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MISSING PIECES IN THE PATCHWORK OF EU FINANCIAL STABILITY REGIME? THE CASE OF CENTRAL COUNTERPARTIES

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Abstract
This article builds on a recent case (Case T-496/11, UK v. ECB (Location policy)), in which the General Court determined that the ECB does not have competence to regulate so-called Central Counterparties (CCPs), and annulled an ECB policy which sought to restrict access to the euro area of certain non-euro area CCPs. It is argued that the Court's central finding, though possibly correct, is problematic from the perspective of financial stability, especially considering the growing systemic importance of CCPs. Second, the Court's finding is symptomatic of certain drawbacks inherent in the patchy architecture of the evolving EU financial stability regime, which is excessively focused on banks. Finally, the case acts as a warning of likely future situations where the exercise of EU level competences and forms of direct administration related to the objective of financial stability can result in an outright conflict with basic free movement rights.

1. Introduction

The financial and eurozone debt crises have given birth to a well-known saga of hard cases where the jurisdictions of the Court of Justice of the European Union have been given the difficult task of assessing the lawfulness of far-reaching financial rescue measures (*Pringle,*[1] *OMT*[2]) as well as the delegation of new types of executive powers to a Union agency (*Short selling*[3]). The case decided by the General Court in March 2015, which spurred the analysis presented here - Case T-496/11, *United Kingdom* v. *European Central Bank*[4] - was about the reach of the ECB's competences, like *OMT*. At issue was the ECB's so-called "location policy", which sought to limit the development of too big and important financial infrastructure providers outside the euro area. The policy was formulated as early as 2001 in the following way:

> "The natural geographical scope for any 'domestic' market infrastructure (including central counterparty clearing) for securities and derivatives denominated in euro is the euro area. Given the potential systemic importance of securities clearing and settlement systems, this infrastructure should be located within the euro area". [5]

The policy was never put in practice, but was challenged by the UK, which feared that it could eventually pressure London-based clearinghouses to relocate their activities to the euro area. In this case, the General Court sided with the applicant, stating that "the ECB does not have the competence necessary to regulate the activity of securities clearing systems", including in particular so-called Central Counterparties (CCP).[6] The ruling made few headlines, sovereign bond markets did not plummet, and the case was finally sealed, evidently for good, when the parties to the dispute announced that a settlement had been reached. No

[1] Case C-370/12, *Pringle* v. *Ireland,* EU:C:2012:756.
[2] Case C-62/14, *Gauweiler and Others* v. *Deutscher Bundestag (OMT),* EU:C:2015:400.
[3] Case C-270/12, *UK Council and Parliament,* EU:C:2014:18.
[4] Case T-496/11, *UK* v. *European Central Bank* (*Location Policy*), EU:T:2015:133.
[5] ECB, "The Eurosystem's Policy Line With Regard to Consolidation in Central Counterparty Clearing, 2001" (Press release, 27 Sept. 2001).
[6] Case T-496/11, *UK* v. *ECB (Location Policy)*, para 110.

appeal was lodged. As part of the deal, the UK agreed to withdraw all the remaining legal actions (altogether three cases were lodged concerning the policy framework).

Despite its relatively "uneventful" character, *UK* v. *ECB (Location policy)* provides a rich source and useful point of reference for the purposes of identifying and assessing several central legal problems and constitutional tensions surrounding the developing EU financial stability regime, and particularly the role of the ECB therein.[7] This article presents the case and its background and then analyses in detail the following three broad problems.

First, the article considers the implications of the General Court's central finding, i.e. that the ECB has no powers over CCPs or other securities settlement systems. The article shows that CCPs, which already handle enormous volumes of transactions every day, should not be disregarded as a mere technicality of the financial market's post-trade "plumbing system".[8] In the regulatory response to the financial crisis, much faith has been placed in the ability of CCPs to contain and manage systemic risk, especially in the global market for over-the-counter (OTC) derivatives.[9] CCPs manage systemic risk by concentrating it; thus the most logical policy prescription was nicely articulated by Ben Bernanke, the previous Chairman of the Federal Reserve of the United States: "If you put all your eggs in one basket, you better watch that basket".[10] Indeed, we should not take the fact that CCPs fared relatively well in the crisis as indication of their immortality.[11] However, the argument in favour of centralizing supervision of CCPs must also show that oversight is needed precisely at the *European* level, i.e. that the objective of financial stability could not be attained by Member State supervision and intervention alone. As will be pointed out, this part of the argument is not as straightforward.

Secondly, the case and its outcome reveal how the EU financial stability regime is excessively focused on banks and the banking system. Indeed, the Banking Union framework for supervision (Single Supervisory Mechanism, SSM) and crisis management (Single Resolution Mechanism, SRM) is solely focused on banks. The underlying problem of the EU regime for prudential supervision of financial institutions is that its scope is defined institutionally rather than functionally. Here the United States offers a useful point of comparison, particularly the broad and functionally defined mandate of the Financial Stability Oversight Committee (FSOC). However, the article also notes that first steps have already been taken in the EU towards a more comprehensive framework for the management of systemic risks stemming from the entire financial system. In particular, the Commission is preparing a legislative framework for the recovery and resolution of financial institutions *other than banks*, with a particular focus on CCPs.[12] With respect to extending the ECB's

[7] In this article the term "financial stability regime" is used in a narrow sense comprising the institutions, tools and policies that are designed to mitigate systemic risks resulting from the failure of individual financial institutions including non-bank entities and financial infrastructure providers. Such a regime covers both ex ante supervision and ex post crisis management functions. Financial stability regime more broadly understood would comprise a much larger set of macroprudential tools and policies, including monetary, for identifying and managing systemic risks in the financial system at large. It should also be noted that the difference between macroprudential and microprudential policies is hard to draw and in part even semantic. Macroprudential policy is nevertheless characterised by its specific objective (limitation of systemic risk), scope (entire financial system), and instruments (various tools, which are mostly prudential). See IMF, Macroprudential Policy Tools and Frameworks - Progress Report to G20, 27 October 2011, p. 4. For instance, the viability of CCPs and other financial market infrastructures is usually considered a macroprudential policy issue, despite the focus is on individual institutions.

[8] The common "plumbing" metaphor was used, e.g. by Ben Bernanke in his speech "Clearinghouses, Financial Stability, and Financial Reform", given at the 2011 Financial Markets Conference, Stone Mountain, Georgia, 4 April 2011.

[9] Derivatives are either traded bilaterally (hence "over-the-counter") or through regulated exchanges (exchange-traded derivatives).

[10] Bernanke, op. cit. *supra* note 8 (citing Mark Twain's character Pudd'nhead Wilson).

[11] Ibid.

[12] The Commission's official consultation on recovery and resolution of financial institutions other than banks was launched already in October 2012.

mandate to cover CCPs, the judgment in *UK* v. *ECB (Location policy)* points out an interesting exit strategy for fixing the competence gap regarding CCPs. According to the Court, this could be done without a Treaty amendment by revising the Statute of the ECB and of the ESCB (the ECB/ESCB Statute) via the exception provided under Article 129(3) TFEU. This would allow the use of the ordinary legislative procedure. However, the prospect of giving the ECB broader regulatory and supervisory powers over systemically important CCPs (and other market infrastructures) poses certain difficult questions, both legal and practical. This is in large part due to the organizational and operational arrangements adopted within the ECB in order to "ring fence" the prudential supervision of banks under the SSM from the effective and independent discharge of the ECB's primary monetary duties.

The third and final problem to be considered concerns the "single market problem" which the Court actually did not need to examine in detail after upholding the UK's first plea regarding competence. The UK had also claimed that the ECB's location policy infringed the key freedoms provided for by the TFEU, in particular the freedom of establishment, freedom to provide services and the free movement of capital. This plea reveals the constitutionally tensioned relationship between free movement restrictions motivated and justified by financial stability concerns, and the single financial market project driven by the founding principles of competition and free movement. It is argued that these occasionally conflicting rationalities, stemming respectively from what has been called the EU's microeconomic and macroeconomic constitutions,[13] risk further deepening the jurisdictional wedge between the "ins" and the "outs" of the Eurozone. The broader economic policy problem, which in the EU is also a constitutional one, is that free movement and unrestricted competition do not necessarily go hand in hand with the policy objective of financial stability – unless policy-making and supervision is centralized (this is known also as the "Financial Trilemma").

2. Validity of the ECB Policy Framework for CCPs: *UK* v. *ECB* (*Location policy*)

2.1. *Background: The ECB location policy and the rationale behind it*

Clearinghouses reduce the costs and operational risks relating to the post-trade phase of financial transactions by centralizing and standardizing specific classes of financial transactions.[14] Clearinghouses differ from exchanges and other market places in that their purpose is solely to ensure payment and delivery.[15] A CCP is a special type of clearinghouse. In a nutshell, a CCP centralizes and warehouses risk by interposing itself between buyers and sellers of securities and derivatives, thus taking a position of the buyer to every seller and the seller to every buyer. [16] Clearing of, for instance an OTC derivative contract through a CCP in practice means that one contract is replaced by two contracts. This contractual novation amounts to a guarantee or insurance for the original counterparties that the contracts will be performed. As for the CCP, because the two replacing contracts mirror and offset each other perfectly, the CCP does not take a position in the market and in normal times need not to

[13]See Kaarlo Tuori and Klaus Tuori, *The Eurozone crisis: A constitutional analysis* (Cambridge University Press, 2014); Kaarlo Tuori, *European Constitutionalism,* (Cambridge University Press, 2015).

[14]See e.g. Bernanke, op. cit. *supra* note 8.

[15]Chang, "The systemic risk paradox: Banks and clearinghouses under regulation" *Columbia Business Law Review* (forthcoming), p. 11. Available at SSRN, <ssrn.com/abstract=2421325> From the late 1990s onwards, CCPs have started to distance themselves from exchanges and offer services on a standalone basis, especially to OTC derivatives markets. See Hills, Rule, Parkinson and Young, "Central Counterparty Clearing Houses and financial stability", *Financial Stability Review*, June 1999, Bank of England.

[16]This common definition is adopted also in Art. 2(1) of the EMIR.

worry about market risk, i.e. price movements.[17] Therefore, the primary concern of the CCPs is the solvency of its trading counterparties.[18] In addition to enhanced transparency, risk management and loss mutualization, CCPs bring efficiency benefits. Pooling of large amounts of transactions allows multilateral netting, i.e. cancelling out of offsetting exposures. Netting reduces the interconnectedness of market participants, but it also lowers collateral demands and facilitates market exit.[19] CCPs have become increasingly important especially in the global market for OTC derivatives after the policy-makers determined that to prevent another financial crisis more derivatives should be centrally cleared. These initiatives will be assessed in more detail (in section 3.2) below.

