United in Diversity? The Relationship between Monetary Policy and Prudential Supervision in the Banking Union

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Banking Union – Single Supervisory Mechanism – Economic interplay between monetary policy and prudential supervision – Strict separation envisaged by the Single Supervisory Mechanism legal framework – Legal framework does not prevent a more holistic approach – Financial stability is a legitimate consideration for monetary policy-making – Price stability is a legitimate concern for prudential supervision – Challenge to European Central Bank legitimacy and independence – Democratising the European Central Bank

'Two souls alas! are dwelling in my breast'

Since November 2014, the European Central Bank has enjoyed a tremendous increase in its powers: The Unified Banking Supervisory Mechanism – known as the Single Supervisory Mechanism – began operating under the auspices of the European Central Bank.[1] It has since been endowed with the task of supervising currently 119 banks in the Eurozone identified as significant.[2] The Single Supervisory Mechanism was established to break the diabolic loop between banking crises, bank bailouts, and ensuing sovereign debt crises. The 2012 Spanish and Cypriot banking crises had required the respective governments to bail out troubled banks, raising sovereign debt to unsustainable levels. This prompted the

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[1] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, p. 63-89 (hereinafter 'SSM Regulation').

[2] Comprehensively on the establishment of the Banking Union: N. Moloney, 'European Banking Union: Assessing Its Risks and Resilience', 51 *Common Market Law Review* (2014) p. 1609 at p. 1616. The list of entities classified as significant and currently supervised by the Single Supervisory Mechanism is available at <www.bankingsupervision.europa.eu/banking/list/who/html/index.en.html>.

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European Stability Mechanism to grant financial assistance to both governments for the recapitalisation of their financial sectors, in accordance with Article 15 of the European Stability Mechanism Treaty, to minimise the consequences of the financial turmoil for the real economy. With the European Stability Mechanism having to shoulder the financial consequences of banking crises resulting, inter alia, from flaws in the supervision of financial institutions by the member states, calls emerged for the Europeanisation of the supervision of systemically important banks, including alongside the Single Supervisory Mechanism a Single Resolution Mechanism and a common deposit guarantee fund.[3] In that way, supervisory responsibility would be aligned with the financial burden of providing a fiscal back-stop to ailing banks.[4]

The European Central Bank was entrusted with hosting the Single Supervisory Mechanism, not only because it appeared to be the most competent institution to discharge that task,[5] but also because Article 127(6) TFEU offered a seemingly convenient legal basis for conferring the task on the Bank.[6] However, charging the European Central Bank with supervision gives rise to potential conflicts of interest between the monetary policy and supervisory functions of the Bank, as there is a high level of interdependence between monetary policy and the stability of the financial system.

[3] H. Van Rompuy et al., 'Towards a Genuine Economic and Monetary Union', 26 June 2012, EUCO 120/12, 4-5. On the Spanish and Cypriot Banking Crises *see* T.H. Tröger, 'The Single Supervisory Mechanism – Panacea or Quack Banking Regulation?', 15 *European Business Organization Law Review* (2014) p. 449 at p. 456 ff.

[4] On this principle *see* T. Padoa-Schioppa, 'EMU and Banking Supervision', 2 *International Finance* (1999) p. 295.

[5] *See* recital 13, SSM Regulation.

[6] Moloney, *supra* n 2, p. 1659; E. Wymeersch, 'The Single Supervisory Mechanism: Institutional Aspects', in D. Busch and G. Ferrarini (eds.), *European Banking Union* (Oxford University Press 2015) p. 93. Whether the Single Supervisory Mechanism respects the limits of Art. 127(6) TFEU is disputed. In favour, emphasising the fact that the Single Supervisory Mechanism relies on the cooperation of national authorities with the European Central Bank and that the latter retain specific tasks: M. Selmayr, 'Artikel 127', in H. von der Groeben et al. (ed.), *Europäisches Unionsrecht* 3 (Nomos 2015) marginal nos. 53-55; C. Ohler, *Bankenaufsicht und Geldpolitik in der Währungsunion* (CH Beck 2015) p. 145-146; J.A. Kämmerer, 'Bahn frei der Bankenunion? Die neuen Aufsichtsbefugnisse der EZB im Lichte der EU-Kompetenzordnung', *Neue Zeitschrift für Verwaltungsrecht* (2013) p. 830 at p. 832-834; sceptical: C. Waldhoff and P. Dieterich, 'Einführung einer gemeinsamen Bankenaufsicht auf EU-Ebene – ein Überblick über die Rechtsprobleme', *Europäisches Wirtschafts- und Steuerrecht* (2013) p. 72 at p. 75; M. Lehmann and C. Manger-Nestler, 'Einheitlicher Europäischer Aufsichtsmechanismus: Bankenaufsicht durch die EZB', *Zeitschrift für Bankrecht und Bankwirtschaft* (2014) p. 2 at p. 6-7; A.-K. Kaufhold, 'Die Europäische Bankenunion - vollendet unvollendet? Eine Zwischenbilanz', 32 *Zeitschrift für Gesetzgebung* (2017) p. 18 at p. 33. Instructive on the legislative history: R. Smits, *The European Central Bank. Institutional Aspects* (Kluwer Law International 1997) p. 356.

According to one view, it is preferable to assign monetary policy and prudential supervision to separate institutions as such conflicts of interest would only endanger price stability or financial stability. In the context of the Single Supervisory Mechanism, Germany successfully insisted on that position.[7] As a result, Article 25(2) of the SSM Regulation provides for the meticulous separation of the monetary policy and supervisory functions of the European Central Bank.[8] Prudential supervision was entrusted to a separate Supervisory Board within the Bank. While the Supervisory Board cannot take binding decisions itself, as primary law requires the Governing Council to take any decisions on behalf of the European Central Bank,[9] the Governing Council may only accept or reject, but not modify the decisions proposed by the Supervisory Board, nor act otherwise upon its own initiative in matters of prudential supervision.[10]

However, others argue that the interplay between monetary policy and financial stability requires a more holistic approach to ensure that monetary policy and prudential supervision mutually reinforce, rather than defeat, each other. The argument is not merely theoretical. On the one hand, during the Great Financial Crisis beginning in 2008, addressing systemic risks required close coordination between monetary and supervisory actions. On the other hand, the aftermath of the crisis has revealed that even in ordinary times, the coordination of monetary policy and prudential supervision might reap some benefits and prevent some harms. For some years now, various stakeholders have articulated their concerns about the stability of the European banking system due to the permissive monetary policy stance taken by the European Central Bank. For example, they believe that the need of many European banks to purge their balance sheets of risky assets in order to meet new capital requirements prevented the expansionary monetary policy of the European Central Bank from taking full effect.[11] Also, market participants have repeatedly voiced concern about the effects of the European Central Bank policy rate at the zero lower bound on financial stability, as it reduces a bank's profitability.[12] Conversely, the European Central Bank's Longer-Term Refinancing Operations,

[7] K. Alexander, 'European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism', 40 *European Law Review* (2015) p. 154 at p. 165; Kämmerer, *supra* n. 6, p. 832.

[8] *See also* the Decision of the European Central Bank on the implementation of separation between the monetary policy and supervision functions of the European Central Bank of 17 September 2004, ECB/2014/39.

[9] Arts. 129 and 282(2) TFEU, in conjunction with Art. 12.1 ESCB Statute.

[10] Art. 26(8), SSM Regulation.

[11] S. Micossi, 'The Monetary Policy of the European Central Bank (2002 to 2015)', *LUISS Guido Carli School of European Political Economy Working Paper* (2015) No. 2015/4, 28.

[12] E.g. C. Siedenbiel, 'Banken und EZB geben sich gegenseitig Schuld an der Misere', *Frankfurter Allgemeine Zeitung*, 5 October 2016, <www.faz.net/aktuell/finanzen/anleihen-zinsen/deutsche-banken-kritisieren-geldpolitik-der-ezb-14466320.html>, visited 16 April 2018.

monetary policy transactions offering instruments with higher interest rates and maturities of up to four years, have contributed to financial stability by providing some relief for financial institutions with otherwise low profits.[13] A more holistic approach to monetary policy and prudential supervision therefore seems apposite.

This article takes issue with the alleged strict separation between monetary policy and prudential supervision in the legal framework of the Economic and Monetary Union. It argues that, whatever the economic merits of a more holistic approach, should the European Central Bank opt for it, neither the SSM Regulation nor the European Treaties seem to provide insurmountable legal hurdles. In fact, a purposive reading of the Treaties reveals that the European Central Bank's monetary policy may take into account considerations relating to financial stability. The same applies *mutatis mutandis* to supervisory decisions under the SSM Regulation, which should pay heed to monetary policy transmission. Consequently, it seems that the SSM Regulation repeats past mistakes in the design of the Economic and Monetary Union by creating the expectation that the law corroborates a clear commitment to a certain economic policy (here, the meticulous separation between monetary policy and prudential supervision). However, the legal provisions meant to guarantee that commitment would hardly stand the test of practice under constantly changing, rather unpredictable economic and financial conditions. The article suggests a legal instability theorem, which explains this observation.

