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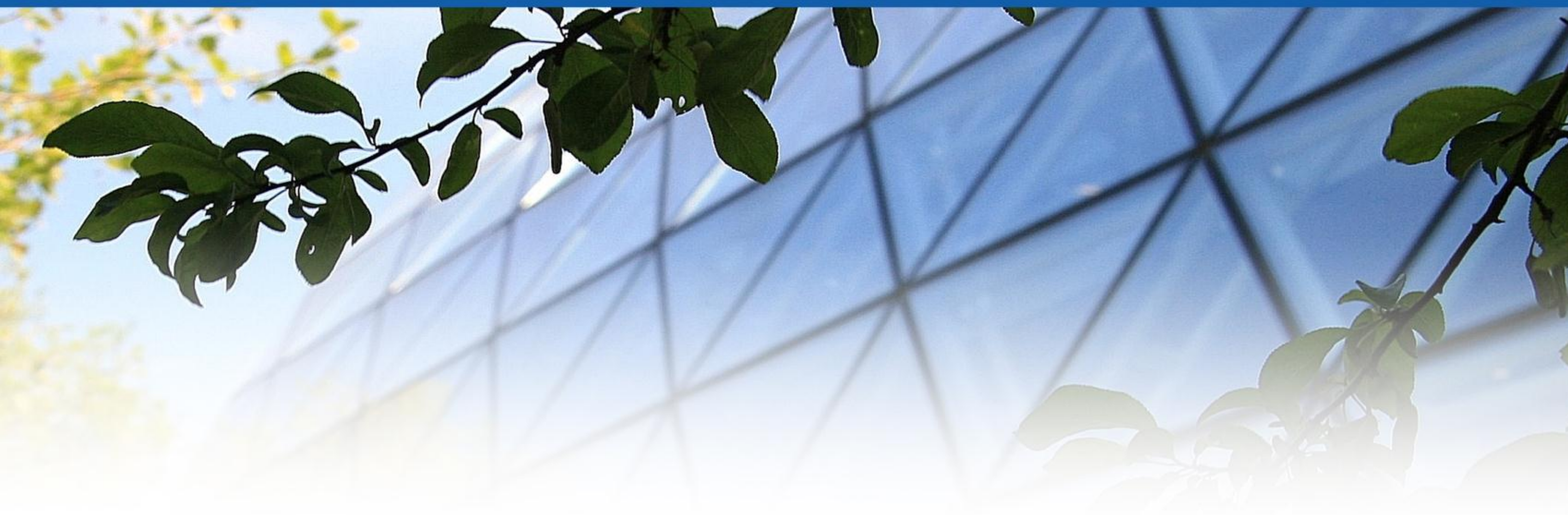

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Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board

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CAN SOFT LAW BODIES BE EFFECTIVE? SOFT SYSTEMIC RISK OVERSIGHT BODIES AND THE SPECIAL CASE OF THE EUROPEAN SYSTEMIC RISK BOARD•

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ABSTRACT

The global response to the financial crisis has included the establishment of new, or significantly revamped, institutions specifically dedicated to the task of overseeing systemic risk. Internationally, the Financial Stability Forum has morphed into the Financial Stability Board (FSB) and has been given a broader mandate. In Europe, a new body, the European Systemic Risk Board (ESRB), has been assigned the role of monitoring and assessing systemic risks. National systemic risk oversight bodies are being set up as well.

"Strengthening" and "reinforcing" are words that feature prominently in many policy statements relating to these institutional developments but many of these bodies, including the FSB and the ESRB, are designed to operate without legally-binding powers. This raises questions about how powerful they will actually prove to be. In this article we suggest that lack of formal power need not prevent systemic risk oversight bodies from acting in a credible and authoritative manner. We draw on existing experience of soft laws and institutions in international financial regulation to support this assessment. However, we also acknowledge that softer approaches have been shown to have weaknesses, particularly with respect to surveillance and enforcement. We suggest that the financial crisis has highlighted the limits of what can be achieved through informal methods and the importance of exploring harder alternatives.

We consider what the ESRB in particular can learn from the wealth of accumulated experience at the international level with respect to both strengths and weaknesses of an informal approach. At the same time, we emphasise that there is much about the ESRB's structure that is special because of its place within the EU constitutional and legal framework and in respect of which lessons drawn from international level experience do not pertain. We explore the implications of the ESRB's special situation. Close connections to bodies with formal power may enhance the ESRB's effectiveness. On the other hand, this capacity to have hard effect could also inhibit the ESRB. The net result could be the loss of some of the advantages, such as flexibility and willingness to experiment, that are associated with a softer approach.

An edited version of this article, entitled 'Can Soft Law Bodies be Effective? The Special Case of the European Systemic Risk Board', which focuses mainly on the ESRB and European law, is forthcoming in the *European Law Review* (December 2010), pp 751-776.

KEYWORDS: financial crisis, systemic risk, macro-prudential oversight, financial market supervision, soft law

JEL classifications: G01, G15, G18, G21, G24, G28, H12, K23

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PART I

Introduction

The prudential regulation and supervision of financial markets require continuous adaptation as the markets themselves evolve: in instruments traded, in institutional structures, and in the degrees of national and international integration. In the past decade the speed of change in the markets accelerated but the regulatory system struggled to keep pace. The consequences of that failure were evident in the recent crisis in banking and wholesale capital markets that threatened the stability of the global financial system. In terms of institutions and market structures, the crisis demonstrated the power of financial contagion in increasingly integrated financial markets. In terms of policy analysis, it made it clear that market-based financial regulatory models – so prevalent in Europe and the US before the crisis – do not adequately monitor and control systemic risks in financial markets. In terms of policy implementation, it showed that outdated regulation can even exacerbate negative aspects of the changing structure of the financial markets. For the EU in particular, the demonstration of how quickly financial losses could spread across Member State markets, as counterparties in multiple jurisdictions were exposed to high levels of financial risk emanating from outside their jurisdictions, was a sharp lesson on the limitations of existing EU legal principles and institutions in establishing the foundational elements of safety and soundness that must exist in order for an integrated internal market for capital and financial services to function properly.

The financial crisis has produced a global consensus on the need for more effective, better-coordinated macro- and micro-prudential regulation and supervision. Moreover, heightened awareness of the threats posed by financial markets - markets which have become increasingly seamless through the operation of large, complex financial institutions and through liberalised wholesale capital markets - has put it beyond question that the oversight of systemic risks has to be globally co-ordinated. It is now accepted that national, supranational and international arrangements need to dovetail with each other if the system is to have any hope of operating in a coherent and effective manner.

As part of this exercise in global co-ordination, around the world new, or significantly revamped, institutions specifically dedicated to the task of overseeing systemic risk are being set up. Such developments have been described as "essential steps forward".[1] Internationally, the Financial Stability Forum (FSF) has morphed into the Financial Stability Board (FSB) and has been given a broader mandate in respect of systemic risk. In Europe, a new body, the European Systemic Risk Board (ESRB) has been assigned the role of monitoring and assessing systemic risks.[2] In the UK, there is to be a new Financial Policy Committee in the Bank of England, which will have primary responsibility for macro-prudential supervision of the system in order to maintain overall financial stability.[3] In addition, financial stability has been added to the statutory objectives of the Financial Services Authority (FSA) and those of the Bank of England.[4] The US Wall Street Reform and Consumer Protection Act 2010 provides for the establishment of a Financial Stability Oversight Council. Switzerland restructured its system in 2009 by establishing a single regulator – the Financial Markets Authority (FINMA) – to oversee prudential regulation and investor and consumer protection, while creating a systemic risk oversight committee consisting of FINMA and the Swiss National Bank.[5] France is to establish a new Financial Regulation and Systemic Risk Council.[6]

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[1] H Paulson, quoted in 'The New Rules of Finance: Experts Grade the Legislation' *Wall Street Journal* July 16, 2010, A.5.
[2] G20 Communiqué, 'Declaration on Strengthening the Financial System' (London Summit, April 2009).
[3] HM Treasury, *A New Approach to Financial Regulation: Judgement, Focus and Stability* (Cm 7874, July 2010).
[4] Financial Services Act 2010, s 1;Banking Act 2009, s 238 inserting Bank of England Act 1998, s 2A.
[5] See Swiss Financial Market Supervisory Authority Act (FINMASA) (effective 1 Jan 2009).
[6] For the ECB's Opinion relating to this development see Opinion of the European Central Bank of 7 January 2010 on certain measures concerning banking and financial regulation (CON/2010/3). It has been suggested that the EU should mandate the

"Strengthening" and "reinforcing" are words that feature prominently in many policy statements relating to these institutional developments but the fact that many of the new bodies, and in particular for the purposes of this article the FSB and ESRB, will operate without legally-binding powers raises questions about how powerful they will actually prove to be. The possibility of the ESRB being a "toothless talking shop, which will duplicate activities already undertaken by other national and international institutions" has already been raised.[7] The thesis put forward in this article is that while much will depend on the legal framework by which it is established, the policy choices that have been made in its detailed design, the professionalism and efficiency of the implementation process, and also on the mechanisms that will underpin its relations with the EU institutions and the new micro-prudential supervisory authorities, in principle the ESRB's lack of formal power need not prevent it from acting in a credible and authoritative manner.

The article draws on the experience of soft laws and institutions in international financial regulation to support this assessment. Alternative modes of regulation and supervision have flourished by necessity at the international level because the capacity for formal law-making and enforcement is restricted. It is clear from accumulated experience at the international level that soft laws and institutions can exert considerable power and that they are not simply symbolic.[8] Indeed, as vigorous debate about the legitimacy of such activity demonstrates, the possibility that too much, not too little, power may be vested in organisations for which proper mechanisms of accountability and control may be lacking, is often the main concern. This is not to suggest that international experience reveals no shortcomings in a soft approach. In particular, serious concerns about weaknesses in surveillance in respect of countries' actual compliance with rules and standards to which they have formally signed up suggest that there are limits to what can be achieved through persuasion, and on the effectiveness of informal and economic sanctions particularly in relation to powerful countries that are unlikely to need financial support from international institutions.[9] Some of these limitations of soft law were evident in the financial crisis.

The crisis has demonstrated the need to adopt a more holistic approach to international financial regulation and supervision that involves linking micro-prudential supervision of individual banks with broader macro-prudential controls and oversight of the financial system. It has also highlighted the fact that the changing nature of financial markets and systemic risks necessitates a more muscular macro-prudential supervisory approach that requires enhanced institutional capacities at the international level to supervise and control systemic risks on a cross-border basis. Unlike micro-prudential supervision, which focuses on the regulation of individual firms, institutions and persons, macro-prudential supervision is responsible for oversight of the whole financial system and for ensuring that the regulation of financial markets takes into account broader developments in the macro-economy and financial markets. With increasing integration at the regional and international levels as a consequence

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introduction of national level systemic risk regulators across the Member States: S Kapoor, *Emergent Global Challenges: What Europe Needs to Do to Tackle the Triple Crises of Tax, Finance and Climate* (April 2010) (report requested by the European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS)).

[7] House of Commons Treasury Committee, *The Committee's Opinion on Proposals for European Financial Supervision* (Sixteenth Report of Session 2008–09), para 49. See also G Hertig, R Lee and JA McCahery, *Empowering the ECB to Supervise Banks: A Choice-Based Approach*, ECGI Finance WP 262/2009, Aug 2009; Kapoor, *Emergent Global Challenges*, (calling for the ESRB to have statutory powers).

[8] For a detailed study of both the coercive effect of international financial soft law and its limitations see CJ Brummer, 'How International Financial Law Works (and How it Doesn't)' (January 26, 2010). Georgetown Law Journal, Forthcoming. Available at SSRN: http://ssrn.com/abstract=1542829.

[9] IMF surveillance is established on the foundation of article IV of the IMF articles of agreement. For evaluation of IMF surveillance see D Lombardi and N Woods, 'The Politics of Influence: An Analysis of IMF Surveillance' (2008) 15 *Review of International Political Economy* 711; B Bossone, 'The Effectiveness of IMF Surveillance A study on global financial governance' (2008) 9 *World Economics* 27.

of the liberalisation of financial markets, the case for a more consolidated and proactive global system of financial regulation becomes increasingly compelling. Whilst there can be no doubt that soft law will continue to play an important role in supporting the institutional framework and normative content of macro-prudential regulation, it may be reaching its limits. In time, macro-prudential supervision may require a stronger and possibly more legalised international regulatory framework than the existing international soft law regime. This is a fundamental underlying issue that policymakers must grapple with as they consider how to build an international macro-prudential regime that strikes a balance between the rights and interests of sovereign countries, the responsibility of the G20 and its Financial Stability Board in overseeing the development of soft international standards and norms for monitoring and controlling systemic risk, and the role of the International Monetary Fund which has legal powers under Article IV of its Articles of Agreement to conduct macro-prudential surveillance of the global economy and financial system.

In this article we consider what the ESRB can learn from this wealth of accumulated experience with respect to both strengths and weaknesses of an informal approach. But, at the same time, we emphasise right from the outset that there is much about the ESRB structure that is unique to it and the European Union constitutional and legal framework within which it sits, and in respect of which lessons drawn from international level experience do not pertain. The ESRB forms an integral part of a structure within which hard enforcement powers are available and it will be empowered to act in ways that could trigger the exercise of those powers. We explore the implications of the ESRB's special situation. Close connections to bodies with formal power may enhance the ESRB's effectiveness. On the other hand this capacity to have hard impact may also inhibit the ESRB by forcing it, in effect, to adopt bureaucratic procedures and practices akin to those that are appropriate for a formal body and thus may result in the loss of some of the advantages of flexibility that are usually associated with a softer approach.

The article is organised as follows. In Part II we review in general terms the operation of soft law in international financial regulation, the ways in which it can exert a compliance "pull" and the concerns with regard to accountability and legitimacy that its operation can engender. We then use the example of the Financial Stability Board and its relationship with the IMF to examine these issues in a specific context. In Part III we consider EU soft law, first in general and then in relation to financial market regulation. Part IV looks in more detail at the very recent reform of the institutional arrangements for financial market supervision in Europe, with particular reference to the role of the ESRB. We examine the legal basis on which the ESRB is established, the nature and scope of its mandate, the challenges it is likely to face in building a reputation for competence and credibility, its relations with the new micro-prudential authorities, and certain issues of EU institutional governance, law and accountability that are presented by the emergence of this innovative and unprecedented body. Part V concludes.

