United or Divided We Stand? Perspectives on the EU's Challenges

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As Good as it Gets? The Impact of the Financial Stability Policy Agenda on the Functioning of the Internal Market

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Introduction

Financial stability has emerged as a policy objective with an astounding influence on regulatory and supervisory reform in the crisis-stricken European Union. As with any policy goal transposed from economic theory, financial stability constitutes a nebulous legal concept and, as this paper will argue, one characterised by its potential conflict with the Treaty objective of promoting a smooth-functioning internal market. Focusing on prudential supervision of the financial sector, this paper will critically examine financial stability against the backdrop of integration in the internal market, taking into consideration substantive and institutional arguments.

Part one will challenge financial stability and argue that, owing to its indeterminacy, this policy objective is indicative of a messianic approach towards prudential supervision. The second part of this paper will introduce the main financial stability policy tools under the CRD IV/CRR framework, referred to as macro-prudential tools. It will be argued that these display a degree of flexibility, which provokes a tension between financial stability and market integration.

This tension will be further explored in part three, which will focus on the inadequacy of the CRD IV/CRR framework to promote the singleness of the internal market. To this effect, it will be argued that the majority of macro-prudential tools suffer from subjectivity and asymmetry. The final part will demonstrate that the shortcomings of the CRD IV/CRR are augmented by the institutional setting. On the basis of this analysis, this paper aims to demonstrate that financial stability should not be seen as the end that justifies any means, and to highlight that the tension between this objective and market integration must not be overlooked.

1. The Messianism of Financial Stability

This section will introduce financial stability, a policy objective which has transformed prudential supervision of the financial system in the EU. It will be argued that, in legal terms, financial stability is a highly indeterminate concept that can encompass an indefinite range of practical rules, and that its suitability is difficult to quantify.

1.1 Prudential supervision and financial stability

Prudential supervision refers to the 'regulation and monitoring' of the financial system to 'ensure its safety and soundness'[1]. It can involve micro- and macro-prudential policies: the former describing the oversight of financial institutions on an individual basis, and the latter referring to the monitoring the financial system as a whole[2]. Both micro- and macro-prudential policies operate by establishing and overseeing the adherence to a 'safety net' of rules, and aim to reduce risk in the financial sector[3]. As such, the objectives and scope of prudential regulation go beyond safeguarding the competitive process and protecting consumers, typically pursued by "conduct-of-business" supervision[4].

Prudential supervision has been identified as a field whose shortcomings contributed to the global financial crisis and is, thus, a field which has undergone far-reaching reform. The post-crisis resurgence of prudential supervision can be explained by the failure of supervisors to either detect or respond to the accumulation of systemic risks in the years leading up to the collapse of Lehman Brothers in 2008, an observation which prompted public pressure for reform[5]. In the EU, post-crisis supervisory reform followed the 2011 de Larosière Report and its finding that financial supervision has failed to, firstly, follow financial risk across regional boundaries and, secondly, rise above its micro-economic outlook[6].

The macro-economic objective of financial stability is neither new, nor revolutionary. It has been recognised by both the Bank of International Settlements and the International Monetary Fund in a multitude of publications preceding the financial crisis[7]. However, as a policy response to the shortcomings of prudential supervision, financial stability only surfaced following the G20 summit of April 2009. In the European Union, its prominence is attributed to the findings of the de Larosière Report, which promulgated that regulation and supervision

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[1] Frederic S Mishkin, 'Prudential Supervision: Why is it Important and What Are the Issues?' in *Prudential Supervision: What Works and What Doesn't* (University of Chicago Press, 2001) 1.
[2] Jakob de Haan, Sander Oosterloo and Dirk Schoenmaker, 'Financial Stability' in *Financial Markets and Institutions: A European Perspective* (2nd edn, Cambridge University Press, 2012), 393.
[3] Mishkin (n 1) 8.
[4] See eg, Section 1B(3) Financial Services Act 2012 on the operational objectives of the UK's Financial Conduct Authority.
[5] Chryssa Papathanassiou and Georgios Zagouras, 'A European Framework for Macro-Prudential Oversight' in Eddy Wymeersch, Klaus Hopt and Guido Ferranini (eds.) *Financial Regulation and Supervision* (Oxford University Press, 2012) 159.
[6] ibid. See also, 'Chapter I: Causes of the Financial Crisis' in The High Level Group on Financial Supervision in the EU, Report (2009) 7-13 <ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> accessed 06 April 2016.
[7] See eg, 'Marrying the macro- and micro-prudential dimensions of financial stability' (*BIS Paper No 1*, March 2001) <www.bis.org/publ/bppdf/bispap01.htm> accessed 06 April 2016 and Jörg Decressin, Wim Fonteyne and Hamid Farugee, *Integrating Europe's Financial Markets* (IMF, 2007).

must be re-oriented so as to adequately counter macro-economic risks[8]. These are believed to emerge from the financial system's 'pro-cyclicality': a term describing the decrease of risk in an economic boom and the exponential increase of financial risk in an economic bust[9]. Accordingly, financial stability is intrinsically connected to the notion that some risks in the financial system can be 'systemic'.

'Systemic risk' refers to financial institutions undergoing initial shocks and subsequent stress, which is transmitted to other institutions and amplified to such an extent that it impacts negatively on the real economy[10]. The objective of financial stability serves as a direct policy response to the accumulation and adverse effects of systemic risk. As such, financial stability is only definable by reference to its targets, as the prevention, mitigation and management of systemic risk[11]. The central issue with financial stability can be summed up in this paradox: in spite of being difficult to define in positive terms, financial stability has emerged as a 'national, regional and international' policy goal, perceived as so indispensable that it transgresses 'institutional boundaries and geographical borders'[12]. Further, it is widely agreed that financial stability can only be attained by a combination of fiscal, monetary and regulatory initiatives[13].

