THE EVOLUTION OF THE LAW AND REGULATION OF THE SINGLE EUROPEAN FINANCIAL MARKET UNTIL THE CRISIS

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Abstract: *The building-up of the single European financial market has relied on a rich variety of institutional approaches over the years, which mirrors the development of the single market as a whole. The financial crisis challenged the legal and regulatory approach to financial integration based on the single passport concept: the application of the principles of home-country control, mutual recognition and minimum harmonisation of law and regulation to the cross-border provision of financial services. Momentous events such as the freezing of interbank markets, the loss of confidence in financial institutions, runs on banks and difficulties affecting cross-border financial groups, questioned the ability of a decentralised EU framework for financial regulation and supervision to contain threats to the integrated single financial market as a whole. Following a report by Jacques de Larosière, the European Commission has put forward in September 2009 proposals for establishing a new two pillar framework consisting of a European System of Financial Supervision for micro-prudential supervision and a European Systemic Risk Board for macro-prudential supervision. The article analyses the evolution of the single European financial market and reviews the main features of the new regulatory architecture emerging from the financial crisis.*

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1. INTRODUCTION

The financial crisis challenged the legal and regulatory approach to financial integration based on the single passport concept: the application of the principles of home-country control, mutual recognition and minimum harmonisation of law and regulation to the cross-border provision of financial services. Momentous events such as the freezing of interbank markets, the loss of confidence in financial institutions, runs on banks and difficulties affecting cross-border financial groups, questioned the ability of a decentralised EU framework for financial regulation and supervision to contain threats to the integrated single financial market as a whole.

In this context, the crisis demonstrated that the main shortcoming of the legal and regulatory framework underpinning the single financial market is that it is based on the sharing of the economic benefits of integration – providing Member States with incentives to foster financial integration – without however mutualising the economic risks – leading Member States to protect their own domestic interests in the case of a crisis. As a result, the financial crisis led to an institutional crossroads: the development of the single financial market should be either constrained to allow Member States to protect their respective financial systems or safeguarded by setting-up European structures for regulation and supervision.

Against this background, this article provides an overview of the evolution of the law and regulation of the single financial market since its origins until the latest developments following the financial crisis.

2. THE BUILDING-BLOCKS FOR LEGAL AND REGULATORY INTEGRATION (1957-1984)

The project of a single financial market started as an ancillary objective to the common market. This stemmed from the original version of Article 67 from the Treaty of Rome of 1957, according to which the liberalisation of capital movements was to take place only "*to the extent necessary to ensure the proper functioning of the common market*." Accordingly, in contrast with the other fundamental freedoms, the freedom of movement of capital did not have direct effect in Member States.[1]

1 See Flynn, 2002: 773-ff and Craig & de Burca, 2008: 680-682. See also Joined cases C-358 & 416/93, *Bordessa,* [1995] ECR I-361.

As a result, the exercise of the freedoms which provide the basis for a single financial market was substantially limited. The freedom of movement of capital was secondary to those relating to goods and services. The freedom to provide financial services could only be invoked on the basis of capital movements, which had to be expressly liberalised by the Council, in accordance with the original version of Article 61 of the Treaty of Rome, and as confirmed by the Court in several occasions.[2] In addition, Article 57 (2) of the EEC Treaty required the Council to act by unanimity on measures concerned with the protection of savings, in particular the granting of credit and the exercise of the banking profession.[3]

The first generation of Community law instruments towards a single financial market can be traced back to the period between the mid-1970s till the mid-1980s. This period was marked politically by the accession of Denmark, Ireland and the UK in the EEC in 1973, and economically by low growth, high inflation and the oil crises of 1973 and 1979. Little progress was achieved in these years in the political and market integration of the Community – particularly in financial market integration. However, two major developments took place in this time period, which set the conditions for the beginning of the construction of the single financial market.

First, the expansion of the Community competences from the mid-1970s onwards,[4] which culminated in the single market programme of 1985-1992, also following the *Cassis de Dijon* judgement of the Court in 1979.[5] In addition, in December 1978, the European Council created the European Monetary

2 Article 61 of the Treaty of Rome stated that the freedom of banks and insurance companies to provide the services linked with capital movements was "to be established in step with the gradual liberalisation of capital movements". The ECJ case law confirmed this interpretation in Case 203/80, *Casati,* [1981] ECR 2595, and Case 267/86, *Van Eycke v. ASPA,* [1988] ECR 4769. For an overview, see Usher, 2000: 15-ff.

3 For an overview of measures on the deregulation of capital movements, see *The European Financial Common Market*, p.13-ff, Office for Official Publications of the European Communities, Luxembourg, 1989. See also the so-called Segré Report, EEC Commission: *The Development of a European Capital Market*, Report of a Group of experts appointed by the EEC Commission, Brussels, November 1966.

4 See Weiler, 1999: 39-ff. In the Paris Summit of 1972, the Member States explicitly decided to make use of Article 235 of the Treaty of Rome (Article 352 TFEU) and to launch the Community in a variety of new policy fields.

5 Case 120/78*, Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein*, ERC [1979] 649.

System involving the co-ordination of the Member States' monetary policies in order to prevent large fluctuations between their currencies.[6]

Second, the internationalisation of finance in the 1970s and early 1980s, which challenged the economic and financial policies by Member States.[7] Following the collapse of the Bretton Woods system in 1971, the volume of international financial flows increased substantially in the 1970s, among other factors, as the result of the US economic policy and also the recycling of the revenues of oil producing countries. This also led to the significant growth of the so-called "Euromarkets", which remained largely unregulated since they developed outside the national regulatory systems.[8] In the early 1980s, there was a new expansion of international finance due to developments in financial innovation, advances in computing and communications technology, and also increasing deregulation.[9]

These developments provided the basis for the main building blocks for the legal and regulatory integration of the single financial market in the period between 1977 and 1984.

First, the Community initiated the harmonisation of national laws relating to banking, securities and insurance regulation and supervision. The First Banking Directive represented the initial effort.[10] It focused on implementing the freedom of establishment for banking activities through the introduction of the principle of home-country control, the harmonisation of the basic legal definitions, principles and rules regarding the authorisation, supervision and

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6 The basic elements of the arrangement were: (i) the ECU: A basket of currencies, preventing movements above 2.25% (6% for Italy) around parity in bilateral exchange rates with other member countries; (ii) an Exchange Rate Mechanism (ERM); (iii) an extension of European credit facilities; (iv) the European Monetary Cooperation Fund: created in October 1972 and allocated ECUs to members' central banks in exchange for gold and US dollar deposits. See Eichengreen, 2008.

7 The wish for reform was made explicit in 1977 by the then President of the European Commission, Roy Jenkins, when delivering the first Jean Monnet lecture at the European University Institute. In his speech, Jenkins put forward a set of arguments for monetary union in order to address in particular the Member States' "apparently intractable problems of unemployment, inflation and international financing." - Roy Jenkins, "Europe's present challenge and future opportunity", Jean Monet Lecture, EUI, Florence, 27 October 1977, European Archives, Florence.

8 The Euromarkets is the designation given to the markets on assets denominated in foreign currencies – but mostly US dollar – based in European financial centres. For an overview of the development of Euromarkets in this period, see Levich, 1991.

9 See Eichengreen, 2008.

10 First Banking Directive 77/780 of 12 December 1977, which entered into force by the end of 1979, on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, OJ 1977, L 322, p. 30.

withdrawal of the authorisation of a credit institution. Regarding the other financial sectors, Community legislation also aimed at reducing the scope for restrictive measures to market-entry through harmonisation of national laws, while allowing for the application of stricter local rules by Member States.[11]

Second, the Community introduced in this period the principle of the home-country control of the regulation and supervision of financial institutions providing cross-border services directly or through branches. The scope of application of the home-country control principle was particularly constrained in the First Banking Directive, given the differences across national laws, as well as the political difficulties in achieving unanimity among Member States for further harmonisation in a strategic area as banking. The approach of the Directive was in this context to merely facilitate the establishment of branches through the harmonisation of national laws and also by reducing the "particularly wide discretionary powers" of banking regulators in the authorisation of foreign branches, which could provide the basis for protectionist measures. This scheme for the authorisation of foreign branches implied that they would remain subject to the law and regulation of the host-country. This restrictive approach was sanctioned by the Court to the extent justified by the special nature of the banking sector, related in particular to the regulatory needs of consumer protection (the so-called "general good exception").[12]

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11 For the securities sector, see Council Directive 79/279/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing, OJ L 66, 16.3.1979, p. 21–32; Council Directive 80/390/EEC of 17 March 1980 coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing, OJ L 100, 17.04.1980, p. 1-26; Council Directive 82/121/EEC of 15 February 1982 on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing, OJ L 48, 20.02.1982, p. 26- 29. For the insurance sector, see Council Directive 73/240/EEC of 24 July 1973 abolishing restrictions on freedom of establishment in the business of direct insurance other than life assurance, OJ L 228, 16.08.1973, p. 20–22; First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance, OJ L 228, 16/08/1973, p. 3-19. First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance, OJ L 063, 13/03/1979, p. 1-18.

12 The special nature of the banking sector from the perspective of the public interest has been recognised in several instances by the Court. See Case C-222/95 *Parodi* at 22: "It must be recognised that the banking sector is a particularly sensitive area from the point of view of consumer protection. It is, in particular, necessary to protect the latter against the harm which they could suffer through banking transactions effected by the institutions not complying with the requirements relating to solvency and whose managers do not have the necessary qualifications or integrity." Case C-222/95, *Parodi v. Banque de Bary*, [1997] ECR I-3899. On other implications of this case, see Usher, 2000: 90.

