego, ‘Europe’s Untapped Capital Market Rethinking financial integration after the crisis’ (Final Report of the European Capital Markets Expert Group, Centre for European Policy Studies European Capital, 2016) <[https://www.ceps.eu/system/files/Capital%20Markets%20Union\\_1.pdf](https://www.ceps.eu/system/files/Capital%20Markets%20Union_1.pdf)> accessed 14 July 2017.

<sup>763</sup> See: Commission Decision 2001/527/EC (n 755) Article 3.

<sup>764</sup> On May 2004, ten new Member States joined the EU, including: Estonia, Latvia, Lithuania, Poland, Hungary, the Czech Republic, Slovenia, Slovakia, Cyprus and Malta.

<sup>765</sup> ECOFIN, 2424th Council meeting in Brussels, 7 May 2002 (Presse 117) 8294/02, 10 <[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/70440.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/70440.pdf)> accessed 14 July 2017.

<sup>766</sup> ECOFIN, May 2002 (n 770) 10.

<sup>767</sup> ‘Report by the Economic and Financial Committee (EFC) on EU financial integration’ (European Commission, Directorate-General for Economic and Financial Affairs Paper No. 171, May 2002) <[http://ec.europa.eu/economy\\_finance/publications/pages/publication1860\\_en.pdf](http://ec.europa.eu/economy_finance/publications/pages/publication1860_en.pdf)> accessed 14 July 2017.

2002.<sup>768</sup> In the latter, the EU Council invited both the Commission and the EFC to review arrangements in financial regulation and supervision in EU and most importantly, to extend the application of the Lamfalussy process to all financial sectors, including banking, and insurance, by establishing as quickly as possible new Committees in each sector by respective decisions of the EU Commission.<sup>769</sup> It should be noted here, that the extension of the Lamfalussy process to banking, insurance and investment services was envisaged since the initial inception of the Lamfalussy procedure.<sup>770</sup>

As a response, the EU Commission launched a package of seven measures in November 2003, including a proposal for a Directive<sup>771</sup> and six Commission Decisions.<sup>772</sup> These six Commission Decisions involved the establishment of: the European Banking Committee (EBC), which was reconstructed into a Level 2 Committee;<sup>773</sup> the European Insurance and Occupational Pensions Committee (EIOPC) set up for the purposes of Level 2;<sup>774</sup> and the known as Level 3 Committees: the Committee of European Banking Supervisors (CEBS)<sup>775</sup> and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).<sup>776</sup> This is not to say that the role of these Committees was limited in Level 3, since

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<sup>768</sup> ECOFIN, 2471st Council meeting in Brussels, 3 December 2002 (Presse 361) 14368/02 <[http://europa.eu/rapid/press-release\\_PRES-02-361\\_en.htm](http://europa.eu/rapid/press-release_PRES-02-361_en.htm)> accessed 14 July 2017.

<sup>769</sup> For the rationale of the extension of the Lamfalussy process see also:

- 'EFC report on financial regulation, supervision and stability, revised to reflect the discussion at the 8 October meeting of the ECOFIN Council' 9 October 2002, Brussels; and
- ECOFIN, 2471st meeting in Brussels, 3 December 2002 (Presse 361) 14368/02 <[http://europa.eu/rapid/press-release\\_PRES-02-361\\_en.htm](http://europa.eu/rapid/press-release_PRES-02-361_en.htm)> accessed 14 July 2017.

<sup>770</sup> Lannoo, Karel and Levin, Mattias and Zurstrassen, Patrick, 'Pan-European Asset Management: Achievements and Regulatory Impediments' (CEPS Task Force Report on Pan-European Asset Management, No. 44, Centre for European Policy Studies 2003), 21.

<sup>771</sup> Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC of the European Parliament and of the Council, in order to establish a new financial services committee organisational structure' COM (2003) 659 final.

<sup>772</sup> See also:

- 'Commission package of measures to improve regulation and supervision of banking, insurance and investment funds - frequently asked questions' 6th November 2003, Brussels, MEMO/03/220;
- 'Financial Services: Commission presents measures to improve regulation of banking, insurance and investment funds' (European Commission, Press Release, IP/03/1507, Brussels, 6th November 2003).

<sup>773</sup> Commission, Decision 2004/10/EC of 5 November 2003 establishing the European Banking Committee [2004] OJ L 3/36.

<sup>774</sup> Commission, 'Decision 2004/9/EC of 5 November 2003 establishing the European Insurance and Occupational Pensions Committee' [2004] OJ L 3/34.

<sup>775</sup> Commission, 'Decision 2004/5/EC of 5 November 2003 establishing the Committee of European Banking Supervisors' [2004] OJ L 3/28.

<sup>776</sup> Commission, 'Decision 2004/6/EC of 5 November 2003 establishing the European Insurance and Occupational Pensions Supervisors' [2004] OJ L 3/30.

their tasks were divided between Level 2 and Level 3. Namely, at Level 2, the Committees were meant to advise the Commission on technical details in implementing measures, subject to request or their own initiation; while at Level 3 would aim to foster supervisory convergence by promoting the exchange of information between NCAs, while ensuring consistency in the implementation of legislation by issuing guidelines, recommendations and standards.<sup>777</sup>

Also, the EU Commission's package involved a decision for establishing the CESR, which would operate at Level 3 along with CEBS and CESR;<sup>778</sup> and an amendment of the decision establishing the ESC.<sup>779</sup> The ESC would serve at Level 2 along with the EBC and EIOPC in their regulatory capacity (at the proposal stage of legislation) and subject to request, could act in an advisory capacity for the EU Commission on the proposals for Level 1 legislation.<sup>780</sup> The EU Commission's proposal for a Directive was subject to a subsequent co-decision between the Council and the Parliament. Thus, the political agreement on the final Directive was reached in May 2004 and the Directive was enacted in March 2005, whereby the scope Lamfalussy process was officially extended to banking, insurance and investment services,<sup>781</sup> but its application differed in accordance with the financial sector.<sup>782</sup>

The EU Commission seems to have given priority to establishing Level 3 Committees, but in the end, created a modified legislative framework to that originally proposed. For instance, CEBS,<sup>783</sup> was designed to undertake extensive responsibilities at Level 3 such as:

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<sup>777</sup> Commission Decision 2001/527/EC (n 755) Article 2; Commission Decision 2004/5/EC (n 780) Article 2; and Commission Decision 2004/6/EC (n 781) Article 2.

<sup>778</sup> Commission, 'Decision 2004/7/EC of 5 November 2003 amending Decision 2001/527/EC establishing the Committee of European Securities Regulators' [2004] OJ L3/32.

<sup>779</sup> Commission, 'Decision 2004/8/EC of 5 November 2003 amending Decision 2001/528/EC establishing the European Securities Committee' [2004] OJ L3/33.

<sup>780</sup> Commission Decision 2001/528/EC (n 755) Article 2; Commission Decision 2004/10/EC (n 778) Article 2; Commission Decision 2004/9/EC (735) Article 2.

<sup>781</sup> 'Directive 2005/1/EC of the European Parliament and of the Council of 9 March 2005 amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 92/49/EEC and 93/6/EEC and Directives 94/19/EC, 98/78/EC, 2000/12/EC, 2001/34/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees' [2005] OJ L79/9.

<sup>782</sup> See: IIMG First Interim Report (n 759) 7; and IIMG, 'Second Interim Report Monitoring the Lamfalussy Process' (Inter-institutional Monitoring Group, Brussels, 26 January 2007), 3 (hereinafter: IIMG Second Interim Report) <<https://eiopa.europa.eu/CEIOPS-Archive/Documents/Comment%20letters/2007-01IIMGSecondInterimReport.pdf>> accessed 14 July 2017.

<sup>783</sup> For a comprehensive analysis of the role of CESR at Level 3 see: Moloney, Niamh, 'Innovation and risk in EC financial market regulation: new instruments of financial market intervention and the Committee of European Securities Regulators' (2007) 32 (5) European Law Review 627.

advising the EU Commission in the preparation of draft implementing measures in the field of banking; contributing to the consistent application of Directives and to the convergence of Member States' supervisory practices throughout the Community; and enhancing supervisory cooperation, including the exchange of information on individual supervised institutions.<sup>784</sup> In practice, however, the CEBS function was limited to bringing together all NCAs, while its role remained merely advisory and it was not assigned any actual decision-making powers. Likewise, the CEIOPS was also designed as an advisory body on insurance and occupational pension matters, while at the same time, aimed at promoting cooperation among national supervision practices.<sup>785</sup>

The institutional change with the extension of the Lamfalussy process in banking was not considered to be ground-breaking, in terms of structural arrangements. Also, while the aim was to achieve tighter convergence of regulation and supervision, it did not provide for centralisation of supervision and regulation at EU level and it was largely based on the existing principles of decentralisation, cooperation and segmentation. As Lastra argued, there was not any transfer of responsibilities from national to EU level, given that Level 2 and 3 Committees required the cooperation between national and supranational level in supervision.<sup>786</sup> On the other hand, it was argued that the value of this extension stands to fact that it shifted the attitude towards tighter institutional changes and political compromise towards centralisation, while it made clear that the existing system was ill-suited for the facilitation of a genuine single banking market.<sup>787</sup>

As mentioned earlier, the Lamfalussy process was part of a broader attempt to complete the FSAP's objectives. Thus, the progress of the Lamfalussy process was interlinked with the progress towards the completion of FSAP, which at that stage, was approaching its due date. To this end, the EU Commission issued a Green Paper<sup>788</sup> and a White Paper<sup>789</sup> in May and December 2005 respectively, evaluating the progress made up to date in meeting

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<sup>784</sup> Commission Decision 2004/5/EC (n 780) Article 2.

<sup>785</sup> For a detailed analysis regarding the Committees see: Ferran, Eilis, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' in Ferrarini, Guido, Hopt, Klaus J. and Wymeersch, Eddy (eds) *Financial Regulation and Supervision: A post-crisis analysis* (Oxford University Press 2012).

<sup>786</sup> Lastra, Rosa M., 'The Governance Structure for Financial Regulation and Supervision in Europe' (2003) 10 (1) *Columbia Journal of European Law* 49, 59.

<sup>787</sup> *Dragomir* (n 647) 193.

<sup>788</sup> Commission, 'Green Paper on Financial Services Policy (2005 - 2010)' COM (2005) 177 final.

<sup>789</sup> Commission, 'White Paper in Financial Services Policy (2005 - 2010)' COM (2005) 629 final.

the intended objectives and setting out the policy objectives in relation to financial services integration for the following five years to follow. However, the period after the release of White Paper seemed to have been characterised by a reluctant attitude towards further financial integration and the adoption of relevant legislation was rather limited. As McCreevy, who served as the Commissioner for Internal Market and Services at the time, highlighted: *“The five years of the Financial Services Action Plan have been a time of concentrated legislative change. Today it is clear that there is no appetite-or need-for many new regulatory initiatives...industry – and not only in the financial services sector - is looking forward to a well-deserved regulatory pause after the rash of regulatory initiatives in financial services of the past years.”*<sup>790</sup>

Therefore, the EU Commission’s aim, at that time, was the implementation of existing rules and the enhancement of co-operation, rather than the proposal of new laws. This is not to say, however, that there were no legislative acts undertaken during that period of time. For instance, as already mentioned, in the banking sector, the first CRD was adopted in June 2006, comprising of two Directives<sup>791</sup> that incorporated the implementation of Basel II capital adequacy framework at EU level.<sup>792</sup> However, it should be noted here that the CRD I,<sup>793</sup> was not a result of the Lamfalussy legislative process and its establishment was envisaged since the drafting of FSAP,<sup>794</sup> in which it was stated that: *“a Directive on capital adequacy setting out revised capital requirements for banks and investment firms was included among the future priorities the Commission.”*

However, the GFC changed the aforementioned regulatory reluctance, opening an era of intense regulatory intervention and a series of measures that would radically change the EU banking landscape. In 2007-08, with the spread of the financial crisis, marked the changing point that opened an era of intense regulatory intervention and a series of measures that

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<sup>790</sup> McCreevy, Charlie, ‘Recent Developments in the Internal Market for Financial Services and Financial Reporting’ (Annual Cocktail at the Association of Corporate Treasurers, Brussels, 8 December 2005, SPEECH/05/778).

<sup>791</sup> See: Directive 2006/48/EC (n 362) and Directive 2006/49/EC (n 362).

<sup>792</sup> For the implementation of Basel II at EU level see: Musch, Frederick C. Rym Ayadi, ‘Basel II Implementation in the Midst of Turbulence’ (Report of a CEPS Task Force, CEPS 2008).

<sup>793</sup> De Visscher, Christian, Maiscocq, Olivier and Varone, Frédéric, ‘The Lamfalussy Reform in the EU Securities Markets: Fiduciary Relationships, Policy Effectiveness and Balance of Power’ (2008) 28 (01) Journal of Public Policy 19, 23.

<sup>794</sup> FSAP (n 718).

would radically change the EU banking landscape. Before analysing the post-GFC EU regulatory response, it is important to address briefly the main gaps of the Lamfalussy process which would serve as the basis of the subsequent debate on regulatory reform.

### 3.3.1 Shortcomings of the Lamfalussy process: a preliminary assessment

On the positive side, it has been widely acknowledged that the Lamfalussy process, was successful in achieving its main goal which was to shorten the decision-making process.<sup>795</sup> Furthermore, the Lamfalussy process has been considered as highly influential in changing the procedures for adopting, implementing and enforcing EU legislation in the financial services field.<sup>796</sup> The process was also considered successful in terms of its general acceptance, since it was well-received by the majority of Member States, markets participants and policymakers.<sup>797</sup> For instance, the average time for the adoption of the first four Directives in the securities sector (including: the Prospectus Directive;<sup>798</sup> the Transparency Directive;<sup>799</sup> Market Abuse Directive<sup>800</sup> and Markets in Financial Instruments Directive or

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<sup>795</sup> This has been evaluated and concluded by EU institutions and the literature. See:

- De Visscher et al (n 798);
- 'Review of the Lamfalussy framework: Eurosystem contribution' (ECB, November 2007b) <<https://www.ecb.europa.eu/pub/pdf/other/lamfalussy-review2007en.pdf?37c70a7069f137668a3a4d60def680d0>> accessed 14 July 2017.
- 'The Application of the Lamfalussy process to EU Securities Markets Legislation: A preliminary assessment by the Commission services' (Commission Staff Working Document, SEC 1459 Brussels, 15 November 2004) <[http://ec.europa.eu/internal\\_market/securities/docs/lamfalussy/sec-2004-1459\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/lamfalussy/sec-2004-1459_en.pdf)> accessed 14 July 2017.

<sup>796</sup> See among the rest:

- Coen, David and Thatcher, Mark, 'Network governance and multi-level delegation: European networks of regulatory agencies' (2008) 28 (1) *Journal of Public Policy* 49;
- Posner, Elliot, 'The Lamfalussy Process: Polyarchic Origins of Networked Financial Rulemaking in the EU', in Sabel, Charles F. and Zeitlin (eds), *Jonathan Experimentalist Governance in the European Union: Towards A New Architecture* (Reprint edn, Oxford University Press 2012).

<sup>797</sup> 'Report on Better Regulation in the European Union' (EU Parliament, Committee on Legal Affairs, 2 July 2007) <<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A6-2007-0273+0+DOC+XML+V0//EN&language=ga>> accessed 14 July 2017.

<sup>798</sup> 'Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC' [2003] OJ L345/64.

<sup>799</sup> 'Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC' [2004] OJ L390/38.

<sup>800</sup> 'Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)' [2003] OJ L96/16.

MiFID<sup>801</sup>), through the Level 4 procedure – from the proposal stage to adoption – did not exceed 20 months.<sup>802</sup> Thus, as the IIMG evaluated in its final report, the Lamfalussy process has been pivotal in the timely adoption of FSAP.<sup>803</sup>

Furthermore, the Lamfalussy process was appraised for its important role in fostering the multilateral mode for the financial services sector and financial stability policies in Europe, which effectively set the scene for further progress in financial integration, cooperation and convergence of EU supervisory practices towards the creation of a Single Banking Market for Europe.<sup>804</sup> To this end, if we were to evaluate whether the Lamfalussy report provided for centralisation of supervisory practices in Europe, it could be argued that although the Lamfalussy process did not encourage the creation of a purely supranational supervisory authority, it set the framework for the centralisation of banking supervision at EU level. Namely, the Lamfalussy process has contributed in intensifying the relationship and cooperation between EU and national level as well as between NCAs.<sup>805</sup> Also, for those arguing in favour of creating a pan-European supervisor, the Lamfalussy Level 3 Committees (CEBS, CEIOPS and CESR) represented a relevant core.<sup>806</sup>

On the more critical side, the Lamfalussy process became subject of a wide debate in terms of both its progress and effectiveness, which was further intensified during the GFC. There were concerns that the Lamfalussy process would fail entirely to deliver its intended

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<sup>801</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC' [2004] OJ L145/1.

<sup>802</sup> Commission Staff Working Document (n 800) para 10.

<sup>803</sup> See:

- 'Final Report Monitoring the Lamfalussy Process' (IIMG, 15 October 2007) para 10 (hereinafter: IIMG Final Report)  
<[http://ec.europa.eu/internal\\_market/finances/docs/committees/071015\\_final\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/071015_final_report_en.pdf)> accessed 14 July 2017.
- 'Review of the Application of the Lamfalussy Framework to EU Securities Markets Legislation Contribution to the Commission's Public Consultation' (ECB, 17 February 2005)  
<<https://www.ecb.europa.eu/pub/pdf/other/lamfalussy-reviewen.pdf?c70e8ba6d4094e321cf5ecb023aa9e78>> accessed 14 July 2017.

<sup>804</sup> Hartmann, Philipp, Maddaloni, Angela and Manganelli, Simone, 'The Euro Area Financial System: Structure, Integration and Policy Initiatives' (ECB Working Paper No. 230, 2003) 39.

<sup>805</sup> See:

- Lannoo, Karel, Casey, Jean-Pierre and Sutton, Alastair, 'EU Financial Regulation and Supervision Beyond 2005' (2005) CEPS Task Force Report No. 54, Centre for European Policy Studies, 6; and
- Kern, Alexander, 'Reforming European Financial Supervision: Adapting EU Institutions to Market Structures' (2011) 12 ERA Forum 229, 236.

<sup>806</sup> Hartmann et al. (n 809) 39.



outcome.<sup>807</sup> Such a critique set the scene for the development of literature regarding further integration for banking regulation and supervision at EU level.<sup>808</sup> Nevertheless, as mentioned earlier, it was acknowledged well before the outbreak of the GFC that the existing regulatory and supervisory system was ill-suited to facilitate the desired integration. For instance, the IIMG review reports, issued in the aftermath of the extension of the Lamfalussy process to banking, insurance and investment services,<sup>809</sup> explicitly highlighted the need to strengthen Level 3 Committees (CEBS, CEIOPS and CESR).<sup>810</sup> This is mainly linked with the criticism against the non-binding nature of Level 3 Committees' decisions, which apart from going against the vision of the Lamfalussy Report, was also undermining the effectiveness of the Lamfalussy process. To this end, the Lamfalussy Report, while highlighting the non-binding nature of the decision of Level 3 Committees, it also emphasised that they would have to: "carry considerable authority."<sup>811</sup> Such "considerable authority" was never achieved in practice,<sup>812</sup> since the Member States retained enough discretion to substantially deviate from the decisions of the Committees.

This is also in line with the concerns expressed in relation to the potential insufficiency of the Lamfalussy process to ensure adequate supervision, which was believed to invoke financial stability risks. The rationale of this belief was based on a simple argument: the stability of a financial system built on growing cross-border activity, could not be maintained in a fragmented supervisory structure. Those fragmentations were not, however, eliminated by the Lamfalussy process. This was to be attributed to the reliance of supervision on the home country control principle, which proved to be lacking the ability to maintain financial stability within a financial system of a common currency and an extensive cross-border activity.<sup>813</sup> The outcome of this nationally-oriented governance of supervision, was an institutional mismatch, whereby NCAs failed to address cross-border externalities due to their

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<sup>807</sup> Hertig, Gérard & Lee, Ruben, 'Four Predictions about the Future of EU Securities Regulation' (2015) 3 (2) *Journal of Corporate Law Studies* 359.

<sup>808</sup> See: Commission, 'Review of the Lamfalussy process Strengthening supervisory convergence' (Communication) COM (2007) 797.

<sup>809</sup> This was highlighted at all six IIMG review reports produced during 2005-2007.

<sup>810</sup> Erdélyi, Olivia Johanna, *Twin Peaks for Europe: State-of-the-Art Financial Supervisory Consolidation: Rethinking the Group Support Regime under Solvency II* (1st edn, Springer 2016), 52.

<sup>811</sup> The Lamfalussy Report (n 738) 38.

<sup>812</sup> Commission Communication (n 813) 9.

<sup>813</sup> See: Orphanides (n 552) 1.

excessive focus on the soundness of their domestic banking system.<sup>814</sup> As was illustrated by Padoa-Schioppa the EU financial markets, at the time, were characterised by a framework consisted of: *“European regulation with national supervision.”*<sup>815</sup> In fact, the Lamfalussy process, while it was considered to have shortened the legislative procedure in comparison with its predecessor, it proved to be rather slow in responding promptly to the cross-border implications of the financial turmoil in 2008.<sup>816</sup>

There were some that predicted the problematic nature the national-oriented EU financial regulation and supervision, and anticipated the unavoidable inadequacies that would eventually occur in a highly integrated system of a common currency, with shared responsibilities in both national and EU level. For instance, Lastra argued that the EU financial architecture was experiencing *“an inevitable tension”*, caused by *“a national mandate in prudential supervision, combined with a single European currency and a European mandate in the completion of the single market in financial services.”*<sup>817</sup> In addition, according to Goodhart *“the Eurozone is a difficult and fragile halfway house because it combines monetary centralism while leaving fiscal and indeed wider political issues to the individual nation states.”*<sup>818</sup> Lastra also predicted that: *“It will take the first pan-European crisis to cast some light on this issue.”*<sup>819</sup>

Part of the same debate was the view that there was a general lack of cooperation between NCAs as well as between the EU institutions, which resulted in a poor flow of information that led to an inability to identify early signs of potential risks.<sup>820</sup> Attempts to enhance this cooperation were made in the past through several Memoranda of

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<sup>814</sup> Mortimer-Schutts, Ivan ‘EU Regulatory and Supervisory Convergence: The Case for a Dual System with Choice’ (AEI-Brookings Joint Center 2005), 8 <[http://gem.sciences-po.fr/content/publications/pdf/IMS\\_1205\\_Dual\\_EU\\_Reg\\_Struct.pdf](http://gem.sciences-po.fr/content/publications/pdf/IMS_1205_Dual_EU_Reg_Struct.pdf)> accessed 14 July 2017.

<sup>815</sup> Padoa-Schioppa, Tommaso, *Regulating Finance: Balancing Freedom and Risk* (Oxford University Press 2004) 121.

<sup>816</sup> Ferran, Ellis and Kern, Alexander, ‘Can soft law bodies be effective? Soft systemic risk oversight bodies and the special case of the European systemic risk board’ (2010) 35 *European Law Review* 751, 770.

<sup>817</sup> Lastra (n 547) 298.

<sup>818</sup> ‘The future of economic governance in the EU’ (Charles Goodhart, as quoted at the House of Lords European Union Committee Report, the Stationery Office Limited, London) para 30, 15 <<http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/EconomicGovernance/TSO%20FINAL%20Economic%20Governance%20report.pdf>> accessed 14 July 2017.

<sup>819</sup> Lastra (n 791) 58.

<sup>820</sup> ‘Euro Area Policies: 2007 Article IV Consultation-Staff Report’ (IMF, Country Report No. 07/260, July 2007) 18-20 <<https://www.imf.org/external/pubs/ft/scr/2007/cr07260.pdf>> accessed 14 July 2017.

Understandings (MoUs), with the first one issued in 2003, aiming to strengthen the cooperation between the EU banking supervisors and central banks in crisis management situations.<sup>821</sup> The next MoU was issued in May 2005, differing in scope from its predecessor, since the latter addressed cooperation by incorporating EU Finance Ministries as well.<sup>822</sup> The MoU of 2005 was replaced by a MoU in June 2008, which was the first to have been released publicly.<sup>823</sup> However, the MoUs have not been considered particularly successful in achieving their objective i.e. to strengthen cooperation, with the view to safeguard financial stability in the EU. This weakness became visible during the GFC era, and as the EU Commission acknowledged: *“The Memorandum of Understanding on financial stability, agreed in June 2008, was in place during the crisis but failed to provide a sufficient or useful basis for cooperation between Member States.”*<sup>824</sup>

Another issue highlighted as being problematic, was the interrelationship between Level 1 and Level 2 and the distribution of powers and tasks.<sup>825</sup> Namely at Level 2 the EU Commission was delegated extensive rule-making power, being the dominant player at both drafting and adopting the measures, whereas the Parliamentary institutional involvement was minimal. Therefore, it is hardly surprising that since the initial release of the Lamfalussy Report and especially, after the decision of the EU Commission to extend the Lamfalussy process to banking, insurance and investment, the EU Parliament had repeatedly displayed significant resistance to the Lamfalussy process. The EU Parliament feared that its limited participation in the legislative process, could threaten the institutional balance of powers in the EU and the transparency of the legislative process.<sup>826</sup> It should be noted that these

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<sup>821</sup> ‘Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations’ (ECB, Press Release, 10 March 2003) <[https://www.ecb.europa.eu/press/pr/date/2003/html/pr030310\\_3.en.html](https://www.ecb.europa.eu/press/pr/date/2003/html/pr030310_3.en.html)> accessed 14 July 2017.

<sup>822</sup> ‘Memorandum of Understanding on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations’ (ECB, Press Release, 18 May 2005) <[https://www.ecb.europa.eu/press/pr/date/2005/html/pr050518\\_1.en.html](https://www.ecb.europa.eu/press/pr/date/2005/html/pr050518_1.en.html)> accessed 14 July 2017.

<sup>823</sup> ‘Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, central Banks and Finance Ministries of the European Union on Cross-border Financial Stability’ (ECB, 1 June 2008) <<https://www.ecb.europa.eu/pub/pdf/other/mou-financialstability2008en.pdf>> accessed 14 July 2017.

<sup>824</sup> Commission, ‘EU Framework for Cross-Border Crisis Management in the Banking Sector’ (Communication) COM (2009) 561 final.

<sup>825</sup> See: Commission Staff Working Document (n 800).

<sup>826</sup> See for instance: Randzio-Plath, Christa, ‘Report A5-0162/2004 on the proposal for a European Parliament and Council directive amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC of the European Parliament and of the Council, in order to establish a new financial services committee organisational structure (COM(2003) 659 – C5-0520/2003 – 2003/0263(COD),’ (Committee on Economic and Monetary Affairs, 17 March 2004)

concerns were addressed since the drafting of the Lamfalussy Report.<sup>827</sup> An examples is also when the EU Parliament voted a resolution in May 2001, calling for a veto right at Level 2, since the role of the Members States was reduced to a right to be informed and the EU Commission could do no more than express an opinion.<sup>828</sup>

Anticipating this criticism, the EU Commission addressed the matter in the Lamfalussy Report,<sup>829</sup> and it was further illustrated through the adoption of three additional control mechanisms at Level 2. Firstly, by the inclusion of the so-called aerosol clause which obliges the Commission: *“to avoid going against predominant views which might emerge within the Council.”*<sup>830</sup> However, the first IIMG interim report highlighted that the aerosol clause was not clearly defined and therefore: *“the lack of clarity about what is meant by “predominant,” may hamper the legislative process on some future occasion. That said, the Group is not aware of any intention, on the part of any Member State, to put the clause into operation.”*<sup>831</sup> Secondly, in order to ensure the equal role of the EU Parliament in the legislative process, the EU Commission, Parliament and Council reached an agreement in February 2002,<sup>832</sup> concerning the inclusion of a time limit of four years (from the entry into force of a Directive or Regulation) to the powers conferred to the Commission by means of a ‘sunset clause,’<sup>833</sup> at

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<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A5-2004-0162+0+DOC+XML+V0//EN&language=ro> accessed 14 July 2017.

See also: Moloney, Niamh, ‘The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime’ (2003) 52 (2) *The International and Comparative Law Quarterly* 509.

<sup>827</sup> The Lamfalussy Report (n 738) 21, 33-35. See also: Moloney, Niamh, ‘The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime’ (2003) 52 (2) *The International and Comparative Law Quarterly* 509.

<sup>828</sup> See: ‘European Parliament resolution A5-0168/2001 on the Treaty of Nice and the future of the European Union’ (Brussels Thursday, 31 May 2001, final edition) para 33

<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P5-TA-2001-0302+0+DOC+XML+V0//EN> accessed 14 July 2017.

<sup>829</sup> The Lamfalussy Report (n 738) 25, 28-32.

<sup>830</sup> IIMG First Interim Report (759) 10 para 5, 14, 39, 40.

<sup>831</sup> IIMG First Interim Report (759) para 5, 14, 39, 40. For the aerosol clause see also: Moloney, Niamh, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press 2014).

<sup>832</sup> See: Prodi, Romano, ‘Implementation of financial services legislation in the context of the Lamfalussy Report’, (Intervention by President Romano Prodi to the European Parliament’s plenary session, Strasbourg, 5 February 2002, SPEECH/02/44)

<http://ec.europa.eu/dorie/fileDownload.do;jsessionid=SdlKpvmHjAXmMbBvXEoNG1YfoDw4HTOb1CIXR7dbA9-mbP90smhel-898031139?docId=199189&cardId=199189> accessed 14 July 2017.

See also: Von Wogau, Karl, ‘Report A5-0011/2002 on the implementation of financial services legislation’ (European Parliament, The Committee on Constitutional Affairs, 23 January 2002)

<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A5-2002-0011+0+DOC+PDF+V0//EN> accessed 14 July 2017.

<sup>833</sup> For the meaning of sunset clause see also:

all legislative acts adopted by Level 1.<sup>834</sup> Thirdly, a period of three months was given to the EU Parliament in order to react to any draft implementing measure forwarded by the EU Commission.<sup>835</sup> The issue was readdressed again in 2005, when subject to an agreement between the three EU institutions (Commission, Parliament and Council), the co-decision procedure was reformed again.<sup>836</sup> This reform gave the right to the EU Parliament to reject the adoption of the EU Commission's draft implementing measures following the review by a Scrutiny Committee in case: "*the measures proposed exceed the implementing powers provided for in the basic instrument or that the draft is not compatible with the aim or the content of the basic instrument or does not respect the principles of subsidiarity or proportionality.*"<sup>837</sup>

Additionally, the delayed transposition of EU measures at national level was another issue that raised scepticism. For instance the 'Lamfalussy League Table' that was launched by the EU Commission on 6 July 2005,<sup>838</sup> and was regularly updated hereinafter, depicted the poor progress made by the majority of Member States in implementing the Lamfalussy Directives.<sup>839</sup> Thus, while the Lamfalussy Process, as mentioned earlier, contributed in shortening the legislative process, it does not seem to have had the same effect to the transposition in national law.<sup>840</sup> This is highly contradictory, if considering that the aim of Level 3 was the timely and successful transposition of Level 1 and 2 legislative measure of the

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- Blom-Hansen, Jens, *The EU Comitology System in Theory and Practice: Keeping an Eye on the Commission?* (Palgrave Macmillan 2011) 76-77;
  - Donnelly, Shawn, *Regimes of European Integration: Constructing Governance of the Single Market* (University Oxford Press 2010) 207-209;
  - Commission Staff Working Document (n 797) 5;
  - Heritier, Adrienne, *Explaining Institutional Change in Europe* (1<sup>st</sup> edn, Oxford University Press 2007) 219-223; and
  - IIMG First Interim Report (n 759) 9, 15, 35 and 41.

<sup>834</sup> Grahl, John, *Global Finance and Social Europe* (Edward Elgar Publishing 2009) 103-104;

<sup>835</sup> Von Wogau (n 837) 8.

<sup>836</sup> Council Decision 2006/512/EC (n 751) Article 1 (7).

<sup>837</sup> Council Decision 2006/512/EC (n 751) Article 1 (7)

<sup>838</sup> 'Financial services: Commission launches "Lamfalussy league table" on Member States' implementation of securities Directives' (Commission Press Release, IP/05/857, Brussels, 6 July 2005) <[http://europa.eu/rapid/press-release\\_IP-05-857\\_en.htm](http://europa.eu/rapid/press-release_IP-05-857_en.htm)> accessed 14 July 2017.

<sup>839</sup> Kaeding, Michael, *Towards an Effective European Single Market: Implementing the Various Forms of European Policy Instruments Across Member States* (VS Verlag für Sozialwissenschaften 2012) 65. See also: the 'Lamfalussy League Table' (as updated by 19 December 2008)

<[http://ec.europa.eu/internal\\_market/securities/docs/transposition/table\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/transposition/table_en.pdf)> accessed 14 July 2017.

<sup>840</sup> Alford (n 734) 422.

Lamfalussy process at national level.<sup>841</sup> The EU Commission's response to this delay was an announcement for pursuing infringement procedures against Member States that had not ratified the EU Directives.<sup>842</sup> Furthermore, the IIMG emphasised that the delayed and imperfect transposition constituted a major bottleneck in the development of the Single Market and in enjoyment of its benefits, and thus, concluded that the Lamfalussy process had not led to the expected improvement of transposition performance.<sup>843</sup>

If we were to put our discussion in the aftermath of the GFC, with the latter shedding light on important regulatory loopholes and fragile governance mechanisms, unavoidably, the criticism against the Lamfalussy process was intensified. Since the main problem in the GFC started with the banks, it is not surprising that a topic that would gather a vast amount of attention was banking supervision. Thus, the need for convergence in banking supervision measures, with particular emphasis to prudential supervision, became a priority at both international and EU level. As McCreevy highlighted in his speech in July 2007: *"closer integration is putting pressure on the current system of financial markets regulation as territoriality of legislation and supervision does not fit well with global and de-materialized capital markets."*<sup>844</sup>

However, as we mentioned already, awareness as to the need to promote supervisory convergence was intensified during the GFC era, but this does not imply that it is purely a creature of the financial crisis. At EU level, as already depicted, the need to strengthen supervisory practices was stressed repeatedly even before the emergence of the GFC. A good example is the Experts Group on Banking set by the EU Commission in 2004.<sup>845</sup> Namely, the

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<sup>841</sup> Gualandri and Grasso (n 749) 16.

<sup>842</sup> 'Internal Market: Commission moves against 16 Member States for failure to implement EU legislation on financial services' (Commission Press Release, IP/05/1035, Brussels, 3 August 2005) <[http://europa.eu/rapid/press-release\\_IP-05-1035\\_en.htm](http://europa.eu/rapid/press-release_IP-05-1035_en.htm)> accessed 14 July 2017.

The issue of poor progress on the transposition process was also highlighted by the third IIMG Report. See: IIMG, 'Third Report monitoring the Lamfalussy Process' (Inter-Institutional Monitoring Group Brussels, 17 November 2004) 22 <[http://ec.europa.eu/internal\\_market/securities/docs/monitoring/third-report/2004-11-monitoring\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/monitoring/third-report/2004-11-monitoring_en.pdf)> accessed 14 July 2017.

<sup>843</sup> IIMG Final Report (n 808) 11.

<sup>844</sup> McCreevy, Charlie, 'Moving forward on Capital Market Integration' (Federation of European Stock Exchanges (FESE) Convention 2007 Brussels, 26 June 2007, SPEECH/07/419) <[http://europa.eu/rapid/press-release\\_SPEECH-07-419\\_en.htm?locale=fr](http://europa.eu/rapid/press-release_SPEECH-07-419_en.htm?locale=fr)> accessed 14 July 2017.

<sup>845</sup> See: 'Financial Services Action Plan: Commission seeks views on new expert reports on state of financial integration' (Press Release, European Commission, Brussels, 6th May 2004) <[http://europa.eu/rapid/press-release\\_IP-04-600\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-04-600_en.htm?locale=en)> accessed 14 July 2017.

Commission called for open consultation reports by four independent groups of experts on the state of financial integration in the banking, insurance, securities and asset management sectors, as part of reviewing the FSAP progress, in which it was argued that improvements were needed in terms of legislation, supervisory arrangements and convergence of supervisory practices.<sup>846</sup> However, at the time, it was believed that tighter regulatory integration would result in convergence of supervisory practices.<sup>847</sup> After the occurrence of the GFC, it became evident that supervisory convergence was below the desired level, with the gap between regulation and supervision integration increasing. This led to a plethora of legislative reforms aiming to reshape the existing EU regulatory framework. Thus, in order to illustrate the impetus of legal integration of EU banking regulation and supervision, the next section analyses the EU regulatory response from the eruption of the GFC onwards.

### 3.4 The GFC and the EU regulatory response

#### 3.4.1 Tighter regulatory response since the outset of The GFC

Despite the criticisms on the effectiveness of the Lamfalussy process, it has been acknowledged that before the occurrence of the GFC, the EU financial market integration had reached momentum, representing one of the most consolidated and unified markets in the world.<sup>848</sup> Also, at that time, as mentioned earlier, the EU banking framework was relatively settled and there were no major initiatives towards furthering financial integration, with the FSAP deemed completed. However, as analysed in the previous section, the regulatory and supervision framework of the financial markets, even prior to the occurrence of the GFC, had started to raise scepticism, while the Lamfalussy process, became subject to ongoing reviews in order to improve its functioning. As the founding father of the Lamfalussy process,

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<sup>846</sup> 'Financial Services Action Plan: Progress and Prospects' (Expert Group on Banking, Final Report, May 2004) <[http://ec.europa.eu/internal\\_market/finances/docs/actionplan/stocktaking/report-bank\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/actionplan/stocktaking/report-bank_en.pdf)> accessed 14 July 2017.

<sup>847</sup> Ferran, Eilís, *Building an EU Securities Market* (Cambridge University Press 2004) 46.

<sup>848</sup> See: Véron, Nicolas, 'Is Europe Ready for a Major Banking Crisis?' (Bruegel policy brief, Issue 2007/03, August 2007) <[http://bruegel.org/wp-content/uploads/imported/publications/pbf\\_030807\\_banking.pdf](http://bruegel.org/wp-content/uploads/imported/publications/pbf_030807_banking.pdf)> accessed 14 July 2017.



Alexander Lamfalussy, stated, there were signs from 2005 onwards about a build-up of risks and a potential crisis.<sup>849</sup>

The GFC experience proved those concerns to be highly accurate, and it soon became apparent that the level of financial integration was not aligned with the regulatory and supervisory integration. The GFC had started to hit global financial markets since the collapse of the US sub-prime mortgage market in early 2007, and did not take long until it was felt in Europe in mid-2008, turning into a sovereign crisis in 2009/2010,<sup>850</sup> which influenced severely a number of Member States (especially: Italy, Spain, Greece, Portugal and Ireland). As stated in 2011 by the House of Lords: *“the interconnection of the sovereign debt and banking sectors was one of the principal elements that contributed to the current crisis.”*<sup>851</sup> Furthermore, the contagious effect and the systemic consequences were rapidly felt in the EU banking system, since many of its banks were heavily involved in international transactions. To this end, it was argued that the existing regulatory system led to the eruption of the GFC, mainly due to shortcomings related to the nationally-oriented governance of banking regulation and supervision.<sup>852</sup> Thus, while initially the focus was on the ongoing evaluation of the Lamfalussy process, the legal integration impetus in EU financial integration was then shifted towards the need to preserve financial stability, especially through

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<sup>849</sup> Lamfalussy, Alexandre, ‘The Specificity of the Current Crisis’ (The Belgian Financial Forum and the Robert Triffin International Foundation, Brussels, 30 April 2009), 2 <[http://ot-ds.sipr.ucl.ac.be/cps/ucl/doc/cehec/documents/The\\_Belgian\\_Financial\\_Forum\\_and\\_the\\_Robert\\_Triffin2.pdf](http://ot-ds.sipr.ucl.ac.be/cps/ucl/doc/cehec/documents/The_Belgian_Financial_Forum_and_the_Robert_Triffin2.pdf)> accessed 14 July 2017.

<sup>850</sup> For a detailed analysis on the linkages between sovereign debt crisis and banking crisis see: Gerlach, Stefan, Schulz, Alexander and Wolff, Guntram, ‘Banking and Sovereign Risk in the Euro Area’ (CEPR, Discussion Paper No. 7833, 2010).

<sup>851</sup> ‘The future of economic governance in the EU’ (House of Lords, European Union Committee Report, 12<sup>th</sup> Report Session 2010/2011), 15.

<sup>852</sup> For early surveys on this view, supporting that the financial crisis are triggered by supervisory framework shortcomings, see:

- ‘Financial Crises: Causes and Indicators: A Survey by the Staff of the International Monetary Fund’ (IMF, Washington, DC, May 1998);
- ‘International Capital Markets Developments, Prospects, and Key Policy Issues’ (IMF, September 1998);
- Lannoo, Karel, ‘From 1992 to EMU: The implications of prudential supervision’ (Centre for European Policy Studies Research Report 23, 1998); and
- Borio, Claudio, ‘Towards a macroprudential framework for financial supervision and regulation?’ (BIS Working Papers No 128, February 2003).