PART II

Soft Law in International Financial Regulation

The use of soft law in international financial regulation: controversies and concerns

International financial regulation is mainly a system of "soft law" – meaning standards, guidelines, interpretations and other statements that are not directly binding and enforceable in accordance with formal techniques of international law but nevertheless capable of exerting powerful influence over the behaviour of countries, public entities and private parties.[10] The FSB (which brings together central

[10] International legal scholarship also recognises the concept of soft provisions within treaties or other binding legal instruments. Since international treaties relating to international financial regulation are insignificant, this type of soft law

banks, regulatory and supervisory authorities, ministries of finance, international financial institutions, standard-setting bodies, and committees of central bank experts[11]) lists twelve key standards for sound financial systems, all of which take the form of soft law.[12] Many of the organisations and other bodies that produce international financial regulatory standards are themselves "soft" in the sense that they are networks or (more-or-less) informally-constituted groups of public, and sometimes private, sector actors rather than organisations formally established by international Treaty.[13]

International soft law can have a hard impact by being adopted into the domestic legal order of a country or, in the case of the EU, supranational legal order; as *Slaughter* puts it, soft law can "offer a focal point for convergence".[14] International Treaty-based organisations, in particular the IMF and World Bank, can exert pressure on countries to adopt internationally-recognised standards and codes by using them as benchmarks in international assessments and reporting on the extent to which countries observe them,[15] thus, in effect, complementing soft law with soft (yet potentially powerful) enforcement.[16] Indeed, the IMF has been described as the "vehicle" of international financial soft law and as "the main instrument by which to disseminate new standards and codes globally, promote their adoption, and monitor their observance".[17] *Strauss-Kahn*, the IMF's Managing Director, has claimed that, while the IMF is not a global regulator, it plays a key role within the international set-up by monitoring the implementation of the agreed framework through its surveillance activities.[18] The endorsement of certain standards by the FSB (itself a soft organisation but one with a strong mandate from economically-developed countries to act as the global overseer of the financial markets) gives them particular authority, which is now reinforced by the commitment of FSB members to submit to periodic peer review.[19] "Naming and shaming" can also have an impact, as demonstrated by the work

need not be considered in this article. But see Sir Joseph Gold *Interpretation: the International Monetary Fund and International Law* (London: Kluwer International Law) (discussing how soft law emerges in the gaps of the IMF Articles of Agreement). See also, CM Chinkin, 'The Challenge of Soft Law: Development and Change in International Law' (1989) 38 *International and Comparative Law Quarterly* 850 notes that the generic term can be misleading simplification because of the diversity of instruments that it covers. For a variety of ways in which soft law can be defined, see A Boyle, 'Some Reflections on the Relationship of Treaties and Soft Law' (1999) 48 *International and Comparative Legal Quarterly* 901.

[11] http://www.financialstabilityboard.org/about/overview.htm

[12] The list is published at http://www.financialstabilityboard.org/cos/key_standards.htm

[13] The organisations that provide the key standards listed by the FSB include international Treaty-based associations (World Bank, IMF), less formally constituted public sector groups (such as the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the Organization for Economic Co-operation and Development (OECD)) and groups that have significant private sector representation (such as the International Accounting Standards Board (IASB)). The FSB itself performs a standard-setting role (compensation packages; cross-border co-operation in crisis management).

Generally on soft institutions: J Klabbers, 'Institutional Ambivalence by Design: Soft Organizations in International Law' (2001) 70 *Nordic Journal of International Law* 403.

[14] AM Slaughter, *A New World Order* (Princeton University Press, 2004) 180.

[15] On the IMF/World Bank Financial Sector Assessment Program (FSAP) and Reports on Observance of Standards and Codes (ROSCs), see http://www.imf.org/external/NP/fsap/fsap.asp (accessed November 2009). See also C Gola and F Spadafora, *Financial Sector Surveillance and the IMF* (IMF WP/09/247). Another example of soft enforcement is provided by the Financial Action Task Force (FATF) which operates a mutual evaluation process to promote implementation of its anti-money laundering and counter-terrorist financing standards. Each member jurisdiction is evaluated in turn by a team made up of other FATF members. FATF views evaluation exercises as a key component of its work. For a general report on evaluation methodologies and a report on recent exercises see Financial Action Task Force, *Annual Report 2008-2009*, 12-15.

[16] Chinkin, 'The Challenge' n 10, 862-3.

[17] Bossone, 'The Effectiveness', n 9, 38.

[18] D Strauss-Kahn, 'National, European, or Global? The Future of Bank Regulation' speech in Paris, 24 November 2009. Text of speech available at http://www.imf.org/external/np/speeches/2009/112409.htm.

[19] FSB, *Framework for Strengthening Adherence to International Standards* (January 2010). On the "hardening" effect of this commitment to peer review: DW Arner and MW Taylor, 'The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?' (2009) 32 *University of New South Wales Law Journal* 488, 498-500.

of the Organization for Economic Co-operation and Development (OECD) with respect to tax havens.[20]

A state's compliance with "best practice" international standards can result in lower funding costs for its sovereign debt and more favourable financing terms for its financial institutions. Similar market incentive-related reasons may lead banks and other regulated firms to adopt soft international standards, even when the country in which they are based has not implemented them, because they will want to signal to the global market that they adhere to the latest, most sophisticated models that have received the approval of the FSB and other international bodies. International soft law can therefore be highly influential by serving as "best practice" market norms to which industry players adhere for a range of motives from positive appreciation of the benefits of international standardisation through to a defensive urge to demonstrate that they can be trusted to self-regulate.[21]

Soft law expands the international regulatory toolkit.[22] Hard law ordinarily gives rise to enforceable obligations and therefore has to be reasonably certain and predictable so that people can determine what is expected of them.[23] Soft law, not being directly enforceable, can be more open-textured. This means that some international standards may be articulated at too high a level of generality to be immediately operational and will need to be supplemented by more detailed rules enacted at national or supranational level to make the position more concrete and to ensure practical effectiveness. The tendency for many soft law instruments to leave considerable leeway for adaptations to fit local circumstances, thereby not encroaching too far on sovereign legislative autonomy, is one of the advantages of the soft law concept: it can both facilitate consensus in the initial standard-setting process and avoid implementation misfits.[24] However, instruments do not have to be loosely worded to be regarded as soft law as the category is wide enough to accommodate technical standards that are written in quite specific language as well.[25] Much of the Basel II capital adequacy framework, which is perhaps the best known and most powerful set of soft law international financial regulation standards, is quite detailed in stipulating "risk-based process frameworks" that is, a set of principles, standards and rules for regulators to measure the particular risks that an institution faces.[26] So, too, are International Financial Reporting Standards.[27] These examples illustrate another aspect of soft law's flexibility that can be viewed positively, namely that the standard-setters can include bodies and groups

[20] In a report issued in 2000, the OECD identified a number of jurisdictions as tax havens. By 2009 no country remained on the list because all had given commitments to implement OECD standards with respect to transparency.
See http://www.oecd.org/document/57/0,3343,en_2649_33745_30578809_1_1_1_1,00.html

[21] The IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies* (2004 (updated 2008) is an example of an international code aimed at influencing industry practice. See
http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf.

[22] GC Shaffer and MA Pollack, 'How Hard and Soft Law Interact in International Regulatory Governance: Alternatives, Complements and Antagonists' (2010) 94 *Minn L Rev* 706.

[23] *Sunday Times* v. *United Kingdom* (1979) 2 ECHR 245, 271, 149.

[24] Generally on reasons for using soft law see H Hillgenberg, 'A Fresh Look at Soft Law' (1999) 19 *European Journal of International Law* 499.

[25] Chinkin, 'The Challenge', n 10, 852.

[26] For example, in Pillar 1 of the Basel II Accord, the Basel Committee recognises that minimum regulatory capital "floors based on the 1988 Accord will become increasingly impractical to implement over time and therefore believes that supervisors should have the flexibility to develop appropriate bank-by-bank floors that are consistent with the principles outlined in this paragraph, subject to full disclosure of the nature of the floors adopted": *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version, Part 2: The First Pillar – Minimum Capital Requirements,* (BIS: Basel Committee on Banking Supervision, 2006) 13-14.

[27] It is sometimes said that IFRS is a "principles-based" system and a comparison is made with US domestic accounting standards, which is said to be a "rules-based" system but Cunningham has argued convincingly that this difference is overstated and that both systems use a combination of bright line rules and vaguer concepts: LA Cunningham, 'A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting' (2007) 60 *Vanderbilt Law Review* 1411.

that have no capacity to make Treaties or other forms of hard law;[28] this enables those with appropriate expertise to contribute directly to the regulatory process.

Soft institutions are often praised for their flexible decision-making structures. Often comprised of a limited number of participants,[29] they are seen to be able to react quickly to changing circumstances, which, in a field as dynamic as international financial market regulation, can be a particularly valuable characteristic. These institutional features lead into a further perceived advantage of the soft law concept, namely, that it is a mechanism that can be superior to hard law-making processes in meeting the need for regulation that can be changed and adapted in response to the ever-evolving, highly-complex interactions of the modern world.[30] The capacity for soft law to be changed more easily than hard law may foster willingness to "try out" regulatory innovations in circumstances of uncertainty; if the experiment "works", this can, in turn, lead to a stabilisation of expectations in that area.[31] However, it should not be assumed that the softness of a standard setter's institutional set-up guarantees a swift response. For example, the International Accounting Standards Board (IASB), the soft standard-setter for international financial standards, failed to meet the expectation of EU institutions and some European politicians for a rapid response to problematic accounting issues in the 2007-9 financial crisis; according to the European Commission, the IASB had shown itself to be "inflexible, slow, over-academic and out of touch".[32]

While there is much to be said for soft law, the picture is not wholly benign as a lively debate in international law scholarship about the merits of softness indicates. Should soft law be regarded as "law"? It is clearly a fiction to regard many of the international standards on financial regulation as purely optional measures because they are bolstered by well-defined supranational processes for follow-up, with institutional responsibilities and timetables for implementation and frameworks for monitoring and reporting that can leave affected parties, including sovereign states, with little choice but to follow them. Admittedly, shortcomings in international surveillance give credence to the view that parties may sometimes be able to get away with paying lip-service to international standards while diverging from them in their actual practices but creative compliance is a problem that can arise in a hard law environment as well.[33] Certain weaknesses in oversight and "enforcement" do not invalidate the general point that the terminology of "law" seems apt in this context because it usefully captures the extent to which non-binding standards can have significant hard impact. However, it is important to point out that it is not semantics that lies at the heart of scholarly discourse on softness in international law.

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[28] The Basel Committee, which is responsible for capital adequacy standards, is composed of Central Bank Governors and senior financial market supervisors. See K Alexander, 'Global Financial Standard Setting, the G10 Committees, and International Economic Law' (2009) 34 *Brooklyn Journal of International Law* 861. The International Accounting Standards Board, which is responsible for international financial reporting standards, is comprised of accounting experts: E Ferran, 'Capital Market Openness After Financial Turmoil', forthcoming in P Koutrakos and M Evans (eds) *Beyond the Established Orders – Policy Interconnections Between the EU and the Rest of the World* (Hart Publishing, 2010).

[29] D Zaring, 'Three Challenges for Regulatory Networks' (2009) 43 *International Lawyer* 211, 214. (attributing the Basel Committee's success to its exclusivity).

[30] Boyle, n 10, 903.

[31] K Abbott and D Snidal, 'Hard and Soft Law in International Governance' (2003) 54 *International Organization* 421.

[32] C McCreevy, 'Financial Reporting in a Changing World: Keynote Address', 7 May 2009. Text of speech available at http://www.iasplus.com/europe/0905mccreevy.pdf.

[33] For example, although there has been general signing up to transparency standards in respect of tax information, the record on implementation is much more patchy (OECD, *A Progress Report on The Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard: Progress made as at 18th February 2010*) and this remains an issue with which the G20 is particularly concerned: *Leaders' Statement: Pittsburgh Summit* 24-25 September 2009. Brummer, 'How International Financial Law Works', n 8, 38 - 44(considering weaknesses in monitoring and other lax disciplines that undermine the compliance pull of soft law).