Third, particularly in the banking field, the strategy for legal and regulatory integration involved from the outset the establishment of administrative networks of national regulators in the form of committee-structures, such as a Banking Advisory Committee to the Commission. These committees were given both legal and regulatory functions in the construction of the single financial market. In what would later take the form of comitology procedures, the committees were responsible for facilitating the implementation of Community legislation and supporting Commission initiatives. Therefore, the Community legislation initiated in this period the development of a layer of administrative co-operation for the single financial market.[13]

In conclusion, the Community initiatives in this period provided the foundations for the legislation and regulation of the single financial market as a whole. The implementation of the freedom of establishment through the principle of non-discrimination provided the basis for the emergence and recognition of the Community's competences to design a common legal and regulatory framework for a single financial market. These foundations were not however further developed due, in particular, the constraints posed by the need to reach unanimity decisions at the Council for Community legislation, together with the national sensitivities regarding the regulation of finance.

3. THE SINGLE PASSPORT FOR THE PROVISION OF FINANCIAL SERVICES (1985-1997)

The development of the EU model for financial regulation and supervision started in 1985, with the Commission's White Paper on Completing the Internal Market, which represented the political willingness for undertaking economic reform, namely in the direction of market liberalisation and further market integration within the Community.[14] The cross-border provision of financial services would be facilitated essentially through the extension of the *Cassis de Dijon* doctrine from industrial and agricultural products under Article

13 The First Banking Directive introduced a legal framework for co-operation between home-country and host-country regulatory authorities: Article 7 (1). It required the national authorities to collaborate closely in the supervision of credit institutions operating in Member States other than the home-country, in particular through the establishment of branches. This collaboration should involve the exchange of information across jurisdictions, which would facilitate the performance of the national authorities' respective supervisory function. The First Non-Life Insurance Directive and the First Life Insurance Directive contain similar provisions.

14 European Commission, *Completing the Internal Market*, White Paper to the European Council of 28/29 June 1985 in Milan, COM (85) 310 final, 14 June 1985.

34 TFEU (ex. Article 28 TEC) to the free circulation of "financial products" throughout the Community. This would involve the application of three key principles of legal and market integration.

First, the principle of *home-country control*, according to which the primary task of regulating a financial institution and its branches established in host countries, would be entrusted to the authorities of the Member State of origin. The financial institution would, therefore, only report to its home-country authorities regarding both domestic and cross-border provision of services directly or through branches. The host-country authorities would no longer apply their respective laws and regulations as in previous period of legal integration.

The second principle was the *mutual recognition* by Member States and their respective authorities of the regulatory regimes and practices of each other. Financial institutions would be free to provide financial services directly or through branches in the jurisdiction of host Member States, subject to the laws, regulation and supervision of the home-country. For host-countries, this would imply recognising that the safeguard of the public interests underlying financial regulation in their jurisdictions – such as depositor and investor protection – would be adequately pursued by the home-country authorities.

Third, home-country control and mutual recognition would be supported by the *minimum harmonisation of national laws*, which would set the standards regarding authorisation, supervision and winding-up of financial institutions.[15]

The application of these principles would provide a *single passport* to financial institutions for the provision of services throughout the Community.

The implementation of the White Paper was made possible by the revision of the EEC Treaty signed on 28 February 1986, which entered into force on 1 July 1987 as the Single European Act (SEA). The SEA committed Member States to achieving a single market by 1992 and introduced a number of innovations relevant for the field of financial services.[16] In particular, the SEA placed the free movement of capital as a fundamental freedom at

15 Minimum standards concerning supervision have been introduced to take care of host Member States' concern about foreign entities providing services in their territories. See Hertig, 2001: 238.

16 The SEA also added the fulfilment of economic and monetary union to the areas of Community competence by introducing provisions regarding the co-operation in the economic and monetary union. Institutional decisions in this area remained however subject to unanimity and ratification by Member States.

the same level as that of goods and services, thus providing the basis for Directive 88/361, which established the basic principle of free movement of capital as directly enforceable as a matter of Community law, both between Member States and with third countries.[17] The SEA also lifted the unanimity requirement and introduced voting by qualified majority for the adoption by the Council of harmonisation measures for the achievement of the internal market, including therefore the single financial market. Finally, the SEA formally recognised the possibility of comitology procedures as a condition that the Council may set for the exercise by the Commission of delegated powers. The constitutionality of these procedures had been previously challenged before the Court, which confirmed their validity in the *Koster* case.[18]

The implementation of the single passport concept as a legal instrument for the development of the single financial market was made initially in the field of securities markets. The first measure was adopted in 1985, which aimed at providing a single passport to investment funds (UCITS).[19] The single passport was then provided in 1987 to issuers of securities to be listed in stock exchanges,[20] and complemented in 1989 by the prospectus Directive.[21] Lastly, the 1993 Investment Services Directive completed the implementation of the single passport in the securities sector by setting out the conditions under which investment firms and credit institutions could

17 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L 178, 8.7.1988, p. 5–18. The Maastricht Treaty then formalised the free movement of capital as a core freedom (Article 56 TEC).

18 Case 25/70, *Koster,* [1970] ECR 1161. The possibility that the Council could delegate powers to the Commission subject to conditions was introduced by the SEA (Article 202 TEC). This provision provided the basis for the rationalisation of comitology procedures, which took place through a Council framework decision in 1987 (Council Decision, 87/373 [1987], OJ L 197/33).

19 Council Directive 85/611/EEC of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) OJ L 375, 31.12.1985, p. 3-18.

20 Council Directive of 22 June 1987 amending Directive 80/390/EEC coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock-exchange listing.

21 Council Directive 89/298/EEC, of 17 April 1989, coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public, OJ L 124, 5 May 1989, p. 8-15.

provide cross-border investment services on the basis of the authorisation and supervision by the home-country.[22]

The concept of a single passport for the cross-border provision of financial services took its main expression in the banking field, where it was envisaged to have a complete liberalisation of the sector.[23] The Second Banking Directive, adopted by the Council on 15 December 1989, was the main instrument for achieving the freedoms of establishment and to provide financial services for credit institutions.[24] It stipulated that the competent authorities of the home Member State, which authorised a credit institution, would have the responsibility for supervising its financial soundness and in particular its solvency. Regarding mutual recognition, the credit institutions authorised in one Member State would be able to provide across the Community, directly or through branches, those financial services listed in Annex 1 of the Directive.[25] Accordingly, the Member States were under the obligation to ensure that there were no obstacles to the provisions of the services benefiting from mutual recognition. A credit institution wishing to provide services or establish a branch in another Member State would only have to observe a

22 Under the ISD, the provision itself of investment services continued to be subject to the host-country's laws, relating for instance to conduct of business rules or advertising, given the needs for the protection of consumers in national markets. The ISD also provided the right of direct or remote access of an investment firm to participate in trading on exchanges or regulated markets in other Member States. The qualification of "regulated markets" would be granted by the home-country of such markets and mutually recognised by Member States, although the host-country could impose its regulations on market access and organisation. See Council Directive 93/22/EEC of 10 May 1993, on investment services in the securities field, OJ L 141, 11 June 1993, p. 27-46 (Investment Services Directive). This Directive has now been repealed by the Markets in Financial Instruments Directive. For an overview, see Tison, 1999.

23 The single passport was implemented with greater delays and less effectively in the insurance sector, due to the wider differences between national laws regarding the regulation of this sector and the protection of policy-holders. The 1985 White Paper's approach started to be implemented in the insurance sector after the series of the so-called "insurance cases of 1986", where the Court decided on the Commission's legal action against Denmark, France, Germany and Ireland, regarding the restrictions placed by these Member States on the authorization of insurance companies from other Member States. The Court considered that such restrictions were in principle compatible with the EEC Treaty, provided that they were justified by regulatory concerns related to consumer protection. Accordingly, such restrictions should not apply to insurance services which do not require consumer protection, such as those related to industrial risks. The development of the single insurance market could therefore only proceed with regard to the provision of services where consumer protection was not a main concern. Cases 205/84, *Commission* v *Germany,* [1986] ECR 3755.

24 Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, OJ L 386, 30.12.1989, p. 1-13. For an analysis, see Katz, 1992.

25 Article 18 (1). Annex 1 of the Second Banking Directive includes an extensive list covering all major commercial and investment banking activities, including securities transactions.

notification procedure by informing its home-country authorities, which in turn inform the host-country authorities.[26] The regulatory authorities of the host-country would have limited powers over the provision of services or branches of credit institutions authorised in other Member States. Such powers were limited to imposing statistical requirements, enforcing rules relating to liquidity when a credit institution does not comply and after the failure of the home-country authorities to do so, and enforcing the host-country's rules relating to the "general good."[27] In emergencies, such as financial crisis situations, the host-country authorities were entitled to take precautionary measures to protect the interests of depositors, investors and others to whom services are provided.[28]

Against the background of the Community legislation just described, and the jurisprudence of the Court on the scope of the single passport, the application of the principles of home-country control and mutual recognition in the financial services sector gave rise to a number of obligations between Member States.

First, the host-country must recognise the jurisdiction of the home-country over the cross-border provision of services in its territory. The jurisdiction of the home-country comprises both the regulation of such services and the supervision or enforcement of the compliance with such regulatory requirements. This implies that the provision of services in one Member State may be regulated and supervised by several jurisdictions at the same time, depending on the origin of the economic operators. The wide extent of this obligation was confirmed in the *Alpine* case, where a restrictive measure imposed by the home-country to the provision of financial services in the host-country was considered compatible with Article 49 TEC. In particular, the Court considered that the home-country's restrictive measure was necessary to fulfil the aim of investor protection, which could not be fulfilled by the host-country within the legal framework for the single passport.[29]

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26 Articles 19 and 20 of the Second Banking Directive.

