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# **ESRB: The Efficacy of Non-Binding Law for Financial Stability**

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## Abstract

*The 2008 Financial Crisis shed light on the lack of macroprudential regulation and proper law for ensure financial stability both in European Union and United States. Starting from 2009 the European Union started to correct the shortcomings that have not arrested one of the most blasting crisis, which has had repercussions not only financially, but also in the real economy. In order to mitigate the negative external of the next crises, the EU decided in 2010 to establish the European Systemic Risk Board, an agency with non-binding powers, whose objectives are the enhancement and protection of financial stability. In this paper will be discussed the historical motivation that led the creation of the ESRB, how it is structured, the tools it has to meet its objectives and the effectiveness of its actions despite the lack of enforcing power. In particular, the latter topic attracted the interest of researchers due to its paradoxical effectiveness: Why does a European institution with such an important responsibility, financial stability, only have non-binding powers at its disposal and hasn't been provided with stronger interventional instruments? how can an agency pursue its goals without any enforcing tool? In answering these questions is necessary to consider the strict cooperation between EU Agencies and ESRB, the credibility it possesses and the reputational damage that can be addressed with its tools*

**Key words:** ESRB, EU Legislator, International Law, European Union, Macroprudential Supervision, Systemic Risk, Financial Stability, Soft Law.

## Summary

1. Introduction .....	5
1.1 Historical Background – 2007 Financial Crisis.....	5
1.2 International Financial Regulation in Europe.....	6
2. The European Systemic Risk Board .....	7
2.1 Motivation of the Establishment .....	7
2.2 Legal Basis .....	9
2.3 Organization.....	10
2.4 Collection and exchange of information.....	11
2.5 Interventional Instruments and Powers .....	12
3. Efficacy of Non-Binding Powers of the ESRB.....	13
3.1 Soft-Law: Definition and Uses .....	13
3.2 The case of ESRB .....	14
4. Conclusion.....	16
Bibliography .....	18
Sitography.....	18

# 1. Introduction

## 1.1 Historical Background – 2007 Financial Crisis

The financial crisis experienced in 2007 represents the most disruptive economic collapse since 1929. The high severity of it led to the contagion of other countries in addition to the USA, bursting national economies and jeopardizing the financial stability of the firms. In fact, it's possible to understand the damage carried by this catastrophe by comparing the loss of the global stock market in 2017, €16 trillion, to the Gross Domestic Product of the European Union, about 1.5 of this loss<sup>1</sup>.

In order to understand the dynamics which led to the financial crisis it is necessary to analyze the single components of the market and understand their actions from the beginning to the explosion of the bubble; by adopting a simplistic vision on the crisis, it is possible to assert that the main causes of it were a combination of two fundamental distress that the market faced until the explosion of the catastrophe: the real estate bubble<sup>2</sup> and the credit boom<sup>3</sup>.

The financial crisis started in 2007: during the previous years, the USA real estate sector was growing exponentially<sup>4</sup> and the market agents were riding the wave in order to make higher profits. Meanwhile, credit institutions loosened the criteria to assess the creditworthiness of their potential customers, leading to an increase of debt-to-national-income ratio from 3.75:1 to 4.75 during the period covering 2002-2007.

This rapid change in the credit analysis procedures was caused by financial instruments such as collateralized debt obligations or mortgage-backed securities, which gave the opportunity to credit institutions to avoid the risk of unpaid mortgages by giving away the risk to the market.

These financial instruments, which were sold to investors, had a risk rating that did not reflect their true risk, as rating agencies used to value them as "AAA" due to wrong economic models or conflict of interest with credit institutions, as stated both by Chao and the Laroseière Group.