Klabbers, a leading critic of soft law, concedes that if the use of the term "soft law" were limited to the descriptive, that would, in his view, be a misleading use of language but there would be little to discuss.[34] His real concern is that "descriptive categories sooner or later transform into normative categories", with potentially disturbing consequences. By operating on the fringes, outside the disciplines that control formal law-making processes, soft law, he contends, "can be regarded as a ploy by the powers that be to strengthen their own position to the detriment of others".[35] Further, "unless we insist that law can only be made through the procedures that themselves have been created to regulate the creation of law, the resulting norms, however nobly inspired, will always remain suspect … we need to insist on a degree of formalism because it is precisely this formalism that protects us from arbitrariness on the part of the powers that be".[36] These comments raise important issues: whatever the strengths of loose informal groups of bureaucrats or experts in reacting quickly and effectively to new situations, it is indisputable that their flexibility can also expose them to charges of being unrepresentative, lacking in transparency, unaccountable, at risk of being used by insiders to promote their own agenda, and in danger of being captured by well-placed interest groups. Given the potential for soft standards and bodies to have a hard impact, these are non-trivial concerns. However, undue pessimism may be misplaced because of the balancing effect of the practical pressures on international soft law bodies to be more open and accountable in order to retain legitimacy and effectiveness. While scholarship has yet to develop unifying descriptive and normative theories on the operation of the influences that control the exercise of soft regulatory power at the international level – some have pointed to the emergence of a system dubbed global administrative law[37] but others are more sceptical about the feasibility and even desirability of identifying a universal set of administrative law principles[38] – at some level, however imperfectly, the apparatus of global "soft" governance has been obliged to take legitimacy and accountability concerns on board.[39]

The deployment of various checks and balances to keep the use of soft law under control provides room for a pragmatically optimistic assessment of the phenomenon. As *Boyle* has noted, soft law can be abused but so can other legal forms; in his view, soft law has been more helpful than objectionable; he concludes that it is best regarded as "simply another tool in the professional lawyer's armoury".[40] That soft law is an indispensable tool is evident in the international reform agenda that emerged during 2009 in response to the financial crisis. Even though emergency situations can open the door to radical ideas, proposals for new hard-edged, Treaty-based rules or institutions have not gained momentum in the immediate post-crisis period.[41] Instead the focus has been on reforming the soft system to make it more effective and more representative. Despite the various imperfections and limitations of softer methods, in the field of international financial market regulatory reform it appears to be accepted that

[34] J Klabbers, 'The Undesirability of Soft Law' (1998) 67 *Nordic Journal of International Law* 381, 385.
[35] Ibid, 387.
[36] Ibid, 391. See also P Weil, 'Towards Relative Normativity in International Law' (1983) 77 *American Journal of International Law* 413.
[37] Meaning 'mechanisms, principles, practices, and supporting social understandings that promote or otherwise affect the accountability of global administrative bodies, in particular by ensuring they meet adequate standards of transparency, participation, reasoned decision, and legality)': B Kingsbury, N Krisch and RB Stewart, 'The Emergence of Global Administrative Law' (2005) 68 *Law and Contemporary Problems* 15, 17.
[38] C Harlow, 'Global Administrative Law: The Quest for Principles and Values' (2006) 17 *European Journal of International Law* 187.
[39] K Alexander, R Dhumale, and J Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (OUP, 2006) 34-74, analysing the effectiveness, accountability and legitimacy of the international financial standard-setting bodies.
[40] Boyle, 'Some Reflections', n 10, 913.
[41] Note, however, the High Level Group on Financial Supervision in the EU, *Report* (February 2009) (*de Larosière Report*), para 230 for a suggestion that, over the medium term, thought might be given to establishing a full international standard-setting authority, established by a treaty. See also the reflections of Mervyn King (Bank of England) discussed below: n 72 and surrounding text.

no better option is realistically available in the immediate future, and that a soft law-based approach can have meaningful effect.

The Financial Stability Board: a soft institution with real power?

The Financial Stability Board is the international body that has been charged with the task of general oversight of systemic risk. The FSB was formally created in April 2009 by the G20 Heads of State with a mandate to promote global financial stability.[42] It has responsibility, working with the IMF, for the issue of early warnings.[43] In broad terms, there are similarities between some of the functions that the FSB performs at the global level and those that have been entrusted to the ESRB within Europe. However, the FSB's remit is wider in certain respects.

As noted already in this article and in contrast to international economic organisations such as the WTO,[44] the IMF, or BIS,[45] international standard-setting bodies in the financial market field are not entities with separate legal personality created by States, but rather informal associations of state representatives and/or professionals that address specific problems and identify issues of concern. The complexities of global finance have driven the development of co-operative and flexible regulatory solutions. The FSB is an institutional continuation of this flexible institutional approach.

The FSB is composed of senior representatives of national financial authorities (central banks, regulatory and supervisory authorities, and ministries of finance), international financial institutions, standard-setting bodies, and committees of central bank experts from leading developed countries and some large developing countries, including the co-called BRIC countries, Brazil, Russia, India and China.[46] The FSB's membership includes significantly more countries than the traditional membership of the G10 committees which, according to some observers, enhances its accountability and legitimacy.[47] Membership carries with it obligations to pursue the maintenance of financial stability, to maintain the openness and transparency of the financial sector, to implement international financial standards, and to submit to periodic peer reviews.

The full mandate of the FSB is wide ranging: to assess vulnerabilities affecting the financial system and identify and oversee action needed to address them; to promote co-ordination and information exchange among authorities responsible for financial stability; to monitor and advise on market developments and their implications for regulatory policy; to advise on and monitor best practice in meeting regulatory standards; to undertake joint strategic reviews of the policy development work of the international standard-setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps; to set guidelines for and support the establishment of supervisory

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[42] G20 'Declaration', n 2, 2.

[43] IMF, 'IMF-FSB Early-Warning Exercise' (Factsheet, October 2009).

[44] The WTO was created by the Uruguay Round of Multilateral Trade Negotiations which adopted the WTO Agreements. *See* Marrakesh Agreement Establishing the World Trade Organization pmbl., Apr. 15, 1994, 1867 U.N.T.S. 154, 33 I.L.M. 1144.

[45] The BIS is an international organisation created under the Hague Agreements of 1930 and the Constituent Charter of the Bank for International Settlements of 1930: JC Baker, *The Bank for International Settlements: Evolution and Evaluation* (Quorum Books, 2002) 34. The BIS served as the payment agent for the European Payments Union, which facilitated the restoration of currency convertibility for the western European countries following the Second World War.

[46] The FSB member countries ares: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, United Kingdom, United States. Non-state representatives include the European Central Bank, International Financial Institutions, International Standard-setting bodies, and Committees of Central Bank Experts. See Financial Stability Board, Press Release, Annex (9 Jan 2010).

[47] See Alexander, 'Global Financial Standard Setting', n 28. The Basel Committee has also attempted to enhance the accountability and legitimacy of its international standard setting process by increasing its membership to twenty countries with the addition of Australia, Brazil, China, India, Korea, Mexico and Russia as full-voting members.

colleges; to manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and to collaborate with the IMF to conduct early warning exercises.

The FSB is thus part of a new and emboldened drive to devise more effective international supervisory and regulatory frameworks to monitor systemic risk and assist countries in establishing an effective macro-prudential supervisory regime.[48] This will require a more holistic approach to regulation and supervision that recognises the interdependence between micro- and macro-prudential risks across financial markets, and enhanced oversight of the linkages between institutions and between institutions and the broader financial system.

The focus on macro-prudential regulation involves, among other things, devising regulatory standards to measure and limit leverage levels in the financial system as a whole, requiring financial institutions to have enhanced liquidity reserves against short-term wholesale funding exposures, and, more generally, counter-cyclical capital regulation whereby capital requirements are linked to points in the macro-economic and business cycle. Macro-prudential regulation will change in important respects the nature of prudential regulation and supervision. For instance, some prudential regulatory approaches focussed on individual firm outcomes and allowed firms to experiment with different risk management practices so long as they achieved satisfactory firm outcomes that were measured by shareholder prices and whether regulatory principles were largely being fulfilled.[49] This approach did not take into account the aggregate effect of firms' performance on the financial system in terms of leverage generated and liquidity risk exposures. To address adequately these macro-prudential risks in the future, prudential regulation will necessarily become more rules-based at the level of the firm and at the level of the financial system.[50] But the effective implementation of this more prescriptive macro-prudential framework on an international basis could stretch the soft law approach to its limits and increase the need to think seriously about the adoption of harder alternatives.

Since its foundation the FSB has been working intensively within the established soft law approach on a diverse range of issues that fall within its remit. For example, taking forward work done by its predecessor, the Financial Stability Forum, it has overseen reviews of the system of supervisory colleges to monitor each of the largest international financial services firms.[51] It has developed guidance notes and other documentation (including draft outline resolution plans) to assist with the practical implementation of its *Principles for Cross-Border Cooperation on Crisis Management*.[52] It has established *Principles for Sound Compensation Practices*, and reinforced them with *Implementation Standards* to strengthen adherence.[53] Working with IOSCO, it is involved in the development of a consistent regulatory framework for the oversight of hedge funds.[54] It is overseeing the emergence of national and regional frameworks for the registration, regulation and oversight of credit rating agencies and encouraging countries to engage in bilateral dialogues to resolve inconsistencies and frictions that may arise because of different regulatory approaches.[55] It has been

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[48] JC Trichet 'Macro-prudential supervision in Europe', Text of the 2nd City Lecture. Text of speech available at http://www.ecb.int/press//key/date/2009/html/sp091211_2.en.html
[49] eg, See FSA, *Principles-based Regulation* (London: April 2007).
[50] For instance, the *Turner Review* supported the creation of a macro-prudential regulatory regime that is directly linked to the micro-prudential oversight of individual firms. See FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (London: 2009).
[51] FSB, *Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability* (September 2009) 2-3; FSB, *Progress since the Pittsburgh Summit in Implementing the London Summit Recommendations for Strengthening Financial Stability* (Nov 2009), 13; FSB, *Progress since the St Andrews Meeting in Implementing the London Summit Recommendations for Strengthening Financial Stability* (Apr 2010), 17.
[52] FSB, *Progress* (Nov 2009), 14.
[53] FSB, *Principles for Sound Compensation Practices: Implementation Standards* (September 2009).
[54] FSB, *Progress* (Nov 2009), n 51, 11-12.
[55] Ibid, 13.

specifically asked by the G20 to address the "too big to fail" problems associated with systemically important financial institutions and is developing a work programme to take this forward.[56] As part of its work in this area, at the November 2009 G20 meeting in St Andrews, the FSB, the IMF and the BIS put forward a paper setting out guidelines for use by national authorities to assess whether a financial institution, a market, or an instrument is systemically important.[57]

The soft institutional structure of the FSB provides a flexible international framework for addressing financial stability concerns. The speed with which it has addressed an array of regulatory reform issues can be attributed in significant part to its institutional flexibility and the legally non-binding nature of its standards and rules, which facilitate regulatory and policy experimentation in addressing complex areas of economic policy. From the regulatory perspective, that is looking simply at the developing framework of standards, guidance and other instruments as they appear "on the books", it is credible to contend that the FSB has usefully exploited the historic opportunity presented by the financial crisis and that its efforts have led to progress on some seemingly intractable issues.

What, though, of the FSB's ability to influence and change behaviour by playing a role in overseeing the implementation of standards and recommended practices, overseeing action to address vulnerabilities and so forth? While only the members of the FSB are under specific obligations (and those only by reason of membership, and not by virtue of a more overarching principle of public international law), these represent significant commitments by the world's leading developed and developing economies to adopt regulatory reforms and a framework for strengthening international standards. The economies of the FSB members – the G20 group of countries – produce almost 90% of world GDP. This suggests that it is well-placed to influence behaviour by employing "leading by example" strategies. Moreover the FSB also has among its membership representatives of other key standard-setting bodies. Reviews, such as the thematic review of compensation practices launched in January 2010, are a mechanism whereby pressure can be put on FSB sovereign members to take stock of their records in implementation and to give (non legally-binding) commitments for the future. Follow up work on the implementation of standards provide opportunities to highlight both "best practice" and areas of weakness. The agreement by member countries to submit to periodic peer reviews has been identified by some as a potentially significant step in the direction of global co-ordination.[58] Particularly noteworthy as transparency-enhancing measures are the periodic progress reports that the FSB now makes to the G20. These reports give a general overview of progress by international standard-setters, countries and others in implementing G20 recommendations. Although not judgmental, regular objective and systematic reports such as these can be helpful in ensuring that momentum is maintained. With respect to non-G20 jurisdictions, the FSB, since it does not have formal legal sanctions at its disposal, must perforce rely heavily on the technique of "leading by example", supplemented by the possibility of "naming and shaming" non-cooperative jurisdictions[59] (with the threat of economic sanctions in reserve[60]) but, as we have noted already, market-based reputational sanctions for entities that are perceived to be non-compliant with best practice can be significant.[61]

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[56] Ibid, 9. See also FSB-IMF, *The Financial Crisis and Information Gaps* (Oct 2009).
[57] FSB, *Progress since the St Andrews Meeting*, n 51, 9 – 10.
[58] B Masters and D Pimlott, 'Peer Reviews Aim to Co-ordinate Bank Reforms', *Financial Times*, 11 January 2010, 2; Arner and Taylor, 'The Global Financial Crisis', n 19. See G20 Leaders' Statement (6-7 Nov. 2009) Meeting of G20 Finance Ministers adopting a 'mutual assistance process' for G20 financial supervisors.
[59] FSB, *Framework for Strengthening Adherence to International Standards* (January 2010).
[60] *Leaders' Statement: Pittsburgh Summit*, n 33, declares a readiness to use countermeasures against OECD-designated tax havens.
[61] Brummer, 'How International Financial Law Works', n 8, 37- 8 (discussing the impact of "naming and shaming" and of other institutional sanctions).

Nevetheless, softer methods of enforcement are open to criticism from an effectiveness perspective. The implicit underlying assumption of the *Framework for Strengthening Adherence to International Standards* published by the FSB in January 2010 is that the past record of the operation of soft mechanisms, such as leading by example, peer review, and naming and shaming in promoting compliance, is sub-optimal and needs to be bolstered. A strengthening process is now in hand. G20 countries have recently stressed their willingness to use economic sanctions against recalcitrant jurisdictions. An arrangement for FSB-IMF collaborative, half-yearly early warning exercises to strengthen assessments of systemic, low probability-high impact risks to the global outlook and to identify possible mitigating actions has been put in place.[62] These exercises are aimed at providing policymakers with policy options and, as such, they add to the data-gathering, analysis and evaluation work and information-sharing activity that the IMF already conducts with a view to preventing crises by identifying policies to address systemic risks.[63] It is thought that by combining the IMF's macro financial expertise with the FSB's regulatory perspective a more holistic view of emerging global concerns can be formed.[64] The exercises are expected to feed into the IMF's surveillance activities and thus to be a route by which findings and policy recommendations may acquire more concrete effect.

