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An Analysis of the Effectiveness of Soft Law Bodies: The Special Case of the European Systemic Risk Board

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Abstract

Since its introduction, the European Systemic Risk Board has been object of accurate analysis and researches in order to study its role, its structure and the effectiveness of the tools that it is empowered of. In this paper we display the main reasons that brought to the introduction of this board, the most important of which is the global financial crisis of 2008, and of the connected institutions. As a result of the introduction of this board, a shift from a strictly micro-prudential to an also macro-prudential based system was highlighted. This is of extreme importance since from that moment the concept of systemic risk started being considered and several different authorities were introduced with the purpose of addressing this issue. However, a set of relevant questions arises: Which are the tools that could be set in force by the ESRB? And which is their effectiveness? Well, the answer is not easy to address, but we found out that even if the board has no direct binding powers, the effects generated on the target entities are equivalent as if the ESRB was entitled with binding powers. There are two main reasons that could explain this fact: the concept of reputation of the addressed entities and the strict cooperation of the board object of our analysis with authorities that could act through the use of binding tools.

Key Words: European Union; Macroprudential supervision; Systemic risk; ESRB; Soft law.

Introduction

The financial crisis that we have witnessed since the last years of the past decade has had clear and relevant consequences not only with regards to the financial sector and the real economy, but also for the judiciary. As a matter of fact, the set of economic repercussions that occurred in years ranging from 2008 to 2014, represented a clear opportunity to reform a system that had historically been in need to be restored; and the crisis, remembered as one of the most dramatic in economic and financial history, is an irrefutable proof of it. In a nutshell, everything started in 2007, when a historically growing real estate bubble started to burst, generating a relevant decrease and a deep depreciation in the subprime mortgage market in the United States. The situation, due to an internal risk spread inside the sector, developed into an international banking crisis therefore affecting not only credit institutions in the U.S.A., like Lehman Brothers but also entities located in the European Union. At this point, the crisis had assumed a global shape, and financial consequences related to that specific sector started to spread deeply into the real economy. What's more, excessive risk-taking by banks, added to the rating-companies scandal, contributed to harm a sector that was already suffering. A relevant role was also played by securitization. This concept is related to the possibility of banks and credit institutions to transfer financial instruments that, without the securitization process, would not be possible to transfer. As a consequence, new tools were set at work by several different authorities in order to limit the spread of that crisis. Bailouts of financial institutions, monetary and fiscal policies in addition to Quantitative Easing operations were therefore introduced.[1] Thanks to the countermeasures adopted, the global economy slowly started to recover, even though in a not homogeneous way. This means that some countries were able to recover more rapidly than others, in accordance with the policies and actions adopted in order to address the distressed period. In this context, a key role was played by national central banks and european financial institutions. Said that, the relevance of a solid and comprehensive legal system is undeniable, to such an extent that a different outcome could have been imagined for the financial crisis and its related consequences. For those reasons, a deep analysis related to international law, regulation, supervision and systemic risk will be provided.

[1] Jeff Madura, "Financial markets and institutions", textbook 11th edition, chapter 1, 2011.

In the first section we will discuss the relevance of the concepts of regulation and supervision, in particular from the perspective of financial markets. In the following section we will instead discuss the concept of macroprudential supervision, which represents the main task delegated to the ESRB, while the effectiveness of its tools will be analysed in depth in the third and in the fourth sections.

Regulation and Supervision

The disastrous financial crisis, that has been discussed in a synthetic way, represented a clear signal that structural changes in the sector and consistent legislative reforms were needed in order to avoid future spill-overs. In particular, some actions were set in force, mainly with the aim of strengthening and enlarging two of the most important concepts in the legislative and financial sector: Regulation and Supervision. The principal aim of them is to avoid market failures and to avoid that circumstances like the ones that started in 2007 occur again. As a matter of fact, the goals of financial regulation could be summarized in the following key points: maintenance of financial stability, protection of financial users and of customers of financial instruments, market efficiency and prevention of financial crime.[2] All those tasks could be fulfilled through the application of the several different, binding and not binding, legislative tools that are in force of the legislator. This means Regulations, Directives, Decisions, Recommendations and Opinions. On the other hand, as reported in "Legal foundations of international monetary stability" by Lastra M.R.[3], the concept of supervision could be defined as "the oversight of firms' behaviour, in particular with regards to risk monitoring and risk control". In other words, the supervisory process consists in overviewing banks, financial entities and companies in order to assess their compliance with law. Some of the features that might be relevant in our context are for instance given by the business model of the bank, by its governance and finally by its capital and liquidity position.[4] All those characteristics are of extreme relevance in order to verify and assess the risk profile of the entity. Said that, as a conclusion of what

[2] John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer, and Jennifer Payne; "Principles of Financial Regulation". Textbook, 2016.