27 On the concept of the "general good" exception to the home-country control principle, see Tison, 1997; van Gerven and Wouters 1993: 55-ff; and also Bjorkland, 1998: 227.

28 Article 21 (7) of the Second Banking Directive.

29 Case C-384/93, *Alpine,* [1995] ECR I-1141. At issue was a ban imposed by the Netherlands on financial intermediaries prohibiting them from engaging in the marketing practice of "cold calling." A similar ban was held to constitute a restriction on the freedom to provide services because it also affected offers

Second, it follows that the host-country cannot impose regulatory requirements, which could override, constrain, or supplement the home-country's jurisdiction. In this context, it may be asked whether the application of the principle of mutual recognition in the area of financial services constitutes rather a principle of "functional parallelism" among national laws, as argued in relation to the free movement of goods: mutual recognition of national laws in this area is due to the fact that they should be considered functionally equivalent in the pursuit of regulatory objectives.[30] Given, however, the highly regulated nature of financial services in Member States, this is highly questionable.

The difficulties in harmonisation at the Community level and in financial integration more specifically confirm that Member States consider that the regulatory objectives pursued by their respective national laws cannot be pursued in other ways. Accordingly, the principle of mutual recognition in the financial services field may be deemed more intrusive in the Member States' legal framework than in the freedom of movement of goods. This may also explain why integration in the financial services sector has been so difficult to achieve thus far. Therefore, in the financial services field, the national laws of the home-country should be recognised, even though they may not be functionally equivalent in the pursuit of regulatory objectives such as financial stability or of investor protection. Ultimately there is a considerable limitation to the exercise of their respective competences by national jurisdictions since the host-country has to abstain from interfering with the legal and economic implications of the home-country's jurisdiction, both in terms of regulation and enforcement. This was confirmed in *Caixa-Bank France*, where the Court found that the host-country's legislation which prohibited the payment of interest on current accounts by all banks in France was incompatible with Community law.[31]

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made to potential recipients in the host-country Member State. The restriction was justified as necessary to protect investors and the good reputation of national markets.

30 For an analysis of the distinction of the principles of mutual recognition and functional equivalence in the field of financial services, see Ortino, 2007.

31 Case C-442/02, *Caixa-Bank France v Ministère de l'Economie, des Finances et de l'Industrie*, [2004] ECR I-8961.The action was brought by the French subsidiary of a Spanish bank, Caixa Holding, following the decision by the French Committee for Banking and Financial Regulation that Caixa-France was not allowed to offer a 2% interest rate on current account. The Conseil d'Etat, the French administrative Supreme Court, referred the issue to the ECJ, which found that the prohibition of interest on current accounts constituted "a serious obstacle" to the pursuit of the activities of foreign banks operating in France because it deprived

Third, it may be asked in addition, whether the home-country has an obligation to also safeguard the regulatory interests of the host-country, rather than just considering its domestic interests. The application of the principle of mutual recognition raises the question of whether it gives rise to a delegation by the host-country to the home-country regarding the fulfilment of regulatory safeguards, or whether it is limited to the presumption that the jurisdiction of the home-country is equally effective in pursuing such regulatory safeguards and interests as the host-country's.[32] Thus far, an obligation of the home-country to safeguard the regulatory interests of the host-country has not been construed in either legislation or jurisprudence regarding the financial services sector.

In *Germany* v *Parliament and Council*, the Court considered that the principle of home-country supervision is not a principle laid down by the Treaty.[33] Therefore, the fundamental freedoms and the Treaty do not impose the application of the home-country's legislation. Instead, what the principle of mutual recognition does is to impose the obligation on the host-country not to exercise its jurisdiction – regarding regulation and enforcement – on the provision of services subject to the home-country's jurisdiction. This is also confirmed by the Commission's interpretation that the host-country cannot question the granting of the single licence, or the conditions under which the licence was granted, to a credit institution intending to provide services directly or through a branch in its territory. The home-country has the exclusive responsibility to grant a single licence. The host-country can only question whether the home-country has fulfilled its obligations under the Community legislation, in accordance with Article 227 EC.[34]

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them from competing effectively with French banks which invariably have an extensive network of branches and a well established customer base.

32 This relates to Weiler's concept of "functional parallelism", which is applied in the context of the free movement of goods. For the distinction between the principle of mutual recognition and functional parallelism, see Weiler, 1999: 365.

33 Case C-233/94, *Germany* v *Parliament and Council,* [1997] ECR I-2405. At stake was the application of Article 4(2) of Directive 94/19/EC on deposit-guarantee schemes, which requires Member States to include in their deposit-guarantee schemes the branches of credit institutions authorised in other Member States so that they supplement the guarantee already enjoyed by their depositors on account of their affiliation to the guarantee system of the home-country.

34 Commission Interpretative Communication on the freedom to provide services and the interest of the general good in the second banking Directive, SEC (97) 1193 final, 20.06.1997, at 14-15. The Commission makes this interpretation on the basis of Case C-11/95, *Commission* v *Belgium,* [1996] ECR I-4115, where the Court ruled that the receiving Member State was not authorised to monitor the application of the law

Accordingly, the Court's jurisprudence only recognised a dimension of negative integration to the principle of mutual recognition, of limiting the jurisdiction of the host-country *vis-à-vis* the home-country. However, the highly regulated nature of this sector, the fact that national laws may not be deemed functionally equivalent, together with the requirements of cross-border collaboration between home- and host-country regulators set out in Community legislation, suggest that the operation of the principle of mutual recognition in the single financial market depends to a large extent on the degree of trust that Member States have on each other's ability to safeguard a certain level of regulatory interests.

Therefore, the operation of the principle of mutual recognition in the single financial market should be underpinned by an obligation of the home-country to safeguard the regulatory interests of the host-country. The uncertainty as to the extent of this legal obligation was at the heart of the shortcomings of the single passport during the financial crisis, as it will be analysed later in this article.

4. REGULATING THE SINGLE FINANCIAL MARKET (1998-2008)

The Maastricht Treaty set out the framework for the Economic and Monetary Union and the creation of the single currency.[35] The introduction of the euro led to the establishment of the first federal regulatory structure of the Community through the full transfer of competences on monetary policy to the ECB and the ESCB. This move towards federalisation was based on the realisation – diagnosed in the 1989 Delors Report – that the development of the single market necessitated more effective co-ordination of economic policy between national authorities, as there was a fundamental incompatibility between (i) full freedom of capital, (ii) freedom to provide cross-border financial services, (iii) fixed exchange rate under ERM, and (iv) autonomous monetary policy.[36]

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of the originating Member State applying to television broadcasts and to ensure compliance with Council Directive 89/522/EEC, OJ L 298, 17.10.1989, p. 23.

35 The Maastricht Treaty also introduced the co-decision procedure between the Council and the Parliament in Article 251 of the Treaty, which governs the adoption of measures regarding the approximation of national laws under Article 47 EC, the legal basis for the Directives regarding the single financial market. In addition, the Treaty made the principle of subsidiarity - only applicable to environmental policy under the ESA - as of general applicability to all Community policies, including therefore the single financial market.

36 See Padoa-Schioppa, 1997.

The federalisation of the currency and monetary policy in 1999 provided the impetus for the regulatory reform of the single financial market and the introduction of EU-wide regulatory structures. The vision of the White Paper that market integration would develop out of the dynamics of competitive market forces, as well as regulatory competition among national legal orders, did not materialise. The single passport approach succeeded to some extent in reducing the regulatory barriers to the provision of cross-border services and in fostering the expansion of financial groups in the EU. However, the principle of minimum harmonisation of laws left ample discretion to the implementation of Community law by Member States. Furthermore, the EU legislative process was too slow and inflexible to be adapted to the structural developments of the single financial market. These limitations were increasingly felt after the introduction of the euro, which pointed to the need for a more integrated regulatory and supervisory framework to sustain a single financial market.[37]

The Financial Services Action Plan (FSAP), which was launched in May 1999, provided the basis for the renewal of the Community policy on financial services following the introduction of the euro. Its aim was to obtain the commitment of the Council, the Parliament and the Member States to forty-three (mostly) legislative initiatives for harmonising by 2005 the national laws relating to the provision of financial services. Such initiatives represented a shift from implementing the single passport concept on the basis of minimum harmonisation to an approach based on a high-level of harmonisation of national laws in the banking, securities and insurance fields, as well as in cross-sectoral issues. It therefore led to a "codification" of financial services law at the European level.[38]

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37 See Padoa-Schioppa, 2004: 75-ff for the geographical and functional separation introduced by EMU between the (federal) central banking competences and the (national) regulatory and supervisory competences.

38 In the banking sector, the FSAP led to the Capital Requirements Directive (Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast); and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast)). In the securities sector, among others, it led to the Directive on markets in financial instruments ("MiFID") (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004, p. 1–44). In the insurance sector, to the "Solvency II" Directive (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance, OJ L 335, 17.12.2009, p. 1–155. Finally, the FSAP also led to the

Furthermore, the main legislative initiatives of the FSAP involved an expansion of the application of the principle of home-country control from branches to the subsidiaries of a financial group. This was achieved by entrusting the home-country authorities of the parent company of a financial group with powers and tasks over the group as a whole, including the subsidiaries located in other Member States. Accordingly, Community law provided the home-country regulator with extra-territorial functions aimed at supporting market integration and fulfilling the objectives of financial regulation. This had the aim of regulating and supervising a financial services group as a whole in order to address the specific risks it entails for the stability of the single financial market.