Although the IMF's surveillance power under Article IV of the Articles of Agreement covers global economic developments as well as national economies, it has in practice only focused its surveillance and early warning assessments on individual economies. Efforts to improve IMF surveillance are now underway to enhance its ability to identify common shocks and risk correlations across countries and the systemic implications of large cross-border financial institutions.[65] These efforts attempt to address shortcomings in IMF surveillance that were exposed by the financial crisis, including failure to spot the aggregate implications of individual risks, lack of follow-through and over-optimism.[66] The IMF now has recognised the importance of monitoring systemic risk and the inter-linkages between economies in the global financial system.[67]

Exactly what impact improvements in surveillance and FSB-IMF early warnings will have remains to be seen.[68] Whether the new arrangements will be more effective than warnings issued by the IMF and other bodies in the period before the financial crisis – warnings that, according to an IMF review, were insufficiently specific, detailed, or dire to gain traction with policy makers[69] – can only be a matter for conjecture. Indeed, generally across the spectrum of monitoring and oversight activities entrusted to the FSB, we are more in the realm of speculation and prediction rather than that of hard empirical data relating to actual performance. Some important opinion-formers are sceptical: for example, *Stiglitz*, a Nobel prizewinner and former chief economist of the World Bank, is among those who have expressed doubt about the FSB's ability to speed up the development of effective co-ordinated international

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[62] *IMF-FSB Early Warning Exercise* (IMF Factsheet, 2009).
[63] The IMF's *Global Financial Stability Reports* and *World Economic Outlook Reports* are its "flagship" global surveillance publications.
[64] IMF, *Initial Lessons of the Crisis for the Global Architecture and the IMF* (IMF Strategy, Policy and Review Dept, 2009). Text available at
http://www.imf.org/external/np/pp/eng/2009/021809.pdf
[65] T Kato, 'Early Warning Systems and Their Role in Surveillance, A Keynote Address' High-Level Seminar, Singapore, 12 February 2010. Text of speech available at
http://www.imf.org/external/np/speeches/2010/020910.htm
See also Strauss-Kahn, 'National, European, or Global?', n 18.
[66] IMF, *Initial Lessons*, n 64.
[67] FSB-IMF, *The Financial Crisis and Information Gaps*, n 56.
[68] ER Carrasco, 'The Global Financial Crisis and the Financial Stability Forum: The Awakening and Transformation of an International Body' (2010) 19(1) *Transnational Law & Contemporary Problems* 203.
[69] FSB-IMF, *The Financial Crisis and Information Gaps*, n 56. See also J Wilkinson, K Spong and J Christensson, 'Financial Stability Reports: How Useful During a Financial Crisis?' (2010) 95 *Economic Review - Federal Reserve Bank of Kansas City* 41 (finding that regular financial stability reports were a useful tool for identifying risks but that regulators and financial institutions failed to respond with sufficient vigour).

financial regulation.[70] Even those who, like us, take a relatively optimistic view of the compliance pull that can be exerted through monitoring, information gathering, analysis and evaluation, transparency, peer pressure, market rewards and the like must concede that there are limitations to what can be achieved through essentially softer methods.

Moreover, an unavoidable paradox of softer methods is that success in terms of practical effectiveness feeds the intensity of concerns about the accountability and legitimacy of the relevant actors. As Brummer notes, "to the extent to which international financial law is coercive, it poses significant problems from the standpoint of legitimacy".[71] Indeed, the attention that the FSB is attracting on this front could be viewed an indirect sign of its growing capacity to exert real power and influence. The Governor of the Bank of England, *King*, has raised important questions regarding the accountability and legitimacy of FSB standards for countries not represented in the G20. He observed that "the legitimacy and leadership of the G20 would be enhanced if it were seen as representing views of others countries too".[72] Close collaboration between the FSB and the IMF is a step towards addressing this concern because, as *Bossone* has pointed out, "with all its limitations, the IMF is a far more legitimate, transparent and accountable institution than any self-selected 'G' group of countries".[73] However, as this quotation implies, the involvement of the IMF does not obviate all such problems because the IMF itself presents legitimacy problems and, moreover, it relies on formalistic procedures that can be an impediment to the delivery of swift, flexible responses.[74] The need for the IMF to develop a "re-energized multilateral mandate" and to engage in internal governance reforms "to reflect the evolution of the world economy and to increase its legitimacy and effectiveness in addressing today's global challenges" has been widely recognised.[75]

This, then, takes us back to the conclusion that we came to in the first section of this Part. The FSB conforms quite closely to the general expectations we identified in respect of a soft law-based approach. Soft law and softer methods of "enforcement" represent pragmatic solutions to difficult problems in the field of international financial regulation. They help to bridge the gap between regulation that is tied to, and dependent on, national and supranational legal systems and the need for global consistency and convergence. But they have shortcomings and limitations and can create some new difficulties of their own, particularly with regard to accountability and legitimacy and in ensuring an effective international macro-prudential supervisory and regulatory regime. Our examination of the FSB does not cause us to revisit our conclusion that we can acknowledge and give weight to these imperfections while still maintaining a belief in the ability of softer methods to achieve meaningful practical results.

Nevertheless, some caveats are in order. International financial soft law has played an important role in influencing and shaping state regulatory and supervisory practice and has had a significant impact on the global financial governance debate. The legal implications of the international financial standards produced by the FSB and its international standard setting bodies have raised important questions

[70] J Stiglitz,'Watchdogs Need Not Bark Together' *Financial Times*, 10 February 2010, 9.
[71] Brummer, 'How International Law Works', n 8, 57.
[72] M King, Text of Speech at the University of Exeter (19 Jan 2010), 8. Text of speech available at http://www.bankofengland.co.uk/publications/speeches/2010/speech419.pdf
[73] Bossone, 'The Effectiveness', n 9, 28.
[74] IMF, *Initial Lessons*, n 64.
[75] The quotations in the text are taken from Committee on IMF Governance Reform, *Final Report* (March 2009). This committee was established by the IMF to review its governance. Follow-up to this review is ongoing. Quota and voice reforms to make quotas more responsive to economic realities by increasing the representation of fast-growing economies and to give low-income countries more say in the IMF's decision making have been adopted and are in the process of being accepted by member countries: *IMF Quotas* (IMF Factsheet, October 2009). The G20 has backed governance reform to deliver an IMF with more credibility, legitimacy and effectiveness: *Leaders' Statement: Pittsburgh Summit* , n 33.

regarding the definition, relevance, and development of international financial law more generally. The growing importance of the international financial standards, such as the Basel Capital Accord, and their acceptance by most countries for their domestic regulatory systems have demonstrated the importance of international financial soft law in influencing state practice.[76] It has also shown that states in the financial regulatory arena have a certain disregard for using traditional public international law to govern state practice and the operations of global financial markets.

However, the catastrophic financial crisis and economic downturn that has plagued Western financial markets from 2007 to 2010 has raised important issues about the content and scope of international financial regulation and in particular the role of soft law in international financial regulation. Macro-prudential supervision and regulation now provides the overarching structure for the reformed international financial architecture. Macro-prudential supervision will necessarily entail a more rules-based approach to financial regulation involving counter-cyclical capital ratios defined by points in the economic cycle, liquidity ratios, leverage caps for banks and firms and possibly across whole sectors of the broader financial system. It may be difficult for this regulatory framework to work effectively on a global basis if it is to rely primarily on legally non-binding international standards and rules. The nature of international macro-prudential supervision will require rules and strict limits that are applied at the level of both the national and international financial systems. The existing international soft law regime may struggle to accommodate and ensure effective implementation of this more rules-based framework. It is thus possible that the regulation of systemic risk in a global macro-prudential regime could become a catalyst for significant change in the character of international financial law.

PART III

Soft Law in EU Financial Regulation

EU soft law: some general issues

EU law provides a generously furnished regulatory toolkit covering both hard and soft mechanisms. Some fifteen separate types of legal instrument were found to be in operation pre-Lisbon.[77] Some types of legal instrument disappear under the Lisbon Treaty but the main types– Regulations, Directives, Decisions, Recommendations and Opinions– continue.[78] The latter two – Recommendations and Opinions – are forms of EU soft law but the category can also embrace communications, notices, guidelines, codes of conduct and interpretative declarations.[79] According to *de Witte*, the EU's elaborate lawmaking structure "adequately performs its technical function of providing a set of legal tools to turn EU policy into practical reality".[80] For *von Bogdandy*, *Bast* and *Arndt*, while the structure is "complex", "it is not chaotic".[81]

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[76] Zaring, 'Three Challenges', n 29 (suggesting that one of the testaments to the effectiveness of the Basel Committee lies in the blame that is being laid at the feet of its second capital accord for the current financial crisis).
[77] J-C Piris, *The Constitution for Europe: A Legal Analysis* (Cambridge: CUP, 2006) 71.
[78] TFEU, art 288. B de Witte, 'Legal Instruments and Law-Making in the Lisbon Treaty' in S Griller and J Ziller (eds), *The Lisbon Treaty: EU Constitutionalism Without a Constitutional Treaty?* (Vienna: Springer, 2008) 79, 95-6 notes certain differences in the Lisbon regime in the functions performed by decisions.
[79] L Senden, *Soft Law in European Community Law* (Oxford: Hart Publishing, 2004) 3.
[80] de Witte, 'Legal Instruments', n 78, 83.
[81] A von Bogdandy, J Bast and F Arndt, 'Legal Instruments in European Union Law and Their Reform: A Systematic Approach on an Empirical Basis' (2004) 23 *Yearbook of European Law* 91, 92.

In this highly-legalised environment and against the background of a deep political commitment to the building of an internal market and broad acceptance of the restrictions on individual Member State autonomy that this process involves, there is not the same impetus as exists at the international level to turn to soft law to overcome obstacles to the making of hard, enforceable, law. Nevertheless, as in national legal orders, the EU institutions can opt for softer alternatives where appropriate, provided there is a Treaty basis for this step.[82]An important distinction between soft law in the EU legal framework and international soft law is that EU soft law may impact on directly-enforceable rights and obligations of individuals.[83] This is an important constraint on its use.

In general, soft law is on the rise in the EU.[84] Soft law in the European context has been defined in a major study by *Senden* as "rules of conduct that are laid down in instruments which have not been attributed legally binding force as such, but nevertheless may have certain (indirect) legal effects, and that are aimed at and may produce practical effects".[85] Its use can be controversial, especially where it is deployed instead of a hard law instrument because this raises questions about the legitimacy of "surrogate" law.[86] The use of soft law as an alternative to legislation ties in with the softer approach to regulation espoused by new modes of governance thinking[87] but it can also be seen in more disturbing terms as a threat to law's special position within the EU order.[88] The European Parliament has warned that the use of soft law is liable to circumvent the properly competent legislative bodies, may flout the principles of democracy and the rule of law, and also those of subsidiarity and proportionality, and may result in actions that do not have a Treaty basis and which are therefore ultra vires.[89] It has suggested that soft law also tends to create a public perception of a "superbureaucracy" that is remote from, or even hostile to, citizens and willing to reach accommodations with powerful lobbies.[90] But the Parliament concedes that it can sometimes play a useful role and it accepts its use "with caution".[91] As *Craig and de Búrca* note, "the admixture of formal and informal law is a common feature of any legal order".[92] Its use is not a reason for alarm per se. In an echo of the stance we have taken in relation to the debate on soft law in international law, we adopt a pragmatic approach that recognises both the value of soft law within the EU set-up and the potential dangers, and therefore acknowledges the crucial importance of close monitoring of its deployment to check that it is not being abused. Moreover, we recognise that the need to ensure that use of soft law does not contravene principles of EU law give rise to certain issues that do not have direct counterparts in the debate about soft law at the international level.

EU soft law and financial regulation

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[82] On the application of the conferred powers principle to Community soft law see Senden, *Soft Law*, n 79, ch 7.
[83] Case C-322/88 *Grimaldi* [1989] ECR 4407, holding that Commission Recommendations that are not intended to have legal effect cannot create rights upon which individuals may rely before a national court but that they have legal significance to the extent that national courts are bound to take them into consideration in order to decide disputes submitted to them.
[84] M Dawson, 'Soft Law and the Rule of Law in the European Union: Revision or Redundancy?' (June 5, 2009). EUI Working Papers (RSCAS) 2009/24. Available at SSRN: http://ssrn.com/abstract=1415003.
[85] Senden, *Soft Law*, n 79, 112 (and discussing (at 111—2) other definitions suggested by Snyder, Thürer, and Borchardt and Wellens).
[86] *Senden* helpfully distinguishes between the *pre-law* function of soft law – which embraces cases where soft law paves the way for the subsequent adoption of legislation – and its *para-law* function – where soft law is used as a genuine alternative to legislation: *Soft Law*, n 79, 118 – 9. See also DM Trubek and LG Trubek, 'Hard and Soft Law in the Construction of Social Europe: The Role of the Open Method of Coordination' (2005) 11 *European Law Journal* 343.
[87] Dawson, 'Soft Law', n 84, 16 – 22.
[88] Resolution of the European Parliament on the institutional and legal implications of the use of soft law instruments, 2007/2028(INI) (P6_TA(2007)0366). But see Dawson, 'Soft Law', n 84.
[89] Resolution, ibid.
[90] Ibid.
[91] Ibid.
[92] P Craig and G de Búrca, *EU Law: Text, Cases and Materials* (OUP, 4th edn, 2007) 87.