1.2 The emergence of macro-prudential supervision

The newfound objective of financial stability has produced a vast body of rules aiming to counter the accumulation of systemic risk. This ascendancy of macro-prudential policy can be attributed to the shortcomings of micro-prudential supervision. These inadequacies are appropriately expressed by the 'composition fallacy'[14], which refers to the misconception that the stability of any financial system follows as a consequence of the soundness of individual financial institutions partaking in that system. Serving as the basis for micro-prudential supervision, this fallacy justified the misplaced supervisory focus on shielding individual institutions from danger prior to the financial crisis. Since financial supervision does not seek to protect the firm itself, micro-prudential supervision can be regarded as inherently consumer

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[8] de Larosière Report (n 6).
[9] Markus K Brunnermeier *et al*, 'The Fundamental Principles of Financial Regulation' (2009) Geneva Reports on the World Economy 11/2009, XVI <www.princeton.edu/~markus/research/papers/Geneva11.pdf> accessed 06 April 2016.
[10] Rosa M Lastra, 'Systemic Risk and Macro-prudential Supervision' and Peter O Mülbert, 'Managing Risk in The Financial System' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds.) *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) 312, 381-382.
[11] Rosa M Lastra, 'Systemic Risk, SIFIs and Financial Stability' (2011) 6(2) CMLJ 197, 207.
[12] ibid.
[13] Carmello Salleo, 'Single Market vs. Eurozone: Financial Stability and Macroprudential Policies' in Franklin Allen, Elena Carletti and Joanna Gray (eds.) *The New Financial Architecture in the Eurozone* (European University Institute, 2015) 179-184.
[14] Brunnermeier *et al* (n 9) XVI.

protection-oriented[15]. Therein lies the rub: by attempting to protect individual market actors from dangers emanating from the condition of the economy, micro-prudential supervision treats the accumulation of risk as 'exogenous'[16]. Consequently, in the years leading up to the crisis, the accumulation of systemic risks was often beyond the reach of supervisors.

Conversely, macro-prudential supervision is deliberately aligned with the objective of financial stability and adopts a 'bird's-eye view' of the financial system[17]. Treating imbalances as endogenous, macro-prudential supervision directly aims at preventing these from being generated, and to limit their build-up and transmission within the financial system. Ideally, macro-prudential policy 'compliments and supersedes' micro-prudential supervision[18]. As such, there is considerable scope for overlap between the two approaches as, for example, the reduction of institutions' common exposures to risk, as well as the monitoring of systemically important institutions illustrate[19]. There is also a considerable number of policy measures, such as liquidity instruments or disclosure requirements, which serve a dual micro- and macro-prudential function[20].

1.3 A messianic approach?

It has been argued that the global financial crisis has acted as a catalyst for the emergence of financial stability as an overarching policy goal, which in turn instigated a shift from micro- to macro-prudential supervision. This shift can be explained by reference to the economics literature, which has exposed the inability of supervisors to address system-wide risk in the years prior to the crisis. Nevertheless, in the absence of the analytical tools available to economists, the brand new regulatory objective of financial stability remains highly elusive to legal scholars.

As aforementioned, the definition of financial stability is a negative one and encompasses the prevention, mitigation and management of systemic risk. In consequence, it is almost impossible to delineate the scope of financial stability by reference to a clearly defined set of practical rules as, for example, the potential conflict between macro- and micro-prudential tools indicates. Further, lacking adequate conceptualisation, the development of macro-prudential policy relies on economic analysis as evidence that a particular instrument will

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[15] Mülbert (n 10) 367.
[16] de Haan, Oosterloo and Schoenmaker (n 2) 394.
[17] Mads Andenas and Iris H-Y Chiu, The Foundations and Future of Financial Regulation: Governance for Responsiiblity (Routledge, 2014) 415.
[18] Mülbert (n 10) 365.
[19] de Haan, Oosterloo and Schoenmaker (n 2) 393.
[20] Mülbert (n 10) 366.

achieve the aim of financial stability. Yet, economic scholarship concedes that the effects of macro-prudential policy rules are incredibly difficult to quantify *ex ante*, particularly in the short- and medium-term[21]. Therefore, it is submitted that the objective of financial stability carries a considerable degree of indeterminacy.

Prima facie, indeterminacy is not problematic: insofar as the financial stability policy agenda is a response to an indefinite range of, often unforeseeable, risks to the financial system, the objective of financial stability needs to retain an equal degree of flexibility. In addition, in light of the complex and transnational outlook of European prudential regulation, all regulatory objectives are, arguably, inherently broad. However, financial stability cannot be equated with other regulatory objectives, such as consumer protection. Indeterminacy becomes problematic because the origins and predominance of financial stability, as well as the institutional setting in which it operates, give this objective a unique role.

With regard to its origins, the confidence in financial stability can also be interpreted as a fear of the widespread instability experienced during the financial crisis. Scholars' inability to define financial stability in positive terms, reinforces this interpretation. In similar terms, the consensus on the merits of macro-prudential policy can be construed as merely a recognition of the inadequacies of micro-prudential regulation. Considering the overwhelmingly positive connotations of the term 'stability' in the context of a financial system struck by crisis, this raises the question of whether the re-orientation of prudential supervision following the crisis is to an extent fear-induced and reactionary.