For after the Great Recession responses supporting the same view see among the rest:

- González-Páramo, José Manuel, ‘Future of banking supervision in Europe’ (Member of the Executive Board of the European Central Bank, Speech at the IBF National Conference 2008 “Beyond Financial Turmoil”, Dublin, 22 October 2008) <<http://www.bis.org/review/r081024e.pdf>> accessed 14 July 2017.



strengthening banking supervision.<sup>853</sup> This was explicitly addressed by the ECOFIN in October 2007, where it was concluded that it was necessary to take further steps, both at the EU and national level, with the view to strengthen financial stability arrangements in order align them with changes in financial markets.<sup>854</sup>

In the same vein, the final IIMG report in October 2007 stressed the need to improve the performance of Level 3 Committees, concluding that the latter should serve: *“as the platform to coordinate supervision and regulation, facilitating the development of supervisory tools and methods, and strengthening the trust between national supervisors.”*<sup>855</sup> As mentioned above, the same argument was followed by the Commission, in the Review of the Lamfalussy Process on November 2007, by highlighting that: *“the recent market turbulence has shown how interconnected markets are becoming-and-injecting an added degree of urgency to evolve the EU supervisory framework in line with these new market realities,”*<sup>856</sup> and therefore, there was a need to: *“adopt a globally convergent approach to regulation and supervision, with sound prudential rules and a consistent approach to supervision.”*<sup>857</sup>

Following the reasoning of both the final IIMG report and the EU Commission’s Lamfalussy Process Review of November 2007, the ECOFIN of December 2007, underlined the importance of working towards a European supervisory convergence and thus, the improvement all four Levels of the Lamfalussy Process was essential for this purpose.<sup>858</sup> Also, the ECOFIN of December 2007 invited the EU Commission to propose possible ways that would enhance the role of Level 3 Committees, without however, changing the non-binding nature of their decisions.<sup>859</sup> Shortly after, the ECOFIN in May 2008 adopted conclusions on supervision and financial stability arrangements, and provided updated roadmaps with

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<sup>853</sup> Andenas, Mads and Chiu, Iris, H.-Y. ‘Financial Stability and Legal Integration in Financial Regulation’ (2013) 38 European Law Review 335, 336.

<sup>854</sup> ECOFIN, 2822nd Council meeting on Economic and Financial Affairs (Council of the EU press release, 13571/07, Luxembourg, 9 October 2007) 2, 22 <[https://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/96375.pdf](https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/96375.pdf)> accessed 14 July 2017.

<sup>855</sup> IIMG Final Report (n 808) 5, 15, 16, 17.

<sup>856</sup> Commission COM (2007) 797 (n 813) 3.

<sup>857</sup> Commission COM (2007) 797 (n 813) 13.

<sup>858</sup> ECOFIN, 2836th Council meeting on Employment, Social Policy, Health and Consumer Affairs in Brussels, 4 December 2007 (Presse 270) 15698/07 <[https://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ecofin/97420.pdf](https://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/97420.pdf)> accessed 14 July 2017.

<sup>859</sup> ECOFIN, December 2007 (n 863) 17.

timetables for: the improvement of the Lamfalussy process; the enhancement of the EU financial stability arrangements; the upgrade of deposit guarantee schemes; and specific actions to be taken in response to the GFC.<sup>860</sup>

Following these findings, a new wave of legislative action began, aiming to address the gaps of the existing framework and to promote further regulatory and supervisory convergence. On 23 May 2008, the EU Commission launched a consultation paper, proposing various mechanisms that Level 3 Committees could use in order to achieve their main objective to enhance supervisory cooperation and convergence, with the view to also achieve: *“the consistent and timely implementation of Community legislation in the Member States.”*<sup>861</sup> Furthermore, the EU Commission stressed the importance of facilitating an improved role of the Level-3 Committees in a way that would ensure financial stability at both European and international level.<sup>862</sup> Later in October 2008, the EU Parliament called the EU Commission to submit official proposals on: the minimum criteria for effective arrangements on regulation and supervision; the adoption of measures to safeguarded financial stability and address systemic risk implications; and the reform of the supervisory framework by enhancing the role of Level 3 Committees.<sup>863</sup>

As a response, the EU Commission in its communication in 29 October 2008, launched work concerning the EU supervisory arrangements which was to be carried out by a high level expert group or the so-called De Larosière Group, chaired by Jacques De Larosière, who had previously served as the managing director of IMF.<sup>864</sup> In November 2008, the EU Commission’s President Barroso mandated the De Larosière Group to start working on: *“strengthening European supervisory arrangements covering all financial sectors, with the*

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<sup>860</sup> ECOFIN, ‘2866th Council Meeting on Economic and Financial Affairs in Brussels, 14 May 2008’ (Presse 113) 8850/08, 13 <[https://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ecofin/100339.pdf](https://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/100339.pdf)> accessed 14 July 2017.

<sup>861</sup> Commission, ‘Public Consultation Paper on Amendments to Commission Decisions establishing CESR, CEBS & CEIOP’ (23 May 2008), 3-10 <[http://ec.europa.eu/internal\\_market/finances/docs/committees/consultation\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/consultation_en.pdf)> accessed 14 July 2017.

<sup>862</sup> Commission, May 2008 (n 866) 10-11.

<sup>863</sup> European Parliament resolution of 9 October 2008 with recommendations to the Commission on Lamfalussy follow-up: future structure of supervision (2008/2148(INI)) <<http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2008-0476&language=GA>> accessed 14 July 2017.

<sup>864</sup> Commission, ‘From financial crisis to recovery: A European framework for action’ (Communication) COM (2008) 706 final, 4 <<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008DC0706&from=EN>> accessed 14 July 2017.

*objective of establishing a more efficient, integrated and sustainable European system of supervision and also of reinforcing cooperation between European supervisors and their international counterparts.*"<sup>865</sup> In the mandate, it was also acknowledged that the national-based supervisory arrangements, as promoted by the Lamfalussy process, although have evolved into promoting further convergence in supervisory practices, performed poorly in addressing and/or identifying the causes of the GFC. At the same period of time, the Level 3 Committees published an updated version of their joint protocol in 19 December 2008, with the view to further cooperate and coordinate their operations and tasks.<sup>866</sup> It is peculiar how the ECOFIN in December 2008, considered that the improvements necessary to EU banking supervision had reached a completion point,<sup>867</sup> while the De Larosière Report, which came two months later, explicitly emphasised that the EU supervisory infrastructure needed a radical change. The following section examines in detail the content of the De Larosière Report and the changes brought to the Lamfalussy process and the EU regulatory and supervisory architecture.

### 3.4.2 The De Larosière Report

As already highlighted, the GFC triggered a growing trend towards Europeanising banking regulation and supervision. Thus, the rationale of the De Larosière Group was clear, it aimed at reshaping the EU regulatory and supervisory environment in order to create a comprehensive, more efficient and integrated legal framework. Following the EU Commission's mandate in November 2008, the De Larosière Group published its Report in 25 February 2009,<sup>868</sup> including 31 recommendations. In May 2009 and in June 2009, the EU

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<sup>865</sup> 'High Level Expert Group on EU financial supervision to hold first meeting on 12 November' (Commission Press Release IP/08/1679, Brussels, 11 November 2008 <[http://europa.eu/rapid/press-release\\_IP-08-1679\\_en.htm](http://europa.eu/rapid/press-release_IP-08-1679_en.htm)> accessed 14 July 2017.

<sup>866</sup> 'Joint Protocol on Cooperation between CESR, CEBS and CEIOPS' (19 December 2008) <[https://www.esma.europa.eu/sites/default/files/library/2015/11/08\\_1001.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/08_1001.pdf)> accessed 14 July 2017.

<sup>867</sup> ECOFIN, '2911th Council Meeting on Economic and Financial Affairs in Brussels, 2 December 2008 (Presse 342) 16231/08, 9 <[https://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/104530.pdf](https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/104530.pdf)> accessed 14 July 2017.

<sup>868</sup> The De Larosière Group, 'The High Level Group on Financial Supervision in the EU' (Brussels, 25 February 2009) (hereinafter: De Larosière Report) <[http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf)> accessed 14 July 2017.

Commission<sup>869</sup> and Council,<sup>870</sup> respectively, endorsed the Report. The main objective of the De Larosière Report was to set a blueprint towards the creation of an improved institutional framework for supervision, whereby both micro- and macro-prudential supervision would be enhanced. As it was analysed in chapter two, in light of the GFC the macro-prudential dimension of supervision came into prominence. This is not, however, to say that micro-prudential supervision was to be neglected. The regulation of micro-prudential supervision was considered as equally important, especially given that financial distress usually starts with individual cases before spreading to the whole financial system.<sup>871</sup> In fact, the importance of the De Larosière Report lies on the fact that apart from highlighting the main weaknesses of the existing regulatory regime, it provided an innovative approach to dealing with the relationship between macro-prudential and micro-prudential supervision. This was considered to be instrumental in promoting the cooperation in monitoring systemic risks at EU level.<sup>872</sup>

From the outset, the De Larosière Report recognised that the GFC was a complex phenomenon, which resulted in severe losses that could not be instantly compensated. Therefore, preventing another financial crisis from happening was set as an immediate objective. This objective would rely on the cooperation of both European and international monetary authorities, including the regulatory and supervisory financial authorities.<sup>873</sup> Hence, the first chapter of the De Larosière Report, examined the causes that led to the GFC, by raising awareness on the implications with both European and international dimension. Namely, the areas that were identified to have embodied contributing factors that caused the GFC, included: macroeconomic issues (such as ample liquidity and low interest rates,<sup>874</sup> risk

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<sup>869</sup> Commission, 'European financial supervision' (Communication) COM (2009) 252 final <[http://ec.europa.eu/internal\\_market/finances/docs/committees/supervision/communication\\_may2009/C-2009\\_715\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf)> accessed 14 July 2017.

<sup>870</sup> ECOFIN, '2948th Economic and Financial Affairs, Council conclusions on Strengthening EU financial supervision' (Luxembourg, 9 June 2009) <[http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ecofin/108389.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/108389.pdf)> accessed 14 July 2017.

<sup>871</sup> See: Borio, Claudio, 'Towards a macroprudential framework for financial supervision and regulation?' (BIS Working Papers No 128, February 2003).

<sup>872</sup> Saccomanni, Fabrizio, 'Fact finding for the examination of the Communication of the European Commission on the European financial supervision' (A Testimony of the Director General of the Bank of Italy-Finance Committee of the Chamber of Deputies, Rome 2009) <<http://www.bis.org/review/r091006e.pdf>> accessed 14 July 2017.

<sup>873</sup> The De Larosière Report (n 873) introduction, para 4.

<sup>874</sup> The De Larosière Report (n 873) 8.

management and a failure in assessing potential risks);<sup>875</sup> weaknesses in terms of the role of Credit Rating Agencies (CRA);<sup>876</sup> corporate governance failures;<sup>877</sup> regulatory, supervisory and crisis management failures;<sup>878</sup> and dynamics of the financial crisis.<sup>879</sup> It could be argued, that these findings go in line with the relevant arguments that prevailed during that time in the literature arguing against the conventional wisdom, and hence, the discussion in chapter two on this matter becomes highly relevant.

The second chapter of the De Larosière Report, named “Policy and regulatory repair”, set out the proposed changes in the regulatory framework for financial services with the view to foster financial stability and prevent the re-occurrence of such a severe financial crisis.<sup>880</sup> Within this context, the De Larosière Report differentiated between regulation and supervision, since the two, often tend to be used in an interchangeable manner, while clarified that they were assessed together in the Report. Namely, regulation was considered to be the set of rules and standards that govern financial institutions, with the main aim to ensure financial stability and protect customers; whereas, supervision was consider the process of overseeing financial institutions that aimed to ensure the consistent application of rules and standards.<sup>881</sup> Furthermore, there was an explicit emphasis given to the macro-prudential oversight of financial institutions, with the involvement of the ECB on this matter being deemed as highly important.<sup>882</sup> It should be noted that at chapter three, it was highlighted that the involvement of ECB was considered pivotal in both micro- and macro-prudential supervision.<sup>883</sup> However, the De Larosière Group, after carefully considering the views in favour of delegating micro-prudential supervision responsibilities to the ECB,<sup>884</sup> advocated against of such an involvement.<sup>885</sup> Within the context of chapter two, the De Larosière Report *inter alia* stressed the impact of Basel II measures and how they have dealt with the challenges of the GFC, concluding that there was a need for a fundamental review of

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<sup>875</sup> The De Larosière Report (n 873) 8.

<sup>876</sup> The De Larosière Report (n 873) 9.

<sup>877</sup> The De Larosière Report (n 873) 10.

<sup>878</sup> The De Larosière Report (n 873) 10-11.

<sup>879</sup> The De Larosière Report (n 873) 11-12.

<sup>880</sup> The De Larosière Report (n 873) 13.

<sup>881</sup> The De Larosière Report (n 873) 13 para 38.

<sup>882</sup> The De Larosière Report (n 873) 15 para 49.

<sup>883</sup> The De Larosière Report (n 873) 42 para 167.

<sup>884</sup> The De Larosière Report (n 873) 43 para 169-171.

<sup>885</sup> The De Larosière Report (n 873) 44 para 172.

Basel II rules.<sup>886</sup> This also links with the reluctance of EU to implement the latest Basel, i.e. Basel III, as discussed in chapter two.

The following chapter, named “EU supervisory repair,” proposed a number of both short and longer term changes in the EU institutional governance for supervision, by highlighting the strong interdependent relationship between regulation and supervision. In the words of the Report: *“competent supervision cannot make good failures in financial regulatory policy; but without competent and well-designed supervision good regulatory policies will be ineffective. High standards in both are therefore required.”*<sup>887</sup> To this end, the De Larosière Report draw the difference between the macro- and micro- prudential supervision, by emphasising their respective importance and their intertwined nature both in substance and in operational terms.<sup>888</sup>

The new supervision architecture involved the creation of a decentralised network, called the European System of Financial Supervision (ESFS), which aimed at strengthening both micro- and macro-prudential supervision. The rationale for the establishment of ESFS was based on the realisation that the role and structure of Level 3 Committees were not sufficient enough to ensure financial stability, as mentioned earlier.<sup>889</sup> Therefore, at micro-prudential level, the ESFS intended to replace the existing Level 3 Committees, with a system of supervisors consisted of both European supervisors and NCAs. The European supervisors would undertake specific tasks that were considered to be better performed at EU level, whereas the NCAs would carry out day-to-day supervision.<sup>890</sup> The bodies or the so-called Authorities, that came to replace Level 3 Committees were: the European Banking Authority (EBA), the European Insurance Authority (EIA) and the European Securities Authority (ESA)).<sup>891</sup> The adoption of the ESFS was proposed to take place through a two stage process. The first stage would be the preparatory stage for ESFS (to be completed by 2009-2010) and

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<sup>886</sup> The De Larosière Report (n 873) 15-19.

<sup>887</sup> The De Larosière Report (n 873) 38 para 144.

<sup>888</sup> The De Larosière Report (n 873) 38 para 145.

<sup>889</sup> The De Larosière Report (n 873) 46 and 47 para 183.

<sup>890</sup> The De Larosière Report (n 873) 47 para 185.

<sup>891</sup> The De Larosière Report (n 873) 47 para 184 and 55.

at the second stage, the ESFS would be implemented (to be completed by 2011-2012).<sup>892</sup> Lastly, the ESFS was meant to be subject to review, three years after its entry into force.<sup>893</sup>

The macro-prudential pillar implied the establishment of the European Systemic Risk Council (later renamed as ESRB) which represented the first formal attempt to regulate macro-prudential supervisory arrangements at EU level. The ESRB would replace the Banking Supervision Committee of the ECB and would be under the auspices and logistical support of the ECB.<sup>894</sup> To this end, the De Larosière Report stressed the need for developing early macro-prudential risk warnings mechanisms to be mainly run by the ESRC, while working in close cooperation with the FSF.<sup>895</sup> The ESRB, however, was envisaged to remain a merely advisory body, since the responsibility to take actions would remain at national level. Also, the ESRB was not granted any decision-making powers and the NCAs would only have to take into account the finding of the ESRB in a voluntary basis.<sup>896</sup> The response of the NCAs to the ESRB's findings would then be reviewed by the ESRB and when necessary report to the EFC.<sup>897</sup> The ESRB was also assigned with the responsibility to inform the global supervisory system (the IMF, the FSF and the BIS) in case an issue was evaluated as having global implications.<sup>898</sup>

The last chapter was named "Global Repair" and focused on the promotion of financial stability at international level, through enhancing: regulatory consistency;<sup>899</sup> the cooperation among supervisors;<sup>900</sup> macroeconomic surveillance and crisis management mechanisms;<sup>901</sup> crisis management and resolution mechanisms;<sup>902</sup> EU's representation at the global institutions;<sup>903</sup> and EU's bilateral financial relations.<sup>904</sup> In order to raise regulatory consistency, the De Larosière Report proposed to enhance the role of the FSF,<sup>905</sup> which would

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<sup>892</sup> The De Larosière Report (n 873) 48 para 191 and 49-56.

<sup>893</sup> The De Larosière Report (n 873) 58 para 215.

<sup>894</sup> The De Larosière Report (n 873) 44 para 177.

<sup>895</sup> The De Larosière Report (n 873) 45 para 180.

<sup>896</sup> The De Larosière Report (n 873) 45 para 180.

<sup>897</sup> The De Larosière Report (n 873) 45 para 181.

<sup>898</sup> The De Larosière Report (n 873) 45 para 181.

<sup>899</sup> The De Larosière Report (n 873) 60-61.

<sup>900</sup> The De Larosière Report (n 873) 61-63.

<sup>901</sup> The De Larosière Report (n 873) 63-66.

<sup>902</sup> The De Larosière Report (n 873) 66.

<sup>903</sup> The De Larosière Report (n 873) 67.

<sup>904</sup> The De Larosière Report (n 873) 67-68.

<sup>905</sup> The De Larosière Report (n 873) 60 para 228.

have to cooperate with the BCBS and report regularly to the IMF and the International Monetary and Finance Committee (IMFC).<sup>906</sup>

Following the recommendations of the De Larosière Report, the EU Commission released a package of draft legislation in 23 September 2009,<sup>907</sup> including proposals for regulations establishing the so-called European Supervisory Authorities (ESAs) including: a European Banking Authority (EBA);<sup>908</sup> a European Insurance and Occupational Pensions Authority (EIOPA);<sup>909</sup> a European Securities and Markets Authority (ESMA)<sup>910</sup> and a ESRB;<sup>911</sup> and a proposal for a Council decision entrusting the ECB with specific tasks concerning the ESRB.<sup>912</sup> The ECOFIN on 20 October 2009 reached agreement on a draft regulation establishing the ESRB,<sup>913</sup> while on 9 December 2009, approved the establishment of the three ESAs.<sup>914</sup>

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<sup>906</sup> The De Larosière Report (n 873) 60 para 228 and 61 para 229.

<sup>907</sup> 'Commission adopts legislative proposals to strengthen financial supervision in Europe' (Press Release, Commission, IP/09/1347, Brussels, 23 September 2009) <[http://europa.eu/rapid/press-release\\_IP-09-1347\\_en.htm](http://europa.eu/rapid/press-release_IP-09-1347_en.htm)> accessed 14 July 2017. See also the two relevant Commission memos:

- 'European System of Financial Supervisors (ESFS): Frequently Asked Questions' (Commission MEMO/09/404, Brussels, 23 September 2009 <[http://europa.eu/rapid/press-release\\_MEMO-09-404\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-09-404_en.htm?locale=en)> accessed 14 July 2017.
- 'New financial supervision architecture: Q&A on the European Systemic Risk Board / the macro-supervision part of the package' (Commission, MEMO/09/405, Brussels, 23 September 2009) <[http://europa.eu/rapid/press-release\\_MEMO-09-405\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-09-405_en.htm?locale=en)> accessed 14 July 2017.

<sup>908</sup> Commission, 'Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority' COM (2009) 501 final.

<sup>909</sup> Commission, 'Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority' COM (2009) 502 final.

<sup>910</sup> Commission, 'Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority' COM (2009) 503 final.

<sup>911</sup> Commission, 'Proposal for a regulation of the European Parliament and of the Council on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board' COM (2009) 499 final.

<sup>912</sup> Commission, 'Proposal for a Council decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board' COM (2009) 500 final.

See also: Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority' COM(2009) 576 final.

<sup>913</sup> ECOFIN, '2967th Council meeting on Economic and Financial Affairs in Luxembourg, 20 October 2009' 4601/09 (Presse 294) 8 <[https://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/110622.pdf](https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/110622.pdf)> accessed 14 July 2017.

<sup>914</sup> ECOFIN, '2981st Council meeting on Economic and Financial Affairs in Brussels, 2 December 2009' 16838/09 (Presse 352) 6 <[https://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/111706.pdf](https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111706.pdf)>



The EU Commission's proposals were welcomed by the EU Parliament that gave the green light for the new supervisory framework on 22 September 2010.<sup>915</sup> This was followed by the EU Council's response, announcing on November 2010 that it had adopted legal texts setting out a reform of the EU framework for supervision of the financial system, which aimed at eliminating deficiencies that were exposed during the GFC.<sup>916</sup> Shortly after, the relevant Regulations were issued by the EU Council and thus, the new EU supervisory framework took shape. This resulted in a network of new institutions with specific tasks and division of responsibilities, intended to address both dimensions of prudential supervision i.e. micro- and macro-prudential. This set of reforms was generally welcomed and has been considered as instrumental in changing the way Europe perceived banking regulation and supervisions until then. Hence, the analysis to follow examines in detail the institutional structure and the role of the relevant institutions in each pillar.

#### *3.4.2.1. The Macro-prudential pillar: the European Systemic Risk Board (ESRB)*

As mentioned earlier, the need to strengthen the macro-prudential dimension of financial regulation and supervision, by focusing on the financial system as a whole as opposed to the soundness of individual financial institutions, became a core element of the policy response to the GFC at both EU and international level. This discussion also links with the analysis advanced in chapter two as to how macro-prudential policies came into prominence in light of the GFC. At EU level, as analysed already, the Lamfalussy process was criticised for neglecting the importance of macro-prudential issues, while it remained focused on individual firms.<sup>917</sup> Hence, the EU Commission in late 2008 highlighted that there was a need to: *"redefine the regulatory and supervisory model of the EU financial sector, particularly for the large cross border financial institutions. The current national-based organisation of EU supervision limits the scope for effective macro-prudential oversight."*<sup>918</sup>

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<sup>915</sup> 'Parliament gives green light to new financial supervision architecture' (European Parliament, Press Release, Strasbourg, 22 September 2010 <<http://www.europarl.europa.eu/news/en/news-room/20100921IPR83190/Parliament-gives-green-light-to-new-financial-supervision-architecture>> accessed 14 July 2017.

<sup>916</sup> 'Council adopts legal texts establishing the European Systemic Risk Board and three new supervisory authorities' (European Council, Press Release, 16452/10, Brussels, 17 November 2010) <[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/117747.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf)> accessed 14 July 2017.

<sup>917</sup> Kern (n 807).

<sup>918</sup> Commission Communication (n 866) 4.

Similarly, Adair Turner, who was serving as the Chairman of FSA at the time, highlighted in his speech in late 2009, that the most crucial things that went wrong in the run-up to the GFC was the excessive focus on micro-prudential risks, while there was a lack of awareness in term of macro-prudential risks to financial stability. Turner also added that for this reason there was a need to establish: *“a body at European level, focused specifically on identifying these big picture risks....and this body will need input from both central banks and from national supervisors - so it has both a ‘top-down’ and a ‘bottom-up’ perspective. But creating such an institution will be the easy bit; making sure it really adds value will be more challenging.”*<sup>919</sup>

Therefore, it is hardly surprising that the De Larosière Report and the subsequent regulatory response focused on enhancing the macro-prudential dimension of supervision. Part of this attempt was the establishment of ESRB in December 2010 on the basis of Article 114, TFEU.<sup>920</sup> The ESRB, as discussed above, represented the macro-prudential pillar of ESFS and intended to replace the existing Banking Supervision Committee of the ECB. Also, the ESRB regulation was complemented by a regulation conferring specific task upon the ECB.<sup>921</sup> The ESRB became operational on 1 January 2011 and its regulation is divided in four chapters, where chapter one addressed its establishment, definitions, and objectives;<sup>922</sup> chapter two outlined its institutional and structural organisation;<sup>923</sup> chapter three specified its tasks;<sup>924</sup> and chapter four set out the final provisions regarding accountability and reporting, its review and entry into force.<sup>925</sup> The main objective of the ESRB was to develop a macro-prudential perspective, with the view to solve the problem of nationally fragmented micro-prudential risk assessment.<sup>926</sup>

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<sup>919</sup> Adair Turner, the Chairman of FSA, Speech at the City of London Corporation’s Annual Reception for the City Office, London, 06 Oct 2009 <[http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1006\\_at.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1006_at.shtml)> accessed 14 July 2017.

<sup>920</sup> ‘Regulation No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board’ [2010] OJ L331/1 (hereinafter: The ESRB Regulation).

<sup>921</sup> Council Regulation (EU) No. 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board [2010] OJ L331/162.

<sup>922</sup> The ESRB Regulation (n 925) Articles 1-3.

<sup>923</sup> The ESRB Regulation (n 925) Articles 4-14.

<sup>924</sup> The ESRB Regulation (n 925) Articles 15-18.

<sup>925</sup> The ESRB Regulation (n 925) Articles 19-21.

<sup>926</sup> The ESRB Regulation (n 925) recital 11.

Furthermore, the ESRB aimed to strengthen the early warning mechanisms, by monitoring and assessing systemic risk with the view to safeguard financial stability.<sup>927</sup> This early warning mechanisms were highly based on information evaluation through cooperation with the micro-prudential pillar,<sup>928</sup> which allowed for greater interaction and cooperation between micro- and macro-prudential pillars.<sup>929</sup> To this end, the ESRB would be responsible to issue warnings in case systemic risk is identified as well as issue recommendations for remedial action,<sup>930</sup> which would include, when necessary, recommendations for legislative initiatives.<sup>931</sup> The addressees of the warnings and recommendations could be: the Union as a whole; or one or more Member States; or one or more of the ESAs; or one or more of the NCAs.<sup>932</sup> It should be noted that the individual financial institutions were excluded from the scope of the ESRB's warnings and recommendations.<sup>933</sup> Lastly, in line with the Larosière Report recommendations, the ESRB was designed to work closely with international institutions, which hold similar responsibilities to issue early warnings of macro-prudential risks, including IMF and the Financial Stability Board (FSB).<sup>934</sup>

With regards to the institutional framework, as it was explicitly stated in its regulation, the ESRB, despite from being an independent body, was not granted a legal personality and thus, its decisions were not legally binding.<sup>935</sup> As it was highlighted by the EU Commission in the ESRB's regulation proposal, the ESRB would draw its legitimacy from its reputation for independent judgements, high quality analysis and sharpness in its conclusions.<sup>936</sup> Particular attention was paid to the ESRB formation, which should reflect: *"an appropriate composition*

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<sup>927</sup> The ESRB Regulation (n 925) recital 10 and Article 3(1).

<sup>928</sup> The ESRB Regulation (n 925) recital 24, 26, Article 1(4), Article 2(2)(a), Article 15

<sup>929</sup> Ferrarini, Guido and Chiodini, Filippo, 'Regulatory Multinational Banks in Europe: An Assessment of the New Supervisory Framework' in IMF, *Current Developments in Monetary and Financial Law, Volume 6: Restoring Financial Stability-The Legal Response* (IMF, Legal Department, February 8, 2013) 93, 127.

<sup>930</sup> The ESRB Regulation (n 925) Article 3(2)(c) and (d).

<sup>931</sup> The ESRB Regulation (n 925) Article 16(1).

<sup>932</sup> The ESRB Regulation (n 925) Article 16(2).

<sup>933</sup> Commission, 'Accompanying document to the Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board; Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board; Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority; Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority; Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority' (Impact Assessment) SEC (2009) 1234, 42.

<sup>934</sup> The ESRB Regulation (n 925) recital 7, Article 3(2)(i).

<sup>935</sup> The ESRB Regulation (n 925) recital 15. See also: Commission (n 938) 7.

<sup>936</sup> Commission (n 938) 4.

*(bringing together the ECB, the national central banks, the new Supervisory Authorities as well as national supervisory authorities) that would create valuable synergies, ensure an appropriate level of representation, and have a mutually reinforcing impact on the stability of the financial system.*<sup>937</sup> This was also illustrated in a number of entities that were to accompany the ESRB's operation, including: a General Board (GB), a Steering Committee, an Advisory Scientific Committee (ASC), the Advisory Technical Committee (ATC) and a Secretariat.<sup>938</sup> The General Board, chaired by the President of ECB and composed of 65 members, would serve as the main decision-making body of the ESRB.<sup>939</sup> The ESRB members would be divided into 37 voting and 28 non-voting. The voting members would include: the President and Vice-President of the ECB; the governors of the national central banks of the EU Member States; the Chairs of the three ESAs; a member of the EU Commission; the Chair and the two Vice-Chairs of the ASC and the Chair of the ATC. The non-voting members would include: the President of the EFC and one high-level representative per EU Member State from the competent NCAs authorities. The Steering Committee would consist of 14 members of the General Board and intended to support the decision-making process of the ESRB by preparing the meetings of the General Board and monitoring the progress of the ESRB's operations.<sup>940</sup> The Advisory Scientific Committee and the Advisory Technical Committee aimed in assisting the operation of the ESRB subject to Chair's request.<sup>941</sup>

This organisational structure created a complex institutional framework consisted of three layers of macro-prudential decision-making (ESRB, ECB's Governing Council and NCAs), which combined with the highly integrated nature of EU financial markets, required a high level of cooperation between all components involved.<sup>942</sup> In fact, there was a mandatory obligation for cooperation and information exchange between NCAs and the ECB/ESCB, as envisaged by the De Larosière Report.<sup>943</sup> This was also illustrated in Article 15(1),(2), ESRB Regulation, according to which the actors of both micro- and macro-prudential pillars would

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<sup>937</sup> Commission (n 938) 9.

<sup>938</sup> The ESRB Regulation (n 925) recital 16 and Article 4(1).

<sup>939</sup> The ESRB Regulation (n 925) Articles 5 and 6.

<sup>940</sup> The ESRB Regulation (n 925) Article 11.

<sup>941</sup> The ESRB Regulation (n 925) Article 12 and 13.

<sup>942</sup> 'Allocating macro-prudential powers' (Report of the Advisory Scientific Committee, ESRB, November 2014), 16

<[https://www.esrb.europa.eu/pub/pdf/asc/Reports\\_ASC\\_5\\_1411.pdf?6c921d3c90969380fb7240e29d032dac](https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_5_1411.pdf?6c921d3c90969380fb7240e29d032dac)> accessed 14 July 2017.

<sup>943</sup> The De Larosière Report (n 873) 45 para 180.

have to cooperate in exchanging information and data with each other. Namely, the ESRB would have to provide the ESAs with all necessary information for risk assessment,<sup>944</sup> while the ESAs along with the ESCB, the EU Commission, the national authorities and national statistical authorities, would have to provide the ESRB with all necessary information as well.<sup>945</sup> This obligation to cooperate was considered of fundamental importance since it implied that: firstly, micro-prudential supervision has been now complemented by a macro-prudential perspective, which practically meant that the focus had shifted from the soundness of individual financial institutions to wider macroeconomic risks that could threaten the soundness of the financial system as a whole;<sup>946</sup> and secondly, an innovative involvement of the ECB in macro-prudential supervision, which paved the way for enhancing the participation of the ECB in banking supervision.

In general, the role and operation of the ESRB met with approval, and was considered to be a key element towards creating a centralised credible framework to identify and mitigate risks to financial stability at EU level.<sup>947</sup> However, there were certain aspects that have been subject to criticism, especially regarding its governance. For instance, there were doubts as to the effectiveness of the ESRB in addressing systemic risk due to the lack of an adequate understanding of what systemic risk entails. However, as Kern argued: *“the absence of a consensus view on the sources of systemic risk...does not preclude the design of effective cross-border institutional structures to monitor and measure systemic risks in European financial markets.”*<sup>948</sup>

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<sup>944</sup> The ESRB Regulation (n 925) Articles 15 (1).

<sup>945</sup> The ESRB Regulation (n 925) Articles 15 (2).

<sup>946</sup> ‘Economic Crisis in Europe: Causes, Consequences and Responses’ (Directorate-General for Economic and Financial Affairs, European Commission 2009)

<[http://ec.europa.eu/economy\\_finance/publications/pages/publication15887\\_en.pdf](http://ec.europa.eu/economy_finance/publications/pages/publication15887_en.pdf)> accessed 14 July 2017.

<sup>947</sup> For a detailed analysis of the ESRB see: Andenas, Mads and Deipenbrock, Gudula (eds), *Regulating and Supervising European Financial Markets: More Risks than Achievements* (1<sup>st</sup> edn Springer 2016), 43-66.

See also: Darvas, Zsolt, Schoenmaker, Dirk and Véron, Nicolas, ‘Reforms to the European Union Financial Supervisory and Regulatory Architecture and their Implications for Asia’ (Asian Development Bank Institute Working Paper No. 615, 27 November 2016), 27

<<https://www.adb.org/sites/default/files/publication/212176/adbi-wp615.pdf>> accessed 14 July 2017.

<sup>948</sup> Kern (n 807) 242.

There was also controversy as to the composition of ESRB for being: *“ludicrously lopsided in favour of central banks in general and of the ECB in particular.”*<sup>949</sup> This assertion was based on the experience of the GFC, which questioned the ability of central banks to address macro-prudential risks. As a response, a number of central bankers argued in favour of the view that their role is pivotal in macro-prudential oversight, due to their informational advantage position, the independence of their operation as well as technical expertise.<sup>950</sup> Other concerns regarding the composition of the ESRB, were based on arguments supporting that it facilitated more favourable treatment towards Eurozone Member States, while it excluded the participation of the non-euro area financial markets.<sup>951</sup> The latter was addressed by the ESRB Regulation in Article 11(1), which required the participation of both Eurozone and non-Eurozone Member States.<sup>952</sup>

Part of the same debate was another highly controversial issue, which refers to the role of the ECB in providing administrative support and participating in macro-prudential supervision within the ESRB. The composition of ESRB raised eyebrows in countries, mainly, outside the Eurozone. For instance, concerns were expressed by the UK, which feared that the interests of the City of London, as the financial centre of Europe, would not be adequately taken into consideration by the proposed macro-prudential supervisory arrangements since most of its members were to be central bankers from only Eurozone Member States. In addition, the UK was of the position that ECB’s role should remain as an observer.<sup>953</sup> This also

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<sup>949</sup> Butier William, ‘The proposed European Systemic Risk Board is overweight central bankers’ (Financial Times, October 28, 2009) <<http://blogs.ft.com/maverecon/2009/10/the-proposed-european-systemic-risk-board-is-overweight-central-bankers/#axzz4cnyolZke>> accessed 14 July 2017.

<sup>950</sup> See among the rest:

- Wellink, Nout, ‘Supervisory arrangements-lessons from the crisis’ (Speech at the 44th SEACEN Governors’ Conference: “Preserving monetary and financial stability in the new global environment”, Kuala Lumpur, Malaysia 6 February 2008) <<https://www.dnb.nl/en/news/news-and-archive/speeches-2009/dnb212157.jsp>> accessed 14 July 2017;
- Landau, Jean-Pierre, ‘Bubbles and macro prudential supervision’ (Remarks by Mr Jean-Pierre Landau, Deputy Governor of the Bank of France, at the Joint conference on “The Future of Financial Regulation”, organised by the Bank of France and the Toulouse School of Economics (TSE), Paris, 28 January 2009) <<http://www.bis.org/review/r090327e.pdf>> accessed 14 July 2017; and
- Thomopoulos, Panayotis, ‘The role of central banks as financial supervisors’ (Speech at ‘The Economist Conferences 8th Banking Forum: Banking and the Economy in Turbulent Times’ Athens, 26 January, 2009) <<http://www.bis.org/review/r090203c.pdf>> accessed 14 July 2017.

<sup>951</sup> Begg, Iain ‘Regulation and Supervision of Financial Intermediaries in the EU: The Aftermath of the Financial Crisis’ (2009) 47 (5) Journal of Common Market Studies 1107, 1120-1121.

<sup>952</sup> The ESRB Regulation (n 925) Article 11 (1)(c).

<sup>953</sup> ‘The future of EU financial regulation and supervision’ (House of Lords, 14th Report of Session 2008-09, The Stationery Office Limited, 17 June 2009) 39-40 and para 141.

goes in line with the wording of Article 127(6), TFEU, which requires unanimity for conferring macro-prudential tasks to ECB. However, given the composition of the ESRB, the ECB was envisaged to play a very active role within ESRB. Namely, the ESRB would be chaired by the ECB President, supported by the Secretariat of the ECB and would be composed mainly of the members of ECB/ESCB General Council (along with the chairpersons of Level 3 Committees as well as one representative of the EU Commission),<sup>954</sup> drawing on technical advice from all EU national central banks and supervisors.<sup>955</sup>

Therefore, it could be argued that the establishment of ESRB constituted the first official attempt to assign prudential supervision tasks to the ECB, drawing its legal basis by Article 127(6), TFEU. Namely, the ECB's involvement in supervision was limited to specific macro-prudential oversight tasks, following closely the wording of Article 127(6), TFEU, which was made use of for the first time.<sup>956</sup> Notably, Article 127(6), TFEU,<sup>957</sup> prohibits the ECB from assuming micro-prudential supervisory tasks unless such a delegation is made through unanimous vote by the Council after consultation with the EU Parliament. The ECB's exclusion from micro-prudential tasks was already stressed by the De Larosière Report, with the latter providing an exhaustive list of reasons against delegating micro-prudential supervisory powers to ECB.<sup>958</sup> However, the ECB's enhanced role within the ESRB structure implied its potential access to micro-prudential information due to the obligation of cooperation between the macro-and micro-prudential pillar. This, although proved to be pivotal in opening the way for further involvement of the ECB in micro-prudential supervision at a later stage, it raised question as to the legitimacy of the ESFS supervisory architecture.

Another issue that was believed to undermine the role and efficiency of the ESRB in achieving its objective was the fact that its operation was based to a great extent on voluntary

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<sup>954</sup> See: The De Larosière Report (n 873) 44 para 178 and the ESRB Regulation (n 925) recital 6, 24; Article 5(1), (2), (7); Article 6(1)(a); Article 11(1); Article 13(1).

<sup>955</sup> See: González-Páramo, José Manuel, 'The regulatory and supervisory reform in Europe' (Speech by Member of the Executive Board of the ECB, Presentation of the Report, Madrid, 22 January 2010) <<https://www.ecb.europa.eu/press/key/date/2010/html/sp100122.en.html>> accessed 14 July 2017.

<sup>956</sup> Commission, 'Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board' COM (2009) 499 final, 4.

<sup>957</sup> An extensive analysis of Article 127(6), including the enabling clause, is developed in chapter four when examining the legal basis of the SSM.

<sup>958</sup> The De Larosière Report (n 873) 44 para 172. See also: Smits, René, 'Europe's Post-crisis Supervisory Arrangements: A Critique' (2010) 1 (2) *Revista de concorrência e regulação* 125.

compliance, since the ESRB was designed to operate without legally binding powers.<sup>959</sup> As previously mentioned, the ESRB was not granted legal personality and as a result, its decisions would be soft law, i.e. not enforceable, as there was also no mechanism to impose legal sanctions.<sup>960</sup> However, this is not to say the ESRB warning and recommendations were completely to be ignored. ESRB recommendations would be subject to a ‘comply or explain’ regime, or as defined by the ESRB Regulation: ‘act or explain’ mechanism. This mechanism would entail an obligation for NCAs to report to the ESRB their willingness to comply or to provide an inadequate explanation as to the reasons of non-compliance.<sup>961</sup> Moreover, under the strict rules of confidentiality, warnings and recommendations would, in principle, be confidential. However, they could be transmitted to the EU Commission, Council and in some cases to the ESAs,<sup>962</sup> or even made public under particular circumstances, which would be decided on a case-by-case basis.<sup>963</sup> Therefore, despite the fact that the ESRB recommendations and warning would not be legally binding, the “comply or explain” mechanism, combined with the “threat” that actions against non-compliance could become public, reflects an objective of enhancing the enforceability of the relevant soft law decisions.<sup>964</sup> It should also be noted that the added benefit of the transmission of non-compliance information between the EU institutions, was that it had the potential to strengthen the cooperation of EU institutions on macro-prudential matters. Deutschebank has highlighted in its Report in 2010, that while the ESRB had only soft powers, those should not be underestimated; adding that, sound analysis and communication to the markets were fundamental in the success of ESRB.<sup>965</sup>

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<sup>959</sup> See: Ferran and Kern (n 821).

<sup>960</sup> ‘The European Systemic Risk Board: from institutional foundation to credible macroprudential oversight’ (Deutsche Bundesbank Monthly Report April 2012) 12, 37 <[https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly\\_Report\\_Articles/2012/2012\\_04\\_esrb.pdf?blob=publicationFile](https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2012/2012_04_esrb.pdf?blob=publicationFile)> accessed 14 July 2017.

<sup>961</sup> Commission (n 961) 19, 37; and The ESRB Regulation (n 925) recital 17, 20.

<sup>962</sup> The ESRB Regulation (n 925) recital 19, 20 and Article 16(3).

<sup>963</sup> The ESRB Regulation (n 925) Article 18.

<sup>964</sup> Dombret, Andreas and Lucius, Otto R. (eds) *Stability of the Financial System: Illusion or Feasible Concept?* (Edward Elgar Publishing Ltd 2013) 40.

<sup>965</sup> Speyer, Bernhard, ‘Financial supervision in the EU’ (Deutsche Bank Research, August 4, 2011) 6 <[https://www.dbresearch.com/PROD/DBR\\_INTERNET\\_EN-PROD/PROD000000000276501.PDF](https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000276501.PDF)> accessed 14 July 2017.