Turning from generalities to the specific context of financial market regulation within the EU, the relevance of controversies about soft law is not immediately obvious because of the apparent predominance of hard law in the legal framework. Moreover, the trend seems to be in favour of ratcheting up the degree of hardness – to use Regulations rather than Directives, to jettison exceptions, derogations and options, and, through maximum harmonisation techniques, to remove the possibility of additions made at national level.[93] This preference for hard law has been reinforced by the financial crisis. Even those Member States, such as the UK, that historically maintained a rather ambivalent attitude towards European financial services regulatory policy have come round, broadly speaking, to the need to expand the common European rulebook. It is true that in the lull between the completion of the Financial Services Action Plan (1995-2005) and the financial crisis, the Commission did incline towards alternative forms of regulation but that approach never had time to put down deep roots.[94] As the brief, unsuccessful experiment with a soft approach to the regulation of credit rating agencies demonstrated, the urge to "upgrade" to hard law as soon as circumstances permit remains strong.[95] This tendency is also evident in the evolution of policy thinking with respect to deposit guarantee schemes.[96]

However, the significance of soft law, and thus the relevance of controversies associated with it, emerges from close examination of the detail of the regulatory and supervisory structure. There is already an important layer of soft law and soft methods in the non-binding guidance that was issued by the so called Lamfalussy Level 3 Committees (the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)).[97] Questions have been raised about the robustness of controls relating to the quasi-legislative role played by these Committees.[98] The European Central Bank (ECB) is authorised to make non-binding recommendations[99] and can also issue opinions and recommendations in discharging its responsibility to contribute to the smooth conduct of prudential supervision.[100] Furthermore, it is relevant here to recall that while the phrase "soft law" is typically used to denote a form of rule-making, it is a commodious term that can also embrace soft methods of supervision and enforcement of both hard and soft law, such as guidance (which has both regulatory and supervisory aspects), peer reviews and mediation.[101] Soft methods involving the application of high level principles, risk-based processes and enforcement are an established and crucial part of the structure of financial market supervision in Europe.[102]

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[93] European Commission, *Driving European Recovery*, COM(2009) 114, para 2.2.
[94] N Moloney, 'The Financial Crisis and EU Securities Law-Making: A Challenge Met?' (forthcoming, 2010).
[95] From European Commission, *Communication from the Commission on Credit Rating Agencies*, [2006] OJ C59/2 (soft law) to Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, [2009] OJ L302/1 (hard law).
[96] In the mid 2000s, the Commission used a non-binding Communication to identify certain short-term and non-legislative ways of improving the functioning of the existing Directive but refrained from making any proposals for legislative change because, mindful of the disciplines of better regulation it felt that it could not proceed further because the case for reform, which would be costly for the banking industry, had not been made. In 2009, post-crisis, the Commission returned to the issue but this time with proposals for hard-edged legislative reform: European Commission, *Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes* COM(2010) 369.
[97] See E Ferran, 'Understanding the Shape of the New Institutional Architecture of EU Financial Market Supervision' (forthcoming).
[98] Moloney, 'The Financial Crisis ', n 94, critically examining aspects of Level 3 guidance issued by CESR.
[99] TFEU, art 132.
[100] TFEU, art 127(5) and ESCB Statute, arts 4 and 25. With respect to the ECB's advisory role, note TFEU, art 124(4) and art 282(5).
[101] Eg, N Petit and M Rato, 'From Hard to Soft Enforcement of EC Competition Law - A Bestiary of 'Sunshine' Enforcement Instruments' C. Gheur and N. Petit (eds), *Alternative Enforcement Techniques in EC Competition Law* (Brussels: Emile Bruylant, 2009) 183.
[102] See Ferran 'Understanding', n 97, (discussing the peer review activities of the Level 3 Committees).

In the aftermath of the financial crisis, steps are being taken to harden some aspects of financial supervision and also to confer legal enforceability on standards developed by supervisors rather than by the EU institutions. However, notwithstanding the urge to put in place a more muscular regime, soft law will continue to be significant. With respect to the oversight of systemic risk, soft law will have particular significance because the new arrangements for macro-prudential oversight by the ESRB will rely heavily on influence and reputation for impact, that is, on the exercise of soft power.[103] The explanation for this structure lies in the political and constitutional limits to what can be done at the pan-European level. The financial crisis has produced a broad consensus around the need to improve financial market supervision within the EU but it has not delivered a *carte blanche* for institutional reform. The space for reform is bounded by legal, institutional, political and practical considerations that stand in the way of setting up European agencies equipped with a full range of hard supervisory and rule-making powers and transferring to such agencies the responsibility for frontline supervision that is currently vested in national authorities. Within that space, all available options, including those that are "soft" but which, for the reasons discussed already, can exert a strong compliance "pull", are being utilised and, as a result, hybrid models that have elements of both hard and soft law are emerging.

Pragmatic exploitation of the flexibility of soft law in the on-going institutional reform effort derives legitimacy insofar as it is necessary in order to deliver the "new framework for macro- and micro-prudential supervision" [104] that the political leaders of the Member States have called for. However, since it is virtually inevitable that the quest to put in place an effective institutional structure will push at the boundaries of what is legally permissible, its deployment demands close examination.

PART IV

Soft Law and the European Systemic Risk Board

European financial market supervision: the need for reform

The financial crisis has created political momentum for reforming the structure of European financial supervision and regulation.

Shortcomings of the Lamfalussy system

It was already recognised before the crisis that the achievements of the Level 3 Committees in promoting consistent implementation of Union legislation and enhancement of convergence in EU supervisory practices had been patchy.[105] In particular there were concerns that the Lamfalussy framework was too slow and lacked the institutional capacity to respond effectively to a cross-border financial crisis within the European Union. This weakness was highlighted in an IMF Report in 2007, which identified the absence of a clear framework of coordination between EU national supervisors with respect to the oversight of the cross-border operations of financial groups in EU states as a weak link in EU supervisory arrangements.[106]

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[103] See notes 211-233 and accompanying text.
[104] Presidency Conclusions – Brussels, 18/19 June 2009
[105] European Commission, *Review of the Lamfalussy process - Strengthening Supervisory Convergence*, COM(2007) 727. See also the review of pre-crisis efforts to improve the organisation of European financial market supervision in the *de Larosière Report*, annex VI.
[106] IMF, *Euro Area Policies: 2007 Article IV Consultation—Staff Report* (IMF Country Report No. 07/260), 27.

Over the years a number of refinements were effected with a view to addressing concerns about institutional weaknesses. In 2003, the Banking Supervision Committee of the ESCB (BSC) developed recommendations to assist EU banking supervisors and central banks in preparing for, and responding to, a financial crisis. This led to the adoption later in 2003 of a Memorandum of Understanding on cooperation in crisis situations.[107] In May 2005, a second MOU was adopted containing the same principles of cooperation and coordination during a financial crisis, but with its scope expanded to include in the deliberations surrounding a financial crisis not only the bank supervisors and central banks, but also EU finance ministers as well.[108] The MOUs were tested in several so-called "war games" in which the need for more refined principles for cooperation and exchanges of information were identified in cases involving cross-border and systemic problems.[109] In 2006, joint guidance from CEBS and the European System of Central Bank's Banking Supervisory Committee (BSC) sought to extend the guidance role of the Level 3 Committees from "going-concern" activities to crisis management cooperation.[110] A CEBS/BSC Joint Task Force on Crisis Management was established in order to enhance cooperative arrangements in a financial crisis.[111] The Task Force issued guidance for supervisors to follow in the event of a systemic financial crisis with cross-border effect.[112] These moves evidenced a recognition by EU authorities that the cross-border operations of large banking groups necessitated further institutional consolidation at the EU level and in particular raised important issues regarding how much authority the Level 3 Committees should be given in overseeing national supervisors and cross-border firms and wholesale capital markets.

In spite of these steps, weaknesses in the EU institutional framework of financial supervision became even more apparent in 2007 and 2008 when the financial crisis incapacitated wholesale financial markets and left supervisory authorities unable at certain points to respond in a coherent or effective manner. The complete lack of any clear institutional responsibility for overseeing the safety and soundness of the financial system as a whole became manifest.

In October 2007, the Council of Ministers approved enhanced arrangements for managing cross-border financial crises that have systemic implications within the EU by authorising the Economic and Financial Committee to prepare an extended Memorandum of Understanding to build on the 2005 MOU.[113] The new MOU established common principles and a common analytical framework for assessing the systemic implications of a potential crisis, and sought to put in place common terminologies for all supervisory authorities to use in examining the cross-border implications of a systemic crisis. The common principles recognised that the objective of crisis management was to protect the stability of the financial system in the EU as a whole while reducing the social costs of harmful financial activity. Although private sector solutions were given primacy in resolving a crisis, the principles emphasised that managers should be held accountable, that shareholders should not be bailed out, and that public money should not be used unless there was a serious disturbance to the economy and the overall social benefits of the bailout exceeded the public costs of recapitalising a failed institution.[114]

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[107] The Banking Supervisory Committee of the ESCB prepared the MOU. See discussion in CEBS, *Annual Report 2004*, 24.
[108] CEBS, *Annual Report 2005*, 25;
[109] Ibid. And see CEBS, *Annual Report 2006*, 5, 25-26.
[110] Discussed in K Alexander, J Eatwell, A Persaud and R Reoch, *Financial Supervision and Crisis Management in the EU* (2007) 39 (study published by European Parliament Policy Department, Economic and Scientific Policy).
[111] Ibid. See also CEBS, *Annual Report 2006*, 5, 25-26.
[112] Alexander et al, *Financial Supervision*, n 110, 47.
[113] Ibid.
[114] Ibid, 26.

However, as the crisis deepened, it became evident that a more holistic approach to reform was required and that a comprehensive overhaul extending far beyond improving crisis-management systems and structures needed to be considered.

The path to institutional reform - de Larosière Report

In 2008 and 2009 various steps were taken to improve the functioning of the Level 3 Committees[115] and also to continue to enhance crisis-management arrangements.[116] However, a path to more radical reform eventually opened up in February 2009 when the high level group under the chairmanship of *Jacques de Larosière*, which had been appointed by the Commission to make proposals on strengthening European supervisory arrangements, delivered a report (the *de Larosière Report*) that provided a comprehensive review of the lessons from the crisis with regard to weaknesses in the Lamfalussy system.[117] The *de Larosière Report* identified significant problems in many areas:[118] lack of adequate macro-prudential supervision; ineffective early warning mechanisms; problems of competences;[119] failures to challenge supervisory practices on a cross-border basis;[120] lack of frankness and cooperation between supervisors; lack of consistent supervisory powers across Member States; lack of resources in the Level 3 Committees; and no means for supervisors to take common decisions. Responding directly to the mandate that had been given to the group, the *de Larosière Report* put forward proposals for a new supervisory structure aimed at making "European supervision more effective and so improve financial stability in all the member countries of the EU". These proposals formed the basis for an extensive re-organisation of the institutional architecture of financial market supervision in Europe.

Reform: an overview of the European Systemic Risk Board and the European Supervisory Authorities

In May 2009 the Commission adopted a Communication outlining its plans for putting into effect the recommendations in the *de Larosière* report.[121] The plans were given political endorsement at the meeting of the European Council in June 2009.[122] Detailed legislative proposals followed in September 2009.[123] Despite support for change at a broad level of generality, some of the more detailed aspects of these proposals were controversial and there followed a period in which alternative texts were put forward by the Council and the Parliament. Intensive trilogue negotiations eventually secured

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[115] European Commission, *Public Consultation Paper on Amendments to Commission Decisions establishing CESR, CEBS & CEIOPS* (DG Internal Market, May 2008). For resulting changes to the committees' role see Commission Decision C(2009)176 establishing the Committee of European Securities Regulators; Commission Decision C(2009)177 establishing the Committee of European Banking Supervisors; and Commission Decision C(2009)178 establishing the Committee of European Insurance and Occupational Pensions Supervisors.

[116] P Athanassiou, 'The Role of Regulation and Supervision in Crisis Prevention and Management: A Critique of Recent European Reflections' [2009] *Journal of International Banking Law and Regulation* 501, 504-5.

[117] High Level Group on Financial Supervision in the EU, *Report* (February 2009).

[118] At paras 152 – 162.

[119] ie in their oversight duties national supervisors failed to perform to an adequate standard (Northern Rock, IKB, Fortis being cited as examples): para 155.

[120] Such as the ineffectiveness of embryonic peer review arrangements being developed within the Level 3 Committees: para 156.

[121] European Commission, *European Financial Supervision* COM(2009) 252.

[122] European Council, *Presidency Conclusions*, (18/19 June 2009).

[123] Proposal for a Regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, COM(2009) 499 (ESRB Regulation); 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; Proposal for a Regulation Establishing a European Banking Authority, COM(2009) 501 (EBA Regulation); Proposal for a Regulation Establishing a European Insurance and Occupational Pensions Authority, COM(2009) 502 (EIOPA Regulation); Proposal for a Regulation Establishing a European Securities and Markets Authority, COM(2009) 503 (ESMA Regulation).

agreement on a compromise package, which was adopted in September 2010.[124] The new institutional arrangements become operational in early 2011.

The ESRB is part of the new supervisory structure.[125] The ESRB's role is to monitor and assess systemic risks – individual banks and the whole European financial system. As noted earlier in this article, the ESRB does not have legally-binding powers. The ECB provides its secretariat.[126] The secretariat's role is to provide analytical, statistical, administrative and logistical support. On the micro-financial side, the existing Level 3 Committees are replaced by three new EU supervisory authorities (ESAs): the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pension Authority (EIOPA).[127] The ESAs assume the functions of the Committees they replace but they also have some additional powers including, somewhat controversially, a right to write technical standards that will acquire legal force via endorsement by the Commission, and the authority to impose binding decisions in certain limited circumstances.[128] This hardening of micro-supervisory power at the EU level tracks a similar course to that identified in regulation but it is at a much earlier stage of development. For now, the emergence of a unified system of supervision conducted directly by euro-agencies remains a distant prospect but also clearly an outcome that would be the logical conclusion of the evolutionary processes that are well underway. The ESAs and the national supervisors form a network known as the European System of Financial Supervision (ESFS). The ESRB is also part of the ESFS.

The new institutional framework is intended to recognise the interdependence between micro- and macro-prudential risks across EU financial markets and the need to be accountable to the views of market participants and all EU stakeholders, including financial institutions, investors and consumers. It aims at providing a more consolidated and rational institutional design for linking micro-prudential supervision of individual firms with the supervision of the linkages between institutions and between institutions and the broader financial system.

The European Systemic Risk Board in more detail

Organisational Structure

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[124] Regulation (EU) No …/2010 of the European Parliament and of the Council on European Union Macro Prudential Oversight of the Financial System and Establishing a European Systemic Risk Board (ESRB Regulation); Regulation (EU) No .../2010 of the European Parliament and of the Council Establishing a European Supervisory Authority (European Banking Authority) (EBA Regulation); Regulation (EU) No .../2010 of the European Parliament and of the Council Establishing a European Supervisory Authority (European Securities and Markets Authority) (ESMA Regulation); Regulation (EU) No .../2010 of the European Parliament and of the Council Establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority) (EIOPA Regulation). The account of the legal framework in this article is based on versions of the legislative text for the ESRB and the EBA that were agreed in trilogue on 2 September 2010.

