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Financial stability and legal integration in financial regulation

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\*335 Abstract

*Financial stability has become a key concern in EU financial regulation.This article examines the regulatory reforms made pursuant to the objective of financial stability and shows that policy-makers in the European Union address financial stability concerns by relying heavily upon the hitherto cherished pursuit of legal integration.This article, however, argues that legal integration may not adequately address the needs of financial stability, and the concern for financial stability could facilitate diverging practices on the part of Member States, causing tension with the promotion of legal integration in EU financial regulation.This article advocates caution in pursuing increasing legal integration, and argues that a more nuanced approach is necessary to meet the legitimate and varied needs of financial stability.*

### Introduction

In the wake of the global financial crisis, "financial stability" has become a public policy driver for enhanced legal integration and harmonisation in financial regulation in the European Union.This article examines the reforms to the legal frameworks and regulatory architecture that have taken place at EU level, to show how EU policy-makers have adopted the rhetoric of concern for financial stability in the promotion of further legal integration.This article, however, argues that legal integration may not adequately address the needs of financial stability, and the concern for financial stability could equally facilitate diverging practices on the part of Member States, causing tension with the promotion of legal integration in EU financial regulation.This article advocates caution and considered reflection for the drive towards increasing legal integration, and argues that a more nuanced approach is necessary in order to meet the legitimate and varied needs of financial stability.

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In the first part, we discuss how policy-makers in the European Union have come to assume that the needs of financial stability and market integration are aligned, and the embarkation upon further legal integration to address this alignment. This part discusses the extensive reforms made to legal frameworks and regulatory architecture in the European Union that are underscored by that assumed alignment. The next part then argues that embracing financial stability as a key regulatory objective in Member States may result in the adopting of local legal divergences, forcing confrontation with the legal integration project at the EU level. This part will show that local divergences occur in three key ways: (1) "law in\*336 action"; (2) "super-equivalent regimes"; and (3) "general good" exceptions that allow deviations from Treaty freedoms (discussed under the corresponding headings respectively). We argue that although EU level policy-makers have been anxious to align financial stability and market integration in order to support ever increasing legal integration, the adoption of local divergences shows that financial stability concerns generate varied needs and so the assumption that the needs of financial stability and market integration are aligned is too simplistic. In other words, the assumption that financial stability and market integration are aligned is made in order to further an overly hasty move to preserve the furthering of market integration. Subsequently, we argue that market and legal integration in EU financial regulation should be re-examined as an ideational premise, and should take into account the legitimate and varied needs of financial stability. This approach will allow EU-level governance in financial regulation to be forged in a more flexible manner, to serve more resilient and not just integrated markets. We argue that the preliminary shape of the eurozone banking union seems to represent such a differentiated and flexible approach albeit within the general rubric of legal integration. The final part of this article contains a conclusion.

### **Legal integration in the European Union as based on the alignment between financial stability and market integration**

Legal integration in financial regulation has proceeded at an accelerated pace since the Financial Services Action Plan 1999 and the establishment of the Lamfalussy framework to provide for fast-tracked legislative production.<sup>1</sup> Such legal integration has been viewed to be necessary to support a single market for capital and financial services, which has been growing at the wholesale level and in the banking sector.<sup>2</sup> The integration of the single market for capital and financial services is the key policy objective driving the developments in EU financial regulation. Commentators have supported legal integration in EU financial regulation on the basis of the high actual level of market integration in the wholesale financial and banking sectors.<sup>3</sup> Market integration has resulted in increasing levels of cross-border activities, which could give rise to issues of supervisory efficacy and crisis management in case of cross-border spillover effects.<sup>4</sup>

Legal integration in EU financial regulation has now been boosted by the global financial crisis of 2008/9. With the onset of the crisis, the legal integration impetus in EU financial regulation is now infused with the need for preserving financial stability.

The crisis has led to a general acknowledgement of the importance of financial stability and mitigating systemic risk as policy goals at EU level. As market integration in the banking and financial services sector has been greatly enhanced since the Financial Services Action Plan 1998 and the resulting legal reforms in the European Union,<sup>5</sup> financial stability concerns are perceived to be EU-wide concerns given\*337 the significant extent of cross-border activities and multi-jurisdictional footprint on the part of many financial institutions in the European Union. Policy-makers are rightly concerned that EU-wide measures and perspectives are necessary to relate the state of market integration in financial services to concerns in financial stability, such as possible contagion effects in multiple jurisdictions that could be engendered by the failure or near-failure of any particular financial insti-

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tution, and any adverse effects that could occur to Member States owing to the regulatory actions or inaction on the part of any Member State concerning its regulated financial institutions. Post-crisis policy-making has adopted the regulatory objective of financial stability at EU level in order to inform legal reforms that would take a pan-European perspective and approach to managing financial stability under the conditions of market integration. Thus, enhanced legal integration is needed to translate the regulatory objective of financial stability into common frameworks for regulatory implementation, and mitigate the risk that Member States may take diverging actions that may be prejudicial to each other's interests in the face of a crisis.

The de Larosière Report supports "regulatory consistency" as being essential to the single market, and such regulatory consistency is seen as essential to preserving financial stability as well.<sup>6</sup> Further, the European Commission continues to assert that there is,

"clear complementarity between financial stability and integration. Economic and financial integration is not an obstacle to stability, and integration can deliver strong benefits for the broader economies."<sup>7</sup>

Although there is a legitimate case for the complementarity of financial stability needs and market integration which supports enhanced legal integration in order to deal with the needs of financial stability, this article is of the view that the case may be over-stated as policy-makers in the European Union have strong vested interests to continue supporting the economic and legal integration project. Policy-makers at EU level seem to have been anxious to align the needs of financial stability with indefatigable legal integration,<sup>8</sup> and gestures such as changing the title of the annual "European Financial Integration Monitor" to the "European Financial Stability and Integration Monitor" since 2010 are indicative of the anxiety to persist with market and legal integration.

The article now turns to the legal and regulatory architecture reforms that have been introduced in the European Union that purport to address financial stability concerns through ever increasing legal integration. Legal reforms have taken place in order to spread the regulatory net over a range of hitherto unregulated financial services institutions. Further, the European System of Financial Supervision (ESFS) has been established as the European institutional architecture for financial regulation to ensure that regulatory convergence is aligned with the needs of financial stability. In September 2012, unified banking supervision was even proposed to be undertaken by the European Central Bank, as a single supervisory mechanism for "[t]he single market and the banking union are ... mutually reinforcing processes".

#### *Substantive law reforms in EU financial regulation*

Where substantive legal reform is concerned, the Regulation for Credit Rating Agencies 2009<sup>9</sup> has been swiftly enacted, creating a system of EU-wide authorisation for credit rating agencies subject to ongoing supervision at Member State level. The Capital Requirements Directives 2009 and 2010 have also amended<sup>338</sup> the 2006 Directive to provide for enhanced credit risk recognition of structured finance products,<sup>10</sup> retention of risk<sup>11</sup> as a form of risk management, supervision over remuneration policies<sup>12</sup> at financial institutions to be aligned with risk management and micro-prudential measures such as the possible imposition of leverage controls.<sup>13</sup> Further, a new Capital Requirements IV Directive and Regulation<sup>14</sup> are being proposed to recast all micro-prudential regulation over credit and other financial institutions to implement the internationally accepted Basel III Capital Accord. The Regulation on Short Selling and certain aspects of Credit Default Swaps 2010 also provides for a disclosure regime for short sales beyond a particular level and the discretionary imposition of regulatory bans and controls in times of "adverse developments and threats to market stability and confidence".<sup>15</sup> The Directive on Alternative Investment Fund Managers 2011<sup>16</sup> also finally passed both Council and Parliament in mid-2011, allowing for the

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expansion of supervisory oversight of prudential and conduct of business matters and disclosure regulation to assist regulatory surveillance. The European Markets and Infrastructure Regulation<sup>17</sup> was also passed in early 2012 to provide for mandatory central clearing of certain derivative products, trade transparency and the oversight of clearing houses.