This finding has repercussions for constitutional theory, as it casts serious doubt on the technocratic legitimacy of the European System of Central Banks. It corroborates claims to step up the democratic legitimacy of the latter. Ultimately, a deliberative understanding of the law, which considers the law as a guideline for procedures and argumentative processes, might be more successful for the governance of the Economic and Monetary Union.

Economics: from functional separation to holistic approaches?

The interplay between monetary policy and financial stability – accept or ignore?

Today, hardly anyone doubts that monetary policy and the stability of financial institutions are highly interrelated. In fact, inflation-targeting monetary

[13] M. Hellwig, 'Financial Stability, Monetary Policy, Banking Supervision, and Central Banking', *Preprints of the Max Planck Institute for Research on Collective Goods* (2014) p. 3-4. On Longer-Term Refinancing Operations, *see* ECB, 'ECB announces measures to support bank lending and money market activity', Press release, 8 December 2011, <www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html>, visited 19 April 2018. *See also* the Decision of the European Central Bank of 29 July 2014 on measures relating to targeted longer-term refinancing operations, ECB/2014/34, OJ L 258/11 of 29 August 2014 and subsequent modifications.

policy and stability-oriented prudential supervision might have a positive or negative influence on one another.[14] Various channels for the transmission of monetary policy affect financial stability. One of them is the bank lending channel. Accordingly, monetary policy determines the supply of money to banks and their refinancing conditions, thereby setting the frame for the supply of credit.[15] The amount of credit has an impact upon financial stability. Another channel is the balance sheet channel. Accordingly, rising interest rates lead to decreasing bond prices as companies face higher costs of capital and as investors find it more attractive to leave their money in their bank deposits instead of investing them in the real economy.[16] This constrains the capacity of bank customers to borrow, as the value of the assets they can pledge as collateral for their loans decreases.[17] Lower bank performance resulting from lower demand for credit as well as the declining value of assets pledged as collateral give rise to stability concerns. A third channel is the risk-taking channel. Accordingly, lower interest rates provide an incentive for banks to make riskier investments.[18]

Conversely, prudential supervision has an impact on the transmission of monetary policy as it affects the capacity of banks to create money through lending. This concerns both microprudential and macroprudential regulation. Microprudential tools such as ordinary capital requirements determine the volume of the loans a bank can make.[19] Macroprudential tools, such as countercyclical

[14] B.S. Bernanke, 'The Effects of the Great Recession on Central Bank Doctrine and Practice', *Speech at the Federal Reserve Bank of Boston 56th Economic Conference, Boston, Massachusetts* (8 October 2011) p. 12; F. De Graeve et al., 'Monetary policy and financial (in) stability: An integrated micro–macro approach', 4 *Journal of Financial Stability* (2008) p. 205; I. Agur and M. Demertzis, 'Will Macroprudential Policy Counteract Monetary Policy's Effects on Financial Stability?', *IMF Working Paper WP/15/283* (2015); K. Alexander, 'The ECB and Banking Supervision: Building Effective Prudential Supervision?', 33 *Yearbook of European Law* (2014) p. 417 at p. 423.

[15] B.S. Bernanke and M. Gertler, 'Inside the black box: the credit channel of monetary policy transmission', *National bureau of economic research Working Paper No. w5146* (1995); S. Glatzl, *Geldpolitik und Bankenaufsicht im Konflikt. Die Pflicht der Mitgliedstaaten zur Unterstützung der EZB im Bereich der Preisstabilität unter besonderer Berücksichtigung der Bankenaufsicht* (Nomos 2009) p. 192-212.

[16] 'Why do interest rates tend to have an inverse relationship with bond prices?', *Investopedia*, 15 December 2017, <www.investopedia.com/ask/answers/04/031904.asp>, visited 16 April 2018.

[17] A.K. Kashyap and J.C. Stein, 'The impact of monetary policy on bank balance sheets', 42 *Carnegie-Rochester Conference Series on Public Policy* (1995) p. 151.

[18] C. Borio and H. Zhu, 'Capital regulation, risk-taking and monetary policy: a missing link in the transmission mechanism?', 8 *Journal of Financial Stability* (2012) p. 236.

[19] S.J. Van den Heuvel, 'Does bank capital matter for monetary transmission?', 8 *Economic Policy Review* (2002) p. 259.

capital buffers,[20] might force banks to curb their lending to prevent financial instability, but at the same time, it decreases the quantity of money.[21]

The interplay between monetary policy and financial stability prompts the question of the right institutional arrangement. Specifically, monetary policy and prudential supervision might be entrusted to one single institution under an integration model, in which the central bank exercises supervisory functions, or to two different institutions (or two different parts of the same institution) under a separation model, in which supervision is assigned to a separate authority. Furthermore, a separation model might provide that the different institutions (or different parts of the same institution) carry out their functions in a cooperative relationship, or in splendid isolation from each other.[22] As the research about the relationship between monetary policy and prudential supervision and the advantages or disadvantages of the different models is an evolving area of research, the question of the right institutional arrangement has found different answers at different times.

The rise of the separation model

At the time of the introduction of financial supervision alongside central banking – a process that spanned, in most jurisdictions, the 19th century to the aftermath of the Great Depression or even beyond[23] – the interplay between monetary policy and financial supervision had little impact on institutional choices. Rather, the choice between an integration model and a separation model often reflected different traditions in dealing with banking crises. The integration model derives from the function of central banks as 'lenders of last resort'.[24] According to Bagehot, lending of last resort should only be granted to banks

[20] Art. 130 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, OJ L 176/338 of 27 June 2013.

[21] I. Angeloni and E. Faia, 'Capital regulation and monetary policy with fragile banks', 60 *Journal of Monetary Economics* (2013) p. 311.

[22] *Cf* C. Goodhart and D. Schoenmaker, 'Should the Functions of Monetary Policy and Banking Supervision Be Separated?', 47 *Oxford Economic Papers* (1995) p. 539; L. Amorello, *The Legal Interaction between Macroprudential Banking Supervision and Monetary Policy in the European Union* (unpublished manuscript, on file with the author, 2017).

[23] For the US: A. Komai and G. Richardson, 'A brief history of regulations regarding financial markets in the United States: 1789 to 2009', *National Bureau of Economic Research Working Paper No. w17443* (2011); for England: F. Capie, *The Bank of England* (Cambridge University Press 2010); for Germany: C. Müller, *Die Entstehung des Reichsgesetzes über das Kreditwesen vom 5. Dezember 1934* (Duncker & Humblot 2003); for France: A. Plessis, 'The history of banks in France', in M. Pohl (ed.), *Handbook on the History of European Banks* (Edward Elgar 1994) p. 185.

[24] Goodhart and Schoenmaker, *supra* n. 22, p. 541.

with a lack of liquidity, not with solvency problems.[25] Once the central bank took over the risk of last-resort lending from informal bankers' clubs, it required detailed information about the financial situation of commercial banks in order to be in a position to assess their solvency in case of a crisis. This model prevailed *inter alia* in Great Britain between 1979 and 2000.[26] By contrast, jurisdictions where banks tend to get bailouts from the treasury rather than having the central bank act as a lender of last resort, tended to opt for a separation model and assigned financial supervision to one or multiple separate authorities within the hierarchy of government.[27] Germany is an example of this model.[28]

In the decades after the Second World War, there was no compelling case for the separation model, either. In fact, little significance was attributed to the impact of capital adequacy on monetary policy.[29] Instead, in line with Keynesian equilibrium theory, monetary policy primarily focused on the real economy. The Philips curve seemed to suggest that monetary policy was a legitimate instrument for controlling unemployment.[30] Expansive monetary policy thus prevailed in many countries, even in the inflationary climate of the late 1960s and 1970s, in order to spur growth.[31] Further, the scarcity of banking crises in industrial states between the Great Depression and the 1970s may have contributed to this shift in the focus of monetary policy away from issues of financial stability and towards macroeconomics.[32] But the neglect of financial stability by monetary policy was rather coincidental and not necessarily an essential aspect of economic theory.

The separation model gained ground only in the following decades because of changing views about monetary policy. Monetarism had argued as early as 1960 that permissive monetary policy would stimulate growth only in the short term and would be macroeconomically neutral in the longer term, leading

[25] W. Bagehot, *Lombard Street. A Description of the Money Market* (Henry S. King & Co 1873) p. 48 ff.

[26] Goodhart and Schoenmaker, *supra* n. 22, p. 539; M. Buckle and J.L. Thompson, *The UK Financial System: Theory and Practice*, 4th edn (Manchester University Press 2004) p. 334 ff; A. Thiele, *Finanzaufsicht* (Mohr Siebeck 2014) p. 193 ff.

[27] Goodhart and Schoenmaker, *supra* n. 22, p. 543-544.

[28] Thiele, *supra* n. 26, p. 194-195; on the origins of the German model, which can also be traced back to the desire of the Nazi regime to control financial supervision, *see* Müller, *supra* n. 23, p. 382-385.

[29] Van den Heuvel, *supra* n. 19, p. 259.

[30] This understanding of the Philips curve was proposed by P.A. Samuelson and R.M. Solow, 'Analytical aspects of anti-inflation policy', 50 *The American Economic Review* (1960) p. 177.