In order to understand deeply the "Mortgage-Backed Securities Phenomenon" it is necessary to seek for the motivation and the goal behind their creation. As stated by Lewis Ranieri and

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<sup>1</sup> de Larosière, *The High-Level Group on Financial Supervision in the EU* (February 25, 2009)

<sup>2</sup> Viral V. Acharya & Matthew Richardson, *Causes of The Financial Crisis* (July 13 2009)

<sup>3</sup> Credit booms are periods of rapid credit growth, this phenomenon is common in both advanced and emerging economies

<sup>4</sup> From 2002 to 2007 the housing prices grew at 11 percent per year

reported by Dennis Chao<sup>5</sup>: *“The goal was to create an investment vehicle to finance housing in which the investor did not have to become a home loan savant. He or she did not have to know very much, if anything, about the underlying mortgages. The structure of the deal was designed to place him or her in a position where, theoretically, the only decisions that had to be made were investment decisions. No credit decisions were necessary. The credit mechanisms were designed to be bullet-proof, almost risk-free. The only remaining questions for the investors concerned their outlook on interest rates and their preferences on maturities.”*

Considering that Mortgage-Backed Securities started to be used in 1970s, a relevant question arises: how could these financial instrument affect so disruptively the financial stability in 2007? As stated by D. Chao, the MBS market shifted from a “buy and hold” mechanism, to pure trading and speculation of this asset.

Moreover, de Larosière Group pointed out that Collateral Debt Obligation played a central role in the financial crisis, in fact, the lack of supervision on these financial instruments led to an increase of leverage and therefore, to a credit expansion.

The combination of economic factors stated so far led to failures of financial institutions and the freezing up of capital markets.

The catastrophic financial crisis has been followed by waves of legislative reforms and new regulations regarding macro prudential regulation and supervision both in Unites States and European Union. In particular, EU legislators decided to focus their attention and efforts on financial stability, which represented one of the main goals of European financial regulation.

From this perspective, the European Systemic Risk Board represents one of the many solutions addressed to enhance financial stability in Europe.

## **1.2 International Financial Regulation in Europe**

Before diving deep in the analysis of the European Systemic Risk Board and its interventional instruments, it is important to fully understand the European model regarding International Financial law. The legislative framework is based on two fundamental concepts: Regulation and

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<sup>5</sup> Chao, *Understanding the Causative Factors of the Subprime Mortgage Crisis: An Examination of Current Literature* (October 12, 2010).

Supervision. The first one it has to do in the strict sense of legislative power and deals with the creation of principles and laws to accomplish the main goal, while the second concept ensures the application of the law by addressees.

Moreover, in order to have a clear view of the scope of the financial regulation, It is fundamental to being aware of its goals and the motivations that make these tasks important for the European Union: protection of financial users (mainly investors, that are considered as the weak part of contract with financial purposes), consumer protection in retail finance, financial stability, market and informational efficiency, the ensurement of market competition and ultimately the prevention of financial crime<sup>6</sup>.

The need for the accomplishment of the goals above stated is given by the failures that the economic market suffers, such as Asymmetric information between parties or imperfect competition<sup>7</sup>. One of the most crucial failures that needs to be avoided are the negative externalities caused by banks or credit institution that raise their risk levels, represent a problem for the ensurement of financial stability. It is clear that risky institutions are more prone to fail and when this event happens, the consequences for the actors of the markets are devastating as demonstrated by the 2007 financial crisis.

The index of this paper is organized as follows: section 2 describes the motivations that led to the establishment of the European Systemic Risk Board its structure; section 3 investigates the reasons behind the Efficacy of Non-Binding Powers of the ESRB. The conclusion will be given in Section 4.

## **2. The European Systemic Risk Board**

### **2.1 Motivation of the Establishment**

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<sup>6</sup> Wymeersch, *Financial regulation: its objectives and their implementation in the European Union* (March 23, 2019)

<sup>7</sup> The asymmetric information phenomenon is quite common in the economic markets especially in private contracts. This market failure represents a threat when the financial market is considered, in fact, banks are able to use their information advantage to harm retail customer in order to make profits. On the other side, imperfect competition, caused by the entry barriers in financial markets and by different regulations in national countries that give less or more "freedom" to credit institutions regarding services provided, harms the actors of the market by making their benefits decrease.

The financial crisis of 2007 left an indelible wound in economic history: the disastrous effects caused by it have spread for years, creating an irreparable scenario. Although the crisis had started in the United States, it quickly spread to Europe, putting its financial stability at risk, due to the lack of adequate EU regulations that could limit the damages caused by it.