[3] Lastra, Rosa Maria. "Legal foundations of international monetary stability", Oxford University Press, 2006

[4] John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer, and Jennifer Payne; "Principles of Financial Regulation". Textbook, 2016.

stated until now, it is important to understand the centrality of the two concepts and their interaction, and to realize how an implementation of the actions carried out in such a context could have avoided the disastrous outcome of the financial crisis.

Macroprudential supervision

One of the most important key points that should be remembered, relative to the post crisis actions undertaken by european authorities, is given by the shift from a micro prudential centred supervision approach, to a both micro and macro prudential one. The former element is about addressing the risk of individual bank failure, whereas the latter one is about addressing the risk of a whole system failure. As a result, the financial crisis has produced a global consensus relative to the need for more effective, better coordinated both macro and micro prudential regulation and supervision in order to avoid the spread of distress among financial entities. However, as stated in the research paper "Can soft law bodies be effective? The special case of the European systemic risk board", by Ferran Ellis and Alexander Kern[5], our interest should mainly be centred on the macro-prudential approach. The reason for that is given by the fact that both financial markets and systemic risk overview need a stronger interconnected and cooperative supervisory system that requires improved institutional capacities on the international level in order to control systemic risk on a cross-border basis. This statement underlines a key feature, that is the cross-border nature of systemic risk and the need of an international authority capable of providing a rigorous and integrated supervisory action. In such a context, the attention pointed on macro-prudential regulation also involves the draw up of regulatory standards with the aim of setting not only some limits to the leverage level for financial entities, but also of liquidity buffers in order to enforce short-term solvency and, more broadly, counter-cyclical capital regulation. Moreover, a challenge for the competent authorities that should be addressed in the future, is given by the continuous development of financial markets. This means that the prudential regulation and supervision of financial markets require continuous adaptation as markets evolve. As a matter of fact, this represents one of the greatest challenges for international institutions and authorities that provide a supervisory service like, for instance, the ESRB. We will later on discuss that the juridical

[5] Ferran, Ellis and Alexander, Kern. "Can soft law bodies be effective? The special case of the European systemic risk board", Zurich Open Repository and Archive, 2011

nature of the board object of our analysis was appositely designed in order to accomplish this task and to be as flexible as possible.

The following section of this research will entirely be dedicated to the European Systemic Risk Board, to its powers and to the effective relevance of them.

The ESRB

Legal basis and organization

Due to the strong economic consequences deriving from the global financial crisis of 2009, the European Commission started considering the possibility to develop and introduce relevant reforms in the financial system. Therefore, the Commission decided to task a high-knowledge-level group of professionals, chaired by Mr. Jacques de Larosière, with the aim of evaluating how financial supervision could be strengthened over the market in order to foster protection among european citizens and rebuild trust in the financial system.[6] As already mentioned in the previous sections, the de Larosière Group remarked the fact that not only both the supervision of individual firms and the stability of the financial system as a whole should be considered, but it also provided a detailed review of the lessons learned from the past crisis, with particular regard to the weaknesses in the Lamfalussy system. In other words, the macro prudential approach is as important as the micro prudential one and a coordination and cooperation of both these concepts is necessary. For all these reasons, in 2009, one year after the breakout of the financial crisis, the de Larosière group stated in an official note that an integrated and internationally based body needed to be introduced at the European level, with the particular task to overview risk and its spread in the financial system.[7] Therefore, in December 2010, regulation 1092/10 introduced the ESRB, which is definitely part, with EBA, ESMA and EIOPA, of the European System of Financial Supervision (ESFS).[8]

[6] Regulation 1092/2010 issued by the European parliament and by the Council
[7] High Level Group on Financial Supervision in the EU, Report (February 2009)
[8] ESRB official webpage: https://www.esrb.europa.eu/about/background/html/index.en.html