Further amendments to the initial Lamfalussy procedure directives have also been passed in respect of the Prospectus Directive 2003,<sup>18</sup> and will be passed for the Markets in Financial Instruments<sup>19</sup> and Transparency Directives.<sup>20</sup>

The substantive law reforms showcase the immensely expanded breadth of regulatory reach in EU financial regulation, setting standards for the prudential aspects and conduct of business of hitherto unregulated entities such as hedge and private equity fund managers, credit rating agencies, derivatives trading, central counterparties and clearing houses. The substantive law reforms also envisage enhanced supervision and enforcement to be carried out by national regulators led by European-level agencies, and in the case of credit rating agencies, to be carried out by a European-level supervisor. The institutional reforms at EU level are of crucial importance for the implementation of substantive law reforms, and we now turn to this.\***339**

#### *Institutional reforms—European System of Financial Supervision (ESFS)*

The institutional reforms to create an ESFS were proposed in the de Larosière Report, and implementation started in 2010. The ESFS is an institutional architecture that applies across the European Union and is intended to spearhead legal integration in substantive legal reforms. Further, in late 2012, political agreement was secured for the European Banking Union or the Single Supervisory Mechanism with banking supervision in the European Central Bank (ECB) for all eurozone banks in the European Union with at least €30 billion in assets, or assets whose value represent a fifth of a Member State's gross domestic product.<sup>21</sup> This development could on the one hand mean more integration as direct supervision is undertaken by the ECB as a centralised body, but could also mean a step back from integration as the banking union creates a differentiated tier of integration for the eurozone banking sector. The third part of this article will argue that the eurozone banking union demonstrates the limits to legal integration for the European Union, and that financial stability needs may not be aligned with simply more integration. We first discuss what has been achieved by the institution of the ESFS.

The ESFS comprises three pan-European financial regulators in the form of the European Banking Authority (EBA),<sup>22</sup> the European Securities and Markets Authority (ESMA)<sup>23</sup> and the European Insurance and Occupational Pensions Authority (EIOPA),<sup>24</sup> a Joint Committee of the three European authorities and national regulators, and a pan-European macro-prudential supervisor, the European Systemic Risk Board (ESRB),<sup>25</sup> which is formed under the auspices of the ECB.

The EBA, ESMA and EIOPA are tasked with the continuing mandate of market integration and legal convergence but also protective objectives such as systemic stability and consumer protection. The Regulations establishing the EBA, ESMA and EIOPA have mirror provisions on the roles, functions and powers of these bodies.<sup>26</sup> In terms of furthering the market integration objective, these bodies have the power to recommend technical standards for uniform implementation of EU Directives in financial regulation, and binding guidelines on supervisory practices and standards.<sup>27</sup> These bodies also seek to achieve market integration through supervisory convergence, which is based on common guidelines,<sup>28</sup> and the monitoring of coherence in supervisory action and the monitoring of coherence in supervisory action taken by Member States. The ECB, however, would, under the proposed Single Supervisory Mechanism, be responsible for the micro-prudential supervision of banks in eurozone countries and

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participating non-eurozone countries, such as the United Kingdom, and will work alongside the EBA in its more general functions mentioned above. The three authorities, in forging supervisory convergence in the implementation of common rulebooks, also have the power to facilitate the settling of disagreements between national regulators by subjecting them to a process of conciliation. Where conciliation fails, the\*<sup>340</sup> three authorities have the power to impose a decision to resolve the disagreement.<sup>29</sup> They are also responsible for establishing colleges of supervisors for joint supervision and stress testing of financial institutions,<sup>30</sup> forging a common supervisory culture<sup>31</sup> and conducting peer reviews of national regulators for convergence in supervisory measures.<sup>32</sup>

The three authorities also have the mandate to take the lead on setting policies and standards in consumer financial protection<sup>33</sup> and to ensure the consistent application of financial guarantee schemes.<sup>34</sup>

The three authorities' final major mandate is in relation to crisis management<sup>35</sup> and systemic risk. Article 18 provides for the three authorities to facilitate co-ordinated crisis management by national regulators. In exceptional circumstances supported by a Council resolution, the three authorities have the power to address decisions directly to national regulators, and where there is non-compliance by regulators, to address a decision directly to financial institutions. In terms of dealing with systemic risk mitigation, the three authorities are tasked to develop quantitative and qualitative systemic risk indicators<sup>36</sup> in conjunction with the ESRB and to develop a permanent capacity to deal with systemic risk policies and governance,<sup>37</sup> by continuing to monitor and assess market developments<sup>38</sup> and by collecting information from national regulators and conducting analyses.<sup>39</sup> The three authorities may for the purposes of discharging their systemic risk mandate put in place plans for resolution or recovery for financial institutions.<sup>40</sup> The three authorities are also required to provide assessments to the European Parliament, the Council, the Commission and the ESRB of trends, potential risks and vulnerabilities at least once a year.<sup>41</sup>

It is arguable that as the three European authorities are mandated to develop a single rule book, financial stability concerns may be assumed to fall in line with the general impetus towards market and legal integration. The ESMA, EBA and EIOPA have mirror and multiple objectives that relate to forging a common rulebook, supervisory convergence, financial stability and consumer protection. Will the three authorities be able to carry out a balancing exercise in discharging the responsibilities related to the multiple objectives? They may regard the forging of common rulebooks as a proxy for achieving objectives such as financial stability and consumer protection. The three authorities have evolved from networked committees whose main roles have been to assist the European Commission in establishing technical legislation, to support primary legislation that seeks to integrate the European Union's financial markets.<sup>42</sup> They continue to be heavily involved in legislative reform—the EBA in the legislative implementation of the internationally accepted Basel III Capital Accord, the EIOPA involved in the implementation of the Solvency II Directive on microprudential regulation for insurance firms, and ESMA involved in reforming the Markets in Financial Instruments Directive (MiFID) 2004, the Transparency and Market Abuse Directives, and in drafting technical supporting legislation for recently enacted post-crisis legislation\*<sup>341</sup> such as the Alternative Investment Fund Managers Directive 2011 and the European Markets and Infrastructure Regulation 2012. Hence it is likely that the three authorities would be overly pre-occupied with legal integration and are likely to consider financial stability concerns as a natural outcome of the legal integration process. Market and legal integration are deeply ingrained in the workings of the three authorities,<sup>43</sup> and these may be regarded as a natural proxy for EU-wide financial stability concerns.

The European Systemic Risk Board (ESRB)<sup>44</sup> is the pan-European body that is tasked with systemic risk macro-prudential oversight. It is nested within the ECB and, although functionally separate, would be envisaged to complement the ECB's role in micro-prudential supervision. It would be responsible for collecting and analysing

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information in order to identify systemic risk signals, determine the priorities of these risks and issue appropriate warnings and recommendations in view of these risks.<sup>45</sup> The Board will be directed by a General Board<sup>46</sup> comprising the chairman and vice-chairman of the ECB, governors of national central banks, the chairpersons of the three European authorities mentioned above, a member of the European Commission, the chairs and vice-chairs of the ESRB's advisory scientific committee and the chair of the ESRB's advisory technical committee. The General Board will be assisted by a Steering Committee<sup>47</sup> including an even spread of representation from the ESRB itself, the General Board, the European Central Bank, the ESMA, EBA and EIOPA, the European Commission, the Economic and Financial Committee of the European Council, and the two advisory committees of the ESRB. The ESRB's work will be assisted by an Advisory Scientific Committee,<sup>48</sup> which comprises experts across a wide range of fields and skills, and the Advisory Technical Committee,<sup>49</sup> which consists of representation from national central banks and EU-level representation.