In 2008, the European Commission mandated de Larosière group to develop proposals to improve European supervisory arrangements across all financial sectors, with the goal of creating a more effective, integrated, and strong system of oversight. The group explained in the report the causes of the financial crisis experienced the year before, asserting the lack of macro-prudential and risk management supervision<sup>8</sup>, the extreme complexity of financial products or the inefficacy of stress-testing due to wrong assumptions. Moreover, one of the most important causes pointed out by the Group was the extreme focus on micro-prudential supervision of financial institutions, which was not counterbalanced by macro-systemic control. The report recommended that a Union-level body should be established with a mandate to oversee the risk in the financial system. Furthermore, the report highlighted the actions to be addressed at European and global level in order to avoid the uncontrolled effects of upcoming financial crisis.

The de Larosière Group pointed up the necessity create regulation mainly focused on the weaknesses of the set-up that the world was experiencing with phenomena, such as the financial bubbles and the poor regulation regarding the supervision or the need for promotion of correct governance of transparency.

Moreover, it is asserted the importance to avoid over-regulation, which could lead to a slow down of financial innovation and undermine economic growth.

The previous paragraph gives the opportunity to understand the balance between enforcing law and non-enforcing law: if all the European Agencies would be legitimated to create new laws, the economy would suffer due to the extreme bureaucracy and over-regulation.

On 16 December 2010 the Regulation No 1092/2010 establishing the European Systemic Risk Board entered into force.

It has been largely discussed about the role of the ESRB, in fact, various objections had been posed against the European Union on this topic. The central objection relies on the scope of action of the ESRB, which is restricted to the European Union, while financial crisis do not have

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<sup>8</sup> The Group asserts that there have been radical failures in the assessment of risk, both by financial firms and by those who regulated and supervised them

borders as already experienced during the one of 2007. Moreover, it has been pointed out that the tasks of ESRB could be accomplished by the Financial Stability Board. The European Commission, as an answer to this objection, asserted the importance of the ESRB due to the existence of an internal market in Europe and the increasing political and financial integration of the EU, that require an EU-level institution that supervises and monitors risks to the financial system. Moreover, the European commission remarked the cooperation and the connection between the ESRB and the Financial Stability Board as a way to ensure financial stability and reduce global damages due to future financial crisis<sup>9</sup>.

In the following subsections, an ample descriptive analysis of the Regulation No 1092/2010 is provided.

## **2.2 Legal Basis**

It is possible to find the legal basis of the European Systemic Risk Board in the Regulation No 1092/2010, published in,16 December 2010 and amended by Regulation (EU) 2019/21, published nine years later.

The European Systemic Risk Board, located is in Frankfurt am Main, is part of the European System of Financial Supervision (ESFS), a set of European Agencies whose objective is the supervision of the Union's financial system.

The ESRB is responsible for the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk. The ESRB therefore has a broad remit, covering banks, insurers, asset managers, shadow banks, financial market infrastructures and other financial institutions and markets. In pursuit of its macroprudential mandate, the ESRB monitors and assesses systemic risks and, where appropriate, issues warnings and recommendations<sup>10</sup>.

In particular, as stated in Article 3 of the regulation, the mission of the ESRB is put in practice by the tasks it pursues, such as the collection and the analysis of relevant information for ensuring financial stability, the identification and prioritization of systemic risks and, most of all, issuing and monitoring warning and recommendations when systemic risks are considered relevant.

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<sup>9</sup> From Q&A on the European Systemic Risk Board – European Commission Website

<sup>10</sup> From ESRB Website

The definition of “systemic risk” is fundamental in order to understand the scope of action and the main interests of the tasks of the European Systemic Risk Board. By citing the Regulation No 1092/2010, systemic risk is defined as: *“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”*.

It is important to notice that reputation of the ESRB is in part due to the close cooperation and connection with almost all the European agencies. In fact, the European Systemic Risk Board can be considered as a gear of the complex and efficient European ecosystem.

### **2.3 Organization**

The structure of the European Systemic Risk Board is divided as follows: the General Board, the Steering Committee, the Secretariat, the Advisory Scientific Committee and the Advisory Technical Committee.