The ECB's interest in CCPs and securities settlement systems is explained by the fact that securities transactions have two "legs", a securities leg and a cash leg, and thus there is a direct link between securities settlement systems and payment systems. Therefore "disturbances in the transfer of securities may spill over to disruptions of the payment systems that are used by the securities settlement systems."[20] Overseeing the functioning of payments systems is a task shared by all currency issuing central banks.

The ECB needs to retain maximum control over its own currency, the euro. One way to achieve that objective is to keep critical payment infrastructures (and other infrastructures) within the currency area and thus within the central bank's sphere of oversight and control. To that end, the ECB developed a policy according to which "the Eurosystem cannot, as a matter of principle, accept that payment infrastructures for euro transactions which are located outside the euro area (the home currency area) have the potential to develop into major euro payment infrastructures".[21] The scope of the ECB "location policy" reached beyond payment systems to cover all market infrastructures, including CCPs, that handle securities and derivatives transactions denominated in euro. According to the ECB, these infrastructures, if important enough, should all be located within the euro area.[22]

In its 2011 Eurosystem Oversight Policy Framework, the ECB further specified its location policy, giving more detailed guidance particularly with regard to CCPs.[23] With respect to OTC derivatives in particular, the policy entailed that there is "a need for at least one European CCP for credit derivatives" and that "given the potential systemic importance of securities clearing and settlement systems, this infrastructure should be located within the euro area".[24] The ECB's 2011 oversight policy also took a step further, setting certain quantitative thresholds, the meeting of which would trigger the application of the location policy to CCPs.

This level of granularity was enough for the UK, which brought several actions in the General Court seeking annulment of the policy framework insofar as it imposed a location requirement applicable to CCPs outside the Eurosystem. The UK's concern was understandable: the policy threatened the position of London as a host for the most important CCPs, not only in Europe but also globally. Indeed, London hosts many of the world's leading

[17]See recital 47 of the Commission Delegated Regulation 153/2013 O.J. 2013, L 52: "Given that a CCP's aim should be to have a flat position with regards to market risk, the only risks that a CCP should need to hedge are those concerning the collateral that it accepts or the risks arising from the default of a clearing member."
[18]Kress, "Credit default swaps, clearinghouses, and systemic risk: Why centralized counterparties must have access to central bank liquidity", 48 *Harvard Journal on Legislation* (2011), 61-62.
[19]Ibid., 66-68; See also Chang, op. cit. *supra* note 15, p. 19: "Because the DCO has numerous positions to offset, the margin that members have to post to maintain their positions will likely be lower than with bilateral clearing."
[20]ECB, "Eurosystem Oversight Policy Framework", 5 July 2011, p. 5.
[21]ECB, "The Eurosystem policy principles on the location and operation of infrastructures settling euro-denominated payment transactions", 19 July 2007. See also ECB, "The Eurosystem policy principles on the location and operation of infrastructures settling euro-denominated payment transactions: Specification of 'legally and operationally located in the euro area'", 20 Nov. 2008.
[22]See ECB 2001, cited *supra* note 5.
[23]ECB, op. cit. *supra* note 20.
[24]Ibid., p. 10.

clearinghouses, two of which stand out in particular: LCH.Clearnet in the area of interest rate swaps, and ICE Clear Europe in credit default swaps.[25]

2.2. *The Court annuls the ECB location policy*

The General Court of the European Union gave its judgment on 4 March 2015 in Case T-496/11, which was the first of three cases lodged by the UK concerning the above-described ECB location policy.[26] In its pleadings, the ECB acknowledged that it lacked explicit mandate to oversee securities settlement systems, but argued that such powers should be construed as consequential to its other tasks as laid down in Article 127 TFEU and the ECB/ESCB Statute. The ECB relied in particular on Articles 127(1) and 127(2) TFEU as well as on Article 22 of the ECB/ESCB Statute.[27] The primary objective of the ESCB is to maintain price stability (Art. 127(1) TFEU), whereas Article 127(2) TFEU provides that the ESCB's core tasks also include the promotion of the smooth operation of payment systems. Article 22 of the ECB Statute further specifies that "the ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound *clearing and payment systems* within the Union and with other countries." The ECB had already argued that the above legal basis, together with the duties to contribute to the stability of the financial system (Art. 127(5) TFEU) also grants it oversight and regulatory powers over all kinds of clearing systems, including CCPs.[28]

Moreover, in the ECB's reasoning the fact that the term "oversight" is unknown in the Treaty of Maastricht should be of no consequence, because at the time the Treaty was signed "the understanding of oversight as a separate function was only just developing" and therefore the omission must have been unintentional. Secondly, at that time "clearing and settlement systems had not yet gained the size and relevance that they subsequently acquired, particularly on a cross-border basis."[29] To implement the oversight policy, the ECB has assumed it had the following powers at its use: moral suasion, public statements, influence on direct participants in the relevant systems, cooperation with other authorities, and finally the adoption of directly binding regulations within the euro area (a power not used by the ECB).[30]

Nevertheless the General Court, after settling the admissibility issues,[31] ruled on the question of competence in favour of the UK, confirming that the "ECB does not have the competence necessary to regulate the activity of securities clearing systems" including CCPs.[32] The Court recognized the "existence of very close links between payment systems and securities clearing systems",[33] but rejected the ECB's "effect argument" which basically asserted that the ECB must have the power to regulate securities clearing infrastructures because their default could seriously affect the functioning of payment systems.[34] In the view of the Court, such links, though clearly existing, cannot be held sufficient to justify the

[25] Barker and Jones, "BoE and ECB settle four-year battle over City clearing houses", *The Financial Times,* 29 March 2015. For a brief description of London-based CCPs, see ECB, "Oversight Report, 2014", p. 33.
[26] Case T-93/13, *UK* v. *ECB* (action brought 15 Feb. 2013) concerned a decision as well as a guideline of the ECB concerning the TARGET2 system; in *UK* v. *ECB* (Case T-45/12) (action brought 27 Jan. 2012) the UK sought the annulment of a separate statement of standards by the ECB insofar as it concerned the location policy.
[27] Case T-496/11, *UK* v. *ECB (Location policy)*, paras. 86-87.
[28] See Opinion of the European Central Bank of 27 Nov. 2012 on various draft regulatory and implementing technical standards submitted by the ESMA to the Commission, O.J. 2012, C 60/1, p. 2 ("The Eurosystem's oversight competence over clearing and payment systems derives from these provisions.")
[29] As also stated in the ECB's 2009 Eurosystem oversight report, p. 3.
[30] Ibid., p. 7.
[31] Case T-496/11, *UK* v. *ECB (location policy)*, paras. 68 and 76.
[32] Ibid., para 110.
[33] Ibid., para 106.
[34] Ibid., para 103.

existence of ECB's implicit powers.[35] To construe such powers would be against the principle of conferral as laid down in Article 13(2) TEU.[36]

In other words, the General Court separated securities settlement systems from payments systems, both functionally and legally. The Court's conclusion is reasonable. As described above, the business of CCPs is to settle both payments and securities transactions, thus their operations entail both a cash leg and a securities leg.[37] The Court held rightly that the securities side of CCPs' clearing operations *per se* could not be perceived as constituting payments.[38] While the ECB clearly has competence to adopt regulations to ensure efficiency and safety of payment systems (including those with a clearing stage) it has not been granted "autonomous regulatory competence in respect of *all clearing systems*".[39] Moreover, the ECB's location policy clearly reaches beyond oversight. As the ECJ observes:

> "the matter at issue is the ECB's competence to impose, on behalf of the Eurosystem, a requirement to be located within the euro area that is applicable to CCPs providing clearing services for euro-denominated securities beyond certain thresholds. It is clear that creation of such a requirement goes beyond mere oversight of the infrastructures of securities clearing systems, and partakes of regulation of their activity."[40]

The UK also presented other pleas relating to the substance of the location policy. One stands out as particularly interesting and problematic: the UK claimed that the ECB's location policy, if considered to be within the ECB's powers and thus formally lawful, would directly encroach upon the TFEU guaranteed key freedoms, i.e. freedom of establishment, freedom to provide services, and the free movement of capital.[41] Since the Court upheld the first of the UK's pleas regarding competence, it did not need to examine the other pleas. Examination of the issues by the Court of Justice will not take place in the near future either, because after the General Court's ruling the parties quickly settled the case. As part of the deal, the UK agreed on cessation of all the remaining legal actions. The UK also agreed to enhance information exchange and cooperation arrangements between the ECB and the Bank of England, which oversees CCPs operating in the UK. In exchange, the ECB agreed not to discontinue, and even extend, its common liquidity support arrangements with the Bank of England - thus maintaining an important euro liquidity backstop for London-based CCPs.[42]

2.3. *Three problems to be considered*

The remainder of this article will consider in detail three problems, each of which relates to the substance of the above-presented case. First, it is argued that the General Court's finding that the ECB lacks competence to exercise oversight and regulatory control over CCPs is problematic from the perspective of financial stability, especially considering the growing importance of CCPs on the global markets for financial derivatives. The lack of competence is

[35]Ibid., para 107.
[36]Ibid., para 105.
[37]The Court also acknowledged that "in order to carry out its activity, a CCP must have access, first, to a payment system enabling liquid assets to be transferred, whether it is operated by a central bank or on a private basis, and, second, to a securities settlement system enabling transfer of ownership of the securities and their custody." Ibid., para 44.
[38]Ibid., para 97.
[39]Ibid., para 101.
[40]Ibid., para 84.
[41]Ibid., para 78. The UK also presented three other pleas, which will not be considered in detail here. The third plea related to an alleged breach of Arts. 101 and 102 TFEU, fourth plea was on the principle of non-discrimination (Art. 18 TFEU) and the fifth plea on the principle of proportionality. Ibid.
[42]ECB, "European Central Bank and Bank of England announce measures to enhance financial stability in relation to centrally cleared markets in the EU", Press release 29 March 2015. See also Barker and Jones, op. cit. *supra* note 25.

symptomatic more generally of certain drawbacks and shortcomings in the patchy architecture of the evolving EU financial stability regime, which is too focused on banks. The second problem concerns the question of broadening the ECB's mandate to include CCPs, especially the "exit strategy" to expand the ECB's mandate, as pointed at by the Court. Good grounds exist to argue that this interpretation by the Court is too liberal. But what is even more problematic, in the event this strategy were to be followed, how exactly would the new powers be located within the ECB's current organizational structure? This problem again points at more general structural design issues ignored or overlooked in the construction of the Banking Union. Finally, the article briefly assesses certain fundamental constitutional problems that arise, first, from the geographic bifurcation of the Union's constitutional reality between the eurozone and the rest of the EU and, second, the likely future clashes between the fast evolving and financial stability oriented macroeconomic constitution, and the more established and stable microeconomic constitution built on the overarching principles of free movement and competition.