In order to better assess the role, the tasks and the powers conferred to this board, it is now time to go more deeply into the technicalities of the legislation and to consider the legal basis that gives birth to this entity: the already mentioned Regulation 1092/2010. In particular, a clear, however not really precise definition is provided in article 3 subsection 1, according to which "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 macroeconomic 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". The task reserved to the ESRB is precise: to provide macroprudential supervision, maintain financial stability and avoid the spread of systemic risk. Therefore, one question arises: how should the board perform those tasks? In order to best address this question, the provision of an analysis relative to the composition of the board is necessary. According to what is reported in article 4 of the regulation, the ESRB is composed by a General Board, a Secretariat, a Steering Committee, an Advisory Scientific Committee and an Advisory Technical Committee. The former is considered to be the decision-making body of the ESRB. It is made up of 65 members, of whom just 37 are empowered of having voting rights. What's more, the President of the ECB is the first Chairperson of the entity, but he does not act alone as he is supported by the work of the vice-president of the ECB, by the governors of the National Central Banks, by the chairs of EBA, EIOPA, and ESMA, and, finally by the support of the European Commission.[9] Going further into the analysis, the role of the Secretariat, the second entity building up the ESRB, is precisely described in article 4, subsection 4, which displays what follows: "The Secretariat shall be responsible for the day-to-day business of the ESRB. It shall provide high-quality analytical, statistical, administrative and logistical support to the ESRB under the direction of the Chair and the Steering Committee in accordance with Council Regulation (EU) No 1096/2010 (1). It shall also draw on technical advice from the ESAs, national central banks and national supervisors". The role is clear: the Secretariat must provide not only support, of different nature, to the board, but it also has to report technical advices coming directly

[9] Regulation 1092/2010, art. 4, subsection 2

from the ESAs. In such a context, the tasks carried out by the Steering Committee are also relevant. Always according to article 4, subsection 3, "The Steering Committee shall assist in the decision-making process of the ESRB by preparing the meetings of the General Board, reviewing the documents to be discussed and monitoring the progress of the ESRB's ongoing work". Considered that, it is quite easy to understand that this entity has the role of assisting, guiding and directing the General board. Last but not least, it is worth spending some words in order to define the role of the Advisory Scientific Committee and of the Advisory Technical Committee. Article 4 subsection 5 of the Regulation clearly displays their role and states what follows: "The Advisory Scientific Committee and the Advisory Technical Committee shall provide advice and assistance on issues relevant to the work of the ESRB." Therefore, we can state that they play an important technical-advisory and consulting role for the board object of our analysis. [10]

The reason for which those articles were reported is given by the fact that they provide a clear and concise overview of the structure of the entity. This is a key point since it is necessary to better understand the powers conferred to the ESRB and their effectiveness. Said that, having provided a detailed introduction relative to the structure of the entity, it is now worth stressing another relevant feature of the ESRB, that is its legislative nature. As previously stated, the ESRB is established by a Regulation under article 114 TFEU, which refers to it as a body without legal personality and with no binding powers. This means that the ESRB is nothing more than a board, it is not an authority neither an institution. Just a board, that of course has to fulfil relevant tasks but that is not characterized by legal authority and independence. Relevant consequences of this feature arise, and we will display them in the next section.

Soft law powers

Having introduced the structure and organization of the ESRB, it is now time to describe another relevant aspect mentioned in Regulation 1092/2010, that concerns the tasks and powers conferred to the board. As already stated in the previous sections, the board responsible for macroprudential supervision and object of our analysis, is mainly entitled to carry out its tasks by using tools which have nature of "soft