The General Board is in charge of the decision-making process necessary to complete the tasks of the Agency and is composed, among all, by the president and vice-president of ECB, the Chairpersons of the European Supervisory Authorities, by the representatives of each Committee of the ESRB and by representatives of each European Supervisory Authority per Member State.

The Steering Committee prepares the meetings of the General Board, reviews the documents to be discussed and monitors the state of ESRB’s tasks.

The Secretariat is entitled of an extensive series of tasks: it provides high-quality analytical, statistical, administrative and logistical support to the Committees of the Agency.

Lastly, the Advisory Scientific Committee and the Advisory Technical Committee with the support of the Secretariat, is in charge of providing advice and assistance to the ESRB when requested by the Chair of the Agency.

The composition of these last two Committees is quite different: the first one is composed mainly by 15 experts with broad set of technical skills and experience, while the second is constituted mostly by representatives of European Supervisory Authorities and national central banks.

It is important to note that national supervisors have no voting right in the General Board; as asserted by the European Commission<sup>11</sup>, the motivation is clear: the presence of the national supervisors in the European Systemic Risk Board enhances the flow of information and makes able the constant exchange of views and opinions between the actors that have a macro-view of the situation<sup>12</sup> and the entities that have micro-prudential perspective. However, on the other side, national supervisors are in charge of supervision of individual banks and credit institutions at micro level, and do not deal with the stability of the financial system as a whole. The difference in voting rights can be explained by the dissimilar in methodology, mission, and analytical perspective used by the EU institutions in ESRB.

It is possible to notice that inside the European Systemic Risk Board, there are over 60 representatives of institutions. At first sight, the high amount of representatives could undermine the efficiency of the Agency; however, the high amount of diversity is an added value that is used to accomplish tasks. In fact, a broad representation of institutions is necessary to ensure a global macro-prudential perspective in the ESRB's risk assessments due to the fact that these institutions contribute to the burdens of ESRB by providing relevant information and expertise.

As stated by Mario Draghi in 26 September 2019, during the fourth annual conference of the European Systemic Risk Board: *"The ESRB's success derives from its broad membership. Systemic risk takes different forms over time, so discussions incorporating a wide range of viewpoints and experience are vital if policymakers are to successfully safeguard the stability of the financial system"*.<sup>13</sup>

## **2.4 Collection and exchange of information**

The exchange of information is fundamental for the ESRB to accomplish its tasks: without sources and providers of information, the stability of the financial system would not be supervised appropriately. In a globally connected environment, data and information represent a way to understand what is going on and gives a summarized perspective from different points of view as we will see in this subsection.

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<sup>11</sup> From Q&A on the European Systemic Risk Board - European Commission Website

<sup>12</sup> Such as the ECB, the National Central Banks, the Commission

<sup>13</sup> From ESRB Website

As stated by the Article 15 of the Regulation No 1092/2010, the ESRB provides to the European Supervisory authorities all the information regarding risks necessary for the accomplishment of their main tasks.

In particular, the ESAs, the national competent authorities and all the other agencies that are part of the European ecosystem cooperate together with the European Systemic risk board providing all the information necessary for the accomplishment of its task. As it's possible to see, the exchange of information is bi-directional: the ESRB receives and gives information consistently to the European ecosystem.

Creating, distributing and gathering information is a costly activity, that's why in Article 15(7), it is asserted that the ESRB must contact the European Supervisory Authority in charge of it before making any request for information that is not in summary or aggregate form to ensure that the request is justified and proportionate. If the European Supervisory Authority does not think the appeal is justified and proportionate, it must immediately refer it to the ESRB and request further reasoning.

## **2.5 Interventional Instruments and Powers**

The European Systemic Risk Board possess interventional Instruments in order to ensure financial stability and the accomplishment of the tasks it is entitled: Warnings and Recommendations.

As stated in the Article 16 of the regulation No 1092/2010, these tools can be either of a general or specific nature and should be used when remarkable risks undermine the achievement of the ESRB. Moreover, these non-binding powers can be addressed to a wide range of entities such as the Union as a whole, a single Member State, one or more European Supervisory Authorities or even to National Competent Authorities. The form of the Recommendations is written and shall include a specific timeline for the policy response; the motivation behind the need of a deadline for the feedback from the addressed entity is the necessity to avoid ambiguous administrative patterns<sup>14</sup>.