Moreover, the predominance of financial stability as a policy objective is another source of concern. For example, financial stability fundamentally recasts fiscal policy, monetary policy and prudential regulation. The interconnectedness of these fields contributes to the prominence of financial stability as a policy goal. Importantly however, this interdependency adds to the concept's nebulous character, by elevating financial stability into something more than the sum of financial stability policy tools, thus, making it more difficult to measure their suitability.

It follows, that the objective of financial stability is, at least to some degree, demonstrative of a messianic approach towards prudential supervision. This is because this objective remains largely unchallenged by the literature, even if the practical rules that can bring about the promised outcome of financial stability cannot be ascertained and delineated. Ultimately, this

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[21]See eg, European Banking Authority Opinion of 30 June 2014 on the macroprudential rules in CRD IV/CRR, <eba.europa.eu/documents/10180/657547/EBA-Op-2014-06+-+EBA+opinion+on+macroprudential+rules+in+CRR-CRD.pdf> accessed 11 April 2016.

is not a value judgement: the above analysis merely demonstrates that this policy objective should not be regarded as irrefutable. The following section will argue that the emerging tension between financial stability and market integration reinforces this view.

2. Macro-prudential Instruments and Market Integration

It has been argued that the policy goal of financial stability should not be regarded as a panacea. In particular, it will be demonstrated that the financial stability policy agenda has the potential to undermine the unity and functioning of the internal market. To this effect, this section will introduce the main macro-prudential policy tools under the CRD IV/CRR framework, and explain how the use of these tools can be prejudicial to market integration.

2.1 The main tools under CRD IV/CRR

The emergence of financial stability as a supervisory goal has produced a macro-prudential policy toolkit, contained in the remodelled Capital Requirements Directive (CRD IV)[22] and the Capital Requirements Regulation (CRR)[23]. The CRD IV/CRR package encompasses a range of macro-prudential instruments, the intermediate objectives of which include the prevention and mitigation of excessive credit growth and leverage, exposure concentrations, and moral hazard[24]. The main macro-prudential tools can be classified according to these objectives.

Firstly, the institution-specific countercyclical capital buffer (CCB), a CET 1[25] buffer intended to act as a layer of protection and deterrent against risk-taking for banks, falls within the first category of tools addressing the pro-cyclicality of the financial system. To counteract the risks of excessive growth and leverage, the CCB is adjusted according to an institution's total exposures and risk weighted assets. The CCB follows a basic supervisory model of guidance and cooperation. Member States are required to nominate a national competent authority (NCA) responsible for calculating a buffer guide based on the deviation of the ratio of credit to

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[22] 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.

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

[24] Recommendation A(2), Recommendation ESRB/2013/1 of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macroprudential policy [2013] C 170/01.

[25] One of two measurements of bank's capital. Calculated by the core equity capital against risk-weighted assets.

GDP, specifically paying regard to any specificities of the national economy[26]. The CCB ratio is then to be calculated[27] by the NCAs on the basis of this guide, taking into account any relevant guidance and recommendations by the European Systemic Risk Board[28].

Secondly, the risk of contagion is dealt with by a number of direct capital requirements for large exposures and indirect measures such as sectoral risk weights (RWs) and loss given default (LGD) [29] parameters, which affect the determining variables of these capital requirements. Articles 124 and 164 CRR, dealing with sectoral RWs and LGD floors respectively, follow a maximum harmonisation model: both Articles set out criteria to be considered, mandatory minimum and maximum values, as well as conditions for the consultation of the European Systemic Risk Board (ESRB) and European Banking Authority (EBA). Further, mandatory reciprocity is imposed in situations of exposures secured by mortgages on property located in another Member State[30].

Thirdly, the risk of moral hazard is addressed, *inter alia*, by measures intended to reduce the probability of failure of systemically important financial institutions (SIFIs). The CRD IV/CRR framework provides for two distinct buffers for global systemically important institutions (G-SII) and other systemically important institutions (O-SII). The former is a mandatory capital buffer for banks which are perceived as 'too big to fail' internationally, and the latter enables NCAs to impose capital charges on institutions which are domestically important or other institutions of systemic importance which are not covered by the G-SII buffer. A versatile supervisory arrangement is in place for these SIFI capital surcharges. With regard to the G-SII buffer, NCAs are to identify G-SIIs and assign them to sub-categories of varying capital charge rates[31]. In doing so, NCAs are required to follow the methodology set out in Article 131(2) CRD, which requires that NCAs establish a system of indicators and equally weight criteria such as size, and interconnectedness. O-SII buffers, on the other hand, are applied on a more discretionary basis and NCAs are only obliged to use one of the criteria listed in Article 131(3) in identifying O-SIIs.

Moreover, there are measures which serve multiple intermediary objectives. For example, the Systemic Risk Buffer (SRB), a CET 1 instrument intended to prevent and mitigate risks of a

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[26] Article 136(2) CRD.
[27] On a quarterly basis. Article 136(3) CRD.
[28] The ESRB is charged with providing guidance on setting rates (Article 135(1) CRD) and with issuing recommendations for exposures to third countries (Article 138 CRD).
[29] Defined as the percentage of the Exposure at Default (EaD) which is expected to be lost if a counterparty goes into default.
[30] Articles 124(5) and 164(7) CRR.
[31] Article 131(1), (4) & (9) CRD.

long-term, non-cyclical nature, compliments both counter-cyclical tools and SIFI capital surcharges. Correspondingly, the main feature of the SRB is flexibility. NCAs are free to introduce this buffer to any subsets of the financial sector and, enjoy considerable discretion in setting the SRB rate. In particular, the CRD does not include specific criteria to be followed and provides no maximum limit for the SRB rate. The only requirement NCA's must comply with concerns the notification of rates below 3%, and a differentiated notification procedure, looking into scope, geographic exposure and rate level, for rates exceeding 3%[32].

