

**Reconciling Lopsided Mandates, Secondary Objectives and the
Importance of Sustainability:**

***The Role of the European Central Bank in the Single Supervi-
sory Mechanism***

Abstract

The article analyses the institutional and legal framework governing the ECB's monetary policy competence to promote price stability alongside its banking supervisory objectives as set forth under the Single Supervisory Mechanism Regulation. The article argues that the ECB's primary mandate to promote price stability in the EU Treaty creates an imbalance in its institutional competence to pursue other secondary objectives referred to in the Treaty and in EU legislation. It is further argued that this so-called lop-sided mandate in favour of the price stability objective may undermine its effectiveness in pursuing other objectives, such as banking sector stability, climate change mitigation and in addressing other emerging financial risks. The article proposes some modifications to the current separation of competences within the ECB in order to achieve more institutional balance so that its objectives can be more effectively carried out.

Keywords: Banking Union, Single Supervisory Mechanism, European Central Bank, banking supervision, price stability, secondary objectives, monetary policy, economic policy, sustainability, regulation

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1. Introduction

This article analyses the European Banking Union's Single Supervisory Mechanism (SSM) and the role of the European Central Bank (ECB) as bank supervisor in the context of the ECB's primary monetary policy objective of price stability and the growing recognition for the ECB to address so-called secondary objectives such as financial stability, environmental protection and social solidarity. In doing so, it analyses the ECB's and the Banking Union's SSM's institutional and legal structure and assesses whether or not it is achieving its Treaty mandated objective of price stability (Article 127 (1) of the Treaty on the Functioning of the European Union (TFEU)) and what it can do as a bank supervisor within the SSM framework to support financial stability and related economic policies of the European Union (EU) such as mitigating climate change. Following this introduction Part 2 addresses how the ECB's price stability objective in Article 127 (1) can be interpreted in light of its so-called secondary objectives (Article 3 (3) of the Treaty on European Union (TEU)) to support the general economic policies of the Union, such as protecting the environment, promoting a competitive economy, and providing social solidarity. Part 3 analyses the SSM and the ECB's role as a bank supervisor and some of the challenges of ensuring that the ECB addresses evolving risks such as climate change that may affect banking sector stability. Part 4 discusses the need for central banks to coordinate monetary policy with banking supervision as part of broader macro-prudential policy and the specific legal and regulatory challenges for the ECB in discharging these responsibilities within the SSM. Part 5 concludes an extensive literature has arisen analysing the ECB and the Banking Union.² The article raises concerns about the future effectiveness of the SSM in light of the ECB's monetary policy functions and its principal primary objective to maintain price stability. The article argues that there is an asymmetric imbalance between the ECB's treaty-based objective to promote price stability and the ECB's powers as a bank supervisor that derive from EU secondary legislation. The article suggests that this imbalance hinders the ECB's efforts to carry out its supervisory role in an effective manner particularly given the growing importance of broader supervisory tasks to reduce climate change risks in the banking system whilst promoting other environmental and social sustainability risks. Indeed, this article is the first to analyse critically the asymmetric imbalance between the ECB's price stability

² See Fabian Amtenbrink and Christoph Herrmann, *The EU Law of Economic and Monetary Union* (Oxford: OUP, 2020) (containing forty two chapters analysing various aspects of EU financial services law and the institutional developments of the ECB and the Banking Union). See also, Danny Busch and Guido Ferrarini, *European Banking Union* (2nd ed, Oxford: OUP, 2019).

mandate and its legal and institutional competence as set forth in the Single Supervisory Mechanism Regulation to carry out its bank supervisory tasks. Commentators previously argued prior to the creation of the Banking Union and the SSM that Article 105 (5) of the Maastricht Treaty (today article 127 (5) TFEU)³ had authorised the ECB to engage in a limited supervisory role in supporting the smooth conduct of policies pursued by member state competent authorities relating to the prudential supervision of Euro area banking institutions.⁴ This article develops this scholarship in the direction of critically analysing the ECB's role as a bank supervisory within the institutional context of the Banking Union and according to the legal framework that governs its monetary policy function to promote price stability.

2. The ECB's Mandate

2.1 Price Stability

Understanding the ECB's mandate is very important for understanding how it will exercise its competences in the SSM. Indeed, this question was explored as part of the ECB's review of its monetary policy mandate that began under the stewardship of President Christine Lagarde in 2019 and was published in 2021.⁵ The 2021 Strategy Review reaffirms that price

³ Article 127 (5) TFEU states: "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to prudential supervision of credit institutions and the stability of the financial system."