[31] For the US: J.B. Taylor, 'A historical analysis of monetary policy rules', in J.B. Taylor (ed.), *Monetary Policy Rules* (University of Chicago Press 1999) p. 319 at p. 338-339.

[32] Hellwig, *supra* n. 13, p. 18.

merely to a higher price level. To address this problem of time inconsistency, monetarists like Milton Friedman advocated a commitment to price stability as the primary objective of monetary policy.[33] When central banks managed to control stagflation through rules-based inflation targeting in the 1980s, many took it as a vindication of monetarism, and the focus of the monetary policy of many central banks shifted towards price stability.[34] This led to calls for central bank independence in order to isolate the central bank from political influence that would distract from its inflation target.[35] Nevertheless, the new ideal of rules-based monetary policy by independent central banks had another ramification that led to the rise of the separation model. Jan Tinbergen's theory of economic decentralisation emphasised that the pursuit of different, potentially conflicting policy goals by government under the conditions of uncertainty required assigning different objectives to different actors equipped with the appropriate instruments to reach that objective.[36] Hence, the central bank's policy rate was considered the perfect instrument for inflation targeting in accordance with the now prevailing neoclassical-Keynesian synthesis, but not for preventing asset bubbles and the related risks to financial stability.[37] These functions are therefore better assigned to

[33] M. Friedman, *A Program for Monetary Stability* (Fordham University Press 1960); M. Friedman, 'The Role of Monetary Policy', 58 *The American Economic Review* (1968) p. 1.

[34] V.P. Ioannidou, 'Does monetary policy affect the central bank's role in bank supervision?', 14 *Journal of Financial Intermediation* (2005) p. 58 at p. 59; R. Franck and M. Krausz, 'Why separate monetary policy from banking supervision?', 36 *Journal of Comparative Economics* (2008) p. 388 at p. 389; R.M. Lastra, 'Central Bank Independence and Financial Stability', 18 *Revista de Estabilidad Financiera* (2010) p. 51; H. James, *Making the European Monetary Union* (Harvard University Press 2012) p. 180 ff.

[35] K. Rogoff, 'The optimal degree of commitment to an intermediate monetary target', 100 *The Quarterly Journal of Economics* (1985) p. 1169; C.E. Walsh, 'Optimal contracts for central bankers', *The American Economic Review* (1995) p. 150; Hellwig, *supra* n. 13, p. 12-13. Somewhat surprisingly, Milton Friedman rejected central bank independence. *See* M. Friedman, 'Should there be an independent monetary authority?', in L. Yeager (ed.), *In Search of a Monetary Constitution* (Harvard University Press 1962) p. 219; M. Friedman, *Capitalism and Freedom* (University of Chicago Press 1962) p. 77. However, the conundrum quickly dissolves when considering that Friedman understood independence as synonymous with discretion, hence in opposition to his proposal of a rules-based, inflation-targeting monetary policy. Central bank independence is in line with Friedman's views to the extent that it relates to the instruments of monetary policy only, not to the goals. *See* S. Fischer, 'Central-Bank Independence Revisited', 85 *The American Economic Review* (1995) p. 201 at p. 202.

[36] J. Tinbergen, *Centralization and Decentralization in Economic Policy* (North Holland Publishing Co 1954) p. 75. On the significance of Tinbergen's work, *see* F. Bruni and D. Masciandaro, 'Evaluating Central Bank Independence. Theoretical Issues and European Perspectives', 99 *Rivista Internazionale di Scienze Sociali* (1991) p. 93 at p. 101-103; O. Issing, 'Monetary and financial stability: is there a trade-off?', 18 *BIS Papers* (2003) p. 16 at p. 19.

[37] A. Greenspan, 'Economic Volatility', *Proceedings of Federal Reserve Bank of Kansas City Symposium, Jackson Hole* (2002).

different authorities.[38] Separating monetary policy from prudential supervision would thus protect monetary policy from potentially problematic distractions from inflation targeting. Another popular view was that the effects of price stability on financial stability would only be positive, and that the best possible contribution of a central bank to financial stability would be to target inflation.[39] This reveals that the separation model corresponded to the epistemology behind (neo)liberalism, which doubts the capacity of the state to perform the incredibly complex task of steering the economy comprehensively and prefers to leave as many decisions as possible to the market.[40] Accordingly, singling out different policy objectives and mandating different actors to pursue one of them each under a policy rule has the benefit of reducing complexity.[41]

Subsequently, the separation model gained traction around the world from about the 1970s, and massively so during the 1990s.[42] This occurred despite the fact that the interplay between monetary policy and prudential supervision began to be recognised during that period.[43] Apart from the historical success of independent, rule-observing central banks in curbing inflation, the rise of the separation model may have been facilitated by the fact that central banks temporarily lost significance as lenders of last resort with the establishment of deposit guarantee schemes and the expansion of the financial sector, including the development of a highly liquid interbank market.[44]

Certainly, not all Member States of the Eurozone follow the separation model. Although the independence of central banks has constitutional status,[45] no similar dogma exists with respect to the separation of monetary policy from supervisory functions.[46] Also, some jurisdictions mix elements of both models, such as the United States. While the Federal Reserve does have important supervisory powers,

[38] *Cf* P. Docherty, 'Basel II and the Political Economy of Banking Regulation-Monetary Policy Interaction', 37 *International Journal of Political Economy* (2008) p. 82 at p. 92-93.

[39] A.J. Schwartz, 'Why Financial Stability Despends on Price Stability', 15 *Economic Affairs* (1995) p. 21.

[40] *Cf* F.A. Hayek, *Law, Legislation and Liberty 1: Rules and Order* (University of Chicago Press 1974) p. 8-31.

[41] Seminal for the rules vs. discretion debate: F.E. Kydland and E.C. Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', 85 *The Journal of Political Economy* (1977) p. 473.

[42] S. Polillo and M.F. Guillén, 'Globalization Pressures and the State: The Worldwide Spread of Central Bank Independence', 110 *American Journal of Sociology* (2005) p. 1764 at p. 1770-1771.

[43] E.g. Bernanke and Gertler, *supra* n. 15.

[44] Goodhart and Schoenmaker, *supra* n. 22, p. 544-545.

[45] Art. 130, 282 (3), TFEU.

[46] R.M. Lastra, *Legal Foundations of International Monetary Stability* (Oxford University Press 2006) p. 90.

they do not extend to all financial institutions.[47] In Germany, there is an elaborate division of labour between the Bundesbank, which collects information at the level of the institutes, and the financial supervisor BaFin, which takes supervisory decisions. Each institution is held to share information relevant for the other,[48] and supervisory rule-making by BaFin requires the approval of the Bundesbank to avoid contradictions between monetary and prudential measures.[49] Moreover, there is no consensus as to whether it is preferable to have just one or several supervisory authorities.[50] Nevertheless, prior to the Great Financial Crisis, there was a clear trend towards the separation model.

After the crisis: towards a more holistic approach?

The experience of the Great Financial Crisis called the separation model into question. An overly strict separation might jeopardise the effective management of systemic crises. Even during normal times, it might generate risks for both financial stability and price stability. This has prompted calls for a holistic approach that unites the diverging policy objectives and reopens questions of institutional design.

As concerns systemic risk, the financial crisis provided a dramatic illustration of the disadvantages of a strictly enforced separation model in case of a systemic event. In such a situation, conducting monetary policy regardless of issues of financial stability could put the banking sector at risk. Likewise, supervisory measures that do not take due account of their implications for monetary policy could jeopardise the central bank's much needed liquidity injections.[51] Ben Bernanke, the Chairman of the Board of Governors of the Federal Reserve at the time, went as far as to assign to systemic stability the same significance as to price stability with regard to the mandate of the Federal Reserve.[52] The De Larosière report, which laid the foundation for macroprudential supervision in Europe, admonished that monetary policy should take credit growth into consideration as the availability of excess liquidity during a period of low inflation had led to the

[47] *See* chart in Federal Reserve System, *The Federal Reserve System. Purposes & Function*, 10th edn (2016) p. 77.

[48] Sec. 7 Kreditwesengesetz. On the controversy about the relationship between BaFin and Bundesbank surrounding the establishment of BaFin: J.H. Lindemann, 'Section 7', in K.-H. Boos et al. (eds.), *Kreditwesengesetz-Kommentar 1*, 5th edn (2016) marginal no. 10-14.

[49] Sec. 7 Kreditwesengesetz. Instructive on the legislative history: H. Humm, *Bankenaufsicht und Währungssicherung* (Duncker & Humblot 1989) p. 117.

[50] Lastra, *supra* n. 46, p. 96.

[51] Committee on International Economic Policy and Reform, 'Rethinking Central Banking', *Brookings Institution* (2011); Hellwig, *supra* n. 13, p. 21; T. Beck and D. Gros, 'Monetary Policy and Banking Supervision: Coordination Instead of Separation', *CEPS Policy Brief No. 286)* (2012).

[52] Bernanke, *supra* n. 14, p. 5.