In the banking sector, the extension of the home-country control principle was made by the Capital Requirements Directive (CRD) adopted in 2006.[39] The consolidating supervisor was given a coordinating role over the national regulators responsible for the components of the group. The most significant legal provision of the CRD in this context is that of Article 129 (2), which allows the consolidating supervisor – in the lack of a consensus among home- and host- supervisors – to take a binding decision on whether a banking group can use its internal systems to measure the risks and the respective capital requirements. The decision will be recognised as determinative and applied by all the host-country regulators in their respective jurisdictions. Accordingly, the host-country Member States surrender to some extent their sovereignty over certain aspects of the regulation of subsidiaries comprising a cross-border banking group.[40]

This surrender of sovereignty from the host-countries to the home-country, although limited to a specific technical aspect of banking law, marks a significant step in the evolution of the law and regulation of the

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Financial Conglomerates Directive (Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council, OJ L 35, 11.2.2003, p. 1-27.

39 The extension of the home-country control principle also took place with regard to financial conglomerates, namely through the nomination of a coordinator supervisor in the Financial Conglomerates Directive.

40 The decision-making powers of the consolidated supervisor raise the issue of the interests that this authority should follow in taking decisions which will produce effect in other Member States. In this respect, although not representing a strict legal obligation, recital 57 of the CRD states that "supervision of credit institutions on a consolidated basis aims at, in particular, protecting the interests of the depositors of credit institutions and at ensuring the stability of the financial system."

single financial market as it further constrains the jurisdiction of Member States through an expansion of the principles of home-country control and mutual recognition over companies with an independent legal personality. This represents a move towards a horizontal transfer of competences among Member States as an alternative to the vertical transfer of competences from the national to the EU level for the regulation of the single financial market as a whole. The CRD provides the scope for further enlarging the extra-territorial scope of the tasks of the home-country by allowing host-country regulators to delegate additional tasks in a written agreement, including delegating the overall responsibility for the supervision of subsidiaries to the consolidating supervisor.[41]

The extensive European legislation in financial services required a regulatory apparatus for its effective implementation at the level of Member States. In 2001, the so-called Lamfalussy Report[42] (after the chairman of a "Committee of Wise Men" established by the ECOFIN in 2000) provided the overall diagnosis that there was a lack of a regulatory system able to provide practical effect to Community legislation and also to cope with the needs of a single financial market as a whole. Community law provided both insufficient and unsatisfactory harmonisation and uniformity among national laws, was cumbersome to design and adopt, and the procedure for law-making was too rigid for coping with the fast pace of market integration. The governance of financial markets was provided by an uneven patchwork of national laws, regulations and enforcement practices. This was particularly worrisome since the FSAP contained a number of measures, most of them Directives, aimed at introducing a complete, coherent and consistent legislative and regulatory framework for securities markets. At the rhythm of legislative procedures existing at the time, the FSAP would not have been able to meet its objectives.

41 The Level 3 Committees were entrusted by the Commission in 2009 with the responsibility to foster the delegation of tasks among regulators.

42 See Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (the Lamfalussy Report), 15 February 2001, available on the Commission web-site. The Lamfalussy Committee was established by ECOFIN on 17 July 2000 with a mandate to assess the current conditions for the implementation of securities markets regulation in the European Union. The Committee was asked 'to assess how the mechanism for regulating those markets can best respond to developments, and, in order to eliminate barriers, to propose scenarios for adapting current practices to ensure greater convergence and cooperation in day-to-day implementation'. The Commission adopted a number of Decisions setting-up a new structure of financial services committees on 5 November 2003. See Ferran, 2004: 75-ff.

The Lamfalussy report led to the setting-up of a European regulatory system for the single financial market in 2003. Such regulatory system would rely on the existing institutional framework for the adoption of Community legislation. It would not involve any transfer of competences from the national to the Community level, thus not requiring any Treaty change. The regulatory system comprised essentially two elements:

(1) the expansion of the use of comitology procedures for Community legislation, in order to enable more flexible, swift and detailed enactment of rules at the European level; and
(2) the establishment of committees of national regulators (supervisors), in order to facilitate, on the one hand, the development of EU-wide regulatory solutions in the form of technical advice to the Commission, and, on the other hand, the convergence of national regulatory practices in the implementation of Community law. As a result, the governance of the single financial market became largely based on a committee-architecture, without any transfer of competences to the Community.

More specifically, the Lamfalussy report set out a "four-level approach" to the regulation of the single financial market, which would be implemented voluntarily by the Council, Parliament, Commission, national regulators and the financial services industry.

First, the adoption of Community law under the co-decision procedure by the Council and the Parliament would be limited to the definition of "framework principles" for the harmonisation of national laws. Community Directives, and where possible regulations, would refrain from covering regulatory details and would focus instead on defining the general legislative principles on which regulation would be based. This would correspond to *Level 1* of the regulatory system.

Second, the Level 1 legislation would include wide delegation clauses enabling the Commission to issue legal acts under a comitology procedure complementing and, if necessary, amending the legislation. The Commission's acts would therefore provide the regulatory details necessary for the implementation of the framework principles set out at Level 1. The exercise by the Commission of such regulatory powers would be subject to voting by Member States' Finance Ministries' representatives gathered in a "regulatory committee". In addition, the Commission would prepare its legal acts on the basis of the technical advice provided by the competent committee of

supervisors. The legal acts issued by the Commission under comitology procedures would correspond to *Level 2* of the regulatory system.

Third, at *Level 3*, national supervisors would establish committees – independent from the Commission – which would support the consistent and equivalent transposition, as well as enforcement, by national authorities of Level 1 and Level 2 Community legal acts. Therefore, the aim of these committees would be to provide a structure for advancing the convergence of regulatory practices across the EU, which would facilitate the development of a seamless regulatory system for the single financial market as a whole. In addition, the committees would support the provision of technical advice to the Commission on the content of regulatory acts to be issued under comitology procedures. This, in turn, would foster the development of consensus among national supervisors on the technical regulatory solutions more appropriate at the EU level.

Lastly, at *Level 4*, the Commission's monitoring of the compliance by Member States of Community law should be reinforced by a more structured co-operation between the Member States, their regulators and the financial industry. In particular, the industry would be provided with efficient mechanisms for reporting cases of non-compliance by Member States of Community law.

The main innovation of the Lamfalussy framework was to introduce a multi-level regulatory process for the single financial market, which combined the traditional Community method with inter-governmental comitology procedures and infra-national networks of regulators in the preparation, adoption and implementation of Community law. As a regulatory experiment, the premise of the Lamfalussy framework was that the institutionalised participation of national authorities in the regulation of the single financial market would replace the need to transfer regulatory competences to the Community level.

In conclusion, the period between 1998 and 2008 consisted of a move towards the re-regulation of the single financial market. It corresponded to the replacement of the principle of minimum harmonisation by more extensive and detailed harmonisation of national laws. This involved three main legal tools of market integration.

First, a high-level of harmonisation of national laws through the FSAP, implying the reform of the legal and regulatory regimes governing markets,

institutions, and market infrastructures in order to ensure their interoperability in the single financial market context.

FIGURE 1: **The regulatory system of the single financial market (2003-2010)**

Level 1: legislation on principles	Council of Ministers (ECOFIN)			
	European Parliament			
Sectors	**Banking**	**Insurance and Occupational Pensions**	**Securities (including UCITS)**	**Financial conglomerates**
Level 2: legislation on details through regulatory committees	European Banking Committee (EBC)	European Insurance and Operational Pensions Committee (EIOPC)	European Securities Committee (ESC)	Financial Conglomerates Committee (FCC)
Level 3: regulatory convergence through committees of Supervisors	Committee of European Banking Supervisors (CEBS) (London)	Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) (Frankfurt)	Committee of European Securities Regulators (CESR) (Paris)	Joint Committee on Financial Conglomerates (comprising CEBS, CEIOPS and CESR)
Level 4: Compliance with EC law	Commission			
	Cooperation among Member States, national regulators, financial industry			

Second, the extensive recourse to comitology procedures to both adapt and specify Community legislation in line with the evolution of integrated markets. This aimed at reducing the rigidities of the process for adopting and implementing Community legislation, while increasing the level of detail of harmonisation.

Third, the expansion of the principles of home-country control and mutual recognition. Firstly, this involved broadening the application of these principles in legal fields, for instance in the field of insolvency law. Secondly, it involved attributing increased extra-territorial effects to the legislation, as well as to the powers of authorities, of the home-country of providers of financial services. The aim was to facilitate the cross-border provision of services by subtracting the competences of host-countries to apply their respective legal

and regulatory regimes to services provided from other Member States. In particular, the home-country control principle was extended to the regulation and supervision of financial services groups – banking, insurance, and conglomerates – thus allowing to also expanding the single passport concept, which was limited to the direct provision of services and through branches.

The process of European financial integration accelerated as a result of these efforts to provide a comprehensive EU legislative and regulatory framework for the provision of cross-border financial services. This led to the integration of financial markets, the emergence of pan-European banking groups and financial conglomerates, and to the consolidation of some market infrastructures.[43] At the same time, such integration also led to broader and deeper systemic inter-linkages across the EU, which increased the likelihood that a disturbance in one Member State would spillover into other Member States and the single financial market as a whole.[44]

However, the model for the regulation and supervision of the single European financial market was based on the guiding principle that a decentralised institutional setting mostly based on the exercise of national responsibilities would be able to prevent and manage crises affecting the single financial market. The national authorities of home- and host-country authorities would cooperate in the management of a crisis on the basis of Community legislation and non-binding agreements such as Memorandum of Understanding. However, also due to the potential impact on national fiscal responsibilities, national authorities would preserve full responsibility and discretion in the actions to take to manage a crisis situation.[45] The financial crisis which started in 2007 put this institutional setting to a crucial test.