[10] Regulation 1092/2010

law". The latter term is a relevant key point in the context of International financial regulation, and it consists of standards, guidelines, interpretations and other statements that have no direct binding and enforceable power.[11] This is fully in line with expected techniques of international and European law. However, it is commonly believed by researchers that the board is capable of exerting powerful influence over the addressed entities. In other words, there is tangible evidence of the fact that the ESRB can express strong influence on the latter ones, even though it is not formally empowered of binding powers. How is this possible? Which are the features that allow the board to have such an influence? Those are just some of the most relevant arguments relative to the effective intervention power of the ESRB, and we will now analyse them starting from the legal intervention powers conferred to the entity. Chapter III of the regulation comes to our aid by introducing the necessity of cooperation between entities as follows: "The ESAs, the European System of Central Banks (ESCB), the Commission, the national supervisory authorities and national statistics authorities shall cooperate closely with the ESRB and shall provide it with all the information necessary for the fulfilment of its tasks in accordance with Union legislation". [12] Once again, the need of a cooperating and unified system of macro prudential supervision is pointed out. However, the relevant part for our purpose comes with article 3, subsection 2, but most importantly with article 16, subsections from 1 to 4. The content of those articles could be summarized in the following way: when a potentially relevant risk is identified, the ESRB has the power to issue warnings and, where considered necessary, recommendations. Both these tools are, as should be clear, not binding and both could assume either a general or a specific nature. Furthermore, another aspect is relevant in this context: when issued, warnings and recommendations might be addressed to the whole Union, to one or more Member States, to one or more of the ESAs, or finally, to one or more of the national supervisory authorities. What's more, at the same time, both warnings and recommendations should be sent, in accordance with rules of confidentiality, to the Council and to the Commission. [13] Last but not least, according to what stated in subsection 4 of the already mentioned article, "[…] the ESRB, in close cooperation with the other parties of the ESFS, shall elaborate a color-coded system corresponding to situations of

[11] Ferran, Ellis and Alexander, Kern. "Can soft law bodies be effective? The special case of the European systemic risk board", Zurich Open Repository and Archive, 2011
[12] Regulation 1092/2010, art. 15, subsection 2
[13] Regulation 1092/2010, art. 16, subsection 1-3

different risk levels […]". The board has therefore the task to identify the risk level to which the object of the warning or recommendation belongs.

Another key point that is important to point out in order to best analyse the object of this report is given by article 17. The main content of this article is referred to the issue of recommendations and, in particular, it states that if a recommendation is addressed to an entity, the addressed institution shall communicate to the ESRB and to the European Council the actions undertaken in order to fulfil the requirement, or it shall otherwise provide a precise justification for inaction. If the recommendation is not followed by the entity as required, the ESRB should inform in an as confidential as possible way, not only the addressees, but also the Council and, when it considers it relevant, the European Supervisory Authority concerned.[14] From the articles of the regulation displayed until now, a key feature of the tasks and duties conferred to the ESRB emerges: their lack of binding powers. In fact, one interesting aspect that could be analysed with regards to this point, is given by the assessment of the effectiveness of the actions carried out through the issue of warnings and recommendations by the ESRB. Said differently, are the tools in force of the board effective with regards to entities for which they are issued? Well, the answer in not easy as it might look like, therefore, we will try to address it in a structured and possibly precise way in the next section.

Effectiveness of soft law powers

Since its introduction, the ESRB has always been subject of analyses and studies aimed at identifying its legal nature and the effectiveness of the intervention instruments at its disposal. In order to depict a clear overview of this topic, a good starting point is provided by the European Commission, which links the ESRB's lack of legal personality to the "wide scope and the sensitivity of its missions".[15] Therefore, the tasks conferred to the board are considered to be characterized by an appropriate nature, perfectly matching the scope and the mission of the ESRB.

[14] Regulation 1092/2010, art. 17, subsection 1-3
[15] Ibid., para 6.

This means that they have nature of soft law. According to Ellis and Kern[16], and contrary to what we might expect, the lack of legal personality and binding powers does not necessarily need to be a drawback to the ESRBs authority and influence. Proof of this is the fact that the board object of our interest could be compared to such an extent to the FSB, which is itself a body without legal personality and which is entitled of fulfilling similar tasks, even though it operates in a different context with respect to the European Union. As pointed out in the research paper, also flexible constituted bodies, like the FSB and the ESRB, are able to exercise considerable power. This statement is completely in harmony with the point of view of the European Commission, according to which it is possible to build up the legitimacy of an entity on its reputation rather than on formal legal powers. However, although for both recommendations and warnings there are no direct binding powers, there is a considerable indirect reinforcement for several reasons. First of all, addressed entities must obligatory underly on a specific "act or explain" obligation. As displayed in section 3.2 of this paper, if the ESRB is dissatisfied by the actions undertaken or by the explanations for inaction provided by the addressed entity, it can report the issue to the Council or to another of the indicated authorities. Secondly, if the competent authority of a member state is not following a recommendation addressed to it, it must report and discuss this issue with the relevant ESA. This means that even if the board has no binding powers, it might be supported by the work of other institutions, which might be characterized by the possibility to use binding instruments. Thirdly, but most importantly, the ESRB can publish, and therefore make available to everyone, its warnings and recommendations. In certain circumstances, generally in the worst ones, this might escalate to a hearing in front of the European Parliament. What's more, recommendations and warnings that are published by the ESRB must be mentioned in its annual report. This means that each entity having access to this report, even the external ones, might be aware of the fact that the addressed institution is not complying with the requirements of the board. As a consequence, the power of the so-called "name and shame" intervention tool assumes an extremely relevant force, in particular if we consider the fact that it is a soft sanction. This is a key point that should be considered in order to further investigate the effectiveness of the actions of the ESRB. In fact, even if this board is not entitled with direct and legal binding powers, the