Further, national flexibility measures, which include own funds requirements, a capital conservation buffer, exposure requirements and more, can be viewed as contributing to all of the aforementioned intermediate objectives. Similarly to the SRB, a detailed notification/approval procedure applies to these measures under Article 458 CRR, as a means of offsetting their intentionally broad scope[33]. The approval procedure requires that Member States submit, among other things, evidence of 'changes in the intensity' of systemic risk[34] and the connection between such changes to the threat to financial stability[35], as well as an explanation of why the proposed measures are 'suitable, effective and proportionate'[36].

The macro-prudential use of Pillar II escapes the above categorisation altogether. The term "Pillar II" originates from Basel II and the Basel Committee on Banking Supervision's 'three pillar' classification of supervisory measures, which encompasses regulatory capital, risk and leverage coverage (Pillar I), risk management and supervision (Pillar II) and market discipline (Pillar III)[37]. CRD IV empowers supervisory authorities with a range of instruments addressing wider systemic risks, including liquidity risks. These include price measures relating to capital increase, as well as volume instruments which seek to limit exposure of individual institutions to risk[38]. Pillar II measures, not bound by pre-defined limits, fall within the class of instruments which can be used by NCAs as complimentary to other requirements, according to risks that arise domestically[39].

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32 Article 133(11) CRD.
33 According to the ESRB these are intended to 'serve different purposes and target different dimensions of systemic risk'. European Systemic Risk Board, 'The ESRB Handbook on Operationalising Macro-prudential Policy in the Banking Sector' (2014) 142 <www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook_mp.en.pdf?b6fc06bd09042179d2c2559a979f8c36> accessed 1 March 2016.
34 Article 458(2)(a) CRR.
35 Article 458(2)(b) CRR.
36 Article 458(2)(e) CRR.
37 BIS, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' June 2004, <bis.org/publ/bcbs107.pdf> accessed 1 March 2016.
38 Article 104(1) CRD.
39 ESRB Handbook (n 33), 134-136.

Finally, asset-based measures may also be considered as exceptional. These seek to improve the resilience of borrowers in the mortgage market, either by making the volume of credit granted dependent on the value of the underlying real estate (LTV ratio) or on the debt servicing capacity of the borrower (LTI and DSTI limits)[40]. In terms of objectives, these measures are counter-cyclical and would therefore fall under the same category as the CCB. However, real estate instruments, such as LTV, LTI and DSTI ratios, while considered as a priority for future reform, remain unharmonised and exclusively reliant on national law.

2.2 Financial Stability vs. Market Integration

The CRD IV/CRR framework pivots on the 'ultimate objective of achieving financial stability'[41]. In theory, financial stability is consistent with the aim of market integration, based on the hypothesis that the prevention and management of systemic risk contributes to the smooth functioning of the European financial market. This is a view endorsed by the ESRB, which presupposes that financial stability, as the 'ultimate' objective of macro-prudential supervision, 'contributes to the smooth functioning of the internal market'[42]. However, this presumption can be contested. Arguably, the pursuit of the financial stability optimum does not improve the functioning of markets *per se*, or bring national markets closer together: it merely seeks to eliminate the obstacle of instability, which is one out of many facing market integration. In practical terms, it should not be presumed that the means by which financial stability is to be achieved do not have the potential to cause distortive effects or otherwise undermine the singleness and functioning of the internal market.

As explained above, the CRD IV/CRR encompasses a multitude of capital- and borrower-based instruments, and equips national authorities with a range of complimentary supervisory powers. While the expansive CRD IV/CRR framework follows a maximum harmonisation approach, the use of macro-prudential policy tools relies primarily on Member States and NCAs. In line with economic theory, this is because macro-prudential policy treats systemic risk as endogenous. Thus, instability at the national level is viewed as a principal source of risk and, thus, one that can only be addressed by paying regard to national specificities.

Therefore, the exercise of CRD IV/CRR tools remains largely decentralised, with Member States given considerable room for manoeuvre in regards to identifying systemic risks, setting

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[40] Therese Grace, Niamh Halissey and Maria Woods, 'The Instruments of Macro-Prudential Policy' (2015) 1 Quarterly Bulletin of the Central Bank of Ireland 90, 98.
[41] European Systemic Risk Board, 'Flagship Report on Macro-prudential Policy in the Banking Sector' (March 2014) 7, <www.esrb.europa.eu/pub/pdf/other/140303_flagship_report.pdf> accessed 1 March 2016.
[42] ibid.

operational standards and rates, and justifying these. To counterbalance the degree of discretion that Member States may enjoy in the use of macro-prudential tools, the CRD IV/CRR framework envisages a model of cooperation and coordination between national and supranational actors, and between Member States. Mandatory reciprocity and multilateral notification procedures, imposed for example to sectoral RWs and LGDs, serve as evidence of the role of such mechanisms.