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build-up of risk in the banking sector.[53] With its Longer-Term Refinancing Operations window, the European Central Bank adopted a monetary policy instrument that had the explicit purpose of improving financial stability, and thus, monetary policy transmission, by offering attractive conditions to commercial banks in a period characterised by low performance and little trust.[54] In that respect, Longer-Term Refinancing Operations show as close an interdependence between monetary policy and financial stability as the European Central Bank's Outright Monetary Transactions programme showed it for the relation between monetary and fiscal policy.[55] Conversely, newly-introduced macroprudential instruments such as counter-cyclical capital buffers might prevent systemic risk as much as they would corroborate a tightening of monetary policy (or undermine a more permissive monetary policy stance).[56] In respect of systemic risk and systemic events, a more holistic approach to monetary policy and prudential supervision therefore seems apposite.

But the crisis also gives reason to explore the potential of closer coordination between monetary policy and prudential supervision during normal times, outside periods of systemic risk. The crisis has refreshed awareness of the interplay between monetary policy and financial stability described above.[57] The credit crunch has demonstrated that the transmission of the monetary policy impulses of the central bank to the financial markets and the ability of these impulses to increase or reduce the quantity of money depends on the smooth intermediation of the financial sector.[58] Higher capital requirements might strangulate output if monetary policy cannot lower interest rates any further.[59] Conversely, the current phase of extremely low interest rates might compromise financial stability, as it incentivises higher risk-taking by banks.[60] To make matters worse, the separation model rests on certain assumptions that have lost credibility as a consequence of the Great

[53] J. De Larosière et al., 'Report of the high-level group on financial supervision in the EU', *European Commission. Brussels* (2009) para. 48. The European Central Bank had recognised the need for central banks to promote systemic stability even before the crisis: L. Bini Smaghi, 'Central Bank Independence in the EU: From Theory to Practice', 14 *European Law Journal* (2008) p. 446 at p. 454.

[54] *See supra* n. 13 and accompanying text.

[55] ECJ 16 June 2015, Case C-62/14, *Gauweiler et al.* v *Deutscher Bundestag*, ECLI:EU:C:2015:400, paras. 51 and 52.

[56] Cf. *supra* n. 20.

[57] *Supra*.

[58] 'Rethinking Central Banking', *supra* n. 51, p. 5 ff; O. Blanchard et al., 'Rethinking Macroeconomic Policy', *IMF Staff Position Note SPN/10/03* (2010) p. 5.

[59] S. Roger and J. Vlček, 'Macroeconomic Costs of Higher Bank Capital and Liquidity Requirements', *IMF Working Paper* (2011).

[60] This is called the risk-taking channel, cf. G. Dell'Ariccia et al., 'Monetary Policy, Leverage, and Bank Risk-Taking', *IMF Working Paper No. 276* (2010).

Financial Crisis. Financial intermediation does not work as smoothly as the Efficient Capital Markets Hypothesis suggests – a cornerstone of any decentralised institutional model that relies on market forces rather than on institutional oversight.[61] Rather, in line with Hyman Minsky's prediction, they tend to build up risk that materialises in fairly regular crisis events.[62] Further, financial liberalisation has increased the possibility of the market to extend credit. There is evidence that this has reduced the influence of the central bank policy rate on effective long-term interest rates. Financial markets have gradually de-coupled themselves from the generation of the base money by the central bank.[63]

This prompts the question whether the dominance of the separation model and the underlying doctrine that monetary policy should remain unaffected by financial stability concerns is still justified. It is unclear in the present situation which goal would be served if monetary policy and prudential supervision pulled on opposite ends of the same string. Important voices in the economic literature therefore favour a more holistic approach, where monetary policy decisions pay due regard to financial stability concerns, and where supervisory decisions account for monetary policy effects.[64] Empirical evidence about the merits of the separation model is still fraught with uncertainties, though.[65]

The holistic approach would not necessarily require rebuilding the institutional setup and unifying supervision and monetary policy in one institution. It would suffice to ensure consistency between monetary policy and financial supervision to

[61] *Cf* E.F. Fama, 'Efficient capital markets: A review of theory and empirical work', 25 *The Journal of Finance* (1970) p. 383.

[62] *Cf* H. P. Minsky, 'The Financial Instability Hypothesis', *Levy Economics Institute Working Paper No. 74* (1992). On the rediscovery of Minsky after the crisis, *see* J.B. Rosser et al., 'A Minsky-Kindleberger perspective on the financial crisis', 46 *Journal of Economic Issues* (2012) p. 449.

[63] Based on econometric data: H. Cömert, *Central banks and financial markets: the declining power of US monetary policy* (Edward Elgar 2013) p. 89 ff.

[64] Goodhart and Schoenmaker, *supra* n. 22, p. 547-548; Issing, *supra* n. 36, p. 18; Blanchard et al., *supra* n. 58, p. 11-13; Rethinking Central Banking', *supra* n. 51; Hellwig, *supra* n. 13, p. 18-19. Overview of the most pertinent arguments pro and contra holistic approaches: E.W. Nier, 'Financial stability frameworks and the role of central banks: lessons from the crisis', *IMF Working Paper WP/09/70* (2009) p. 14 ff.

[65] R. Goyal et al., 'A banking union for the euro area', *IMF Staff Discussion Note SDN/13/01* (2013) p. 14; sceptical about the merits of the separation model: W. Berger and F. Kißmer, 'Central bank independence and financial stability: A tale of perfect harmony?', 31 *European Journal of Political Economy* (2013) p. 109. Evidence from before the crisis: De Graeve et al., *supra* n. 14; Ioannidou, *supra* n. 34; emphasising the need for further research: G. Carboni et al., 'Exploring the Nexus between Macro-Prudential Policies and Monetary Policy Measures', *ECB Financial Stability Review* (May 2013) p. 99; finding evidence for the positive effects of a coordination between macroprudential supervision and monetary policy: V. Bruno et al., 'Comparative assessment of macroprudential policies', 28 *Journal of Financial Stability* (2017) p. 183.

render both effective.[66] Hence, the holistic approach mostly concerns the way in which institutions exercise their respective mandates.[67] It could even be implemented under a separation model if the central bank and the supervisory authority coordinated their decisions. Not surprisingly, proponents of this view mostly have a certain affinity for Keynesian approaches to macroeconomics, which encourage holistic thinking. The opposite view maintains that monetary policy is simply too blunt for supervisory considerations and that the functions should therefore preferably remain separated.[68]

The call for more holistic approaches has not remained without practical consequences, the most obvious being the establishment of bodies for macroprudential, or systemic, supervision in most developed jurisdictions, which regularly include central banks alongside supervisory authorities.[69] As concerns microprudential supervision, the UK Financial Services Authority was dissolved and supervisory powers were transferred to the Prudential Regulation Authority, which forms an integral part of the Bank of England. Even Germany, the strongest advocate of the separation model at the European level, discussed conferring supervisory powers to the Bundesbank in the crisis aftermath.[70]

Concerning monetary policy, it seems that the European Central Bank had already made its choice in 2003 when it officially adopted a two-pillar strategy to monetary policy.[71] It consists on the one hand of an economic analysis of risks to price stability in the short to medium term, and on the other hand of a monetary analysis focusing on monetary growth in the medium to long term.[72] The Bank uses the longer perspective of its monetary analysis to cross-check the results of its economic analysis.[73] As part of the monetary analysis, the European Central Bank

[66] R.M. Lastra, *International Financial and Monetary Law*, 2nd edn (Oxford University Press 2015) p. 125.

[67] D. Green, 'The Relationship between Micro-Macro-Prudential Supervision and Central Banking', in E. Wymeersch et al. (ed.), *Financial Regulation and Supervision* (Oxford University Press 2012) p. 57 at p. 63 (3.32).

[68] G. Claeys and Z.M. Darvas, 'The financial stability risks of ultra-loose monetary policy', *Bruegel Policy Contribution No. 2015/03* (2015), 12; S. Laseen et al., 'Systemic Risk: A New Trade-off for Monetary Policy?', *IMF Working Paper WP/15/142* (2015).

[69] A.-K. Kaufhold, 'Systemaufsicht. Der Europäische Ausschuss für Systemrisiken im Finanzsystem als Ausprägung einer neuen Aufsichtsform', *Die Verwaltung* (2012) p. 21.

[70] L. Dalla Pellegrina, D. Masciandaro and R.V. Pansini, 'The central banker as prudential supervisor: Does independence matter?', 9 *Journal of Financial Stability* (2013) p. 415 at p. 415-416: 'great reversal'.

[71] ECB, 'The ECB's monetary policy strategy', press release, 8 May 2003, available at <www.ecb.europa.eu/press/pr/date/2003/html/pr030508_2.en.html>, visited 19 April 2018.

[72] 'The ECB's monetary policy strategy after the evaluation and clarification of May 2003', Speech by Jean-Claude Trichet, President of the European Central Bank, delivered at the Center for Financial Studies' key event, Frankfurt am Main, 20 November 2003, available at <www.ecb.europa.eu/press/key/date/2003/html/sp031120.en.html>, visited 19 April 2018.

[73] *Ibid*.

observes asset price developments, as the collapse of asset price bubbles could lead to deflation in the long term. The Bank does not attempt to burst asset price bubbles, but pursues a strategy of 'leaning against the wind' to prevent unhealthy developments while staying focused on price stability.[74] This move towards holistic approaches raises the question whether it would be in conformity with the legal framework of the Economic and Monetary Union.