43 See ECB, *Financial Integration in Europe*, 2008.

44 The awareness of financial regulators to the increasing systemic inter-linkages between Member States provided the impetus for the enhancement of the European arrangements for dealing with financial crises. In May 2005, the EU Banking Supervisors, Central Banks and Finance Ministries signed a Memorandum of Understanding (MoU) on co-operation in financial crisis situations, which set out principles and procedures for sharing information, views and assessments, in order to facilitate the pursuance of national mandates and preserve the overall stability of the financial system of individual Member States and of the EU as a whole. This MoU was replaced in June 2008, by a MoU on cross-border financial stability which provides for further detailed procedures and structures for crisis management (available at www.ecb.europa.eu).

45 See Schinasi & Teixeira, 2006.

5. THE FINANCIAL CRISIS: (DES-) INTEGRATING MARKETS?

The financial crisis unfolded in Europe in July 2007 with the first reports of sub-prime related losses suffered by the European banks and in August 2007 with the freezing of interbank markets.[46] The crisis involved a number of significant events of financial instability which included a loss of confidence in the soundness of European banks, bank-runs, the prospect of failure of cross-border and domestic financial institutions which required recapitalisation measures,[47] and even the financial collapse of an entire country – Iceland – which was part of the EU single financial market as a member of the EEA.

The financial crisis challenged fundamental assumptions regarding the functioning of the single financial market, relating in particular to the principles underpinning the operation of the single passport. In particular, Member States took unilateral actions to protect their respective financial system once the crisis occurred, effectively segregating and insulating their domestic markets from the single financial market. For example, certain national measures were only aimed at domestic financial institutions, thus contravening the basic principle of non-discrimination, as well as home-country control and mutual recognition. Coordination among Member States only emerged at the Paris summit on 12 October 2008, which was the first event ever bringing together the euro area Heads of State and Government. It was triggered by the rapidly increasing concern for the integrity of the financial system and the need to restore public and market confidence on financial institutions and markets, particularly within the closely integrated euro area. Accordingly, the euro area Member States agreed at the summit to take a number of national measures within a broadly coordinated framework in order to "avoid that national measures adversely affect the functioning of the single market and the other Member States." [48]

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46 For a full chronology and description of the global financial crisis, see the 79th Annual Report of the Bank for International Settlements (1 April 2008-31 March 2009), Basel, 29 June 2009, available at http://www.bis.org.

47 The definition provided by Reinhart and Rogoff of a financial crisis is useful in this context: "one of two types of events: (i) bank runs that lead to closure, merger or takeover by the public sector of one or more financial institutions, (ii) in the absence of runs, closure, merger, takeover or large-scale government assistance of an important financial institution (or group of institutions) that marks the start of a string of similar outcomes for other financial institutions". See Reinhart & Rogoff, 2008.

48 See "Summit of the euro area countries: declaration on a concerted European action plan of the euro area countries", 12 October 2008, available at www.ue2008.fr. The spectrum of measures aimed at ensuring appropriate liquidity conditions for financial institutions, facilitating the funding of banks, providing capital to financial institutions so that they continue to finance the economy, recapitalising distressed

In legal and institutional terms, the crisis demonstrated that the increased integration of the single financial market gives rise to an unsustainable incompatibility of objectives within the EU's institutional and regulatory framework. In particular, the crisis put into evidence that there is a mutual incompatibility over time between:

(1) pursuing financial market integration through free movement of capital and establishment based on home-country control and mutual recognition, and
(2) safeguarding the stability of an increasingly integrated market, which progressively increases the level of common economic risks among Member States, while
(3) retaining nationally-based regulatory competences for addressing such common economic risks, thus avoiding the mutualisation of risks among Member States.[49]

The incompatibility derives basically from the fact that the tools of market integration – home-country control, mutual recognition and minimum harmonisation of national laws – provide a framework of incentives to the unlimited expansion of the cross-border provision of services, independently of their country of origin. However, such expansion is not accompanied by incentives (or the obligation) for the home-country to take responsibility for the economic risks stemming from the provision of services in other (host) Member States.

Within the single market, governments and regulators remain only accountable to national parliaments and taxpayers. They have no specific legal mandate or responsibility to safeguard the single market as a whole and to contain the related common economic risks in other Member States. This means that there is a misalignment between (i) the incentives for the expansion of the cross-border provision of services and (ii) the incentives for safeguarding the single market from the corresponding cross-border expansion of economic risks. Therefore, the framework of the single financial

banks, ensuring flexibility in the application of accounting rules, and enhancing cooperation procedures among EU Member States. The Commission was also requested to act quickly and apply flexibility in state aid decisions. The European Council of 15 and 16 October 2008 endorsed the euro area agreement for the EU as a whole.

49 This was foreseen in Schoenmaker, 2009, and characterised as the "trilemma" of financial stability in the EU: the fact that financial integration, stability, and national regulation cannot be pursued at the same time.

market implies that as market integration increases, the common economic risks expand. Nationally-based regulatory competences become therefore more and more inadequate to address such risks, particularly when the degree of market integration leads to significant cross-border spillovers.[50]

In normal times, the operation of the principles of home-country control and mutual recognition prevent this misalignment of incentives within the single market from coming to the fore as the expansion of cross-border services spread economic benefits across Member States. However, in the case of a financial crisis – which given the current state of market integration, is likely to involve significant cross-border externalities – this misalignment becomes apparent. National authorities are obliged by their mandates to minimise the potential economic and fiscal costs for their own Member State rather than reducing the collective costs for the EU as a whole or for the group of Member States affected by the crisis. In this context, the operation of the principles of home-country control and mutual recognition may lead to outcomes which are opposite to those of integration: it will be rational for the home-country to safeguard the assets in its Member State and limit any liabilities *vis-à-vis* host-countries, while the host-country will tend to ring-fence the assets and thus avoid that they are repatriated to the home-country.[51] Rather than a mutual sharing of economic risks in line with the sharing of the economic benefits of integration, the tools of market integration in a crisis may lead to the perverse effects of misallocation of risks and the increase of the related costs among Member States.

In a nutshell, the single financial market was constructed in a setting where the economic benefits of market integration are spread and shared among Member States on the basis of home-country control and mutual recognition. Conversely the common economic risks stemming from integration are not mutualised but rather dealt with on the basis of national interests.

The incompatibility of objectives within the framework of the single financial market is similar in terms and in implications to the contradiction

50 In order to address the limitations of the national mandates, the concept of a common European mandate for national regulators was vented in several instances. Such mandate would include an obligation for each national regulator to minimise the collective costs facing Member States. See Hardy, 2009.

51 The application of national commercial and insolvency laws implies that the location of assets in the case of the failure of a cross-border financial institution is relevant for the compensation of the domestic creditors. The national regulators cannot rely on asset in one Member State to compensate losses in another. See Herring & Litan, 2005.

that preceded the federalisation of monetary policy in the euro area (see Section 4 above). In particular, the intensification of the common economic risks in the single financial market as a result of integration leads to an institutional crossroads, where either:

(1) the competences for the single financial market are transferred from the national to the European level to the extent required to internalise in the regulatory decision-making process both the common benefits and risks (potential cross-border spill-over effects) of market integration; or
(2) there is a renationalisation of the single financial market by the Member States to the extent required to safeguard national interests from the economic risks of market integration.

The crisis has also challenged the principle of *minimum harmonisation of national laws* as the sufficient underpinning for the operation of the principles of home-country control and mutual recognition. The crisis demonstrated that the harmonisation of national laws required for the operation of the single passport was insufficient. It cannot be limited to pursuing market integration by eliminating barriers to the freedom of provision of financial services. Harmonisation would need to be more extensive and deeper so as to include the legal framework for the safeguarding of financial stability and the management of crises. This includes areas which are entrenched into national legal traditions, such as the powers of regulators to intervene over financial institutions and its foreign establishments, commercial law relating to the rights of creditors, resolution and bankruptcy law (including a possible special resolution regime for financial institutions), as well as private international law as to the jurisdiction of host-countries vis-à-vis home-countries.[52]

Finally, the crisis demonstrated the need for an EU framework which is able to safeguard the stability of the single financial market as a whole. The construction of the single financial market had relied for the most part on tools focusing on achieving market integration, particularly through the removal of barriers to the cross-border provision of services. The financial crisis showed that sustaining market integration requires also pursuing

52 See the Commission's Communication *An EU Framework for Cross-Border Crisis Management in the Banking Sector*, COM(2009) 561 final, published for public consultation on 20.10.2009 on the Commission web-site.

financial stability as a public good. This would require arrangements for the mutualisation of economic risks among Member States and also for the prevention and mitigation of crises affecting the EU's financial system as a whole.

There were several European initiatives in 2009 to draw the lessons from the financial crisis and put forward proposals for regulatory reform.[53] The most important was the setting-up by the Commission in October 2008, at the peak of the financial crisis, a High-Level Group, chaired by Jacques de Larosière, with the mandate to put forward proposals to improve the arrangements for financial supervision in the EU in light of the financial crisis experience.[54] This led to the development of a new regulatory architecture for the single financial market based on two pillars: a new European System of Financial Supervision (ESFS) to conduct micro-prudential supervision; and a new European Systemic Risk Board (ESRB) to conduct macro-prudential supervision. This new architecture will in principle be in place in 2011, if the adoption of the legislation proposed by the Commission in September 2009

53 The Economic and Financial Committee mandated in December 2008 a High-Level Working Group, chaired by Lars Nyberg, to draw the lessons for the financial crisis management arrangements (ECOFIN Council Conclusions of 20 October 2009, available at www.se2009.eu and www.consilium.europa.eu). The Commission adopted in May 2009 a Communication on European Financial Supervision, which set out the proposed steps for enhancing the EU supervisory arrangements, and which were broadly endorsed by the ECOFIN Council of 9 June and the European Council of 18 and 19 June 2009 (Communication from the Commission - European financial supervision, COM/2009/0252 final). The ECOFIN Council in Luxembourg on 20 October 2009 consolidated all these initiatives in a single European roadmap which sets out the short, medium and long term priorities in strengthening EU financial supervision, stability and regulation. These priorities include actions on (1) the supervisory framework, (2) the framework for crisis prevention, management and resolution, (3) the regulatory framework, and (4) promoting the integrity of financial markets (ECOFIN Council Conclusions of 20 October 2009, available at www.se2009.eu).