The question which emerges is whether a model of coordination and cooperation can adequately safeguard the singleness of the European financial market. Issues, such as the absence of any such mechanisms for borrower-based measures, cast doubt on whether this question can be answered in the affirmative. More importantly, the financial stability policy agenda can have a prejudicial impact on the internal market in spite of any cooperation or coordination mechanisms that are in place. This is not a radical proposition: generally, prudential instruments can have an adverse impact on the internal market, for example if they are used for illegitimate purposes. However, even if serving the purpose of financial stability, macro-prudential instruments can conflict with market integration, insofar as their exercise displays subjectivity or asymmetry.

Subjectivity refers not only to Member State discretion, but also to the lack of objective methodology, which can widen national differences and solidify divergent interpretations of macro-prudential rules among Member States. Asymmetry alludes to the possibility of differences in the usage of macro-prudential rules, which can lead to an asymmetrical impact on the internal market and to inconsistency in terms of their effectiveness. Subjectivity and asymmetry stem from the imperfect transnational architecture of the European financial system. The CRD IV/CRR framework, revolving around the NCAs, does not treat the European financial market as a unitary system. Notably, the lack of a true "European" financial market, and the resulting need to incorporate national specificities in the evaluation of macro-prudential objectives, suggests that a degree of divergence between Member States will always be required in this setting.

Furthermore, macro-prudential policy does not automatically eliminate Member States incentives for employing macro-prudential rules in ways which undermine market integration. This relates, in particular, to the risks of ring-fencing and regulatory arbitrage. Macro-prudential policy may exacerbate such risks insofar as a decentralised supervisory model incentivises protectionism. Reference can also be made to the risk of cross-border spillovers. In relation to this, Member States are under no obligation to reciprocate the majority of macro-prudential instruments. Therefore, even at this preliminary stage, there are indications that macro-prudential policy may have an impact on the functioning of the internal market.

Consequently, the ESRB's assumption that financial stability policy automatically contributes to the smooth functioning of the internal market can be considered as basic, if not ill-conceived. By way of contrast, the EBA recognises the singleness of the European financial market as a distinct objective of macro-prudential policy[43], a view that is supported by a number of CRD IV/CRR provisions which feature market integration as a consideration. The EBA's approach indicates an implicit rejection of financial stability as the sole standard by which the success of macro-prudential tools should be measured. The following sections will explore the potential for conflict between macro-prudential policy and market integration, and further question the assumption that the internal market aspirations of macro-prudential supervision are self-fulfilling.

3. The CRD IV/CRR Framework

It has been argued that the objective of financial stability should not be presumed as automatically contributing to market integration. This section will substantiate this argument by examining the extent to which macro-prudential tools under the CRD IV/CRR suffer from a degree of subjectivity and asymmetry that affects the internal market.

3.1 Subjectivity as a consequence of flexibility

The subjectivity of macro-prudential measures is not synonymous to, but rather a consequence of, their flexibility. The most prominent example in this category is the SRB. The CRD IV/CRR framework requires that Member States include in their notification an assessment of the 'likely positive or negative' impact of the measure on the internal market, 'based on information which is available' to them[44]. References to the internal market signify a pre-emptive approach, whereby even potential and indirect negative effects are anticipated and prevented. However, the same low threshold applies to potential positive effects on the internal market. It must also be remembered that Member States are only required to assess potential effects on the internal market on the basis of information which is available to them[45]. To the extent that scarcely credible, 'likely' positive effects can be supported and justified by a conceivable lack of information at the national level, a risk of subjectivity is emerges.

A similarly-worded requirement applies to national flexibility measures under Article 458 CRR. In relation to this set of tools, the Council may reject draft proposals 'only' if 'one or more' of

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[43] EBA Opinion (n 21) 6.
[44] Article 133(11)(d) CRD for rates up to 3% and Article 133(12)(d) CRD for rates exceeding 3%.
[45] ibid.

the requirements listed in paragraph (4)(a)-(e) are not complied with. Further, paragraph (4) clearly sets out that only 'robust, strong and detailed evidence' that a measure 'will' have a negative impact on the internal market will suffice. Such evidence must demonstrate that the impact on the internal market 'outweighs' financial stability considerations[46]. Owing to the indeterminacy of financial stability, it is difficult to conceive that a strictly interpreted internal market consideration will ever outweigh financial stability estimations.

There are analogous issues with SIFI capital surcharges. Not only does the G-SII and O-SII buffer regime lack consistent predetermined rules but, as the ESRB admits, the allocation of the O-SII buffer is near to discretionary[47]. In the words of the EBA, these tools operate without a 'uniform objective methodology'[48]. The criteria set out in Article 131(2) and (3), as well as the requirement of notification[49], may encourage convergence in terms of terminology. However, they do little to eliminate, firstly, the scope for divergent application and, secondly, Member States' incentives for ring-fencing[50]. The potential impact of these measures on the singleness of the internal market is magnified considering that SIFIs will account for a large portion of cross-border activity in the EU.

In relation to the CCB, an argument can be made that the requirement of incorporating national specificities in the assessment of this buffer prevents convergence in its usage across the Union. However, this risk occurs not as a consequence of the CCB's broad scope, but because of the weak reciprocity model the CCB employs to support it. Mandatory reciprocity will apply to rates up to 2,5% from 2019. This points to a highly uneven playing field for rates exceeding the 2,5% cap, which is exacerbated by the lack of a framework for the sharing of information, empirical and methodological data between Member States. As a result, it can be suggested that the CCB rules suffer from a degree of subjectivity that maintains the risk of leakages.