3. Does the ECB need more powers over CCPs?

The argument in favour of centralizing supervision of CCP's must satisfy two conditions: first, the business of such entities must be such as to be able to cause sufficiently serious problems in the financial system, i.e. that they are systemically important. Secondly, it must be shown that oversight is needed precisely at the *European* level, i.e. that the objective of financial stability could not be attained by decentralized Member State supervision and intervention alone. To that end, this section will next consider the systemic importance of CCPs especially in light of the recent developments that have taken place in the global market for financial derivatives. After that the need for European level supervision in general and the possible role of the ECB in particular will be evaluated.

3.1. *CCPs are systemically important*

Systemically important financial institutions (also known as SIFIs) are institutions "whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity".[43] Generally all financial market infrastructures, such as CCPs and payment systems,[44] are presumed to be systemically important, at least in the jurisdiction in which they are located.[45] This is first because of the sheer amount of transactions they process. CCPs, for instance, typically clear transactions worth hundreds of trillions annually.[46]

The systemic concerns relating to CCPs have been steadily climbing up the priority list on the international policy agenda. The Financial Stability Board (FSB)[47] and its member organizations the Committee on Payment and Settlement Systems (CPMI) and the

[43]Financial Stability Board, "Reducing the moral hazard posed by systemically important financial institutions, FSB Recommendations and Time Lines", 20 Oct. 2010, p. 1.
[44]Other financial market infrastructures include central securities depositories, securities settlement systems, and trade repositories. CPSS-IOSCO Principles for Financial Market Infrastructures - April 2012.
[45]Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions", 15 Oct. 2014, p. 57
[46]According to the ECB's figures on 2014, CCPs located within the euro zone "cleared a total of €14.3 trillion in cash securities transactions, €121 trillion in repo transactions, and €193 trillion in derivatives transactions." See the Eurosystem Oversight Report 2014. LCH.Clearnet Ltd.'s SwapClear service, the leading platform for interest rate derivatives, cleared in 2014 derivative transactions valued in total more than USD 600 trillion: LCH.Clearnet Ltd., Annual Report and Financial Statements for the year ended 31 Dec. 2014, p. 3.
[47] Established in April 2009, as the successor to the Financial Stability Forum (FSF), the FSB is an international body, hosted by the BIS, that monitors and makes recommendations about the global financial system.

International Organization of Securities Commissions (IOSCO) have been developing several standards and principles for better oversight, risk management, and resolution of CCPs. The CPMI and IOSCO are also in the process of initiating a comprehensive review of stress testing by CCPs.[48]

Given their critical role in the everyday functioning of the financial markets, financial market infrastructures are sometimes likened to public utilities such as electricity grids.[49] Whether they should be regulated as such is a matter of debate, but what is certain is that it is in the interest of regulators to ensure continued availability of such infrastructures' services.[50] As with systemically important too-big-to-fail banks, the regulators would have little choice in a situation where a significant CCP faced difficulties in performing its obligations. The consequence of inadequate action would be no less than the likely implosion of the financial system.[51] To fully understand why the CCPs have stepped up from a relatively unknown and unregulated market innovation to one of the central concerns of regulators and central banks globally, one must appreciate the nature and effects of perhaps the most important of the regulatory responses to the financial crisis of 2008, that is, the reform of the OTC derivatives markets.

3.2. *CCPs and the OTC derivatives reforms*

Prior to the financial crisis, the large majority of OTC derivative transactions was executed bilaterally outside CCPs, where freedom of contract prevailed and parties did not need to worry about mandatory risk management requirements, e.g. on posting collateral. Unchained for decades, the OTC derivatives market has reached an enormous size (USD 630 trillion notionally[52]) and become extremely globalized. In 2012 around 80 per cent of credit derivative transactions had a cross-border element.[53] The market is also interconnected and heavily dominated by certain primary dealers; for instance, at the time of its bankruptcy filing, Lehman Brother investment bank had hundreds of thousands of contracts outstanding in the OTC derivatives market with around 8,000 different counterparties.[54] Lehman's collapse had well-known catastrophic consequences in the OTC markets. This was in large part because the market participants had systematically undercollateralized counterparty risk.[55] For OTC derivatives that are not cleared through a CCP (bilateral or uncleared OTC derivatives) there exists no robust, rule-based system for setting collateral. Therefore "safe clients" such as sovereigns and AAA-rated institutions have tended not to post adequate collateral. Moreover, systemically important financial institutions, i.e. primary dealers like Lehman Brothers used

[48] Bank for International Settlements, "CPMI and IOSCO begin review of CCP stress testing", Press release, 11 March 2015.

[49] See Singh, "Making OTC derivatives safe: A fresh look", IMF Working Paper 11/66, 201 (2011), p. 17.

[50] See Cœuré, "Central counterparty recovery and resolution", keynote Speech by Benoît Cœuré, Member of the Executive Board of the ECB, At Exchange of Ideas #2, London, 24 Nov. 2014.

[51] Kress, op. cit. *supra* note 18, 73. See also Levitin, "The tenuous case for derivatives clearinghouses" 101 *The Georgetown Law Journal* (2013), 445 at 463 ("the failure of a clearinghouse would have systemic consequences that would be far worse than a dealer bank's failure").

[52] Bank for International Settlements, *Quarterly Review*, June 2015, p. 4-5. The number represents the amount of all outstanding OTC derivatives contracts, offering an indicator of deal activity. Gross market value of all reported derivatives contracts, i.e. the cost of replacing all outstanding contracts at reporting date's market prices, is significantly smaller (USD 21 trillion).

[53] See Barnier, "International cooperation: a sine qua non for the success of OTC derivatives markets reforms", in *OTC Derivatives: New Rules, New Actors, New Risks,* Banque de France, Financial Stability Review, No. 17, April 2013.

[54] Hull, *Options, Futures, and Other Derivatives* (Pearson Education India, 2006), p. 3.

[55] Studies indicate that undercollateralization has only got worse after Lehman's collapse. See Singh, "Collateral, netting and systemic risk in the OTC Derivatives Market" IMF Working Paper 10/99 (Washington: International Monetary Fund) (2010); Singh and Aitken, "Counterparty risk, impact on collateral flows and role for central counterparties", IMF Working Paper 09/173, 2009.

to be, typically post no initial margin to each other for OTC derivative contracts.[56] As is now well known, the triple-A rating of the American Insurance Group (AIG) made its counterparties feel secure enough not to require up-front collateral.[57] The AIG was thus able to build up massive exposure by selling Credit Default Swaps (through its London-based subsidiary) while hardly committing any capital.

While the opaque OTC market collapsed in the crisis, CCPs navigated through the turbulence and protected their members from substantial losses primarily without government assistance. Therefore, the EU, together with other jurisdictions hosting the world's most important capital markets, enacted laws to fulfil its G-20 commitment to steer more derivative instruments to the presumed safety of central clearing.[58] The Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (more usually known as the European Market Infrastructure Regulation, or its acronym: EMIR)[59] sets a mandatory requirement to clear all standardized OTC derivatives through an authorized CCP (Art. 4).[60]

The derivatives reform means a significant offloading of standardized OTC derivatives to CCPs. The majority of OTC derivatives are already cleared through CCPs (60% in 2013[61]) and more is expected to follow after the new regulations kick in. Both the EU and U.S. have proposed mandatory clearing of interest rate derivatives - which make up the lion's share of the OTC market's activity.[62] The change has been visible also in the credit default swap (CDS) markets, where contracts with CCPs accounted for more than a quarter of all outstanding (notional) CDS contracts at end-June 2014, a notable increase compared with the pre-crisis figures.[63] For CCPs this means significantly higher volumes. To take one example: the number of OTC derivatives contracts cleared by LCH.Clearnet Ltd, a London-based CCP that is particularly important for the European derivatives market, has more than doubled since 2009.[64]

3.3. *Are CCPs safe?*

Though it is clear that an uncontrolled failure of a CCP would devastate financial markets, perhaps even more than a bank failure, it has been less clear to what extent regulatory intervention is needed to counter that threat. CCPs differ from banks in a number of important ways. For instance, commercial banks customarily deal with liquidity problems by turning first to the inter-bank market to receive short-term funding and take recourse to the central bank liquidity assistance only if the inter-bank market is not available, e.g. due to impaired

[56]Singh, op. cit. *supra* note 49, p. 10.
[57]Hull, op. cit. *supra* note 54, p. 33.
[58]Related initiatives include moving more derivative trades on regulated exchanges and other organized trading venues, and subjecting the remaining, non-standardized and uncleared OTC derivatives to stringent risk mitigation requirements. In particular, the G20 leaders declared in 2009 that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements." Group of 20, Declaration, Pittsburgh summit, September 2009.
[59]Regulation (EU) 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, O.J. 2012, L 201/1.
[60]However the mandatory clearing requirement becomes effective only after a derivative has been declared subject to the clearing obligation.
[61]Deutsche Börse, "How Central Counterparties Strengthen the Safety and Integrity of Financial Markets" (July 2014), p. 7.
[62]In fact, by the end of 2013, around 65 % of outstanding notional interest rate derivative contracts was already cleared through CCPs. See ISDA, *Size and Uses of the Non-Cleared Derivatives Market: An ISDA Study* (April 2014).
[63]BIS, op. cit. *supra* note 52.
[64]See Committee on Payments and Market Infrastructures, "Statistics on payment, clearing and settlement systems in the CPMI countries, Figures for 2013" (December 2014), p. 414 (data on the value of cleared contracts is not available).

balance sheet and lack of confidence.[65] Unlike the case in the typical banking business, possible liquidity needs of CCPs result from the defaults of their members, not from the maturity mismatch between their assets (loans) and liabilities (deposits): in other words their liability side is not at the risk of a run. CCPs have developed sophisticated risk management systems to handle member defaults. First of all, they only accept trades from their direct members and apply strict membership criteria.[66] Most crucially, CCPs apply a special margining system and sophisticated default management processes.[67] The CCPs require collateral (margins) from each of their members, who must also make payments to a special default fund.[68] Moreover, in the event a CCP member defaults and its posted margin and default fund contributions prove inadequate, the CCP has the ability to mutualize the loss among its clearing members, e.g. through a mutualized default fund.[69] In other words, CCPs "sit atop a fortress of margin pledged by members to collateralize trades",[70] i.e. the costs arising from a default of a member of the CCP are borne by the members of the CCP themselves.[71] As pointed out by Benoît Cœuré of the ECB: "A key difference between banks and CCPs is that a CCP's recovery plan can be based on contractual agreements with its members. …CCPs are in a unique position in drawing on additional resources from members if and when needed."[72]

That CCPs have become prominent risk managers of the global financial system is not without merit. Most CCPs have thus far been able to manage and contain crises without (at least direct) government funding.[73] For instance, the London-based LCH.Clearnet Ltd's default history comprises seven defaults and three "near misses", but none of the events threatened its viability.[74] The most serious test was presented by Lehman's default, which the LCH.Clearnet Ltd managed through a specific and pre-tested process where affected positions were basically auctioned off as a package. This strategy proved to be highly successful: the margin posted by Lehman was sufficient to manage the auctioning process and hedge the risks involved. In fact, LCH.Clearnet Ltd returned a significant amount of Lehman's margin pot to the administrators.[75] On the other hand, LCH.Clearnet SA, a French CCP (which is a part of

[65]Campbell and Lastra, "Revisiting the Lender of Last Resort", 24 *Banking & Finance Law Review* (2009), 453, 463 - noting however, that the way banks fund lending has undergone a significant transformation in recent years: instead of using deposits, banks increasingly fund their lending activities through money markets, where they borrow large sums for fixed periods. This is commonly combined with securitization of loan portfolios. Ibid.