54 The High-Level Group on Financial Supervision in the EU, February 2009, available at http://ec.europa.eu. The de Larosière Report, acknowledges the limitations of the institutional and legal architecture of the single financial market which were made evident by the crisis. In order to enhance the European framework, the de Larosière Report contains a comprehensive set of recommendations at the EU level covering: (1) Financial regulation and international cooperation, with recommendations covering a wide range of areas, including Basel II, accounting rules, credit rating agencies, Solvency 2, hedge funds, securitised products and derivatives, investment funds, corporate governance, internal risk management of financial institutions (Recommendations 1-12); (2) Financial crisis management, with recommendations covering a framework for managing crises, the further harmonisation of deposit-guarantee schemes, and the need for Member States to agree on more detailed criteria for burden sharing than those contained in the existing Memorandum of Understanding, which should be amended accordingly (Recommendations 13-15); and (3) The European supervisory framework, with proposals for the setting-up of a two-pillar structure for the EU regulatory and supervisory architecture. In particular, it proposes to distinguish at the EU level the conduct of macro- from micro-prudential supervision through the establishment of two distinct structures. For a first comment see Goodhart & Schoenmaker, 'The de Larosière report: two down, two to go', ft.com/economistsforum, 13 March 2009.

is adopted by the Council and the European Parliament in the course of 2010 (and in accordance with the terms of the Lisbon Treaty which entered into force on 1 December 2009).

6. THE EUROPEAN SYSTEM OF FINANCIAL SUPERVISION[55]

The de Larosière Report identified a number of weaknesses relating to the conduct of financial supervision at the EU level.[56] Such weaknesses included issues relating to (1) supervisory failures with regard to individual institutions; (2) the impossibility to challenge supervisory practices on a cross-border basis; (3) the lack of frankness and cooperation between supervisors; (4) the lack of consistent powers across Member States; (5) the lack of recourses in the Level 3 Committees; and (6) the lack of means for supervisors to take common decisions.[57]

In this context, in its Communication on European Financial Supervision, the Commission considered that the EU had reached the limits of what could be done with the Level 3 committees. These committees only play an advisory technical role to the Commission and do not provide a mechanism to ensure cooperation and information exchange between national supervisors and the best possible supervisory decisions for cross-border institutions. In addition, the patchwork of national regulatory and supervisory requirements may prevent joint action by national supervisors, which may lead to the prevalence of national solutions in responding to European problems.[58]

Following the recommendations of the de Larosière Report and the Commission Communication, as well as the Conclusions of the ECOFIN Council of 9 June 2009 and of the European Council of 18 and 19 June 2009, the Commission adopted on 23 September 2009 legislative proposals to enhance the EU supervisory framework. In the micro-prudential field, the Commission put forward proposals for Regulations of the European Parliament and the Council leading to the setting-up of a *European System of Financial Supervision (ESFS)*.

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55 This and the following section of the article build on Recine & Teixeira, 2009.

56 See Ferrarini & Chiodini, 2009.

57 See paragraphs 152 to 166 of the de Larosière Report.

58 See Commission Communication, *European Financial Supervision*, COM (2009) 252 final, 27.5.2009, p. 8-ff.

The ESFS would be established as an integrated network comprising the national supervisors and three new European Supervisory Authorities (replacing the existing Level 3 Committees): a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). The Authorities will be Community bodies with a legal personality and may be characterised as EU agencies with significant independence and autonomy, particularly vis-à-vis the Commission.[59]

In addition, the three new Authorities will cooperate through a Joint Committee of European Supervisory Authorities, composed of the Chairpersons of the Authorities. This Committee should also aim at ensuring supervisory consistency across sectors. In this context, there will be a Subcommittee to deal specifically with cross-sectoral issues, including financial conglomerates.

FIGURE 2: **The European System for Financial Supervision**

Current institutional setting		**ESFS**
Coordination of the three committees on the basis of a Joint Protocol (3L3)	**Cross-sectoral**	Joint Committee of European Supervisory Authorities
Committee of European Banking Supervisors (CEBS)	**Banking**	European Banking Authority (EBA)
Committee of European Insurance and Occupational Pension Supervisors (CEIOPS)	**Insurance**	European Insurance and Occupational Pensions Authority (EIOPA)
Committee of European Securities Regulators (CESR)	**Securities**	European Securities and Markets Authority (ESMA)
Colleges of supervisors for banking and insurance groups		
National supervisors		

The establishment of the ESFS is expected to enhance significantly the framework for financial supervision in the EU. In particular, the ESFS will have the objectives of (1) improving the coordination of cross

59 For the characterisation of the new European Supervisory Authorities as a new type of European agency, see Chiti, 2009.

border supervision, including through colleges of supervisors and ensuring consistent supervisory decisions across borders; (2) raising the quality of financial regulation across the EU, including through a consistent application of rules and the development of a single EU rulebook; (3) improving crisis prevention, coordination and management across the EU as a whole; and (4) improving the effectiveness and efficiency of supervision.

In order to fulfil these objectives, the new European Supervisory Authorities will take on all the tasks of the existing supervisory committees – CEBS, CEIOPS and CESR – and in addition have significantly increased responsibilities, defined legal powers and greater authority than the committees. According to the Commission's proposals, the tasks and powers of the Authorities will include the following.[60]

First, the Authorities will issue technical standards with the aim of identifying and removing differences among national financial regulations, which may stem from exceptions and derogations allowed under Community law. This should allow developing a harmonised core set of standards across the EU, which will provide as much as possible a single rulebook for participants in the single financial market. In order for standards to be as effective as possible, the Commission will endorse them as Community law, thus providing for binding legal effect at the EU level.

Second, they will issue guidelines and recommendations that contribute to ensuring coherent application of Community legislation. These guidelines and recommendations will not have a legally binding nature, but national supervisors will have an interest in complying with them in order to provide a level playing field for market participants. The Authorities will conduct periodical peer reviews of national supervisors' activities in order to enhance consistency in supervisory practices.

Third, the Authorities may also issue recommendations to specific national supervisors, particularly when a specific supervisor is considered to be diverging from the existing Community legislation, including the technical

60 Commission Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority, Brussels, 23.9.2009, COM(2009) 501 final; Commission Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority, Brussels, 23.9.2009, COM(2009) 502 final; Commission Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities Markets Authority, Brussels, 23.9.2009, COM(2009) 503 final.

standards. This will therefore represent a mechanism for supporting the compliance with the Authorities' instruments.

Fourth, the Authorities will be expected to play a coordination role in financial crisis situations – which are defined as adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Community. In particular, they will be expected to promote a coordinated Community response by facilitating the exchange of information between supervisors, determining the scope and verifying the reliability of relevant information, acting as mediator between supervisors, and notifying the European Systemic Risk Board of any potential emergency situation. In this context, the Authorities may adopt decisions requiring national supervisors to take an appropriate action to address the risks in the crisis situation. The types of action that may be taken will be defined in Community legislation. Furthermore, if a national supervisor does not comply with the decision, the Authorities may adopt a decision directed at a specific financial institution requiring it to comply with the relevant Community legislation.

Fifth, the Authorities will contribute to the efficient and consistent functioning of colleges of supervisors. The Authorities may participate as observers in colleges and receive all relevant information shared between the members of the college. In addition, the Authorities will have the task to collect information for national supervisors in order to facilitate the work of colleges. In this context, the Authorities will have the obligation to establish and manage a central database to make information available to the national supervisors involved in colleges.

Sixth, the Authorities will have the general task of contributing to consistent supervision across the EU. In addition to the tools of technical standards, guidelines and recommendations, the Authorities may, in case of disagreements among national supervisors on cooperation, coordination or joint decision-making, take a decision, after an attempt for conciliation, requiring the national supervisors to take or refrain from taking action. Moreover, the Authorities can also facilitate the delegation of tasks among supervisors and generally support a common supervisory culture through opinions, reviews and training programmes.

Seventh, the Authorities will be able to collect information from supervisors and other public authorities of Member States necessary to carry out their tasks.

Lastly, the Authorities will be responsible for monitoring and assessing market developments, particularly with regard to the relevant micro-prudential trends, potential risks and vulnerabilities. For this purpose, the Authorities shall conduct stress-testing exercises, in cooperation with the ESRB. The outcome of such monitoring and assessment should be conveyed to the ESRB, the European Parliament, the Council and the Commission.

Figure 3: **The legal and regulatory instruments of the European Supervisory Authorities**

	Tools
1	Guidelines and recommendations for the consistent supervisory practices and application of EU law
2	Specific recommendations to national supervisors failing to ensure compliance of financial institutions with EU law
3	Last resort decisions addressed to individual financial institutions not in compliance with EU law
4	Decisions addressed to national supervisors in crisis situations
5	Last resort decisions addressed to individual financial institutions in crisis situations
6	Collection of information and setting-up of central database
7	Mediation of disagreements between national supervisors, including the possibility to address decisions to national supervisors to take or refrain from taking action

In addition to these tasks, which are common to all Authorities, the ESMA will have supervisory powers for credit rating agencies. Such powers could include the power to request information and to conduct investigations or on-site inspections and, in addition, the possibility to withdraw the registration or suspend the use for regulatory purposes of credit ratings. The responsibilities of ESMA in this regard will be possibly defined in an amendment to the Regulation on Credit Rating Agencies.