The picture which emerges is that the main capital requirements in the CRD IV/CRR framework fall short of the standard of consistency between financial stability and market integration enunciated by the ESRB. Tension between the two emerges, firstly, from the problematic formulation of the provisions governing macro-prudential tools and, secondly, from the overall weakness of these provisions to address cross-border situations.

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[46] Article 458(4) CRR.
[47] ESRB Handbook (n 33), 81-83.
[48] EBA Opinion (n 21) 26.
[49] Article 131(12) CRD.
[50] EBA Opinion (n 21) 26.

3.2 Asymmetrical tools

Beyond instruments whose inherent flexibility impacts on the functioning of the internal market, there is a range of instruments which are weakened by asymmetry in their operation. In the majority of cases, asymmetry arises because of the instruements' unique role within the CRD IV/CRR framework and, in some cases, in spite of their perceived neutrality.

Instruments perceived as neutral follow a methodology can be regarded as objective, even if flexible to national specificities. Sectoral RWs demonstrate such neutrality: for example, Articles 125(1) and 126(1) set out maximum values and criteria for the adjustment of RW in mortgages on both residential and commercial immovable property. This model is strengthened by Article 124(5), which establishes mandatory reciprocity for situations involving exposures secured by mortgages on property located in another Member State. Nevertheless, their stringent supervisory model does not eliminate the potential for asymmetry, between the impact of RWs in different Member States, and between the usage of RWs and LGD floors. One reason for this is that, while RWs serve similar functions as the LGD, their scope is not 'symmetrical', which suggests that their impact will vary considerably[51].

More importantly, in spite of mandatory reciprocity, the setting of risk weights and LGD floors may not be 'correctly and consistently mapped to the level of risk across countries'[52]. To explain, these provisions must be applied on the basis of 'financial stability considerations', which are connected to, and dependent upon, the 'actual risks' identified[53]. Leaving aside the vagueness of the term 'financial stability consideration', this twofold test allows for a degree of inconsistency insofar as the factors that the NCAs are required to take into account when connecting the two are not clearly defined.

Another category of measures includes tools which are intentionally discretionary because of their exceptional position in the CRD IV/CRR framework. Typically, these tools act as complimentary to other macro-prudential instruments and, often, target regional sources of instability. For example, borrower-based tools such as LTV, LTI and DSTI limits are intended to operate in a 'granular' and 'targeted' manner[54]. The key challenge facing these tools is that identical measures may serve considerably different purposes in each Member State. In some

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[51] EBA Opinion (n 21) 37.
[52] ibid, 38.
[53] Article 124(2) CRR.
[54] Vítor Constâncio, 'Macroprudential Policy in Europe – ensuring financial stability in a banking union' (Speech by VP of ECB, October 2015) <ecb.europa.eu/press/key/date/2015/html/sp151028.en.html> accessed 16 March 206.

Member States LTV, LTI and DSTI limits are not even considered as macro-prudential instruments at all, falling instead within the field of consumer protection or bank solvency[55].

Moreover, their 'granular' and 'targeted' role suggests that to an extent these measures operate *in silo*. Member States will not always be able to take into account arrangements in other countries or ensure that asset-based measures coincide with other instruments and policy areas[56]. The fact that asset-based measures are considered a priority for future revisions of the CRD IV/CRR[57] reinforces the view that their impact is currently asymmetrical. The macro-prudential use of Pillar II operates in a similar way. Coordination of Pillar II policy may require Member States to share confidential information, which, in the absence of an appropriate coordination mechanism, is unrealistic to expect[58].

Therefore, it can be argued that, while justifiably retaining discretion in their application, the CRD IV/CRD does not safeguard the symmetry of certain tools whose role is to compliment the main capital measures. At the same time, the example of RWs and LGDs, suggests that asymmetry is not limited to exceptional tools such as Pillar II.

3.3 Concluding remarks on the CRD IV/CRR

The standard set by the ESRB is that financial stability is not only consistent with, but that it 'contributes' to the smooth functioning of the internal market. However, the tools under the CRD IV/CRR fall short of this standard. The main capital tools suffer from a degree of subjectivity, which, even if intentional or justifiable, certainly impacts adversely on the singleness of the European financial market. The weak model of reciprocity under the CRD IV/CRR contributes to this tension between the financial stability policy agenda and market integration.

A further source of conflict originates from the asymmetrical impact of some tools. The use of seemingly neutral measures such as RWs may not support comparable tools such as LGD parameters, and the lack of uniform criteria may allow for overall inconsistency. Other tools, considered complimentary, rely heavily on a consultation procedure at the expense of more symmetrical substantive rules.

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[55] Philipp Hartmann, 'Real Estate Markets and Macroprudential Policy in Europe' (2015) 47(S1) JMCB 69, 77.

[56] Anat Keller, 'The possible distributional effect of the loan-to-value ratio and its use as a macro-prudential tool by the European Systemic Risk Board' (2013) 28 JIBLR 266, 268-269.

[57] Constâncio (n 54).

[58] EBA Opinion (n 21), 44-47.

It is beyond the scope of this paper to propose ways to reform the current CRD IV/CRR framework. However, the above analysis serves the purpose of challenging financial stability as an irrefutable, messianic objective. In conclusion, there is an incontestable potential for the financial stability policy agenda under the CRD IV/CRR to hinder market integration. The following section will argue that this is significantly augmented by the institutional setting in which macro-prudential policy operates.