[66]EMIR defines "clearing member" as an undertaking which participates in a CCP and which is responsible for discharging the financial obligations arising from that participation (Art. 2(1)(14)).

[67]See Allen, "Derivatives clearinghouses and systemic risk: A bankruptcy and Dodd-Frank analysis." 64 *Stanford Law Review* (2012), 1089-1090.

[68]Margins comprise a fixed component paid up front, called the "initial margin" and a "variation margin", which reflects changes in the value of open positions. See e.g. Feder, "Deconstructing Over-the-Counter Derivatives" 2002 Colum. Bus. L. Rev. (2002), p. 733-734.

[69]Kress, op. cit. *supra* note 18, 63. Koeppl and Monnet, "Emergence and Future of Central Counterparties" *FRB of Philadelphia Working Paper* No. 10-30 (2010). Available at SSRN: <ssrn.com/abstract=1687862>.

[70]Chang, op. cit. *supra* note 15, p. 30.

[71]However, the CCP operator is itself responsible for other types of risks such as operational risks or failures in the collateral and liquidity management systems. Such losses are covered by the CCP's regulatory capital, insurance or through other contingent resources. See LCH.Clearnet White Paper, "CCP Risk Management, Recovery, and Resolution", p. 4.

[72]"Central counterparty recovery and resolution", Keynote Speech by Benoît Cœuré, member of the Executive Board of the ECB, At Exchange of Ideas #2, London, 24 Nov. 2014.

[73]However, the statement that CCPs survived the financial crisis without government support is to a certain extent misleading. As noted by Ben Bernanke, "the official sector's support arrangements for financial firms and markets … also indirectly eased liquidity pressures on the clearinghouses". Bernanke, op. cit. *supra* note 8.

[74]See LCH.Clearnet's Default History, available from <www.lchclearnet.com/risk-collateral-management/risk-management-overview> (last visited 12 Oct. 2015).

[75]For a brief description of the process, see Allen, op. cit. *supra* note 67, 1089-1090.

LCH.Clearnet Group and a sister company of LCH.Clearnet Ltd) needed to access the liquidity facilities of the Bank of France in managing the Lehman Brothers default.[76]

However, the use of a CCP does not, strictly speaking, *reduce* the risks inherent in derivatives transactions, but rather reallocates and centralizes the risk to a facility that specializes in managing it. Roe claims that there is a fundamental misunderstanding among policymakers about this underlying risk transfer function of CCPs. If a loss arises from a counterparty failure, a CCP can transfer the loss elsewhere but it cannot eliminate it.[77] Therefore, according to Roe, the promise to confine financial contagion with the help of CCPs is at least "oversold";[78] at the same time, the possibility that the CCPs themselves become too big to fail is often overlooked.[79] This overconfidence, as so often the case in financial markets, seems to be based on the assumption that history repeats itself. But things have not stayed equal: the regulatory overhaul of the derivatives markets is actually changing CCP business. As mentioned above, Lehman's fall happened at a time when most OTC derivatives, especially the key categories of Credit Default Swaps and many Interest Rate Swaps, where executed *outside* clearinghouses. After the post-crisis reforms, CCPs are rapidly increasing their gravitational pull for new types of financial derivatives. This changes their risk profile because "as CCPs begin to clear more complex, less liquid, and longer-term instruments, their potential need for funding support *in extremis* will rise".[80]

It is also likely that given the new and rapidly expanding market for clearing eligible derivatives, CCPs start facing increased competition pressures. The insurance provided by CCPs is costly for market participants in comparison to the bilateral OTC markets, where prior to the crisis well-rated market participants could trade while committing little capital or none at all. Moving these contracts to the bosom of the CCPs will require a bulk of good-quality collateral.[81] A CCP may therefore have an incentive to start competing for market share at the cost of capitalization, thus in fact increasing leverage and systemic risk.[82] CCPs could under-price risk, for example, through setting low margin requirements, relaxing capital and membership requirements, or demanding less information from their clearing members.[83] The European regulator has acknowledged the risk of under-pricing, noting that "CCPs should not reduce their margins to a level that compromises their safety as a result of the existence of a highly competitive environment".[84]

3.4. The developing EU framework for CCPs

[76]BIS, "Payment, clearing and settlement systems in the euro area" (2012), p. 113.

[77]"Clearinghouses are merely a device to reduce the risk that stems from a dealer-bank failure. They are not general systemic risk panaceas." Levitin, op. cit. *supra* note 51, 465.

[78]Roe, "Clearinghouse Overconfidence" 101 *California Law Review* (2013), 1644.

[79]Ibid., 1645 also noting that "clearinghouse construction may move regulators from having to bail out a systemically dangerous failed financial institution to having to bail out a systemically dangerous clearinghouse." Ibid., 1648. See also Kress, op. cit. *supra* note 18, 72 ("Instead of reducing systemic risk, CCPs may simply redistribute and concentrate dangers within the financial system").

[80]Singh, op. cit. *supra* note 49, p. 10.

[81]Ibid., p. 3. It should be noted that efficient multilateral netting, which is one of the primary benefits of CCPs, can reduce the amount of required collateral. But increased competition between CCPs and easier entrance to the derivatives clearing market is likely to hamper reaching efficient netting across a broad range of derivatives. See ibid., p. 5-6 (noting that "A single CCP with an adequate multicurrency central bank liquidity backstop that is regulated and supervised and spans the broadest range of derivatives would have been an ideal 'first best' solution.").

[82]This can introduce a problem of "ruinous competition" which is familiar from the insurance markets: at times, regulatory interventions in the form of direct insurance rates regulation have been needed to protect policyholders from the ultimate dangers caused by systematic under-pricing of risk. The danger of "ruinous competition" has been referred to by both Chang, op. cit. *supra* note 15, p. 24-25 and Levitin, op. cit. *supra* note 51, 464. Both refer to an article by Borselli, "Insurance rates regulation in comparison with open competition", 18 *Connecticut Insurance Law Journal* (2011), 112.

[83]Levitin, op. cit. *supra* note 51, 463.

[84]Recital 23 of Commission Delegated Regulation 153/2013 of 19 Dec. 2012, O.J. 2012, L 52/41.

Considering the risks involved, it is comforting that CCPs remain on the radar of the EU legislature. The EU regulatory framework for CCPs is laid down in the EMIR and its various implementing regulations. Before the adoption of the EMIR, the EU hosted divergent Member State regimes for CCPs; for instance, in some Member States CCPs needed to be formally recognized, while in others they could operate without recognition.[85] The EMIR harmonized the requirements for conducting CCP business at a very detailed level, setting rules on authorization (Art. 14), capital requirements (Art. 16), organizational requirements and governance (Arts. 26 through 35) and conduct of business (Arts. 36 through 39), for example. The EMIR also introduces several prudential requirements regarding risk management.

Supervision of CCPs under the EMIR remains the prerogative of Member State authorities.[86] Many CCPs nevertheless operate cross-border and typically have members from various countries. For that reason, the EU regulation of CCPs resembles the pre-crisis EU banking regulation which allocated supervisory responsibilities between home and host Member State national supervisors, while banking groups operating cross-border were also supervised by colleges of supervisors.[87] Article 18 of the EMIR requires the establishment of supervisory colleges with broad membership, ranging from ESMA and various national competent authorities to the central banks of issue of the most relevant Union currencies of the financial instruments cleared.[88] Supervisory colleges facilitate and ensure exchange of information, voluntary entrustment of tasks among its members, the coordination of supervisory examination programmes, and the determination of procedures and contingency plans to address emergency situations.[89]

The EU-level supervisory duties are divided between the ESMA and the ECB. The ESMA has a seat in every supervisory college. Notwithstanding that the ruling in *UK* v. *ECB (Location policy)* stripped the ECB of its presumed regulatory and oversight competences with respect to CCPs in general, the ECB still exercises certain important functions. The ECB is represented in several colleges of supervisors because it acts as the "Central Bank of Issuer" in every CCP established within the EU but outside the euro area.[90] Therefore, the ECB represents the Eurosystem in the EMIR colleges of five CCPs situated outside the euro area (four of them are established in the UK and one in Sweden).[91] In one important respect CCP colleges are different from supervisory colleges for cross-border banks: they also play a role in authorizing a CCP.[92] In certain exceptional cases of disagreement, the authorization can even be referred to the ESMA who should make the ultimate determination on the

[85]As also noted in the Commission FAQ on EMIR.

[86]Art. 22 of the EMIR.

[87]See Moloney, "European Banking Union: Assessing its risks and resilience" 51 CML Rev., 1617-8.

[88]The complete list is the following: (a) ESMA; (b) the CCP's competent authority; (c) the competent authorities responsible for the supervision of the clearing members of the CCP that are established in the 3 Member States with the largest contributions to the default fund of the CCP; (d) the competent authorities responsible for the supervision of trading venues served by the CCP; (e) the competent authorities supervising CCPs with which interoperability arrangements have been established; (f) the competent authorities supervising central securities depositories to which the CCP is linked; (g) the relevant members of the ESCB responsible for the oversight of the CCP and the relevant members of the ESCB responsible for the oversight of the CCPs with which interoperability arrangements have been established; (h) the central banks of issue of the most relevant Union currencies of the financial instruments cleared.)

[89]Art. 18(4) of the EMIR. In addition, Art. 23 provides a general cooperation requirement for the national competent authorities to cooperate closely with each other, with the European Securities Markets Authority (ESMA) and, when necessary, with the European System of Central Banks (ESCB).

[90]ECB, "Eurosystem oversight report 2014", February 2015, 30.

[91]Ibid., p. 33 (the UK-based CCPs are CME Clearing Europe, ICE Clear Europe, LCH.Clearnet Limited, LME Clear Limited (observer status)).