Law: legality of a holistic approach to monetary policy and supervision

The preferability of a holistic approach is a question in which I readily defer to the economics profession. The salient legal issues are whether a holistic approach to monetary policy is in conformity with the current legal framework of the Economic and Monetary Union, and whether monetary considerations are legitimate within the framework for prudential supervision, should the Single Supervisory Mechanism wish to opt for a holistic approach in that respect as well. In my view, both questions are to be answered in the affirmative. Both the mandate for monetary policy and the supervisory powers of the European Central Bank are drafted in a relatively abstract, open manner, leaving the Bank sufficient scope for holistic approaches. The European Central Bank can take due account of its monetary policy within the scope of its supervisory functions (or to take due account of supervisory concerns within the frame of its monetary policy) as long as such influence remains proportionate to the supervisory (or monetary) policy objective. It thus turns out that the legal framework of the Economic and Monetary Union is rather neutral if it comes to the choice between strict functional separation and more holistic approaches. It does not subscribe to a particular school of economic thought in that respect. The capacity of the Single Supervisory Mechanism legal framework to adapt to holistic approaches reflects the instability inherent in legal rules that should be observed in policy-making.

Financial stability as a concern for monetary policy

The conformity of a holistic approach to monetary policy, such as the one adopted by the European Central Bank in the framework of its two-pillar strategy, had never been called in question prior to the establishment of the Single Supervisory Mechanism. This is not particularly surprising as the Bank was not a supervisory authority at the time. In addition, the debate surrounding the establishment of the Single Supervisory Mechanism has sharpened attention for this issue, as it

[74] ECB, *The Monetary Policy of the ECB* (2011) p. 83-86.

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suggested prima facie that the European Central Bank should follow a strict separation model.

Upon closer scrutiny, this impression turns out to be wrong. Financial stability, understood as 'a condition where the financial system is able to withstand shocks without giving way to cumulative processes which impair the allocation of savings to investment opportunities and the processing of payments in the economy',[75] is a legitimate consideration for the European Central Bank in the formulation of its monetary policy. According to Article 127(1) TFEU, the Bank's primary objective in the pursuit of monetary policy is price stability. This notion is open to interpretation.[76] It lends itself to a broad reading, which allows monetary policy to take prudential considerations into account as long as other treaty provisions are respected. This results from the fact that that the attainment of price stability presupposes some degree of financial stability. In other words, one needs to understand the concept of price stability in a more holistic sense. The argument proceeds from textual via historic and systematic to purposive reasons.

The text of the treaties does not necessarily impose the possibility of a holistic reading. Article 127(1) TFEU does not even mention financial stability.[77] Only Article 127(5) TFEU stipulates that '[t]he ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system'. The mere wording of this provision does not reveal whether it creates only an accessory competence for the European Central Bank outside of its monetary policy mandate, or whether it implies that stability considerations may influence monetary policy decisions taken in accordance with Article 127(1) TFEU.

The drafting history reveals that the powers of the European Central Bank with regard to financial stability were first included in the draft of Article 3.1 of the ESCB Statute – which reproduces the basic tasks of the Bank in accordance with Article 127(2) TFEU – but then relegated to Article 3.3 of the ESCB Statute.[78] This might imply that the powers relating to financial stability and prudential supervision are unrelated to the monetary policy mandate. At first sight, this position appears to find confirmation in the systematic structure of the ESCB

[75] T. Padoa-Schioppa, 'Central banks and financial stability: exploring the land in between', in V. Gaspar et al. (ed.), *The Transformation of the European Financial System* (European Central Bank 2003) p. 269 at p. 287. Similar: Issing, *supra* n. 36, p. 16.

[76] ECJ, Case C-370/12, *Pringle* v *Ireland*, EU:C:2012:756, para. 53.

[77] Concluding that financial stability concerns therefore have no place in monetary policy: H. Siekmann, 'Missachtung rechtlicher Vorgaben des AEUV durch die Mitgliedstaaten und die EZB in der Schuldenkrise', in T.M.J. Möllers and F.-C. Zeitler (ed.), *Europa als Rechtsgemeinschaft-Währungsunion und Schuldenkrise* (Mohr Siebeck 2013) p. 101 at p. 145.

[78] R.M. Lastra and J.V. Louis, 'European Economic and Monetary Union: History, Trends, and Prospects', 32 *Yearbook of European Law* (2013) p. 57 at p. 82.

Statute. Article 25.1 of the ESCB Statute, the only provision of the chapter on prudential supervision, assigns only an advisory function to the European Central Bank in supervisory matters.[79] However, Article 25.1 is the provision of the Statute that corresponds to the advisory Article 127(5) TFEU. One may, therefore, argue that it is enumerative only for the competences of the European Central Bank exercised on that legal basis and is irrelevant for the monetary policy mandate and the question whether financial stability is a legitimate concern for the latter.[80]

Further, given that some National Central Banks follow an integration model,[81] one might argue that it would not contradict the systematic structure of the legal framework of the Economic and Monetary Union if the European Central Bank takes stability issues into consideration in its monetary policy. Thus, a look at the text, history and systematic structure of the Economic and Monetary Union legal framework reveals that there are no compelling reasons that would *exclude* a holistic approach. But that alone does not *positively* empower the European Central Bank to exercise its monetary policy mandate in a holistic fashion.

The latter depends on a purposive reading of the relevant provisions in the European Central Bank legal framework. The European Court of Justice clarified in *Gauweiler* that the stabilisation of the Euro area as such is not a goal of monetary policy, but an economic policy objective.[82] Instead, the objective of monetary policy is price stability. Nevertheless, the court recognised the interplay between monetary policy and financial stability[83] and confirmed that measures of the European Central Bank aimed at ensuring the effective transmission of monetary policy are covered by its monetary policy mandate.[84] Article 127(5) TFEU corroborates that view in that it explicitly recognises the relationship between monetary policy and financial stability in the text of the TFEU.[85] It therefore seems plausible to argue that the European Central Bank, in the discharge of its monetary policy mandate under Article 127(1) and (2) TFEU, may legitimately take into account financial stability considerations as long as the overall objective of such policy is price stability, i.e. as long as it enhances financial stability to

[79] Art. 25.1 ESCB Statute. Art. 25.2 ESCB Statute refers to Art. 127 (6) TFEU and has no relevance for the question under consideration.

[80] Disagreeing: C. Waldhoff, 'Art. 127', in H. Siekmann (ed.), *Kommentar zur Europäischen Währungsunion* 2 (2013) p. 263, marginal no. 69.

[81] Smits, *supra* n. 6, p. 338-339.

[82] *Pringle*, *supra* n. 76, para. 56; *Gauweiler*, *supra* n. 55, para. 64.

[83] *Gauweiler*, *supra* n. 55, paras. 51 and 52.

[84] *Gauweiler*, *supra* n. 55, paras. 49-50.

[85] *Cf* Ohler, *supra* n. 6, p. 74, who, however, locates the competence of the European Central Bank for financial stability considerations only in Art. 127(5) TFEU.

further price stability, and not as an end in itself. In that sense, financial stability would be an intermediate, second-order goal of monetary policy. This consideration is independent of the empirical question whether a holistic approach would produce better *aggregate* results.[86] It only needs to be beneficial for price stability.

In conclusion, a purposive reading of the European Central Bank's monetary policy mandate reveals that it is open for a holistic approach. Financial stability considerations may therefore play a role in the exercise of the Bank's monetary policy mandate. Along the lines of the *Gauweiler* case, the pursuit of financial stability concerns under the monetary policy mandate finds its limit in the proportionality principle.[87] Any trade-off between price stability and financial stability in monetary policy decisions therefore needs to have the objective of fostering price stability, and to be appropriate, necessary, and proportionate to that objective. Where that line lies exactly is primarily entrusted to the discretion of the European Central Bank. However, the Bank has to provide reasons, which are subject to judicial scrutiny.[88] The independence of the European Central Bank does not stand in the way of a holistic approach, as the Bank's monetary policy pillar is exposed to the factual effects of other actors' decisions all the time anyway, whether they are political, legal, or administrative.

One might add that the European Central Bank is not under a legal duty to adopt a holistic approach. While it was argued prior to the introduction of the Single Supervisory Mechanism that the principle of loyal cooperation pursuant to Article 4(3) TEU obliges domestic supervisors to support the Bank's monetary policy in the exercise of their supervisory powers,[89] this provision does not apply to the Single Supervisory Mechanism as a part of a European institution. The analogous provision in Article 13(2) TEU, which imposes a duty of mutual sincere cooperation on the institutions of the Union, does not affect legal relationships within one institution. The internal law of the institution defines the latter by establishing a hierarchical order.

Price stability as a concern for prudential supervision

According to common wisdom, the SSM Regulation provides for the strict separation of the European Central Bank's monetary and supervisory pillars. While much emphasis was put on this aspect of the Single Supervisory Mechanism in public communications during the drafting process, the exact significance of that separation remains somewhat unclear. I argue that this provision does not

[86] *Cf supra* n. 63.
[87] Art. 5(4) TEU; ECJ *Gauweiler*, *supra* n. 55, paras. 66 ff.
[88] *See* Art. 296(2) TFEU; ECJ *Gauweiler*, *supra* n. 55, para. 70.
[89] Glatzl, supra n. 15, p. 244.

