

The Role of Financial Stability in EU Law and Policy

Gianni Lo Schiavo

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Ai miei genitori ed a Eleni

‘Per aspera sic itur ad astra’
(Senex, Hercules furens, Act II, v. 437)

Foreword

The financial crisis, which started to unfold in 2007, has had a major impact on the political, economic and social shape of Europe. It is often not emphasised enough that it has also re-shaped the evolution of European law. That is the contribution of this pioneering book by Gianni Lo Schiavo to European legal scholarship. It depicts a Copernican revolution in European law: the shift from market integration to financial stability as the justification for the law of the single financial market.

Until the financial crisis and within the framework of the Treaty, the sole purpose of the law of the single financial market was achieving market integration. It aimed essentially at removing national obstacles to the freedom to provide financial services. This created a contradiction between market integration and financial stability, for two main reasons. First, since regulatory competences remained national, financial stability could only be achieved by constraining the activities of financial institutions and markets within national borders. For example, at the limit, imposing capital controls could be a financial stability measure. In turn, this would contradict market integration and is prohibited by the Treaty. Second, only national fiscal sovereignty could provide the backstop for addressing financial crises. The fiscal capacity of the state was the last resort for containing financial instability, including through the bailout of banking institutions as it happened during the crisis. Since there was no European fiscal capacity, financial stability could not be ensured across national borders despite market integration.

Over time, the outcome was that the single financial market steadily expanded but without a European framework for financial stability. All the financial stability functions remained national: the monitoring of the financial system; the supervision of financial institutions and markets; the provision of lender of last resort (LOLR) facilities; the insurance of deposits; the winding down of financial institutions. Even the creation of the single currency did not change this outcome, with the ECB given the limited task to contribute to the smooth conduct of national policies on prudential supervision and financial stability. It was widely assumed that national competences, together with spontaneous cooperation between national authorities, would suffice to contain systemic risk. This would enable further market integration without transferring financial stability competences to the European level or impinging on national

fiscal sovereignty. In other words, Member States would be able to share the benefits of market integration without sharing any of its potential risks and related costs.

This proved an illusion. When the crisis erupted, the contradiction between market integration and financial stability came to the fore. There were no European institutions, rules or instruments to prevent or manage the crisis in the single financial market. Member States rescued their domestic institutions with public funds and ring-fenced their markets. The liabilities of these institutions became the liabilities of the Member States that came to their rescue, later contributing to the sovereign debt crisis. The previous dominance of market integration over financial stability in the single financial market was inverted: national financial stability prevailed and led to a retrenchment in European market integration.

This is where the book of Gianni Lo Schiavo starts. It analyses whether financial stability has become a new justification for European law. As well argued throughout the book, the legal and institutional developments in European law since 2008 have been remarkable. They include the introduction of the European Systemic Risk Board as a macro-prudential body; the creation of new supervisory agencies; the transfer of banking supervision and resolution to the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism, respectively, as the two pillars of the Banking Union; the reform of economic governance, including the Treaty on Stability, Coordination and Governance (TSCG); the establishment of the European Financial Stability Facility (EFSF) and European Stability Mechanism as backstops for the stability of individual Member States; and a new approach to European financial regulation based on a single rulebook and ‘total harmonisation’.

These developments are quite diverse, but there is a common denominator between them, which corresponds to the title of the book: the pursuance of ‘stability’. This required at every step a balancing act in law between achieving stability and market integration, while respecting national fiscal sovereignty. As highlighted in the book, there was a plethora of legal solutions. Some were found within the boundaries of the Treaty, which remained unchanged. For example, the harmonisation clause of Article 114 of the Treaty, which provided the legal basis for all market integration measures before the crisis, had also to provide the basis for a large part of the financial stability initiatives since the crisis, including more recently the Single Resolution Mechanism. Other solutions were found outside the Treaty, notably on the basis of intergovernmental agreements. There were several judicial challenges along the way at the Court and national constitutional courts, which reaffirmed, by turns, the primacy of the Treaty and of national sovereignty.

Ultimately, the evolution of European law itself was re-shaped by these developments, as concluded by Gianni Lo Schiavo. While stability was initially justified for

safeguarding market integration, it became a constitutional requirement for wider European integration, towards a ‘Stability Union’ where not only the benefits but also the risks of integration are shared.