The ESRB's role to date has been very active in macro-prudential oversight and its general performance has been appraised as satisfactory.<sup>966</sup> As for February 2017, the ESRB has issued 10 recommendations in total;<sup>967</sup> 15 Reports;<sup>968</sup> 7 stress test;<sup>969</sup> 2 opinions;<sup>970</sup> 35 responses and letters;<sup>971</sup> 1 survey;<sup>972</sup> 1 handbook providing detailed assistance for macro-prudential authorities on how to use the instruments for the banking sector,<sup>973</sup> including an Addendum on macro-prudential leverage Ratios;<sup>974</sup> a flagship report providing an overview of the macro-prudential policy framework in the European Union for the banking sector;<sup>975</sup> and two decisions.<sup>976</sup> Also, on 22 September 2016 the ESRB issued warnings to eight Member States on medium-term vulnerabilities in the residential real estate sector,<sup>977</sup> and a

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<sup>966</sup> 'European Union: Publication of Financial Sector Assessment Program Documentation—Technical Note on Macroprudential Oversight and the Role of the ESRB' (IMF Country Report No. 13/70, March 212), 12.

<sup>967</sup> For all the ESRB recommendations see ESRB website:

<<https://www.esrb.europa.eu/mppa/recommendations/html/index.en.html>> accessed 14 July 2017.

<sup>968</sup> For all the ESRB reports see ESRB website: <<https://www.esrb.europa.eu/pub/reports/html/index.en.html>> accessed 14 July 2017.

<sup>969</sup> For all the ESRB stress tests see ESRB website:

<<https://www.esrb.europa.eu/mppa/stress/html/index.en.html>> accessed 14 July 2017.

<sup>970</sup> For all the ESRB opinions see ESRB website:

<<https://www.esrb.europa.eu/mppa/opinions/html/index.en.html>> accessed 14 July 2017.

<sup>971</sup> For all the ESRB responses and letters see ESRB website:

<<https://www.esrb.europa.eu/mppa/responses/html/index.en.html>> accessed 14 July 2017.

<sup>972</sup> For all the ESRB surveys see ESRB website:

<<https://www.esrb.europa.eu/mppa/surveys/html/index.en.html>> accessed 14 July 2017.

<sup>973</sup> 'The ESRB Handbook on Operationalising Macro-prudential Policy in the Banking Sector' (ESRB)

<[https://www.esrb.europa.eu/pub/pdf/other/140303\\_esrb\\_handbook\\_mp.en.pdf](https://www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf)> accessed 14 July 2017.

<sup>974</sup> 'The ESRB Handbook on Operationalising Macroprudential Policy in the Banking Sector - Addendum: Macroprudential Leverage Ratios' (ESRB, June 2015)

<[https://www.esrb.europa.eu/pub/pdf/other/150625\\_esrb\\_handbook\\_addendum.en.pdf](https://www.esrb.europa.eu/pub/pdf/other/150625_esrb_handbook_addendum.en.pdf)> accessed 14 July 2017.

<sup>975</sup> 'The ESRB Flagship Report provides an overview of the macroprudential policy framework in the European Union for the banking sector' (ESRB, 2014)

<[https://www.esrb.europa.eu/pub/pdf/other/140303\\_flagship\\_report.pdf](https://www.esrb.europa.eu/pub/pdf/other/140303_flagship_report.pdf)> accessed 14 July 2017.

<sup>976</sup> See:

- 'Decision of the European Systemic Risk Board of 27 January 2014 on a coordination framework regarding the notification of national macro-prudential policy measures by competent or designated authorities and the provision of opinions and the issuing of recommendations by the ESRB' [2014] ESRB/2014/2 C98/03; and
- 'Decision of the European Systemic Risk Board of 16 December 2015 on a coordination framework for the notification of national macroprudential policy measures by relevant authorities, the issuing of opinions and recommendations by the ESRB, and repealing Decision ESRB/2014/2' [2015] ESRB/2015/4.

<sup>977</sup> 'The ESRB issues eight Warnings on medium-term residential real estate vulnerabilities and a

Recommendation on closing real estate data gaps' (ESRB, Press Release, 28 November 2016)

<<https://www.esrb.europa.eu/news/pr/date/2016/html/pr161128.en.html>> accessed 14 July 2017. For the

report see: 'Vulnerabilities in the EU residential real estate sector' (ESRB, November 2016)

<[https://www.esrb.europa.eu/pub/pdf/reports/161128\\_vulnerabilities\\_eu\\_residential\\_real\\_estate\\_sector.en.pdf](https://www.esrb.europa.eu/pub/pdf/reports/161128_vulnerabilities_eu_residential_real_estate_sector.en.pdf)> accessed 14 July 2017.

recommendation on closing real estate data gap.<sup>978</sup> The role of the ESRB has been further strengthened with the assumption of micro-prudential supervisory tasks from the ECB in 2014. This is subject to further discussion in chapter four, wherein the role of the ESRB within the new supervisory framework and the possible synergies involved are analysed in detail.

#### *3.4.2.2. The Micro-prudential pillar: European Supervisory Authorities (ESAs)*

As discussed earlier in this chapter, the micro-prudential pillar of the new supervisory architecture involved the establishment of three ESAs. The organisation of the ESAs was based again on a sectoral approach and with one ESA for each sector i.e. one for the banking sector (EBA),<sup>979</sup> one for the securities sector (ESMA),<sup>980</sup> and one for the insurance and occupational pensions sector (EIOPA).<sup>981</sup> The ESAs were established with the view to replace the existing Level 3 Committees (CESR, CEBS, and CEIOPS), to address their main weaknesses,<sup>982</sup> and to create a stronger network of close cooperation and information exchange between NCAs in order to ensure effective micro-prudential supervision.<sup>983</sup> The ESAs became operational on 1 January 2011 and their regulations are supported by the so-called Omnibus I Directive<sup>984</sup> and later by the Omnibus II Directive in respect of the ESAs powers.<sup>985</sup> The responses as to this decision to strengthening the role of Level 3 Committees

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<sup>978</sup> 'Recommendations European Systemic Risk Board of 31 October 2016 on closing real estate data gaps' [2017] ESRB/2016/14 C 31/1.

<sup>979</sup> 'Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC' [2010] OJ L331/12 (hereinafter: EBA Regulation).

<sup>980</sup> 'Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC' [2010] OJ L331/84 (hereinafter: ESMA Regulation).

<sup>981</sup> 'Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC' [2010] OJ L331/48 (hereinafter: EIOPA Regulation).

<sup>982</sup> Clausen, Nils Jul, 'An Overview of a New Regulatory Regime in EU Financial Market Regulation' (2015) 4 (1) *Ricerche Giuridiche*, 17.

<sup>983</sup> Darvas et al (n 952) 5.

<sup>984</sup> 'Directive 2010/78/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority)' [2010] OJ L331/120.

<sup>985</sup> 'Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions

were mixed, with some Member States to have favoured this step, whereas other Member States feared the fiscal burden implications and limitations to sovereign powers that this decision might imply.<sup>986</sup>

The ESAs were granted legal personality<sup>987</sup> as well as administrative and financial independence from the other EU institutions.<sup>988</sup> The regulatory responsibilities of ESAs referred to the development of draft regulatory standards<sup>989</sup> and implementing technical standards<sup>990</sup> in the areas specified in each ESA Regulation. The regulatory technical standards aimed at assuring the consistent harmonisation of basic legislative acts and would become legally binding after the EU Commission's endorsement by means of delegated acts pursuant to Article 290, TFEU.<sup>991</sup> The implementing technical standards intended to ensure the consistent implementation of legally binding EU legislative acts and would become legally binding by means of implementing acts pursuant to Article 291, TFEU.<sup>992</sup> For anything that was not covered by regulatory or implementation technical standards, the ESAs could issue guidelines and recommendations towards NCAs or financial institutions,<sup>993</sup> whereas NCAs or financial institution would have to make every effort to comply with those guidelines and recommendations.<sup>994</sup>

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Authority) and the European Supervisory Authority (European Securities and Markets Authority)' [2010] OJ L153/1.

<sup>986</sup> See: Spendzharova, Aneta, 'Is More 'Brussels' the Solution? New European Union Member States' Preferences about the European Financial Architecture' (2012) 50 (2) Journal of Common Market Studies 315.

<sup>987</sup> EBA Regulation (n 984): recital 14 and Article 5; ESMA Regulation (n 985): recital 14 and Article 5; EIOPA Regulation (n 986): recital 13 and Article 5.

<sup>988</sup> EBA Regulation (n 984): recital 45, recital 59, Article 1(5), Article 42, Article 46, Article 49, Article 52, Article 59; ESMA Regulation (n 985): recital 45, recital 52, Article 1(5), Article 42, Article 46, Article 59; EIOPA Regulation (n 986): recital 44, recital 58, Article 1(6), Article 42, Article 46, Article 59.

<sup>989</sup> EBA Regulation (n 984): recital 22, Article 8 (1)(a), Article 8(2)(a), Article 10; ESMA Regulation (n 985): recital 22, Article 8 (1)(a), Article 8(2)(a), Article 10; EIOPA Regulation (n 986): recital 21, Article 8 (1)(a), Article 8(2)(b), Article 10.

<sup>990</sup> EBA Regulation (n 984): Article 8 (1)(a), Article 8(2)(b), Article 15; ESMA Regulation (n 985): Article 8 (1)(a), Article 8(2)(b), Article 15; EIOPA Regulation (n 986): Article 8 (1)(a), Article 8(2)(b), Article 15.

<sup>991</sup> EBA Regulation (n 984): recital 23 and Article 10(1); ESMA Regulation (n 985): recital 23 and Article 10(1); EIOPA Regulation (n 986): recital 22 and Article 10(1).

<sup>992</sup> EBA Regulation (n 944): recital 25 and Article 15 (1); ESMA Regulation (n 985): recital 25 and Article 15 (1); EIOPA Regulation (n 986): recital 24 and Article 15 (1).

<sup>993</sup> EBA Regulation (n 984): recital 26, Article 8(1)(a), Article 16; ESMA Regulation (n 985): recital 26, Article 8(1)(a) and Article 16; EIOPA Regulation (n 986): recital 25, Article 8(1)(a) and Article 16.

<sup>994</sup> EBA Regulation (n 984): Article 16 (3); ESMA Regulation (n 985): Article 16 (3); EIOPA Regulation (n 986): Article 16 (3).

In case an addressee would fail to comply with EU law or applies it incorrectly, amounting to a breach, the ESAs may investigate the alleged breach or non-application of Union law and address a recommendation to the NCA concerned, while setting out the actions necessary to comply with EU law.<sup>995</sup> Furthermore, the ESAs were entitled to adopt legally binding decisions in case of disagreements between supervisors, including the colleges of supervisors, on the application of EU rules.<sup>996</sup> The intended outcome of the ESAs operation was that by preparing uniform standards and ensuring supervisory convergence and coordination, the ESAs would contribute to the further development of the Single Rulebook applicable to all financial institutions of the Single Market.<sup>997</sup> The ESAs could also act in emergency or settlement situations affecting the stability of a financial institution.<sup>998</sup> However, the decisions taken by ESAs should not impinge on the fiscal responsibilities of Member States,<sup>999</sup> while national authorities would be given the right to refuse following decisions taken by ESAs in justified cases.<sup>1000</sup>

It is worth discussing here the notion of the Single Rulebook since the enhancement of which was among the key objective of ESAs. As defined by Andrea Enria, the Chairman of the European Banking Authority, the Single Rulebook constitutes: *“a comprehensive set of common standards for banks’ ...’ introduced to restore a legal framework consistent with such ultimate goal.”*<sup>1001</sup> The creation of a Single Rulebook, was not a new idea introduced with the establishment of ESAs in the post-GFC era. The notion of a Single Rulebook finds its roots back in 2004, when Tommaso Padoa-Schioppa described it as: *“a streamlined, uniform and flexible regulatory framework across the EU,”*<sup>1002</sup> proposing its adoption within the Level 2

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<sup>995</sup> EBA Regulation (n 984): recital 29 and Article 17; ESMA Regulation (n 985): recital 29 and Article 17; EIOPA Regulation (n 986): recital 26 and Article 17.

<sup>996</sup> EBA Regulation (n 984): recital 32, Article 8(1)(b), Article 19, Article 20; ESMA Regulation (n 985): recital 32, Article 8(1)(b), Article 19, Article 20; EIOPA Regulation (n 986): recital 31, Article 8(1)(b), Article 19, Article 20.

<sup>997</sup> EBA Regulation (n 984): recital 5 and 22; ESMA Regulation (n 985): recital 5 and 22; EIOPA Regulation (n 986): recital 5 and 21.

<sup>998</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): Articles 18 and 19.

<sup>999</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 5, recital 50 and Article 38.

<sup>1000</sup> Commission (n 961) 16, 50.

<sup>1001</sup> Enria, Andrea, ‘The Single Rulebook in banking: is it ‘single’ enough?’ (EBA, 28 September, 2015) <<https://www.eba.europa.eu/documents/10180/1208645/2015+09+28+-+Single+Rulebook+at+UniPadova.pdf/4ee29f76-c8ab-4cc3-afc2-d613aeac0b14>> accessed 14 July 2017.

<sup>1002</sup> Padoa-Schioppa, Tommaso, ‘How to deal with emerging pan-European financial institutions?’ (Member of the Executive Board of the ECB, Speech at the Conference on Supervisory Convergence organised by the Dutch Ministry of Finance, Hague, 3 November 2004) <<https://www.ecb.europa.eu/press/key/date/2004/html/sp041103.en.html>> accessed 14 July 2017

Committees as was originally introduced by the Lamfalussy process. Since then, the concept of the Single Rulebook has evolved and has gathered more attention as the process towards further financial integration was progressing towards tighter harmonised rules and coordinated practices across the EU. In 2009 the EU Council, following the recommendations of the De Larosière Report, used the term Single Rulebook to illustrate the goal of an integrated EU regulatory framework that would enable the completion of a Single Market in financial services.<sup>1003</sup> The term was later adopted by the ESAs Regulation, as analysed above, to describe the consistent application of EU rules in financial services by NCAs.

In line with the recommendations of De Larosière Report, ESAs Regulations imposed a cooperation obligation between all ESFS components pursuant to the principle of sincere cooperation under Article 4(3), TEU.<sup>1004</sup> The rationale of the cooperation approach is based on the belief that each component of the new supervisory architecture constitutes an integral part of it and as such, is closely intertwined and dependant to the other components.<sup>1005</sup> To this end, in the micro-prudential pillar, the ESAs, in order to ensure cross-sectoral consistency, would have cooperate in a regular basis and closely with each other through a Joint Committee.<sup>1006</sup> Along with the obligation to cooperate with each other, the ESAs would have to work in close cooperation with the ESRB.<sup>1007</sup> Namely, both the ESAs<sup>1008</sup> and the ESRB<sup>1009</sup> would have to exchange all necessary information for the achievement of their respective tasks. Furthermore, the ESAs are obliged to take the utmost account of the warnings and recommendations of the ESRB,<sup>1010</sup> and could also become the addressees of ESRB's warning and recommendations.<sup>1011</sup> Also, the ESRB Secretariat would draw on technical advice - apart from the national central banks and NCAs - from the ESAs as well.<sup>1012</sup>

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<sup>1003</sup> See: 'The Single Rulebook' (EBA website) <<http://www.eba.europa.eu/regulation-and-policy/single-rulebook>> accessed 14 July 2017.

<sup>1004</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): Article 2(4).

<sup>1005</sup> The ESRB Regulation (n 925) recital 30.

<sup>1006</sup> EBA Regulation (n 984): recital 57, Article 2(3) and Articles 54-57; ESMA Regulation (n 985): recital 57 and Articles 54-57; EIOPA Regulation (n 986): recital 57 and Articles 54-57.

<sup>1007</sup> ESRB Regulation (n 925): Article 3(2)(g); EBA Regulation (n 984): recital 47, Article 2(3), Article 8 (1)(d), Article 36; ESMA Regulation (n 985): recital 47, Article 2(3), Article 8 (1)(d), Article 36; EIOPA Regulation (n 986): recital 47, Article 2(3), Article 8 (1)(d), Article 36.

<sup>1008</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): Article 8(1)(b).

<sup>1009</sup> The ESRB Regulation (n 925) Article 15(1).

<sup>1010</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): Article 36(6).

<sup>1011</sup> The ESRB Regulation (n 925) Article 16(2).

<sup>1012</sup> The ESRB Regulation (n 925) Article 4(4).

As mentioned earlier, the ESAs' main tasks would focus on assisting the NCAs in the consistent interpretation and application of EU law. Additionally, ESAs were also designed to contribute to the mutual goal of safeguarding financial stability, through identifying early risks and vulnerabilities at micro-prudential level and inform accordingly the EU institutions, the other ESAs and the ESRB<sup>1013</sup> To this end, the ESAs, along with the ESRB, were also tasked to initiate and coordinate an EU-wide stress test in order to assess the resilience of financial institutions to adverse market developments.<sup>1014</sup> The ESRB would also be highly involved in the composition of the ESAs, since: the Chairperson of the Joint Committee would be a Vice-Chair of the ESRB;<sup>1015</sup> a representative of the ESRB should be invited to the meetings of the Joint Committee;<sup>1016</sup> the composition of the Board of Supervisors should include a representative of the ESRB, with a non-voting participation.<sup>1017</sup> The main difference between the micro-prudential pillar and the macro-prudential pillar, is that ESAs constituted separate legal entities and may adopt legally binding decisions, whereas the ESRB, as highlighted earlier, was not granted a legal personality and may only adopt soft-law decisions and recommendations.<sup>1018</sup>

The principal decision-making organ of the ESAs would be the Board of Supervisors, consisted of a Chair and the heads of the relevant NCAs,<sup>1019</sup> which would decide in simple majority.<sup>1020</sup> Also, a Management Board would be operating within each ESA, composed of the Chair of the respective ESA and of a representative of the EU Commission and NCAs, and tasked with management tasks such as: to propose the annual and multi-annual work programme, to exercise certain budgetary powers, to adopt the Authority's staff policy plan, to adopt special provisions on the right to access to documents and to propose the annual report.<sup>1021</sup> Responsible for preparing the work of the Board of Supervisors would be a

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<sup>1013</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 17, Article 2(1).

<sup>1014</sup> EBA Regulation (n 984): recital 43, Article 22(2), Article 23, Article 32; ESMA Regulation (n 985) recital 43, Article 23; EIOPA Regulation (n 986): recital 42, Article 23.

<sup>1015</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 57 and Article 55(3).

<sup>1016</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): Article 55(2).

<sup>1017</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): Article 40(1)(d).

<sup>1018</sup> Nagy, Zoltan B. and Csiszar, Anett S., 'Aspects of the European System of Financial Supervision' (2016) 50 (3) Zbornik Radova 977, 984.

<sup>1019</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 52, Article 6(1), Article 40-44.

<sup>1020</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 53, Article 44(1).

<sup>1021</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 54, Article 6(2), Articles 45-47.

Chairperson appointed on a full-time basis by the Board of Supervisors, who would also chair the meetings of the Board of Supervisors and the Management Board.<sup>1022</sup> The Chairperson's appointment would be subject to hearing by the EU Parliament, which can object the designation.<sup>1023</sup> This is comparable with the process of appointment of the Members of ECB's Executive Board.<sup>1024</sup> Lastly, there is also an Executive Director appointed to conduct management duties, who can participate in meetings of the Board of Supervisors and Management Board as a non-voting party.<sup>1025</sup>

Within the framework of micro-prudential pillar, the ESAs were designed to play the most important role. Their role, however, was complemented by the colleges of supervisors, which would work in close cooperation with the ESAs. The colleges of supervisors constitute an important component for effective financial supervision, which is evident from their progressively enhanced role at both EU and international level. Hence, in order to understand their updated tasks within the ESFS structure, it is important to examine their meaning, role and historical evolution.

#### *3.4.2.3. The colleges of supervisors under the ESFS's regulation*

The college of regulators or college of supervisors are not a new concept, or an idea that emerged only in the aftermath of the GFC. In fact, their use can be traced to the 1980s, when a group of bank regulators from the UK and other European countries became involved in the supervision of Bank of Credit and Commerce International ("BCCI").<sup>1026</sup> The *raison d'être* of their creation was based on the need to improve information exchange mechanisms regarding banks with international activity. This need emerged as a result of the realisation

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<sup>1022</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 55, Article 6(3), Articles 48-50.

<sup>1023</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 55.

<sup>1024</sup> Smits (n 963) 146.

<sup>1025</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): recital 56, Article 6(4), Article 40(7), Article 45(2), Articles 51-53.

<sup>1026</sup> See: Kerry, John and Brown, Hank, 'The BCCI Affair: A Report to the Committee on Foreign Relations' (General Accounting Office Washington, United States, 1993).

that BCCI, which had extensive cross-border activity, was not sufficiently supervised by the national supervisory authorities.<sup>1027</sup>

The crisis of BCCI broke out in 1991 after BCCI was forced into liquidation, following the discovery of pervasive fraudulent practices by BCCI's senior managers, board members, and representatives of major shareholders.<sup>1028</sup> Prior to its official closure, the situation became chaotic: national regulators were either restricting or blocking the activity of BCCI branches that were operating within their jurisdictions, and by mid-July 1991 forty-four jurisdictions had closed BCCI branches. The BCCI was worth roughly 20 billion dollars and its operations extended to sixty-nine countries, with most of its capital being located in the UK. At the time, international rules did not provide for the resolution of banks with international activity, and as a result, national supervisors took actions pursuant to their domestic laws. The interesting part about BCCI's failure, was that national supervisors had expressed their concerns about the reliability and long-term soundness of BCCI years before the scandal became known to the public.<sup>1029</sup>

The BCCI failure is considered to be the biggest banking failure of the twentieth century<sup>1030</sup> and as such, has attracted a significant amount of international attention.<sup>1031</sup> However, while details of the fraudulent activities might have been forgotten shortly after the scandal, the lessons in regard to the legal implications had a long-term impact on the way international banking is perceived. In fact, the case of BCCI has been considered as a milestone in raising awareness about challenges of the cross-border operations of financial institutions and the respective role of supervision and regulation.<sup>1032</sup> With regards to banking supervision, the part that drew considerable attention was the role of college of supervisors.

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<sup>1027</sup> 'Foreign Bank: Initial Assessment of Certain BCCI Activities in the U.S' (Report to the Honorable Robert H. Michel, Republican Leader, House of Representatives General Accounting Office United States, September 1992), 3 <<http://www.gao.gov/assets/220/216951.pdf>> accessed 14 July 2017.

<sup>1028</sup> For more details on the history of BCCI see: Truell, Peter and Gurwin, Larry BCCI, *The Inside Story of the World's Most Corrupt Financial Empire* (Bloomsbury Publishing PLC 1992).

<sup>1029</sup> For a detailed analysis on BCCI failure see: Alford, Duncan E., 'Basle Committee minimum standards: International regulatory response to the failure of BCCI' (1992) 6 (2) *George Washington Journal of International Law and Economics*.

<sup>1030</sup> See: Arnold, Patricia J. and Sikka, Prem, 'Globalization and the state-profession relationship: The case of the Bank of Credit and Commerce International' (2001) 26 (6) *Accounting, Organizations and Society* 475.

<sup>1031</sup> Zhang, Peter G., *Barings bankruptcy and financial derivatives* (World Scientific Publishing Company 1996).

<sup>1032</sup> Kern, Alexander, 'The Role of the Basle Standards in International Banking Supervision' (ESRC Centre for Business Research, University of Cambridge, Working Paper No. 153, 2000), 9.



The college of supervisors were not involved in supervisory duties *per se*, but constituted rather an informal, ad hoc body which facilitated the exchange of information and established a forum for dialogue between NCAs, with the view to identify and address risks involved from cross-border banking activity.

The subsequent closure of the BCCI proved that their use was ineffective, which was to be attributed to a number of factors, including cooperation among them in information-exchange regarding the BCCI's activities.<sup>1033</sup> However, the college of supervisors raised awareness about the importance of supervisory cooperation at both international and EU level, given also the fact that the BCCI closure did not have severe spillover effects to the financial system.<sup>1034</sup> As Callum McCarthy (the Head of the FSA at the time) stated in respect with the effectiveness of the college of supervisors: *"I do not doubt their individual quality, nor their willingness, but in some cases the resources are simply not up to the task of acting as the home regulator for a large group."*<sup>1035</sup>

This led to reconsidering prudential supervisory practices, with the role of supervisory colleges to have gathered renewed attention: at international level, within the context of the BCBS and at EU level, through the regulatory initiatives calling for cooperation among NCAs of banks with cross-border activity.<sup>1036</sup> At EU level, CEBS played an active role in enhancing the role of colleges of supervisors, by issuing explanatory and non-binding guidelines on their functioning.<sup>1037</sup> Therefore, it is hardly surprising that at the dawn of the GFC, the regulatory

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<sup>1033</sup> See: Laifer, Daniel M., 'Putting the Super Back in the Supervision of International Banking, Post-BCCI' (1992) 60 (6) Fordham Law Review.

<sup>1034</sup> Herring, Richard J. and Litan, Robert E., *Financial Regulation in a Global Economy* (Brookings Institution 1994) 105.

<sup>1035</sup> McCarthy, Callum, 'How should international financial service companies be regulated?' (Speech, FSA, 22 Sep 2004) para 13 <<http://www.fsa.gov.uk/library/communication/speeches/2004/sp196.shtml>> accessed 14 July 2017.

<sup>1036</sup> Among the legislative acts regulating the colleges of supervisors in a more formal way were: Directive 2006/49/EC (n 362); Directive 2006/48/EC (n 362); Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management' COM (2008) 602/3; 'Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council' OJ L 35/1, Article 5-17; Commission, 'Amended Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (SOLVENCY II)' COM(2008) 119 final, Article 251-263.

<sup>1037</sup> CEBS published two documents in December 2007 regarding the supervisory colleges function:

initiatives aiming to strengthen the role of supervisory colleges were only intensified. This was also evident by the views developed by various international institutions, reflecting a consensus as to the importance of college of supervisors and the need to strengthen their role as part of a general attempt to promote convergence and cooperation among NCAs. For instance, the G-20 in its November 2008 Summit, highlighted the importance of colleges of supervisors and called for the adoption of measures to facilitate and strengthen their role. As it was highlighted in the G-20 Summit: “...supervisors should collaborate to establish supervisory colleges for all major cross- border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm’s activities and assessment of the risks it faces.”<sup>1038</sup>

Prior to that the IMF had underlined in 2007 that: “ongoing efforts at coordination through international colleges of supervisors and codes of conduct will certainly help.”<sup>1039</sup> In the same vein, the Financial Stability Forum (FSF) in 2008 highlighted that: “Supervisors should build on existing examples of supervisory colleges, both in the Basel II framework and in regional arrangements such as the EU, to establish an international college of the most relevant supervisors for each of the largest global financial institutions by end-2008.”<sup>1040</sup> Also, the report of FSA on March 2009 (known as: the Turner Review), recommended to enhance the role of supervisory colleges, by arguing that they constitute: “a much more unified approach to global financial supervision and even fiscal support...” that can “...ensure better flows of information between NCAs and achieve the voluntary coordination of NCAs actions

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- ‘Range of Practices on Supervisory Colleges and Home-Host Cooperation’ (CEBS, 27 December 2007) <[https://www.eba.europa.eu/documents/10180/16166/CEBS+2007+75+\(Range+of+practices\)%20final.pdf](https://www.eba.europa.eu/documents/10180/16166/CEBS+2007+75+(Range+of+practices)%20final.pdf)> accessed 14 July 2017; and
  - ‘Template for a Multilateral Cooperation and Coordination Agreement on the Supervision of XY Group (CEBS, 27 December 2007) <[https://www.eba.europa.eu/documents/10180/16166/CEBS+2007+177+rev+2+\(template+for+written+agreements\)%20final+2.pdf](https://www.eba.europa.eu/documents/10180/16166/CEBS+2007+177+rev+2+(template+for+written+agreements)%20final+2.pdf)> accessed 14 July 2017.

<sup>1038</sup> ‘Declaration Summit on Financial Markets and the World Economy’ (G-20 Summit, 15 November, 2008) <<https://www.treasury.gov/resource-center/international/g7-g20/Documents/Washington%20Nov%20Leaders%20Declaration.pdf>> accessed 14 July 2017.

<sup>1039</sup> ‘Initial Lessons of the Crisis for the Global Architecture and the IMF’ (Prepared by the Strategy, Policy, and Review Department, Approved by Reza Moghadam, IMF, February 18, 2009), 10 <<https://www.imf.org/external/np/pp/eng/2009/021809.pdf>> accessed 14 July 2017.

<sup>1040</sup> ‘Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience’ (FSF, 7 April 2008), 42 <[http://www.fsb.org/wp-content/uploads/r\\_0804.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_0804.pdf?page_moved=1)> accessed 14 July 2017.

For the same approach see also: ‘Financial Reform: a Framework for Financial Stability’ (Working Group on Financial Reform) <<http://fic.wharton.upenn.edu/fic/Policy%20page/G30Report.pdf>> accessed 14 July 2017.

which will reduce the likelihood of firms coming close to crisis.”<sup>1041</sup> In furtherance of this objective, the BCBS issued a set of principles in 2010 which aimed to codify general rules for colleges of supervisors in order to promote and enhance their functioning.<sup>1042</sup> The principles were to be reviewed after a period of two years, with the aim to draw up on lessons learned from their practice until then. Thus, in January 2014, the BCBS published a Consultative Document,<sup>1043</sup> setting out an updated version of principles on colleges of supervisors. The final revision on the principles regarding the functioning and operation of colleges of supervisors was published in June 2014.<sup>1044</sup>

At EU level, as discussed already, the post-GFC process of reshaping the supervisory architecture was signalled by the De Larosière Report, which *inter alia* envisaged the enhancement of the role of supervisory colleges in the context of micro-prudential supervision.<sup>1045</sup> Following the recommendations of the De Larosière Report, the CRD II, introduced a mandatory obligation to establish supervisory colleges for banks with significant activity in order to coordinate NCAs in a more effective manner and to facilitate the handling of ongoing supervision and emergency situations.<sup>1046</sup> Also, Article 131a of CRD II provides the legal basis for the creation of a single college for global EU based banks. Following the recommendation of CRD II,<sup>1047</sup> the CEBS, in 2010, issued guidelines for the functioning of the

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<sup>1041</sup> ‘The Turner Review: A regulatory response to the global banking crisis’ (FSA, March 2009) <[http://www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf)> accessed 14 July 2017.

<sup>1042</sup> ‘Good practice principles on supervisory colleges’ (BCBS, October 2010) <<http://www.bis.org/publ/bcbs177.pdf>> accessed 14 July 2017.

<sup>1043</sup> ‘Revised good practice principles for supervisory colleges’ (Consultative Document of BCBS issued for comment by 18 April 2014 January) <<http://www.bis.org/publ/bcbs276.pdf>> accessed 14 July 2017.

<sup>1044</sup> ‘Principles for effective supervisory colleges’ (BCBS, June 2014) <<http://www.bis.org/publ/bcbs287.pdf>> accessed 14 July 2017.

<sup>1045</sup> The De Larosière Report (n 873) 51 para 203.

<sup>1046</sup> ‘Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management’ OJ L 302/97, recital 6, Article 131a and 42a.

CRD II is comprised of two additional Directives:

- Commission Directive 2009/27/EC of 7 April 2009 amending certain Annexes to Directive 2006/49/EC of the European Parliament and of the Council as regards technical provisions concerning risk management OJ L94/97;
- Commission Directive 2009/83/EC of 27 July 2009 amending certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council as regards technical provisions concerning risk management OJ L196/14.

<sup>1047</sup> Directive 2009/111/EC (n 1051) recital 2 and 8.

colleges of supervisors, including their organisational operation, information exchange among them and communication with the supervised institutions and other specific tasks.<sup>1048</sup>

It follows that the colleges of supervisors were also included within the new supervisory architecture as formed by the ESFS. Within the new structure the college of supervisors, as defined by EBA are: “*permanent, although flexible, coordination structures that bring together regulatory authorities involved in the supervision of a banking group.*”<sup>1049</sup> In order to strengthen their role, the ESAs were tasked to promote and monitor the function of the colleges of supervisors as well as to foster coherence of the application of EU law among them.<sup>1050</sup> Furthermore, ESA’s were designed to have an active participation in colleges’ activities. For instance, ESMA would conduct on-site verification or investigations, carried out jointly by two or more competent authorities.<sup>1051</sup> EBA would also participate in colleges’ operations as it deems appropriate, having the role of the NCA, while there is also an obligation for cooperation between EBA and the NCA participating in the colleges of supervisors.<sup>1052</sup> The EBA could develop draft regulatory technical specifying the general conditions of colleges’ functioning and draft implementing technical standards in order to determine their operational functioning.<sup>1053</sup>

At this stage, the colleges of supervisors were not mandated with any direct supervisory powers, but they were rather designed to be coordination structures that would facilitate information exchange and cooperation among NCAs.<sup>1054</sup> This was clearly stated in Article 131a(1), Directive 2009/111/EC as following: “*The establishment and functioning of*

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<sup>1048</sup> ‘CEBS’ Guidelines for the Operational Functioning of Supervisory Colleges’ (CEBS, 15 June 2010) <<http://www.eba.europa.eu/documents/10180/16094/CollegeGuidelines.pdf/586871d7-414a-45bd-88f0-e185e59a76fe>> accessed 14 July 2017.

This was accompanied by: “Guidelines for The Joint Assessment of the Elements Covered by the Supervisory Review and Evaluation Process (SREP) and the Joint Decision Regarding the Capital Adequacy of Crossborder Groups’ (CEBS (GL39) 293 Final, 22 December 2010) <<http://www.eba.europa.eu/documents/10180/15920/CEBS%27%20Guidelines+for+Joint+Risk+Assessment+%28GL+39%29.pdf/5b4f246e-1a52-4204-9d74-4b1a2dbcce44>> accessed 14 July 2017.

<sup>1049</sup> EBA website <<http://www.eba.europa.eu/supervisory-convergence/supervisory-colleges>> accessed 14 July 2017.

<sup>1050</sup> EBA Regulation (n 984): recital 36, Article 8(1)(b), 8(1)(b)(i), Article 21; ESMA Regulation (n 985): recital 36, Article 8(1)(b), 8(1)(b)(i), Article 21; and EIOPA Regulation (n 986) recital 35, Article 8(1)(b), (i), Article 21.

<sup>1051</sup> Directive 2010/78/EU (n 989) 136 recital 22.

<sup>1052</sup> Directive 2010/78/EU (n 989) 151 recital 35.

<sup>1053</sup> Directive 2010/78/EU (n 989) 146 recital 15, and 151 recital 35.

<sup>1054</sup> See also: Alford, Duncan, ‘The Use of Colleges of Regulators under European Union Banking Law’ (2009) 24 (7) Journal of International Banking Law and Regulation 355, 360.

*colleges of supervisors shall not affect the rights and responsibilities of the competent authorities under this Directive.*"<sup>1055</sup> This rather consultative role and the lack of direct supervisory powers or any power to resolve or mediate disputes between NCAs, raised question as to their effectiveness to promote cooperation and regulatory convergence. However, with the subsequent regulatory measures, the role of the supervisory colleges, including their relationship with ESAs, ESRB, ECB and NCAs, has been reshaped, especially with the establishment of SSM and new CRD IV package. The role of the college of supervision, being an integral part of the new structure, is also to be assessed in conjunction with the relevant legislative measures as discussed in chapter four.

### 3.5 The way forward: a step closer towards the centralisation of supervisory practices?

Having discussed the evolution of EU banking regulation, it could be argued that the process towards centralisation was initiated with the Lamfalussy process and the introduction of 'four level' governance. The Lamfalussy process, along with evidence brought by the GFC led to the De Larosière Report, which proved to be pivotal in changing the thinking and general attitude towards more integrated regulatory and supervisory arrangements.<sup>1056</sup> Furthermore, the transformation of the Level 3 Committees to Authorities (i.e. ESAs) with legal personality entitled to adopt legally binding decisions on the consistent implementation of EU law, has been considered as a crucial step towards furthering the integration of regulation and prudential supervision.<sup>1057</sup> As discussed earlier, the new ESAs, if compared to Level 3 Committees, constituted enhanced, more specialised and technically modified supervisory structures, which were tasked with a more sophisticated responsibility in the harmonisation process: the creation of a Single Rule for financial services.<sup>1058</sup> However, there was still a considerable amount of divergence of supervisory practices across Europe. In

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<sup>1055</sup> Directive 2009/111/EC (n 1051).

<sup>1056</sup> Ferran, Eilís, 'Crisis-Driven EU Regulatory Reform: Where in the World is the EU going?' in Ferran, Eilís, Moloney, Niamh, Hill, Jennifer G. and Coffee Jr John C. (eds), *The Regulatory Aftermath of the GFC* (Cambridge University Press 2012) 62.

<sup>1057</sup> Chamon, Merijn, 'EU agencies between Meroni and Romano or the devil and the deep blue sea' (2011) 48 (4) *Common Market Law Review* 1055, 1068-1070.

<sup>1058</sup> Tridimas, Takis, 'EU financial Regulation: federalization, crisis management, and law reform', in Craig, Paul and De Búrca, Gráinne (eds) *The Evolution of EU law* (2nd edn, Oxford University Press 2011) 804.

addition, the scope of powers that ESAs held, in terms of both their operational and regulatory functioning, remained rather limited.

As already discussed, the ESFS supervisory structure was highly based on the existing decentralised national supervisory regime, while the principles of mutual recognition and home country control retain their applicability.<sup>1059</sup> Financial supervision was to be exercised on the basis of detailed harmonised rules, through a system of two different layers of protection (i.e. national and supranational) and a complex distribution of responsibilities between home states, host states and college of supervisors, under the coordination of the respective ESAs.<sup>1060</sup> Within this institutional framework, ESAs operational functioning was highly influenced and constrained by the role of NCAs, given firstly, the prominent role of the NCAs on the Board of Governors and secondly, the great emphasis put in retaining a certain degree of Member State's fiscal discretion. As already mentioned, the ESAs would have to operate without impinging on the fiscal responsibilities of Member States.

The ESAs, as already analysed, were mainly focused on coordinating and monitoring the operation of NCAs and were not assigned any per se supervisory powers. Thus, they cannot be considered as creating any form of a supranational platform for centralisation of supervision at EU level.<sup>1061</sup> As CESR explained: *"by strengthening the Committees you would arrive at something which is, on the one hand, not a European single regulator, a body written in the Treaty, you would have a more flexible thing which is based on the coordinating role of the committees and on the existence of the national supervisors."*<sup>1062</sup> In other words, within this structure, the NCAs of 28 EU Member States would remain in charge of day-to-day supervision, with the only difference that now the NCAs would have to be accountable to the relevant ESA. This implied a high level of regulatory arbitrage, comprised of various divergences in terms of supervisory approaches, methods or the level of oversight rigidity, which in turn, led to fragmentation of supervisory practices instead of unification. To this end,

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<sup>1059</sup> Kern (n 807) 8; see also: Nagy, Ágnes, Pete, Ștefan, Benyovszki, Annamária, Petru, Tünde Petra and Györfy, Lehel-Zoltán, 'The De Larosière Report Regarding the new Structure of European System of Financial Supervision' (2010) 17 (11) *Theoretical and Applied Economics* 5 <<http://store.ectap.ro/articole/524.pdf>> accessed 14 July 2017.

<sup>1060</sup> Ferran (n 1061) 46.

<sup>1061</sup> Lo Schiavo, Gianni, '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 Comparative Law* 110, 117.

<sup>1062</sup> House of Lords (n 958) 48 para 179.

it could be argued that this fragmentation of supervisory practices could favour distortions in the operation of financial institutions with cross-border activity, while a comprehensive view and evaluation of systemic risk implications were highly restricted.

Similar to their operational role, the regulatory functioning of ESAs, was also narrow. The main decision-making powers of ESAs would be to develop regulatory and implementing technical standards, which will have no legally binding power. The process of making them enforceable would start with open public consultations and Banking Stakeholder Group opinion, followed by the EU Commission endorsement, and then finally for approval to the EU Parliament and Council. As explicitly stated in Articles 11 and 15 of each ESA Regulation, the regulatory and implementing technical standards would not: *“imply strategic decisions or policy choices and their content shall be delimited by the legislative acts on which they are based.”* Thus, the ESAs would practically be entitled only to develop the standards while, the EU Commission would hold the main discretionary power and the final word on their endorsement, partly endorsement or their amendment.<sup>1063</sup>

The reason behind this limited enforceability of ESAs decision finds its legitimacy in the so-called Meroni doctrine. The Meroni doctrine derives from the principle of upholding the balance of powers among institutions as created by the Treaties, and thus, limits the possibility of delegating tasks to regulatory agencies that go beyond the *stricto sensu* wording of the existing Treaty provisions. Thus, the ESAs were constrained from obtaining more powers than a delegating authority has under the provisions of the EU Treaty without Treaty amendment. This argument builds on the ruling of ECJ on the Meroni case, which concerned the delegation of powers to a non-institutional body.<sup>1064</sup> In the Meroni case, ECJ clarified that

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<sup>1063</sup> EBA Regulation (n 984), ESMA Regulation (n 985) and EIOPA Regulation (n 986): Articles 10 and 15.

<sup>1064</sup> Joined Cases C-9/56 and 10/56 *Meroni & Co., Industrie Metallurgiche, S.A.S. v High Authority of the European Coal and Steel Community* [1957/1958] ECR 133 (hereinafter: Meroni Case).

For more on the Meroni doctrine and the delegation of powers on regulatory agencies see:

- Yataganas, Xénophon A., ‘Delegation of Regulatory Authority in the European Union, The relevance of the American model of independent agencies’ (Jean Monnet Working Paper 3/01 2001);
- Moloney, Niamh, *EC Securities Regulation* (Oxford University Press 2002).

For a more recent analysis on the Meroni doctrine and the changing attitude towards it after the establishment of the ESAs see: Chatzimanoli, Despina, ‘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.