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stand in the way of a holistic approach to prudential supervision which would give due consideration to monetary policy concerns. Its significance is mostly institutional. I base this argument on textual, systematic, and purposive reasons.

As concerns the wording of the SSM Regulation, it hardly reflects the public clamour surrounding the separation issue during the drafting process. According to Recital 12, the Single Supervisory Mechanism needs to ensure that 'credit institutions are subject to supervision of the highest quality, unfettered by other, non-prudential considerations'. The use of the word 'unfettered' would indeed be difficult to reconcile with a holistic approach. However, the wording of Article 25(2) of the SSM Regulation sets another tone. Accordingly, '[t]he ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. The tasks conferred on the ECB by this Regulation shall neither interfere with, nor be determined by, its tasks relating to monetary policy'. The crucial terms of that provision do not appear to be as categorical and absolute as 'unfettered'. Thus, the terms 'without prejudice to' and '[not] interfere with' seem to rule out any negative influence of supervisory decisions on monetary policy, but not necessarily beneficial ones. In that respect, it seems apposite to recall the logic of the holistic approach, which consists of exchanging short-term disadvantages for long-term mutual benefits. Making both financial supervision and monetary policy more effective in the long run can hardly be considered prejudice or interference. The term 'separate from' seems to refer to the organisational structure of the Single Supervisory Mechanism within the European Central Bank alone. Finally, for financial supervision to be 'determined by' monetary policy would require monetary policy to have a dominant influence over supervision. This is not the intention behind a more holistic approach.

The result of the textual analysis is confirmed by the context of the other provisions of the SSM Regulation. This puts the multiple institutional links that connect the monetary policy and supervisory pillars of the European Central Bank into perspective. The SSM Regulation does not establish a completely separate organisation, as the theory of functional separation would have it. Despite the safeguards undertaken to separate supervisory from monetary policy decisions such as the separation of the staff,[90] the duty to convene separate meetings of the Governing Council for each pillar, and the prohibition for the Governing Council to modify draft supervisory decisions,[91] etc., considerable linkages remain.[92]

[90] Recitals 65 and 66 SSM Regulation.

[91] Art. 25(4) SSM Regulation.

[92] In this sense also Kämmerer, *supra* n. 6, p. 832; Moloney, *supra* n. 2, p. 1635; E. Ferran and V.S. Babis, 'The European single supervisory mechanism', 13 *Journal of Corporate Law Studies* (2013) p. 255 at p. 266.

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Notably, decisions concerning both pillars eventually come together in the Governing Council.[93] Furthermore, the Chair of the Supervisory Board is appointed by the Council on the proposal of the European Central Bank.[94] The most direct overlap concerns the position of the Vice-Chair of the Supervisory Board. She is an ex-officio member of the Governing Council and consequently participates in monetary policy decisions.[95] A comparable overlap exists with respect to the role of the President of the Bank as Chair of the European Systemic Risk Board. The provisions of Article 25(2) SSM Regulation have to be read in light of these links. It seems difficult to deny that the latter would not 'relativise' the former.

The purposes of monetary policy and prudential supervision, respectively, corroborate this view. Given the mentioned interplay between monetary policy and financial supervision, and considering the fact that financial stability also depends on smooth monetary transmission and thus the ability of the central bank to provide liquidity, at least three additional reasons support a holistic approach.

First, in democracies, decision-makers have to assume responsibility for their acts. Adopting the proposals of the Supervisory Board means that the Governing Council endorses them and accepts responsibility. But how can it accept responsibility for decisions that potentially cancel out each other?[96] It is difficult to imagine how the Governing Council or the Vice-Chair of the Supervisory Board would justify decisions that defeat each other to some extent. Apart from the paradoxical situation which this creates for the respective office holders, it would render democratic control of such decisions rather difficult. How should one criticise officeholders who adopt contradictory decisions except for the fact that the decisions they have taken are contradictory? Adopting decisions at separate meetings might make the contradiction less visible, but does not eliminate it. Only a holistic approach would have that effect.

Second, if the Governing Council wants to avoid said contradictions, it seems likely to reject supervisory decisions which it believes would get into the way of monetary policy.[97] This would avoid the self-contradiction. But it would also give precedence to monetary policy over financial stability. This would be problematic on many levels. Economically, there is no reason to assume that suboptimal

[93] Art. 26(8) SSM Regulation.

[94] Art. 26(3) SSM Regulation.

[95] Art. 26(3) SSM Regulation.

[96] C. Manger-Nestler, 'Die Bankenunion. Einheitliche Mechanismen zur Bankenaufsicht und -abwicklung', in H.-J. Blanke and S. Pilz (eds.), *Die 'Fiskalunion'* (Mohr Siebeck 2014) p. 299 at p. 325-326. *See also* O. Sacarcelik, 'Europäische Bankenunion: Rechtliche Rahmenbedingungen und Herausforderungen der einheitlichen europäischen Bankenaufsicht', *Zeitschrift für Bank und Kapitalmarktrecht (BKR)* (2013) p. 353 at p. 355.

[97] *Cf* Art. 26(8) SSM Regulation.

monetary policy would have more serious consequences than suboptimal prudential supervision. Politically, it would be biased against taxpayers who might ultimately have to bear the costs of bank recapitalisation. And constitutionally, there is no reason to favour monetary policy over other economic policies. While Article 127(1) TFEU does indeed prioritise price stability over other policy goals, that provision only applies to monetary policy and exchange rate policy, as Article 119(2) TFEU reveals with great clarity.[98] The separation envisaged by the SSM Regulation would end up in an asymmetry between monetary policy and supervision that seems difficult to justify. This might give rise to systemic risk – which the Single Supervisory Mechanism is supposed to better protect against.

Third, contradictory decisions would involve risks to the European Central Bank's reputation and hence to monetary stability. Central banks depend on the trust of market participants. One possible way of earning such trust is by acting consistently. Contradictory or self-defeating measures emanating from the two pillars of the European Central Bank would only undermine its reputation, and thereby its capacity for the effective conduct of monetary policy. The holistic approach seeks to avoid that risk.

In conclusion, contrary to the impression one might gain from the public debate, the SSM Regulation would hardly prevent a more holistic approach to financial supervision, should the European Central Bank opt for it. The Bank, and especially the Supervisory Board, may give due consideration to monetary policy considerations in the discharge of their supervisory function, as long as this influence does not become dominant and, of course, respects the principle of proportionality.[99] The substantive rules relating to financial regulation provide many entry points for monetary policy considerations in supervisory decisions. One possible entry point is the liquidity coverage requirement[100] as well as other provisions on liquidity risk.[101] But what matters crucially for monetary policy transmission is the availability of credit to the real economy. Hence, the entire regulatory framework for capital requirements and risk management might contribute to the smooth transmission of monetary policy.

[98] H. Siekmann, 'Art. 119', in H. Siekmann (ed.), *Kommentar zur Europäischen Währungsunion* (2013) marginal no. 102; C. Waldhoff, 'Art. 127', in Siekmann, *supra* n. 80, p. 263, marginal no. 7; H.J. Hahn and U. Häde, *Währungsrecht*, 2nd edn (2010) Sec. 15 marginal no. 14. Dissenting, arguing that the treaties give precedence to price stability: Manger-Nestler, *supra* n. 96, p. 326.

[99] *See supra* n. 87 and accompanying text.

[100] Art. 411 ff., Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176/1 of 27 June 2013.

[101] E.g. Art. 86 Directive 2013/36/EU, *supra* n. 20.

Towards a legal instability theorem for finance?

The foregoing analysis of the SSM Regulation holds an important lesson concerning the capacity of the law to steer behaviour, and in particular to regulate issues of economic policy. That capacity is much more limited than many seem to suggest. After the no-bailout clause[102] and the concept of price stability,[103] Article 25(2) SSM Regulation provides yet another example of a legal rule that seemingly erects an insurmountable, rock-solid legal barrier – which then turns out to be much softer and malleable than expected when faced with changing circumstances or increasing external pressure. In analogy to Minsky's financial instability hypothesis,[104] one might be tempted to propose a legal instability theorem for finance. This article might not be the right place to develop a fully-fledged legal theory. Suffice it therefore to outline with a broad brush some salient features such a theory may potentially have.

My starting point is Katharina Pistor's legal theory of finance.[105] Accordingly, the uncertainty of market developments and liquidity constraints make financial markets inherently unstable. Law contributes to that instability, as debts are nothing but enforceable legal obligations. In case of a crisis, many creditors try to enforce their claims at the same time, which propels the system toward collapse. To avoid that consequence, obligations at the apex of the hierarchy of finance might not be honoured to ensure the system's survival, while borrowers in the lower echelons of the financial hierarchy without systemic significance would have to pay.