Frankfurt, 1 September 2016
Pedro Gustavo Teixeira
Director-General Secretariat
European Central Bank

List of Abbreviations

A.G.	Advocate General
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BoE	Bank of England
BoP	Balance of Payments
BRRD	Bank Recovery and Resolution Directive
CCI	Convergence and Competitiveness Instrument
CEBS	Committee on European Banking Supervisors
CET	Common Equity Tier
CMU	Capital Markets Union
COM	European Commission
CPI	Consumer Price Index
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DG	European Commission Directorate-General
DGS	Deposit Guarantee Scheme
EBA	European Banking Authority
EBU	European Banking Union
ECB	European Central Bank
ECJ	European Court of Justice
ECMH	Efficient Capital Market Hypothesis
EDIS	European Deposit Insurance Scheme

List of Abbreviations

EDP	Excessive Deficit Procedure
EDRF	European Debt Redemption Fund
EFSF	European Financial Stability Facility
EFSI	European Fund for Strategic Investments
EFSM	European Financial Stabilisation Mechanism
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EIP	Excessive Imbalance Procedure
ELA	Emergency Liquidity Assistance
ELTIF	European Long Term Investment Fund
EMU	Economic and Monetary Union
ENISA	European Network and Information Security Agency
ESAs	European Supervisory Authorities
ESCB	European System of Central Banks
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESMA	European Securities and Market Authority
ESMT	European Stability Mechanism Treaty
ESRB	European Systemic Risk Board
EU	European Union
EUR	Euro
EUSEF	European Social Entrepreneurship Fund
EuVECA	European Venture Capital Fund
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FISMA	Financial Stability, Financial Services and Capital Markets Union
FRS	Federal Reserve System
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSA Plan	Financial Services Action Plan
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSOC	Financial Stability Oversight Council
GDP	Gross Domestic Product

GFSR	Global Financial Stability Report
G-SIB	Global-Systemically Important Banks
HM	Her Majesty
IFA	International Financial Architecture
IMF	International Monetary Fund
IRB	Internal Risk Based
IT	Information Technology
JST	Joint Supervisory Team
LCR	Liquidity Coverage Ratio
LOLR	Lender of Last Resort
LTRO	Long(er) Term Refinancing Operations
MIP	Macroeconomic Imbalance Procedure
MoU	Memorandum of Understanding
MREL	Minimum Requirements for Eligible Liabilities
MTO	Medium-Term Budgetary Objective
NCA	National Competent Authority
NCB	National Central Bank
NRA	National Resolution Authority
NSFR	Net Stable Funding Ratio
OJ	Official Journal
OMTs	Outright Monetary Transactions
PMSF	Primary Market Support Facility
PRA	Prudential Regulation Authority
PSPP	Public Sector Purchase Programme
QE	Quantitative Easing
RQM	Reverse Qualified Majority
RWA	Risk Weighted Assets
SGP	Stability and Growth Pact
SIFIs	Systemically Important Financial Institutions
SMEs	Small and Medium Enterprises
SMSF	Secondary Market Support Facility
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process

SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSB	Standard Setting Body
SSM	Single Supervisory Mechanism
SSR	Short Selling Regulation
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
TLAC	Total Loss Absorbing Capacity
TLTROs	Targeted Longer-Term Refinancing Operations
TSCG	Treaty on Stability, Coordination and Governance
UK	United Kingdom
UN	United Nations
US	United States
WFO	World Financial Organisation

Acknowledgements

This book is the revised version of my Ph.D. that was successfully defended at King's College Law School in 2016¹. Writing a book is very challenging without the appropriate motivation and inspiration. The journey of thinking, researching, developing arguments, writing and refining a book is a unique experience that requires a lot more than one would normally need in life. My interest in the EU law and policy responses to the financial crisis dates back to my years in Bruges and Brussels. During those years, I have developed a true passion for EU law that I have kept and will keep forever. The possibility to join King's College with a project on the EU law response to the financial crisis has strengthened my interest for EU law and policy by allowing me to deepen my research interests in the field.

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1. The views expressed in this book are purely personal and they are in no way intended to represent those of the ECB or its SB Secretariat. All errors and omissions remain my own.

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