For an even more recent comprehensive analysis of the Meroni doctrine see: Chamon, Merijn, *EU Agencies: Legal and Political Limits to the Transformation of the EU Administration* (Oxford University Press 2016).

the delegation of power could not imply a wide margin of discretion,<sup>1065</sup> and could: “*only relate to clearly defined executive powers, the use of which must be entirely subject to the supervision of the High Authority.*”<sup>1066</sup>

The Meroni doctrine was constitutionalised by Article 290, TFEU and created a precedent that was followed in various subsequent ECJ jurisprudence. For instance, the ECJ in the Romano case (where the bodies in question was the Administrative Commission of the European Communities on Social Security for Migrant Workers), emphasised that Article 155 of the Treaty and the judicial system created by the Treaty, and in particular by Articles 173 and 177 thereof, prohibit the EU Commission to delegate powers to the aforementioned bodies to adopting acts having force of law.<sup>1067</sup> Thus, according to the Meroni doctrine, EU agencies are not entitled to exceed the limits of their powers, which in case of ESAs, would be to develop and propose regulatory and implementing technical standards.

The Meroni doctrine has been also used as the basic justification for those who have questioned the constitutionality of establishing a supranational body on the basis of Article 114, TFEU, which is a debate that predates the establishment of ESAs.<sup>1068</sup> For instance, in the Smoke Flavouring case, the United Kingdom questioned the adoption of Regulation 2065/2003,<sup>1069</sup> on the basis of Article 114, TFEU. Those claims were dismissed by the ECJ, with the latter confirming the legitimacy of the EU institutions’ decisions to adopt harmonisation measures under Article 114, TFEU.<sup>1070</sup> This reasoning was taken even further in the so-called ENISA ruling, wherein the United Kingdom doubted the constitutionality of creating the European Network and Information Security Agency (ENISA) on the basis of Article 114, TFEU. The Court, however, held that the establishment of ENISA fell within the scope of Article 114, TFEU, confirming in this way, the legality of ENISA’s decisions.<sup>1071</sup> Thus, according to the ECJ,

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<sup>1065</sup> Meroni Case (n 1069) 151-52.

<sup>1066</sup> Meroni Case (n 1069) 152.

<sup>1067</sup> Case C-98/80 Giuseppe Romano v Institut National d'Assurance Maladie-Invalidité [1981] ECR 1241, 1256 para 20 (hereinafter: Romano case).

<sup>1068</sup> Vos, Ellen, ‘Reforming the European Commission: What Role to Play for EU Agencies?’ (2000) 37 (5) Common Market Law Review 1113.

<sup>1069</sup> ‘Regulation (EC) No 2065/2003 of the European Parliament and of the Council of 10 November 2003 on smoke flavourings used or intended for use in or on foods’ [2003] OJ L 309/1.

<sup>1070</sup> Case C-66/04 *United Kingdom of Great Britain v. European Parliament and Council* [2005] ECR I-10553.

<sup>1071</sup> Case C-217/04 *United Kingdom of Great Britain and Northern Ireland v. European Parliament and Council of the European Union* [2006] ECR I-3771 (hereinafter: ENISA ruling).



Article 114, TFEU, provides not only as a legal basis for harmonisation but also as the legal basis for the establishment of a new supranational body as long as its operation and decisions contribute to the implementation of a process of harmonisation.<sup>1072</sup>

Therefore, building on the ENISA ruling, it is hardly surprising that Article 114, TFEU, at a later stage, served as an adequate legal basis for the establishment of ESAs.<sup>1073</sup> There is also an explicit mention of the ENISA case on the preamble of ESAs regulations.<sup>1074</sup> In a recent case (known as: ESMA short-selling case),<sup>1075</sup> concerning the ESAs and their delegated powers, the ECJ ruling came to introduce a new delegation doctrine regarding EU agencies that seems to have departed from the stringent interpretation of the Meroni doctrine. Namely, in ESMA short-selling case, wherein the United Kingdom questioned the delegated powers of ESMA, the ECJ held that the ESAs can exercise discretionary powers only when this discretion is limited, confirming, in this way, ESMA's compatibility of delegated powers with the EU Treaty provisions and the ECJ's case law.<sup>1076</sup> In particular, the ECJ observed that while: *"the bodies in question in Meroni v High Authority were entities governed by private law, the ESMA is a European Union entity, created by the EU legislature."*<sup>1077</sup> Also the ECJ pointed out that: *"unlike the delegation of quasi-legislative powers, which is expressly governed by Article 290 TFEU, there is no mention in the Treaties as to whether or to what extent executive powers may be delegated. In regard to executive powers, Articles 17 TFEU and 291 TFEU do not rule out the possibility that the EU legislature or the Commission may, in principle, delegate such powers to a non-institutional body."*<sup>1078</sup>

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<sup>1072</sup> Enisa Ruling (n 1076) para 44. See also: Shuibhne, Niamh Nic and Gormley, Laurence W. (eds), *From Single Market to Economic Union: Essays in Memory of John A. Usher* (Oxford University Press 2012) 65.

<sup>1073</sup> For a detailed interpretation of TFEU (n 5) Article 114 as the legal basis for the establishment of supranational bodies and as the most commonly used legal basis to harmonise laws in order to further the internal market see: Van Cleynenbreugel, Pieter, 'Meroni Circumvented? Article 114 TFEU and EU Regulatory Agencies' (2014) 21 (1) *Maastricht Journal of European and Comparative Law* 64.

See also: Fahey, Elaine, 'Does the Emperor Have Financial Crisis Clothes? Reflections on the Legal Basis of the European Banking Authority' (2011) 74 (4) *The Modern Law Review* 58, regarding Article 114 as the legal basis for the establishment of EBA.

<sup>1074</sup> See: EBA Regulation (n 984) and ESMA Regulation (n 985): recitals 17; EIOPA Regulation (n 986): recitals 16.

<sup>1075</sup> Case C-270/12 *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union* [2014] ECR I-0 (hereinafter: the ESMA-short selling case). For a detailed analysis on the constitutionality of the delegation of powers to EU agencies and in particular the ESMA-short selling case see: Scholten, Miroslava and Van Rijsbergen, Marloes, 'The ESMA-Short Selling Case: Erecting a New Delegation Doctrine in the EU upon the Meroni-Romano remnants' (2014) 41 (4) *Legal Issues of Economic Integration* 389.

<sup>1076</sup> ESMA-Short selling case (n 1080) para 76.

<sup>1077</sup> ESMA-Short selling case (n 1080) para 43.

<sup>1078</sup> ESMA-Short selling case (n 1080).

From the analysis above, it could be seen that the scope of ESAs' discretionary powers, although stretched due to the broad interpretation of Article 114, TFEU, in the recent ECJ rulings, has not overcome the limits of the Meroni doctrine, which is still applicable. Namely, in the ESMA-short selling ruling, the ECJ clarified that: *"It should be observed that the bodies in question in Meroni v High Authority were entities governed by private law, whereas ESMA is a European Union entity, created by the EU legislature."*<sup>1079</sup> Thus, it can be argued that the ESAs are allowed to adopt legally binding decisions, as long as these remain within the limits of the delegating powers. To this end, the existing European prudential supervisory architecture as formulated by the ESFS, while contributing to strengthening the cooperation at both national and EU level, failed to eliminate the diversity among Member States. At this stage, the creation of a supranational supervisory body assigned with direct supervisory tasks, existed only in the context of a debate among policymakers. This discussion grew in prominence in light of the GFC, with many supporting the creation of a single supranational body assigned with direct supervisory tasks across all financial services sectors: banking, insurance and securities.<sup>1080</sup> Some called for greater centralisation, but suggested the NCAs to retain their active role.<sup>1081</sup> There were also strong arguments advocating against the establishment of such a body, while supporting that this would exceed the scope of the existing Treaty provisions. For instance, according to Antonio Sáinz de Vicuña, who served as the General Counsel of the ECB at the time: *"to create a new agency with new powers is in my view across the line of what is permissible under the internal market's legal basis."*<sup>1082</sup> However, there were also views developed from the EU officials proposing the ECB as the most appropriate body to undertake supervisory tasks.<sup>1083</sup>

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<sup>1079</sup> ESMA-Short selling case (n 1080) para 43.

<sup>1080</sup> See: Avgerinos, Yannis V., 'The Need and the Rationale for a European Securities Regulator' in Andenæs, Mads and Avgerinos, Yannis V. (eds) *Financial Markets in Europe: Towards a single regulator* (Kluwer Law International 2003).

<sup>1081</sup> See:

- Lannoo, Karel, 'Concrete Steps towards More Integrated Financial Oversight: The EU's Policy Response to the Crisis' (Centre for European Policy Studies, Task Force Report 2008) <<http://aei.pitt.edu/11471/1/1762.pdf>> accessed 14 July 2017; and
- Schoenmaker, Dirk and Oosterloo, Sander, 'Financial Supervision in Jonung, Lars, Walkner, Christoph and Watson, Max (eds), *Europe: A Proposal for a New Architecture' in Building the Financial Foundations of the Euro: Experiences and Challenges* (Routledge 2008).

<sup>1082</sup> House of Lords (n 958) 12 para 165.

<sup>1083</sup> Smaghi, Lorenzo Bini, 'Regulation and supervisory architecture: Is the EU on the right path?' (Member of the Executive Board of the ECB, Speech at 2009 ECON meeting with national parliaments: 'Financial crisis: Where

It is evident from this brief analysis that the possibility of centralising supervision at EU level met with significant criticisms and push-back, which will be further examined within the context of the debate on assigning supervisory tasks to the ECB through the establishment of the SSM. The creation of this authority under the ECB's umbrella, has brought substantial changes to the existing supervisory and regulatory structure as formed by the ESFS, including the role of ESRB, ESAs, college of supervisors and NCAs. The discussion of the role, tasks and specific responsibilities of each component of ESFS as well as their interaction with each other, apart from shedding light to the rationale of the institutional framework and regulatory functioning of the financial supervision architecture, set the ground for the core discussion of this thesis on the centralisation of banking supervision at EU level.

### 3.6 Conclusion

The idea of creating an adequate regulatory and supervisory framework that would facilitate the enhancement of banking services integration, can be traced back to the very creation of the EU. With various regulatory initiatives aimed to achieving this long-declared goal, the process of making a Single Banking Market was officially signalled in 1985 by the White Paper on the Completion of the Internal Market, which provided for the free movement of people, goods, services and capital across the EU. The process was further developed through a continuous wave of deregulation, which included milestone legislative acts such as the SEA, the Second Banking Directive, and the Maastricht Treaty. The peak of this integration process was reached with the introduction of the euro, the establishment of ESCB and the FSAP in the early 2000s. Throughout this process, European banking policymaking, starting with the core objective of opening the domestic markets of Member States, moved forward through the principle of minimum harmonisation, which was followed by a period that incorporated mutual recognition, harmonisation and the principles of home country control.

Despite these efforts, Europe came again to the realisation that the integration of financial market had outpaced regulatory integration. This in turn, brought the need for an institutional change that was initiated on the basis of the Lamfalussy Report, which

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does Europe stand?', Brussels, 12 February 2009) <<https://www.ecb.europa.eu/press/key/date/2009/html/sp090212.en.html>> accessed 14 July 2017

introduced an innovative 4 Level decision-making process. The 4 Level process brought substantial changes to financial regulation and supervision, without however, creating a truly supranational mechanism. Therefore, when the GFC hit the European market, the shortcomings of the existing regulatory framework were brought into the surface, while the need to strengthen further cooperation and convergence at both national and EU level, became a matter of priority. Prudential supervision was identified among the areas that were lacking an adequate regulatory framework for both micro- and macro-prudential oversight of EU financial markets.

As a response, the De Larosière Report, introduced an updated version of the Lamfalussy process through the establishment of the ESRB and the three ESAs, with the view to enhance cooperation and promote the consistent application of EU law. However, the new regulatory and supervisory architecture, while contributed to changing the attitude towards more centralisation, it was lacking the institutional and structural means to unify the regulation of EU financial markets. At macro-prudential level, the ESRB remained an advisory body with no enforceable decision-making powers. The ESAs, on the other hand, while designed as bodies with a separate legal personality entitled to produce enforceable decisions, remained within the limits of the Meroni ruling, which significantly constrained the exercise of effective prudential supervisory powers. Thus, divergent approaches on prudential supervision rules persisted, generating fragmentation in the European financial markets.

In light of the above, a new wave of regulatory reforms started with particular focus on the banking sector. Hence, in order to create a truly unified European Banking Market, there emerged the need to create a supranational mechanism to undertake the coordination, monitoring and the oversight of financial institutions operating within the European Single Market. Thus, the creation of a single supervisory authority in 2014 came to complement the existing structure but also to strengthen the role of the ECB in banking supervision. As we discussed in this chapter, the ECB's role within the ESFS was already enhanced, but mainly focused on the macro-prudential supervision pillar. This initial, but 'indirect' involvement of the ECB in banking supervision was questioned and many have started to argue in favour of the possible synergies involved, especially, with respect to the monetary policy tasks of the ECB. Therefore, it is not surprising that the decision to delegate supervisory tasks to the ECB, only deepened these concerns.

Following this discussion, the next chapter examines the rationale behind this decision, by providing a comprehensive analysis of the legal implications and the possible synergies involved. In particular, the establishment of the new supervisory framework, links the monetary policy and supervisory functions under the same umbrella, creating a complex structure wherein new and existing bodies become closely involved, while multiple instruments and interlinked tasks interact and perhaps overlap with each other. This has raised many questions as to the division of tasks and objectives between the two domains (i.e. monetary policy and banking supervision); – especially, whether their respective tasks and objective are compatible or conflicting – the limit of powers; availability of tools; and as to the possible implications that this might pose to the goal price stability, as the main mandate of ECB, while the ECB is also aiming to retain its independent status and accountability.

## Chapter 4. From the ESFS to the establishment of the EU Banking Union: The Single Supervisory Mechanism

*“The structure of the regulatory system needs to reflect the structure of the markets that are regulated.”<sup>1084</sup>*

### 4.1 Introduction: the era in-between

Having discussed the historical evolution of European financial integration in the previous chapters, it could be argued that the creation of a Single Market for financial services was considered to be part of a broader political mission which started from the EU’s inception. However, the process of creating a fully-fledged European financial market, with harmonised rules and practices, started to take shape in the early 1970s, while the White Paper in 1985 signalled the beginning of a new era, during which significant progress was made towards creating a ‘level playing field’ for banks, insurance and securities markets. This was followed by the Maastricht Treaty in 1992, which created the Single Market, laid down the legal foundation of the ESCB and paved the way to the introduction of the euro in 1999. Henceforth, financial services integration has undergone a long, yet slow process, with the introduction of a plethora of legislative measures that enabled the liberalisation of capital

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<sup>1084</sup> Abrams and Taylor (n 568) 3.

movement, the free establishment of subsidiaries and branches, and the harmonisation of rules among the EU Member States. However, financial services integration, although was considered as one the main components of the Single Market, experienced the slowest progress; in fact, certain of its aspects remain until today “work in progress.”

The Member States had shown strong reluctance in transferring their sovereignty in financial matters at EU level; a reluctance, however, that was slowly diminished as a result of a patchwork of regulatory responses to the GFC. This was a consequence of a number of gaps in the existing regulatory and supervisory framework that were revealed by the GFC, as extensively discussed in chapter three, and the severe implications brought in the financial markets. Namely, it soon became evident that the EU financial system was lacking the legal and institutional capacity to deal effectively with financial institutions that were operating extensively across borders. This was mainly related to the interlinkages created within a complex system of national and supranational cooperation. To this end, although the regulation of EU financial market was progressively moving towards tighter integration, its supervision remained nationally-oriented. In addition, the EU internal market of a common currency, was characterised by financial institutions that were heavily involved in cross-border operations, which resulted in an interconnected financial system of complex interlinkages and mutually dependant market players. Therefore, the GFC exposed the fallacies of the existing legal framework and created momentum for regulatory reform mainly aimed at reshaping financial regulation, with special focus on supervision. Starting with the Lamfalussy Process and followed by the De Larosière Report, the EU banking landscape entered the era of Europeanisation.

This process led to the establishment of the SSM, which became fully operation on 4 November 2014, conferring specific tasks to the ECB concerning the prudential supervision of credit institutions. Thus, pursuant to the SSM, the ECB became the central prudential supervisor of financial institutions in the Eurozone. The SSM represents the first pillar of the wider European Banking Union project, while the other two are a common framework for recovery and resolution (the Single Resolution Mechanism – SRM), and for deposit protection (The European Deposit Insurance Scheme – EDIS). The SRM was implemented in July 2014 and came into force in August 2016, whereas the EDIS was subject to the EU Commission’s proposal in November 2015 but has not been implemented yet. It should be noted here that

this thesis does not intent to dwell on the SRM and the EDIS, since this exceeds the scope of the analysis, which focuses on examining the dual mandate of the ECB, i.e. monetary policy and banking supervision, and its compatibility with the existing Treaty provisions.

As discussed in chapter three, the establishment of the ESFS, including the establishment of the ESRB and the three ESAs, created a complex system of multiple layers, where the various elements that comprise it would have to cooperate and coordinate with one another. Thus, when the establishment of a single supervisory body, i.e. the SSM, came to be introduced in 2012, it became apparent that old and existing regulatory arrangements would have to be re-examined through the lenses of centralisation. This chapter aims to provide a comprehensive analysis of the SSMR, while critically assessing the role of the ECB within the changed institutional environment.

Thus, the analysis starts with an historical background on the genesis of the idea of centralising supervision in Europe and the impetus of the decision to choose the ECB as the supranational supervisor. This is followed by a critical examination of the legal basis of conferring these supervisory tasks to the ECB. Next, the discussion moves to addressing the mandate and scope of the ECB's supervisory role. The third part advances a discussion on how the balance and the division of responsibilities between the ECB and NCAs has been reshaped after the SSM establishment. The fourth part offers a detailed exploration of the operational structure of the SSM, including the role of the existing and new bodies. The next part, examines the coordination of supervisory powers between the ECB and the other supervisory institutions, including EBA, the college of supervisors and the ESRB. The tenth part of this chapter critically analyses the 'separation principle' and the underlying legal constrains, which comes to the core idea of this thesis. In conclusion, the last part examines whether the ECB's independent status has been challenged under the new regulatory and supervisory framework.

## 4.2 The centralisation of supervision in Europe

It is well known that the impetus for banking supervision centralisation at EU level came from the events surrounding the occurrence of the GFC. Indeed, the first half of 2012 - right before the introduction of the SSMR - found Europe in the middle of one of the most

severe economic disruptions in its history. Namely, many EU countries were experiencing major sovereign debt crises<sup>1085</sup> and major banking groups were facing liquidity problems and were unable to meet their short-term liabilities. Thus, the need to deepened Europe's Economic and Monetary Union came into the fore, while any political resistance of the past was slowly diminished. Part of the same trend, was the great emphasis given to strengthen the institutional design for banking supervision in a way that would reflect transparency, cooperation, and convergence. This was also linked with the need to rebuild confidence of depositors and investors, and to weaken the nexus between sovereigns and banks.<sup>1086</sup>

As a response to this realisation, in June 2012, the President of the EU Council at the time, Herman Van Rompuy, announced that the EU was willing to move towards the establishment of a genuine Banking Union.<sup>1087</sup> The intention behind the creation of a Banking Union was to elevate supervision, recapitalisation, resolution and deposit protection at EU level, all based on a Single Rulebook. As was mentioned by Herman Van Rompuy Report: “...an integrated financial framework should have two central elements: single European banking supervision and a common deposit insurance and resolution framework.”<sup>1088</sup> Shortly after, the Euro Area Summit Statement specified the mandate given to the EU Commission to present a proposals on the basis of Article 127(6), TFEU for the creation of a Single Supervisory Mechanism, which was to undertake supervisory duties at EU level.<sup>1089</sup> The EU Commission's response came in September 2012, by introducing: a Communication, explaining the rationale for the creation of a Banking Union for Europe, while setting the ground for its completion;<sup>1090</sup>

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<sup>1085</sup> In early 2010 the Greek sovereign debt crisis became apparent and many countries were experiencing serious financial circumstances: Ireland, Portugal, Italy and Spain.

<sup>1086</sup> Mersch, Yves, 'The Banking Union - a European perspective: reasons, benefits and challenges of the Banking Union' (Speech by Member of the Executive Board of the ECB, at the seminar 'Auf dem Weg zu mehr Stabilität – Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis' organised by Europolis and Wirtschaftswoche, Berlin, 5 April 2013) <<https://www.ecb.europa.eu/press/key/date/2013/html/sp130405.en.html>> accessed 14 July 2017.

<sup>1087</sup> 'Towards a Genuine Economic and Monetary Union' (Report by President of the European Council Herman Van Rompuy, Presse 296, Brussels, 26 June 2012), (hereinafter: Herman Van Rompuy Report) <[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131201.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf)> accessed 14 July 2017.

<sup>1088</sup> Herman Van Rompuy Report (n 1093) 4.

<sup>1089</sup> 'Euro Area Summit Statement' (Brussels, 29 June 2012) <[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131359.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf)> accessed 14 July 2017.

<sup>1090</sup> Commission, 'A Roadmap towards a Banking Union' (Communication) COM (2012) 510 final.



a proposal for the creation of SSM,<sup>1091</sup> which would be centred by the ECB and NCAs;<sup>1092</sup> and a proposal for the amendment of EBA Regulation,<sup>1093</sup> which intended to amend the existing role of EBA in accordance with the new supervisory framework.

The idea for the SSM establishment was supported by the EU Council in its meeting in 18-19 October 2012, calling for a legislative proposal for its establishment as a “matter of priority.”<sup>1094</sup> However, the SSMR before being finally approved by the EU Council in October 2013,<sup>1095</sup> underwent several revisions and amendments by the EU Council and Parliament: at first stage by the Cyprus Council Presidency in December 2012 and later by the EU Parliament in March 2013. The SSMR entered into force on November 2013, and on 4 November 2014, the SSM became fully operational.<sup>1096</sup> The establishment of the SSM has effectively empowered the ECB with prudential supervision tasks, enhancing the complexity of an already entangled supervisory architecture, which, as we analysed in chapter three, consisted of multiple layers and interlinked tasks and responsibilities. However, before analysing the institutional and legal framework of the new supervisory framework, it is important to examine the origins of the idea of centralisation, the choice of the ECB and the legal basis of transforming the latter into a supranational body entitled with prudential supervisory tasks.

#### 4.3 The idea of supervision centralisation at EU level and the choice of ECB as the supranational supervisor

Undeniably, the centralisation of banking supervision at EU level represented a drastic regime shift and a complete remodelling of the institutional supervisory framework for EU financial markets. Historically, the question of whether banking supervision should be

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<sup>1091</sup> Commission, ‘Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions’ COM (2012) 511 final.

<sup>1092</sup> Commission (n 1097) 7.

<sup>1093</sup> Commission, ‘Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No.../... conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions’ COM (2012) 512 final.

<sup>1094</sup> ‘Conclusions of the European Council, 18/19 October 2012’ (European Council, EUCO 156/12) para 6 <<http://register.consilium.europa.eu/doc/srv?!=EN&f=ST%20156%202012%20INIT>> accessed 14 July 2017.

<sup>1095</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L 287/63 (hereinafter: SSMR).

<sup>1096</sup> SSMR (n 1101) Article 33(2).

included among the ECB's tasks and responsibilities, has constituted one of the most controversial, questionable and debated topics. Namely, in 1989 the Delors Report when referring to establishment of the ESCB, specified that it would participate in banking supervision by coordinating the national supervisory authorities.<sup>1097</sup> Similarly, during the Maastricht Treaty negotiations in the early 1990s, the belief that a strong monetary union should be complemented with a supranational supervisory mechanism, constituted an integral part of the discussions throughout the drafting process.<sup>1098</sup> However, this idea was still premature and failed to reach political agreement since the EU Member States were highly reluctant in giving away part of their regulatory space, as we discussed in chapter three.<sup>1099</sup>

At a later stage, the FSAP while touching upon the issue of banking supervision by emphasising that there was a need for convergence and harmonisation of practices,<sup>1100</sup> did not result in any concrete discussion or proposals for potential scenarios for centralisation. As was discussed already, at the time, the focus was on developing a set rules aimed at harmonising practices across the EU, rather than centralising supervision at EU level. However, the idea of integrating supervision at EU level, was always a major concern and although seemed to have been a politically unreachable goal, found official support by the EU Parliament in many instances. In fact, the EU Parliament expressed 'guarded satisfaction' on FSAP measures, due to the fact that it considered *inter alia* that: "*greater formal centralisation of supervision of all credit institutions through the ECB as provided for in the Treaty (Article 105) should be pursued and, if not, how and by whom centralised action should be implemented, if such a need should arise because of technological change and a new competitive environment, which are both pervasive factors.*"<sup>1101</sup>

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<sup>1097</sup> The Delors Report (n 54) 22 para 32.

<sup>1098</sup> James, Harold, Caruana, Jaime and Draghi Mario, *Making the European Monetary Union* (Harvard University Press 2012) 313-317.

<sup>1099</sup> Constâncio, Vítor, 'The nature and significance of Banking Union' (Speech by Vice-President of the ECB, at the conference 'Financial Regulation: Towards a global regulatory framework?' , Chatham House City Series, London: 11 March 2013) <<https://www.ecb.europa.eu/press/key/date/2013/html/sp130311.en.html>> accessed 14 July 2017.

<sup>1100</sup> FSAP (n 718) 13–14.

<sup>1101</sup> European Parliament resolution on the Commission communication on implementing the framework for financial markets [1999] OJ C 40/453, 457.

The Lamfalussy Report took a similar stance with the FSAP and the idea of creating a supranational supervisor for Europe, not only did not find any support again, but it was explicitly highlighted that the reasons against centralisation outweighed the reasons in favour.<sup>1102</sup> Thus, the Lamfalussy Report, as we analysed in detail in chapter three, illustrated the actual implementation of the harmonisation rules through the establishment of an institutional mechanism (the Level 4 Committees). This intended to simplify the process of coordination, implementation and consistent application of EU law by the NCAs, rather than creating a system of integrated supervision at EU level. In fact, what came into being instead, was a legislative process that aimed to achieve most of the benefits of a single supervision authority through a network of national supervisors and the 4 Level Committees. Thus, as highlighted already, the role of the 4 Level Committees was merely focused on the preparation of regulation, while their decision-making power remained limited.

This exclusion of supervisory tasks from the new supervisory architecture was in line with the specific mandate that the Committee of Wise Men - which produced the Lamfalussy Report - was given by the relevant ECOFIN in 2001 that excluded prudential supervision from the Committee's working agenda. As Alexander Lamfalussy clarified later, this limitation on the mandate could be explained by the fact that the focus, at that time, was on regulating the securities market, while the extension to banking and insurance came at a later stage (in 2005).<sup>1103</sup> Nevertheless, the Lamfalussy Report provided with a clear indication, leaving an open window for the creation a supranational body in the future, in case the proposed 4 Level mechanism would fail to achieve its intended objectives by 2004. As it was explicitly stated: *"it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community."*<sup>1104</sup> The EU Parliament, in its Lamfalussy follow-up recommendations, argued about the ultimate need to strengthen the role of the ECB in prudential supervision.<sup>1105</sup> Lastly, it is worth mentioning that apart from

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<sup>1102</sup> The Lamfalussy Report (n 738) 106.

<sup>1103</sup> Lamfalussy, Alexandre, 'The Specificity of the Current Crisis' (The Belgian Financial Forum and the Robert Triffin International Foundation, Brussels, 30 April 2009), 1 <[http://otds.sipr.ucl.ac.be/cps/ucl/doc/cehec/documents/The\\_Belgian\\_Financial\\_Forum\\_and\\_the\\_Robert\\_Triffin2.pdf](http://otds.sipr.ucl.ac.be/cps/ucl/doc/cehec/documents/The_Belgian_Financial_Forum_and_the_Robert_Triffin2.pdf)> accessed 14 July 2017.

<sup>1104</sup> The Lamfalussy Report (n 738) 41

<sup>1105</sup> 'Lamfalussy follow-up — Future Structure of Supervision European Parliament resolution of 9 October 2008 with recommendations to the Commission on Lamfalussy follow-up: future structure of supervision, Annex to the Resolution Detailed recommendations on the Content of the Proposal(s) Requested' [2010] OJ C 9E 2010/48, 56.

this reference in the Lamfalussy Report, there was also some sporadic mention in other EU legislation initiatives that implicitly indicated the possibility of supervisory centralisation in the future. For instance, Directive 2003/71/EC, envisaged the possibility of creating a European Securities Unit.<sup>1106</sup>

Furthermore, as explicitly highlighted in chapter three, the Lamfalussy Process, although did not provide for centralisation of supervision and despite its lapses in terms of reaching the intended objectives, set the ground for further integration in both financial regulation and supervision. However, it was only after a series of events – originating mainly from the GFC – that the loopholes in the existing regulatory and supervisory architecture came to view, bringing the need for deepening financial integration beyond the 4 Levels Lamfalussy process. This was clearly illustrated in the De Larosière Report, which led to the establishment of an updated supervisory structure with the view to strengthen both micro- and macro-prudential supervision through the establishment of ESRB and the three ESAs. In regard to the role of the ECB within this structure, this remained within the borders of the framework created since its establishment. Namely, the ECB since its creation was designed to serve solely the goal of monetary policy, while banking supervision was concentrated at national level. Indeed, there was a clear separation between the two functions, with the first (monetary policy) being highly centralised, since it was entrusted to the ECB, and the second (supervision) remaining decentralised, with the national authorities remaining responsible for day-to-day supervision and enforcement.

However, as analysed in chapter three, the 4 Level mechanism, as updated by the De Larosière Report, empowered for the first time the ECB with some limited macro-prudential supervisory tasks through its participation in the ESRB. To the contrary, micro-prudential oversight remained a responsibility of NCAs and the colleges of supervisors, coordinated through the ESAs. With the establishment of the SSM, the ECB effectively assumed direct micro-prudential supervisory powers over the euro area financial institutions, exceeding the vision of the De Larosière Report.<sup>1107</sup> Indeed, the De Larosière Report while referred at the views suggesting the ECB's involvement in both macro- and micro-prudential supervision,

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<sup>1106</sup> Directive 2003/71/EC (n 803) Recital (47),

<sup>1107</sup> Lastra, Rosa M., 'Banking Union and Single Market: Conflict or Companionship?' (2013) 36 (5) Fordham International Law Journal 1195, 1196.

explicitly excluded the ECB from micro-prudential supervision.<sup>1108</sup> Also, in order to support this approach, the De Larosière Report provided an extensive list of arguments against the ECB's involvement in micro-prudential oversight, including the possible impingement that this could create on its monetary stability mandate. In addition, a strong argument was linked with the possible implications that may arise as a result of a dual mandate for the ECB's independence: *"in case of a crisis, the supervisor will be heavily involved with the providers of financial support (typically Ministries of Finance) given the likelihood that taxpayers' money may be called upon. This could result in political pressure and interference, thereby jeopardizing the ECB's independence."*<sup>1109</sup>

All in all, as seen in the previous chapter, all the efforts to centralise supervision at EU level with the creation of the ESAs, the ESRB and the enhanced role of ECB, did not lead to any ground-breaking changes. In fact, the prudential supervision regime remained unchanged, and highly based on the principle of home country control and mutual recognition. Thus, the Single Market for banking services, whilst, it became highly centralised on certain aspects, remained decentralised to a large extent in regard to its supervisory framework. Practically, before the establishment of the SSM, supervision was performed at national level subject to various practices that were varying from State to State. Namely, in some Member States, the NCBs were responsible to supervise directly the financial institutions; in some other States, accountable for supervision was an independent from the NCB public authority; and some Member States combined the supervisory operation of a competent authority with the involvement of the NCB. Here becomes relevant Lastra's description of the pre-Banking Union EU supervisory framework as characterised by elements of decentralisation, cooperation and segmentation.<sup>1110</sup>

In light of the above, it seems that while the discussion on supervision centralisation was well-developed, it took a major financial crisis for a political agreement to be reached. Thus, while the De Larosière Report and the regulatory framework to follow opened the door to the involvement of the ECB in macro-prudential oversight, EU policymakers maintained a position strictly against the assignment of micro-prudential supervisory task to the ECB. Thus,

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<sup>1108</sup> The De Larosière Report (n 873) 44 para 172. See also: Smits (n 963).

<sup>1109</sup> The De Larosière Report (n 873) 44 para 171.

<sup>1110</sup> Lastra (n 791) 50.

it did not come as a surprise that the conferral of supervisory powers to the ECB, three years later, raised various social, political, economic and legal questions that led to an enormous multi-dimensional debate. The ECB played a prominent role during the GFC, without, however, acting as the official banking supervisor, while the possibility of assigning supervisory tasks, as extensively discussed, remained part of a rather theoretical debate. However, with the introduction of the SSM, the ECB is entrusted with explicit supervisory responsibilities, leaving space for discussion as to how the ECB from “an option” became the “ultimate choice.”

An alternative option was to transform EBA into the supranational supervisor, since it was already carrying out some supervisory tasks.<sup>1111</sup> Transforming EBA into the supranational supervisor was strongly supported by the EU Commission.<sup>1112</sup> Even after the support in favour of the ECB seemed to be prevailing, the EU Commission still attempted to draft a proposal in favour of conferring supervisory tasks on EBA.<sup>1113</sup>

The argument against using EBA was based on the view that a decision to confer supervisory powers on EBA without Treaty amendment would have been both politically and legally unachievable for a number of reasons.<sup>1114</sup> Firstly, as analysed in chapter three, EBA’s role was not extended in covering supervisory responsibilities, but was focused merely on coordinating the NCAs, while its decision making power remained limited. Secondly, such a decision would go against the Meroni doctrine as analysed in chapter three. Indeed, according

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<sup>1111</sup> For the view supporting the choice of EBA as the supranational supervisor see:

- Schoenmaker, Dirk and Gros, Daniel, ‘A European Deposit Insurance and Resolution Fund’ (2012) Centre for European Policy Studies No. 364, 8 <<https://www.ceps.eu/system/files/WD364%20European%20Deposit%20Insurance.pdf>> accessed 14 July 2017.
- Ferrarini, Guido and Chiodini, Filippo, ‘National fragmented supervision over multinational banks as a source of global systemic risk: a critical analysis of recent EU reforms’ in Wymeersch, Eddy, Hopt, Klaus J. and Ferrarini, Guido (eds) *Financial Regulation and Supervision: A post-crisis analysis* (Oxford University Press 2012) 193- 231.
- Goyal, Rishi, Brooks, Petya Koeva, Pradhan, Mahmood, Tressel, Thierry, Dell’Ariccia, Giovanni, Leckow, Ross, Pazarbasioglu, Ceyla and an IMF Staff Team, ‘A Banking Union for the Euro Area’ (IMF, February 13, 2013) <<https://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf>> accessed 14 July 2017.

<sup>1112</sup> Barker, Alex, ‘Backing grows for one EU bank supervisor’ (Financial Times June 18, 2012) <<https://www.ft.com/content/1c94e34e-b958-11e1-a470-00144feabdc0>> accessed 14 July 2017.

See also: Ferran, Eilis and Babis, Valia, ‘The European Single Supervisory Mechanism’ (University of Cambridge Faculty of Law Research Paper No. 10 2013) 2.

<sup>1113</sup> Chang, Michele, ‘The Rising Power of the ECB: The Case of the Single Supervisory Mechanism’ (Paper prepared for the biennial conference of the European Union Studies Association, 5-7 March 2015, Boston).

<sup>1114</sup> Ferran and Babis (n 1119) 2.

to the Meroni doctrine, any delegation of powers from an EU institution to other bodies that are not clearly defined and involves a wide margin of discretion, would be likely to threaten the balance of powers between the EU institutions and would eventually lead to Treaty amendment that would require several years to be completed.<sup>1115</sup> To the contrary, it was supported that the delegation of supervisory powers to the ECB would not require a Treaty amendment, since the interpretation of the existing provisions of the Treaty (Article 127(6), TFEU) would allow the ECB to undertake supervisory powers.<sup>1116</sup> A Treaty amendment was not desirable at that stage, since immediate action was needed to rebuild confidence in the EU financial markets. The EU recent experience during ratification of the Lisbon Treaty, which proved to be a lengthy process, was enough evidence that the implementation of the EU Banking Union would have been subject to significant delays, which, given the emergency character of the situation, was not an option.

In additional, the ECB's strong reputation both at EU and international level, provided a good ground in favour of assigning supervisory tasks to the ECB.<sup>1117</sup> Especially, considering that there was a strong need to rebuild market trust and confidence in a timely manner, a body with strong reputation, credibility and a background of positive achievements, would be in a favourable position to serve this purpose, in comparison to a newly established institution, which would have to prove its reputation over time. Another argument in favour of entrusting the ECB with supervisory powers was the comprehensive knowledge and information that the ECB obtained during the GFC in its role as the lender of last resort. These information and expertise were considered as an advantage in strengthening the operation of future supervisory tasks.<sup>1118</sup> Moreover, by empowering the ECB with supervisory tasks, would bring at EU level the three ultimate objectives of a central bank: price stability, financial

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<sup>1115</sup> See: Yataganas, Xénophon A., 'Delegation of Regulatory Authority in the European Union, The relevance of the American model of independent agencies' (Jean Monnet Working Paper 3/01 2001).

<sup>1116</sup> See:

- Ferran and Babis (n 1119) 2-3; and
- Wymeersch, Eddy, 'The European Banking Union, a First Analysis' (2012) Financial Law Institute Working Paper Series WP 2012-07, 6-9.

<sup>1117</sup> Ruding, Onno H., 'The Contents and Timing of a European Banking Union: Reflections on the differing views' (2012) CEPS Essay No. 2, 4.

<sup>1118</sup> Sibert, Anne (2012), 'Banking Union and a Single Bank Supervisory Mechanism' (EU parliament DG for Internal Policies 2012) 11

<[http://www.europarl.europa.eu/document/activities/cont/201210/20121004ATT52935/20121004ATT52935\\_EN.pdf](http://www.europarl.europa.eu/document/activities/cont/201210/20121004ATT52935/20121004ATT52935_EN.pdf)> accessed 14 July 2017.

stability and payment systems.<sup>1119</sup> Lastly, the ECB was both praised and criticised during the GFC for its role and crisis management duties, especially, in times when the Member States were struggling to deal with the issues arose. It seems, however, that despite the criticism, the ECB's role remained pivotal throughout the GFC, placing it in the best suited position to be proposed for the assignment of supervisory tasks.<sup>1120</sup>

All in all, the credibility and the strong reputation of the ECB; the Meroni ruling that prevents the delegation of powers to a new body; the pressure of time that did not allow for complex procedures and Treaty amendments; and the role of the ECB during the GFC, all combined explain the final institutional structure of the SSM and the new tasks of ECB. Thus, the new supervisory body - the SSM – was established as a special mechanism that would work under the ECB's wings, rather than a single supervisory institution that would imply the establishment of a new EU institutions. The latter, i.e. establishment of a new EU body, in order to be a legitimate option would have required the amendment of the Treaty, since Article 127(6), TFEU, does not provide an adequate legal basis to such an extent. The idea that the ECB would be given the power to oversight Eurozone's financial institutions was welcomed from the ECB sometime before the political agreement was reached. In 2009 Trichet, who served as the president of the ECB during that time stated that: *"The ECB and the Eurosystem have the technical capacity to assume a stronger role in macro-prudential supervision. Indeed, it would be a natural extension of the mandate already assigned to us by the Treaty, namely to contribute to financial stability."*<sup>1121</sup> Also, in 2009, Smaghi (who served as member of the Executive Board of the ECB at the time) pointed out that: *"strengthening the role of the ECB in the field of supervision has some important advantages which, in my view, outweigh the disadvantages."*<sup>1122</sup>

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<sup>1119</sup> Zavvos, George, S., 'Towards a European Banking Union: Legal and Policy Implications' (Speech delivered at the 22nd Annual Hyman P. Minsky Conference: 'Building a Financial Structure for a More Stable and Equitable Economy' Levy Economics Institute Bard College, New York, April 18 2013) 4 <[http://www.levyinstitute.org/conferences/minsky2013/Zavvos\\_speech.pdf](http://www.levyinstitute.org/conferences/minsky2013/Zavvos_speech.pdf)> accessed 14 July 2017.

<sup>1120</sup> Yiangou, Jonathan, O'keeffe, Mícheál and Glöckler, Gabriel, 'Tough Love: How the ECB's Monetary Financing Prohibition Pushes Deeper Euro Area Integration' (2013) 35 (3) Journal of European Integration 223.

<sup>1121</sup> Trichet, Jean-Claude, 'Remarks on the future of European financial regulation and supervision' (Keynote address by the President of the ECB at the CESR, Paris, 23 February 2009. <<http://www.ecb.europa.eu/press/key/date/2009/html/sp090223.en.html>> accessed 14 July 2017.

<sup>1122</sup> Smaghi, Lorenzo Bini, 'Regulation and supervisory architecture: Is the EU on the right path?' (Speech by a Member of the Executive Board of the ECB in ECON meeting with national parliaments: 'Financial crisis: Where does Europe stand?' Brussels, 12 February 2009 <<http://www.ecb.europa.eu/press/key/date/2009/html/sp090212.en.html>> accessed 14 July 2017.



However, the empowerment of the ECB to oversee the major banks of the Eurozone, opened a Pandora's box and raised questions concerning the ECB's accountability; a possible trade-off between monetary policy and supervisory tasks, and the likelihood of sacrificing the independent status of the ECB. However, before analysing the legal implication of these issues, it is worth examining the legal basis of the SSM establishment, and the conferral of supervisory tasks to the ECB.