All of the factors of instability observed by Pistor are exogenous to the law, including the simultaneous enforcement of contractual obligations, as this presupposes an external shock.[106] This is not surprising for a theory that is predominantly inductive and meant to explain empirically measurable causal relations. The legal instability theorem differs from Pistor's account in three respects. First, it focuses on the instability of the law itself rather than on that of financial markets; second, it considers a good deal of the sources of such instability to be endogenous to the law, similar to Minsky's hypothesis, according to which financial instability results from the ordinary operation of financial markets and not necessarily from external shocks; and third, it considers issues of democratic legitimacy as a main driver of change, not merely power as defined by the financial hierarchy.[107]

[102] Art. 125(1) TFEU.
[103] Art. 127(1) TFEU.
[104] Minsky, *supra* n. 62.
[105] K. Pistor, 'A legal theory of finance', 41 *Journal of Comparative Economics* (2013) p. 315.
[106] *Ibid.*, p. 316.
[107] *Cf*, however, *ibid.*, p. 323: Pistor hints at the significance of democracy for financial stability several times, but never really engages with this issue.

I think that one can understand law's instability to a considerable extent as endogenous. This assumption derives from the hermeneutic nature of the law. Law is neither a piece of wood or iron, nor a computer program. It is a communicative practice whose existence is ultimately confined to the human mind – despite its undeniable social effects. Whether something is illegal or legal depends on processes of understanding which are based on language. The meaning of legal rules, much like language in general, derives from its usage in a certain context.[108] The meaning of legal rules therefore varies with our perceptions of their context and the construction of that context by those understanding and applying the law.[109] This makes law adaptable, especially to unpredictable and instable contexts such as financial crises. However, this comes at the cost of law's predictability. Reliance on the law to produce a certain effect in the future is therefore nearly impossible as long as one does not know that future.[110]

But how about numerical rules? Instead of a vague term like price stability, one might as well adopt a legal provision that stipulates a target of close to 2%. At this point, another feature of the hermeneutic nature of the law comes into play: one rule never stands alone; each rule is part of a context of rules that lend themselves to systematic interpretation. Interpreting a rule consists for a good deal of imagining and constructing the relations between that rule and other rules. This construction is situational, and it is therefore impossible to predict which rule will prevail. Thus, in theory, even a numerical rule might have to give precedence to another legal principle.

What, then, explains change in the law? Is it entirely dependent on subjective preferences, idiosyncratic constructions of the context of a certain rule within the legal order in a given situation? Or is change in the law simply a question of power – be it economic, political, institutional, social, moral, or cultural? While many of these factors might play a role, one should not overlook issues of democratic legitimacy – of the rules to be applied, the actors applying them, the entities affected by that application, and above all of the discourse surrounding their application.[111] Law – whether we are talking about legislation or adjudication[112] – ultimately needs to be acceptable, and in our present constellation, that usually requires democratic legitimacy. What sets democratic legitimacy apart from other factors inducing change in the law, like economic, social, or other forms of power, is that its influence

[108] L. Wittgenstein, *Philosophische Untersuchungen 1*, 16th edn (2004) Sec. 43.

[109] H.-G. Gadamer, *Wahrheit und Methode* (JCB Mohr 1960) p. 333-335.

[110] With respect to Dworkin's right answer thesis: J. Habermas, *Faktizität und Geltung* (1992) p. 278-279.

[111] *Cf* Habermas, *supra* n. 110, p. 272 ff.

[112] On the democratic ramifications of judgments by (international) courts, *see* A. von Bogdandy and I. Venzke, 'In Whose Name? An Investigation of International Courts' Public Authority and Its Democratic Justification', 23 *European Journal of International Law* (2012) p. 7.

can be normatively justified. In that sense, the method of purposive interpretation allows legal rules to change in parallel with processes of democratic deliberation. If the democratic consensus regarding a certain legal rule evolves as a consequence of these processes, courts might become less inclined to resist. At least, this appears to be a likely result in economic policy matters with distributive relevance, provided that no fundamental human rights are seriously affected.

As emphasised above, this is still a very general, somewhat speculative theory for explaining legal instability in relation to macroeconomic regulation. Nevertheless, it might explain why the hope to erect a solid legal wall separating the Single Supervisory Mechanism from monetary policy decisions might have been forlorn from the outset. The dichotomy between rules and discretion, a common reference point in economic theory, thus appears to be misleading, as rules are a lot more discretionary than the dichotomy suggests.[113]

Constitutional theory: the democratic legitimacy of the European Central Bank

The end of rechnocratic legitimacy

The realisation that the Single Supervisory Mechanism and monetary policy might follow a holistic approach raises the question whether the European Central Bank enjoys sufficient democratic legitimacy for that purpose. According to Article 10(1) TEU, the Union and its Member States are based on the principle of representative democracy. Article 130 TFEU, which ensures the independence of the European Central Bank, constitutes an exception to this rule.[114] It is justified by the functional necessity to protect monetary policy from the difficulties arising from time inconsistencies.[115] However, this exception is based on the explicit assumption that monetary policy follows defined rules, and that its faithfulness to these rules is subject to political control and judicial review:[116] these assumptions

[113] *Cf* F.E. Kydland and E.C. Prescott, 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', 85 *The Journal of Political Economy* (1977) p. 473.

[114] BVerfG *Gauweiler*, decision of 14 January 2014, ECLI:DE:BVerfG:2014:rs20140114.2bvr272813, para. 59; with respect to Art. 88 of the Basic Law: BVerfG *Maastricht*, judgment of 12 October 1993, 89 BVerfGE 155, 208-9; F. Amtenbrink and R.M. Lastra, 'Securing Democratic Accountability of Financial Regulatory Agencies – A Theoretical Framework', in R.V. De Mulder (ed.), *Mitigating Risk in the Context of Safety and Security – How Relevant is a Rational Approach?* (2008) p. 115; S. Dinov, 'Europäische Bankenaufsicht im Wandel', *Zeitschrift Europarecht (EuR)* (2013) p. 593 at p. 606.

[115] *See supra* n. 33 and accompanying text.

[116] E.g. O. Issing, 'The Eurosystem: Transparent and Accountable or "Willem in Euroland"', 37 *JCMS: Journal of Common Market Studies* (1999) p. 503.

are incompatible with the legal instability theorem. Accordingly, the functions of the Bank are much more vaguely defined and it is uncertain how they will develop in the future.[117] The technocratic, expertise-based legitimacy of the European Central Bank, on which the Bank has tried to capitalise by a strategy of 'hyper-scientisation' in the form of myriad conferences and papers produced by its directorate for research,[118] therefore convinces less and less[119] – especially now after the highly controversial decisions concerning access to normal lending windows and Emergency Liquidity Assistance for Greek banks during the Greek debt crisis in 2015.[120]

The allocation of supervisory powers to the European Central Bank increases its democratic deficit, as financial supervision has enormous distributional consequences.[121] A further aggravating factor is the independence enjoyed by the Bank for its supervisory functions, as necessary as it may have been to protect its independence in respect of monetary policy.[122] And the adoption of a holistic approach to monetary policy and financial supervision would intensify the problem. While the holistic approach does not render the powers of the European Central Bank entirely discretionary, it allows the Bank to make certain trade-offs between price stability and financial stability within the limits of the proportionality principle. As necessary as one might deem a holistic approach for the effective fulfilment of the Bank's two principal functions, it increases its discretionary powers – those for which democratic legitimacy is most needed. This calls for a rethinking of the democratic legitimacy of the European Central Bank.

Undoing Central Bank independence?

In light of these difficulties, some take a radical step and call into question the value of the European Central Bank's independence. On the one hand, this view is held by considerate observers of economic policy, who recall that independence is justified only as long as the central bank follows only one clearly defined

[117] *See also* J. De Haan and S.C.W. Eijffinger, 'The Democratic Accountability of the European Central Bank: A Comment on Two Fairy-tales', 38 *Journal of Common Market Studies* (2000) p. 393 at p. 397-398.

[118] S.L. Mudge and A. Vauchez, 'Fielding supranationalism: the European Central Bank as a field effect', 64 *The Sociological Review Monographs* (2016) p. 146.

[119] For an early critique *see* L.W. Gormley and J. De Haan, 'The democratic deficit of the European Central Bank', 21 *European Law Review* (1996) p. 95.

[120] *Cf* Case T-368/15, Order of the General Court (Fourth Chamber) of 14 July 2016, *Alcimos Consulting SMPC* v *European Central Bank*, ECLI:EU:T:2016:438; for a detailed account, *see* DIEM25, '#TheGreekFiles. Why independence is impossible without greater transparency' (2017).

[121] *Cf* Franck and Krausz, *supra* n. 34.

[122] Art. 19 SSM Regulation.

policy goal.[123] Accordingly, reassigning monetary policy to the treasury would amount to a return to the early postwar period – a period that many consider as one of exceptional growth and equality. On the other hand, there are some who simply disagree with the European Central Bank's policy rate at the zero lower bond and see it as a threat to price stability and – most importantly – their own personal wealth. This view seems to be held predominantly by persons at the very right end of the political spectrum.[124] However, to the author's knowledge, proponents of these views have not produced new solutions for the time inconsistency problem that would make an independent central bank superfluous. As concerns the last-mentioned view, the goal of its proponents may well be not to replace the Bank's independence with something else, but to replace the European Central Bank with supposedly independent national central banks.