The ESRB has the power to collect and request information from the three European authorities mentioned above, national central banks and regulators.<sup>50</sup> It is also tasked with provision of information to the three European authorities mentioned above where appropriate.<sup>51</sup> The collection of information by the ESRB, however, has to be in aggregate form and must not identify any particular financial institution.<sup>52</sup> Although this may be understandable in terms of protecting any financial institution from premature reputational risk, it may also constrain the ESRB from making a judgment on whether any individual institution may be important in contributing to systemic risk. The ESRB may also consult private sector stakeholders for advice, contributing to its analysis capacity.<sup>53</sup>

The ESRB's role is to issue warnings and/or recommendations to the European Union as a whole or to individual Member States or national regulators.<sup>54</sup> These warnings and recommendations are to be contemporaneously transmitted to the Council and Commission as to the addressees. The ESRB may follow up with the addressees as to what action is taken in respect of the warnings or recommendations, but the general enforcement procedure for breach of Union law under the Treaty is not explicitly provided for.<sup>55</sup> Where appropriate, the General Board may make its warnings or recommendations public, upon<sup>342</sup> informing the Council and addressees in advance and the achievement of a two-thirds majority vote in the meeting of the General Board.<sup>56</sup>

A number of commentators argue that macro-prudential supervision undertaken by the ESRB is not exactly a centralised EU function as it is not supported by greater force of law<sup>57</sup> and the ability to issue corrective mechanisms.<sup>58</sup> However, others<sup>59</sup> have noted that although the power of the ESRB lies in giving warnings and may be regarded as a measure of "soft law", these measures are unlikely to be ignored, and facilitate a form of economic governance that could be adapted to suit both boom and crisis times. It may be argued that if unified micro-prudential supervision for eurozone banks and banks in non-eurozone participating countries is undertaken by the ECB, the position of the ESRB could be enhanced. As the ESRB is nested within the ECB, the ESRB and the ECB could work synergistically together in monitoring micro- and macro-prudential soundness in the EU financial markets. However, as the ECB's remit is over eurozone banks and non-eurozone banks from participating countries above a certain asset threshold, the ECB's new role may entail "eurozone bias" in terms of how the ECB, and perhaps influencing the ESRB, would perceive financial stability needs. The bias may be a natural consequence if the ECB and ESRB become more equipped with information with regard to the banking sector in the eurozone. But this could mean that the macro-prudential supervision that the ESRB is meant to carry out for the benefit of all EU Member States may have to be closely scrutinised in terms of its adequacy for the non-eurozone Member States.

It is clear that the EU policy-makers see legal integration as being reinforced by financial stability concerns, and

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integrated regulatory and institutional frameworks have now been put in place to deal not only with market and legal integration but also financial stability concerns. However, this article argues that the needs of financial stability may not be fully aligned with European market integration, and will also pose challenges to the development of European financial regulation.

The next part will argue that the needs of financial stability are varied and may justify the adoption of divergences by individual Member States or groups of Member States within the European Union.

### **Can financial stability justify local legal divergences from EU financial regulation?**

Financial stability has always been recognised as one of the objectives in financial regulation. Cranston<sup>60</sup> identifies the maintenance of "systemic stability" as a public good that "financial regulation" can provide. Systemic stability is referred to as a "public good", as individual firms are generally not able or motivated to take actions that may collectively protect the financial system as a whole,<sup>61</sup> therefore generating a market failure. "Public goods" are defined as being collectively enjoyed by society,<sup>62</sup> but the provision of which<sup>343</sup> is often subject to a collective action problem, and so the state is ultimately looked to in order to supply it.<sup>63</sup>

In the context of the European Union, at what level is the collective public good of financial stability provided? If we turn to what "financial stability" means, we will realise that "financial stability" is a highly relative concept, and this may mean that where local needs may differ in parts of the European Union, the needs of financial stability would be different.

Schinasi<sup>64</sup> argues that the financial sector's essential purpose is to manage risks and allocate resources in the real economy. In taking on its intermediary purpose, the sector becomes itself a clearing house for risk and an essential facilitator for wealth creation in the real economy. Risk-taking is inherent in financial sector intermediation, and so financial stability or instability should be understood as a continuum of a state of affairs where the financial sector serves the needs of economic activity, and in so doing is able to tolerate a certain extent of deficiencies, vulnerabilities and disturbances.<sup>65</sup> The key issue in understanding financial stability or instability is *whence* certain vulnerabilities or sub-optimalties should be regarded as no longer tolerable in the system and should be regarded as a form of "instability". In other words, the "financial stability" desired to be achieved is a state of risks which are "difficult to decide [as to] what [are] undesirable as compared to what [are] tolerable or desired".<sup>66</sup>

Drawing from the sociologist philosopher Niklas Luhmann's writings on risk in general, the "disaster threshold" for different individuals or groups of constituents "will be located at very different positions, depending on whether one is involved in risk as a decision-maker or as someone affected by risky decisions. This makes it difficult to hope for consensus on [risk] calculations ...".<sup>67</sup> Davies and Green<sup>68</sup> are of the view that "financial stability ... cannot be defined in terms other than broad and general ones that give little guidance on policy or action, and indeed that it could even be dangerous so to do".<sup>69</sup>

The understanding of financial stability/instability is thus difficult not because of difficulties in measuring or evaluating financial flows and their potential ramifications. The understanding is difficult because of the value judgments that need to be made as to the tolerance of levels of financial stability or instability.<sup>70</sup>

As "financial stability" essentially relates to a relative tolerance level for risk-taking, it may be argued that commonly accepted levels are more likely to be achieved within smaller communities than within larger com-

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munities. This would mean that it is more likely that a determination of tolerance levels could be made more readily at a national level than a pan-European or international level.<sup>71</sup> Further, the eurozone States may have more common interests among themselves than with the non-eurozone Member States and may adopt preferences for "financial stability" that are different from non-eurozone Member States. Hence, "financial stability" is a malleable concept that can operate on national, pan-European and\*<sup>344</sup> international levels, and could justify different policy choices at different levels.<sup>72</sup> This also explains why, in the name of "financial stability", Member States have responded divergently to the global financial crisis.<sup>73</sup> The global financial crisis has affected the financial institutions and sectors of Member States differently and to different extents, and the choices made have been reflective of the need to maintain national interests in "financial stability". The Commission has identified reversals and pauses in market integration in the financial sector since 2010,<sup>74</sup> and concerns for financial stability may have played a part in these developments. We turn now to three types of divergences that have taken place and how they have reflected national interests in "financial stability".

The first type of divergence refers to actions taken by Member States that are not subject to maximum legal harmonisation in EU financial regulation. It may be said that such divergences are therefore a matter of course as maximum legal harmonisation has not been envisaged. However, a number of these actions have been clear expressions of national interest without conferment at EU level and with little consideration of spillover effects upon other Member States. This brings to question whether the EU policy-makers can really force harmonisation upon these areas and whether there may be legitimate national interests of financial stability that would remain challenging to legal integration. The second type of divergence actions refers to "super-equivalent" regimes that have been legislated in order to reflect and protect national interests even if a maximum legal harmonisation measure is already in place in EU financial regulation. The third type of divergence would be exceptional regimes that would likely deviate from the Treaty freedoms in that they erect obstacles to the freedom of establishment or to provide services but may nevertheless be arguably justified under general good or public interest. This article does not regard the eurozone banking union as a "divergence" as it would continue to operate along the same rulebooks in the form of legislation or the EBA's technical rules. The banking union, however, represents a differentiated and flexible governance approach within the general fabric of legal integration and the third part of this article will further explain how this approach may reflect the balance needed to be struck between market and legal integration needs and the needs of financial stability.