[92]Recital 57 of the EMIR lays down the principle in the following way: "A CCP should not be authorized where all the members of the college, excluding the competent authorities of the Member State where the CCP is established, reach a joint opinion by mutual agreement that the CCP should not be authorized."

conformity with Union law. Other than this, the ESMA has no voting rights on the opinions of the college.[93]

3.5. *The emerging crisis management framework for CCPs*

The EMIR framework establishes a detailed and directly applicable rulebook for European CCPs. However, CCPs are not covered by a recovery and resolution framework similar to that established under the Banking Union (see Section 4.1). The Commission is on course to change this state of affairs, as it is preparing a legislative proposal regarding recovery and resolution of financial institutions *other than banks*, with a particular focus on CCPs. According to the published road map of the Commission, the envisaged reforms "would require CCPs to design comprehensive recovery plans to mitigate distress and equip national authorities with standardized tools such that they can intervene in the public interest to manage the failure of a CCP in an orderly manner, countering the possible negative repercussions on financial stability and ensuring the costs associated with its failure are borne by the shareholders and creditors of the institution without recourse to public funds."[94]

The Commission's work coincides with increased international attention being given to the safety of financial market infrastructures and other systemically relevant non-bank financial institutions. [95] The Financial Stability Board updated in October 2014 its important document "Key attributes of effective resolution regimes for financial institutions", incorporating specific guidance on the application of the principles to non-bank financial institutions such as insurers and financial market infrastructures. The Key Attributes provide the "umbrella standard for resolution regimes covering financial institutions of all types that could be systemic in failure".[96] A complementary set of standards is provided by the CPMI and IOSCO in their "Principles for financial market infrastructures".[97] The updated principles seek to harmonize and strengthen the international standards for systemically important financial market infrastructures, incorporating specific guidance on CCPs dealing with OTC derivatives.[98] The CPMI and IOSCO published additional guidance on the recovery of financial market infrastructures in 2014.[99]

The EU regulatory initiatives will provide a welcome addition to the EU's regulatory framework for CCPs and other non-bank financial institutions. However, the proposals leave open certain difficult questions with regard to the division of supervisory tasks between Member State authorities and the EU authorities, and particularly the role of the ECB and other central banks (both Eurosystem and non-eurosystem) as providers of emergency funding for CCPs.

3.6. *The critical role of central banks*

Regulatory authorities such as ESMA cannot replace the critical function of central banks which can provide quick and limitless emergency funding in times of stress. [100] The preamble

[93]Art. 17(4) and 19(3) of the EMIR.
[94]See Commission Roadmap, "Framework for resolution of financial institutions other than banks", April 2015.
[95]It should be noted that the work started already in 2012 with a consultation: Commission, "Consultation on a possible framework for the recovery and resolution of financial institutions other than banks", 5 Oct. 2012.
[96]FSB, "Key attributes of effective resolution regimes for financial institutions", 15 Oct. 2014, 2
[97]CPMI-IOSCO, *Principles for financial market infrastructures*. April 2012.
[98]Ibid., p. 5.
[99]CPMI-IOSCO, *Recovery of financial market infrastructures*, October 2014.
[100]"Now central banks in Europe and the US are turning their attention to developing frameworks that ensure the system can keep functioning when a clearing house runs into trouble – and without governments picking up the bill". Stafford, "'Too big to fail' worries reach clearing houses", *Financial Times*, 2 Dec. 2014. See also Stafford, "Clearing houses may face new capital rules", *Financial Times*, 24 Nov., 2014 and Stafford, "Centralised risk raises systemic worries over derivatives", *Financial Times*, 28 April 2015.

to the EMIR acknowledges that the ESCB is responsible for promoting the smooth operation of payment systems and that therefore its members also oversee clearing and payment systems.[101] In most cases in the euro area the oversight function is exercised by national central banks under national law competences, and it is the role of the Eurosystem to ensure effective coordination.[102] It is commonly recognized that due to the critical importance of CCPs, they should have direct access to central bank liquidity.[103] In the U.S., the Dodd-Frank Act explicitly made available the Federal Reserve tap for critical financial market infrastructures (see section 4.2 below). In a similar vein, the ECB has pointed out that CCPs should have "access to central bank liquidity in the currency in which the products cleared are denominated."[104] This latter statement reveals the fundamental problem concerning CCPs operating within the eurozone from outside the ESCB jurisdiction. The problem is elucidated by the following remark:

> "The key commercial problem for CCPs in the UK is [the] absence of any entitlement to access euro liquidity facilities from the ECB/ESCB …. In principle, the Bank of England could provide euro liquidity but as it does not have the power to print euros, it would have to liquidate the UK's foreign reserves, or borrow from the ECB itself."[105]

This explains why the ECB continuously has in place common liquidity support arrangements with the Bank of England. This arrangement ensures that in case a London-based CCP should run into trouble, the ECB can step in quickly, even if formally no commitment to provide liquidity exists.[106] It should be noted that the Swap arrangement between the Bank of England and the ECB is not unusual: the ECB similarly relies on dollar liquidity lines from the Federal Open Market Committee of the United States.[107]

The possibility of unlimited central bank liquidity, even if discretionary, brings with it the usual moral hazard problem. As is the case with banks, this alone makes a good case for supervision of CCPs. But the question still remains on which level the supervision should be exercised.

3.7. *The case for more European oversight*

That the EU should act only when and insofar as the objectives cannot be sufficiently achieved by the Member States is inherent to EU law through the requirement of subsidiarity (Art. 5 TEU). The case for centralization of financial supervision and of policy-making is often formulated as a theoretical case for preventing uncoordinated actions based on misaligned incentives that could lead to outcomes detrimental to the interests of the Union as a whole.

[101] Recital 11 of the EMIR.
[102] ECB, "Eurosystem oversight policy framework", July 2011, p. 5.
[103] See e.g. Chamorro-Courtland, "The Trillion dollar question: Can a central bank bail-out a Central Counterparty (CCP) Clearing House which is' too big to fail'?" (2012) *Brooklyn Journal of Corporate, Financial & Commercial Law,* 434 (including the sources cited in footnote 9). See also Kress, op. cit. *supra* note 18, 51 (and part V more broadly).
[104] ECB, *Credit Default Swaps and Counterparty Risk* (2009), p. 51.
[105] House of Lords, EU Economic and Financial Affairs Sub-Committee, Review of the EU financial regulatory framework Written and Oral evidence (Written evidence by Graham Bishop, p.138).
[106] ECB, "European Central Bank and Bank of England announce measures to enhance financial stability in relation to centrally cleared markets in the EU", Press release, 29 March 2015. See also Barker and Jones, op. cit. *supra* note 25.
[107] As noted by Lastra, "Since December 2007, the Federal Open Market Committee (FOMC) has authorized dollar liquidity swap lines with the European Central Bank and other central banks to provide liquidity in U.S. dollars to overseas markets". Lastra, "The Evolution of the European Central Bank", Queen Mary University of London, School of Law Legal Studies Research Paper No. 99/2012, p. 9 (footnote 17).

Perhaps the strongest general argument in favour of centralization of financial supervision is articulated by the Financial Trilemma, which maintains that the three policy objectives (1) financial stability, (2) financial integration and (3) national financial policies are by definition impossible to realize simultaneously. Two of the three objectives can be achieved, but not all three at the same time.[108] The incompatibility is primarily due to the public good nature of financial stability, which basically means that not all nations share the same incentives to internalize the costs of containing systemic risks. National authorities are prone to prioritize domestic objectives at the expense of others, protect the domestic financial system and taxpayers, and thus ignore what economists call cross-border externalities.[109]

The economic logic of the Financial Trilemma could even be translated into a democratic answer to problems created by interdependence: according to one narrative, the crisis is a democratic failure to address the growing interdependence among the Member States. The absence of European politics and the excessive reliance on (or even imprisonment to) national politics reveals "the real EU democratic deficit".[110] However, needless to say, the transfer of powers to the European level will hardly be enough to remedy the democratic deficit if the transfer itself lacks democratic legitimacy.[111]

In Europe, given the continuing emphasis on the completion of the single market and the status of financial stability as an overarching policy objective, the Financial Trilemma provides a strong case in favour of centralization of direct supervisory powers. Indeed, the approach has been explicitly mentioned as one of the intellectual justifications for the Banking Union: "[t]he Banking Union is a tool to deal with [the problems relating to the financial trilemma] by replacing national for supranational responsibility".[112] With regard to CCPs and other financial market infrastructures, the ECB's oversight policy in 2011 spells out similar concerns about misaligned incentives as well as lack of access to information. According to the ECB if a crisis situation materializes outside its sphere of influence, access to "timely information from the infrastructure might not be possible, and the [national] central bank with primary oversight responsibility might – in its policy actions – focus more on addressing the consequences for its *own currency and financial system*."[113] This might again cause cross-border externalities and be detrimental to the Union as a whole.

Nevertheless, supervision and oversight of CCPs remains the task of national central banks of the Eurosystem and they also act as the first lender of last resort for such infrastructures. To a certain extent, the lack of express regulatory and oversight powers of the ECB with respect to CCPs is of less consequence when it comes to CCPs that are situated within the eurozone. Common currency arguably diminishes the problem of misaligned incentives. However, just like with banks, too-big-to-fail CCPs are excessively linked to sovereign funds and, ultimately, actions of national Eurosystem central banks such as the granting of credit lines through emergency liquidity assistance could interfere with the ECB's

[108] Schoenmaker, "The financial trilemma" 111 *Economics Letters* (2011), 57-59.
[109] Schoenmaker, "Banking supervision and resolution: The European dimension" 6 *Law and Financial Markets Review* (2012), 52-60.
[110] Poiares Maduro, *A New governance for the European Union and the Euro: Democracy and Justice*, Compendium of Notes (2012), European Parliament, Directorate-General for Internal Policies, Policy Department C: Citizen's Rights and Constitutional Affairs (PE 474.438) "… no effective mechanisms were available to ensure that the fiscal policies of a Euro-Member State would take into account the interests of the other Member States. This can be presented as a form of democratic externality that is favoured by deeper integration and the interdependence it creates. The crisis makes clear our interdependence but also our failure to internalize its consequences. This failure is a democratic failure.", Ibid. p. 31.
[111] See especially, Scharpf, "Legitimacy intermediation in the multilevel European polity and its collapse in the euro crisis", MPIfG Discussion Paper No. 12/6, 2012.
[112] See Commission, "Economic Review of the Financial Regulation Agenda", a Staff Working Document (accompanying the document "A reformed financial sector for Europe", COM(2014)279), p. 134.
[113] ECB 2011, p. 9 (emphasis added).

monetary policy duties.[114] Decentralised supervision of CCPs becomes problematic especially when a too-big-to-fail CCP is also one that is too big to save by actions of its home central bank alone. In the case of banks, it has been argued that the supervisory responsibilities that have been moved to the European level in the form of the SSM should be followed by such macroeconomic emergency powers.[115] The same argument can be applied to CCPs: if the ECB were to receive more oversight powers over systemically important CCPs the size of which clearly exceeded the capacity of national central banks to provide credible liquidity support in an emergency situation, the ECB should also be the central bank in charge of the decision-making on the provision of liquidity assistance.