4. The Institutional Setting

This section will examine the inadequacies of the institutional setting in which macro-prudential policy operates. This aspect is important because financial stability has precipitated the establishment of the European System of Financial Supervision (ESFS) and the Banking Union (BU), which fundamentally alter the structure of prudential supervision in the Union and have the potential to cause further fragmentation of the internal market.

4.1 The European Systemic Risk Board

One response to the financial crisis stemming from the findings of de Larosière report has been the overhaul of the architecture of European financial supervision. Within the newly-established ESFS, the objective of financial stability has acted as a catalyst for the conferral of a limited range of macro-prudential powers to the ESAs[59] and, more importantly, for the creation of the ESRB.

The ESRB is a committee responsible for the 'macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability […], so as to avoid periods of widespread economic distress'[60]. The 'smooth functioning of the internal market' is pronounced as a secondary objective[61], arguably to justify the adoption of the ESRB Regulation on the basis of Article 114(1) TFEU.

The ESRB's mandate is broader than its actual powers: intended to lead by virtue of its expertise, the ESRB can only issue warnings and recommendations, as well as monitor their follow-up[62]. Nevertheless, its recommendations can be addressed to any supervisory authority,

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[59] Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford European Union Law Library, 2014) 1009.
[60] Article 3(1), Regulation (EU) 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.
[61] ibid, Article 3(1).
[62] ibid, Article 3(2).

Member State, the European Commission or collectively to the Union, and are reinforced by a "comply-or-explain" standard[63]. Further, The ESRB Regulation assigns a number of analytical and coordination functions to the ESRB, including the task of identifying risks and cooperating with other ESFS bodies[64]. Nevertheless, the ESRB's lack of direct intervention powers deprive it of the influence that its American counterpart enjoys[65].

Similarly to ESMA and the other European Supervisory Authorities established during the period of post-crisis reform the ESRB is not an EU institution, but rather a 'new independent body'[66]. Devoid of legal personality however, the ESRB is supported institutionally, logistically and financially by the ECB[67]. This includes the ESRB's administrative capacity being exclusively provided by the ECB[68], as well as ECB membership in the ESRB's General Board and Steering Committee[69]. In spite of dependency on the ECB, authors are generally optimistic of the ESRB's genuine independence[70]. This is in no small part due to the impartiality requirements set out in Article 7(1), and the ESRB's 'advisory' role as sharply contrasted with the 'quasi-rulemaking' functions of ESMA and the ESAs[71].

4.2 The Single Supervisory Mechanism

In addition to the above developments, the financial crisis has accelerated the European Banking Union project and, in relation to financial stability, contributed to the rise of the ECB as a reserve macro-prudential supervisor. The BU encompasses over 30 intergovernmental, legislative and administrative measures, and the adoption of a single banking rulebook for the euro area[72]. It consist of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). For purposes of compatibility with the Treaties, 'mechanism' denotes 'significant institutional innovations', which remain short of the establishment of a new supranational institution[73].

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[63] ibid, Article 17(1).
[64] ibid, Article 3(2).
[65] de Haan, Oosterloo and Schoenmaker (n 2) 413.
[66] Recital 15, Regulation 1092/2010.
[67] Papathanassiou and Zagouras (n 5) 167-171.
[68] Article 4(4), Regulation 1092/2010.
[69] ibid, Articles 6 & 11.
[70] See eg, Papathanassiou and Zagouras (n 5) 171.
[71] Moloney (n 59) 1011.
[72] Eddy Wymeersch, 'The Single Supervisory Mechanism' in Danny Busch and Guido Ferranini (eds.) *European Banking Union* (OUP, 2015) 93-100.
[73] ibid, 103.

The SSM was constructed on the basis of Article 126(7) TFEU[74], according to which the Council acting unanimously may 'confer specific tasks upon the ECB concerning policies relating to the prudential supervision'. Article 1(1) of Regulation 1024/2013 (SSM Regulation) specifies that any supervisory powers are conferred 'with a view to contributing to the safety and soundness of credit institutions and the financial stability of the system within the Union and each Member State'[75].

It should be noted that financial stability, as expressed by the macro-prudential tools in CRD IV/CRR, extends to the entire European financial market. However, following the coming into force of the SSM, the ECB gained explicit reserve powers over macro-prudential policy in the euro area. Specifically, by virtue of Article 5(1) of the SSM Regulation NCAs are required to notify the ECB prior to adopting or adjusting macro-prudential instruments and, where the ECB objects, to 'duly consider' the ECB's reasoning. Further, the ECB is enabled to tighten capital buffers, subject to 'duly consider[ing]' any reasons for objection by the Member State concerned[76]. Recital 24 of the SSM Regulation purports that the SSM arrangements are 'without prejudice to any coordination procedures provided for in other acts of Union law'.

By way of contrast, the SSM Regulation confers upon the ECB a leadership role over micro-prudential supervision, comprising significant rule-making and direct intervention functions. The ECB is charged as 'exclusively competent' to carry out direct supervisory tasks, such as the authorisation of credit institutions and the approval of acquisition or disposal of qualifying bank shareholdings[77]. Additionally, on the basis of Article 6(4) of the SSM Regulation, the ECB acquires an exclusive responsibility for the oversight of 'significant' banks. NCAs retain the function of overseeing 'less significant' banks[78], in practice amounting to a mere 15% of bank assets in the euro area[79], but the ECB maintains the power to coordinate and intervene where necessary[80].