#### 4.4 The legal basis of the SSM and the conferral of supervisory tasks on the ECB

The SSM constitutes the mechanism through which the ECB will exercise its new supervisory powers, and this is facilitated through the creation of a new Single Supervisory Board (SSB) which is designed to operate within the ECB.<sup>1123</sup> The legal basis for the SSM establishment and the assumption of supervisory tasks from the ECB, was a key aspect of the decision to furthering supervisory integration and as such, came into the spotlight, albeit gathering mixed responses. In short, the legal bases of the SSM establishment are: Article 127(6), TFEU, which confers regulatory power on the ECB; the SSMR, which assigns the ECB with specific regulatory duties; and the SSM Framework Regulation (SSMFR),<sup>1124</sup> which aims at regulating the cooperation and coordination between the ECB and the national supervisors. Although the SSMR and SSMFR were newly adopted, Article 127(6), TFEU, finds its roots back to the creation of the EMU. Also, Article 127(6), TFEU, although served as the legal basis of the ECB's newly adopted supervisory power, its wording does not allow for a direct delegation of supervisory power to the ECB. In fact, starting with the EU primary law, there is no provision that empowers the ECB with the any direct supervisory tasks. Thus, in order to understand the use of Article 127(6), TFEU, as the legal basis for the SSM establishment, it is important understand the intended meaning of the provision, which arises from the rationale behind its adoption, the historical background of its formulation and the reasoning behind its wording.

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<sup>1123</sup> COM (2012) 511 (n 1153) 7.

<sup>1124</sup> Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014, establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities ECB/2014/17 [2014] OJ L 141/1 (hereinafter: SSMFR).

As was mentioned already, the centralisation of supervision at EU level has been subject to discussion long before the establishment of the SSM. A specific mention of this fact was made in the SSMR, emphasising the long-standing existence of the view in favour of centralisation, which strengthens even further its rationale and importance. According to the SSMR: *“The European Parliament called on various occasions for a European body to be directly responsible for certain supervisory tasks over financial institutions, starting with its resolutions of 13 April 2000 on the Commission communication on implementing the framework for financial markets: Action Plan, and of 21 November 2002 on prudential supervision rules in the European Union.”*

Putting the discussion back to the genesis of the EMU, the draft Report of Delors Committee defined in that: *“the system would participate in the coordination of banking supervision policies of the national supervisory authorities”*. However, in the final Report, although prudential supervision was included among the basic tasks of the ESCB, the term “national” was removed as following: *“the System would participate in the coordination of banking supervision policies of the supervisory authorities,”*<sup>1125</sup> which indicates the possibility that supervisory authorities would be European.<sup>1126</sup> Furthermore, the ESCB was assigned prudential supervisory responsibilities in the first draft Statute,<sup>1127</sup> defining that the ESCB shall (note: not the ECB alone): *“participate as necessary in the formulation, co-ordination and execution of policies relating to prudential supervision and the stability of the financial system.”*<sup>1128</sup> However, the final version of the ESCB Statute, did not include prudential supervision as the one of the basic tasks of the ESCB.<sup>1129</sup> This can be also explained by the strong opposition faced, which was led primarily by the German Bundesbank, with the latter stressing the issue of a possible conflict of interest between the supervisory and monetary policy task of the central bank.<sup>1130</sup> Thus, the intention to include prudential supervision

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<sup>1125</sup> The Delors Report (n 54) 22 para 32.

<sup>1126</sup> James, Harold, ‘International Cooperation and Central Banks’ in Cassis, Youssef, Grossman, Richard S. and Schenk, Catherine R. (eds), *The Oxford Handbook of Banking and Financial History* (2<sup>nd</sup> edn. Oxford University Press 2016) 364, 381-382.

<sup>1127</sup> For a detailed analysis of the interpretation of the Articles of the draft statute see: Smits (n 206).

<sup>1128</sup> ‘Draft Statute of the European System of Central Banks and of the European Central Bank: Introductory Report and Commentary’ (Central Banks Governors, 8 December 1990, Brussels) 3.

<sup>1129</sup> See basic tasks of the ESCB: TFEU (n 5) Article 127(2).

<sup>1130</sup> James (n 1133) 382.

among the basic tasks of the ECB was clearly expressed by the EU policy makers; an intention, however, that never came to be implemented due to failure in reaching a political agreement.

As a result, neither Article 127(6), TFEU nor Article 25, ESCB Statute, assigned to the ECB direct prudential supervisory duties. According to Article 25, ESCB Statute, the ECB was only granted consulting and advisory duties in relation to prudential supervision and financial stability issues,<sup>1131</sup> and *“the performance of specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings (Article 25(2), ESCB Statute).”* However, according to Article 127(6), TFEU: *“The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning the policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings;”*<sup>1132</sup> the wording of which leaves space for further interpretation as to the potential expansion of the ECB’s prudential supervisory powers.<sup>1133</sup> This is also known as the enabling clause, which was used to confer specific prudential supervision tasks upon the ECB within the context of ESRB; and was also, activated recently when the Member States acting unanimously pursuant to Article 127(6), TFEU, adopted the SSMR and assigned supervisory tasks to the ECB.

However, the interpretation of Article 127(6), TFEU, is far from being straightforward. Views are divided between those supporting the narrow interpretation of the provision and those advocating a wider reading. Namely, in the first category belonged those who supported that the ECB’s role in prudential supervision has to remain advisory<sup>1134</sup> and on the second group, those who advocated that the enabling clause of Article 127(6), TFEU, leaves space for broader interpretation, allowing for a possible conferral of supervisory tasks on the ECB.<sup>1135</sup> Arguments against the idea that Article 127(6), TFEU, constitutes a sufficient legal basis for the establishment of the SSM, concentrate on the wording of the provision. In particular, according to the wording of Article 127(6), TFEU, the ECB could only be conferred:

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<sup>1131</sup> ESCB Statute (n 243) Article 25(1).

<sup>1132</sup> TFEU (n 5) Article 127(6).

<sup>1133</sup> Lastra, Rosa M., ‘The Division of Responsibilities between the European Central Bank and the National Central Banks within the European System of Central Banks’ (2000) 6 (2) Columbia Journal of European Law 167, 174.

<sup>1134</sup> For the argument in favour of the narrow interpretation see: Posner (n 801).

<sup>1135</sup> For arguments in favour of the wider interpretation: Lastra (n 533), Smits (n 206) and Dragomir (n 647).

*“specific tasks concerning the policies relating to the prudential supervision of credit institutions.”* According to this interpretation, “the specific tasks” refer to limited responsibilities and did not intent to leave space for a possible conferral of prudential supervisory responsibilities on the ECB. Moreover, since the wording of Article 127(6), TFEU, clearly refers to “tasks”, the conferral of “powers”, seems to exceed the intended meaning of the provision.

This view finds further support to the wording of Article 25, ESCB Statute, which, as mentioned earlier, entrusts the ECB with advisory and consultancy duties in regard to prudential supervision, yet without providing for any direct supervisory competence. Indeed, this provision, if read in conjunction with Article 127(6), TFEU, suggests that the role of the ECB in prudential supervision remains advisory and supportive. Moreover, according to Article 127(5), TFEU: *“the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.”* Hence, it could be argued that since this provision refers to the conduct of “policies”, it practically makes reference to the Reports and Studies published by the ECB and the examination or review of prudential supervisory operation undertaken by other entities (i.e. NCAs, EBA, EFC and FSC). Accordingly, the “specific tasks” of Article 127(6), TFEU, are to be interpreted as closely related to the conduct of those policies, which serve mainly a supportive and advisory role, rather than a supervisory role.<sup>1136</sup> Moreover, according to Article 13(2), TEU: *“Each institution shall act within the limits of the powers conferred on it in the Treaties, and in conformity with the procedures, conditions and objectives set out in them,”*<sup>1137</sup> and since the ECB was not granted with any direct supervisory powers by the EU

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<sup>1136</sup> Millar, Anita, ‘EU Banking Union-Operational Issues and Design Considerations’ (Report prepared for the International Regulatory Strategy Group, October 2012) <<https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2012/EU-banking-unions-final3.pdf>> accessed 14 July 2017.

<sup>1137</sup> The ECJ has repeatedly emphasised in a number of cases that each institution is to act within the limits of the powers conferred upon it by the Treaty See the following rulings:

- Case C-93/00 *Parliament v Council* [2001] ECR I-10119, para 39;
- Case C-110/03 *Belgium v Commission* [2005] ECR I-2801, para 57
- Case C-403/05 *Parliament v Commission* [2007] ECR I-0000, para 49; and
- Case C-133/06 *European Parliament v Council* [2008] ECR I-3189, para 44.

However, the rules regarding the manner in which the Community institutions arrive at their decisions are laid down in the Treaty and are not at the disposal of the Member States or of the institutions themselves. See: Case C-133/06, para 54 and Case 68/86 *United Kingdom v Council* [1988] ECR 855, para 38.

Treaties, it is questionable whether the intention of Article 127(6), TFEU, can be considered as an adequate legal basis for the assignment of supervisory tasks to the ECB.

On the contrary, among the arguments supporting that Article 127(6), TFEU, constitutes an adequate legal basis for the conferral of supervisory powers on the ECB, were those who supported that the wording of the provision, in fact, suggests a broader interpretation. Namely, it has been supported that Article 127(6), TFEU, contains an enabling clause, which allows the conferral of supervisory powers on the ECB without requiring a formal amendment of the Treaty.<sup>1138</sup> Another argument in favour, is the fact that the supervisory powers conferred to the ECB with the SSMR are limited and thus, compatible with the wording of the provision. To this end, firstly, the supervisory tasks of the ECB are limited geographically, since they apply only to financial institutions of Eurozone Member States; and secondly, they are limited in scope, since the ECB is entrusted only with prudential supervisory tasks.<sup>1139</sup>

Given the historical background of Article 127, TFEU, its rationale and the first draft of the ESCB Statute (with its intention to include prudential supervision among the basic task of the ECB), it would be unrealistic to accept a narrow interpretation of its meaning. Even if one focuses only on the vaguely formulated wording of the provision, although it reflects a limited scope of the intentional meaning, it could be said that it leaves indeed, space for broad interpretation. Furthermore, provided the importance of the issue of prudential supervision in the EU financial architecture, which is evident from the reference made even during the very early discussions of the EMU creation – since the drafting of the Maastricht Treaty – it would be sensible to believe that the EU policymakers' intention was to empower the ECB with supervisory tasks. This idea, however, at the time, was immature and subject to political tensions that made its final implementation unachievable. This perhaps explains the vague formulation of Article 127(6), TFEU that leaves “space” for broad interpretation. To this end, there are strong arguments supporting the view that this “space” was intentionally neglected in order to leave the option open for the consideration of this matter from the EU Council in

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<sup>1138</sup> Dragomir (n 647) 174.

<sup>1139</sup> See: Lackhoff, Klaus, 'How will the single supervisory mechanism (SSM) function? A brief overview' (2014) 29 (1) *Journal of International Banking Law and Regulation* 13.

the future.<sup>1140</sup> This was also confirmed by the recent use of Article 127(6), TFEU as the legal basis for conferring specific macro-prudential tasks on the ECB with the establishment of the ESRB in 2010.<sup>1141</sup>

Apart from the doubts raised in relation to Article 127(6), TFEU and its adequacy as the legal basis for the ECB's involvement in banking supervision, when interpreting the new supervisory tasks of the ECB, the principles of subsidiarity and proportionality should be taken into consideration. Specifically, according to Article 5(2), TEU: *“Under the principle of conferral, the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences not conferred upon the Union in the Treaties remain with the Member States.”* Thus, competences of the ECB should be interpreted within the limits its objectives as were set by primary EU law, and in accordance with the principles of subsidiarity and proportionality.<sup>1142</sup> Moreover, Article 5(3), TEU specifies the principle of subsidiarity as following: *“Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.”*<sup>1143</sup>

As a result, it is not surprising that the principles of subsidiarity and proportionality were applied accordingly to the conferral of supervisory powers to the ECB. Thus, it could be argued that, the supervisory powers conferred to the ECB may apply only to the extent that cover aspects that cannot be sufficiently monitored at national level or because it has been acknowledged that the common objectives of the conferred powers can be achieved better at EU level. Accordingly, the SSMR has endorsed the principle of subsidiarity and proportionality, by pointing out that the objectives of the conferred powers: *“cannot be sufficiently achieved at the Member State level and can therefore, by reason of the pan-Union structure of the banking market and the impact of failures of credit institutions on other*

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<sup>1140</sup> Lackhoff (n 1147) 15.

<sup>1141</sup> ECB, ‘Opinion of 8 January 2010, on three proposals for regulations of the European Parliament and of the Council establishing a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities and Markets Authority’ (CON/2010/5) 2 <[https://www.ecb.europa.eu/ecb/legal/pdf/en\\_con\\_2010\\_5\\_f.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2010_5_f.pdf)> accessed 14 July 2017.

<sup>1142</sup> TEU (n 233) Article 5 (1). See also: TEU (n 233) Articles 5(3) and (4).

<sup>1143</sup> TEU (n 233) Article 5(2).

*Member States, be better achieved at the Union level, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 TEU. In accordance with the principle of proportionality, as set out in that Article”, by emphasising also that the SSMR: “does not go beyond what is necessary in order to achieve those objectives.”*<sup>1144</sup> Furthermore, the compliance of the conferral of supervisory task to the ECB with the principles of subsidiarity and proportionality, was affirmed by the Report of the Joint Committee for EU Affairs.<sup>1145</sup>

#### 4.5 Mandate and scope of the ECB’s supervisory power

Having discussed the legal basis for conferring supervisory tasks to the ECB, it is crucial to examine the content of the Banks’ supervisory mandate and scope. According to Article 1(1), SSMR, the main objective of the ECB is to ensure the safety and soundness of the Eurozone credit institutions, the stability of the financial system as a whole as well as the unity and integrity of the internal market. The ECB’s supervisory powers apply to all Eurozone Member States, and to non-Eurozone Member States, subject to their decision to enter into a ‘close cooperation’ with the ECB,<sup>1146</sup> as defined in Article 7, SSMR. In regard to other EU Members States, i.e. EU Member States that have not adopted the euro and have not established a close cooperation with the ECB as defined by Article 7, SSMR (hereinafter: non-participating Member States), their participation is subject to contracts, administrative arrangements and memoranda of understanding between the ECB and the respective NCAs; which would be coordinated by EBA, but would not create legal obligations for the Member States.<sup>1147</sup> This arises from the wording of Article 2(1), SSMR which defines “*participating Member State*” as Member States whose currency is the euro or a Member State whose currency is not the euro which has established a close cooperation in accordance with Article

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<sup>1144</sup> SSMR (n 1101) Recital (87).

<sup>1145</sup> ‘Report 13/2012 by the Joint Committee for EU Affairs on the compliance of the principle of subsidiarity by the proposal for a Council Regulation conferring specific tasks on the European central bank concerning policies relating to the prudential supervision of credit institutions [COM (2012) 511 final]’ [2012/0242 (CNS)].

<sup>1146</sup> SSMR (n 1101) Article 7(1), (2)(a), (c) and Recital (42). Also, SSMFR (n 1131) sets the specifics and the rules to be applied when a close cooperation is established: Articles 106-108 SSMFR. See also: SSMFR (n 1131) Article 109-119.

<sup>1147</sup> SSMR (n 1101) Article 3(6), 8 and Recital (14). See also: SSMR (n 1101) Recitals (44), (49), (50), (77); Articles 4(2), 6(4), 17(3), 30(1) and 32(a), (h).

7, SSMR.<sup>1148</sup> Hence, the non-participating Member States are the EU Member States that have not adopted the euro and have not established a close cooperation with the ECB as defined by Article 7, SSMR.

As mentioned earlier, the ECB did not assume responsibility immediately after the SSMR was adopted. It was on 4 November 2014 that the ECB became the official pan-European banking supervisor, with the SSM getting involved in the supervision of around 6000 entities within the participating Member States, while 120 of them fell under the direct supervision of the ECB.<sup>1149</sup> The SSMR sets out criteria that should be met by a financial institution in order to be supervised by the ECB. Namely, in order for a financial institution to become subject to ECB's direct supervision should fulfil two criteria: firstly, they should fall within the definition of "credit institution" as defined by EU law; and secondly, they should be "significant," as defined by Article 6(4) SSMR. The banks that do not meet the criteria of Article 6(4) SSMR, would be considered less significant and would remain under the supervision of the NCAs. Regarding the meaning of a "credit institution" the SSMR makes reference to the respective definition as provided by the Capital Requirement Regulation (CRR), Article 4(1): "*credit institution means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own.*"<sup>1150</sup> In relation to other credit institutions that do not meet the requirements of the aforementioned definition, these do not seem to be subject to the SSMR's remit, although the wording of Article 127(6), TFEU: "*other financial institutions*" indicates otherwise. Similarly, insurance firms, despite their considerable significance in the financial market, are also excluded from the SSMR. The same applies to investment firms and securities depositories.

An issue that has raised concerns and has been considered as one of the limitations of SSMR, is the fact that the majority of the banks operating in the euro area will escape direct supervision by the ECB. This happens because there are many credit institutions that although they are considered as financial institution within the country of their operation, do not

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<sup>1148</sup> SSMR (n 1101) Article 2(1) and Article 7.

<sup>1149</sup> 'ECB assumes responsibility for euro area banking supervision' (ECB, Press Release of 4 November 2014) <<https://www.ecb.europa.eu/press/pr/date/2014/html/pr141104.en.html>> accessed 14 July 2017.

<sup>1150</sup> 'Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012' [2013] OJ L176/1 (known as Capital Requirements Regulation, hereinafter: CRR) Article 4(1) and SSMR (n 1101) Article 3(1).



formally qualify as ‘credit institutions’ under EU law. This happens due to their operation as businesses that do not receive credit, and as such, despite their size and importance, they fall outside the scope of the SSMR and remain subject to NCAs. This may prove to be problematic long term, since many of these financial institutions, while do not qualify as ‘credit institutions’ according to EU law, could be considered as systemically important in terms of size and operation, and would still will remain excluded from the supervision of the ECB unless they are part of a supervised group.<sup>1151</sup>

The second criterion for determining whether a financial institution will be supervised by the ECB, is the ‘significance’ component. This was another controversial aspect of ECB’s supervisory powers’ scope, which constituted part of an extensive debate during the drafting of SSMR. Within this context, it was questionable whether the ECB should be entrusted to supervise all Eurozone banks or only the systemically important ones.<sup>1152</sup> Germany, which was in favour of the second view, supported that the NCAs should retain their power to supervise the less significant banks, since their size and importance was unlikely to impose any significant risk to the EU financial market; and even in case of default, every country should be responsible to resolve the situation by its own means.<sup>1153</sup> This finds further support by those arguing that the assignment of the responsibility to supervise all the Eurozone banks to the ECB, would be difficult in practice. As Schäuble characteristically pointed out, the ECB: *“should focus its direct oversight on those banks that can pose a systemic risk at a European level. This is not just in line with the tested principle of subsidiarity. It is also common sense; we cannot expect a European watchdog to supervise directly all of the region’s lenders – 6,000 in the Eurozone alone – effectively.”*<sup>1154</sup> Indeed, it would have been almost unmanageable for the ECB to undertake the supervision of almost 6000 banks, and since a quick solution was

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<sup>1151</sup> Wymeersch, Eddy, ‘The single supervisory mechanism or “SSM”, part one of the Banking Union’ (National Bank of Belgium Working Paper No 255, Brussels, April 2014) 27.

See also: Veron, Nicolas, ‘Europe’s Single Supervisory Mechanism: Most small banks are German (and Austrian and Italian)’ (Bruegel, September 22, 2014) <<http://bruegel.org/2014/09/europes-single-supervisory-mechanism-most-small-banks-are-german-and-austrian-and-italian/>> accessed 14 July 2017.

<sup>1152</sup> Zavvos, George S., ‘Towards a European Banking Union: Legal and Policy Implications’ (Speech delivered at the 22nd Annual Hyman P. Minsky Conference: “Building a Financial Structure for a More Stable and Equitable Economy, New York, April 18 2013) <[http://www.levyinstitute.org/conferences/minsky2013/Zavvos\\_speech.pdf](http://www.levyinstitute.org/conferences/minsky2013/Zavvos_speech.pdf)> accessed 14 July 2017.

<sup>1153</sup> Ruding, Onno H., ‘The Contents and Timing of a European Banking Union: Reflections on the differing views’ (Centre for European Policy Studies 2012) 2

<[http://aei.pitt.edu/58425/1/Essay\\_No\\_2\\_European\\_Banking\\_Union.pdf](http://aei.pitt.edu/58425/1/Essay_No_2_European_Banking_Union.pdf)> accessed 14 July 2017.

<sup>1154</sup> Schäuble, Wolfgang, ‘How to protect EU taxpayers against bank failures’ (Financial times, August 30, 2012).

needed in order to restore confidence in the markets, the decision to focus on the most significant banks came into prominence. However, one may argue that even smaller banks, that would not normally fall under the scope of Article 6, SSMR, have proved to play a significant role during the GFC, and thus, their systemic effect should not be underestimated. Good examples are the Northern Rock and the Spanish savings banks or cajas (especially: Bankia, Catalunya Caixa y Novagalicia Banco), which despite their relatively small size, proved to have significant negative effect for the financial system as a whole during the GFC. The importance of smaller credit institutions is also highlighted in the SSMR as following: “*smaller credit institutions can also pose a threat to financial stability,*”<sup>1155</sup> hence, the possibility of the ECB’s intervention is left as an option when necessary. As it is clearly outlined: “*...the ECB should be able to exercise supervisory tasks in relation to all credit institutions authorised in, and branches established in, participating Member States.*”<sup>1156</sup> To this end, the ECB in its 2014 Guide to Banking Supervision added that: “*These objectives can only be achieved through: collaboration in good faith between NCAs and the ECB; an effective exchange of information within the SSM; and a harmonisation of both processes and consistency of supervisory outcomes.*”<sup>1157</sup>

When it comes to determine the ‘significance’ component, the SSMR provides four elements that would qualify a credit institution as significant, including its size, its importance to the EU economy or the Member State’s economy and the significance of its cross-border operations. As ‘significant’ in terms of size, are considered financial institutions with assets that exceed EUR 30 billion;<sup>1158</sup> or when they hold 20% of the participating Member State GDP, but in any case, their assets should exceed EUR 5 billion;<sup>1159</sup> or their size is considered of significant importance for the domestic economy, subject to the ECB’s confirming decision, following the relevant notification of the NCA and a comprehensive assessment by the ECB.<sup>1160</sup> Also, significant by default, are considered the financial institutions that are the

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<sup>1155</sup> SSMR (n 1101) Recital (16).

<sup>1156</sup> SSMR (n 1101) Recital (16).

<sup>1157</sup> ‘Guide to banking supervision’ (ECB, September 2014b) 39

<<https://www.ecb.europa.eu/pub/pdf/other/ssmguidebankingsupervision201409en.pdf>> accessed 14 July 2017.

<sup>1158</sup> SSMR (n 1101) Article 6(4) (subparagraph 2)(i).

<sup>1159</sup> SSMR (n 1101) Article 6(4) (subparagraph 2)(ii).

<sup>1160</sup> SSMR (n 1101) Article 6(4) (subparagraph 2)(iii).

largest of the participating Member State and those that have been subject to the EFSF's or the ESM's financial assistance.<sup>1161</sup>

In addition, the ECB, on its own initiative, holds the right to determine whether a financial institution, which is considered as 'less significant' according to Article 6(4), SSMR, should be deemed as significant: "*where it has established banking subsidiaries in more than one participating Member States and its cross-border assets or liabilities represent a significant part of its total assets or liabilities subject to the conditions laid down in the methodology.*"<sup>1162</sup> Lastly, the ECB is entitled to decide the direct supervision of a less significant financial institution, either on its own initiative or after the request of the concerned NCA, subject to the ECB's final decision, when the criteria set in Article 67, SSMFR, are met, and: "*when necessary to ensure consistent application of high supervisory standard...on its own initiative after consulting with national competent authorities or upon request by a national competent authority, decide to exercise directly itself all the relevant powers for one or more credit institutions.*"<sup>1163</sup> The decision to directly supervise a financial entity pursuant to Article 6(5) (b), SSMFR, could be terminated if the conditions of Article 47, SSMFR are met.

In regard to the scope of ECB's supervisory power, this is defined by Article 1, SSMR, and it covers only the prudential dimension of supervision. However, the exact definition of the term 'prudential supervision' has not been explicitly provided by the SSMR. Thus, the intended meaning of SSMR's reference to prudential supervision, should be drawn by the provisions outlining the scope of the ECB's supervisory mandate and by the intended aim of the mandate. To this end, according to the ECB, the latter shall contribute "*to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State, with full regard and duty of care for the unity and integrity of the internal market based on equal treatment of credit institutions with a view to preventing regulatory arbitrage.*"<sup>1164</sup>

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<sup>1161</sup> SSMR (n 1101) Article 60(4) (subparagraphs 4-5).

<sup>1162</sup> SSMR (n 1101) Article 6(4) (subparagraph 3).

<sup>1163</sup> SSMR (n 1101) Article 6(5) (b), SSMR (n 1101) Articles 39(5) and 68. See also: SSMFR (n 1131) Articles 37-39 for the criteria and the procedure that the ECB shall follow when adopting the decision of Article 6(5)(b).

<sup>1164</sup> SSMR (n 1101) Article 1(1).

Furthermore, the SSMR specifies that the prudential supervisory tasks conferred on the ECB, include both micro-prudential and macro-prudential responsibilities.<sup>1165</sup> Namely, Article 4, SSMR, outlines the specific tasks involved in the micro-prudential supervisory mandate of the ECB, including *inter alia*: the authorisation and the withdrawal of authorisation of credit institutions;<sup>1166</sup> the assessment of acquisitions of qualifying holdings;<sup>1167</sup> the responsibility to ensure compliance with prudential measures;<sup>1168</sup> the task to run supervisory reviews, including stress tests when appropriate and in coordination with the EBA;<sup>1169</sup> the competence to operate supervisory tasks in relation to recovery plans and early interventions under specific circumstances.<sup>1170</sup> The rationale of entitling the ECB responsible to assess and decide upon the authorisation of credit entities is laid down in the SSMR as following: “*prior authorisation for taking up the business of credit institutions is a key prudential technique to ensure that only operators with a sound economic basis, an organisation capable of dealing with the specific risks inherent to deposit taking and credit provision, and suitable directors carry out those activities. The ECB should therefore have the task of authorising credit institutions that are to be established in a participating Member State and should be responsible for the withdrawal of authorisations, subject to specific arrangements reflecting the role of national authorities.*”<sup>1171</sup> The authorisation and withdrawal of authorisation, along with the assessment of acquisitions of qualified holdings, are referred by the SSMFR as common procedures, upon which: “*the ECB has an overall and exclusive competence,*”<sup>1172</sup> with applicability to all financial entities, including both significant and less significant.<sup>1173</sup> Thus, the division between significant and less significant financial institutions does not apply to these tasks.

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<sup>1165</sup> ECB, ‘Public consultation on a draft Regulation of the European Central Bank, establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation)’ [2014] (ECCO/2014/030), 3.

<sup>1166</sup> SSMR (n 1101) Articles 4(1)(a) and 14; SSMFR (n 1131) Articles 73-84.

<sup>1167</sup> SSMR (n 1101) Articles 4(1)(c) and 15; SSMFR (n 1131) Articles 85-87.

<sup>1168</sup> SSMR (n 1101) Article 4(1)(d)(e).

<sup>1169</sup> SSMR (n 1101) Article 4(1)(f).

<sup>1170</sup> SSMR (n 1101) Article 4(1)(i).

<sup>1171</sup> SSMR (n 1101) Recital (20).

<sup>1172</sup> SSMFR (n 1131) Article 2(3).

<sup>1173</sup> ECB (n 1166) 17.

The second set of tasks conferred to ECB by the SSMR concerns macro-prudential measures,<sup>1174</sup> which, as the SSMFR clarifies, should not be addressed to individual institutions and thus, do not qualify as supervisory procedures of the ECB or the NCA.<sup>1175</sup> The macro-prudential supervisory tasks of the ECB are specified by Article 5, SSMR and Article 101, SSMFR, and are to be conducted in cooperation with NCAs of the participating Member States, and as the SSMR defines: *“the ECB’s tasks should include measures taken in pursuance of macro-prudential stability, subject to specific arrangements reflecting the role of national authorities.”*<sup>1176</sup> However, since macro-prudential supervision is not among the explicit responsibilities of the ECB, its analysis should be incorporated with the ECB’s interaction with the NCAs and the ESRB. Namely, the involvement of ECB in macro-prudential supervision, has to be examined firstly, in relation to the respective macro-prudential powers of the NCAs, since the latter retain the main role in the implementation of macro-prudential measures in accordance with EU law; and secondly, in respect with the ESRB, which is the existing EU body, already assigned with macro-prudential tasks. Both cases, will be further explored in the relevant sections in this chapter.<sup>1177</sup>

The key element in ensuring the soundness of individual financial institutions as well as the stability of the financial system as a whole, is the compliance with the prudential requirements imposed by the ECB. Thus, with the view to ensure this compliance, the SSMR empowers the ECB to directly address its supervisory measures to the supervised financial entity in the form of a request to take early measures.<sup>1178</sup> In particular, the ECB can ask any financial entity within the Eurozone to take early measures in case one of the following scenarios arise: a) non-compliance with the relevant prudential requirements as set by measures of the ECB based on EU Law (either Directive or Regulation); or b) there is evidence that such a breach (i.e. of the relevant prudential requirements) is likely to happen within the following 12 months; or c) following a supervisory review, the ECB finds out that there are issues in terms of the soundness of management and coverage risks adequacy that could

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<sup>1174</sup> SSMR (n 1101) Article 5.

<sup>1175</sup> SSMFR (n 1131) Article 101(2).

<sup>1176</sup> SSMR (n 1101) Recital (15).

<sup>1177</sup> For the relation of the ECB and NCAs see section 4.6, whereas for the ECB and ESRB see section 4.9.3.

<sup>1178</sup> The specific supervisory measures that the ECB is entitled to require from the NCAs are listed in SSMR (n 1101) Article 16(2) (a-m).

threaten the viability of the credit institution.<sup>1179</sup> The aim of this power of the ECB to request early measures from the NCAs, is to empower the ECB's supervisory tasks with some kind of enforceability.<sup>1180</sup> However, the ECB in its Guide to Banking Supervision, suggests that the ECB before exercising the right to require early measures from the concerned financial entities: *"may consider first addressing the problems informally, for example by holding a meeting with the management of the credit institution or sending a letter of intervention,"*<sup>1181</sup> which in turn, may prove to pose a limitation to this supervisory power of the ECB to require directly early measures from the supervised financial entity.

Furthermore, the SSMR provides the ECB with enforceability measures in case a significant financial institution fails to comply with prudential requirements or with the measures adopted within the context of SSMR. Namely, the ECB in order to ensure that the prudential supervisory requirements are adequately applied, can issue instructions, guidelines and general instructions to NCAs concerning the adoption of decisions by the latter in respect to ECB's conferred supervisory powers upon significant institutions, except from the cases related to the authorisation and assessment of an acquisition and disposal of qualifying holding.<sup>1182</sup> The ECB may also address instructions in cases it has required early stage measures from NCAs in accordance with Article 16 SSMR.<sup>1183</sup> Also, the SSMR entitles the ECB to impose effective, proportionate and dissuasive administrative penalties against a supervised financial entity<sup>1184</sup> including: a) administrative pecuniary penalties in case of an intentional or negligent breach of: *"a requirement under relevant directly applicable acts of Union law in relation to which administrative pecuniary penalties shall be made available to competent authorities under the relevant Union law;"*<sup>1185</sup> and b) sanctions (i.e. fines and

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<sup>1179</sup> SSMR (n 1101) Article 16(1) and ECB (n 1061) 30.

<sup>1180</sup> SSMR (n 1101) Article 16(2).

<sup>1181</sup> ECB (n 1166) 37.

<sup>1182</sup> SSMR (n 1101) Article 6(5) (a) (subparagraph 1).

<sup>1183</sup> SSMR (n 1101) Article 6(5) (a) (subparagraph 2).

<sup>1184</sup> SSMR (n 1101) Recital (36) and Article 18(3).

<sup>1185</sup> SSMR (n 1101) Article 18(1) and 'Council Regulation (EU) 2015/159 of 27 January 2015 amending Regulation (EC) No 2532/98 concerning the powers of the European Central Bank to impose sanctions' [2015] OJ L 27/1 (hereinafter: ECB Amended Sanctions Regulation), Recital (3).

periodic penalty payments) in accordance with the ECB Sanctions Regulation<sup>1186</sup> in case of a breach of ECB regulations or decision.<sup>1187</sup>

In addition, according to Article 34 (3), ESCB Statute, the ECB can also impose fines or periodic penalty payments on undertakings for failure to comply with the obligations under its regulations and decisions. However, it could be argued that the power of the ECB to impose sanctions has been stretched beyond the wording of ECB Sanctions Regulation, since it covers cases that are not only directly related with a breach of ECB regulations and decisions. For instance, the CRD IV provides that effective, proportionate and dissuasive administrative penalties and other measures could be imposed in relation to national provisions transposing both CRD IV and CRR.<sup>1188</sup> Lastly, it is worth mentioning that the sanctions could also be imposed to less significant financial institutions in case of an infringements of ECB regulations or decisions.<sup>1189</sup>

Any penalty imposed, regardless of whether it has been appealed or not, and after the concerned financial entity has been informed (except from the cases of Article 132(1), SSMFR), shall be published on the ECB's website and remain published for 5 years.<sup>1190</sup> According to Article 132, SSMFR, when the decisions regarding administrative penalties: (a) jeopardise the stability of the financial markets or an on-going criminal investigation; or (b) cause, insofar as it can be determined, disproportionate damage to the supervised entity concerned, it shall be published on an anonymised basis.<sup>1191</sup> Moreover, all fines imposed by the ECB in the exercise of its supervisory tasks are subject to the same upper limits of all fines the ECB may impose on an undertaking for a breach of directly applicable EU law, in order to ensure consistency in the treatment of equally serious infringements; subject to the same

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<sup>1186</sup> Regulation (EC) No 2532/98) 'Council Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the European Central Bank to impose sanctions [1998] OJ L 318/4 (hereinafter: ECB Sanctions Regulation).

<sup>1187</sup> TFEU (n 5) Article 132(3); ESCB Statute (n 243) Article 34; SSMR (n 1101) Article 18(7); ECB Sanctions Regulation (n 1195) Article 2; and ECB Amended Sanctions Regulation (n 1194) Article 1a (1).

<sup>1188</sup> 'Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC' [2013] OJ L176/338 (hereinafter: CRD IV), Articles 65(1), 66(2)(c)-(e) and 67(2)(e)-(g).

<sup>1189</sup> SSMFR (n 1131) Article 122(b).

<sup>1190</sup> SSMR (n 1101) Article 18(6); SSMFR (n 1131) Article 132; and ECB Amended Sanctions Regulation (n 1194) Article 1a (3).

<sup>1191</sup> SSMFR (n 1131) Article 132. See also: ECB Amended Sanctions Regulation (n 1194) Recital (7), Article 1a (3).

upper limit are also all periodic penalties imposed.<sup>1192</sup> However, the Amended ECB's Sanctions Regulation, acknowledging the complexity of the investigation of infringements in the supervisory field, provided that the ECB's power to impose and enforce sanctions relating to its supervisory tasks will be subject to longer time limits in comparison to the sanctions relating to the non-supervisory tasks.<sup>1193</sup> It should be noted that the enforceability measures should be exercised within the limits of the principles of effectiveness and proportionality.<sup>1194</sup>

Lastly, the SSMR in order to support the sufficient exercise of ECB's supervisory tasks, empowers the ECB with specific investigation and on-site competences, which are applicable on significant financial entities or less significant under the conditions of Article 138, SSMFR.<sup>1195</sup> Namely, the ECB may require all necessary information directly from the natural or legal persons listed in Article 10 (1) (a-f), SSMR, who are obliged, regardless of professional secrecy provisions, to provide the information requested.<sup>1196</sup> Also, under specific circumstances and when it is required, the ECB may operate on-site inspections without prior announcement.<sup>1197</sup> For the purposes of the on-site inspection the ECB shall establish on-site inspection teams in accordance with Article 144, SSMFR.<sup>1198</sup>

All in all, the ECB shall perform its prudential supervisory tasks within the SSM and has to work closely with NCAs.<sup>1199</sup> Thus, the SSM is comprised of the ECB and NCAs,<sup>1200</sup> which shall exchange all necessary information, and cooperate closely and in good faith when exercising their supervisory and investigatory powers.<sup>1201</sup> The ECB is entitled, when exercising prudential supervisory rules, to apply the relevant EU law, including directly applicable Regulation or Directives; when these rules are based on EU Directives, the national legislation transposing them, is accordingly applicable and when they are based on Regulations, the

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<sup>1192</sup> ECB Amended Sanctions Regulation (n 1194) Recitals (8) and (9).

<sup>1193</sup> ECB Amended Sanctions Regulation (n 1194) Recital (11), Article 4a and Article 4c. See also: Article 4b.

<sup>1194</sup> ECB Sanctions Regulation (n 1195) Article 2(2). See also: 'Enforcement' (ECB, Banking Supervision) <<https://www.bankingsupervision.europa.eu/banking/tasks/enforcement/html/index.en.html>> accessed 14 July 2017.

<sup>1195</sup> SSMR (n 1101) Article 10 and 12.

<sup>1196</sup> SSMR (n 1101) Article 9(1) (subparagraph 2), Article 10 (1), (2); SSMFR (n 1131) Article 139(1). See also: CRD IV (n 1197) Article 53.

<sup>1197</sup> SSMR (n 1101) Article 12(1).

<sup>1198</sup> SSMFR (n 1131) Article 143.

<sup>1199</sup> SSMR (n 1101) Article 6(1)(2).

<sup>1200</sup> SSMR (n 1101) Article 6(1); SSMFR (n 1131) Recital (2).

<sup>1201</sup> SSMR (n 1101) Article 6(2) and 9(2).



national legislation executing the explicitly granted options is also applicable.<sup>1202</sup> Lastly, where the SSMR does not explicitly confer prudential supervisory tasks on the ECB, the latter acting within the context of its conferred powers and to the extent necessary, may address instructions to NCAs requiring them to exercise the supervisory powers as set by their national legislation, while NCAs shall keep the ECB informed.<sup>1203</sup>

#### 4.6 The division of supervisory tasks between the ECB and the NCAs of the participating Member States

As analysed earlier, one of the reasons that brought centralisation of supervision at EU level was the realisation that the existing supervisory framework proved to be inadequate in coordinating supervisory practices in times of instability, which was attributed to the fact that supervision was mainly performed at national level while financial institutions were operating internationally. This created increased fragmentation, while the goal of creating a truly unified and integrated supervisory framework was far from being accomplished. With the creation of the SSM, as the first step towards a European Banking Union, one would expect that fragmentation would be replaced by integration, and the 'national' component would be replaced by the 'European.' However, although the new supervisory framework confers important supervisory tasks to the ECB, there are still major aspects of the ECB's supervisory discretion that remain dependant on the involvement of national level. Namely, the whole structure of the new mechanism operates subject to the close cooperation and coordination between the ECB and NCAs.

As it is defined by the SSMR, Recital (5): *“the competence for supervision of individual credit institutions in the Union remains mostly at national level.”* This creates a complex system of supervision that is divided between national and EU level, which may pose potential limitations to ECB's supervisory powers. Hence, it is questionable whether the centralisation of supervision in Europe has been fully achieved or remains a national responsibility coordinated by a supranational supervisor (i.e. the SSM). Therefore, the supervisory tasks of the new legal framework are to be divided into two categories: shared tasks between the ECB and the NCAs, and explicit ECB supervision responsibilities. According to SSMR, the ECB is

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<sup>1202</sup> SSMR (n 1101) Recital (34), Article 4(3) (subparagraph 1).

<sup>1203</sup> SSMR (n 1101) Article 9(1) (subparagraph 3).

deemed to be exclusively competent for specific conferred supervisory tasks, as defined by Article 4, whereas other tasks that fall outside its scope would remain with national authorities.<sup>1204</sup> However, as mentioned earlier, according to Article 6(4), SSMR, even the supervisory tasks conferred on the ECB are to be divided between the ECB and NCAs. The legal basis for this coordination of supervisory tasks between the ECB and the NCAs is laid down in the SSMR, the SSMFR and the ECB Rules of Procedure.<sup>1205</sup>

The main criterion to determine whether a financial entity falls within the ECB's supervisory scope or remains under the umbrella of its NCA, is the significance of the financial institution. As already mentioned, the SSMR entitles the ECB to supervise all the significant financial institutions and leaves the less significant or the ones that do not fall within the scope of the ECB's supervisory powers, under the supervision of the NCAs of participating Member States. As the SSMR outlines: "*supervisory tasks not conferred on the ECB should remain with the national authorities.*"<sup>1206</sup> However, even when the NCAs serve as the legitimate supervisors, this does not imply that they can operate freely and merely based on their own discretion. Namely, NCAs operation shall follow the framework set by the ECB,<sup>1207</sup> and this operations is also subject to the ECB's oversight.<sup>1208</sup> Moreover, the ECB, is eligible to issue regulations, guidelines or general instructions to the NCAs, when they adopt supervisory decisions.<sup>1209</sup> Most importantly, the ECB holds the right to decide on its own initiative, whether a less significant institution should be subject to its direct supervision.<sup>1210</sup> Thus, while the ECB shall share its duties with the NCAs, it holds the right to take over, at any time, the oversight of a credit institutions that is already under the NCA's remit. Moreover, as discussed

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<sup>1204</sup> SSMR (n 1101) Recital (15).