An important difference to banks is that euro area CCPs are already more in the grips of the ECB because they are firmly integrated in the Eurosystem's payment and settlement infrastructures. Euro area CCPs typically manage payment and settlement risk by making the majority of payments in central bank money via a specific settlement system called TARGET2 (Trans-European Automated Real-time Gross settlement Express Transfer system).[116] Moreover, the recently launched T2S system (TARGET2 Securities) provides a single platform for securities settlement in central bank money. On the other hand, non-euro area CCPs (or "offshore" CCPs as the ECB often calls them), cannot be as tightly integrated into the Eurosystem's settlement and payment systems. For instance, national central banks of the Member States not participating in the euro may only connect to TARGET2 indirectly by concluding an agreement with the central banks of the Eurosystem.[117]

Therefore, even if the ECB does not have formal powers to regulate CCPs, whether they are located in the euro area or not, it can exert regulatory pressure on euro area CCPs by way of regulating the payment and securities settlement systems as well as the access to such systems that are vital for CCP business. This is not the case with non-euro area CCPs. While cooperative arrangements with offshore authorities can mitigate stability concerns, they cannot replace direct oversight and control.[118] The problems are technical, but fundamentally political because the risks are ultimately borne by euro area taxpayers.

To conclude, there are good arguments in favour of consolidating CCP supervision at the European level and such powers should also be accompanied with the necessary powers on emergency liquidity assistance. However, this matter was not part of the substance of Case T-496/11, *UK* v. *ECB (Location policy)*. In fact, to author's knowledge, the ECB has not been actively lobbying for such powers. The ECB's primary concern has been the "offshore CCPs" established in London. In case such a CCP needs a liquidity injection in euros, and the deficit were so large it exceeded the reserves of the Bank of England, the ECB would be the central bank next in line. The commitment might be substantial.[119] Therefore, the most interesting

[114]Banks provide a useful comparison here too. See Goyal et al., "A Banking Union for the euro area", IMF Staff discussion note, February 2013, p. 11. ("Banks can place deposits and refinance eligible assets with the Eurosystem and, if collateral constraints bind, resort to emergency liquidity assistance (ELA) from their national central banks. While the ECB's Governing Council has authority to ensure that LOLR activities by national central banks do not interfere with common monetary policy, losses arising on ELA remain the responsibility of the national central banks, which exacerbate sovereign-bank linkages")

[115]Lastra, "Banking Union and Single Market: Conflict or companionship?", 36 *Fordham Int. Law Journal* (2013), p. 1215-16 (footnote 82) ("In future, for the credit institutions for which the supervisory responsibility is moved to the ECB, it would make full sense that the decision whether or not to grant ELA is taken by the ECB.")

[116]TARGET2 provides a single technical platform for the processing of Euro denominated payments in central bank money and with immediate finality. See the ECB's website on TARGET2 <www.ecb.europa.eu/paym/t2/html/index.en.html> On the legal basis, see ECB, "Legal Framework of the Eurosystem and the European System of Central Banks", July 2014, p. 31-32.

[117]See ECB, ibid., p. 32.

[118]ECB, "Eurosystem oversight policy framework 2011", p. 9-10.

[119]See Written evidence by Graham Bishop, cited *supra* note 105, p. 138-139. "If heavy losses were at all likely, the ECB's paid-in capital to meet such losses is only €7.6 billion so it might have to call for fresh capital from ESCB members very quickly. … Could anyone be sure about the size of the black hole to be filled as the giant 'nuke' exploded? Or how quickly the loan would be repaid?" House of Lords, EU Economic and Financial Affairs Sub-Committee, Review of the EU financial regulatory framework Written and Oral evidence.

question for the moment is, if the ECB were handed explicit powers over CCPs sometime in the future (which will be topic of section 4 below) how would a Court assess another attempt by the ECB at installing a Location policy or a similar instrument designed to curtail the increasing importance of London-based CCPs? This article can only point at some fundamental constitutional controversies involved in such a judgment (see section 5).

4. Breaking up Europe's love affair with its banks

4.1. *Banking Union's limited focus*

The Banking Union set up a single European framework for banking supervision (SSM[120]), a single framework for the resolution of banks and financial institutions (Single Resolution Mechanism, SRM[121]), and eventually it should lead to a common deposit guarantee scheme. In carrying out its tasks as the single supervisor,[122] the ECB will be considered, as appropriate, the competent or designated authority in the participating Member States, though national authorities remain the principal holders of macro-prudential powers.[123] Under the SSM, the ECB is responsible for the supervision of currently 123 systemically important European banks, of which holdings amount to more than 80 per cent of banking assets in the euro area.[124] If the preventive supervision fails, the SRM will enable centralized, orderly management of a failing bank with the help of a Single Resolution Fund. The SRM also sets uniform rules and procedures for the resolution of European banks falling under its remit, thus implementing the Bank Recovery and Resolution Directive (BRRD).[125] Moreover, these rules and procedures will be applied by a new Union agency, the Single Resolution Board, together with the Council and the Commission as well as the national authorities within the SRM framework. Finally, if both the bail-in mechanism of the SRM and the support of the Single Resolution Fund prove insufficient, the European Stability Mechanism (ESM) can under the "ESM direct recapitalization instrument" recapitalize banks directly.[126]

The Banking Union installed a system of executive supervisory governance, which truly is a "constitutional and political novelty".[127] The system combines preventive *ex ante* supervisory and recovery arrangements with forms of *ex post* centralized resolution measures. Given the multitude of political, institutional, and legal constraints, it is easy to agree that the project has been surprisingly successful.[128] The Banking Union is not watertight and too much emphasis has arguably been put on preventive supervision while leaving important macroprudential tasks to the Member States.[129] However, the scope of the EU framework for

[120]The SSM rests on two legislative acts: Council Regulation 1024/2013, O.J. 2013, L 287/63 (the SSM Regulation) and Regulation 1022/2013, O.J. 2012, L 287 (Amended EBA Regulation).
[121]Regulation 806/2014, O.J. 2014, L 225 (SRM Regulation). Part of the SRM is founded on an Inter-Governmental agreement, adopted outside EU legislative procedures and signed by 26 Member States (Sweden and the UK opted out). See agreement on the transfer and mutualization of contributions to the Single Resolution Fund (SRF), an essential part of the Single Resolution Mechanism (SRM) – Statement/14/119, 21 May 2014.
[122]Conferred on it by Arts. 4(1), 4(2) and 5(2)) of the SSM Regulation.
[123]Art. 5(1) of the SSM Regulation. The ECB can, however, if deemed necessary to address systemic or macro-prudential risks, apply higher capital requirements as imposed by national authorities, or impose more stringent measures (Art. 5(2)).
[124]See <www.bankingsupervision.europa.eu/about/thessm/html/index.en.html> (Last visited, 12 Oct. 2015).
[125]Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, O.J. 2014, L 173 (BRRD Directive).
[126]See the European Stability Mechanism, ESM direct bank recapitalization instrument adopted, press release, 8 Dec. 2014, <www.esm.europa.eu/press/releases/esm-direct-bank-recapitalisation-instrument-adopted.htm> (Last visited, 12 Oct. 2015).
[127]Moloney, op. cit. *supra* note 87, 1612.
[128]Ibid.
[129] Kern, "European Banking Union: a Legal and institutional analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism", 40 *European Law Review* (2015), p. 154-187, 171.

financial supervision and resolution also reflects well what has recently been dubbed Europe's "love affair with its banks."[130] Under Article 1(2) of the SSM Regulation, the scope of the ECB's supervisory tasks is strictly limited to the prudential supervision of credit institutions. The SRM framework similarly covers only credit institutions and certain parent undertakings such as financial holding companies (Art. 2(1)(b)). The ultimate focus on banks is in part dictated by the SSM's legal basis (Art. 127(6) TFEU), which automatically rules out tasks such as consumer protection as well as supervision of non-bank institutions, regardless of their systemic relevance.[131] Prudential supervision of central counterparties is expressly carved out from the remit of the Banking Union.[132]

If Europe wishes to continue down its path of integration and single market creation, as it is at present doing, especially in the areas of capital markets and post-trade financial market infrastructures, there are good reasons to believe that the Banking Union, as it stands, is not complete. After the financial crisis and the findings on how non-bank actors contributed and worsened the crisis (the "shadow banking system" has become the predominant catch-all term), one can safely conclude that "the assumption that only regulated banks matter to stability is manifestly false."[133] Non-bank financial institutions, such as insurers and hedge funds, can become systemically important, too. This has been painstakingly illustrated by the bail-out experiences in the U.S. of the American Insurance Group (2008) and, even earlier, the hedge fund Long Term Capital Management (1987). Blackrock, the world's biggest asset management firm, manages assets worth around 5 trillion (equalling roughly the economic size of Japan).[134] Therefore, the problem of too-big-to-fail is very much present outside the banking sector as well.

In the future, notwithstanding the abundance of Treaty and political obstacles some of which may seem insurmountable, a more functional and institutionally less constrained focus would be needed to appreciate the dynamism of global financial markets. To that end, before assessing the possibilities of broadening the scope of the EU's supervisory system and certain legal and other problems involved in such an endeavour, it is useful to look at the system that has been set up on the other side of the Atlantic.

4.2. *The US framework – The Financial Stability Oversight Council*

The U.S. has since 2010 had a new macro-prudential regulatory authority. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[135] established the Financial Stability Oversight Council (FSOC) which is tasked with identifying and responding to "the risks to the financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace".[136] The FSOC consists of a broad range of Federal regulatory bodies and is chaired by the Treasury Secretary.[137]

[130] Davies, "A capital-markets union is highly unlikely to end Europe's love affair with its banks." <www.project-syndicate.org>, 15 Feb. 2015.
[131] See also Moloney, op. cit *supra* note 87, p. 1631.
[132] On the institutional limits, see generally Moloney, ibid.
[133] Tucker, "The political economy of macroprudential regimes", in Schoenmaker (Ed.) *Macroprudentialism (*VoxEU.org, CEPR, 2014), p. 62. Tucker notes that in the case of Eurozone, it seems to be unclear whether there is a macroprudential authority or not: "Will the ECB's new microprudential body determine macroprudential policy for the currency area's banking system? What about capital markets and shadow banking? Or, as elsewhere in the EU, is macroprudential policy still a national competence within the monetary union?" Ibid.
[134] Nelson, "Bond swings so extreme even Blackrock rewrites risk measures", www.bloomberg.com, 15 June 2015.
[135] Pub L No 111-203, 124 Stat. 1376 (2010) (The Dodd-Frank Act).
[136] Section 112 of the Dodd-Frank Act.
[137] The Member Agencies of the FSOC are the Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Housing Finance Agency,

The FSOC not only oversees also non-bank financial companies but also has the power to subject them to enhanced supervision and prudential standards. Meeting certain requirements, the FSOC can designate a nonbank financial company as systemically important and thus subject the company to regulation by the Federal Reserve.[138] What is important, the FSOC can also designate "financial market utilities"[139] (including CCPs) as systemically important, or as likely to become such, and thus impose upon them more stringent regulatory requirements.[140]

The U.S. financial stability regime also makes possible the extension of emergency funding to systemically important non-bank financial companies as well as financial market infrastructures. Title VIII of the Dodd-Frank Act provides the Federal Reserve with the legal power to extend credit to critical financial market infrastructures through its discount window, which is normally preserved only for banks. The exercise of this option requires nevertheless the existence of "unusual or exigent circumstances" and the possibility is open only for those entities which have been designated systemically important.[141]

To date, the FSOC has designated as systemically important four non-bank financial companies[142] and eight infrastructure providers.[143] The majority of entities in the latter category are CCPs.