[125] The idea of having a pan-European body with responsibility for macro-prudential oversight goes back a long way. See LB Smaghi, 'Macro-prudential Supervision'. Speech at the CEPR/ESI 13th Annual Conference on *Financial Supervision in an Uncertain World*, European Banking Center at Venice International University, Venice, 25-26 September 2009, mentioning proposals from the 1990s.

[126] ESRB Regulation, art 4(4); Council Regulation (EU) No …/2010 entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board.

[127] Generally, Ferran, 'Understanding', n 97.

[128] The technical standards endorsement mechanism is designed to work around the limitations on the powers that can be conferred on agencies that are derived from ECJ caselaw: Case 9/56 *Meroni v High Authority* [1957-8] ECR 133. There is considerable potential uncertainty about the scope of the ESASs' powers in respect of technical standards and the relationship between such standards, non-binding guidance and other Commission implementing measures. See further Moloney, 'The Financial Crisis', n 94.

The ESRB is composed of a General Board, a Steering Committee, a Secretariat, an Advisory Technical Committee and an Advisory Scientific Committee. [129]

The General Board is the decision-making body of the ESRB.[130] It has 65 members, of whom 37 have voting rights.[131] The President of the ECB is the first Chairperson and he is to hold the office for a five year term.[132] Arrangements thereafter have been left open (reflecting lack of consensus on whether the ECB President should hold the post *ex officio*, as suggested in the *de Larosière Report* and supported by the Parliament).[133] There are also two Vice-Chairs.[134] One of the Vice-Chairs is elected by and from the ECB General Council members of the General Board (ie central bank Governors). The electors are mandated to have regard "to the need for a balanced representation of Member States between those within and outside the euro area".[135] This wording does not guarantee that there will always be a governor from a non-eurozone central bank at the top level of the ESRB. The lack of a firm arrangement for non-eurozone representation in key positions is a feature that some commentators have identified as a weakness that could undermine the ESRB's accountability and legitimacy to non-eurozone Member States.[136] However, there are also views the other way: the ECB made the point that, as the composition of the euro area is likely to change with time, it could be inadvisable to lay down rigidities in law.[137] The Chair of the Joint Committee of the ESAs serves as the ESRB's second Vice-Chair.[138]

The members with voting rights are the President and the Vice-President of the ECB, the Governors of national central banks, a member of the European Commission, the Chairpersons of the three ESAs, the Chair and the two vice Chairs of the Advisory Scientific Committee, and the Chair of the Advisory Technical Committee.[139] The members without voting rights are one representative per Member State of the competent national supervisory authorities, and the President of the Economic and Financial Committee.[140] Voting members each have one vote and most decisions will be adopted by simple majority.[141] The quorum is two-thirds of the members with voting rights.[142] Members of the General Board are required to perform their duties impartially and solely in the interests of the Union as a whole.[143] No member of the General Board (voting or non-voting) may have a function in the finance industry.[144] Arrangements may be made for representatives from third countries, in particular EEA countries, to participate on a limited basis in the work of the ESRB.[145] High-level representatives from international financial organisations may be invited to attend meetings of the General Board.[146]

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[129] ESRB Regulation, art 4.
[130] ESRB Regulation, art 4(2).
[131] ESRB Regulation, art 6.
[132] ESRB Regulation, art 5(1).
[133] This matter is to be considered in the three year review provided for in ESRB Regulation, art 20.
[134] ESRB, art 5(1)(a)-(b).
[135] This consideration is also relevant in elections to the Steering Committee, discussed further below.
[136] European Financial Services Roundtable, *Response* (July 2009), paras 40 – 45.
[137] Opinion of the European Central Bank of 26 October 2009, (CON/2009/88), para 6.
[138] ESRB Regulation, art 5(1)(b).
[139] ESRB Regulation, art 6(1).
[140] ESRB Regulation, art 6(2).
[141] ESRB Regulation, art 10. But a majority of two-thirds of the votes is needed to adopt a recommendation or to make a warning or recommendation public: art 10(3a) and art 18(1).
[142] ESRB Regulation, art 10(3). This can be reduced to one-third for extraordinary meetings except meetings involving decisions to make a warning or recommendation public: art 18(1).
[143] ESRB Regulation, art 7(1).
[144] ESRB Regulation, art 7(1a).
[145] ESRB Regulation, art 9(3b).
[146] ESRB Regulation, art 9(3a).

The size of the General Board is a potential impediment to its efficiency and effectiveness.[147] By way of contrast, the US Financial Stability Oversight Council will have only 15 members, of whom ten will be voting members. On the other hand, the FSB also has more than 60 members, and the expansion of its membership has been viewed positively.[148] A potentially more troubling issue than mere size is that the membership structure arguably creates too strong a bias in favour of central banks and gives insufficient weight to the fiscal element of financial stability (compare, for example, the FSB which does include representatives from national finance ministries among its members).[149] Also debatable is whether there is over-representation of central banks at the expense of the insurance and securities sectors.[150] Furthermore, fundamental questions can be asked about the ability of those who are deeply embedded within an established system to engage in fresh thinking, though this consideration must be balanced against the obvious need for in-depth knowledge and expertise.[151] The inclusion of the Chair and two vice Chairs of the Advisory Scientific Committee as members of the General Board may broaden the range of skills and experience that is represented at its meetings but perhaps not to a great extent because the ESRB Chairman and the Steering Committee of the General Board will effectively control appointments to the Scientific Committee.[152]

The Steering Committee's role is to assist in the decision-making process of the ESRB by supporting the preparation of the meetings of the General Board, reviewing the documents to be discussed and monitoring the progress of the ESRB's ongoing work.[153] In view of large and potentially unwieldy size of the General Board, it is likely that the Steering Committee will play a major role in agenda-setting and in detailed analysis. The members of the Steering Committee are the Chair and First Vice-Chair of the ESRB, the Vice-President of the ECB, four other members of the General Board elected for three year periods by and from the ECB General Council members of the General Board (ie the central bank Governors),[154] a member of the European Commission, the Chairs of each of the ESAs, the President of the Economic and Financial Committee, the Chair of the Advisory Scientific Committee, and the Chair of the Advisory Technical Committee.[155]

The role of the Advisory Technical Committee is to provide advice and assistance on technical issues.[156] This, too, is a body with a large membership, comprising a representative of each national central bank and of the ECB, one representative per Member State of the competent national supervisory authority, one representative of each of the ESAs, two representatives of the Commission, one representative of the Economic and Financial Committee, and one representative of the Advisory Scientific Committee. The Advisory Scientific Committee, which was not part of the Commission’s original proposal and is an additional feature put forward by the European Parliament, is intended to provide advice and assistance on matters within its competence “in a spirit of openness”[157] but the

[147] Treasury Committee, *Opinion on Proposals for European Financial Supervision* (Sixteenth Report of Session 2008–09), paras 36 – 39.
[148] Arner and Taylor, ‘The Global Financial Crisis’, n 19.
[149] Treasury Committee, *Opinion on Proposals for European Financial Supervision* (Sixteenth Report of Session 2008–09), paras 38 – 39.
[150] European Financial Services Roundtable, *Response to the European Commission’s Communication on European Financial Supervision* (July 2009).
[151] GP Miller and G Rosenfeld, ‘Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008’ (2010) 33(2) *Harvard Journal of Law & Public Policy* 807 (suggesting that the composition of the ESRB could make it vulnerable to the problem of “intellectual hazard”).
[152] ESRB Regulation, art 11a.
[153] ESRB Regulation, art 4(3).
[154] The instruction to have regard for balanced eurozone/non-eurozone representation applies to this election process: ESRB Regulation, art 11(1)(c).
[155] ESRB Regulation, art 11.
[156] ESRB Regulation, art 12 and art 4(5).
[157] ESRB Regulation, rec. 13.

precise nature of its role is not spelt out in detail in the legislative text.[158] It is a body of 15 independent experts "representing a wide range of skills and experiences", proposed by the Steering Committee and approved by the General Board.[159] It is intended to operate as a reactive body, performing tasks at the request of the Chair of the General Board rather than on its own initiative.[160]

The ESRB is mandated to seek the views of private sector stakeholders where appropriate.[161] There is also provision for the Advisory Scientific Committee to organise open and transparent consultations with stakeholders, such as market participants, consumer bodies and academic experts.[162]

Legal status, accountability and independence

The ESRB is established by a Regulation under art 114 TFEU (art 95 EC) as a body without legal personality and with no binding powers.[163] In its original proposals for the ESRB, the Commission stressed the advantages of flexibility that flow from the absence of legal personality.[164] It suggested that this would allow the ESRB, along with the other constituent parts of the ESFS, to "form a common innovative framework for financial supervision, while maintaining a clear distinction of responsibilities between [itself] … and the other bodies".[165] The Commission also linked the ESRB's lack of legal personality to the "wide scope and the sensitivity of its missions".[166] However, it appears that this policy choice was also influenced by more pragmatic considerations because of certain technical difficulties pertaining to the ECB's capacity to provide services to another legally-constituted body.[167]

Lack of legal personality and binding powers need not necessarily be an impediment to the ESRB establishing authority and influence in relation to the financial markets. It may be compared in this respect to the FSB, which is also a body without legal personality Our examination of international soft law institutions in Parts II and III of this article indicates that relatively loosely constituted bodies can exert considerable power and this finding supports the Commission's view that legitimacy can be built on a reputation for effective action (in other words, output-legitimacy) rather than on formal legal powers.[168] However, it is necessary to say more about the ESRB's informal institutional structure because of certain aspects of EU law and governance.

By being conceived of as a soft law body without legally-binding powers, the ESRB structure finds a way around the strict limits on the powers that can be delegated to regulatory agencies in the current Union legal order.[169] These limits are that agencies cannot be empowered to adopt general legislative acts and cannot be granted decision-making power in areas in which they would have to arbitrate between conflicting public interests, exercise political discretion or carry out complex economic assessments. Clearly the ESRB is very likely to be involved in carrying out complex economic

[158] ESRB Regulation, art 11a.
[159] ESRB Regulation, art 11a(1).
[160] ESRB Regulation, art 11a(3).
[161] ESRB Regulation, art 13.
[162] ESRB Regulation, art 11a(5).
[163] COM(2009) 499.
[164] Ibid, explanatory memorandum, para 4.
[165] Ibid.
[166] Ibid., para 6.
[167] C Zilioli, 'The EU September Package of Reform: A View from the EU Institutions', speech, December 11, 2009.
[168] COM(2009) 499, para 6.1.
[169] See generally K Lenaerts, 'Regulating the Regulatory Process: Delegation of Powers in the European Community' (1993) 18 EL Rev 23. The alleged inflexibility of EU law with respect to delegation is questioned in some academic literature but this interpretation appears to be firmly entrenched in the Commission's thinking. See European Commission, *The Operating Framework for the European Regulatory Agencies* COM(2002) 718; European Commission, *European Agencies – The Way Forward* COM(2008) 135.

assessments in areas that are highly sensitive politically and which could impinge on numerous public interest concerns. But it has power only to recommend or warn and not, ultimately, to decide or enforce. While it is possible that the ESRB's structure could be vulnerable to constitutional challenge as an infringement of the "spirit" of the limitations – not least because its recommendations and warnings will trigger legal effects in spite of being non-binding in themselves – its lack of formal decision-making powers does appear to keep it just on the right side of the constitutional line.[170] Furthermore, the body of scholarship that suggests that an inflexible interpretation of the legal restrictions on delegation is outmoded is in the ESRB's favour.[171]

This takes us then to accountability concerns. If the ESRB does in fact operate in the ambitious way that is envisaged for it, its role will be much more than that of a narrow technocractic organisation for the gathering and processing of information. The practical impact of its "advice" could be very strong indeed. What the ESRB has to say on matters that could be highly sensitive and politically-charged will have the potential to affect the Union as a whole, Member States, the European Supervisory Authorities, national supervisory authorities, and even the Commission. Indeed, if its pronouncements were not to be taken seriously, the new European framework for macro-prudential oversight would be fundamentally flawed. In discussing international soft law bodies in Part II, we made the point that the intensity of accountability and legitimacy concerns is inevitably linked to the degree of power and influence that a body is able to exert. This point is relevant to the ESRB. Clearly, the system of accountability in respect of the ESRB must respond to the realities of its power and influence and not be distracted by its lack of binding powers. The ESRB's unusual organisational structure and wide range of advisory powers may require some special, quite nuanced, arrangements.[172] In the first instance annual reporting obligations and annual hearings in the European Parliament (more frequently in the event of widespread financial distress), confidential oral discussions at least twice a year between the ESRB President and the Chair and Vice-Chairs of the Parliament's Economic and Monetary Affairs Committee, and other hearings before the Parliament at its request are the principal accountability mechanisms that have been applied to the ESRB[173] but these arrangements could be tightened up in due course if adjustments are warranted by experience.[174]

The possibility that lack of legal personality could hamper the ESRB in maintaining an appropriate distance from the ECB also cannot be ignored. However, for its part, the ECB will presumably also be keen to ensure a proper demarcation so that its role in relation to the ESRB does not interfere with the performance of its monetary policy tasks.[175]

Treaty basis

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[170] The possibility of a constitutional challenge cannot be ruled out. From a comparative perspective: *Free Enterprise Fund v. Public Company Accounting Oversight Board* U.S. Supreme Court, 28 June 2010.

[171] e.g. R Dehousse, 'Misfits: EU Law and the Transformation of European Governance', in C Joerges and R Dehousse (eds), *Good Governance in Europe's Integrated Market*, (Oxford: OUP, 2002) 207; D Geradin, 'The Development of European Regulatory Agencies: Lessons from the American Experience', in D Geradin, R Muñoz and N Petit (eds), *Regulation Through Agencies in the EU* (Cheltenham: Edward Elgar, 2005) 215. But see S Griller and A Orator, 'Everything Under Control? The 'Way Forward' for European Agencies in the Footsteps of the Meroni Doctrine' (2010) 35 E L Rev 3, 20.