#### *Divergences where no maximum legal harmonisation exists or can be achieved*

In the pre-crisis years, one area in financial regulation that was not subject to any legal integration was financial institution crisis management and resolution regimes. Although market and legal integration promoted more cross-border financial activity and the establishment of financial institutions with an EU-wide footprint, financial institutions were "global in life and national in death".<sup>75</sup> Policy integration in the much-needed areas of cross-border supervision, deposit-guarantee schemes, lender-of-the-last resort policy and crisis management and resolution schemes such as special bankruptcy regimes and state bailout has been urged<sup>76</sup> before the onset of the global financial crisis, but as Pisani-Ferry and Sapir<sup>77</sup> have pointed out, market integration has outpaced policy integration. National authorities realised that it was up to them\*<sup>345</sup> to take the best courses of action to protect national financial stability after the fall of Lehman Brothers in the United States in September 2008, which was a key trigger point for bank crises in various parts of the European Union.

Faced with threats of banking collapses in 2008–09, national governments in the European Union have taken a number of actions that principally reflect domestic interests and policy, although ad hoc forms of co-ordination have been observed. In terms of bank bailouts, the United Kingdom, which needed to bail out the Royal Bank of



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Scotland and Halifax Bank of Scotland in late 2008, developed a plan to provide liquidity to the financial system, through the special liquidity scheme operated by the Bank of England; to recapitalise banks whereby the Government would buy bank shares; and to provide government guarantees of new debt issued by banks.<sup>78</sup> Quaglia argues that this is essentially a British plan<sup>79</sup> which has been afterwards "transferred" to other Member States as they designed their own banking bailouts. The European Commission exerted its influence much later in developing a communication both on bank recapitalisation and on impaired assets at banks in December 2008 and February 2009 respectively.<sup>80</sup> The subsequent bailout of the cross-border bank Fortis had also been carried out by the loose co-ordination of the national governments concerned with these banks, the Benelux countries. The three governments injected capital into the national parts of Fortis within their respective territories, but when the injection proved to be insufficient for Fortis, the Netherlands nationalised its part of Fortis, Belgium nationalised its part of Fortis too but quickly disposed of its part to BNP Paribas, and Luxembourg sold its part of Fortis to La Baloise, a non-life insurance group. The flurry of bank bailouts in 2008 has therefore been characterised by ad hoc co-ordination if necessary among Member States, in bilateral rather than multilateral forms of policy co-ordination. Although the resolution of Dexia by France, Belgium and Luxembourg in late 2011 was more of a co-ordinated and joint effort, such co-ordination was still relatively bilateral and ad hoc in nature.<sup>81</sup> The bank bailout patterns in the European Union have shown the tendency to exert strong national preferences in the absence of a multilateral strategy for pan-European crisis resolution. Further, the most heavily criticised government in the global financial crisis has been that of Iceland. Iceland had taken unilateral action to freeze depositor accounts and assets when its three largest banks, Landsbanki, Glitnir and Kaupthing, descended into trouble, affecting depositors in the European Union including the United Kingdom and Netherlands. The United Kingdom's retaliatory action against Iceland, by using national terror laws to freeze Icelandic bank assets located in the United Kingdom, was also an expression of national actions in divergence to protect national depositors' interests.

The de Larosière Report acknowledges that EU financial regulation has been inappropriate and inadequate in many areas,<sup>82</sup> exacerbated by the collective action problems<sup>83</sup> on the part of EU Member States. This unsatisfactory state of affairs has now been met with robust action on the part of the European Commission<sup>346</sup> pushing for an integrated rulebook on crisis management,<sup>84</sup> and for deposit guarantee schemes.<sup>85</sup> It may be argued that with the Commission's plan to bring about an integrated rulebook for crisis management, ad hoc measures that have been unpredictable and subject to political haggling would disappear to give way to a more predictable and coherent set of practices. However, this article queries whether the Commission's proposed Directive would achieve the above. This article argues that the proposed Directive has provided for some forms of legal integration but the different needs of crisis management and the responsibility of Member States to bear fiscal cost are issues that affect national interests differently.

The proposed Directive provides for legal integration in the special resolution regimes to be established in Member States. Special resolution regimes are legal frameworks allowing national authorities to take over a financial institution in crisis in order to stem panic and decide how the institution may be recovered or resolved. The resolution tools are: the outright sale of business, the creation of a bridge institution to temporarily own and run the failing institution until a purchaser may be found, the separation of good from bad assets, and mandatory bail in for creditors and equity holders so that the private sector will absorb as many losses as possible.<sup>86</sup> The global financial crisis has shown, however, that nationalisation is a key tool and is perhaps the tool most resorted to, and the Proposal is silent on this issue, leaving cross-border resolution problems that involve nationalisation to Member State negotiations. Perhaps the omission is due to concerns for moral hazard in case banks and financial institutions are given the impression that state bailouts are on the cards. But this omission is a serious gap in the purportedly EU-wide strategy in crisis management to preserve financial stability. Commentators have argued that the public interest in the banking sector is such that state bailouts necessarily need to be conside-

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red.<sup>87</sup>With cross-border banking in the European Union, a co-ordinated strategy in state bailout is required to prevent protectionist and beggar-thy-neighbour approaches, and assist in distributing the fiscal burden in a more predictable way.<sup>88</sup>Fiscal burden sharing<sup>89</sup>is mentioned as the possible subject of Member States' bilateral agreements, but is not EU-level legal integration supposed to overcome some of the differences and difficulties in Member States' approaches that could be subject to protracted wrangling and negotiation?It is queried whether the proposed Directive is leaving the most difficult issues that relate to financial stability—the role of government assistance and fiscal cost sharing to one side and merely putting together what it can for the purposes of legal integration?Draghi<sup>90</sup>suggests that an EU-wide resolution authority may be required to deal with cross-border resolutions.This issue is likely to be subject to intense negotiations among Member States and the limits of the proposed Directive show that legal integration should perhaps not be prematurely rushed into and that national financial stability needs do pose challenges to legal integration.\*<sup>347</sup>

Further, fiscal cost may also be incurred for the Directive's other proposed resolution options such as the Bridge bank and the separation of assets, as bad assets may have to be underwritten or absorbed by the taxpayer.Although the Directive provides that Member States should establish group resolution schemes for cross-border banks in the European Union on an ex ante basis,<sup>91</sup>such ex ante schemes would be tested when a real situation arises.Ex ante financing arrangements<sup>92</sup>would also be tested when ex ante arrangements are insufficient.<sup>93</sup>The proposal to borrow from deposit guarantee schemes<sup>94</sup>in Member States may also entail national interest resistance.

The Commission also encourages a policy of early intervention<sup>95</sup>in institutions that may show signs of imminent failure.In cross-border groups, the decision whether or not to intervene early may be contested between joint supervisors.The template for convergence in the Commission's proposed Directive will not rule out actual implementational differences between Member States and problems that may occur at the level of co-ordination.

Although legal integration is afoot in the key area of financial institution crisis management and resolution, this is an area that will arguably expose the limits of legal integration as national interests are varied and the achievement of common ground may be questionable.For example, the United Kingdom's banking sector features many internationally active global banks, many of which have originated from the United States.The United Kingdom's shared interests with the United States in terms of crisis management and resolution are more pronounced than with many other Member States.The United Kingdom and United States have now entered into an agreement to entrust leadership of resolution operations to the Federal Deposit Insurance Corporation if a systemically important financial institution which originates from the United States should fail.<sup>96</sup>This is a form of divergence adopted by the United Kingdom in relation to how resolution would apply to bank subsidiaries in the United Kingdom whose parent companies are based in the United States.Resolution in such situations would be led by the US authorities who would apply different legal frameworks to those that may be harmonised at EU level.