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<sup>14</sup> The addressed Entity may not be interested in answering the ESRB or it could postpone sending the reply pending the occurrence of a certain event. Furthermore, without a specific timeline, the addressed Entity would have no interest in sending a timely answer, letting time pass and waiting for a solicitation from the ESRB. The pattern just described would make Recommendations almost ineffective and the authority of the ESRB would be heavily harmed.

Nonetheless, the recommendations and warnings sent to addressees is also delivered to the Council and the Commission.

After the recommendation is sent, it follows a follow-up phase, where the addressees are invited to give a response to ESRB and the Council regarding the actions undertake to remedy the risk situation or, if not if no measure is taken, to justify the reason for the inaction. In the case of relevant situation, the ESRB communicates the answer received to the European Supervisory Authorities.

The most powerful tool that ESRB has at its disposal is the possibility to make its warnings and recommendations public as it will be discussed in the following section of this paper, that will dive deep into the efficacy of the tools analyzed despite their non-binding power.

Lastly, the ESRB is obliged to create public reports at least annually or in the event of important financial distress. The report is composed by the information made public.

### **3. Efficacy of Non-Binding Powers of the ESRB**

#### **3.1 Soft-Law: Definition and Uses**

The “positive” strict definition of soft law is hard to find, in fact, it can be seen as residual category, defined in a “negative” way, by excluding it from clearer categories rather than on its own terms.

Moreover, soft law is often connected to the concept of non-binding (non-enforcing) powers, defined as interventional instruments that do not create any obligation or commitment.

A clear but unofficial definition that fully gathers all the characteristics of soft law is stated by Guzman and Meyer<sup>15</sup>: *“we define soft law as those nonbinding rules or instruments that interpret or inform our understanding of binding legal rules or represent promises that in turn create expectations about future conduct.”*

The existence of soft law is quite controversial if its efficacy is compared to the one of hard law, which are characterized by their binding power.

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<sup>15</sup> Guzman, Meyer, *International Soft Law* (March 1 2010)

However, Guzman and Meyer tried to give some possible motivations behind the presence of soft law, asserting that each one of them provide a precise perspective that justifies the preference of this kind of law with respect to hard law.

The first reason that could explain the existence of soft law is that states might choose this kind of interventional instrument to solve a straightforward coordination problem, a situation in which states have a good degree of confidence that once a set of rules is selected, those rules will remain self-enforcing in the future.

The second motivation explained has an economic focus: considering that states use to maximize the value (the adoption and the compliance) of their agreements, soft law could be preferred over hard law as represents a tool that matches the needs of the state. In fact, hard law, due to their binding power, create compliance costs if violated, while soft laws, despite being less effective, provoke a reputational damage that at first sight may lead one to think that it has no consequence. However, in reality, the loss of reputation are expensive because they make it more difficult for a state to make agreements with other parties. It's important to note that the European Systemic Risk Board uses reputational damage to harm states and institutions that are not compliant with the recommendations they address.

Indeed, a practical example of soft law is provided by the analysis of the research proposed by Ferris and Kern: the non-binding guidelines provided by the so-called Lamfalussy Level 3 Committees (the Committee of European Securities Regulators) already contains a significant layer of soft law and soft methods. The Committee of European Banking Supervisors (CEBS), the Committee of European Banking Supervisors (CESR), and the Committee of European Banking Supervisors (CESR) Supervisors of Insurance and Workplace Pensions (CEIOPS)).

### **3.2 The case of ESRB**

The previous subsection has given an abstract and theoretical perspective on soft law, while in this one it will be focused on the practical motivations that make effective the interventional tools of the ESRB.

As already stated, recommendations and warnings are not per-se legally binding but there are some peculiar characteristics that make them in a sense “enforcing”.

In particular, as stated in Art 16(3) of Regulation No 1092/2010, when a recommendation is sent to the addressee, it is also delivered to the Commission and the Council in order to make these Authorities aware of the risk the financial system is experiencing.