[16] Ferran, Ellis and Alexander, Kern. "Can soft law bodies be effective? The special case of the European systemic risk board", Zurich Open Repository and Archive, 2011

reputational aspect of the addressed entities plays an important role for their compliance to warnings and recommendations. In other words, the binding feature is provided by a reputational basis for the addressed entities rather than by a legislative power. However, it is fear to report also the fact that the public report of a recommendation or a warning is in practice a rather rare event. This means that it is quite unusual for the board to formally display to the public the non-fulfilment of a specific institution. Another relevant point that should be highlighted is given by the fact that the ESRB is an integral and relevant part of a broader structure, within which hard enforcement powers are available. This means that there are European-levelled authorities that work in strict connection with the board and that are entitled of enforceable and binding powers. As a result, the close connection of the ESRB to bodies enforced with formal powers enhances its effectiveness. On the other hand, as stated by Ellis and Kern in "Can soft law bodies be effective? The special case of the European systemic risk board", a drawback could be given by the cooperation occurring between the ESRB and the just mentioned types of authorities. More in detail, a relevant point to analyse could be given by the impact which is still inhibiting the board and forcing it to adopt bureaucratic procedures similar to the ones that are appropriate for a body with formal powers. Therefore, a consequence of this fact may be the loss of flexibility, which is usually considered to be one of the building blocks of the ESRB.

In addition to what displayed until now, the latter concept, which is strictly related to soft law powers, should be addressed. It is especially worth noting that generally, institutions entitled with powers similar to those of the ESRB, need to be centred on a flexible basis. This means that those entities are usually considered relevant because of their flexible and continuously developing decision-making structure. As a matter of fact, since this kind of boards are often made up of a limited number of participants, they are considered to be able to react promptly and quickly to continuously changing circumstances, which, in the field of international financial market regulation, can be a particularly valuable feature.

Conclusion

In this paper, a precise and accurate analysis regarding systemic risk, macroprudential supervision and, most importantly, about the ESRB has been provided. The need to develop a system and to renew the legislative framework after the crisis of 2008, brought to a series of reforms that had as main aim that of avoiding the new occurrence of a period of economic and financial distress. For these reasons, starting from 2010, the regulatory and supervisory framework were object of improvements. The most important one is given by the introduction of a new entity, the ESRB. This board, that has no legal authority and that is not independent, has the aim of fulfilling a macroprudential supervision action, that means identifying and assessing systemic risk with the purpose of avoiding its spread. However, an important question arose among researchers: Is the board able to carry out those fundamental tasks if it acts through soft law tool? Which is the effectiveness of the actions carried out by the ESRB? Those questions are of course not easy to address, but we developed and provided several reasons for which the powers entitled to the board perfectly fit the operations that it has to carry out. First of all, recommendations and warnings play an important role, since the reputational aspect regarding the compliance of an entity to these two instruments might have a stronger effect than strictly binding tools. This means that reputation matters, and sometimes it matters more than fines and penalties. What's more, another relevant aspect that arose in the last ten years, is given by the strict connection and cooperation of the ESRB with other European entities. These latter ones are often entitled to act through binding and coercive actions; therefore, we could state that the board might also indirectly benefit from the application of these tool. Last but not least, we pointed out the reasons for which the ESRB acts through soft low powers, and the reason is that it has to act in a dynamic, flexible and continuously developing context. For all those reasons, the conclusion we reached is that the board, contrary to what we might expect, has the possibility to intervene in an efficient way through the use of tools that perfectly match the objectives that it has to achieve.