Another example of divergence actions taken by Member States in the global financial crisis has been policy choices made in respect of national deposit guarantee schemes.The European Union has provided minimum legal harmonisation for deposits, at €20,000 per defined deposit account in 1994.<sup>97</sup>However, the United Kingdom exceeded that level even before the crisis, providing for 100 per cent of the first £2,000 plus up to 90 per cent of the next £33,000.After the United Kingdom suffered the Northern Rock bank run in October 2007, the deposit guarantee in the United Kingdom was raised to £50,000 per defined deposit account.In the wake of the Icelandic banking crisis in June 2008, the UK Government then guaranteed 100 per cent of the defined deposits placed with the failed Icelandic banks for UK depositors.In September 2008, when a number of Irish banks including Anglo-Irish were on the brink of collapse, the Irish Government announced a 100 per cent guarantee for deposits in six banks, causing deposit outflows to take place from other Member States, criticised by some commentators as a

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"begging-thy-neighbour" approach.<sup>98</sup>This remains in place although a policy decision has been taken\*<sup>348</sup> at EU level to increase the deposit guarantee to €100,000 per defined account.<sup>99</sup>The unilateral Irish decision remains the poster child for questioning whether legal convergence in deposit guarantee schemes will actually bring about conforming action in all Member States.The Commission's proposed Directive that allows deposit guarantee schemes as a form of back-up funding for resolution arrangements will also directly threaten the ability of Member States to make a commitment as Ireland has done, and would place in stark contest national interest against European approaches.

Finally, the financial stability needs of the eurozone may be different from the non-eurozone Member States.Many eurozone banks have been acutely affected by the fiscal imprudence<sup>100</sup>of several eurozone countries, triggering sovereign debt crises.The eurozone may need to be subject to more convergent economic governance, as demonstrated in the new fiscal and growth pact,<sup>101</sup>and the interest in decoupling banks and sovereigns in the eurozone has given rise to the need to house banking supervision of eurozone banks in an independent entity at EU level, which is the Single Supervisory Mechanism.The unique concerns with eurozone banks, which may become more apparent after the ECB takes over supervision of them, could trigger a rethink of the extent that can possibly be achieved in terms of legal integration in crisis management and resolution in EU financial regulation.

Although the policy-makers in the European Union have quickly infused the financial stability rhetoric into the market and legal integration machinery (perhaps in order to shore up confidence in continuing with market integration), the case for the alignment of financial stability concerns with market and legal integration may be overstated, and EU policy-makers need to confront difficult issues with regard to national interests and objectives, in order to adequately address financial stability concerns at the national as well as the pan-European levels.The gaps in the proposed Directive where state bailout is concerned, the differences in Member States' banking sectors which may require different resolution needs and the importance of deposit guarantee to national interests are all issues that may highlight the limits to which maximum legal harmonisation can be achieved in the difficult area of crisis management and resolution.Legal integration is not a proxy for addressing financial stability concerns and should not be rushed for its own sake.

#### *Super-equivalent legal regimes*

The second type of divergence observed relates to the institution of regulatory regimes that add to regulatory frameworks that are already subject to maximum legal harmonisation at the EU.Such "gold-plating" or introduction of more stringent "super-equivalent" regimes may be justified for the purposes of national interests such as consumer protection.The perception that there is a need to take national measures to safeguard regulatory objectives such as consumer protection may be justified as European policy-makers have hitherto not placed much emphasis on those objectives in the pursuit of market and legal integration.

European market integration has been driven by policy-makers supporting supply-side interests in the pre-crisis years.We suggest that the areas of policy integration that have been achieved in the pre-crisis years are reflective of industry and producer interests,<sup>102</sup>and those interests have given a tremendous boost\*<sup>349</sup> to policy will.There was also no incentive for the industry to push for legal integration in areas that are politically challenging such as crisis management or fiscal burden-sharing, or areas of consumer protection as the needs of overall economic governance and consumer protection were not of immediate commercial concern.Market integration has provided a friendly climate for the rise of supply-side interests such as the growth in cross-border activity and the rise of European-wide systemically important financial institutions that could undermine the patchwork of home-host country supervision in the pan-EU arrangements, and give rise to risks and losses that exceed what one Member

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State can bear. EU policy-makers have hitherto supported a form of market and legal integration that are most relevant to supply-side interests. Can EU policy-makers now convince us that market and legal integration objectives are seamlessly infused with financial stability concerns?

The United Kingdom, for example, has set out on its own road map on how best to achieve consumer protection so as to prevent future systemic crisis that could arise from failures in the retail sector. The example that will be discussed here is the United Kingdom's Retail Distribution Review (RDR) that seeks to regulate conflicts of interest in the provision of investment advice, with a view to improving the quality of advice to customers. It may be argued that the United Kingdom quite rightly sees the RDR as a necessary reform as the United Kingdom has a vibrant financial products market for consumers, and persistent episodes of mis-selling from endowment mortgages<sup>103</sup> in the 1990s to payment protection insurance<sup>104</sup> that has been the subject of a major clampdown show the need for the enactment of more consumer protection regimes in the United Kingdom.

The RDR intends to improve the quality of investment advice through the prohibition of product provider commissions. The banning of commissions is viewed to be crucial to addressing conflicts of interest that may entail biased investment advice. The RDR does not apply to personal pensions and protection insurance products.<sup>105</sup> From 2013, the RDR requires investment advisers to draw up a scale of charges for advice up front, so that remuneration is computed according to the adviser charges and not according to product commissions.<sup>106</sup> This regime will also apply to online platform providers.<sup>107</sup> This is intended to remove any perverse incentives that may be introduced by product commissions influencing advisers to encourage consumers to purchase any particular products. However, some concessions are made to mitigate the potentially high cost for consumers. Advisers may be paid from deductions<sup>108</sup> made to customer's investment amount, but however the payment is arranged, payment for advice must not be linked to product providers. Product providers are banned from giving customers cash rebates<sup>109</sup> to pay advisers. Customers may obtain "unit rebates" from product providers. Factoring is banned<sup>110</sup> in order to prevent the return of remuneration incentives influencing the quality of advice.\*350

The RDR requires advice to be clearly labelled to consumers in the form of "restricted" or "independent" advice.<sup>111</sup> Advice should not be labelled as independent unless the adviser is able to carry out a comprehensive and fair analysis of the market in order to find products suitable<sup>112</sup> for the customer's needs. Independent advice is evidenced by the breadth of research and suitability considerations tailored to the customer.<sup>113</sup> The RDR's standard of independence is not merely about managing conflicts of interests but is related more to suitability and the ability to represent to customers that the adviser is free from any particular incentives from recommending any particular products. "Independence" is hence closer to being "tailor-made". An FSA empirical research study has found that tailor-made encounters are one of the most useful mechanisms for meeting the needs of consumers,<sup>114</sup> the benefits to consumers ranging from the satisfaction of having made appropriate investments to the longer-term learning and enhancement in the capacity of consumers in making financial decisions in general. The RDR may entail longer-term effects in improving financial literacy and perhaps also empowering consumers to become more able to exert market discipline as a form of governance. In the short term, however, regulatory supervision over whether dispensers of "independent" advice have really discharged their duties is important to foster the credibility of the "independent" advice standard.

Where advisers are unable to offer "independent" advice, they may offer other forms of advice under the label "restricted" advice. "Restricted" advice is usually given when advisers are tied to a range of pre-selected products. The regulator recognises that advisers may represent their restrictions in such a way so that the scope of their services may be misleading to consumers. Hence intensive and intrusive forms of supervision would be necessary

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to prevent abuse.<sup>115</sup> Whether it is "independent" or "restricted" advice, upfront charges for advice may pose as an obstacle to access to financial products. The regulator recognises that the RDR may mean that investment advice could become costly and out of reach for many, and hence the regulator is willing to allow two categories of restricted advice that may be more cheaply offered to consumers. One is basic advice, which is tied to a stakeholder product such as a deposit or savings account, and the other is simplified advice that can be offered online or over the telephone.