After the follow-up phase, where the addressee is in charge of responding to the recommendation; the justifications of inaction provided will be forwarded to the ESAs.

On the other hand, when the addressee fails to comply with the recommendation or does not provide a sound justification, the ESRB contacts the European Council and when relevant, the European Supervisory Authority concerned. These procedures that concern the forwarding of information to the competent authorities represents a call to action and an alarm about the stability of the financial system: the financial institutions should take some action in order to put remedy the situation using their enforcing power<sup>16</sup>.

Another important feature that the interventional tools possess is the possibility, when relevant, to make a recommendation or warning public in order to make everyone aware of the problem that the financial system is experiencing. This kind of action creates a reputational damage for the addressee which is not secondary as damage compared to a sanction or penalty. In fact, for example, a member state with low reputation will not be able to create new agreements with other entities, leading to its isolation at European or global level.

Indeed, as asserted by Ferris and Kern in *“Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board”*, “Naming and shaming” can also have an impact, as demonstrated by the work of the Organization for Economic Co-operation and Development (OECD) with respect to tax havens.

However, 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-destabilizing effects of public announcements.

The processes described and the effectiveness of the tools of the European Systemic Risk Board rely on its strong reputation in the European ecosystem developed thanks to its sound technical competence and judgement. Moreover, its close cooperation with the European Supervisory

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<sup>16</sup> Ferran, Eilis and Alexander, Samuel Kern, *Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board* (November 4, 2010)

Authorities, the Council, the Parliament and the Commission plays an important role in the determination of the authority of the ESRB.

The role of the European Systemic Risk Board is extremely discussed by researchers and experts in international law due to its peculiar position and responsibilities, in fact, despite this agency is in charge for the supervision of financial stability, a fundamental and delicate topic that could create devastating results to the society if threatened, the interventional tools that it can use do not have any binding power. Indeed, the ESRB does not have any legal basis for the creation of hard law: how this extreme imbalance is possible? After reading different opinions from experts and researcher, in my personal opinion, in order to give a rational answer, it is fundamental to understand that the tools that ESRB has at its disposal define partially its role in the European ecosystem of agencies. In my judgement, the tools provided to the European Systemic Risk Board as well as its tasks suggest that its role is not to impose hard law. It is essential to recognize that the ESRB is a supervisory body and having a well-defined role increases its reputation and its effectiveness at European level and beyond. The European system is based on a clear division of tasks: if the ESRB could create hard law, then its burden would increase and problems of competence and overlapping law would rise. Instead, its role rests on overseeing financial stability and supporting other ESAs, while the power to create law and enforce it rests with the ESAs.

#### **4. Conclusion**

To sum up everything that has been stated to far, the European Systemic Risk Board has been established after the financial crisis as a solid solution for ensuring financial stability. It part of an ecosystem of European Agencies and cooperates with them in order to accomplish its tasks.

The interventional instruments (recommendations and warnings) used by the ESRB are not per-se legally binding, but their practical efficacy is due to some particular characteristics.

In fact, the close connection and cooperation with other Agencies gives to ESRB an high reputation and therefore, charges it with a superior authority that makes warnings and recommendations powerful tools.

Moreover, the possibility to make the interventional instruments used and the relative answers public, makes them a useful tool for damaging reputation of the ones not compliant. The threat

represented by this possibility makes the ESRB powerful when they issue recommendations or warnings in order to accomplish their tasks.

Furthermore, it is known that many researchers and experts find the soft law ineffective and that the European Systemic Risk Board, as well as other international agencies acting through non-binding laws, should have stronger powers in order to ensure the achievement of its objectives such as hard law. However, this reasonable objection is countered by the need to avoid over-regulation which slows economic growth and creates competence problems.

In conclusion, taking into account what has been stated so far, it is possible to assert that soft law can be considered a powerful enforcing tool. The degree of strength of this kind of law is determined by the ecosystem in which the law is applied, by the reputation of the institution who addresses it and, lastly, by the consequences caused by the non-application of the law.

The European Systemic Risk board is an impeccable and practical example of how soft law can be effective at international level.

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