[172] e.g. it is possible that reference could be made to experience with the much-discussed accountability mechanisms and practices (formal and informal) pertaining to the ECB: F Amtenbrink, 'On the Legitimacy and Democratic Accountability of the European Central Bank: Legal Arrangements and Practical Experiences', in A Arnull and D Wincott, *Accountability and Legitimacy in the European Union* (Oxford: OUP, 2002) ch. 9; F Amtenbrink and K van Duin, 'The European Central Bank Before the European Parliament: Theory and Practice after 10 Years of Monetary Dialogue' (2009) 34 EL Rev 561; P Magnette, 'Towards Accountable Independence? The European Central Bank and the Rise of Parliamentary Controls' (2000) 6 ELJ 326.

[173] ESRB Regulation, art 19.

[174] Specifically, ESRB Regulation, art 20 provides for a review of the Regulation three years after its entry into force.

[175] Note ESRB Regulation, rec. 5.

The question of the legal basis in the Treaty for the creation of the ESRB is relevant for determining the legal validity of its proposed functions and operations. It is permissible, within limits, to use art 114 TFEU as the legal basis for the establishment of bodies that are vested with responsibilities for contributing to the harmonisation process and facilitating uniform implementation by the Member States.[176] Even for the creation of soft EU institutional structures under art 114 TFEU, it is necessary for it to be actually and objectively apparent from the legal act creating the body in question that its purpose is to improve the conditions for the establishment and functioning of the internal market.[177] Moreover, the ECJ has indicated that the tasks conferred on such a body must be closely linked to the subject-matter of the relevant harmonising legislation.[178]

The preambles to the Regulation creating the ESRB state that the ESRB should "contribute directly to achieving the objectives of the Internal Market"[179] and that it "contributes to the financial stability necessary for further financial integration in the Internal Market".[180] Yet mere assertion of an internal market role does not guarantee that the legislative measure in question is intra vires. In determining whether the ESRB Regulation is constitutionally sound from a Treaty-basis perspective within a soft law institutional context, it is thus necessary to examine the ESRB's mission and the specific tasks conferred on it.

The ESRB's mission, objective and tasks: issues of legal basis and certainty

The ESRB has been given an ambitious mission and objective that are worth quoting verbatim:

> The ESRB shall be 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 in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth.[181]

The tasks conferred on the ESRB cover: data collection and analysis; systemic risk assessment and prioritisation; issuing systemic risk warnings and recommendations for remedial action and monitoring follow-up; issuing confidential warnings to the Council of impending emergencies; co-operating closely with the other parties in the ESFS and providing the ESAs with information on systemic risks; working with the ESAs in the development of quantitative and qualitative indicators to identify and measure systemic risk; participating in the Joint Committee of the ESAs; coordinating with international institutions and relevant bodies in third countries on matters related to macro-prudential oversight; and other related tasks as specified in EU legislation.[182] These tasks are to be undertaken by the ESRB for the purpose of discharging its overarching responsibilities with respect to macro-prudential oversight and containment of systemic risk. During the legislative process there were suggestions that the power to declare an "emergency situation" should be assigned to the ESRB but, in

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[176] *United Kingdom v Parliament and Council (Smoke Flavourings)* (C-66/04) [2005] E.C.R. I-10553; *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union (ENISA)* (C-217/04) [2006] E.C.R. I-3771.
[177] *Smoke Flavourings* [2005] E.C.R. I-10553, para. 44; *ENISA* [2006] E.C.R. I-3771, para. 42. G Borchadt and K Wellens, 'Soft Law in European Community Law' (1989) 14 ELRev. 267, 297.
[178] *ENISA* [2006] E.C.R. I-3771, para. 45.
[179] ESRB Regulation, rec. 19.
[180] ESRB Regulation, rec. 19a.
[181] ESRB Regulation, art. 3(1).
[182] ESRB Regulation, art. 3(2).

the end, its role is more limited. The location of power in respect of this matter has particular political sensitivity because the declaration of an emergency situation acts as a trigger for the ESAs in exceptional circumstances to intervene more directly in the supervision of financial market activity.[183] With respect to another sensitive matter, although the ESRB will be involved in the process of setting the criteria for the identification of systemically important financial institutions, it will not have the final say in respect of the classification of specific firms.[184]

"Macro-prudential" and "systemic risk" are not well-established terms in existing EU legislation relating to the regulation of financial markets.[185] This complicates the task of identifying a close link between the subject-matter of the harmonising laws in question and the tasks conferred on the relevant body, which is required for art 114 TFEU to be used as the legal basis for the establishment of a European body.[186] But since stability and soundness are essential pre-requisites for the smooth operation of any financial market, macro-prudential oversight and containment of systemic risk can be regarded as fundamental parts of the general subject-matter to which the body of EU law on the harmonisation of financial market regulation relates.[187] That the EU regulatory framework failed historically to recognise sufficiently their crucial significance is a weakness that current reform efforts are aimed at correcting rather than an indication of a boundary line that cannot be crossed.[188] Moreover, the ECJ has said that art 114 TFEU confers on the Union legislature a discretion, depending on *the general context and the specific circumstances of the matter to be harmonised* (emphasis added), as regards the harmonisation technique most appropriate for achieving the desired result, in particular in fields which are characterised by complex technical features.[189] The legislature may deem it necessary to provide for the establishment of a Union body responsible for contributing to the implementation of a process of harmonisation in situations where, in order to facilitate the uniform implementation and application of acts based on that provision, the adoption of non-binding supporting and framework measures seems appropriate.[190] Within the normative context of financial market regulation, it can be strongly argued, therefore, that the ESRB, while unprecedented, is within the room for innovation in harmonisation techniques that art 114 TFEU provides.[191] This suggests, therefore, that there is little likelihood of a successful challenge to the use of art 114 TFEU as the legal basis for the establishment of the ESRB.[192]

But other issues of legal certainty also arise. The ESRB's role in "macro-prudential oversight" for the prevention or mitigation of "systemic risks" embraces concepts that are not easy to pin down from a legal perspective. It is certainly possible to identify specific examples of systemic failure.[193] Systemic

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[183] See further Ferran, 'Understanding', n 97.
[184] EBA Regulation, art 12b. Compare the U.S. Financial Stability Oversight Council, which will be empowered to identify and designate systemically important non-bank financial institutions.
[185] Occasional references to systemic risk can be found in older legislation (e.g. Directive 98/26/EC (Settlement Finality Directive) but, historically, there was no express comprehensive legal definition.
[186] *ENISA* [2006] E.C.R. I-3771, para. 45.
[187] Compare the Treasury Committee, *Opinion on Proposals for European Financial Supervision* (Sixteenth Report of Session 2008–09), paras 29-32.
[188] ESRB Regulation, rec 6 (acknowledging past failings in emphasising macro-prudential issues).
[189] *Smoke Flavourings* [2005] E.C.R. I-10553, para. 45.
[190] *ENISA* [2006] E.C.R. I-3771, para. 44.
[191] TFEU, art. 352 (art. 308 EC) provides an alternative legal basis for the establishment of agencies but the ECJ has said that art. 352 may be used as the legal basis for a measure only where no other provision of the Treaty applies: *Parliament v Council* (C-436/03) [2006] E.C.R. I-3733.

The legal basis for the decision to confer secretariat functions on the ECB is art. 127(6) TFEU (art. 105(6) EC) (Council power to adopt regulations requiring unanimity).
[192] See also ESRB Regulation, rec 19a.
[193] HS Scott, 'The Reduction of Systemic Risk in the United States Financial System' (2010) 33 *Harvard Journal of Law & Public Policy* 671. On the interpretation of "macro-prudential": P Clement, 'The Term "Macroprudential": Origins and Evolution' (March 20101) *BIS Quarterly Review* 59.

risk can arise from problems with payment and settlement systems or some type of financial institution failure that induces a macro-economic crisis.[194] The recent crisis suggests that systemic risks can also result from solvency and liquidity risks that arise from imprudent lending and trading activity in the wholesale capital markets.[195] High levels of leverage at individual banking institutions and across wholesale capital markets can result in systemic collapse. However, there is no universally generally accepted legal definition of the concept of systemic risk as a whole.[196] Indeed, according to a recent FSB/IMF/Bank for International Settlements (BIS) Report, most G20 countries do not have a legal or formal definition in their domestic legal framework of what constitutes systemic importance.[197] Tremendous uncertainty also exists among economists and other experts with regard to the definition of systemic risk and how it manifests itself in the financial system.[198] No general agreement exists regarding how to measure it, nor is there a consensus about which regulatory measures are necessary to combat it.[199]

Systemic risk has such protean qualities it could be a mistake to attempt to give it an express detailed legal definition as that could cabin and confine it with potentially disastrous consequences given what we have learnt about its capacity to evolve and emerge in new forms.[200] On the other hand, because it is so pivotal to the ESRB’s role, not defining it could be challenged for appearing to leave an unacceptable level of uncertainty on a key feature of the new institutional arrangements. [201] The final legislative text of the ESRB Regulation attempts to reconcile these competing considerations by including an open-textured, inclusive definition of the term as follows: [202]

> “systemic risk” means a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.

This is not dissimilar to the definition of systemic risk recently suggested by the FSB-IMF-BIS as “a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy”.[203] It is doubtful how much additional certainty from a legal perspective the inclusion of this express definition in the ESRB Regulation actually provides but it may have symbolic value. Since“macro-prudential” oversight of “systemic risks” are key terms within the new institutional and regulatory set-up, they

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[194] Alexander et al, *Global Governance*, n 39, 23-26, 184-200.
[195] Ibid., 24.
[196] For an attempt from a legal perspective to provide a working definition of systemic risk see SL Schwarcz, ‘Systemic Risk’ (2008) 97 Geo LJ 193.
[197] International Monetary Fund, Financial Stability Board & Bank for International Settlements. *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations- Background Paper: Report to the G-20 Finance Ministers and Central Bank Governors*, October 2009. See also A Anand, ‘Is Systemic Risk Relevant to Securities Regulation?’ University of Toronto Law and Economics WP (2010).
[198] A Sibert, *Systemic Risk and the ESRB* (Brussels: European Parliament Committee on Economic and Monetary Affairs, 2009) para. 1.2; MK Brunnermeier, A Crockett, CA Goodhart, A Persaud and HS Shin, *The Fundamental Principles of Financial Regulation* (London: Centre for Economic Policy Research, 2009), ch. 2; O De Bandt and P Hartmann, ‘Systemic Risk: A Survey’ (ECB WP No. 35, November 2000).
[199] On ways of measuring systemic risk see AW Lo, ‘The Feasibility of Systemic Risk Measurement: Written Testimony for the House Financial Services Committee Hearing on Systemic Risk Regulation’ (October 19, 2009); K Whelan, ‘Containing Systemic Risk’ (UCD Centre for Economic Research, WP09/27, December 2009).
[200] On systemic risk as revealed by the financial crisis: M Hellwig, ‘Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis’ (2009) 157(2) *De Economist* 129.
[201] The absence of a definition of systemic risk in early versions of the legislative text was criticised by the European Economic and Social Committee, which argued that the concept needed to be discussed in public, not just behind closed doors in the new ESRB: EECS Opinion on Macro and Micro Prudential Supervision (ECO/268, 22 January 2010).
[202] ESRB Regulation, art. 2(ba).
[203] FSB-IMF-BIS Report, 2.

must be regarded as "EU law concepts" over which the European Court of Justice will be the ultimate arbiter.[204]

Imprecision in the scope of its mandate could impede the ESRB as it seeks to establish its authority and influence in relation to Member States, within the EU institutional framework, and as an important voice in international deliberations. It cannot point to a list of quite specific matters that are for it to determine unlike, for instance, the US Financial Stability Council, which is empowered to make the judgment calls on certain key matters of systemic importance. The ESRB's own understanding of what systemic risk is and what to do about it will be pivotal to the performance of its tasks. It will be crucial for the ESRB to concretise its role at an operational level by setting out (and refreshing over time as need be) a clear framework covering conceptual issues of systemic risk, the structure it will employ to deal with it, and more prosaic matters pertaining to its procedures and organisation.[205] These self-definitions will not be legally conclusive but by clearly and openly defining its role in this way, the ESRB could usefully enhance its own legitimacy and credibility.

Mission competence –early challenges

As a soft law institution whose ability to influence behaviour will depend heavily on its reputation, it will be crucial for the ESRB to build credibility quickly, and that it faces an uphill task in doing so cannot be in doubt. Criticism of the ESRB has already come from a number of different directions. For example, *Buiter* has argued that a central bank (or a group of central bankers as in the ESRB) is not an appropriate institution for macro-prudential supervision because central bankers are not legitimate politically to make decisions that involve important trade-offs between political and economic objectives and that such decisions should be left with finance ministries and other elected officials.[206] *Sibert* has raised the issue of lack of diversity in the ESRB as well its potentially unwieldy size.[207] Questions have also been raised about the wisdom of vesting responsibility for macro-prudential supervision in a central-bank dominated body given the potential for the demands for price stability and financial stability to pull in opposite directions and thus to give rise to conflicts of interest.[208]

Concerns have also been expressed with respect to more specific aspects of the arrangements for access to information and the location of technical competence to assess its significance.[209] The effective monitoring of systemic risk requires the collection and interpretation of data at both the micro-level of the firm and at the macro-level of the broader financial system. Whilst the ESRB has extensive powers on paper to request the ESAs, national supervisory authorities, national central banks and other authorities in Member States to provide it with all the information it needs to ensure consistency between micro- and macro-oversight,[210] much will depend on the practical effectiveness of these information-sharing mechanisms.[211] Moreover, even if the practical arrangements work well, it is open to question whether the ESRB will have the expertise to identify and understand the type of firm-level risks which can threaten financial stability. Doubt on this score is related to the fact that in many jurisdictions central banks have not recently had the responsibility for supervising banks and other

[204] *Hoekstra v Bestuur der Bedrijfsvereniging voor Detailhandel en Ambachten* (75/63) [1964] E.C.R. 177.
[205] L.B. Smaghi, 'Macro-prudential Supervision', n 125, suggests that the ECB is already moving in this direction.
[206] Written evidence quoted in Treasury Committee, *Opinion on Proposals for European Financial Supervision* (Sixteenth Report of Session 2008–09), para 37.
[207] Sibert, *Systemic Risk*, n 198, para. 3.
[208] Treasury Committee, *Opinion on Proposals for European Financial Supervision* (Sixteenth Report of Session 2008–09), paras 36-37, quoting Buiter.
[209] Ibid,, para 36 quoting Buiter.
[210] See below.
[211] B Weder di Mauro and U Klüh, 'Reshaping Systemic Risk Regulation in Europe' (2010) 16 *The Brown Journal of World Affairs* 179.

financial firms and so have not been accustomed to collecting the necessary micro-level data (although, there is now a trend (of which the UK is part) to transfer supervisory responsibilities back towards central banks) . Again, much will depend on how well arrangements for collaboration and co-operation between the ESRB and the ESAs, which will also have responsibilities for the identification and measurement of systemic risk posed by financial institutions, work in practice.[212]

The challenging nature of the ESRB's role is further compounded by the fact that much economic scholarship contradicts the conventional view that more liberalisation and financial integration are worthy economic policy objectives in that liberalised and integrated financial markets are more likely to increase financial fragility by subjecting markets to volatile cross-border capital flows and financial contagion during times of crisis.[213] Therefore, less financial integration in the form of price-based limitations on cross-border capital flows and market access limitations on cross-border presence of foreign banks might enhance financial stability and more efficiently control systemic risk.[214] In other words, the promotion of the financial integration objective might lead to *more* financial crises and cross-border contagion. It is thus open to question whether the objective of regulatory and supervisory harmonisation to achieve the Treaty's integration objective will actually lead to improved systemic risk controls. The convergence trend could conflict with the objectives of prudential regulation and supervision, which may need diverse approaches to control systemic risk. The ESRB must somehow find a way of managing this conundrum, which touches upon potentially sensitive issues concerning the respective roles of national bodies and of the ESRB itself. While the legal justification for the ESRB on subsidiarity and proportionality grounds is compelling,[215] it will be important for it to establish smooth relations with Member State systemic risk oversight bodies so that they do indeed complement each other and do not become embroiled in debilitating turf wars.