It should be noted that the FSOC's first steps have not been without troubles, and both its unpredictable decision-making and non-transparent procedures have faced criticism from the industry and the legislature.[144] Reportedly, the FSOC's powers remain limited and its jurisdiction contested even by domestic regulators.[145] Two bills have been presented regarding the authority and transparency of the FSOC. One seeks to make the Council more transparent and accountable, *inter alia* by opening its meetings to non-FSOC members. The other bill goes so far as to propose a one-year moratorium on systemic risk designations.[146]

National Credit Union Administration, Office of the Comptroller of the Currency, Securities and Exchange Commission, Treasury Department, Consumer Financial Protection Bureau.

[138]Section 113 of the Dodd-Frank Act.

[139]Defined under Section 803(6)(A) of the Dodd-Frank Act as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person."

[140]Section 804 of the Dodd Frank Act.

[141]Section 806 of the Dodd-Frank Act. The access of financial market infrastructures to Federal Reserve funding in times of stress through an express legislative provision is a novelty in the U.S. However, it has been argued that the Federal Reserve's powers prior to enactment of Dodd-Frank already allowed backstopping CCPs, and that the Dodd-Frank legislation therefore predominantly "maintains the status quo in which clearinghouses may borrow from the central bank under emergency circumstances" See Kress, op. cit. *supra* note 18, 84.

[142]These are The American International Group, General Electric Capital Corporation, Prudential Financial and Metlife. Metlife, however, disputed the finding and has challenged the designation in court. In addition, the FSOC has been reviewing the biggest asset managers (such as Blackrock) but it eventually decided to focus on certain stability threatening products and activities of the firms instead of using the catch-all systemic designation - not least because of heavy lobbying from the industry. See Chon and Foley, "Asset managers may escape systemic label", *Financial Times*, 31 July 2014. This is a part of a more global debate on how to manage systemic risks relating to fund management – a battle that the industry seems to be winning. Jopson and Foley, "Big US fund managers fight off 'systemic' label", *Financial Times*, 14 July 2015.

[143]See the list of designations at the website of the Financial Stability Oversight Council (Designations) <www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> (Last visited, 21 Oct. 2015). The designated firms are: The Clearing House Payments Company L.L.C. (on the basis of its role as operator of the Clearing House Interbank Payments System), CLS Bank International, Chicago Mercantile Exchange, Inc., The Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation, The Options Clearing Corporation

[144]Jopson and Chon, "MetLife to mount legal challenge to systemic risk label", The Financial Times, 13 Jan., 2015.

[145]Tucker, op. cit. supra note 133, p. 62.

[146]The Committee on Financial Services, Committee Approves TRIA, FSOC Reform Legislation, 20 June 2014. <financialservices.house.gov/news/documentsingle.aspx?DocumentID=385335> (Last visited, 12 Oct. 2015)

4.3 *Extending the scope of the EU financial stability regime*

It is evident that the time for complacency has not yet arrived in the EU. The Commission is pursuing both more integrated and better functioning Union capital markets, as well as the completion of its European supervisory foundations. A flagship project of the present Commission is to build a European capital markets union (CMU), with a specific objective of diversifying funding sources and reducing reliance on bank-based financing.[147] However, financial stability and systemic risk are not part of the CMU project, and in its present form the CMU entails no initiatives on further Europeanization of financial supervision and crisis management, but rather presents a classic single market reform programme of the Commission, aimed at market building through facilitating competition and free movement.[148]

Notwithstanding, the institutional limits of the EU's financial supervision and resolution framework are well recognized by top policymakers. The need to update and strengthen the Union's macroprudential toolkit was underlined in the recent report "Completing Europe's Economic and Monetary Union".[149] The Report acknowledges that deeper integration of EU capital markets will gradually increase demand for a supervisory framework that is designed to "ensure the solidity of all financial actors" and that this should ultimately lead to the creation of a "single European capital markets supervisor."[150]

The path towards a single European capital markets supervisor is no doubt rocky both politically and legally. After *UK* v. *ECB* (*location policy*) the path seems rockier and longer still. But turning back to the issue of CCPs, what is particularly interesting in *UK* v. *ECB* (*Location policy*) is that the General Court, after answering the question of the existence of the ECB's powers in the negative, pointed out what could be called an exit strategy. Whilst the ECB/ESCB Statute is a protocol annexed to the Treaties and therefore, as a rule, any change in it would require a treaty reform in accordance with Article 48 TEU,[151] the Court pointed to Article 129(3) TFEU, which provides an exception to this rule.[152] That provision enables the European Parliament and the Council, acting in accordance with the ordinary legislative procedure, to amend certain provisions of the ECB/ESCB Statute, including Article 22 (which gives the ECB regulatory powers, e.g. in order to ensure efficient and sound clearing and payment systems within the Union and with other countries). This would allow a significant extension of the ECB's rulemaking and oversight authority via qualified majority of votes, in other words, without the assent of the UK. To initiate the procedure, either a recommendation from the ECB or a proposal from the Commission would be needed. In light of the above, the General Court notes that

> "it would be for the ECB, should it consider that the grant to it of a power to regulate infrastructures clearing transactions in securities is necessary for proper performance

[147] Commission, "Building a Capital Markets Union", Green paper, COM(2015)63 final.

[148] As emphasized by Commissioner Jonathan Hill, "this is a classic single market project for all 28 Member States". A speech delivered at a Conference "Next Steps to Build a Capital Markets Union", Brussels, 8 June 2015. The Commission issued a communication on 30 Sept. 2015 detailing the steps and priorities of the CMU. Commission, "Action Plan on Building a Capital Markets Union", COM(2015)468 final.

[149] "The EU needs to continue to pay attention to potential new risks developing in the banking sector, including risks related to the shadow banking sector. Existing structures need to be able to detect risks to the financial sector as a whole. To this end, we should consider strengthening our macroprudential institutions, building on the role and powers of the European Systemic Risk Board (ESRB) while maximizing its synergies with the ECB", Report by Jean-Claude Juncker, (in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz), "Completing Europe's Economic and Monetary Union", p. 12.

[150] Ibid., p. 12.

[151] See e.g. Ziller, "The reform of the political and economic architecture of the eurozone's governance: A legal perspective", in Allen, Carletti, Simonelli (Eds.), *Governance for the Eurozone: Integration or Disintegration*, European University Institute Florence, Italy and Wharton Financial Institutions Center, University of Pennsylvania, Philadelphia, USA (FIC Press, 2012)

[152] *UK* v. *ECB (Location policy)*, para 108.

of the task [of promoting the smooth operation of payment systems under Art. 127(2) TFEU], to request the EU legislature to amend Article 22 of the Statute, by the addition of an explicit reference to securities clearing systems." (para 109)

The Court's interpretation is not without problems. Because the issue is in essence that of conferring on the ECB prudential oversight powers with regard to new financial entities, Article 127(6) TFEU would *prima facie* seem a more appropriate basis for such an action. That provision provides for the possibility of the Council to confer specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions (with the exception of insurance undertakings). Article 127(6) indeed provides the legal basis for the Single Supervisory Mechanism (SSM), too, but its downside for the Eurosystem is the requirement to reach a unanimous decision by the Council.[153] The language of Article 127(6) is also restrictive and possibly rules out the conferral of powers with respect to certain important non-bank financial entities (in addition to insurance firms) as well as resolution and restructuring powers.[154]

Another interesting question would be how exactly to locate such oversight powers within the ECB. The ECB argues that the need to oversee and regulate CCPs is crucial to properly execute its duty to oversee the functioning of payments systems (Art. 127(2) TFEU) because, again, "the failing of securities settlement systems could, indirectly, affect the smooth operation of payment systems."[155] In fact, the ECB has maintained that overseeing such systems is a constituent part of its primary duty to maintain price stability. However, prudential supervision of systemically risky financial institutions, at least when it comes to tasks such as stress testing, falls better within the domain of the ECB's supervisory authority, i.e. the SSM. In fact, several important euro area CCPs are legally licensed as banks. For instance, German law defines CCP clearing as a banking business and thus Eurex Clearing AB, a significant CCP based in Germany, acts under a banking licence.[156] However, in the Banking Union framework it is considered "less significant" and thus the day-to-day supervision is entrusted to national authorities and only indirectly to the SSM.[157] Another important eurozone CCP, the French LCH.Clearnet S.A., is not in the SSM's list of supervised entities despite also being licensed as a credit institution. Indeed, the EMIR does not regulate the question of whether CCPs should be licensed as credit institutions or as something else, though it did bring about a mandatory reauthorization process where each EU CCP, regardless of their authorization status, was reassessed and authorized to provide CCP services under the EMIR.

Therefore the business of CCPs, whether they operate under a banking licence or not, does not directly concern the ECB's supervisory arm under the SSM. Indeed, the SSM is built on the principle of *separation of monetary responsibilities from supervisory responsibilities*. This functional separation has been executed operationally respecting the constitutional position of the Governing Council as the ultimate decision-making body.[158] Article 25(2) of the SSM Regulation clearly states that the ECB shall carry out the tasks conferred on it by that Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. Operational separation also means that the respective staff carrying out

[153]Democracy concerns should not be overlooked here either, as Art. 127(6) does not require Parliament approval.
[154] A very restrictive reading of Art. 127(6) is set forth in Kern, op.cit. *supra* note 129.
[155]Case T-496/11, *UK* v. *ECB (location policy)*, para 47.
[156]BIS, op. cit *supra* note 76, p. 115.
[157]See the list of supervised entities available from the SSM website: <www.bankingsupervision.europa.eu/ecb/pub/pdf/list_sse_lsi.en.pdf?492828653da06f7b24babd65e9e3077c> (Last visited 12 Oct. 2015)
[158]See Goyal et al., op. cit. *supra* note 114, p. 24.

the SSM-related tasks must be organizationally separated from, and subject to separate reporting lines, from the staff involved in carrying out the ECB's other tasks.[159]

Such operational separation seems to result in an interesting outcome: the oversight of financial market infrastructures such as CCPs would be a task conducted by the ECB under its monetary policy and payment systems-related mandates, whereas the prudential supervision of banks would remain a task solely reserved for the SSM. Furthermore, these supervisory tasks would have to be separated from each other, both functionally and operationally. This would not seem like an optimal arrangement. Comparison can again be made to the Financial Stability Oversight Council in the U.S., which has a broad and functionally defined systemic risk mandate and which involves every important regulator sitting at the same table. If such consolidation of powers, both vertically and horizontally, is to be pursued in the European Union, the question will arise whether the ECB is the best location for such powers. In any case, a more thorough and functional exercise would then be more likely, given that such a project, especially if the target is not limited to CCPs, would in all likelihood not fit within the present Treaties.