Basic advice may be provided via scripted questions and answers so that the cost of advice may be driven down.<sup>116</sup> But such advice must be clearly represented as restricted and must nevertheless satisfy the requirement of suitability for the consumer.<sup>117</sup> Simplified advice<sup>118</sup> allows advisers to set up automated online procedures to sell products or telephone-advised sales. Simplified advice is tied to a range of pre-selected products that must be disclosed, and the advice is therefore restricted in nature. The regulator is concerned that telesales procedures and automated online procedures must be suitably robust in order<sup>351</sup> to meet the requirements of suitability, but does not prohibit simplified advice as such. In these two cheaper categories of advice, adviser charges must be disclosed up front.

The adviser charging and independent advice standards in the RDR are complemented by reforms to enhance the training and qualification requirements for investment advisers.<sup>119</sup> All advisers would need to be subject to the same training and qualifications requirements imposed on advisers. This provides a level of minimum standards in terms of adviser competence, which act as a consumer protection measure.

This super-equivalent regime not only adds to the conflicts of interest management rules in the EU MiFID,<sup>120</sup> but also attempts to get around the limitations associated with the suitability duty in the MiFID.<sup>121</sup> The MiFID's regime for conflicts of interest management is highly procedural in nature, requiring firms to identify and manage conflicts of interest through a policy that should be reviewed and disclosed to customers. Such a regime leaves it to firms to determine the proxy indicators for conflicts and may confine regulatory supervision to procedural matters rather than substantive outcomes for customers. The RDR, however, takes into regulators' hands a key proxy indicator for conflicts of interests, i.e. inducements in the form of product commissions. The European Commission is considering<sup>122</sup> the relationship between product provider commissions and the quality of advice, given the United Kingdom's pioneering approach, but the EU Parliament is concerned that this may lock consumers out of advice and not achieve better outcomes for consumers.<sup>123</sup> The uptake of a similar RDR regime in the European Union seems remote.

The RDR is arguably indirectly concerned about the quality of advice consumers receive. This is governed by the "suitability" duty harmonised in European legislation. "Suitability" requires investment advisers making a personal recommendation to obtain sufficient information from the customer to ensure that the product purchased meets the customer's investment objectives, is understood by the customer and that the customer is able to bear the financial risks associated with the product.<sup>124</sup> Hence, "suitability" takes a micro view of the recommendation made to the customer—it asks the question whether the recommendation meets the suitability requirements, but does not ask the question whether there are other recommendations that may better meet the suitability requirements.<sup>125</sup> Consumers arguably need advice that is based on comparative intelligence, and this seems to be the point in the RDR's "independent advice" standard. The RDR, in championing the gold standard of "independent advice", is seeking to address a gap in advice quality which is not subject to EU regulation.

The United Kingdom may be regarded as having a unique reputation for challenging regulatory convergence in EU financial regulation by introducing super-equivalent regimes. However, there are national interests in view of

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the perceived lack of consumer protection in financial services, and inadequate levels of protection led by EU-level regulation may pose a future problem for financial stability. Gerding argues that the underlying layer of consumer activity in the US subprime mortgage market has been key to the precipitation of the financial crisis imploding in the wholesale sector in late 2007.<sup>126</sup> Hence, the <sup>352</sup> impetus for taking national approaches in governing the retail financial services sector flows from supporting the regulatory objective of financial stability and mitigation of systemic risk.

*Deviations from Treaty freedoms—structural reforms to the banking sector*

The third type of divergence that is discussed would be regulatory reforms that could impose additional barriers to entry for foreign establishments or providers of services coming from other EU Member States. The example raised here is the prospect of the United Kingdom's implementation of structural reforms to the banking sector as proposed in the Independent Banking Commission Report (or Vickers Report).<sup>127</sup> Although this example is again taken from the United Kingdom, the United Kingdom's position on this shows how an international financial centre plans to deal with the issue of national financial stability. The European Commission has instituted the Liikanen review<sup>128</sup> to see if structural reforms may be required in the European Union as a whole. Although the Liikanen review<sup>129</sup> favours structural separation of trading activities for banks that hold trading assets beyond 15 per cent of its total assets, the Liikanen proposals differ from the UK Vickers proposals in some respects, and it is much more remote that the Liikanen proposals may be implemented. The EBA<sup>130</sup> for instance does not support an immediate implementation of the Liikanen review's structural reform proposals, preferring to focus on legal integration in resolution regimes in the European Union. Even if the Liikanen proposals were adopted in the European Union, any differences between the Liikanen proposals and the Vickers proposals (much of which have been endorsed by the UK coalition government) would still raise the question of whether the divergences may be tolerated within the accepted legal principles for deviation.

The Vickers Report proposes to ring-fence banks which undertake retail deposit taking and individual and small business lending, in order that they may be structurally separate from the larger parent banking group which may undertake risky activities exposed to market risk. Ring-fenced banks are prohibited from trading activities, securities sales, and purchase and derivatives trading generally, but are allowed to undertake legitimate hedging activities<sup>131</sup> and engage in wholesale funding arrangements which are ancillary to the retail deposit-taking and lending business.

Ring-fenced banks must provide "mandated activities", a list of services set out in the Report which preserves the social utility function of retail banks. The list of "mandated activities" would be services that, if interrupted, would result in severe economic costs usually borne by customers who are least able to bear such costs.<sup>132</sup> A bank labelled as a "retail bank" in the United Kingdom would have to provide mandated services such as retail deposit-taking, payment systems and facilities, and individual and small business credit. Legislation supporting the structural reform would further specify the list of mandated activities. A "retail bank" is ring-fenced in the sense that it cannot participate in "prohibited activities" which is defined as banking services that meet any of the following criteria<sup>133</sup>:

"make it significantly harder and/or more costly to resolve the ring-fenced bank;<sup>353</sup>

directly increase the exposure of the ring-fenced bank to global financial markets;

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involve the ring-fenced bank taking risk and are not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector; or

in any other way threaten the objectives of the ring-fence. The HM Treasury White Paper, in affirming the political will to implement the Vickers recommendations, defines the per se prohibitions as:

origination, trading, lending or making markets in securities (including structured investment products) or derivatives;

secondary market purchases of loans and other financial instruments;

conduit financing or securitisation of assets originated outside the ring-fenced bank; and

underwriting of securities issues.<sup>134</sup> Besides a prescriptive approach to what a retail ring-fenced bank can or cannot undertake, the Vickers Report proposes how such banks may be structurally separated from the rest of the parent banking group. The ring-fenced retail bank would be a separate subsidiary with its own Board. Although the Report has considered the elimination of the connection of ownership between ring-fenced retail banks and their universal banking group parents, the Report is of the view that common management or sharing of resources is much more detrimental to potential contagion than common ownership. Hence, there is no prohibition on common ownership. The ring-fenced retail bank would have to be separate from its universal bank parent in respect of management, legal and economic connections.