Democratising an independent European Central Bank

Besides the lack of viable alternatives for solving the time inconsistency problem, calls to strip the European Central Bank of its independence miss the significance of independent institutions for European integration. According to Antoine Vauchez, European integration has mostly been advanced by the independent, expertise-driven institutions of the Union – the Commission, the European Court of Justice, and the European Central Bank. He argues that the independent institutions are at the centre of the Union's legitimacy – and not the Parliament, whose elections face a smaller and smaller voter turnout despite the nomination of *Spitzenkandidaten*. By contrast, the independent institutions provide a healthy counterweight to ordinary intergovernmental settings. This provides them with a form of legitimacy that is not apolitical and purely technocratic, yet does not rely on traditional parliamentary representation.[125] Instead, democratic control over these institutions, at first in the hands of member state governments, is now mostly exercised by domestic courts.[126]

[123] W. Münchau, 'Central bank independence is losing ist lustre', *Financial Times*, 19 February 2017, <www.ft.com/content/6ed32b02-f526-11e6-95ee-f14e55513608>, visited 19 April 2018. This position refers to Issing, *supra* n. 114.

[124] K. Allen, 'Mario Draghi defends ECB independence after German criticism', *The Guardian*, 21 April 2016, <www.theguardian.com/business/2016/apr/21/mario-draghi-defends-ecb-independence-german-criticism-central-bank-eurozone-interest-rates>, visited 19 April 2018; A. Weidel, 'Der EZB Einhalt gebieten', 22 March 2016, <www.afdbayern.de/alice-weidel-der-ezb-einhalt-gebieten/>, visited 19 April 2018.

[125] A. Vauchez, *Démocratiser l'Europe* (Seuil 2014), especially at p. 45-46; A. Vauchez, 'The Appeal of Independence: Exploring Europe's Way of Political Legitimacy', *TARN Working Paper 7/2016* (2016).

[126] Vauchez (2014), *supra* n. 125, p. 51-53, 57-58.

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Faced with current anti-European sentiment which has brought the independent institutions under pressure,[127] Antoine Vauchez has spearheaded calls for strengthening their democratic accountability.[128] In particular, it seems necessary to develop mechanisms of control and accountability at the European level to escape the trap of nationalism. In this respect, various options exist for strengthening democratic control over the European Central Bank.

First, the European Central Bank could increase its output legitimacy by stepping up its transparency. It has already made considerable progress in that respect.[129] The Governing Council is now publishing the results of its monetary policy meetings.[130] But the availability of individual bank data might help the public to review the performance of the Bank as a supervisor and to strengthen its reputation[131] – especially in controversial cases such as Monte dei Paschi.[132] Furthermore, in cases where the legality of the Bank's acts is in question, the Bank may simply publish its assessments of the legal situation, just as any administrative authority provides a reasoned opinion on its views.[133]

But transparency alone does not enable effective control – the European Central Bank needs to be responsive to public debate. This usually requires some kind of institutionalised mechanism for holding the Bank to account.[134] In that respect, parliamentary scrutiny of the Bank is moving in the right direction.[135] The Bank's accountability to the European Parliament extends over both its monetary policy and its supervisory activities.[136] National parliaments, by

[127] *Ibid.*, p. 59 ff., p. 77-79.

[128] *Ibid.*, p. 80-81.

[129] On the European Central Bank transparency policy, *see* ECB, *supra* n. 74, p. 86 ff.

[130] *Cf* 'ECB to adjust schedule of meetings and to publish regular accounts of monetary policy discussions in 2015', ECB Press conference of 3 July 2014, <www.ecb.europa.eu/press/pr/date/2014/html/pr140703_1.en.html>, visited 19 April 2018.

[131] C. Gandrud and M. Hallerberg, 'Does Banking Union Worsen the EU's Democratic Deficit? The Need for Greater Supervisory Data Transparency', 53 *JCMS: Journal of Common Market Studies* (2015) p. 769.

[132] *See* A. Barker et al., 'Brussels and ECB split on Monte dei Paschi's capital proposals', *Financial Times*, 23 February 2017, <www.ft.com/content/9635b04c-f923-11e6-bd4e-68d53499ed71>, visited 19 April 2018.

[133] *Cf* DIEM25, *supra* n. 120.

[134] Instructive: R.W. Grant and R.O. Keohane, 'Accountability and Abuses of Power in World Politics', 99 *American Political Science Review* (2005) p. 29 at p. 36.

[135] Moloney, *supra* n. 2, p. 1611; *cf* also Recital 48, SSM Regulation.

[136] *Cf* Art. 284(3) TFEU; Art. 20 of the SSM Regulation, in conjunction with the Interinstitutional Agreement between the European Parliament and the European Central Bank on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the European Central Bank within the framework of the Single Supervisory Mechanism.

contrast, can only hold the Supervisory Board accountable[137] or their own national central bank,[138] but not the European Central Bank, despite its involvement in the so-called troika.[139] These differences in accountability are difficult to justify in view of the close links between monetary policy and supervision,[140] especially under a holistic approach.

Ultimately, the question arises whether the European Central Bank's technocratic legitimacy can be enhanced by greater representativeness, yet without stripping it of its identity as an expertise-driven institution.[141] At the moment, the Bank is extremely far removed from electoral accountability. The Governing Council is composed of the heads of the National Central Banks of the Eurozone, appointed in accordance with the law of their member states, and the Executive Board, appointed by the European Council on a recommendation of the Council and after consultation with the European Parliament and the Governing Council (Article 283 TFEU). Voting rights among the heads of the National Central Banks rotate in accordance with Article 10.2 of the ESCB Statute. These factors make it nearly impossible to derive the legitimacy of the decisions of the most important body of the European Central Bank from the will of the people in any meaningful way. It rather appears to be the more or less random result of a whole series of appointments – and related backroom deals – at the European level to some extent, yet mostly still at the domestic level. This hardly provides the Governing Council with sufficient legitimacy, given the policy implications and high level of discretion involved in the discharge of its functions.[142] It would help a lot to make the Governing Council more representative in one way or another which would strengthen – and not compromise – its independence. For example, one might give the European Parliament the right to appoint the members of the Executive Board in a single, comprehensive vote. Likewise, a rotating system for the heads of National Central Banks seems worthy of a technical body, but not of a politicised institution. One possibility would be to have the

[137] G.L. Schiavo, 'From National Banking Supervision to a Centralized Model of Prudential Supervision in Europe? The Stability Function of the Single Supervisory Mechanism', 21 *Maastricht Journal of European and Comparative Law* (2014) p. 110 at p. 125.

[138] D. Curtin, 'Democratic accountability of EU executive power. A reform agenda for parliaments', in F. Fabbrini (ed.), *What form of government for the European Union and the Eurozone?* (Bloomsbury 2015) p. 171 at p. 171, 185.

[139] T. Beukers, 'Constitutional changes in Euro government and the relationship between the ECB and the executive power in the Union', in Fabbrini, *supra* n. 138, p. 95, 109 (on Draghi defying accountability before national parliaments).

[140] *Ibid.*, p. 109.

[141] Vauchez (2014), *supra* n. 125, p. 83. Along similar lines with respect to the Federal Reserve: J. Stiglitz, 'Central Banking in a Democratic Society', 146 *De Economist* (1998) p. 199 at p. 217 ff.

[142] Vauchez (2014), *supra* n. 125, p. 90 ff.

Council, the European institution representing the member states, elect representatives of National Central Banks. That would introduce into the European System of Central Banks the dual legitimacy characteristic of the EU in general.[143]

Towards a deliberative paradigm of the law

Anyone who expects that the law will entrench a strict separation model for the relationship between monetary policy and prudential supervision is liable to be disappointed. Legal barriers are all but rock-solid, as the legal instability theorem explains. There is no point in trying to nail jelly to the wall. Still, such barriers find their way into current legislation again and again, as the attempt to separate monetary policy from supervision in the SSM Regulation shows. It would enhance the effective governance and credibility of the Economic and Monetary Union if the institutions in charge of making and applying such laws took the unfeasibility of these barriers more seriously.

This would imply moving from a substantive paradigm of law to a deliberative one.[144] By that I mean an understanding of the law primarily as a guideline for decision-making processes, as a means for structuring future decisions in a procedural and argumentative sense that may determine the overall frame and direction of those decisions, rather than their precise content. Such a paradigm appears to be commensurate with contemporary democratic capitalism and its unpredictable and crisis-prone existence. Under the deliberative paradigm, law legitimises public authority not by casting in stone decisions taken at a certain point irrespective of future developments, but by ensuring that democratically adopted decisions adapt to changing circumstances, and by establishing feedback channels between the *demos* and the decision-makers for that purpose. Hence, the deliberative paradigm advocates a more flexible idea of the law. Paradoxically, though, this might lead to greater economic and political stability. It allows finding situationally adequate and acceptable solutions between diverging policy goals instead of raising unrealistic expectations about the potential of legal regulation. In that sense, diversity might ultimately foster unity.

[143] J. Habermas, 'The Crisis of the European Union in the Light of a Constitutionalization of International Law', 23 *European Journal of International Law* (2012) p. 335 at p. 344.

[144] Habermas, *supra* n. 110, Ch. 9.