The framework proposed by the Commission for the European Supervisory Authorities implies that national supervisors will continue carrying out day-to-day supervision, also on the basis of colleges of supervisors, which will be set up for all major cross-border institutions. Accordingly, the tasks and powers of the new Authorities are largely of a coordinating nature which falls short of a federal architecture such as the one of the ECB and the Eurosystem.

In the words of the de Larosière Report, the new "European System for Financial Supervision would be a largely decentralised structure, fully respecting the proportionality and subsidiarity principles of the Treaty. So existing national supervisors, who are closest to the markets and institutions they supervise, would continue to carry-out day-to-day supervision and preserve the majority of their present competences."[61]

In this context, an important element of the proposals of the Commission is the introduction of a safeguard clause relating to the fiscal responsibilities of Member States. In particular, the Commission proposals provide that no decision by the Authorities – namely those adopted in emergency situations and for settling disagreements among national supervisors – may impinge in any way on the fiscal responsibilities of Member States. This is in line with the ECOFIN and European Council Conclusions of June 2009. In order to ensure that this is respected, it is provided that, where a Member State considers that a decision by an Authority impinges on its fiscal responsibility, it may notify the Authority and the Commission that the national supervisor does not intend to implement the Authority's decision. This notification should be accompanied by a justification clearly demonstrating how the decision by the Authority impinges on fiscal responsibilities. Within a period of one month the Authority shall inform the Member State as to whether it maintains its decision or whether it amends or revokes it. Where the Authority maintains its decision, the Member State may refer the matter to the Council and the decision of the Authority is suspended. The Council shall, within two months, decide whether the decision should be maintained or revoked, acting by qualified majority.

In conclusion, the setting proposed by the Commission for the ESFS and the three European Supervisory Authorities should enhance significantly the financial regulation and supervision at the EU level. This will be achieved by attributing to the Authorities a set of tasks and powers, which will be conducive essentially to (1) a single EU rulebook for market participants, (2) better coordination at the EU level between national supervisors, (3) improved exchange and collection of information relevant for micro-prudential supervision, and (4) improving the ability of the EU as a whole to respond to a financial crisis.

61 See paragraphs 184 of the de Larosière Report.

7. THE EUROPEAN SYSTEMIC RISK BOARD

The crisis highlighted key features of the financial market landscape in Europe and elsewhere, which had been possibly underestimated and need to be addressed by a new structure for financial regulation and supervision. Such features include the increasing relevance of systemic risk stemming from structural developments related to financial integration and financial innovation, as well as the close links between the financial system and the real economy. As a result, the crisis largely materialised out of mutually reinforcing dynamics between macroeconomic conditions, structural changes, and the specific vulnerabilities linked to individual institutions. These dynamics were not sufficiently captured by the regulatory and supervisory system. Therefore, the crisis reinforced the view that a well-regulated market requires the introduction of macro-prudential supervision aimed at a broad and effective monitoring and assessment of the potential risks covering all components of the financial system: the so-called macro-prudential supervision.[62] This is in contrast with the scope of micro-prudential supervision, which focuses on the factors and processes that can affect the stability of individual financial institutions, thus aiming to ensure that financial institutions have a strong shock-absorbing capacity and effective risk management.[63]

The de Larosière Report recommended the establishment of a European Systemic Risk Council (ESRC) with the responsibility for conducting macro-prudential supervision. The report recommended in particular three main design features for the ESRC. First, macro-prudential supervision should concern all the financial sector and not only banks. Second, macro-prudential supervision should take a wide EU perspective, and take also into account the judgements made by the authorities of individual Member States. Third, there must be an effective and enforceable mechanism to translate the assessment of risks identified by macro-prudential analysis into specific supervisory actions. In this context, the ESRC would have the tasks to "form judgements and make recommendations on macro-prudential policy, issue risk warnings, compare observations on macro-economic and prudential developments and give direction on these issues".

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62 See *The Fundamental Principles of Financial Regulation*, Geneva Reports on the World Economy 11, Centre for Economic Policy Research (CEPR), 2009.

63 See Aglietta & Scialom, 2009.

The de Larosière Report acknowledged that central banks have a key role to play in a macro-prudential framework in view of their role and interest in safeguarding the stability of the financial system as a whole. Central banks' focus on systemic stability puts them in a position to better assess not only the likelihood and the potential impact of macro-shocks or disturbances in domestic and international capital markets, but also the operation of common factors affecting the stability of groups and intermediaries. Accordingly, the ESRC would be primarily composed of the members of the General Council of the ECB, and the ESRC would be set-up under the auspices of the ECB.

The ECOFIN Council of 9 June renamed the proposed macro-prudential body as European Systemic Risk Board (ESRB), possibly in order to follow the terminology used for the setting-up of the Financial Stability Board by the G-20 in April 2009.[64] The ECOFIN defined many of the features of the ESRB namely with regard to its core tasks, the general scope of financial stability risk warnings and recommendations, the composition of the General Board of the ESRB, and considered that the ECB should provide analytical, statistical, administrative and logistical support to the ESRB, also drawing on technical advice from national central banks and supervisors.[65] The European Council of 18 and 19 June 2009 agreed that the members of the General Council of the ECB will elect the ESRB Chair.[66]

The Commission presented on 23 September 2009 two legislative proposals for the setting-up of the ESRB: (1) a proposal for a Parliament and Council Regulation on Community macro-prudential oversight of the financial system and establishing a ESRB, on the basis of Article 95 of the Treaty, and (2) a proposal for Council Decision entrusting the ECB with specific tasks concerning the functioning of the ESRB, on the basis of Article 105 (6) of the Treaty, which enables the Council to confer upon, through unanimity voting, the ECB tasks relating to prudential supervision, after consulting the ECB and after receiving the assent of the Parliament.[67] The ECOFIN Council meeting on 20 October reached a broad agreement

64 See the Charter of the Financial Stability Board, endorsed at the G-20 Pittsburgh Summit of 25 September 2009, available at www.financialstabilityboard.org.

65 See www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ecofin/108392.pdf.

66 See www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/108622.pdf.

67 Commission Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, Brussels, 23.9.2009, COM(2009) 499 final; and Commission Proposal for a Council Decision entrusting

on a compromise by the Swedish Presidency, which changed some of the provisions of the original proposals by the Commission.[68]

On the basis of the Commission's legislative proposals and the compromise agreed at the ECOFIN, the ESRB will have the following distinguishing features.

First, the ESRB will be set up as an independent EU body without legal personality – in contrast to the European Supervisory Authorities, which will have legal personality – responsible for macro-prudential oversight of the EU financial system. In this context, since it is proposed to establish the ESRB on the basis of Article 95 of the Treaty (now 114 (1)), the ESRB may be considered as a quasi- EU agency responsible for tasks which contribute to the realisation of the single market.

Second, in order to fulfil its mission, the ESRB will be entrusted with a set of tasks, which will include (1) the collection and analysis of information, (2) the identification and prioritisation of systemic risks, (3) the issuance of warnings where risks are deemed to be significant, (4) the issuance of recommendations for remedial action, (5) the monitoring of the follow-up to warnings and recommendations, (6) the cooperation and exchange of information with the ESFS, and (7) the coordination with the IMF and the Financial Stability Board, as well as other relevant macro-prudential bodies.

Third, the ESRB's governance structure includes a General Board composed of the ECB President and Vice-President, the EU central bank governors, the three Chairs of the European Supervisory Authorities and the Commission as members with voting rights. National supervisors and the Chairman of the Economic and Financial Committee are members without voting rights. The Commission's proposal provides for the establishment of a Steering Committee, to set the agenda and prepare the decisions, as well as a Technical Advisory Committee through which the ESRB will obtain the assistance of EU central banks and supervisors.

Fourth, the ECB and the ESCB will play a key role in the functioning of the ESRB. In particular, in line with the ECOFIN Conclusions of 9 June 2009, the ECB will provide analytical, statistical, administrative and logistical

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the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board, Brussels, 23.9.2009 COM(2009) 500 final.

68 The documents agreed at the ECOFIN Council of 20 October 2009 are available at the public register of the Council: ec.consilium.europa.eu.

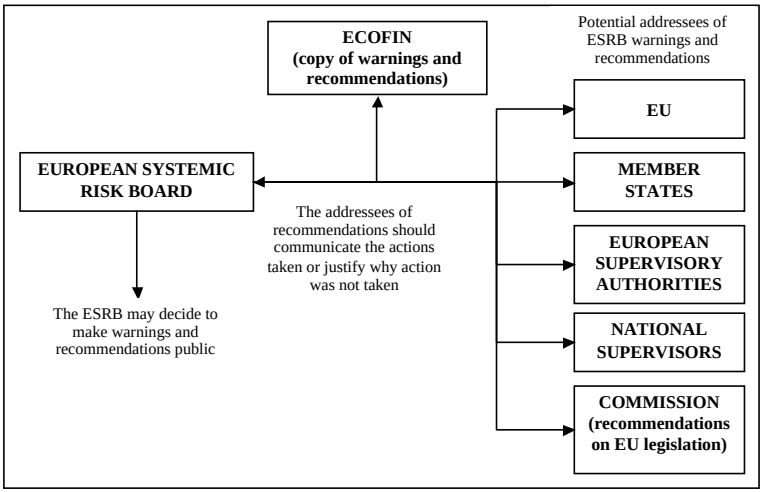
support to the ESRB. This entails also the provision of the Secretariat, in line with the Commission proposal for a Council Decision. In addition, the ESRB Chair will be elected by the members of the General Council of the ECB. The ESRB will also be supported by an advisory committee of EU central banks and supervisors, which can in principle be based on the existing ESCB Banking Supervision Committee.