In terms of management separation, the ring-fenced retail bank should have its own board and be "suitably independent" from the rest of the group.<sup>135</sup> Only one director on the board of the ring-fenced retail bank is allowed to have a cross-directorship with another entity in the group.<sup>136</sup> The Government is, however, keen to recommend that at least half the board be independent, and hence refines on Vickers's original recommendation.<sup>137</sup> Ring-fenced banks should also have their own independent board committees on nomination, remuneration, audit and risk.<sup>138</sup>

In terms of legal separation, the ring-fenced retail bank would be a separate legal entity with operational independence. This means that the ring-fenced entity should be independent in terms of its access to resources, staff and operational facilities, and infrastructure and such should not be compromised irrespective of the health of the group.<sup>139</sup> The Government, however, considers that there is the possibility that ring-fenced subsidiaries could have some funding reliance on the parent company, but will consider setting limits on such arrangements.<sup>140</sup>

On economic links, the Report proposes that ring-fenced entities should not transact with the rest of the group in such a manner as to render the fence meaningless. Hence, all dealings with group companies should be on a third-party basis.<sup>141</sup> Such dealings would be on an arm's-length basis on terms that are no more favourable than in third-party relationships. In particular, asset sales or swaps must be on a third-party basis.<sup>142</sup> This proposal is intended to prevent ring-fenced entities from being used to support the rest of\*<sup>354</sup> the group and expose it to the solvency and liquidity risks of the group. The Government agrees in principle and will likely consider more explicit limitations on specific transactions.<sup>143</sup> In particular, any exposures the ring-fenced entity may have to the rest of the group would be controlled under existing legislation on large exposures, the ring-fenced entity should not provide any form of unlimited guarantee or indemnity to the group, limits should be placed on the total intraday exposures permitted between ring-fenced entities and the rest of the corporate group, and the ring-fenced

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entity should not be party to agreements which contain cross-default clauses, or be subject to similar arrangements triggered by the default of entities in the rest of the group.<sup>144</sup>Chow and Surti, however, warn that ring-fenced banks may contract more on an intra-group basis owing to the restrictions placed on permitted activities, and hence the concentration of intra-group exposures may itself pose a risk to the ring-fenced bank.<sup>145</sup>

The above features in the Vickers Report are not significantly different from the EU Liikanen review. However, the Vickers Report proposes that as ring-fenced retail banks serve social utility purposes providing intermediation and deposit services for the retail and small business sectors, they should be subject to separate and more stringent prudential regulation in order to make them more robust against potential failure. Hence, ring-fenced retail banks need to hold more loss-absorbing equity and debt than other financial institutions.<sup>146</sup> The Liikanen review does not propose to impose more stringent capital adequacy standards for retail banks and prefers to allow national discretion to require wider structural separation if resolvability remains an issue.

The structural reforms in the Vickers Report would mean that cross-border entities that wish to engage in retail banking business in the United Kingdom would be subject to the regulatory regime of structural separation as implemented in the United Kingdom. This would be the case if the legislation supporting the Vickers Report comes into effect in 2015,<sup>147</sup> which may be ahead of any EU initiative based on the Liikanen review. On the one hand, such structural reforms would directly address the problems raised by the unilateral actions taken by Iceland in relation to the Icelandic banks' retail business in the United Kingdom in late 2008; on the other hand, these reforms could be viewed as protectionist and infringing the Treaty freedoms in relation to establishment and provision of services, if the European Union has not embarked or is not going to embark on similar structural reforms. Mervyn King, the Governor of the Bank of England, has admitted that the Vickers Report reforms could be challenged by the European Union.<sup>148</sup> The Vickers Report has been accepted by the UK Government<sup>149</sup> and looks likely to be implemented by 2015.

Can the structural reforms be justified as being acceptable exceptions to the Treaty freedoms in view of the general good of financial stability in the United Kingdom? First, it may be argued that the United Kingdom's Vickers Report reforms have been well publicised in the UK and international press, and the Council or Commission could have worked through dialogue and diplomacy to ensure that the Vickers proposals remain consistent with the interests in cross-border banking and financial services in the European Union. However, in the absence of a judicial challenge, the silence of the European Commission may not be taken as acquiescence. Next, if the European Union does not adopt the Liikanen review and there is no legal integration in structural separation frameworks for banks, then there is a need to consider whether<sup>355</sup> the United Kingdom's unilateral imposition of structural separation can be justified as a legitimate deviation from the Treaty freedoms that support market integration. We turn to the jurisprudence of the Court of Justice allowing public interest-based restrictions upon the freedom to provide services or establishment, and are of the view that the Vickers Report reforms could fall within the public interest of the United Kingdom's need to preserve financial stability.

In *Alpine Investments BV v Minister van Financiën*,<sup>150</sup> Alpine took the Minister in the Netherlands to the Court of Justice to complain against the Minister's rule that prohibits cold-calling in commodity-linked investment transactions. Such cold-calling has taken place in relation to Dutch customers as well as customers in the United Kingdom, Belgium and Luxembourg. Alpine argued that the Minister's rule infringed Alpine's right to provide cross-border financial services to customers. The Court characterised the Minister's rule as a restrictive measure that could be regarded as infringing the freedom to provide services. However, the Court held that the restrictive measure was justified as it was in the public interest of the Netherlands to provide for regulatory controls that are necessary to maintain the reputation of its financial markets. As the Minister had a valid concern with respect to



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customer treatment and possible complaints, he had a justified basis for imposing the restrictive measure. In other non-financial services cases, the European Court has held, in the context of restrictive rules imposed by health authorities in respect of citizens seeking medical treatment abroad and then claiming reimbursement from their domestic health authorities, that restrictive rules such as prior notification and assessment by the domestic health authorities are justified as a matter of public interest in balancing the fiscal position of the social security systems responsible for public health in Member States.<sup>151</sup>

It may be argued that in view of the trillions of pounds spent on bank bailout in the United Kingdom significantly burdening the national deficit, the public interest in limiting the fiscal cost to the real economy is a palpable one. The United Kingdom has a large international banking and finance sector and is exposed to taking on fiscal burdens in relation to cross-border spillovers; hence, the intention of the Vickers Report in limiting such future fiscal burdens<sup>152</sup> is very much based on the unique vulnerabilities of the United Kingdom. It would be highly arguable that a restrictive measure such as the Vickers Report's structural reforms would be justifiable as in the public interest of the UK tax-paying public. This may mean that the United Kingdom's approach of structural separation may be upheld in its national interest. Further, the Liikanen review seems to support affording local authorities some discretion<sup>153</sup> in determining the extent of structural separation based on the authorities' assessment of the resolvability of the financial institution concerned. Thus, even if the European Union ultimately harmonises a form of structural separation regulation, the differences between the United Kingdom's regime (which is based on the Vickers Report) and any legal integration in the European Union (based on the Liikanen review) may be justified in the United Kingdom's public interest.

The above has examined three types of divergences that Member States have engaged in and are likely to engage in to protect the national interests of financial stability, which could be different from the interest of financial stability looked at from the EU-level. These differences are due to the essential different<sup>356</sup> preferences in risk tolerance in financial activities, the relative economic and social importance of the financial sector in Member States' economies and the different needs of consumers and the domestic corporate sector in each Member State.<sup>154</sup>

As the rhetoric of financial stability is adaptive to different contexts, what challenges do the needs of financial stability pose to the dogged and cherished goal of market and legal integration in the European Union? Do financial stability needs undermine market and legal integration and should we rethink the market integration project?

### **Refining market integration as a regulatory objective**

There is a point in supporting supranationally co-ordinated frameworks for regulating finance in the European Union, given the relatively high levels of integration in the wholesale finance and banking sectors. Such supranational frameworks will prima facie be in a position to address individual Member States' collective action problems.<sup>155</sup> However, Moloney warns that if regulatory power is concentrated at the pan-European level, then a systemic error of judgment that is made at that level could be magnified many times across the European Union.<sup>156</sup> In this respect, policy-makers at EU-level should, for example, consider carefully whether legislation that focuses on pan-European access to markets, such as in the Alternative Investment Fund Managers Directive 2011, is too path dependent, and how granting access and pursuing market integration would work with the financial stability rationale for regulating hedge and private equity funds.

Post-crisis, it is questioned<sup>157</sup> whether we could take it for granted that European financial integration, and indeed international finance, should be regulated at a level beyond the nation state when the fiscal cost to nation states is

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still fundamentally a domestic issue. Compelling legal integration in the European Union and persisting with the dogged nature of European legal integration in finance could backfire if Member States are of the view that the one-size-fits-all rules do not reflect local needs in financial stability. If legal integration proceeds at a level of broader principles in order to "fit all", then the implementation of broader principles could be adapted to local conditions, resulting in a reality of divergent laws in action in Member States even if emanating from a common "law in the books".