<sup>1205</sup> 'Decision of the ECB of 19 February 2004 adopting the Rules of Procedure of the ECB (ECB/2004/2)' [2004] OJ L 80/33 (hereinafter: ECB Rules of Procedure) as amended by:

- 'Decision of the European Central Bank of 22 January 2014 amending Decision ECB/2004/2 adopting the Rules of Procedure of the European Central Bank (ECB/2014/1)' [2014] OJ L 95/56.
- 'Decision (EU) 2015/716 of the ECB of 12 February 2015 amending Decision ECB/2004/2 adopting the Rules of Procedure of the ECB (ECB/2015/8)' [2015] OJ L 114/11.
- 'Decision (EU) 2016/1717 of the ECB of 21 September 2016 amending Decision ECB/2004/2 adopting the Rules of Procedure of the ECB (ECB/2016/27)' [2016] OJ L 258/17.

<sup>1206</sup> SSMR (n 1101) Recital (28).

<sup>1207</sup> SSMR (n 1101) Article 6(7); ECB Rules of Procedure (n 1214) Article 13j.

<sup>1208</sup> SSMR (n 1101) Article 6(5)(c).

<sup>1209</sup> SSMR (n 1101) (Article 6(5)(a)).

<sup>1210</sup> SSMR (n 1101) Article 6 (5)(b).

above, the ECB is eligible to issue regulations, guidelines or general instructions to the NCAs when the latter adopt supervisory decisions.

As was mentioned already, the authorisation and authorisation withdrawal of financial institutions, fall within the explicit responsibilities of the ECB,<sup>1211</sup> regardless of whether they are considered significant or less significant.<sup>1212</sup> Also, the ECB retains the right to withdraw the licence of financial institutions that have already been authorised by a NCA.<sup>1213</sup> Therefore, the role of NCA in the authorisation process is limited to the following tasks: a) the assessment of an application for authorisation, which should be based on national law;<sup>1214</sup> b) the rejection of an application for authorisation when the relevant conditions set in national law are not met;<sup>1215</sup> c) the preparation of a draft decision proposing that the ECB grant the applicant authorisation, subject to the ECB's assessment and final decision;<sup>1216</sup> d) the proposal for withdrawal, when the NCA has proposed the authorisation and subject to ECB's final decision;<sup>1217</sup> e) the right to object a withdrawal decision of ECB in case the NCA: "*remain competent to resolve credit institutions*" and "*considers that the withdrawal of the authorisation would prejudice the adequate implementation of or actions necessary for resolution or to maintain financial stability*", which is again subject to the ECB's final decision;<sup>1218</sup> f) the withdrawal of an authorisation when the conditions of Article 18, CRD IV are met; while, in cases the authorisation lapses pursuant to Article 18(a), CRD IV, the NCA should act in cooperation with the ECB and in accordance with Article 79, SSMFR. In any case, the ECB when deciding upon an authorisation or an authorisation withdrawal, except from Union Law, should take into consideration the relevant existing national law that might be providing additional rules; and thus, take action only in cases of non-compliance with national law, after the concerned NCA's proposal.<sup>1219</sup> In conclusion, it could be argued that authorisation, while it is highlighted as one of the explicit powers of the ECB, constitute a

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<sup>1211</sup> SSMR (n 1101) Article 4(1)(a).

<sup>1212</sup> SSMR (n 1101) Recital (20) and Article 14.

<sup>1213</sup> SSMR (n 1101) Article 14(5)(subparagraph 1).

<sup>1214</sup> SSMR (n 1101) Recital (21) and Article 14(1); SSMFR (n 1131) 74.

<sup>1215</sup> SSMR (n 1101) Article 14(2); SSMFR (n 1131) Article 75.

<sup>1216</sup> SSMR (n 1101) Article 14(2); SSMFR (n 1131) Articles 76-78.

<sup>1217</sup> SSMR (n 1101) Article 14(5) (subparagraph 2).

<sup>1218</sup> SSMR (n 1101) Recital (56) and Article 14(6).

<sup>1219</sup> SSMR (n 1101) Recital (21).

rather shared and interlinked duty between the ECB and NCAs, especially given the right of the latter to object when the resolution is national.

Similarly, the assessment of acquisitions of qualifying holdings is subject to close cooperation between the ECB and NCAs, whereas the final decision remains with the ECB, except cases of bank resolution.<sup>1220</sup> The process of assessment starts with the receipt of notification for the acquisitions of a qualifying holding by the NCA,<sup>1221</sup> which is entitled to assess the notification,<sup>1222</sup> and to decide upon its validity in accordance with the relevant Union and national law.<sup>1223</sup> Following this assessment, the NCA holds the responsibility to notify the ECB within 5 days from the acknowledgement of receipt<sup>1224</sup> and send the draft decision to oppose or not to oppose the acquisition to the ECB within 15 working days before the expiry of the assessment period.<sup>1225</sup> In turn, the ECB decides on the acquisition: *“on the basis of its assessment of the proposed acquisition and the NCA’s draft decision.”*<sup>1226</sup>

The ECB’s investigation and on-site inspection tasks, while they are listed among the exclusive responsibilities of the ECB, are also, subject to close cooperation between the ECB and NCAs where appropriate.<sup>1227</sup> Namely, the ECB, prior to require information from the legal or natural person pursuant to Article 10(1), SSMR, should make use of the existing information available within NCAs,<sup>1228</sup> while informing the NCAs about the decision to request information.<sup>1229</sup> However, the NCA should assist the ECB by all means in exercising the investigation tasks and on-site inspection, in case the concerned person opposes to cooperate.<sup>1230</sup> Also, the ECB and NCAs shall cooperate when using the NCA resources concerning the on-site inspection teams.<sup>1231</sup> The cooperation of the ECB and the NCA involving investigation task, is also based on the principle of general cooperation set by Article

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<sup>1220</sup> SSMR (n 1101) Recital (22) and Article 4(1) (c); SSMFR (n 1131) Article 87.

<sup>1221</sup> SSMR (n 1101) Article 15(1), (2); SSMFR (n 1131) Article 85.

<sup>1222</sup> SSMFR (n 1131) Article 86.

<sup>1223</sup> SSMR (n 1101) Article 15(1), (2); SSMFR (n 1131) Article 86(1).

<sup>1224</sup> SSMFR (n 1131) Article 85(1).

<sup>1225</sup> SSMFR (n 1131) Article 86(2).

<sup>1226</sup> SSMR (n 1101) Article 15(3); SSMFR (n 1131) Article 87.

<sup>1227</sup> SSMR (n 1101) (Recital (47) and Article 9(2).

<sup>1228</sup> SSMFR (n 1131) Article 139(2).

<sup>1229</sup> SSMR (n 1101) Article 10(3); SSMFR (n 1131) Article 139(3).

<sup>1230</sup> SSMR (n 1101) Article 11(2), 12(5); SSMFR (n 1131) Article 142.

<sup>1231</sup> SSMFR (n 1131) Article 144.

21, SSMFR and the general obligation of NCAs to report to the ECB in accordance with Article 99, SSMFR.<sup>1232</sup>

As regard the power of ECB to impose administrative penalties, in case of a breach that is not covered by the wording of Article 18(1), SSMR. Namely, the ECB, in pursuing its prudential supervisory tasks, is entitled to require the NCAs to open proceedings in order take actions that will ensure the imposition of penalties in an proportionate and dissuasive manner, and in accordance with any relevant EU law and national law that regulate powers that are not conferred by EU law.<sup>1233</sup> The opening of a proceeding could be initiated only after the explicit request of the ECB, or after the NCA asks the ECB to request the opening of a proceeding.<sup>1234</sup> It should be noted the SSMR requires that the powers of ECB to impose penalties is strictly limited to credit institutions, financial holding companies or mixed financial holding companies, and should not be extended to natural or legal persons.<sup>1235</sup>

There is, however, an exception from this rule, which implies that in case the proceeding that has been opened by the NCA and is subject to ECB's request pursuant to Article 15(5)(subparagraph 1), involves a breach of national law transposing an EU directive, administrative penalties may be imposed to members of the management board of the concerned financial entity: *"who under national law are responsible for a breach by a credit institution, financial holding company or mixed financial holding company."*<sup>1236</sup> This is explained by the fact that, the ECB holds the right to impose penalties on its own initiative, only to the extent and within the limits of its supervisory power, which are to be applied in accordance with EU law. For breaches concerning explicit tasks of the ECB as set by the EU Treaties and ESCB Statute, the ECB may initiate an infringement procedure on the basis of ECB Sanctions Regulation, regardless of national law provisions that may provide for different procedures; while for infringements that fall outside the ECB's conferred tasks, the right to initiate an infringement procedure is, again, independent of any right of the NCAs to initiate separate procedures.<sup>1237</sup> As regard national law enforceability, even when this concerns the

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<sup>1232</sup> ECB Public Consultation (n 1174) 16.

<sup>1233</sup> SSMR (n 1101) Article 18(5) (subparagraph 1).

<sup>1234</sup> SSMFR (n 1131) Article 134(2).

<sup>1235</sup> SSMR (n 1101) Recital (53).

<sup>1236</sup> SSMR (n 1101) Article 18(5)(subparagraph 2); SSMFR (n 1131) Article 134(1) SSMFR).

<sup>1237</sup> ECB Amended Sanctions Regulation (n 1194) Article 3(10).

transpositions of EU Law, the NCAs retain their discretion to decide. This is repeated many times in the SSMR provisions, and it is also included in the imposition of penalties part. In particular according to Recital (36), SSMR: *“the National authorities should remain able to apply penalties in case of failure to comply with obligations stemming from national law transposing Union Directives. Where the ECB considers it appropriate for the fulfilment of its tasks that a penalty is applied for such breaches, it should be able to refer the matter to national competent authorities for those purposes.”*

When it comes to macro-prudential supervision,<sup>1238</sup> the ECB and the NCAs would have to act in close cooperation and by sharing their responsibilities accordingly. However, Article 1 (subparagraph 6), provides that the rules of SSMR shall apply: *“without prejudice to the responsibilities and related powers of the competent or designated authorities of the participating Member States to apply macro-prudential tools not provided for in relevant acts of Union law.”* This practically means that the NCAs are entitled to undertake all macro-prudential tools available at national level, when needed, regardless of their inclusion or not in the SSMR. This also links with NCAs’ right to set the requirements for capital buffers,<sup>1239</sup> in accordance with EU law and with respect to the CRD IV minimum standards, after notifying the ECB 10 days before any action is taken.<sup>1240</sup>

Nevertheless, while macro-prudential supervision seems to remain a key responsibility of NCAs, the ECB is entitled to reject the relevant decision of the concerned NCA.<sup>1241</sup> Also, the ECB, in order to address systemic or macro-prudential risks, may require higher requirements for the capital buffers and stricter measures on its own initiative, but in close cooperation with the NCA, or after the request of the NCA concerned.<sup>1242</sup> In any case, the NCA shall be notified by the ECB, 10 days before the adoption of the final decision. The NCA holds the right to file a written and reasoned objection within 5 working days following the decision, subject to the ECB’s assessment.<sup>1243</sup> From the wording of the aforementioned

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<sup>1238</sup> The macro-prudential tools are outlined in Article 5, SSMR. For the explicit definition and application of the macro-prudential tools and the procedure of cooperation between the ECB and the NCAs see: SSMFR (n 1131) Article 101-105. See also: SSMR (n 1101) Recital (24).

<sup>1239</sup> For the definition of capital buffers see: CRD IV (n 1197) Article 128.

<sup>1240</sup> SSMR (n 1101) Recital (24) and Article 5(1).

<sup>1241</sup> SSMR (n 1101) Article 5(1).

<sup>1242</sup> SSMR (n 1101) Recital (24), Article 5(2), (3), (4); SSMFR (n 1131) Article 105(1). See also: ECB Public Consultation (n 1174) 15.

<sup>1243</sup> SSMR (n 1101) Article 5(4); SSMFR (n 1131) Article 105(2).

provisions, it is clear that the role of the ECB in the context of macro-prudential supervision is very limited. Namely, the ECB is not entitled to direct or influence the decision of a NCA to increase capital buffers, since the ECB may only request an increase of capital buffers and/or express its objection against a decision of the NCA. In this respect, provided that the ECB and NCAs shall act in close cooperation, and each may decide in increasing the capital buffers, who has the overall responsibility for them? Secondly, what happens in case of conflicting decisions? These are questions that have not been addressed by the existing regulatory framework and may potentially lead in conflicting supervisory measures or in overlapping powers.

One conclusion that could be drawn by the analysis above is that despite the prominent, and in most of the cases, decisive role of ECB regarding prudential supervisory tasks, the NCAs retain a strong presence throughout, with their tasks being highly interlinked with those of the ECB. This makes their role necessary within supervisory structures and the ECB, dependent upon their cooperation in order to exercise adequately the conferred supervisory tasks. In this respect, can we really talk about a truly unified and centralised system, or do we have an even more fragmented structure? The existing supervisory structure has been a revolution and a stepping stone towards further integration, but it is far from forming a truly integrated supervisory structure. It seems that this was the most convenient and feasible choice at the time, given the fact that its institutional arrangements are based on the existing EU legal framework. As a result, the NCAs involvement is unavoidable since the existing Treaty provisions do not provide for extensive conferral of prudential supervisory tasks on the ECB. As analysed already, the wording of Article 127(6), TFEU refers to specific supervisory tasks, which from the outset poses restrictions to the scope of the ECB's supervisory powers. Hence, anything beyond 'specific' should be covered by the NCAs. This complex cooperation between the ECB and NCAs may give rise to practical problems. For instance, the difference between prudential and conduct supervision is blurred in many EU countries where both are tasks are conducted by the same national authority. Therefore, it remains unclear how the division of these distinct responsibilities is to be achieved.

## 4.7 The operational structure of the SSM

As it has been discussed already, the SSM is designed to operate within the ECB, with the latter sharing its duties with the NCAs. In the centre of the SSM is operating the Single Supervisory Board (SSB), assisted by a Steering Committee,<sup>1244</sup> and the Joint Supervisory Teams (JST). The SSB operates within the ECB, encompassing the specific expertise of national supervisors, while serving as the main body responsible for preparing decisions on supervisory matters.<sup>1245</sup> As it is highlighted by the SSMR, the SSB would undertake the supervisory tasks that have been traditionally subject to national discretion.<sup>1246</sup> Thus, given the importance of SSB within the new supervisory framework, the analysis of the operational structure of SSM starts with a detailed examination of the SSB's role, including its internal composition and its interaction with the Governing Council and the new bodies established with the view to strengthen the ECB's supervisory mandate, and its decision-making procedure. This is then followed by a discussion on the other SSM bodies, the rationale of their creation, and their respective tasks and duties.

### 4.7.1 The Single Supervisory Board

The EU Treaties contain a set of provision concerning the decision-making procedure within the ECB. However, the relevant provisions in both the TFEU and the ESCB Statute, were created when the ECB was meant to serve solely the mandate of price stability. Therefore, after conferring supervisory task on the ECB, the decision-making framework was altered accordingly in order to accommodate the operation and implementation of the new supervisory rules. The two main supervisory decision-making bodies of the new SSM include: the newly created SSB, and the existing ultimate decision-making body of the ECB, the Governing Council. Under EU Law, the ultimate decision-making body of the ECB is the Governing Council,<sup>1247</sup> which consists of the members of ECB's Executive Board and the Governors of NCBs of the Eurozone Member States.<sup>1248</sup> One may question that since the

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<sup>1244</sup> SSMR (n 1101) Recital (71).

<sup>1245</sup> SSMR (n 1101) Recitals (67), (69).

<sup>1246</sup> SSMR (n 1101) Recital (69).

<sup>1247</sup> According to ESCB Statute (n 243) Article 9(3), which is based in TFEU (n 5) Article 129, the decision-making bodies of the ECB are the Governing Council and the Executive Board.

<sup>1248</sup> TFEU (n 5) Article 283(1) and ESCB Statute (n 243) Article 10.



Governing Council is the ECB's decision-making body, what is the purpose of having the SSB and what the rationale of its creation? This question comes to one of the most discussed issues during the drafting of the SSMR and the core idea of this thesis: the principle of separation between monetary policy and supervisory tasks.

To this end, although the Governing Council constitutes the main decision-making body of ECB, it would have been contradictory to be assigned the responsibility to prepare the ECB's supervisory decisions, while at the same time having the power to guide those decisions. This apart from the potential of raising conflict of interest issues between the two ECB mandates (i.e. monetary policy and banking supervision), would have also posed a serious risk to the principle of separation between the ECB's competences in the pursuit of their respective objectives (i.e. price and financial stability) as provided by Article 25, SSMR. As a result, the creation of the SSB, aimed at creating a balance, organisational separation and impartial cooperation between the two functions of the ECB. However, the SSB, hierarchically, stands below the Governing Council, since it does not have any legally binding decision-making powers. The SSB is rather established to serve as the internal body of the SSM, responsible for the planning and preparation of draft decisions on supervisory matters. The latter are subject to the final decision of the Governing Council, which remains the body that produces the legally binding decisions of the ECB.<sup>1249</sup> This is also highlighted by the ECB Rules of Procedure, Article 13a as following: *“any tasks of the Supervisory Board shall be without prejudice to the competences of the ECB decision-making bodies.”*

In regard to its composition, the SSB would consist of: a Chair and a Vice-Chair; four representatives of the ECB; and one representative of each NCBs or other NCA,<sup>1250</sup> who would be all subject to SSB's Code of Conduct, including any participating, accompanying and alternates participants in the SSB meeting.<sup>1251</sup> This practically means that the SSM is governed by a Supervisory Board, which consist of 25 members in total, including 6 ECB staff members and 19 representatives from national supervisors.<sup>1252</sup> An interesting aspect of SSB is the

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<sup>1249</sup> SSMR (n 1101) Recital (67) and Article 26 (8); ECB Rules of Procedure (n 1214) Article 13a.

<sup>1250</sup> SSMR (n 1101) Recital (67), (69) and Article 26; ECB Rules of Procedure (n 1214) Article 13a.

<sup>1251</sup> 'Code of Conduct for the Members of the Supervisory Board of the European Central Bank' [2015] OJ C 93/2 (hereinafter: SSB Code of Conduct) Article 1(1).

<sup>1252</sup> Schoenmaker, Dirk, 'Firmer Foundation for a Stronger European Banking Union' (Bruegel Working Paper 2015/13, November 2015) 17 <[http://bruegel.org/wp-content/uploads/2015/11/WP-2015\\_132.pdf](http://bruegel.org/wp-content/uploads/2015/11/WP-2015_132.pdf)> accessed 14 July 2017.

appointment of the Chair and Vice Chair, which in the initial proposal of the EU Commission was listed among the responsibilities of the Governing Council.<sup>1253</sup> However, this was changed in the final version of SSMR, which provides that the Chair and the Vice Chair of the SSB, would be appointed by the EU Council. This clearly reflects an attempt to enhance further the separation between the monetary policy and supervisory tasks of the ECB.

The process of appointing the Chair and the Vice Chair of SSB, starts with the relevant proposal of the ECB. Namely, the Chair is to be selected in an open selection procedure and the Vice Chair, among the members of Executive Board.<sup>1254</sup> The ECB forwards the proposal to the EU Parliament, after hearing the Supervisory Board,<sup>1255</sup> while the EU Parliament and Council shall be kept informed at all times throughout the selection procedure. The final decision for the appointment is to be taken by the EU Council with qualified majority, and with the non-participating Member States having no voting right.<sup>1256</sup> The selection of both the Chair and the Vice Chair of the SSB, shall be based on the principle of gender balance, experience and qualification.<sup>1257</sup> Furthermore, the Chair and Vice Chair of the SSB, should be highly independent figures, with a specific timeframe for their office term, which may not exceed the 5 years and is not renewable.<sup>1258</sup> Also, based on the principle of separation between the monetary policy and supervision functions of the ECB, the SSMR excludes the members of the Governing Council to be appointed as the SSB's Chair.<sup>1259</sup> For the same purpose, the four representatives of the ECB, which are appointed by the Governing Council, would have voting rights but shall not be involved directly to monetary policy tasks.<sup>1260</sup> Lastly, in case the NCA of the participating Member State is not the central bank, the concerned participating Member State is entitled to bring a representative from the central bank, who should sign a declaration of compliance with the Code of Conduct prior the participation,<sup>1261</sup> whose vote together with the vote of the NCA representative will count as one.<sup>1262</sup>

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<sup>1253</sup> COM (2012) 511 (n 1153) Recital (36) and Article 19 (2).

<sup>1254</sup> SSMR (n 1101) Article 26(3).

<sup>1255</sup> ECB Rules of Procedure (n 1214) Article 23(3) and 13b (3).

<sup>1256</sup> SSMR (n 1101) Article 26(3).

<sup>1257</sup> SSMR (n 1101) Recital (67) and Article 26(2).

<sup>1258</sup> SSMR (n 1101) Recital (70); ECB Rules of Procedure (n 1214) Article 13b(5).

<sup>1259</sup> SSMR (n 1101) Article 26(3).

<sup>1260</sup> SSMR (n 1101) Article 26(5); ECB Rules of Procedure (n 1214) Article 13b(6).

<sup>1261</sup> ECB Rules of Procedure (n 1214) Article 13e(2); SSB Code of Conduct (n 1260) Recital (4).

<sup>1262</sup> ECB Rules of Procedure (n 1214) Article 26(1) (subparagraph 2) and Article 13b(2).

The SSB is complemented by another body called the Steering Committee, with no decision-making power and a role limited to carrying preparatory and supportive to the SSB tasks, and a main responsibility to prepare the meetings of the SSB.<sup>1263</sup> Its composition is also limited and includes eight Members of the SSB: the Chair and the Vice-Chair of the SSB, one representative of the ECB and five representatives of the NCAs.<sup>1264</sup> The five representatives of the NCAs should be appointed for one year, and their allocation should be made in fair balance and by rotating them between the four groups that are set according to a ranking based on the total consolidated banking assets in the relevant participating Member State, and with each group having a minimum of one representative in the Steering Committee.<sup>1265</sup> The four ECB representatives are to be appointed by the President among the four ECB representatives on the SSB, with a term office to be determined also by the President. The Steering Committee members should carry out their task: *“solely in the interest of the Union as a whole, and work in full transparency with the Supervisory Board.”*<sup>1266</sup>

The members of the SSB and the Steering Committee are granted a highly independent status. Their independence is enshrined in both the SSMR and the SSB Code of Conduct. Namely, the members of SSB when performing supervisory task shall act independently, objectively, in the interest of the Union as a whole and are not permitted to seek or take any instructions from any EU body or institution, or from any government of a Member State, or any other public or private body; while they are all obliged to respect this independence.<sup>1267</sup> Furthermore, Article 4, SSB Code of Conduct extends independence beyond the Members of SSB, including all the participants in the meetings of the SSB. Namely, all the participants in SSB meetings are required to perform their supervisory tasks: *“free from undue political influence and from commercial interference,”*<sup>1268</sup> while they should avoid or even resign from positions that: *“could hinder their independence or present them with the possibility of using privileged information.”*<sup>1269</sup>

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<sup>1263</sup> SSMR (n 1101) Recital (71) and Article 26(10); ECB Rules of Procedure (n 1214) Article 10.

<sup>1264</sup> SSMR (n 1101) Recital (71) and Article 26(10)(subparagraph 1); ECB Rules of Procedure (n 1214) Article 11(1).

<sup>1265</sup> ECB Rules of Procedure (n 1214) Article 11(2), (3).

<sup>1266</sup> SSMR (n 1101) Recital (71).

<sup>1267</sup> SSMR (n 1101) (Recital (71) and Article 19(1) (2); SSB Code of Conduct (n 1260) Recital (1) and Article 4(1).

<sup>1268</sup> SSB Code of Conduct (n 1260) Article 4(2).

<sup>1269</sup> SSB Code of Conduct (n 1260) Article 4(3).

Private financial transactions of the Members and participants of the SSB, including their personal assets are also subject to the notion of independence. Namely, confidential information arising from private financial transactions, to which they have access either directly or via third parties, at their own risk and at their own account or at the risk and on the account of a third party, are not permitted to be used by the members or any participant of the SSB.<sup>1270</sup> Moreover, their personal assets, which go beyond those required for family use, shall be organised in a way that would ensure their independence and would be also subject to the rules on private transactions adopted by the ECB for its members of staff; or if the members or participant of the SSB represent the NCAs, they would be subject to the relevant national rules.<sup>1271</sup> Lastly, Article 2(2) outlines the principles applied on the operation of supervisory tasks, including: *“honesty, independence, impartiality, discretion and regardless of self-interest.”*

The independence of the SSB Members’ and any other participant’s is subject to cooling-off periods, after their office term has finished, and appropriate compensation.<sup>1272</sup> In particular, the Members and any participant in the SSB meetings should wait one year and six months, respectively, after their office term termination, in order to get involved in occupational activities concerning credit institutions directly supervised by the ECB, or in relation to financial institutions non-directly supervised by the ECB, but *“where a conflict of interest exists or could be perceived to exist”*; or six months for the SSB members or three months for any other participant in the SSB meetings, when the occupational activity involve a non-credit institution, *“save where a conflict of interest exists or could be perceived to exist.”*<sup>1273</sup> The cooling-off period of occupational activities concerning banks directly supervised by the ECB, are subject to an extension of two years maximum for the SSB members and one year maximum for any other participant, after the relevant recommendation of the ECB’s Ethics Committee: *“where the possibility of conflicts of interest resulting from subsequent occupational activities cannot be excluded for longer periods.”*<sup>1274</sup> In any case, the members of SSB and any other participant to the SSB meetings, are obliged

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<sup>1270</sup> SSB Code of Conduct (n 1260) Article 5(1).

<sup>1271</sup> SSB Code of Conduct (n 1260) Article 5(2),(3).

<sup>1272</sup> SSB Code of Conduct (n 1260) Article 8.

<sup>1273</sup> SSB Code of Conduct (n 1260) Article 8(1)(a-c) and (2),(a-c).

<sup>1274</sup> SSB Code of Conduct (n 1260) Article 8(4).

to inform the President of ECB for their intention to get involved in any occupational activities in one year period, for any other participant or in two years period, for the SSB members, post their office term termination, including the non-profit activities.<sup>1275</sup>

Furthermore, the members and other participant in SSB meetings are subject to strict rules in order to avoid any conflict of interest situations, concerning private or personal factors that may influence the objectivity of their performance. These shall be disclosed in writing, in order to exclude them from their voting rights.<sup>1276</sup> The same restrictions apply to their spouse or recognised partner, which should be reported to the Ethics Committee.<sup>1277</sup> The objectivity of the members or other participant in the SSB meetings is also subject to specific rules in regard to the acceptance of gifts of other benefits, which should be done in accordance with Article 10, SSB Code of Conduct. The members and any participant in the SSB meetings, should also, pay particular attention to: a) their public appearances, including the prudence of their invitation, in conferences, receptions, cultural events, connected entertainment and appropriate hospitality, which should comply with the principle of independence;<sup>1278</sup> b) the activities undertaken in their personal capacity, which should comply with their professional obligations, the reputation of the ECB, excluding the academic activities.<sup>1279</sup> Moreover, according to Recital (74), SSMR, the members or participants in the SSB Meetings, shall comply with the professional secrecy rules.<sup>1280</sup>

#### 4.7.2 The decision-making procedure

The decision-making procedure of the SSB, is based on the Governing Council's prototype of the simple majority, with the members having one vote each and the Chair a casting vote,<sup>1281</sup> while qualified majority is only required for draft regulations.<sup>1282</sup> Furthermore, the decision-making process is designed on the basis of a 'non-objection'

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<sup>1275</sup> SSB Code of Conduct (n 1260) Article 8(1),(2).

<sup>1276</sup> SSB Code of Conduct (n 1260) Article 9.

<sup>1277</sup> SSB Code of Conduct (n 1260) Article 13.

<sup>1278</sup> SSB Code of Conduct (n 1260) Article 11 (1).

<sup>1279</sup> SSB Code of Conduct (n 1260) Article 12.

<sup>1280</sup> ESCB Statute (n 243) Article 37; SSMR (n 1101) Article 27(1); ECB Rules of Procedure (n 1214) Article 23a; SSB Code of Conduct (n 1260) Article 14(1).

<sup>1281</sup> SSMR (n 1101) Article 26(6).

<sup>1282</sup> SSMR (n 1101) Article 26(7). For the specific rules applied in regard to qualified majority see also: ECB Rules of Procedure (n 1214) Article 13c.

procedure,<sup>1283</sup> which implies a negative decision of the Governing Council. In the absence of the negative decision, the draft decision of the SSB shall be deemed adopted. In particular, when a draft decision of the SSB refers to micro-prudential tasks pursuant to Article 4, SSMR, it should be forwarded to the Governing Council along with explanatory notes, stressing the background and its reasoning, and from there to the concerned NCA.<sup>1284</sup> If the Governing Council does not object the draft decision of the SSB within a maximum of ten working days,<sup>1285</sup> it would be considered as an approved decision, and thus, as adopted.<sup>1286</sup>

When the draft decision of the SSB concerns macro-prudential powers as conferred on the ECB by Article 5, SSMR, the decision is considered as adopted when the Governing Council does not object it within a period of three working days, after the receipt of the concerned NCA's notification to the Secretariat of the SSB, expressing an intention to undertake a macro-prudential measure, which is followed by the relevant proposal of the SSB.<sup>1287</sup> Lastly, in case the draft decision of the SSB is based on the ECB's intention to impose stricter macro-prudential measures pursuant to Article 5(2), SSMR, the NCA should be informed of such an intention ten days before the Governing Council adopts the decision, and the NCA hold the right to object it within five working days.<sup>1288</sup>

In any case, an objection decision of the Governing Council against a draft decision of the SSB that concerns micro-prudential tasks, shall be justified by providing written reasons, which should '*in particular stating monetary policy concerns*'<sup>1289</sup> and should be forwarded to both the SSB and NCAs.<sup>1290</sup> Moreover, the President of ECB holds the responsibility to explain to the Chair of the EU Parliament's competent committee, the reasoning of the objection.<sup>1291</sup>

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<sup>1283</sup> 'Guide to banking supervision' (ECB, November 2014c), 14

<<https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidetobankingssupervision201411.en.pdf>> accessed 14 July 2017.

<sup>1284</sup> ECB Rules of Procedure (n 1214) Article 13g.

<sup>1285</sup> In emergency circumstances 48 hours, see: SSMR (n 1101) Article 26(8) and ECB Rules of Procedure (n 1214) Article 13g (2).

<sup>1286</sup> SSMR (n 1101) Article 26(8); ECB Rules of Procedure (n 1214) Article 13g(2).

<sup>1287</sup> ECB Rules of Procedure (n 1214) Article 13h.

<sup>1288</sup> ECB Rules of Procedure (n 1214) Article 13h (2).

<sup>1289</sup> SSMR (n 1101) Article 26(8); ECB Rules of Procedure (n 1214) Article 13g(2).

<sup>1290</sup> ECB Rules of Procedure (n 1214) Article 13g (2).

<sup>1291</sup> 'Interinstitutional Agreement between the European Parliament and the European Central Bank on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism 2013/694/EU' [2013] OJ L 320/1, para 4.

An objection decision of the Governing Council that refers at macro-prudential tasks should also be written and reasoned, and should be forwarded to the NCA within five working days following the notification to the ECB.<sup>1292</sup>

#### 4.7.3 The Mediation Panel

Another tool that was created by the SSMR with the view to enhance further the strict line drawn between monetary policy and banking supervision objectives of the ECB, is the Mediation Panel.<sup>1293</sup> The main responsibility of the Mediation Panel, is to resolve the differences that might arise between the Governing Council and the SSB. As discussed already, the Governing Council's holds the right to object a draft decision proposed by the SSB.<sup>1294</sup> In case this happens, the concerned NCA is given the right to express its opposite view on Governing Council's objection decision before the Mediation Panel.<sup>1295</sup> The Mediation Panel would be chaired by the Vice-Chair of the Supervisory Board<sup>1296</sup> and would be composed by one representative from each participating Member State. These representatives would be chosen among the members of the Governing Council and SSB, and would decide in simple majority with one vote each.<sup>1297</sup> The composition should be set in a way: *"to ensure that it resolves differences of views in a balanced way, in the interest of the Union as a whole."*<sup>1298</sup> The Mediation Panel Regulation includes a set of rules that govern the meetings, organisation and voting procedure.<sup>1299</sup>

The NCA interested in appealing the objection decision of the Governing Council,<sup>1300</sup> holds the right to request from the SSB the initiation of a mediation process within five working days from the receipt of the objection decision, and with: *"a view to ensuring*

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<sup>1292</sup> ECB Rules of Procedure (n 1214) Article 13h.

<sup>1293</sup> SSMR (n 1101) Recital (73).

<sup>1294</sup> SSMR (n 1101) Article 26(8).

<sup>1295</sup> SSMR (n 1101) Article 25(5).

<sup>1296</sup> 'Regulation (EU) No 673/2014 of the European Central Bank Concerning the Establishment of a Mediation Panel and its Rules of Procedure ECB/2014/26' [2014] OJ L 179/72 (hereinafter: Mediation Panel Regulation), Recital (4) and Article 3(1).

<sup>1297</sup> SSMR (n 1101) Article 25(5); Mediation Panel Regulation (n 1305) Article 4(1). For the specifics of the voting procedure see also: Mediation Panel Regulation (n 1305) Article 7.

<sup>1298</sup> SSMR (n 1101) Recital (73). See also: Mediation Panel Regulation (n 1305) Article 4(3).

<sup>1299</sup> Mediation Panel Regulation (n 1305) Article 5-7.

<sup>1300</sup> An objection decision by the Governing Council can be appealed only once. See: Mediation Panel Regulation (n 1305) Article 8(3).

*separation between monetary policy and supervisory tasks.*<sup>1301</sup> The concerned NCA shall file a notice to the SSB, including a statement with the reasoning of the request and by identifying the objection decision. After the request for mediation has been received from the Secretariat, the latter shall inform the Members of the SSB.<sup>1302</sup> The SSB's Secretariat, within ten working days after receiving the notice of the NCA requesting mediation - submitted within the deadline set by Article 8(1) - shall file the notice with the Governing Council's Secretariat, in which, the draft decision of the SSB and the Governing Council's decision objecting it, shall be annexed.<sup>1303</sup>

Also, any other participating Member State that disagrees with an objection decision of the Governing Council, but holds a different view from the participating Member State that has already expressed its disagreements, is given the right to submit a separate request for mediation against the same objection decision or join an existing request within five working days from the notification of the initial request for mediation.<sup>1304</sup> In regard to the non-Euro participating Member States, when their NCA, pursuant to Article 7(7), SSMR,<sup>1305</sup> have notified the ECB of their reasoned disagreement with the objection decision of Governing Council concerning a draft decision of SSB, cannot request for meditation.<sup>1306</sup> In case the NCA has requested already for meditation regarding an objection decision of the Governing Council, and then notifies the ECB of its reasoned disagreement in accordance with Article 7(7), the mediation shall be deemed withdrawn.

Following the filing of a notice requesting mediation, the Chair of the Mediation Panel shall forward it to the Mediation Panel Members.<sup>1307</sup> The Mediation Panel, within five working days from the filing date, has to establish a Case Committee, the main aim of which is to create a balance between the Members of the Governing Council and the SSB.<sup>1308</sup> The Case Committee's responsibility is to provide a draft opinion to the Chair of Mediation Panel, within 15 working days (or faster in urgent circumstances) from the receipt of the notice requesting

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<sup>1301</sup> Mediation Panel Regulation (n 1305) Article 8(1).

<sup>1302</sup> Mediation Panel Regulation (n 1305) Article 8(1).

<sup>1303</sup> Mediation Panel Regulation (n 1305) Article 8(5).

<sup>1304</sup> Mediation Panel Regulation (n 1305) Article 8(2).

<sup>1305</sup> See also: ECB Rules of Procedure (n 1214) 13g(4).

<sup>1306</sup> Following the aforementioned procedure of Mediation Panel Regulation (n 1305) Article 8(1), regarding the same objection decision.

<sup>1307</sup> Mediation Panel Regulation (n 1305) Article 9(1).

<sup>1308</sup> Mediation Panel Regulation (n 1305) Article 9(2),(3).



mediation by the Mediation Panel, analysing whether the request for mediation is admissible and legally founded. The Chair of the Mediation Panel, after receiving the draft opinion, shall forward it to the Mediation Panel and calls for a meeting.<sup>1309</sup> The Case Committee would consist of the Chair of the Mediation Panel, and four members among the Mediation Panel Members.<sup>1310</sup> The members of participating Member States, whose NCA has expressed an opposing view against an objection decision of the Governing Council in accordance with Article 8(1) or has joint an existing request for mediation following the procedure of Article 8(2), would be excluded from becoming part of the Case Committee.<sup>1311</sup>

The final procedure following the submission of the draft opinion by Case Committee, which would eventually lead to the adoption of the decision by the Mediation Panel, is outlined in Articles 10-11, Mediation Panel Regulation. In particular, the Mediation Panel has a deadline of 20 days, (or in urgent circumstance less days) from the receipt of the notice requesting mediation, to provide a written opinion upon the request for mediation, explaining its reasoning. The draft opinion is to be submitted to the SSB and the Governing Council, but does not have any binding effect on them. Within ten days from the submission of the Mediation Panel's draft opinion, the SSB, holds the right to submit to the Governing Council a new draft decision, and the objection of the latter from the Governing Council cannot be subject to a request for mediation. However, in urgent circumstances, the Chair of the SSB could decide for a shorter deadline.<sup>1312</sup>

#### 4.7.4 Administrative Board of Review

The Administrative Board of Review (hereinafter: Administrative Board) constitutes body established by the ECB,<sup>1313</sup> with the main responsibility to run internal reviews upon decision of the ECB concerning its conferred supervisory tasks. The rationale of the Administrative Board's establishment and the internal review procedure, while may challenge the decisions of ECB concerning supervisory findings, is not meant to intervene to ECB

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<sup>1309</sup> Mediation Panel Regulation (n 1305) Article 9(5).

<sup>1310</sup> Mediation Panel Regulation (n 1305) Article 9(4).

<sup>1311</sup> Mediation Panel Regulation (n 1305) Article 9(3).

<sup>1312</sup> Mediation Panel Regulation (n 1305) Article 11(2).

<sup>1313</sup> 'Decision of the ECB of 14 April 2014 concerning the establishment of an Administrative Board of Review and its Operating Rules (ECB/2014/16)' [2014] OJ L 175/47 (hereinafter: Administrative Board Decision).

conferred supervisory task and its discretion to adopt decisions upon supervisory matters. The main objective of the internal review is to provide the possibility, to any person who wishes to challenge a decision of the ECB that concerns supervisory matters, to request for internal review, either because the decision in question addresses them or it affects them individually and directly.<sup>1314</sup> Furthermore, the scope of Administrative Board's review is limited on the: "*procedural and substantive conformity*" of the contested decision with the SSMR, while at the same time should act: "*respecting the margin of discretion left to the ECB to decide on the opportunity to take those decisions.*"<sup>1315</sup>

In terms of composition, the Administrative Board would consist of five members, who can be replaced temporarily by two alternates, in case of incapacity, death, resignation, removal from the office or conflict of interest.<sup>1316</sup> The conflict of interest case, as defined by Article 3(3), Administrative Board Decision occurs: "*where a member of the Administrative Board has a private or personal interest which may influence, or appear to influence, the impartial and objective performance of their duties.*" Moreover, the members of Administrative Board and the two alternates, shall be appointed from the Member States based on the following criteria: high reputation, proven record of relevant knowledge and professional experience, high level of supervisory experience in banking or other financial services.<sup>1317</sup> The members of the Administrative Board and the two alternates, are appointed by the Governing Council, including the terms and conditions of their appointment,<sup>1318</sup> following the submission of the nominees selected by the Executive Board, two months before the start of the meeting of Governing Council that would adopt the final decision for their appointment. The selection of the nominees by the Executive Board to the Governing Council is subject to a public call announcement in the EU Official Journal, and after the Executive Board hears the SSB.<sup>1319</sup>

The staff of ECB, or NCAs, or any other staff from national or Union institutions, bodies, offices and agencies, who are involved in supervisory tasks, cannot be nominated to be

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<sup>1314</sup> SSMR (n 1101) Recital (64) and Article 24(1),(5); Administrative Board Decision (n 1322) Article 7(1).

<sup>1315</sup> SSMR (n 1101) Recital (64) and Article 24(1); Administrative Board Decision (n 1322) Article 10(1).

<sup>1316</sup> Administrative Board Decision (n 1322) Article 24(2) and Article 3(1),(3).

<sup>1317</sup> SSMR (n 1101) Recital (64) and Article 24(2); and Administrative Board Decision (n 1322) Article 3(2).

<sup>1318</sup> Administrative Board Decision (n 1322) Article 4(5).

<sup>1319</sup> SSMR (n 1101) Article 24(2); and Administrative Board Decision (n 1322) Article 4(1),(2).

appointed as Administrative Board members or alternates.<sup>1320</sup> The appointment of the Administrative Board members is made by the Governing Council, based on a geographical and gender balance across the Member States, for a term office of five years, renewable only once.<sup>1321</sup> Moreover, the members of Administrative Board and the alternates, would be granted a highly independent status. Namely, they should: “*not be bound by any instructions,*”<sup>1322</sup> but should “*...act independently and in the public interest,*” and “*...shall not be subject any instruction and shall make a public declaration of interests indicating any direct or indirect interest which might be considered prejudicial to their independence or the absence of any such interest.*”<sup>1323</sup> Also, except from the members, two alternates, the Chair and Vice-Chair,<sup>1324</sup> the Administrative Board would be assisted from the Secretary of SSB, which would serve as its Secretary, and the ECB, which is required to provide appropriate support and legal expertise in supervisory matters.<sup>1325</sup>

As mentioned already, the review procedure can be also initiated by the directly concerned natural or legal persons. The wording of the provisions in both the SSMR and the Administrative Board Decision, i.e. the applicants for the internal review shall be of “*direct and individual concern*”, does not clearly define whether or not the intention was to qualify the representatives of the Member States or NCAs as eligible applicants to the request for review. However, the latter does not seem to be the option, since the Member States are entitled to submit their request to the ECJ,<sup>1326</sup> while the NCAs have already been part of the adopted decision due to their participation on the voting procedure in the SSB. In any case, in order the procedure of internal review to start, the concerned person shall request for review by filing a written notice with the Secretary within a month from the day the concerned person was notified for the decision or if there is no notification, one month from the day it came to the knowledge of the concerned person.<sup>1327</sup> The notice requesting the review shall include: a statement of grounds on which the request is based or statement of grounds of the suspensive effect review, if the latter was requested; any document related; a

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<sup>1320</sup> SSMR (n 1101) Article 24(2); Administrative Board Decision (n 1322) Article 3(2).