Fifth, the ESRB may request information from the European Supervisory Authorities in summary or collective form, such that individual financial institutions cannot be identified. If the requested data are not available to those Authorities or are not made available in a timely manner, the ESRB may request the data from national supervisory authorities, national central banks or other authorities of Member States. The ESRB may also address a reasoned request to the European Supervisory Authorities to provide data that are not in summary or collective form. In this case, the ESRB should consult the relevant European Supervisory Authority in order to ensure that the request is proportionate.

Sixth, and most importantly, the ESRB will have the power and obligation to issue risk warnings and recommendations. Warnings or recommendations issued by the ESRB may be either of a general or specific nature. They may be addressed to the Community as a whole or to one or more Member States, or to one or more of the European Supervisory Authorities, or to one or more national supervisors. Recommendations may also be addressed to the Commission in respect of the relevant Community legislation. In the case of recommendations, they should specify a timeline for the policy response. The addressees will have the obligation to communicate to the ESRB their policy response or to explain why they have not acted ("act or explain" mechanism). If the ESRB decides that its recommendation has not been followed and that the addressees have failed to explain their inaction appropriately, it shall inform the Council and, where relevant, the European Supervisory Authorities concerned.

The draft Regulation agreed at the ECOFIN Council meeting of 20 October provides for a compromise solution on voting modalities: simple majority for warnings, reinforced majority for recommendations. This differs from the original Commission's proposal according to which ESRB decisions on risk warnings and recommendations are to be taken on the basis of simple majority voting.

FIGURE 4: **The framework for the implementation of the ESRB risk warnings and recommendations**



The degree of effectiveness of the risk warnings and recommendations will be a crucial aspect of the functioning and credibility of the macro-prudential tasks to be exercised by the ESRB. In particular, the ESRB will have no legally-binding powers to ensure compliance by the addressees of risk warnings and recommendations. Therefore, it will need to rely on a combination of solid technical analysis, institutional and policy credibility, and peer pressure as the sources of its legitimacy.

In this context, the ESRB could rely on the combination of five main tools and mechanisms. Firstly, the active monitoring by the ESRB on the extent to which its policy recommendations are implemented and the mitigating effects of such implementation on the identified risks.

Secondly, the regular reporting to the ECOFIN of the outcome of such monitoring, in order to raise attention and foster action by policy-makers.

Thirdly, the "act or explain" principle, according to which the addressees of ESRB recommendations will be required to take the appropriate remedial action or justify the reasons why they have not acted. The draft Regulation agreed at the ECOFIN Council meeting of 20 October states that the Commission is also subject to the "act or explain" mechanism, as it was considered that this does not affect the Commission's right of initiative

under the Treaty. In addition, the ECOFIN also agreed that the addressees of ESRB recommendations should communicate their actions and provide justification for inaction not only to the ESRB but now also to the Council. Although the draft regulation does not provide the Council with any specific powers, the change increases the institutional involvement of the Council in the implementation of the ESRB recommendations.

Fourthly, the close cooperation with the European Supervisory Authorities, particularly to support the implementation of recommendations addressed to one or more competent national supervisory authorities. In particular, the European Supervisory Authorities will be required to use their powers to ensure a timely follow-up. Furthermore, when a national supervisor does not follow-up, it has to inform the Board of Supervisors of the respective ESA. In its reply to the ESRB, the national supervisor has to take into account the input of the respective ESA.

Lastly, the right of the ESRB to decide to publish its risk warnings and/or recommendations on a case by case basis, which may increase the pressure for the prompt corrective actions. Given the sensitiveness of such a publication, it will be expected the decision of the ESRB would be taken on an exceptional basis, when serious threats to financial stability are not being addressed to the extent necessary. The ECOFIN of 20 October also agreed that the Council should be consulted by the ESRB on the publication of warnings or recommendations.

The appropriate combination of these tools and mechanisms, which will be contemplated in the Community legislation establishing the new European financial stability architecture, should provide a sufficient institutional framework for ensuring the effectiveness of the risk warnings and policy recommendations of the ESRB.

Overall, the proposed establishment of the ESRB will considerably enhance the current financial regulatory framework as it will allow, in particular: overcoming the current lack of an integrated financial stability assessment at the EU level covering the whole financial sector; translating financial stability assessments into risk warnings and policy recommendations for EU and national authorities; exploiting at the EU level the central banking, as well as supervisory, analytical capabilities and expertise in financial stability and macroeconomic analysis.[69]

69 See Gleeson, 2009.

FIGURE 5: **The legal and regulatory instruments of the European Systemic Risk Board**

	Tools
1	Issuance of risk warnings.
2	Issuance of recommendations with a specified timeline for policy response addressed to the Community as a whole, to one or more Member States, to one or more of the European Supervisory Authorities, or to one or more national supervisors, and also to the Commission in respect of Community legislation.
3	Publication of risk warnings and recommendations.
4	Monitoring of the follow-up to the ESRB recommendations; in particular, the addressees have the obligation to communicate to the ESRB their policy response or to explain why they have not acted ("act or explain").
5	If the ESRB decides that its recommendation has not been followed and that the addressees have failed to explain their inaction appropriately, it shall inform the Council and, where relevant, the European Supervisory Authorities concerned.
6	The ESRB may request information from the European Supervisory Authorities in summary or collective form, such that individual financial institutions cannot be identified. If the requested data are not available to those Authorities or are not made available in a timely manner, the ESRB may request the data from national supervisory authorities, national central banks or other authorities of Member States. The ESRB may address a reasoned request to the European Supervisory Authorities to provide data that are not in summary or collective form.

8. CONCLUSION: PEELING THE LAYERS OF EUROPEAN INTEGRATION

The evolution of the law and regulation of the single financial market represents a paradigm of the process of European integration as a whole. This article reviewed the successive legal and regulatory stages, each involving specific strategies and tools towards market integration. The analysis provides evidence that each stage is characterised by the need to address fundamental obstacles to market integration, which arise as a result of the progress made in the previous stage. This corresponds to the ideal of functional integration, according to which steps towards integration create economic and political dynamics leading to further integration. In particular, there are functional spillovers when "incomplete integration undermines the effectiveness of existing policies, thereby creating pressures for new European policies."[70]

70 See Majone, 2005: 43.

Figure 6, below, summarises the layers peeled by the process of integration of the single financial market, or, in other words, the fundamental obstacles that were overcome by legal and regulatory integration to fulfil the conditions of a single financial market. The last obstacle is the fiscal sovereignty of Member States, which represented a decisive factor in the way that the EU addressed the financial crisis. As argued in Section 5 above, the financial crisis revealed the limitations of a legal and regulatory strategy towards market integration, which is not accompanied by the development of political integration and mutualisation of economic risks – ultimately a federal solution for the law and regulation of the single financial market. In particular, the crisis put into evidence the mutual incompatibility between (i) pursuing market integration through free movement of capital and establishment, (ii) safeguarding the stability of an integrated market as a public good, while (iii) retaining national fiscal responsibilities and regulatory competences.[71]

In this context, the setting-up of the ESFS and of the ESRB corresponds to a new model of European financial regulation and supervision, which replaces the regulatory framework for financial integration based exclusively on home-country control, mutual recognition and minimum harmonisation.[72]

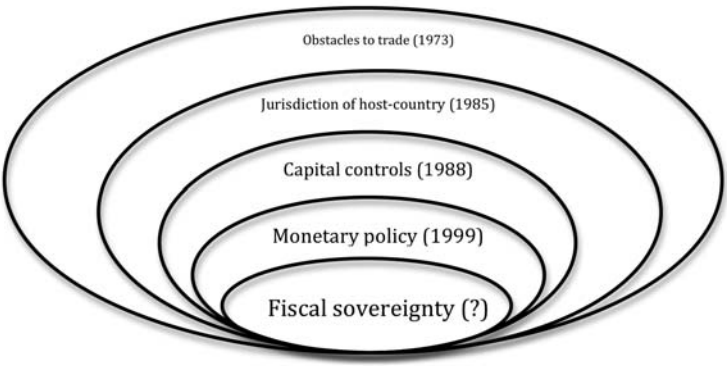
Regarding the ESFS, the new institutional model draws to a large extent from the good experience with the ECB and the European System of Central Banks (ESCB). The ECB/ESCB are responsible for the federal competences linked to the Economic and Monetary Union. However, their manner of operating based on the principle of unitary decision-making and executive decentralisation of tasks is rather similar to the framework being proposed for the ESFS, where the ESAs agree on regulatory standards, which should be implemented by national supervisors. Furthermore, the ability of the ESAs to agree on standards that may be adopted by the Commission as European law provides the potential for a high-degree of regulatory harmonisation, therefore replacing to a certain extent the minimum harmonisation concept. Lastly, the ability of the ESAs to mediate between home and host-country regulators, and to support as well the delegation of tasks between them, provides for a managed application of the principles of home-country control and mutual recognition, therefore changing the way they have applied thus far.

71 See Fonteyn *et al.*, 2010.

72 For a critical assessment, see Begg, 2010.

On the other hand, the establishment of the ESRB will introduce for the first time the notion of a regulatory public good for the single financial market: the stability of the European financial system. This may be qualified as a condition *sine qua non* for having European-based financial regulation and supervision. In particular, in the previous model, the design and implementation of financial regulation and supervision was made on the basis of pure national interests, namely the safeguard of the domestic financial systems. European committees and other arrangements then tried to bridge national interests through cooperation mechanisms. With the ESRB, its risk warnings and recommendations have the potential to influence and guide the design and implementation of regulation and supervision with a truly European scope. It may therefore be a first step towards a federal solution, in the same way that the emergence of the public good of European monetary stability was a precursor to EMU.

FIGURE 6: **The layers of the integration of the single financial market**



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