It is commented that the governance of finance at EU-level and internationally should be subject to ideational re-examination.<sup>158</sup> This means that the European Union should accept that market integration, encouraging and facilitating market access should not be doggedly pursued without considering national financial stability needs. A number of commentators<sup>159</sup> in fact suggest that more forms of decentralisation should take place so that different pockets of financial stability needs that reflect the local socio-economic and developmental profiles could be better taken care of. Helleiner and Pagliari term this form of governance<sup>357</sup> a form of co-operative decentralisation,<sup>160</sup> and this is reflective in general contemporary EU governance literature such as Sabel and Zeitlin's "direct deliberative polyarchy" model.<sup>161</sup>

Sabel and Zeitlin's model posits a multi-level approach of non-hierarchical participation in EU policy-making that is networked yet orderly. The key characteristic in this approach is the deliberative aspect that allows policy-making to be forged through discussions and negotiations at every level. Policies may be deliberated and negotiated between EU-level institutions and Member State politicians, and how implementation should take place may be negotiated and deliberated upon at lower levels of agencies, epistemic communities and stakeholder groups. This model allows for experimentalist governance to work out in a more considered way where different issues of concern may arise in different quarters in relation to an area of governance. Arguably, governing finance in the European Union has also reached this stage where an easy assumption that integration is beneficial and benefits everyone equally should not be made. Deliberative and experimentalist forms of governance should instead encourage the pooling together of information, arguments and dialogue so that it may be re-examined as to what issues may best be dealt with at the collective level in terms of standard-setting, supervision or even enforcement, and what issues should be decentralised. The states of socio-economic convergence between Member States and the cost/benefit of legal convergence would also factor in such deliberations.<sup>162</sup>

In terms of considering what may be appropriately addressed at EU level in the interests of financial stability, a supranational level of governance is arguably appropriate for issues that are subject to collective action problems. For example, there is a case for saying that micro-prudential measures that may affect the competitiveness of financial institutions or subject to regulatory arbitrage should be considered as appropriate candidates for legal integration. Further, legal integration that is in the interests of transaction cost efficiency may also be warranted. If all Member States have a common concern, then a regulatory framework harmonised at EU level may be an efficient and effective way of ensuring that an adequate framework is put in place for all Member States. However, even where the overwhelming case may be justified for legal integration in financial regulation, such integration should be sensitive to national needs, and allow decentralised governance where relevant to monitor and adjust rules to meet national needs.

The definition of "financial stability" as discussed earlier includes notions of tolerance for risk-taking and disaster thresholds measured by local as well as supranational needs.<sup>163</sup> EU policy-makers should engage in dialogic considerations with Member States in respect of the "financial stability" profiles regarded as optimum at EU and Member State levels. Such "financial stability" profiles include Member States' desired levels of risk tolerance given the structure and profile of their economy, corporate and financial sectors, and thresholds of resilience that

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are regarded as essential to protect services that are in the public interest. Differences in such risk/resilience profiles should be subject to dialogic and ideational negotiations at EU level in order to ascertain the extent of integration that is optimal.

We envisage that Member States' needs could differ in relation to the risk and growth needs of an economy, the profile of the financial sector in the domestic and international economy, and key local needs pertaining to certain financial services. There should be more room for dialogue and deliberation in terms of how national regulatory regimes may meet those particular needs which may not be shared with others. For example, a Member State that has a large small and medium-sized enterprise sector may\*<sup>358</sup> need to ensure adequate amounts of lending to such a sector although such loans are risky. Another Member State that has a large state-owned corporate sector may not have the same needs. Hence, the financial regulation framework developed at EU level should be able to take into account such local needs and avoid causing unnecessary stress to the economic fabric of Member States. A one-size-fits-all approach should be avoided where such an approach cuts across different financial sector profiles, ignoring local consequences. In the proposed Commission Directive on recovery and resolution, bail-in by creditors is seen as a key resolution tool regarded as appropriate to be the subject of legal integration to be applied across all Member States. However, one must consider the profile of creditors to determine if the legal integration of bail-in mechanisms is ideal. In Germany, bank creditors may be other banks, and in the United Kingdom, bank creditors may be institutional investors, both UK and foreign. How would bail-in impact banks as creditors if systemic stress is affecting the entire financial sector? Further, would bail-in by institutional investors necessarily be ideal as there is a social dimension to the obligations they owe to savers? If the European Union were to pause and rethink the indefatigable legal integration machinery, perhaps more nuanced and efficient common frameworks could be achieved to address largely common concerns, while leaving room for more experimental and decentralised approaches to deal with local needs. This would also address Moloney's earlier mentioned critique that "more Europe" could impose more risks and magnify systemic impacts of wrong decisions taken at the policy level.

One development is that the financial stability needs of eurozone Member States may be different from other non-eurozone Member States. Being tied to one currency and one monetary policy in the face of sovereign debt trouble in Greece, Italy, Portugal, Ireland and Spain generates unique financial stability concerns for sovereigns and banks. In late December 2012, political agreement was secured to make the ECB the single micro-prudential banking supervisor for major eurozone banks as well as banks from participating non-eurozone Member States, in order to decouple banks from sovereigns, and to allow eurozone banks to regain stability and credibility. This development is arguably necessary to meet the unique financial stability needs of eurozone Member States. However, in order to ensure that non-eurozone and non-participating Member States would not be sidelined in respect of policy-making, these Member States have bargained for double majority voting powers at the EBA so that legal integration would proceed in a way adequately taking into account their interests. This article views the eurozone banking union as an approach that attempts to strike a balance between the legal integration that has already occurred in financial regulation on the one hand and developing policies to meet differentiated financial stability needs on the other hand. This approach seems to recognise that legal integration needs to be subject to dialogic forces, and does not rule out that policy divergences may follow when the eurozone banking union comes into place in 2014. However, the extent and scope of future policy and legal divergences against the backdrop of legal integration may be determined by the relational dynamics between the ECB and the EBA. We are of the view that any differentiated approach that will be allowed to be taken by the ECB would lead the way for opening up opportunities for dialogic processes to take place at both the ECB and EBA levels so that Member States' interests can be represented, and that challenging legal integration would not be taboo. The eurozone banking union negotiations also show that where divergences such as meeting the eurozone Member States' needs occur, such

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divergences are managed within an inclusive dialogic framework that includes non-eurozone Member States.

The rejuvenation of "financial stability" as an important rationale for financial regulation has provided an opportunity in the European Union to consider refining its persistent pursuit of market and legal integration. The eurozone banking union seems to embrace early signs of adjusting the pursuit of market and legal integration in the face of financial stability needs in the eurozone Member States. Instead of viewing the advent of "financial stability" rhetoric as an unwelcome disturbance to the fabric of market integration, the European Union should embrace the opportunity to consider refining the objective of market integration to a form of market integration that is more resilient for all, and taking into account\*<sup>359</sup> the need to perhaps move to a different form of governance that includes decentralised considerations for meeting local financial stability needs.

## Conclusion

This article has pointed out how the governance of finance in the European Union has been reluctant to move away from the pursuit of market and legal integration, and hence, the new post-crisis needs of financial stability have quickly been absorbed within the rhetoric supporting legal integration. However, the relative nature of financial stability and divergences undertaken by Member States in the wake of the financial crisis compel us to recognise local needs for financial stability, and to recognise that addressing such needs may mean divergence from the market and legal integration project in European finance. Policy-makers in the European Union need to consider that in the governance of finance, the post-crisis model may need to be more deliberative, to permit decentralisation while addressing collective issues where there is a collective action problem among Member States, especially in relation to cross-border entities and systemically important financial institutions (SIFIs). This would require a re-examination of the extent to which, or the speed with which, the market and legal integration project may advance. A flexible approach to market and legal integration in finance may further contribute to the building of a European financial market and governance that is more resilient and better adapted to supranational and national financial stability needs.

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