5. Tensions in the Economic Constitution of the EU: Stability vs. free movement

The Maastricht principles expressly provided that Member States will continue to bear the primary responsibility for the prudential supervision of financial institutions as well as the stability of the financial system (principles that were left untouched by subsequent Treaty amendments[160]). The crisis era reforms in the area economic and fiscal policy convergence as well as the creation of EU competences with respect to prudential supervision of financial institutions are gradually invalidating these principles, but the EU's financial stability regime remains a young phenomenon and it is built on a constitutional foundation that is far from solid, especially if compared to the Union's microeconomic constitution.

Macroeconomic and microeconomic constitutions are fundamentally different both in terms of scope and nature. First, the macroeconomic constitution created by the Maastricht Treaty is a constitution not shared by all Member States of the European Union. This bifurcated constitutional reality of the Union has become increasingly salient during the financial and eurozone crises.[161] In terms of the nature of the constitutions, the following distinction is analytically helpful: whilst the microeconomic layer of the European Economic Constitution has aimed at overcoming *legal* diversity and is supported by a well-developed and extensive body of free movement and competition law, moulded respectively in the practice of the ECJ and the Commission's competition enforcement practice, the macroeconomic stability constitution is more vulnerable and less susceptible to juridification basically because it is more about overcoming *policy* diversity.[162]

Moreover, the concept of financial stability, which is central to the macroeconomic constitution, is economically more problematic and politically more contestable than the economic paradigm behind the microeconomic constitution.[163] From the perspective of a central bank, price stability as a policy goal is simpler than financial stability.[164] The financial

[159]Art. 25(2) of the SSM Regulation.
[160]Tuori and Tuori, op. cit. *supra* note 13, p. 36. On the concept of European economic constitution and the division between micro-economic and macro-economic constitution, see p. 37 et seq. and also Tuori, op. cit. *supra* note 13*,* Chapters 6 and 7.
[161]Tuori, op. cit. *supra* note 13*,* p. 200.
[162]See Tuori, op. cit. *supra* note 13,p. 175, 209.
[163]Tuori and Tuori, op. cit. *supra* note 13, p. 39
[164]As Lastra observes: "The relative simplicity of one goal (price stability) – one instrument (monetary policy) that characterizes the monetary responsibilities of central banks contrasts with the multiplicity of instruments (supervision, regulation, crisis management, lender of last resort and others) that characterizes the pursuit of financial stability." Lastra, op. cit. *supra* note 107, p. 19.

and economic crises are nevertheless gradually changing central banking, also in Europe. Financial stability as a policy objective, despite its inherent ambiguity, is reaching the importance of the more traditional target of price stability. Schoenmaker observes that "central banks are returning to their roots by re-assuming a broad mandate" with respect to financial stability.[165] Goodhart also remarks that though financial stability is often not a part of the original mandate of modern central banks, this has not stopped them diversifying their tasks as "clauses relating to such matters as maintaining a well-running payment systems were stretched in concept to cover financial stability overall as well."[166] As the recent case law has made clear, these tendencies have been very much present in Europe as well. In *OMT,* the ECB's price stability mandate was stretched, with certain caveats and conditions, to cover possibly extensive open market operations (which were even conditional on the agreed bail-out terms of the Troika, amongst other things). According to one interpretation financial stability has already replaced price stability as the overriding policy objective.[167]

What does this mean for the Union's microeconomic constitution? The microeconomic constitution is built on fundamental economic freedoms which, through the doctrine of direct effect, have been transformed into enforceable private rights; the macroeconomic constitution, on the other hand, is defined more in terms of broad objectives and policies.[168] The effective execution of macroeconomic policies, a pursuit considered by some "more art than science",[169] also requires discretionary powers and more diverse toolkits. Insofar as the financial stability-oriented regulatory or policy measures do not violate the concrete individual rights that form the core of the microeconomic constitution, the two constitutions, despite their differences, can most likely coexist peacefully. But when they conflict, choices between statutory objectives must be made and this can prove difficult especially in the bifurcated constitutional reality of the two-speed European Union. It is commonly suggested that financial stability concerns should prevail over, for instance, soundness of individual financial institutions or "microprudentialism" more generally.[170] But when the conflict is that between financial stability motivated restrictions on the provision of services and the fundamental principles as established by the EU's free movement law, striking the balance will become a nightmarish exercise. Inter-institutional conflicts might not be avoided either.

UK v. *ECB (Location policy)* is an apt demonstration of a situation where the exercise of new EU level competences and forms of direct administration related to the objective of financial stability can result in an outright conflict with basic free movement rights. What the ECB policy tried to achieve was nothing less than a systematic market foreclosure of euro area markets for certain financial entities operating into the eurozone from the non-euro Member States. Perhaps most strikingly, *UK* v. *ECB* (Location policy) coincided with difficult and ongoing transatlantic talks on mutual recognition of CCPs between the U.S. and EU. One of the most difficult topics in the talks has been the mutual recognition of regulatory frameworks for CCPs, which would enable the use of each region's CCPs by their respective market participants without costly additional capital penalties.[171] Stakes are getting higher as suggestions have already been made about possible restrictions on access to U.S. market for EU CCPs, in case agreement is not reached.[172] Interestingly, these talks have been led by the ESMA and the Commission with no apparent involvement from the ECB. Against such

[165]Schoenmaker, "Introduction", in Schoenmaker op. cit. *supra* note 133, p. 2.
[166]Goodhart, "The use of macroprudential instruments", in Schoenmaker ibid., p. 12.
[167]Tuori, op. cit. *supra* note 13, p. 196-197.
[168]Ibid., p. 149, 209-210.
[169]Schoenmaker, op. cit. *supra* note 165, p. 1.
[170]See ibid., p. 4. According to Tucker "hierarchy of statutory objectives is warranted, with stability coming first", p. 71.
[171]See Stafford, "Europe and US fail to agree on derivatives rules", *Financial Times*, 7 May 2015; Stafford, "EU and US aim for May deal on derivatives clearing", *Financial Times*, 24 April 2015.
[172]Ibid.

international negotiations, it seems peculiar that at the same time the ECB was defending in court its policy aimed at restricting altogether market access to the euro area of certain systemic CCPs from *inside* the EU (even if the restriction would have been triggered only after reaching certain quantitative thresholds).

The attempted restrictions also coincide with the ongoing endeavour by the EU legislature to create a pan-EU level-playing field for post-trade financial market infrastructures. In fact, the EMIR is designed to prevent direct and indirect forms of discrimination against CCPs located in *any Member State* or against a Member State or a group of Member States as a venue for CCPs.[173] This general principle is further enforced by the MiFID II (Markets in Financial Instruments Directive, as revised[174]) which, for instance, requires that Member States ensure that investment firms from other Member States have the right to access CCPs in their territory and that such access is subject to the same non-discriminatory, transparent and objective criteria.[175]

These tensions are symptomatic of a deepening division between the "ins" and the "outs" of the Eurosystem, which is a "transitional period of unknown duration".[176] Similar concerns have been expressed in the context of the Banking Union as well. As noted by Andrea Enria, in case of important disagreements between the ECB as a single supervisor and the authorities of non-participating countries, "there is a potential risk that a greater degree of flexibility will be maintained at the EU level, while the SSM will move to more homogeneous rules and supervisory practices."[177] In the longer run there is a clear risk that such a two-speed Union generates "a rift within the Single Market."[178]

To conclude, the financial and eurozone debt crises have caught the EU's single financial market between the Scylla of disintegration and gradual return to protectionism, a likely outcome of a failure to erect adequate supervisory and crisis management systems,[179] and the Charybdis of the "uneasy coexistence"[180] with the Banking Union and the organically expanding financial stability mandate of the ECB.

6. Concluding remarks

This article analysed the implications of and the several legal problems involved in *UK* v. *ECB (Location policy)*, where the General Court determined that the ECB does not have competence to regulate CCPs or securities settlement systems and thus annulled a Policy Framework of the ECB insofar as it imposed on CCPs involved in the clearing of securities a requirement to be located within the euro area.[181] Three broad problems of the case were

[173]E.g. recital 47 of the EMIR provides that "A CCP might be established in accordance with this Regulation in any Member State. No Member State or group of Member States should be discriminated against, directly or indirectly, as a venue for clearing services. Nothing in this Regulation should attempt to restrict or impede a CCP in one jurisdiction from clearing a product denominated in the currency of another Member State or in the currency of a third country. Art. 17(6) of the EMIR further provides that: "no proposal or policy of any member of a college of supervisors should, directly or indirectly, discriminate against any Member State or group of Member States as a venue for clearing services in any currency."

[174]Directive 2014/65/EU of 15 May 2014 on markets in financial instruments, O.J. 2014, L 173 (MiFID II).

[175]Art. 37(1) and 37(2) of the MiFID II.

[176]Lastra and Louis, "European Economic and Monetary Union: History, trends, and prospects", (2013) YEL, 128.

[177]Enria, "Establishing the Banking Union and repairing the Single Market" in Allen, Carletti, and Gray (Eds.), *Political, fiscal and Banking Union in the Eurozone?* (FIC Press, 2013), p. 60.

[178]Ibid.

[179]Avgouleas and Arner, "The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform", University of Hong Kong, Faculty of law research paper No. 2013/037 (2013), available via <ssrn.com/abstract=2347937>

[180]Lastra, op. cit. *supra* note 115, 1190.

[181]Case T-496/11, *UK* v. *ECB (location policy)*, para 110.

assessed: first, it was shown that CCPs are systemically important financial market infrastructures which play a dominant risk management role especially in the market for OTC derivatives. Such position of CCPs would warrant more European oversight, but this would not solve the ECB's problem that most important CCPs in Europe are established in London outside the regulatory and supervisory grip of the Eurosystem. Second, the article argued that depriving the ECB of powers with respect to such critical financial market infrastructures is symptomatic more generally of certain structural design issues in the Union's evolving financial stability regime. The regime is too focused on banks and therefore we should welcome the initiatives on developing the regime towards a more functional and comprehensive framework for the management of systemic risks stemming from the entire financial system. Finally, the article pinpointed certain risks involved in the gradual expansion of the ECB's mandate and toolkit as the guardian of the financial stability of the euro area. As *UK* v. *ECB (Location policy)* made clear, the financial stability mandate or macroeconomic constitutionalization more generally will be able to coexist with the Union's foundational microeconomic constitution only insofar as the new powers are not exercised in a manner that violates the core rights guaranteed by established free movement law. The article nevertheless anticipates that such conflicts might be inevitable. The occasionally conflicting rationalities of stability on one hand and competition and free movement on the other, present perhaps the biggest danger in terms of further deepening the jurisdictional wedge between the "ins" and the "outs" of the eurozone.