<sup>1321</sup> SSMR (n 1101) Recital (64) and Article 24(2); Administrative Board Decision (n 1322) Article 4(1),(3).

<sup>1322</sup> SSMR (n 1101) 24(2).

<sup>1323</sup> SSMR (n 1101) Article 24(4); Administrative Board Decision (n 1322) Article 4(4).

<sup>1324</sup> For the duties of the Chair and Vice-Chair see: Administrative Board Decision (n 1322) Article 5.

<sup>1325</sup> Administrative Board Decision (n 1322) Article 6(1),(3).

<sup>1326</sup> See: SSMR (n 1101) Article 24(11); Administrative Board Decision (n 1322) Article 19.

<sup>1327</sup> SSMR (n 1101) Article 24(1),(5),(6); Administrative Board Decision (n 1322) Article 7(1),(2).

summary of all the rest if the notice of review exceeds ten pages; and the contested decision annexed to it.<sup>1328</sup> Moreover, the notice shall be written in one of EU's official languages, including also, the contact details of the applicant.<sup>1329</sup> Although, the notice requesting the review does not have suspensory effect on the contested decision, the Governing Council, has the discretion to suspend the contested decision. The decision of Governing Council to suspend the contested decision shall be taken on grounds of an admissible and not obviously unfounded request for review, and when: "*immediate application of the contested decision may cause irreparable damage.*"<sup>1330</sup>

Within a deadline that does not exceed two months from the receipt of notice requesting for review, the Administrative Board shall formulate a written and reasoned opinion<sup>1331</sup> upon the review, and forward it to the SSB, with the latter having to provide a new draft decision.<sup>1332</sup> The Administrative Board before defining whether a request for review is legally founded, would have to examine the admissibility of the request for review,<sup>1333</sup> but in any case, the opinion of the Administrative Board does not have a binding effect for neither the SSB, not the Governing Council.<sup>1334</sup> A notice requesting a review against the new decision of the Governing Council that has been taken on grounds of Article 24(7) would be considered admissible.<sup>1335</sup>

In case the Administrative Board, reasons that the request for review is wholly or partly inadmissible, this: "*shall be recorded in the Administrative Board's opinion pursuant to Article 17.*"<sup>1336</sup> This practically leads, to the preparation process of a new draft decision from the SSB, with the latter having two options: a) either to submit a new draft decision replacing the initial decision with a one of identical content, within 10 days from the receipt of the Administrative Board's opinion or b) to submit a new draft decision within 20 days abrogating

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<sup>1328</sup> SSMR (n 1101) Article 24(6); Administrative Board Decision (n 1322) Article 4(a),(b),(c),(d).

<sup>1329</sup> Administrative Board Decision (n 1322) Article 7(1),(5).

<sup>1330</sup> SSMR (n 1101) Article 24(8); Administrative Board Decision (n 1322) Article 9(1),(2).

<sup>1331</sup> The opinion of the Administrative Board should be adopted with a majority of at least three members of the Administrative Board (SSMR (n 1101) Article 28(3); Administrative Board Decision (n 1322) Article 16(3)).

<sup>1332</sup> SSMR (n 1101) 24(7); Administrative Board Decision (n 1322) Article 16(1),(4).

<sup>1333</sup> Administrative Board Decision (n 1322) Article 11(1).

<sup>1334</sup> Administrative Board Decision (n 1322) Article 16(5).

<sup>1335</sup> SSMR (n 1101) (24 (5); Administrative Board Decision (n 1322) Article 11(2)).

<sup>1336</sup> Administrative Board Decision (n 1322) Article 11(1).

or amending the initial decision.<sup>1337</sup> The assessment of the opinion of Administrative Board by the SSB, shall not remain only within the scope of the notice requesting for review, but may also consider other elements on its new draft proposal.<sup>1338</sup> The new draft decision of SSB shall be deemed adopted, if within a maximum period of ten days the Governing Council has not objected it.<sup>1339</sup> As it was mentioned already, the Governing Council's decision is not subject to further review requests and if any is submitted, would be considered non admissible. Thus, the only option left for appealing the decision of Governing Council, is to bring the claim before the ECJ.

However, the opinions of Administrative Board, the new decisions of SSB and the final decisions of Governing Council, should include the reasons they are based on and forwarded to the parties.<sup>1340</sup> This implies that the review procedure differs from the general decision-making procedure, especially in regard to the final decision of the Governing Council, which regardless of resulting in objection or not, the Governing Council would have to provide its reasoning. The same applies to the draft decisions of SSB and the Administrative Board opinions, which have the potential to lead to further judicial review, since the right to request for internal review: *"is without prejudice to the right to bring proceedings before the Court of Justice in accordance with the Treaties."*<sup>1341</sup>

#### 4.7.5 The Joint Supervisory Teams

In 30 September 2014, the Chair of Supervisory Board, Danièle Nouy, as part of the SSM's operational structure and in an attempt to create: *"a truly pan-European supervisor operating without national bias or prejudice"*, announced that the SSM would be accompanied by Joint Supervisory Teams (JSTs).<sup>1342</sup> The JST would, practically, be the vehicle of NCAs in assisting the ECB's supervisory tasks. This is in line with the relevant responsibility

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<sup>1337</sup> SSMR (n 1101) Article 24(7); Administrative Board Decision (n 1322) Article 17(2).

<sup>1338</sup> Administrative Board Decision (n 1322) Article 17(1). It should be noted that the wording of this Article is not quite clear, as to the exact meaning of the other elements.

<sup>1339</sup> SSMR (n 1101) Article 24(7).

<sup>1340</sup> SSMR (n 1101) Article 24(9); Administrative Board Decision (n 1322) Article 18.

<sup>1341</sup> SSMR (n 1101) Article 24(11); Administrative Board Decision (n 1322) Article 19.

<sup>1342</sup> Nouy, Danièle, 'One more step towards a better Europe: building banking supervision' (Opinion piece by the Chair of the Supervisory Board of the Single Supervisory Mechanism, 30 September 2014) <<https://www.bankingsupervision.europa.eu/press/interviews/date/2014/html/sn140930.en.html>> accessed 14 July 2017.

of NCAs that is embedded in Article 6(3), SSMR as following: “Where appropriate and without prejudice to the responsibility and accountability of the ECB for the tasks conferred on it by this Regulation, national competent authorities shall be responsible for assisting the ECB.” The JST would be the body to replace the colleges of supervisors and would consist of both ECB and NCAs representative, serving as the main form of cooperation between the ECB and NCAs.<sup>1343</sup> The main responsibility of JSTs would be the day-to-day supervision of each significant financial institution of the participating Member States or Member States into close cooperation,<sup>1344</sup> and would consist of representatives from both the ECB and the NCAs. Each JST would be led and coordinated by a designated ECB member (JST coordinator) and one or more sub-coordinators from the NCAs.<sup>1345</sup>

The JST coordinator should hold a different nationality from the supervised financial institutions and is to be appointed for three to five years, subject to the risk profile and complexity of the bank.<sup>1346</sup> The main responsibility of the JST’s coordinator is to coordinate the work among the members of JST - who are obliged to follow his/her instructions<sup>1347</sup>- and to implement supervisory tasks and activities.<sup>1348</sup> The sub-coordinators are given a supportive role to JST coordinators and the responsibility to define the: “*thematic or geographic areas of supervision.....reflecting the views of the relevant NCAs.*”<sup>1349</sup> The composition and appointment of the JSTs members are among the responsibilities of the ECB,<sup>1350</sup> while the NCAs are responsible for appointing one or more members of JST from their own staff, among which the sub-coordinator will be chosen.<sup>1351</sup> The appointment decision of NCAs is subject to modification request by the ECB.<sup>1352</sup> Both members of the JSTs and the coordinators should rotate periodically.<sup>1353</sup>

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<sup>1343</sup> ‘Joint Supervisory Teams’ (ECB Banking Supervision website)

<<https://www.bankingsupervision.europa.eu/banking/approach/jst/html/index.en.html>> accessed 14 July 2017.

<sup>1344</sup> SSMR (n 1101) Article 3(1); SSMFR (n 1131) Article 115.

<sup>1345</sup> SSMFR (n 1131) Article 3 (1).

<sup>1346</sup> ECB (n 1161) 17.

<sup>1347</sup> SSMFR (n 1131) Article 6(1).

<sup>1348</sup> ECB (n 1161) 17.

<sup>1349</sup> ECB (n 1161) 17.

<sup>1350</sup> SSMFR (n 1131) Article 4(1).

<sup>1351</sup> SSMFR (n 1131) Article 4(2) and Article 6(2).

<sup>1352</sup> SSMFR (n 1131) Article 4(3).

<sup>1353</sup> ECB (n 1161) 17.

#### 4.9. The supervisory coordination of ECB with the other EU institutions

According to SSMR, Article 3(1): *“the ECB shall cooperate closely with EBA, ESMA, EIOPA and the European Systemic Risk Board (ESRB), and the other authorities which form part of the ESFS, which ensure an adequate level of regulation and supervision in the Union.”* Also, as ECB’s Guide to Banking Supervision outlines that: *“the SSM will not “reinvent the wheel”, but “aims to build on the best supervisory practices that are already in place. It works in cooperation with the European Banking Authority (EBA), the European Parliament, the Eurogroup, the European Commission, and the European Systemic Risk Board (ESRB), within their respective mandates, and is mindful of cooperation with all stakeholders and other international bodies and standard-setters.”*<sup>1354</sup> This means that the SSM, is not an ‘independent’ unit within the union, eligible to act separately from the other units, but it is rather the missing part of a puzzle. As mentioned already, along with the adoption of the SSMR, came EBA’s amending regulation,<sup>1355</sup> which reinforced the need for cooperation between the ECB and the other EU institution, and reflected the attempt to rebalancing the powers between EBA and the ECB.

Therefore, it could be argued that the conferred supervisory task on the ECB by the SSMR, are not to be exercised solely, but they constitute a natural extension of what already existed at both EU and national level. Thus, it is important to examine the interlinkages between the ECB tasks and their interaction with the tasks and objectives of the other EU institutions; especially the way the ECB, as the common supranational supervisor, would have to cooperate, rely and interact with the existing EU bodies. The EU bodies that are directly affected by the ECB’s supervisory mandate, include EBA and ESRB, due to their role in micro- and macro-prudential supervision respectively. ESMA’s and EIOPA’s roles, since they cover areas of responsibilities that do not fall within the scope of SSM, have remained in general

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<sup>1354</sup> ECB (n 1292) 4.

<sup>1355</sup> ‘Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) in regard to the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013’ [2013] OJ L 287/5 (hereinafter: EBA Amended Regulation).

unchanged, with only one exception: EIOPA's tasks in respect with the bank-led financial conglomerates, which may involve some supervisory interference from the ECB.<sup>1356</sup>

#### 4.9.1 The ECB and EBA

As extensively discussed already, EBA was one of the bodies that received a great deal of attention when discussing the centralisation of supervisory powers at EU level, and it was even considered of becoming the single European supervisor. The principle objective of EBA is to contribute to the creation of the European Single Rulebook in banking, which aims at providing a single set of harmonised prudential rules for financial institutions throughout the EU. This in turn, intends to help the creation a level playing field in the EU financial markets and to provide high protection to depositors, investors and consumers.<sup>1357</sup> Also, EBA, in order to achieve the adequate operation of its tasks, and to ensure supervisory convergence and consistency of supervisory measures throughout the EU, is entitled *inter alia* to issue guidelines and recommendations;<sup>1358</sup> technical standards;<sup>1359</sup> and individual decisions, addressing either the NCAs<sup>1360</sup> or financial institutions pursuant to Article 35, SSMR.<sup>1361</sup> EBA's guidelines and recommendations, however, are not legally binding; and the draft regulatory technical standards and draft implementing technical standards, in order to become legally binding should be endorsed by the EU Commission pursuant to Article 290 and 291, TFEU, respectively.<sup>1362</sup> These standards constitute a tool, aiming to contribute into the development of the Single Rulebook,<sup>1363</sup> but at the same time, form part of the EU banking regulation. Moreover, EBA, is also empowered with micro-prudential supervisory task such as: the

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<sup>1356</sup> SSMR (n 1101) Recitals (26),(34) and Article 4(1)(h).

<sup>1357</sup> EBA Regulation (n 984) Recital (22).

It should be noted that when referring at EBA's Regulation, the author means the initial EBA Regulation: Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC' [2010] OJ L 331/12.

For EBA's task and missions see also: EBA website: <<http://www.eba.europa.eu/about-us/missions-and-tasks>> accessed 14 July 2017.

<sup>1358</sup> EBA Regulation (n 984) Article 16.

<sup>1359</sup> Including both the responsibility to develop draft regulatory technical standards and draft implementing technical standards, pursuant to EBA Regulation (n 984) Article 10 and 15 respectively.

<sup>1360</sup> In the cases set out in EBA Regulation (n 984) Articles 18(3) and 19(3).

<sup>1361</sup> SSMR (n 1101) Recital (32); EBA Regulation (n 984) Article 8(2).

<sup>1362</sup> EBA Regulation (n 984) Recitals (23),(25) and Articles 10, 15.

<sup>1363</sup> Witte, Andreas, 'The Application of National Banking Supervision Law by the ECB: Three Parallel Modes of Executing EU Law?' (2014) 21 (1) Maastricht Journal of European and Comparative Law 89, 91.



collection of the necessary information from the NCA,<sup>1364</sup> to run stress test;<sup>1365</sup> and its involvement within the colleges of supervisors.

It has been acknowledged that EBA's role, along with the other ESAs, has significantly contributed in improving cooperation of NCAs and has also helped in promoting convergence of supervisory practices.<sup>1366</sup> With the creation of the SSM, the EBA's regulatory role overall, remained unchanged, including its role in regard to the development of the Single Rulebook and common regulatory practices.<sup>1367</sup> The EBA's supervisory tasks have not changed either, and the relevant amendments have only altered its voting procedure. As it has been clearly stated by the SSMR, Recital (32): *"the ECB should not replace the exercise of those tasks by EBA, and should therefore exercise powers to adopt regulations in accordance with Article 132 of the Treaty on the Functioning of the European Union (TFEU) and in compliance with Union acts adopted by the Commission on the basis of drafts developed by EBA and subject to Article 16 of Regulation (EU) No 1093/2010."* On the contrary, the ECB, when exercising its supervisory powers, should act in compliance with the binding regulatory and implementing technical standards developed by EBA.<sup>1368</sup> Moreover, according to Recital (31), SSMR: *"the conferral of supervisory tasks on the ECB should be consistent with the framework of the ESFS and its underlying objective to develop the single rulebook and enhance convergence of supervisory practices across the whole Union."*

The SSMR *inter alia* designated the ECB with duties to cooperate with international bodies in relation to supervision, with the view to strengthen international supervisory coordination.<sup>1369</sup> This was a task, which was originally conferred to EBA,<sup>1370</sup> and for this reason the SSMR provides that while the ECB should exercise its task *"in respect of international standards and in dialogue and close cooperation with supervisors outside the Union"*, this should be done in way *"without duplicating the international role of EBA"* and *"while coordinating with EBA and while fully respecting the existing roles and respective competences*

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<sup>1364</sup> EBA Regulation (n 984) Article 8(2)(h).

<sup>1365</sup> EBA Regulation (n 984) Articles 23(1) and 32(d). See also: Articles 21(2)(b) and 22(2)(subparagraph 2).

<sup>1366</sup> This was also reaffirmed by the SSMR (n 1101) Recital (7).

<sup>1367</sup> 'EBA Work Programme 2014' (EBA short report, 13 September 2013) 1

<https://www.eba.europa.eu/documents/10180/425836/EBA+2014+Work+Programme.pdf/a6d9ed92-fd17-479a-bd43-3284a12d9f80> accessed 14 July 2017.

<sup>1368</sup> SSMR (n 1101) Article 4(3)(subparagraph 2).

<sup>1369</sup> SSMR (n 1101) Recital (80) and Article 8.

<sup>1370</sup> EBA Regulation (n 984) Recital (44),(66), Article 1(5)(c), Article 33.

*of the Member States and the institutions of the Union.*"<sup>1371</sup> Thus, the role of EBA in promoting international supervisory convergence is not anymore an explicit task of EBA, but has transformed into a shared responsibility between the latter and the ECB.

As highlighted earlier, the main amendments in EBA Regulation targeted the voting procedures within the SSB. These changes aim at enabling cooperation between the participating and non-participating Member States, and hence, to prevent the predominance of the former over the latter. Namely, EBA's technical standards are to be decided by qualified majority, from both participating and non-participating Member States.<sup>1372</sup> Accordingly, EBA's Management Board shall include in its composition at least two representatives of non-participating Member States.<sup>1373</sup> Moreover, when there will be four non-participating Member States, the EU Commission shall review and report to the EU Parliament and Council.<sup>1374</sup>

The EBA is also provided the right to participate in discussions concerning supervisory matters, since SSB may invite the latter in its meetings as an observer along with the EU Commission and the Chair of European Resolution Authority.<sup>1375</sup> Accordingly, the ECB is entitled to participate in EBA's Board of Supervisors,<sup>1376</sup> with one representative nominated by the SSB, but with no voting right.<sup>1377</sup> To this end, Recital (52), EBA Regulation, states that the ECB's representative shall have the status of the observer: *"Representatives of the Commission, the ESRB, the European Central Bank, the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority) should participate as observers."* The ECB's representative may also attend discussions within the Board of Supervisors concerning individual financial institutions.<sup>1378</sup> Also, one representative of the ECB, with expertise on central banking tasks, may complement the participation of the representative nominated by the SSB.<sup>1379</sup> The SSMR goes one step further in deepening the ECB's involvement in EBA's

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<sup>1371</sup> SSMR (n 1101) Recital (80) and Article 8.

<sup>1372</sup> EBA Amended Regulation (n 1364) Article 44 (1).

<sup>1373</sup> EBA Amended Regulation (n 1364) Article 45(1)(subparagraph 3).

<sup>1374</sup> EBA Amended Regulation (n 1364) Article 81a.

<sup>1375</sup> SSMR (n 1101) Recital (70).

<sup>1376</sup> SSMR (n 1101) Article 3(2).

<sup>1377</sup> EBA Amended Regulation (n 1364) Article 40(1)(d).

<sup>1378</sup> EBA Amended Regulation (n 1364) Article 44(4).

<sup>1379</sup> EBA Amended Regulation (n 1364) Article 44(4)(a).

supervisory activities, by stating that: *“Where necessary the ECB shall contribute in any participating role to the development of draft regulatory technical standards or implementing technical standards by EBA in accordance with Regulation (EU) No 1093/2010 or shall draw the attention of EBA to a potential need to submit to the Commission draft standards amending existing regulatory or implementing technical standards.”*<sup>1380</sup>

To this end, although EBA is the main EU body involved in the regulatory process, the analysis above indicates a clear participation of the ECB to this process. This participation has raised questions in regard to the division between regulatory and supervisory powers. As already, mentioned, ‘regulation’ and ‘supervision’ are two different notions, which differ mainly in terms of responsibilities rather than in terms of scope. In theory, ‘regulation’ is generally anticipated as entailing the written rules that define the commonly accepted standards, while ‘supervision’ refers to the enforcement of these standards.<sup>1381</sup> In practice, in many jurisdiction, such as the UK, regulation and supervision are usually two terms that are used interchangeably. However, the SSMR treats ‘regulation’ and ‘supervision,’ as two distinct notions, which are two be carried out in a different way. To this end, as repeatedly emphasised in SSMR, the regulation of credit institutions shall remain a competence of national authorities guided by EU law, while the ECB, through the SSM, is entrusted with the prudential supervision of EU financial market. Furthermore, EBA’s legally binding technical standards form part of the EU banking regulation, whereas the ECB shall be subject to *“binding regulatory and implementing standards developed by the EBA.”*

However, provided the fact that the ECB is given an active participating role in the internal procedures of EBA – drafting technical standards – it could be said that the ECB’s role does not remain within the limits set out by its conferred supervisory tasks, but it rather expands the ECB’s involvement into the regulatory process. This is particularly problematic given that the SSMR does not confer rulemaking powers to the ECB in relation to its supervisory tasks, but it only empowers the ECB to issue recommendations and decisions pursuant to EU law and within the limits set by EU law. However, Recital (32), SSMR states that the ECB may: *“exercise powers to adopt regulations in accordance with Article 132 of the*

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<sup>1380</sup> SSMR (n 1101) Article 4(3)(subparagraph 4).

<sup>1381</sup> For more on the differences of regulation and supervision see: Lastra, Rosa M., *Central Banking and Banking Regulation* (London School of Economics 1996) Chapter 2.

*Treaty on the Functioning of the European Union (TFEU) in compliance with Union acts adopted by the Commission on the basis of drafts developed by EBA and subject to Article 16 of Regulation (EU) No 1093/2010.”*

Thus, the wording of this provision indicates that the ECB is entrusted with rulemaking power by default. The legal basis of such rulemaking powers, could perhaps find a legitimate justification in Article 132, TFEU, which confers rulemaking powers to the ECB in relation to its monetary policy mandate, including the powers: *“to make regulations to the extent necessary to implement the tasks defined in Article 3.1, first indent, Articles 19.1, 22 and 25.2 of the Statute of the ESCB and of the ECB in cases which shall be laid down in the acts of the Council referred to in Article 129(4); to take decisions necessary for carrying out the tasks entrusted to the ESCB under the Treaties and the Statute of the ESCB and of the ECB; and to make recommendations and deliver opinions.”* It is evident from the wording of Article 132, TFEU, that the rulemaking powers of the ECB, aim at helping the latter to carry out its tasks entrusted to the ECB by EU Law, and thus, should be applied only within the limits of the conferred tasks as set out by the ESCB Statute and the EU Treaties. To this end, the wording of Article 132, TFEU although provides for rulemaking powers only with respect to the monetary policy mandate of ECB, at the same time, does not exclude the supervisory tasks. Thus, Article 132, TFEU can be interpreted as providing rulemaking powers to the ECB in the supervisory domain as well, but only as long as this is done in accordance with the provisions of the SSMR, ESCB Statute and EU Treaties. However, the SSMR limits the ECB’s supervisory tasks to the extent that the EU allows for, and in respect with the responsibilities set to the other EU bodies by EU law. Therefore, since the SSMR does not allow for rulemaking powers, the legitimacy of ECB’s involvement in the regulatory domain is highly questionable.

Another linking point between the supervisory powers of ECB and EBA is the stress test duties. As discussed already, one of the core responsibilities of the ECB, as part of its supervision mandate, is to carry out stress test in coordination with EBA.<sup>1382</sup> The run of stress tests is also among the EBA’s tools aimed at addressing and identifying systemic risk.<sup>1383</sup> Furthermore, EBA is entitled to initiate and coordinate a Union-wide assessment of the

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<sup>1382</sup> SSMR (n 1101) Article 4(f).

<sup>1383</sup> EBA Regulation (n 984) Article 22(2)(subparagraph 2) and Article 23(1).

resilience of financial institutions, in cooperation with the ESRB.<sup>1384</sup> However, it is sensible to consider that this Union-wide test is distinct from the stress test that requires the incorporation of ECB, since the wording of provision on Union-wide test explicitly mention the cooperation between EBA and ESRB, while there is no mention on ECB.

Furthermore, the EBA in pursuing its main task of collecting information, is entitled to address the relevant request to the NCAs.<sup>1385</sup> In case the response from the NCA is not received in a timely fashion, EBA may address the request directly to the financial institution, its holding companies or branches, and the non-regulated operational entities within a financial group or conglomerate that are considered of being significant.<sup>1386</sup> In addition, if the response to the request does not: “*provide clear, accurate and complete information promptly*”, there is the option for EBA to refer to the ECB and NCAs for assistance.<sup>1387</sup> These amendments have clearly stretched out EBA’s data collection power, since EBA could request information directly not only from the NCA and financial institutions, but also, from holding companies, branches and non-regulated entities. Moreover, EBA’s responsibilities have been extended in the area of its participation within colleges of supervisors, including the right to promote joint supervisory plans and joint examinations, while its staff may participate in the activities of the colleges of supervisors, including on-site examinations.<sup>1388</sup> Lastly, another involvement of EBA within the SSM structure, is on the process of establishing the close cooperation, since the concerned non-Eurozone Member State, in order for its request for close cooperation to be considered, should not only notify the other Member States and ECB, but EBA as well.<sup>1389</sup>

On the critical side, some observers have stressed that the coexistence of ECB and EBA within this complex system that blends together cooperation and independence in the name of effective supervision, might create: firstly, a possible overlapping of their respective responsibilities; secondly, a conflict between the respective mandates of ECB and EBA, and thirdly, duplicating in reporting. For instance, in October 2014, the EBA conducted a Union-

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<sup>1384</sup> EBA Amended Regulation (n 13564) Article 22(1a) and Article 32(3a).

<sup>1385</sup> EBA Regulation (n 984) Article 35(1-5).

<sup>1386</sup> EBA Amended Regulation (n 1364) Article 35(6).

<sup>1387</sup> EBA Amended Regulation (n 1364) Article 35(7a).

<sup>1388</sup> EBA Amended Regulation (n 1364) 21(1).

<sup>1389</sup> SSMR (n 1101) Article 7(2)(a).

wide stress test,<sup>1390</sup> which was based on 123 banking groups, whereas, in November 2014, the ECB published a list of 130 banks that underwent a comprehensive assessment.<sup>1391</sup> Thus, the overlap between the groups of banks monitored by the cross-border supervisors was difficult to be avoided, since the three-quarters of banking groups that underwent the stress test by EBA fell under ECB's supervisory umbrella shortly after. However, while both EBA's Union-wide test and ECB's comprehensive assessment, used the same methodology and data, and thus, resulted in a coordinated outcome, which was well-received by the markets.<sup>1392</sup> To this end, and in order to avoid possible overlapping, duplicating or even, conflicting in future reports, further emphasis should be paid in strengthening the cooperation between the ECB and EBA, by clearly defining their role both for when cooperating and when they act independently.

#### 4.9.2 The role of college of supervisors

The role of colleges of supervisors, as already analysed in the previous chapter, aims at facilitating the cooperation between home and host supervisors. With the creation of SSM, the home-host state supervision has fundamentally changed. For the Eurozone Member states that fall within the SSM remit, home and host state authority has vanished. Namely, the role of college of supervisors in coordinating of Eurozone cross-border banking groups, has been entrusted to the JSTs, which are coordinated by the ECB. It is important to note here that the role of college of supervisors is substantially different than the role of JSTs, since the former are focused on coordination, whilst the latter constitute operational structures of the SSM.

The SSM Regulation and the shift of supervisory powers of significant financial institutions in Eurozone Member States from NCAs to the ECB, have fundamentally changed the role and responsibilities of college of supervisors, including the participation of NCAs, ECB and EBA within them. In addition, the implementation of CRD IV package has also brought

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<sup>1390</sup> See for further details on the stress test: EBA's website <<http://www.eba.europa.eu/-/eba-publishes-2014-eu-wide-stress-test-results>> accessed 14 July 2017.

<sup>1391</sup> 'Results of the 2014 comprehensive assessment' (ECB, Banking Supervision website, 2014) <<https://www.bankingsupervision.europa.eu/banking/comprehensive/2014/html/index.en.html>>

<sup>1392</sup> Lannoo, Karel, 'ECB Banking Supervision and Beyond' (CEPS Task Force Reports, December 11, 2014) 15 and 37 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2561205](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2561205)> accessed 14 July 2017.

changed in the operation of college of supervisors. This revised version of CRD, involves apart from the adoption of a Directive,<sup>1393</sup> as the traditional legal means to set common rules in financial services, also the adoption of a Regulation,<sup>1394</sup> introducing a new ‘maximum harmonisation’ approach with the aim to enhance harmonisation and contribute towards the completion of a Single Rulebook.<sup>1395</sup> It should be noted that the new Regulation and one Directive, which would form the legal framework governing the access to the activity, the supervisory framework and the prudential rules for credit institutions and investment and thus, should be read in conjunction.

College of supervisors retained their important role in supervision after the establishment of SSM, while EBA full participation rights.<sup>1396</sup> Moreover, EBA’s role, after the SSM establishment, within colleges of supervisors has been increased in order to ensure the coherent, effective and consistent functioning of the colleges, with the view to promote supervisory convergence and consistent application among them.<sup>1397</sup> The CRD IV package came also to enhance EBA’s role within college of supervisor, which is entrusted with the task to develop draft regulatory technical standards laying down specifics of the functioning of colleges of supervisors, and draft implementing technical standards determining their operation functioning.<sup>1398</sup> In December 2014 EBA has published its draft Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS), which lay down the conditions for the establishment and operational functioning of colleges of supervisors and outline the cooperation between the consolidating supervisor and the relevant NCA, which are to participate within college of supervisors under the status of ‘members’ or ‘observers’.<sup>1399</sup>

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<sup>1393</sup> CRD IV (n 1197).

<sup>1394</sup> CRR (n 1158).

<sup>1395</sup> CRR (n 1158) premb 9.

<sup>1396</sup> EBA Regulation (n 984) Recital (36)

<sup>1397</sup> EBA Regulation (n 984) Articles 8(1)(b),(i) and 21.

<sup>1398</sup> CRD IV (n 1197) Article 51(4),(5),116

<sup>1399</sup> ‘FINAL draft regulatory and implementing technical standards on colleges of supervisors in accordance Articles 51 and 116 of Directive 2013/36/EU (Capital Requirements Directive)’ (EBA, 19 December 2014) <<http://www.eba.europa.eu/documents/10180/935300/EBA-RTS-2014-16+and+EBA-ITS-2014-07+%28Final+draft+RTS+and+ITS+on+Colleges+of+Supervisors%29.pdf/9543ad13-e7b5-4acb-b0c4-b7ad1f23e658>> accessed 14 July 2017.

The RTS and ITS, were then officially implemented by the Commission in December 2016.

- ‘Commission Implementing Regulation (EU) 2016/99 of 16 October 2015 laying down implementing technical standards with regard to determining the operational functioning of the colleges of supervisors according to Directive 2013/36/EU of the European Parliament and of the Council’ [2016] OJ L 21/21.



Namely, subject to the invitation of the consolidating supervisor, members of colleges can become: a) the competent authorities responsible for the supervision of institutions which are subsidiaries of an EU parent institution or of an EU parent financial holding company or of an EU parent mixed financial holding company and the competent authorities of host Member States where significant branches as referred to in Article 51 of CRD IV are established; b) the ESCB central banks of Member States that are involved in accordance with their national law in the prudential supervision of the legal entities referred to in point a, but which are not competent authorities; c) the EBA.<sup>1400</sup> Also, the consolidating supervisor could invite to participate with the status of ‘observers’: a) the supervisory authorities of third countries where institutions are authorised or branches are established; b) authorities of third countries where institutions are authorised or branches are established to participate; c) the ESCB central banks which are not empowered by national law to supervise an institution authorised or a branch established in a Member State; d) the public authorities or bodies in a Member State, which are responsible for or involved in the supervision of a group entity, including authorities responsible for the prudential supervision of the group's financial sector entities or competent authorities responsible for the supervision of markets in financial instruments, the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, or consumer protection.<sup>1401</sup>

With the creation of SSM, ECB's has been granted a number of duties within colleges of supervisors. Namely, the SSMR provides the ECB with full participation rights within the colleges of supervisors.<sup>1402</sup> Also, the ECB may act as the chair of colleges of supervisors, when qualifies as the consolidating supervisor,<sup>1403</sup> and along with NCAs may participate in the college of supervisors in case the consolidating supervisor is not in a participating Member

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- ‘Commission Delegated Regulation (EU) 2016/98 of 16 October 2015 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards for specifying the general conditions for the functioning of colleges of supervisors’ [2016] OJ L 21/2.

<sup>1400</sup> Commission Delegated Regulation (n 365) Article 3 (1). See also: ‘Report on the Functioning of Supervisory Colleges in 2015’ (EBA Colleges Action Plan, 1 March 2016) 14  
<<http://www.eba.europa.eu/documents/10180/1390624/Report+on+the+functioning+of+supervisory+college+s+in+2015.pdf/eafde612-f85d-4ec4-baaf-14db0b03fccd>> accessed 14 July 2017.

<sup>1401</sup> Commission Delegated Regulation (n 365) Article 3 (2), (3), (4). See also: EBA Colleges Action Plan (n 1405) 14. See also: CRD IV (n 1197) Article 116 (6). See also: SSMFR (n 1131) Article 9(1) and 10.

<sup>1402</sup> SSMR (n 1101) Recital (42), Article 4(g)

<sup>1403</sup> SSMFR (n 1131) Article 9. For the meaning of consolidating supervisors see: CRR (n 1158) Recital (41) and CRD IV (n 1197) Article 111.



State, subject to the requirements of Article 10(a-c), SSMFR. In addition, as outlined in the 2014 ECB Guide to Banking Supervision, in relation to the significant financial entities, the ECB would act as home supervisor for colleges that include supervisors from non-participating Member States (European colleges) or from countries outside the EU (international colleges); and the host supervisor for colleges in which the home supervisor is from a non-participating Member State (or a country outside the EU).<sup>1404</sup>

#### 4.9.3 The ECB and the ESRB

As analysed in chapter three, since the creation of the ESRB, the particular position that the ECB should occupy within the ESRB has been subject to discussion. Although one would expect that the SSMR will address the issue, the latter, however, is not explicit in regard to the role of the ESRB within the new supervisory framework. The only reference made to the ESRB, is in Recital (31) and Article 3(1) (subparagraph 1), SSMR, both highlighting that the ECB would have to perform its supervisory tasks in close cooperation with the ESRB. Also, there is another mention made in Article 25(2), where it is stated that the ECB is to perform the conferred supervisory tasks without interfering to the ESRB's tasks. As was discussed in chapter three, the ESRB is a part of the ESFS, and is entrusted with the responsibility of macro-prudential supervision of the EU financial system, and the prevention and mitigation of systemic risk.<sup>1405</sup> Also, the ESRB in pursuing its tasks can provide warnings and issue recommendations.<sup>1406</sup> The establishment of SSM did not bring any substantial amendments to the operation of ESRB and its macro-prudential mandate. However, the conferral of macro-prudential responsibilities on the ECB, may prove challenging to the existing powers of the ESRB, the cooperation with latter with the ECB and the division of responsibilities between the ECB and ESRB. All these combined raise questions as to the balance of powers between the ECB and ESRB. Here also becomes relevant the discussion developed in the previous chapter regarding the respective roles of ECB and ESRB in macro-prudential supervision.

Post SSM establishment, apart from its already leading role in the ESRB operation, the ECB is provided with the right to request an increase of the requirements for capital buffers

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<sup>1404</sup> ECB (n 1161) 12.

<sup>1405</sup> ESRB Regulation (n 925) Article 3(1).

<sup>1406</sup> ESRB Regulation (n 925) Article 16.

and the right to object decisions of the NCAs as regard macro-prudential matters, regardless of whether they are based on the ESRB's specific recommendations to the NCAs.<sup>1407</sup> Thus, within this structure, although the NCAs retained their prominent role in macro-prudential supervision, the ECB is also granted key responsibilities that may overlap or even create conflicting issues with the existing role of the ESRB. This issue is not clearly addressed by the SSMR and it leaves space for broad interpretations, including the possibility of centralisation of macro-prudential powers at EU level. The latter is positively seen by the supporters of the view that the macro-prudential supervision should be explicitly carried out by the ECB in the name of stability.<sup>1408</sup> A counterargument as to the overlapping issue could be based on the wording of Article 25(2), SSMR according to which any interference of ECB's supervisory tasks in the respective ESRB tasks is prohibited. Also, according to Recital (24), SSMR, highlights that: *"the provisions in this Regulation on measures aimed at addressing systemic or macro-prudential risk are without prejudice to any coordination procedures provided for in other acts of Union law."*

To this end, Vitor Constancio, the Vice President of the ECB, in an attempt to highlight the compatibility between the respective roles of ECB and ESRB in macro-prudential supervision, emphasised that the macro-prudential functions of both institutions (ECB and ESRB) are expected to be complementary, and: *"while the SSM will exclusively focus on banking systems, the ESRB has an additional macro-prudential function regarding the nonbank parts of the financial sector, and as such will be well placed to address cross-sectoral issues."*<sup>1409</sup> In addition, as analysed in chapter three, the involvement of the ECB in macro-prudential tasks through its participation in the ESRB is particularly problematic, given the lack of an adequate legal basis. As already highlighted, the ECB is excluded from undertaking macro-prudential tasks which do not qualify as specific without Treaty amendment. Macro-prudential supervision in the EU is still in a relatively early stage of operationalisation, but it is certainly interesting to observe how this complex structure of shared macro-prudential

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<sup>1407</sup> SSMR (n 1101) Article 5.

<sup>1408</sup> Lo Schiavo, Gianni, '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 Comparative Law 110, 133.

<sup>1409</sup> Constâncio, Vítor, 'Implications of the SSM on the ESFS' (Speech by the Vice-President of the ECB, Public Hearing on Financial Supervision in the EU, Brussels, 24 May 2013) <<https://www.ecb.europa.eu/press/key/date/2013/html/sp130524.en.html>> accessed 14 July 2017.

supervision tasks and responsibilities between the ECB, ESRB and NCAs, will manage in the long run to maintain a balance between the task and responsibility of each actor by eliminating any overlapping or conflict of interest issues.

#### 4.10 A strict separation between monetary policy and supervisory tasks

As has been thoroughly analysed, prior to the establishment of SSM, the ECB from the outset of its establishment was designed to operate as a 'pure' monetary policy authority with primary objective to maintain Eurozone's price stability. With the advent of the new supervisory framework, the ECB's role has shifted towards a completely different objective: in micro-level the safety and soundness of individual credit institutions, and in macro-level the stability of the financial system as a whole. However, the combination of these two goals (i.e. monetary policy and banking supervision), which were traditionally seen as non-complementary, received a vast amount of attention, with a plethora of arguments stressing issues that may arise as a result, such as conflicting objectives, incentives, accountability and independence. At EU level, the willingness to maintain a strict 'Chinese Wall' between the ECB's monetary policy and supervision mandate has been highly reflected to the SSMR, in which it is explicitly highlighted that monetary policy and supervisory tasks should "*be carried out in full separation, in order to avoid conflicts of interests and to ensure that each function is exercised in accordance with the applicable objectives.*"<sup>1410</sup> This is often referred to as the principle of separation, which is enshrined in 25(2), SSMR, as following "*the ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. The tasks conferred on the ECB by this Regulation shall neither interfere with, nor be determined by, its tasks relating to monetary policy.*"<sup>1411</sup> Furthermore, as outlined in Article 25(1), SSMR, the ECB when acting as supervisor should perform only the task explicitly conferred on it by the SSMR and: "*shall take all necessary measures to ensure separation between the monetary policy and the supervisory functions.*"<sup>1412</sup> The principle of separation is further regulated by the ECB's Decision of 17

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<sup>1410</sup> SSMR (n 1101) Recital (65).

<sup>1411</sup> See also: ECB Rules of Procedure (n 1214) 13k(1) and 'Decision of the European Central Bank of 17 September 2014 on the implementation of separation between the monetary policy and supervision functions of the European Central Bank (ECB/2014/39)' [2014] OJ L 300/57, Article 1(2) (hereinafter: ECB 2014 Decision).

<sup>1412</sup> ECB Rules of Procedure (n 1214) Article 13k (2).

September 2014,<sup>1413</sup> which sets out the specific arrangements of the separation between monetary policy and supervision.<sup>1414</sup>

There are a number of measures introduced with the SSMR that have reshaped the operational and structural mechanisms within the ECB, aimed at adequately addressing the principle of separation. To this end, as analysed already, under the new supervisory framework the Governing Council holds a strong decisive role, which is in line with its status as the main monetary policy decision-making body of the ECB. Thus, the first aspect to be addressed is the separation between the monetary policy and supervisory operations of the Governing Council, with the latter having to: *“operate in a completely differentiated manner in regard to monetary and supervisory functions. Such differentiation should at least include strictly separated meetings and agendas.”*<sup>1415</sup> For this purpose, a new body was established, the SSB, which, as we discussed, constitutes a separate from the Governing Council body and is designed to prepare the draft decisions of the Governing Council in regard to supervisory matters, but with separate meetings agenda and its own members. Thus, the whole composition of the SSB is designed to safeguard the separation principle. Namely, its member and other participant in SSB meeting are granted: an independent status; cooling-off periods; professional secrecy; should act within the limit of the supervisory task conferred on the ECB by the SSMR, and without interfering with the other tasks of the ECB; and have the obligation: *“to respect the separation of the ECB’s specific tasks concerning policies relating to prudential supervision from its tasks relating to monetary policy, as well as other tasks, and shall comply with internal ECB rules on the separation of prudential supervision from monetary policy to be adopted pursuant to Article 25(3), SSMR.”*<sup>1416</sup>

The professional secrecy of SSB’s members, is further specified by the ECB 2014 Decision. The latter requires non-disclosure of any *“information covered by the obligation of professional secrecy,”* from any person involved in supervisory activities, including: *“members of the Supervisory Board, of the Steering Committee and of any substructures established by*

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<sup>1413</sup> ECB 2014 Decision (n 1421).