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[74] Treaty on the Functioning of the European Union [2008] OJ C 115/01.
[75] Council Regulation 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63.
[76] Article 5(2) and (4) SSM Regulation.
[77] Article 4(1) SSM Regulation.
[78] Article 6(6) SSM Regulation.
[79] Brigitte Haar, 'Organizing Regional Systems: The EU Example' in Moloney, Ferran and Payne (n 10) 180.
[80] Article 6(5) SSM Regulation.

4.3 Fragmentation of the internal market?

The BU represents an unprecedented centralisation of supervisory powers at the supranational level. Under the SSM, the ECB's influence over banking supervision can scarcely be exaggerated. Not only is the ECB directly in charge of supervising over 100 of the largest banks operating in the internal market, but it also enjoys considerable indirect control over banking supervision in the euro area on the basis of reserve powers and coordination tasks. Therefore, it is clear that the post-crisis supervisory framework is 'centred on the ECB'[81]. To the extent that ECB influence can extend outside the boundaries of banking and micro-prudential regulation, the new institutional arrangement poses a distinct threat to the singleness of the internal market.

Specifically, the centralisation of supervisory powers within the SSM threatens the functions of the EBA, an ESFS agency with standard-setting and limited intervention powers over banking in the internal market. Established on the basis of Article 114 TFEU, the EBA is explicitly charged with the task of promoting the smooth functioning of the internal market. Insofar as membership of the SSM remains limited, it is conceivable that the interests of the ECB will not always be aligned with those of the EBA[82]. Taking into account the ECB's representation in the EBA's Board of Supervisors, as well as the influential position of the ECB as default supervisor, there is a danger that EBA decision-making will become increasingly SSM-driven. In turn, this could lead non-euro area countries taking counter-action and, consequently, to the 'disintegration' of banking supervision[83].

Moreover, there are concerns that the independence of the ESRB is endangered by the influence the ECB obtains over macro-prudential supervision through the SSM. It must be remembered that the ESRB is integrally dependent on the ECB for administrative support, and that the ECB is represented in the General Board and Steering Committee of the ESRB. Further, taking into account Europe's reliance on banking finance, the political dominance of the ECB as default supervisor of the banking system coupled with its monetary powers, and the fact that there is no clear dividing line between macro- and micro-prudential supervision, it is safe to assume that the SSM equips the ECB with influence extending far beyond its reserve powers under the SSM Regulation. In spite of impartiality requirements, it is difficult to conceive a situation where the ESRB's position will explicitly contradict that of the ECB.

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[81] Haar (n 79) 182.
[82] ibid, 182.
[83] ibid.

Consequently, there are indications that the institutional reform of the prudential supervisory architecture of the EU augments the impact of macro-prudential policy on the internal market. Importantly, a curious dynamic exists between the reliance of the CRD IV/CRR framework on national authorities and the considerable centralisation of macro-prudential powers under the SSM. While constitutional and political issues emerge from the ECB's influence over macro-prudential policy, what is relevant for the purposes of this paper is that the euro area and the internal market follow differentiated rates of integration. In turn, this generates concerns about the overall effectiveness of the ESFS. More importantly, considering that financial stability has to an extent precipitated institutional reform, and the influence of the SSM on macro-prudential policy, the gap between the euro area and the internal market serves as further evidence that the financial stability agenda can constitute a cause of fragmentation.

5. Conclusion

This paper has sought to demonstrate that, financial stability should not be accepted as the end that justifies any means. At the same time, it is difficult to reject financial stability as a target for prudential regulation. However, it is precisely because of the broad consensus that future instability must be prevented that financial stability is erroneously treated as a panacea. Reactionary post-crisis reform transforms financial stability, from an economic optimum, to a messianic regulatory objective.

These concerns relate both to the substantive, and the institutional dimension. With regard to the former, the CRD IV and CRR introduce a range of capital- and borrower-based measures, and overall enhance the powers of national supervisors. Ideally, these macro-prudential tools should be consistent with market integration. However, owing to the fact that the CRD IV/CRR framework revolves around national authorities, there exists a possibility that these tools undermine the unity of the internal market even if they are not used for improper purposes.

More specifically, macro-prudential tools under CRD IV/CRR demonstrate a degree of subjectivity and asymmetry. Their formulation, weaknesses in the envisioned cooperation and coordination mechanisms, as well as the limited mandatory reciprocity model of the CRD IV/CRR contribute to this effect. The shortcomings of the CRD IV/CRR are further augmented by those of the institutional setting. In particular, a curious dynamic emerged following the crisis between the SSM and the decentralised structure of macro-prudential policy. It has been argued that the ECB's leadership role may have a spillover effect on the overall architecture of macro-prudential supervision. This could be seen as widening the gap between the euro area and the internal market, and undermining the effectiveness of pan-European bodies such as the EBA and the ESRB.

In final analysis, substantive and institutional arguments indicate that the financial stability policy agenda has an alarming impact on the singleness and functioning of the internal market. It must be remembered that the inability of prudential regulation to address the transnational nature of the European financial market is considered as a factor which contributed to the financial crisis. With this in mind, and having examined that the new macro-prudential policy framework fails to adequately address core transnational issues, it is questionable whether the newfound emphasis on financial stability constitutes a paradigm shift. To some extent, the concerns raised can be tackled by, firstly, delineating the scope of financial stability and, secondly, developing an appropriate conceptual framework for macro-prudential policy. However, the starting point for a true paradigm shift needs to be the constitutional question of the co-existence between the euro area and the internal market. Guided instead by the policy goal of financial stability, prudential supervision in the EU is still in deep water.