Information gathering and issuing warnings and recommendations: hard-edged soft powers

Regular publication of systemic risk reviews that examine the condition of the financial system and identify risks is already a well-established practice in Europe.[216] The ESRB will thus complement the work of the ECB, Bank of England and other central banks in the scientific evaluation of relevant information. However, if that is all it does, clearly charges of duplication will begin to stick; more is expected of the ESRB. The meaningful additional contribution projected for the ESRB lies in its role in pan-European surveillance and co-ordination, and in its ability to issue public and private warnings and recommendations.[217] Thus whether the ESRB succeeds in building a reputation for competence, effectiveness and credibility is likely to hinge on how it uses these powers. Will the ESRB build public legitimacy by establishing a reputation for competence - that is not missing the risks that do materialise and also not devoting attention to risks that turn out to be insubstantial?[218] Will its warnings and recommendations be taken seriously, or, in other words, will they be credible? The latter question appears to bring the discussion back to the issue of the compliance "pull" or traction that can be exerted by soft law bodies and to the limitations of softer methods of enforcement. However, to develop these issues in the context of the ESRB, it is necessary to turn to the detail of the mechanisms whereby its powers in relation to the issuance of recommendations and warnings will be translated into concrete action. In this context a clear distinction between the ESRB and the FSB-IMF emerges: because the ESRB is an integral part of a regional system located within a legal order in which formal

[212] ESRB Regulation, art. 3(2)(f).
[213] See M. Dungey and D. Tambakis *International Financial Contagion: Progress and Challenges* (OUP, 2005) ch. 1.
[214] Ibid.
[215] ESRB Regulation, rec. 20.
[216] e.g. the ECB, *Financial Stability Review* published on a twice-yearly basis.
[217] ECB, *Financial Stability Review* (June 2010) 137.
[218] Smaghi, 'Macro-prudential Supervision', n 125, elaborates on the types of errors the ESRB could make.

enforcement powers are available, there is more direct backup for activities in respect warnings and recommendations than is available at the international level for FSB-IMF early warnings.

Clearly, timely access to all relevant information will be a crucial precondition to the ESRB's effectiveness. The ESRB has powers to request information from ESAs, the ESCB, national supervisory authorities, national statistical authorities, and Member States.[219] That it can only "request" and not "require" is consistent with the ESRB's soft law status. Yet it is essential to note that bodies from which information may be requested are obliged to co-operate closely with the ESRB and must provide all the information necessary for the fulfilment of its tasks in accordance with EU legislation.[220] Amendments to relevant sectoral legislation will ensure there are no confidentiality or other legal obstacles to competent authorities fulfilling their information-sharing obligations. The existence of these various duties in respect of information-sharing and co-operation generally means that failure to comply with an ESRB "request" could constitute a breach of an obligation under EU law in respect of which formal enforcement action could be taken. The ESRB will thus operate in a way that is some steps removed from the modus operandi of a typical soft-law body.

It is contemplated that information supplied to the ESRB on request will normally be in summary or collective form but, in limited circumstances, the ESRB can address a reasoned request for firm specific data.[221] It can be argued that information about the solvency and liquidity of a particular financial institution or group is highly sensitive and should be reserved solely for its micro-prudential supervisors. This is thus an area in which tensions could emerge with respect to the space for non-compliance with an ESRB request that is compatible with the addressee's legal obligations.

The ESRB is empowered to issue general or specific warnings, or recommendations addressed to the Union as a whole, to one or more Member States, to one or more of the ESAs, or to one or more national supervisory authorities.[222] Recommendations may also be addressed to the Commission in respect of EU legislation.[223] The ESRB may not address financial firms directly: that remains the responsibility of Member States, under the oversight of the ESAs.

As with its information-gathering powers, although ESRB recommendations and warnings are not binding in themselves, there is considerable indirect reinforcement. First, there is a specific "act or explain" obligation on all recipients of ESRB recommendations.[224] If the ESRB is dissatisfied with the action taken or the explanation for inaction, it can refer the matter to the Council, the Chair of the European Parliament's Economic and Monetary Affairs Committee and, where relevant, the ESA concerned.[225] Secondly, if a Member State competent authority is minded not to follow a recommendation addressed to it by the ESRB, it must discuss this with the relevant ESA Board of Supervisors.[226] This will provide an opportunity for an ESA, which is under an enforceable duty generally to cooperate closely with the ESRB and specifically to ensure a proper follow-up to ESRB

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[219] ESRB Regulation, art. 15(3)-(5). The flow is not just one way, the ESRB must also share information with the other authorities: ESRB Regulation, art. 3(2)(f) and art. 15(1).
[220] ESRB Regulation, art. 15(2). The Regulations establishing the ESAs contain mirroring provisions requiring the ESAs to co-operate with the ESRB. See, e.g. EBA Regulation, rec. 32, art. 1a(3)-(4), art. 6(1)(d), art. 16, art 17 and art. 21.
[221] ESRB Regulation, art. 15(4)-(5).
[222] ESRB Regulation, art. 16.
[223] Ibid.
[224] ESRB Regulation, art. 17(1). Mirroring provisions in the Regulations under which they are established require ESAs that are recipients of ESRB recommendations to act or explain inaction: e.g. EBA Regulation, art. 21(4).
[225] ESRB Regulation, art. 17(2).
[226] eg EBA Regulation, art. 21(5).

recommendations and warnings and to take the "utmost account" of them, to exert pressure in support of the ESRB's action.[227]

Thirdly, on a case-by-case basis, the ESRB can make public its warnings and recommendations.[228] In certain circumstances, this could then lead to a hearing before the European Parliament.[229] Recommendations and warnings that are made public must also be mentioned in the ESRB's annual report.[230] As discussed earlier in the international context, the power to "name and shame" has considerable potential force notwithstanding the fact that it is a "soft" sanction. Yet its potential strength could have an inhibiting effect: that is, the ESRB may hesitate to use its power for fear of the market-destabilising effects of public announcements.[231] The publication of a risk recommendation or warning could in practice turn out to be a rather rare event, with cautiousness in this respect then becoming a self-reinforcing feature of the ESRB's operations.

So, how effective is the ESRB likely to be in those areas of responsibility that go beyond the collection and scientific evaluation of information? The various "enforcement" mechanisms support the conclusion of a UK Parliamentary committee that: "it would be a mistake to underestimate the extent of the ESRB's potential to trigger real effects".[232] But another part of that committee's conclusion – "It is true that the ESRB will have influence rather than power, and that its effectiveness will, in the long run, depend on its credibility" - is, we suggest, an understatement: as a body operating within a hybrid framework that combines elements of soft and hard law, the ESRB is supported by legal obligations imposed on other parties by EU law and, so, its ability to be effective and to exert real power will not be wholly dependent on its reputation. Given that the financial crisis exposed unheeded warnings as one of the major weaknesses of "soft" international financial regulation, the good sense of the policy of providing legal reinforcement for the ESRB's work so that it can be as robust as possible is obvious. However, this strengthening may come at a price in that awareness of its capacity to trigger legal effects could engender a rather cautious approach on the part of the ESRB. There is also the risk of the ESRB becoming tainted by association. The ESRB's dependency on other bodies for the translation of its requests, recommendations and warnings into concrete action means that its success, or otherwise, will inevitably be affected by the scope of the powers vested in those bodies and how well they use them. Interconnectedness means that the ESRB could be drawn into a highly contentious, reputationally-damaging protracted political and, ultimately, legal disputes about the obligations and rights of other bodies, There is thus a risk that the ESRB could find itself in the state of being neither fish nor fowl and having to suffer the worst of both worlds: too closely connected to formal mechanisms to be able to exploit the flexibility of soft law yet liable to be undermined by its dependency on others for actual enforcement. The compelling logical clarity of equipping the ESRB directly with legal enforcement powers means that this is an option that is unlikely to go away completely even though, for the medium term, there are formidable constitutional and political hurdles that stand in the way of taking that step.[233]

PART V

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[227] eg EBA Regulation, art. 21(5)-(6).

[228] ESRB Regulation, art. 18. A two-thirds majority of the vote in the General Board, with a quorum of two-thirds of the members, is required for a decision to go public: ibid.

[229] ESRB Regulation, art. 17(2).

[230] ESRB Regulation, art. 19(1a).

[231] F Recine and PG Teixeira, 'The New Financial Stability Architecture in the EU', Paolo Baffi Centre Research Paper No. 2009-62.

[232] Treasury Committee, *Opinion on Proposals for European Financial Supervision* (Sixteenth Report of Session 2008–09), para 52.

[233] Note the comment by the European Parliament Rapporteur on the ESRB Regulation "The ESRB does not have any binding power; ultimately, perhaps it needs to go further": S Goulard, *Report on COM(2009) 499* (February 2010) 48.

Summary and Conclusions

The financial crisis has triggered intense efforts internationally, regionally and nationally to enhance the monitoring of systemic stability and to strengthen the links between macro- and micro-prudential oversight. The establishment of the European Systemic Risk Board is the EU's contribution to this institutional re-ordering. The ESRB has been assigned scientific responsibilities for the collection and evaluation of information pertaining to systemic risk. It is empowered to ask European supervisory authorities and public bodies in Member States for such statistical information as it needs to enable it to perform its functions. It will also be authorised to issue warnings and recommendations, which may be made public so as to "name and shame". However, it will not have binding powers to impose its will on others and thus occupies the realm of soft law. The lack of binding powers raises questions about whether the ESRB will be too weak to operate effectively.

We have explored these questions first by examining the operation of soft law in the context of international financial regulation, where softer methods are particularly well-established, and with specific reference to the Financial Stability Board. Like the ESRB, the FSB is a soft law body that has come into existence as a result of the financial crisis, being part of the G20's effort to reinvigorate global macro-prudential oversight of systemic risk, although, unlike the ESRB, it has evolved from an existing body rather than being entirely new. There are also some similarities in their mandates: the FSB has been entrusted with a range of tasks relating to the monitoring of systemic stability and has been empowered to work alongside the IMF in the issuance of early warnings. Our study of the operation of the operation of soft law at the international level has demonstrated that soft laws and institutions can exert considerable power and that it is misconceived to dismiss them as simply symbolic. However, it has also revealed shortcomings that have implications for the FSB. There are clear weaknesses in the operation of a soft law approach to international financial market regulation particularly with respect to implementation: surveillance in respect of countries' actual compliance with regulatory standards to which they have formally signed up can fall short; warnings can go unheeded; and there are limits to what can be achieved through persuasion, informal and economic sanctions. We suggest that the need for a robust internationally-coordinated system of macro- and micro-prudential regulatory and supervision that was highlighted by the financial crisis may be starting to test the limits of the soft approach.

It is clear from experience at the international level that the effectiveness of bodies without binding legal powers depends to a large part on their ability to develop a strong reputation for technical competence and good judgment. We have identified certain challenges for the ESRB in this respect, particularly with regard to the immense complexity of the tasks that have been entrusted to it and the uphill battle it may face in winning over those who question whether a large, central banker-dominated body is up to the job. But we have also established that there are limits to the lessons for the ESRB that can be drawn from the experience of soft law at the international level. The ESRB will operate as an integral part of a system in which binding powers are available and in which legal obligations, including in respect of support for the ESRB, are imposed. We have argued that its links to specific legal back-up means that in many respects the ESRB's position is quite different from, and is more robust than, that of the FSB or any other international body.

With enhanced strength come a different set of potential problems. We have discussed the constitutionality of the ESRB and its accountability. We have explored certain possible drawbacks for the ESRB of being part of a system in which hard power is available, but not to it directly. The option of equipping the ESRB itself with binding powers is not currently available. By being conceived of as a soft law body without legally-binding powers, the ESRB structure cleverly finds a way around perceived limits on the powers that can be delegated to regulatory agencies in the current EU legal order, and sidesteps some of the acute political sensitivities about the centralisation of supervisory responsibilities. Paradoxically, either success or failure could eventually lead to the ESRB gaining more direct power: that is to say, this development could be driven by a wish to improve the effectiveness and efficiency of a body that has established a strong reputation and overcome doubts as to its legitimacy, or could come about in order to close gaps and to streamline processes that have proved to be too cumbersome for the proper containment and mitigation of systemic risk.