<sup>1414</sup> ‘Decision of the ECB of 17 September 2014 on the implementation of separation between the monetary policy and supervision functions of the European Central Bank (ECB/2014/39)’ <[https://www.ecb.europa.eu/ecb/legal/pdf/en\\_ecb\\_2014\\_39\\_f\\_sign.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/en_ecb_2014_39_f_sign.pdf)> accessed 14 July 2017.

<sup>1415</sup> SSMR (n 1101) Recital (65) and Article 25(3), and ECB 2014 Decision (n 1421) Article 1(3).

<sup>1416</sup> SSB Code of Conduct (n 1260) Article 3.

the Supervisory Board, staff of the ECB and staff seconded by participating Member States.”<sup>1417</sup> The professional secrecy obligation applies during or after the termination of their office term and applies to: “persons having access to data covered by Union legislation imposing an obligation of secrecy.”<sup>1418</sup> The professional secrecy obligation does not apply in case of a civil or commercial proceeding that involves a credit institution that: “has been declared bankrupt or is being compulsorily wound up”, without implicating third parties; and in case the applicable EU Law requires information exchange with EU or national authorities.<sup>1419</sup>

Another rule that serves the principle of separation, is the inclusion of strict restrictions applied in relation to the information exchanged between the monetary policy and supervision member of staff, which should be done: “within the limits and under the conditions set out in the relevant Union legislation, including with the Commission for the purposes of its tasks under Articles 107 and 108 TFEU and under Union law on enhanced economic and budgetary surveillance;”<sup>1420</sup> and shall not exceed the limits of: “the information necessary for the achievement of ECB and ESCB tasks.”<sup>1421</sup> This is reinforced by Article 5(1), ECB 2014 Decision, which provides for information exchange only when this is required by EU Law. Furthermore, the ECB 2014 Decision regulates thoroughly all forms of information exchange between the two functions, setting strict rules. Namely, Article 5(2), ECB 2014 Decision, requires the exchange of confidential information – excluding raw data – to be subject to “governance and procedural rules” and “to a need to know requirement, which shall be demonstrated by the requesting ECB policy function”.

The ‘need to know’ requirement, enables the circulation of information when “necessary for the fulfilments of statutory or tasks of the ECB.”<sup>1422</sup> The latter specifies even further the wording of the SSMR’s provisions and ECB Rules of Procedure that allow for disclosure of information between the two functions only when this is required by EU Law. The meaning of the term: ‘need to know’ is defined by Article 2(2), ECB 2014 Decision as following: “the need to have access to confidential information necessary for the fulfilment of

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<sup>1417</sup> ECB 2014 Decision (n 1421) Article 4(1) and (2).

<sup>1418</sup> ECB 2014 Decision (n 1421) Article 4 (7).

<sup>1419</sup> ECB 2014 Decision (n 1421) Article 4(5) and (6).

<sup>1420</sup> SSMR (n 1101) Recital (74).

<sup>1421</sup> ECB Rules of Procedure (n 1214) Article 13k(3).

<sup>1422</sup> ECB 2014 Decision (n 1421) Article 2(2).

*a statutory function or task of the ECB, which in case of information labelled as 'ECB-CONFIDENTIAL shall be broad enough to enable staff to access information relevant to their tasks and take over tasks from colleagues with minimal delays.'* Thus, only upon request on a 'need to know' basis, except when required otherwise by EU law, the monetary policy and supervisory function of ECB are allowed to exchange confidential information between each other. Monetary policy, in the form of non-anonymised and supervision in the form of anonymised, common reporting and financial reporting.<sup>1423</sup>

Also, upon request on a 'need to know basis,' when each function operates within the limits of its own objectives and when the Executive Board provides authorisation, the ECB's monetary policy function may exchange information, involving assessments or policy recommendations, with the ECB's supervisory function.<sup>1424</sup> The monetary policy division of the ECB is also, entitled to exchange information with the supervisory function, again upon request on 'a need to know basis,' when each function acts within the limit of its objectives, and there is no information included that involves individual banks or policy-sensitive information related to the preparation of decisions.<sup>1425</sup> Each function holds the right to analyse autonomously and decide upon the confidential information received, in accordance to their respective objectives.<sup>1426</sup> In any case, the decision for access to the requested information should be taken by the respective function of the ECB (i.e. either monetary policy or supervision) that owns the relevant information. In case there is a conflict of interest between the two functions, the body to decide about the access to confidential information is the Executive Board, yet always in accordance with the principle of separation.<sup>1427</sup> Article 5(3), ECB 2014 Decision takes it a step further by requiring consistency and an obligation to record the decisions of the Executive Board concerning the access to information. Lastly, in case of the emergency situation of Article 114 of CRD IV, both functions should exchange information as long as they act within the limits of this emergency.<sup>1428</sup>

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<sup>1423</sup> ECB 2014 Decision (n 1421) Article 6(1).

<sup>1424</sup> ECB 2014 Decision (n 1421) Article 6(2) (subparagraph 1).

<sup>1425</sup> ECB 2014 Decision (n 1421) Article 6(2) (subparagraph 2).

<sup>1426</sup> ECB 2014 Decision (n 1421) Article 6(3).

<sup>1427</sup> ECB 2014 Decision (n 1421) Article 5(3).

<sup>1428</sup> ECB 2014 Decision (n 1421) Article 8.

Among the tools intended to support the separation principle is also the operational structure of the Mediation Panel, which is composed by members that would act for the interest of the EU as a whole, aiming to create a balance between the two ECB's function and striving to resolve any differences in a balanced way.<sup>1429</sup> In addition, the Mediation Panel allows the NCAs to resolve differences of their views between the Supervisory Board and the Governing Council, arising from both monetary and supervisory responsibilities of the ECB. The same purpose serves the Administrative Board, which is entrusted with the responsibility to run internal reviews upon decisions of the ECB, concerning its conferred supervisory tasks. Moreover, according to Article 32(1)(I), SSMR, the responsibility of the EU Commission to publish reports on the application of SSMR, should include *inter alia* the: effectiveness of the separation between supervisory and monetary policy functions within the ECB and of the separation of financial resources devoted to supervisory tasks from the budget of the ECB.

The ECB Rules of Procedure have been amended accordingly to facilitate *inter alia* the principle of separation, which is reflected especially on the decision-making procedure and on the operational arrangements for each body separately and in relation to each other. Namely, the Governing Council, as was mentioned already, is entitled to get involved in the drafting of supervisory decisions, yet it holds the final saying, since it is the ECB's main decision body according to primary EU law. This raises questions as to the objectivity of its member, since the same people that would carry out monetary policy tasks, would be called to decide on supervisory matters. This is regulated to a certain degree by the added provisions in the amended Rules of Procedure of the ECB, which requires the Governing Council to arrange separate meetings for monetary policy and supervisory matters respectively.<sup>1430</sup> However, the issue of impartiality as to the participation of the same members in both functions' decision-making process, remains still blurry.

The supervisory function of the ECB does not involve only the Governing Council, but it also applies to the Executive Board, which is a logical consequence of its participation in the SSB. As discussed already, one of the Executive Board members would be appointed as the Vice-Chair of SSB. The selection procedure of the SSB's Vice Chair was initially criticised, as to

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<sup>1429</sup> SSMR (n 1101) Recital (73) and Article 25(5).

<sup>1430</sup> ECB 2014 Decision (n 1421) Article 13I(1).



the possible implications that this might pose to the independent status of the ECB.<sup>1431</sup> For this reason the amended ECB Rules of Procedure have addressed this issue, by outlining that the *“the competence of the Executive Board in respect of the ECB’s internal structure and the staff of the ECB shall encompass the supervisory tasks,”* but this internal structure should be subject to consultation with the Chair and Vice Chair of the SSB.<sup>1432</sup> Furthermore, the SSB in agreement with the Executive Board, may establish and dissolve: *“substructures of a temporary nature, such as working groups or task forces,”*<sup>1433</sup> with the Executive Board placed as their managing director.<sup>1434</sup>

Furthermore, the SSMR requires organisation separation of staff, and separate reporting lines from the staff that operate other ECB’s tasks.<sup>1435</sup> In regard to the staff operating in the supervision section, the Executive Board will act as their reporting body in respect with organisation, human resources and administrative issues, subject to functional reporting to the SSB’s Chair and Vice Chair.<sup>1436</sup> Also, according to Recital (66), SSMR, the organisational separation of staff: *“should concern all services needed for independent monetary policy purposes and should ensure that the exercise of the tasks conferred by this Regulation is fully subject to democratic accountability and oversight as provided for by this Regulation.”* However, in order to avoid an overlapping in services, there will be areas of shared responsibilities, aiming to support both monetary policy and supervision tasks, excluding the information exchange restrictions.<sup>1437</sup> In addition, Article 3, ECB 2014 Decision, provides for the organisational separation between the two functions of the ECB, by requiring that there should be two separate and independent from each other decision-making procedures for monetary policy and supervisory tasks of the ECB respectively, with the staff of the former being organisationally separated from the staff of the latter.

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<sup>1431</sup> Mersch, Yves, ‘The Banking Union - a European perspective: reasons, benefits and challenges of the Banking Union’ (Speech by a Member of the Executive Board of the ECB, at the seminar “Auf dem Weg zu mehr Stabilität – Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis“ organised by Europolis and Wirtschaftswoche, Berlin, 5 April 2013) <<https://www.ecb.europa.eu/press/key/date/2013/html/sp130405.en.html>> accessed 14 July 2017.

<sup>1432</sup> ECB Rules of Procedure (n 1214) Article 13m(1) and ECB 2014 Decision (n 1421) Article 3(2).

<sup>1433</sup> ECB Rules of Procedure (n 1214) Article 13m(2).

<sup>1434</sup> ECB 2014 Decision (n 1421) Article 3(2).

<sup>1435</sup> SSMR (n 1101) Article 25(2) (subparagraph 2).

<sup>1436</sup> ECB 2014 Decision (n 1421) Article 3(3).

<sup>1437</sup> ECB 2014 Decision (n 1421) Article 3(4).



However, the SSMR, ECB Rules of Procedure, and ECB 2014 Decision, although stress the importance of the separation principle, equally emphasise the need to retain a high level of cooperation between monetary policy and supervisory tasks of the ECB. This was expressed already by the SSMR and the amended ECB Rules of Procedure within the context of information exchange arrangements, but it is further clarified and explicitly defined by the ECB 2014 Decision as following: *“effective separation between the monetary policy and supervisory functions should not prevent the reaping, wherever possible and desirable, of all the benefits to be expected as a result of combining these two policy functions in the same institution, including drawing on the ECB’s extensive expertise in macroeconomic and financial stability issues and reducing double work when gathering information. It is therefore necessary to put in place mechanisms that allow an adequate flow of data and other confidential information between the two policy functions.”*<sup>1438</sup>

From the analysis above, it is clear that much emphasis has been paid to separating the monetary and supervisory tasks of the ECB, which goes in line with EU law in regard to the decision-making procedure and the balance of powers within and outside the ECB structure. However, this has resulted in the creation of a complex system, which marries coordination and separation within two layers of decision-making and reposting, two groups of different staff, and two distinct meeting agendas. The only limit, in regard to the strict separation between the supervisory and monetary policy powers of the ECB, is the obligation for information exchange.<sup>1439</sup> The SSMR, the Amended Rules of Procedure and the ECB 2014 Decision, were formulated or amended accordingly in order to facilitate such a separation, without changing the balance of powers and in accordance to existing Treaty provisions. This is reflected on the: organisational arrangements; decision-making process; relationships between the various bodies; and the creation of additional bodies.

However, it is questionable whether these arrangements have created a truly separated dual mandate. Namely, the new supervisory framework, whereas includes a number of provisions that enable the facilitation of the separation, still retains the decision-making power of the Governing Council. Practically, the Governing Council will have the final

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<sup>1438</sup> ECB 2014 Decision (n 1421) Recital (14).

<sup>1439</sup> ECB Rules of Procedure (n 1214) Article 13k(3).

word for any decision of the SSB. The latter, although intended to decide on supervisory matters, its role remains highly preparatory and consultative. This clearly arises by the wording of Article 13h(3), ECB Rules of Procedure, according to which the Governing Council is not only empowered with the right to “*endorse, object to or amend*” proposals of the SSB concerning both micro-and macro-prudential tasks and with the right to request the SSB to submit a proposal concerning both micro-or macro-prudential matters; but the Governing Council is also entitled to adopt decisions on its own when the SSB submits non-proposal on the requested issue.<sup>1440</sup> This depicts the limited role of the SSB and the willingness to retain the prominence of Governing Council.

A true ‘Chinese Wall’ between monetary policy and banking supervision, requires a balance between the two functions and equal prominence of the main bodies of each. In our case, equal prominence of the Governing Council and the SSB, is not achievable, since by EU law the Governing Council constitutes the main decision body of the ECB, thus, every change on this respect would have required a Treaty amendment. However, the possibility of a Treaty amendment could be possible and finds legitimate ground in the wording of Recital (85), SSMR, which emphasises that there are ‘some legal constrains’ in the SSM design, which could be overcome only by Treaty amendment. This also reaffirms the concerns expressed in the thesis in relation to ECB’s dual mandate and the tension created between new and existing bodies, including the cooperation of their respective tasks, the balance of powers and the division of responsibilities.

Furthermore, Recital (85), SSMR, when referring to possible amendments, points to Article 127(6), TFEU, which constitutes the legal basis of the ECB operation, and as we discussed already, limits the supervisory powers of the ECB on carrying out only specific task. This in turn, unavoidably empowers the NCAs with the supervision of areas that the ECB does not or is not permitted to reach. As a result, the created system of banking supervision is far from achieving the intended outcome, i.e. a truly centralised system of banking supervision for Europe, but it has rather created a complex system of shared responsibilities and cooperation between national and supranational level. Lastly, Recital (85), explicitly defines where these ‘legal constrains’ occur within the SSM structure, by making reference firstly, to

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<sup>1440</sup> ECB Rules of Procedure (n 1214) Article 13h(3).

the model of 'close cooperation' and the possibility of its enhancement, if certain amendments take place, which is equally important and has been analysed already; and secondly, to the internal separation of decision-making on monetary policy and supervision. Therefore, this indicates that the SSMR acknowledges that there are still legal constraints in regard to the separation of monetary policy and supervision, which could only be fixed by amending the Treaty. It might therefore take another major financial crisis, to bring us back to the realisation that the combination of national and supranational elements within a highly integrated financial system of a common currency and common regulatory framework is not sufficient in maintaining the soundness of the financial system as a whole.

#### 4.11 Is ECB's independence adequately safeguarded under the new supervisory framework?

As analysed in chapter one, a price stability-oriented independent central bank was considered to be the ultimate central banking orthodoxy of the late 1980s and early 1990s, which was based on influential economic theories and empirical evidence. This trend, became widely accepted and embedded at both national and international level.<sup>1441</sup> At EU level, this model was highly reflected to the drafting of the Maastricht Treaty and the establishment of the ECB. Hence, the ECB since its creation, was granted a high level of independence in pursuing its monetary policy objective, which shielded it from specific national agendas, constraints and pressures. At the same time, in order to balance the independence of ECB, the latter is also held accountable to the EU Parliament. The independence of ECB is widely appraised as one of the reasons that the ECB has been viewed as a strong, reputational and credible institution in maintaining price stability and the value of the common currency. Thus, it is hardly surprising that the SSMR strive to safeguard ECB's independence and accountability in respect to its supervisory tasks. To this end, although the main aim of the separation principle is to avoid conflicts of interest between monetary policy and banking supervision, it also intended to safeguard the independence and accountability of the ECB from both angles, i.e. for monetary and supervisory purposes.

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<sup>1441</sup> See for instance: BCBS, 'Core Principles for Effective Banking Supervision' Principle 2.

However, the operational structure of the ECB, along with its independence and accountability, as originally laid down in Treaty, were unambiguously designed and formulated to serve a central bank, intended to be focused on the sole mandate of price stability. With the advent of the first pillar of Banking Union, i.e. the SSM, the ECB is no longer only a price stability-oriented monetary authority, but has become the major supranational supervisory authority for the Eurozone. The banking supervision tasks of the ECB cover mainly micro-prudential supervision and some limited macro-prudential tasks in the pursuit of financial stability. Thus, one might raise the question of whether the same provisions regarding the ECB's monetary policy mandate, including the independent status of its operation, apply equally to the ECB's newly assigned supervisory tasks. To this end, Recital (75), SSMR, provides that: *"in order to carry out its supervisory tasks effectively, the ECB should exercise the supervisory tasks conferred on it in full independence, in particular free from undue political influence and from industry interference which would affect its operational independence."* Furthermore, as already analysed, the members of the Supervisory Board and the Steering Committee are required to act independently and objectively in the interest of the Union as a whole, while they are prohibited to seek or take any instructions from the institutions or bodies of the EU, or any government of a Member State or from any other public or private body, and the latter are obliged to respect their independence.<sup>1442</sup> In addition, the Members of the Supervisory Board and Steering Committee are granted by both the SSMR and the SB Code of Conduct a high level of independence, aiming to protect them from any political interference. Likewise, the same level of independence applies to the Administrative Board of Review.

Practically, the functioning of monetary policy and supervision are fundamentally different. Namely, monetary policy involves a measurable objective, i.e. achieving price stability by keeping inflation rates at a clearly defined range and maintaining low unemployment rates. On the contrary, banking supervision involves a wide range of tasks and objectives, including financial stability, consumer protection, financial crime etc., and often utilises more regulatory tools in pursuing them, and it also requires a combination of financial, accounting and legal expertise. The main challenge of banking supervision is that the prerequisites of achieving these objectives are practically difficult to address and the

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<sup>1442</sup> SSMR (n 1101) Article 19(1),(2).

assessment of whether have been accomplished might prove illusionary. Thus, it could be argued that due to the differences with monetary policy in terms of tasks and objectives, banking supervisory independence cannot be the same as monetary policy independence. Therefore, it is questionable whether the Treaty provisions that are designed to protect the independence of ECB's monetary policy mandate could be adequate in safeguarding the independence of its supervision mandate.

The same applies to the accountability of both functions, provided that for monetary policy decisions the only institution accountable is the ECB, whereas for supervisory operations the NCAs play also a key role.<sup>1443</sup> Thus, remains unclear to whom the NCAs are accountable too, both when acting alone or in conjunction with the ECB. It follows that it is highly controversial whether political interference is kept away from the functioning of the ECB when acting under its dual mandate and how this is to be evaluated. In addition, as discussed in earlier in this chapter, the ECB may, by way of instructions and to the extent necessary to carry out its supervisory tasks, require the NCAs to exercise their supervisory powers in case the SSM Regulation does not confer such powers on the ECB. In case the NCAs act in accordance to ECB's instruction to whom they are accountable to for their actions? These are important aspects of the ECB's accountability that might raise even more serious concerns in terms of the legitimacy of ECB's supervisory powers. The discussion developed in chapter one regarding the issue of accountability of non-majoritarian institutions is also relevant here.

The next question to answer is whether the widening of the ECB's mandate poses a challenge to its overall independence. In the monetary policy domain, the ECB has traditionally enjoyed a far-reaching independence. In an attempt to address the question of whether the same applies to its newly conferred supervisory tasks, it is important to understand the legitimacy of ECB's independence. With regard to monetary policy, as discussed earlier the ECB's independent status derives its legitimacy from EU primary law, i.e. from the EU Treaties and the ESCB Statute. To this end, the wording of the EU Treaties provisions has equipped the ECB with a high level of discretion when carrying out its monetary

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<sup>1443</sup> See: Lastra, Rosa M., *International Financial and Monetary Law* (2<sup>nd</sup> edn, Oxford University Press 2015) Chapters 2 and 3.

policy tasks, meaning that the ECB is not directly accountable for its day-to-day decision to the EU Parliament, the EU Council, or to any other national or EU body and its decisions are not subject to approval. Also, apart from the ECJ, none of the EU institutions or national bodies have the power to discharge any of the members of ECB decision-making bodies.<sup>1444</sup> Thus, the ECB retains its legitimacy to make policy decisions, provided only that it operates within the limits of its mandate as provided by EU law. When it comes to its supervisory powers on the other hand, while the legitimacy of the conferral of supervisory tasks is based on the Treaty, the legal instrument that specifies those tasks, i.e. the SSMR, constitutes secondary EU law. Thus, it could be argued that by default, as long as the ECB stays within the limits of its supervisory mandate, it is legitimate to make supervisory decisions.

However, experience has shown that for supervision the scenario is different, and a mixture of factors might lead to results, which are likely to pose serious risks to the ECB's independence. A good example is the role of ECB during the GFC, especially in relation to Greece, when the ECB was faced with the dilemma of whether to cut-off emergency funding to Greece provided through the Emergency Liquidity Assistance (ELA). To this end, the ECB's decision to limit emergency funding to Greece in 2015, raised questions in terms of its independence. Namely, this move was considered as an act of politicisation of the ECB and as an example of central bank dependence, since a decision of ECB to cut-off ELA could have amounted as de facto forcing Greece out of the euro, which in itself constitutes a highly political decision.<sup>1445</sup> This perhaps explains why at the end, the ECB decided to maintain emergency funding, albeit at carefully calibrated levels.<sup>1446</sup> As Mario Draghi, the President of ECB stated: *"The ECB is a rule-based institution. It's not a political institution."*<sup>1447</sup> This discussion is also related to the role of ECB as lender of last resort, which has not been adequately addressed by the SSM Regulation or from any relevant legislative act.

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<sup>1444</sup> ESCB Statute (n 243) Articles 11(4) and 14(2).

<sup>1445</sup> Wyplosz, Charles, 'Grexit: The staggering cost of central bank dependence' (Voxeu, 29 June 2015)

<<http://voxeu.org/article/grexit-staggering-cost-central-bank-dependence>> accessed 14 July 2017.

See also: Jones, Claire, 'ECB weighs pulling plug on Greek banks' (Financial Times, 18 February 2015)

<<https://www.ft.com/content/64f6e8d4-b6b8-11e4-95dc-00144feab7de?mhq5j=e3>> accessed 14 July 2017.

<sup>1446</sup> 'ELA to Greek banks maintained at its current level' (ECB Press Release, 28 June 2015)

<<https://www.ecb.europa.eu/press/pr/date/2015/html/pr150628.en.html>> accessed 14 July 2017.

<sup>1447</sup> 'Introductory statement to the press conference (with Q&A)' (Mario Draghi, 5 March 2015)

<<https://www.ecb.europa.eu/press/pressconf/2015/html/is150305.en.html>> accessed 14 July 2017.

From the analysis above, it could be argued that the centralisation of supervisory powers, although it does not appear to pose any immediate risk to ECB's independent status, could lead to problems in the future. The detailed provisions on the role, tasks and responsibilities of the members that form the ECB's decision-making bodies in respect with micro-prudential supervision, appear to be adequate in shielding their independent operation. However, as mentioned earlier, since the means to achieve the objectives of monetary stability and banking supervisor are fundamentally different, it is debatable whether the same Treaty provisions can be adequate for both. This becomes more prominent in times of crisis, as was depicted by the recent involvement of ECB in emergency liquidity decisions. More problematic seems to be the issue of accountability, especially with regards to the NCAs. Lastly, the independence of the ECB, seems to be more at risk when it comes to macro-prudential supervision in two ways. Firstly, as the experience of the GFC has shown, the ECB will eventually get involved in macro-prudential supervision, mainly due to its role as lender of last resort. Under the updated supervisory framework, it is not clear how the ECB would combine its micro-prudential duties with its lender of last resort duties, which is a significant gap on the current legal framework. This seems to be highly problematic, especially in times of crisis, and it seems to be as one of the missing elements of the Banking Union project and the ECB's involvement in banking supervision. Secondly, as discussed above, the macro-prudential supervisory duties of the ECB, through its cooperation with the ESRB, while have been defined as specific, are not clearly outlined and leave space for broad interpretations. It follows, that the tasks of the decision-making bodies of the ECB may be subject to broader interpretation, which in turn, may prove challenging as according to EU law can only be involved into specific banking supervision tasks.

#### 4.12 Conclusion

The ECB on November 2014, officially became the micro-prudential supervisor for the financial institutions in the Eurozone. Since 2014 a number of legislative initiatives have been introduced, aimed to strengthen the ECB's supervisory function and to define the responsibilities between the ECB and the existing bodies. This has resulted in a complex system resting an edifice of legislative measures, which complement each other in a peculiar manner. Since the inception of the idea to centralise EU banking supervision, the debate on

the synergies, legal constraints and its long-term sufficiency has been only increasing. Yet, the issues in question, including *inter alia*, the ECB's independence, the balance of powers between EU institutions, and the conflict of interest between monetary and supervisory powers, remain unresolved.

As we analysed, the clear distinction between ECB monetary policy and supervisory powers is not straightforward, the intended creation of a strong 'Chinese Wall' between the two functions is not always feasible under the current framework. This becomes more prominent when considering the macro-prudential domain of supervision, which blurs the lines between the two functions even further. This, as discussed earlier in this chapter, is particularly concerning when it comes to the ECB's independence. These elements combined have stretched the role and tasks of ECB beyond the wording of their legal basis i.e. Article 127(6), TFEU, which requires specific tasks in case the ECB gets involved in macro-prudential supervision. However, this expansion of the ECB's role and purpose is a natural consequence of the changes that financial markets have undergone since the drafting of Maastricht Treaty, when the ECB's legal basis was established. The whole structure and operational framework of the ESCB has been designed to serve the optimal models as were perceived in the early 1990. Since then, financial markets due to extensive cross-border activity have become truly international, more complex and interlinked, yet, regulation has been slow in reflecting this change.

The GFC experience, however, is the greatest example of the inadequacy of certain beliefs of that time, including the national-based model of financial supervision in a financial market of a common currency and increased cross-border activity. As we analysed, during the GFC the ECB, due to its position as the guardian of the euro, was the best-suited institution to act promptly in order to save and restore the EU financial system. As a result, the EU financial regulation, which had already entered the era of Europeanisation, became subject to a significant reshaping process, with a series of regulatory reform that targeted primarily to deepen the EU financial integration. This process reached momentum when the ECB assumed banking supervision responsibilities, becoming the supranational supervisor of the Eurozone. This decision was based on a mandate given by the existing EU primary law. Although this might have been a sensible choice for that time, due to the emergency character of the circumstances involved, a careful re-consideration of this role would be advisable.



Namely, the stringency of the separation principle which intends to retain the clear distinction between the monetary policy and banking supervision responsibilities of the ECB it has many lapses and gaps, which are not clearly defined by the SSMR. In addition, the issue of accountability is also another major concern, especially in relation to the role of NCAs, given their immediate involvement in the supervision domain. In addition, the involvement of the ECB in macro-prudential supervision through its participation in the ESRB is also concerning, given the lack of legitimacy for the ECB in assuming such responsibilities. It is perhaps time to acknowledge that the creation of a truly integrated market for banking services centred by a strong supranational supervisor, requires a new approach and a true reconstruction of the existing legal framework. This would require a Treaty amendment, which is a lengthy process, but the creation of a fully-fledged Banking Union requires a stronger legal basis and explicitly defined task and responsibilities that will eliminate current conflicts and institutional inefficiencies.

## General conclusion

The main aim of this thesis was to critically examine the broadening of the ECB's mandate and the compatibility of this development with EU Treaty provisions, while exploring the nexus between the objectives of monetary policy and banking supervision. In addressing this topic, the analysis started with a discussion on the historical evolution of central banks and one of the core elements of monetary policy regimes, central bank independence. Having presented the historical context of the debate, recent developments and underlying policy concerns in the post-GFC era were also considered, drawing some initial conclusions on the synergies involved when central banks designed to serve as purely monetary authorities undertake supervisory tasks.

As it was argued in chapter one the marrying of monetary policy and supervision objectives under the same roof is likely to endanger central banks' instrument/operational independence, often as a result of the loose monetary policies that central banks often pursue in an attempt to prevent (or address) a banking crisis. This was particularly relevant during the GFC, when many central banks performed duties that can be classified as highly

politicised. One of the most representative examples was, as discussed in chapter four, the decision of the ECB to limit ELA provision to the Greek banking system. However, as was advocated in chapter one, central bank independence, while constituting an important component for effective monetary policy, it should not be considered as an end in itself or a constraint on the central bank's role, especially in times of crisis, when central bank decisions are of fundamental importance to systemic stability.

Central bank independence, as emphasised in chapter one and two, laid at the core of price-stability-oriented monetary policy regimes. Thus, chapter two focused on exploring the theoretical foundation of this orthodoxy and its evolution throughout the years, which was followed by an analysis of the dichotomy between price stability and the financial stability objectives of central banks. To this end, while both objectives were traditionally given equal importance, the advent of inflation targeting monetary policy regimes and central bank independence, gave primacy to the price stability mandate. This implied a neglectful attitude towards other financial variables that were not considered to affect inflation, stemming from the belief that by maintaining price stability through inflation targeting was enough to maintain at the same time financial stability. However, the experience of the GFC has decisively challenged the conventional view, with many arguing about the need to strengthen the role of central banks in pursuing a more consolidated financial stability mandate.

In this context, the literature in the aftermath of the GFC, as discussed in chapter two and three, has converged on the view that financial stability policy, macro-prudential regulation and monetary policy are highly interlinked and complementary, since the inadequate performance of one may have negative impacts on the other. Thus, as analysed in detail in chapter two the reasons to combine them seem to outweigh arguments in favour of their separation. In addition, as depicted in chapter two, central banks, regardless of whether they are formally assigned with supervisory tasks, will eventually get involved in the macro-prudential supervisory domain, especially due to their traditional role as lender of last resort. The problem arises when it comes to choosing the optimal institutional framework that would facilitate the combination of their tasks.

As discussed in chapter two, the theoretical basis for the prevalence of the view that the combination of both mandates, i.e. price stability and financial stability, triggers the

'conflict of interest' issue, draws upon the time-inconsistency problem and the Tinbergen Rule. Namely, when each objective is addressed with only one instrument, the central bank will be highly rule-based but still in line with the Tinbergen Rule and the time-inconsistency theory. However, as the evidence brought by the GFC has shown, when the objective of price stability is solely pursued by monetary policy instruments, this might lead to neglecting macro-prudential implications and as a result, pose a risk to financial stability goals. On the other hand, as discussed in chapter two and four, if the two objectives are combined, questions around the central bank's independence may arise, or conflicts of interests between the two objectives, which in turn, might pose a risk to the main objective of price stability itself.

At EU level, the pre-GFC institutional framework of the ECB was highly influenced by the aforementioned traditional view and the whole functioning of the ESCB was designed to facilitate a pure monetary authority with the sole objective of maintaining price stability through explicit inflation targets. In addition, as repeatedly mentioned throughout this thesis, the wording of EU Treaty provisions is explicit as to the hierarchy of ECB's tasks, giving a clear primacy on the goal of price stability, while any assignment of supervisory tasks to the ECB (beyond of being specific) would require an amendment to the Treaty. As thoroughly discussed in chapter three, this primacy given to the price stability objective, considering the political considerations to say the least, explains the increased reluctance, for many years, of EU policymakers and EU institutions to transfer any supervisory responsibilities to the ECB. This reluctance is also evident by the slow pace of the process of financial integration, with the transfer of sovereignty with regards to financial matters to the supranational level to have been a controversial broader political mission since the EU's inception. However, starting with Lamfalussy Report, the EU supervisory framework slowly began to shift direction towards Europeanisation and the innovative 4 Level Committees constituted the basis for the subsequent centralisation of banking supervision at EU level.

The GFC was a 'waking call' to a system that had already shown signs of inadequacy, reflecting segmentation and fragmentation rather than a truly consolidated integration. As a post-GFC regulatory response, the De Larosière Report came to address the loopholes in the existing regulatory and supervisory framework. However, although it represented a step closer to centralisation, it remained within the limits that the Lamfalussy Report had set. The

most innovative part of the amendment was the involvement of the ECB – for the first time – in macro-prudential supervision through the ESRB, which was accomplished by activating the enabling clause of Article 127(6), TFEU. Meanwhile, the micro-prudential banking oversight remained a shared responsibility between the NCAs and colleges of supervisors, coordinated through the ESAs. As mentioned in chapter three, at that stage albeit further integration was highly desirable, its actual implementation seemed politically unachievable. Indeed, the Lamfalussy Report advocated against the creation of a supranational supervisor for Europe, while the De Larosière Report explicitly excluded the ECB from assuming micro-prudential supervision, by also providing a list of arguments against the ECB's involvement in micro-prudential oversight, including the possible risks that this could create for its monetary stability mandate and institutional independence.

From the analysis above, it is evident that the conferral of micro-prudential supervisory tasks to the ECB through the establishment of the SSM, represents a radical change in how banking supervision is carried out in Europe and one of the most important steps towards European integration, albeit a hugely controversial one. From 2014, when the SSM became fully operational, the ECB, although originally was conceived as a purely monetary authority, was transformed into the supranational banking supervisor for the financial institutions of the euro area. The thorough examination of the SSM Regulation and the accompanying legislative acts in chapter four identified a number of important gaps that give rise to several legal concerns, which are summarised below.

Firstly, a topic of concern is the division of responsibilities between the NCAs and the ECB, which as analysed in chapter four, is not clearly defined by the SSMR. Namely, the NCAs remain responsible for macro-prudential supervision, while they are entitled to perform micro-prudential duties subject to instructions from the ECB whenever the supervisory tasks are deemed non-specific. In the micro-prudential supervision domain, while the SSM Regulation intended to centralise micro-prudential supervision at EU level, this seems to have not been fully achieved. While the ECB is to perform explicit micro-prudential tasks, many of the latter remain subject to coordination and close cooperation with the NCAs. Among these tasks are the authorisation of financial institutions, with the NCAs retaining the right to object to relevant decisions of the ECB when the resolution is national. The same applies to the assessment of acquisitions of qualifying holdings and the ECB's investigations, including on-

site inspection tasks, which although they are listed among the exclusive responsibilities of the ECB, they remain subject to close cooperation between the ECB and NCAs where appropriate. It is important to highlight that these restrictions of the ECB's discretion to perform micro-prudential supervision tasks is primary due to the limit imposed by the wording of Article 127(6), TFEU and the required specificity of the relevant supervisory tasks.

When it comes to macro-prudential supervision, although this remains a key responsibility of NCAs, the ECB and the NCAs would have to act in close cooperation and by sharing their responsibilities accordingly. This practically means that the NCAs are entitled to use all macro-prudential tools available at national level when needed, regardless of their inclusion or not in the SSMR. However, the ECB is entitled to reject the relevant decision of the concerned NCA and it also holds the right to require higher requirements for the capital buffers and stricter measures on its own initiative, but always in close cooperation with the NCA. This complex cooperation between the ECB and NCAs might give rise to practical implications. For instance, prudential and conduct supervision for many EU countries are both to be operated by the same NCA, which may result in conflict of interest in times of financial instability for the obvious reasons. In addition, the involvement of ECB in macro-prudential tasks through the ESRB, complicates even further the already tangled tasks and powers within the new supervisory framework, as we discussed in both chapter three and four. To this end, it is not clear what is the balance of power between the ECB and NCAs as well as between the ECB and the ESRB in relation to macro-prudential supervision. This apart from raising issues of legitimacy, it also questions the accountability of the ECB and its independence, as analysed in the final chapter of the thesis. Particularly, problematic is the issue of accountability in relation to the NCAs. As discussed in chapter four, it remains unclear to whom the NCAs are accountable too, both when acting alone or in conjunction with the ECB. Namely, the ECB may require the NCAs to exercise their supervisory powers in case the SSMR does not confer such powers on the ECB. Thus, in case the NCAs act in accordance with the relevant instruction of the ECB, to whom are the NCA are accountable to for their actions?

Secondly, the cooperation of the ECB with the other supervisory bodies is also not clearly outlined. For instance, although EBA is the main EU body involved in the regulatory process, the active participating role of the ECB in the internal procedures of the EBA, i.e. the drafting of technical standards, raises questions in regard to the division of responsibilities

between regulatory and supervisory powers. Another issue is the participation of the ECB in the ESRB, which as discussed in chapter three and four has been subject to criticism. Indeed, the composition of the ESRB, which would be chaired by the ECB President, supported by the Secretariat of the ECB and composed mainly of the members of ECB/ESCB General Council, emphasises the active role of the ECB in macro-prudential supervision. This, in conjunction with the power of the ECB to reject the macro-prudential decisions of the concerned NCA and the right to require higher requirements for capital buffers and stricter measures on its own initiative (but in close cooperation with the NCA), although not being favourable in transforming the ECB to a fully-fledged macro-prudential supervisor, leave also space for an implicit macro-prudential mandate that exceeds the wording of Article 127(6), TFEU.

Thirdly, at the core of the new supervisory framework lays the separation principle between the objectives of ECB in monetary policy and supervision. The separation principle as analysed in chapter three reflects the key theories that constitute the theoretical basis for monetary policy-oriented regimes. Thus, it is hardly surprising that the SSMR has placed particular emphasis to the institutional separation between monetary policy and banking supervision tasks, which is also in line with EU law regarding the decision-making procedure and the balance of powers within and outside the ECB structure. However, as highlighted in chapter four, this has resulted in the creation of a complex system, which marries coordination and separation within two layers of decision-making and reposting, two groups of different staff, and two distinct meeting agendas.

Overall, it is questionable whether the two poles of the dual mandate are truly separated. As emphasised in chapter four, the SSMR, the ECB Rules of Procedure, and the ECB 2014 Decision, although stress the importance of the separation principle, they equally emphasise the need to retain a high level of cooperation between monetary policy and supervisory tasks of the ECB. In addition, although the SSB was designed to serve as the decisive body within the SSM, its role remains highly preparatory and consultative, while the Governing Council, which is the main decision-making body of the ECB, will practically have the final word for any decision of the SSB. The wording of Article 13h(3), ECB Rules of Procedure, provide grounding for this view, by outlining that the Governing Council is not only empowered with the right to “*endorse, object to or amend*” proposals of the SSB concerning both micro-and macro-prudential tasks, or with the right to request the SSB to submit a

proposal concerning both micro-or macro-prudential matters; but the Governing Council is also entitled to adopt decisions on its own when there SSB fails to submit a proposal on the requested issue. This depicts the limited role of the SSB and the prominence of the Governing Council. Therefore, the connection points between the two mandates (i.e. monetary policy and banking supervision) create blurry areas that leave space for broad interpretations.

As argued in chapter four, a true “Chinese Wall” between monetary policy and supervision, requires a balance between the two functions and equal prominence given to the main bodies of each. In our case, equal prominence between the Governing Council and the SSB is not achievable, since by EU law the Governing Council constitutes the main decision body of the ECB, thus, every change on this respect would have required a Treaty amendment. This is a possibility that in any case is left open by the SSM Regulation, as Recital (85) emphasises that there are “*some legal constrains*” in the SSM design, which could be overcome only by a Treaty amendment. Furthermore, Recital (85), SSMR, when refereeing to amendments, highlights Article 127(6), TFEU, which constitutes the legal basis of the ECB, and discussed already, limits the supervisory powers of the ECB on carrying out specific tasks. Therefore, it could be argued that the SSM Regulation acknowledges that there are still legal constrains in regard to the separation of monetary policy and supervision, which could be fixed only by amending the Treaty.

Lastly, having discussed the genesis of the idea of centralisation and the rationale for the choice of the ECB as the core institution, the legal basis of the conferral of supervisory tasks to the latter has raised several concerns. This is mainly to be attributed to the vague wording of Article 127(6), TFEU which as discussed in chapter four leaves space for broad interpretation. To this end, based on the historical background of Maastricht Treaty, it was argued that the wording of Article 127(6), TFEU was potentially left intentionally vague, since the discussion on assigning the ECB with supervisory tasks was well-developed, but the relevant proposal failed to attain political agreement at the time. Thus, Article 127(6), TFEU serves well as the legal basis for assigning micro-prudential tasks to the ECB. The question is, which are the limits of these powers and what are the implication when being stretched beyond ‘specific’? Having thoroughly analysed the supervisory powers of the ECB under the new regulatory framework, it could be argued that limits are inevitably broad.

It is evident from the conclusions drawn in this thesis that the newly established regulatory and supervisory framework has stretched the role of ECB beyond its original mandate as set by EU primary law, exceeding the wording of Article 127(6), TFEU. This was the consequence of challenges that the centralisation decision has placed on the key elements of the ECB's functioning (the notion of accountability and independence of the ECB), and the balance of powers between new and existing bodies. This is especially true given the vague division of responsibilities between the ECB and the NCAs, as well as the unclear relationship between the ECB and EBA, and the assignment of new tasks to the ECB that are not clearly defined, i.e. the ECB's macro-prudential supervision tasks. In addition, the complex macro-prudential pillar of supervision, which lays somewhere between the NCAs, ESRB and ECB, raises questions as to the division of responsibilities between each of the bodies and the legitimacy of their actions, given the specificity requirement of Article 127(6), TFEU regarding macro-prudential tasks.

To this end, the only avenue to transforming the ECB into a truly supranational supervisor with full discretion, is the amendment of the Treaty and the empowerment of the ECB with direct supervisory powers. This conclusion stems from the realisation that the main problem in the pre-GFC era (and perhaps one of the reasons for the crisis itself), was that banking supervision had remained at national level while financial markets were becoming increasingly integrated and highly interlinked. This conclusion was also the practical justification of assigning supervisory powers to the ECB. Furthermore, the separation principle does not seem adequate to address the aforementioned policy concerns, especially regarding the involvement of the ECB in the macro-prudential domain of supervision. The empowerment of the ECB with direct supervisory powers by means of EU primary law, is also likely to give rise to legitimate policy concerns regarding the ECB's role in banking supervision. Hence, in order to achieve a fully-fledged centralisation of banking supervision, the transformation of the ECB into a supranational supervisor should be accompanied by the necessary amendments that will equip it with the right means to pursue its objectives.



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