⁴ See Mads Andenas, *Harmonising and Regulating Financial Markets*, in Mads Andenas and Camilla Andersen, *Theory and Practice of Harmonisation* (Cheltenham UK, Northampton USA: Edward Elgar Publishing, 2010), and Nordic & European Company Law Working Paper No. 10-08 <<https://ssrn.com/abstract=1685971>> accessed 16 Sept. 2021. Professor Andenas initially developed the argument that Article 127 (5) provided the legal basis for the ECB to coordinate banking supervision and policies in Mads Andenas and Christos Hadjiemmanuil, *Banking Supervision, The Internal Market and European Monetary Union*, in Mads Andenas, *European Economic and Monetary Union: the Institutional Framework*, 373 (London, Dordrecht: Kluwer Law International, 1997). See also Mads Andenas and Lazaros E. Panourgias, *Applied Monetary Policy and Bank Supervision by the ECB*, in Joseph J. Norton and Mads Andenas, *International Monetary and Financial Law Upon Entering the New Millennium. A Tribute to Sir Joseph and Ruth Gold*, 119 (London: BIICL, 2002) (developing this argument that the ECB had competence for supervisory oversight of member state authorities). See also Mads Andenas, *Who is Going to Supervise Europe's Financial Markets*, in Mads Andenas and Yannis V. Avgerinos, *Financial Markets in Europe: Towards a Single Regulator, with a Foreword by Charles Goodhart*, xv-xxvi (London, The Hague, New York: Kluwer Law International, 2003) (developing the argument further that Article 127 (5) provided the legal basis for the ECB to coordinate member state supervision and adopt supervisory policies).

⁵ Mario Draghi, *We Face a War Against Coronavirus and Must Mobilise Accordingly*, Financial Times (25 March 2020); Christine Lagarde, *Hearing at the Committee on Economic and Monetary Affairs of the European Parliament* (2019) <<https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp191202~f8d16c9361.en.html>> accessed 16 Sept. 2021; Prudential Regulation Authority (PRA), *Transition in Thinking: The Impact of Climate Change on the UK Banking Sector* (2018) <<https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector.pdf>> accessed 16 Sept. 2021; Benoît Cœuré, *Monetary Policy and Climate Change*, Speech at the Bundesbank-NGFS-CEP Conference on Scaling up Green Finance: The Role of Central Banks (8-9 November 2018) <<https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp181108.en.html>> accessed 16 Sept. 2021; Guy Debelle, *Climate*

stability is the all-encompassing objective that shapes and informs the ECB's fulfilment of its various functions. Generally, price stability emerged as the primary objective for most central banks in the late 1980s following the dramatic inflation and stagflation experienced by most advanced developed countries in the 1970s and 1980s. Based on this experience, a consensus view developed amongst central bankers that the only effective way to control inflation was for central banks to use mainly interest rates to achieve an inflation target that was defined by either the Government or the Central Bank. Moreover, it was considered necessary that central banks have independence from political influence in deciding which tools they could use to achieve their price stability objective. The EU Maastricht Treaty of 1992 (Maastricht Treaty) adopted a model based on independence for the newly-created ECB, Article 105 (1) EC providing that the ECB's primary objective shall be price stability. This mandate is now set forth in clear terms in Article 127 (1) TFEU:

“The primary objective of the European System of Central Banks (hereinafter referred to as ‘ESCB’) shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.”

Whilst Article 127 (1) TFEU establishes the primacy of the price stability mandate, it does not give a precise definition of what is meant by price stability. The ECB Executive Board has therefore defined price stability to be a quantitative target that is “defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%” and clarified that, in the pursuit of price stability, it aims to maintain inflation rates “below, but close to, 2% over the medium term.”⁶

The typical way the ECB works to achieve its price stability objective is by utilising a number of monetary policy tools, which include setting interest rates on inter-bank loans and creating credit for the banking system by electronically printing money, which can be used to purchase

Change and the Economy, Speech Reserve Bank of Australia (2019)

<<https://www.rba.gov.au/speeches/2019/pdf/sp-dg-2019-03-12.pdf>> accessed 16 Sept. 2021.

⁶ European Central Bank (ECB), *The Definition of Price Stability* (2020), <www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html> accessed 16 Sept. 2021.

In the *Weiss* case, Judgment, *Weiss and Others v ECB*, C-493/17, EU:C:2018:1000, the Court of Justice of the European Union (CJEU) agreed that the 2% interpretation was proportionate, saying it is for the ECB to decide and that 2% does not appear manifestly erroneous (para. 56).

assets, such as bonds issued by banks, corporates, and governments with the effect of stimulating the economy to achieve the 2% price stability objective.

Until now and historically, the ECB has been focused on maintaining price stability that is defined as a 2% consumer price inflation target. This narrow definition of price stability was adopted based on macroeconomic models that assume markets are efficient and that an open-market economy with free competition results in an efficient allocation of resources, but as mainstream economists have pointed out this ignores standard economic theory and empirical evidence that markets are prone to failure and that government regulation is necessary to reduce moral hazard and to curb externalities.⁷ During the early years of the euro, the ECB was generally inconsistent in achieving its inflation target between 2001 and 2008 while between 2008 and 2012 not only did it fail to achieve its inflation target it presided over record fluctuations in output and employment, which were caused by the financial crisis of 2007-08 (global financial crisis, GFC).⁸ The crisis underscored the ECB's disproportionate attention to price stability at the expense of growth, employment and financial stability. Inadequate regulation resulted in weak banking systems, which led to member state bailouts of banks and in turn to the European sovereign debt crisis of 2012. Between 2012 and 2020, inflation was below target more often than not and in some cases below 0%, which is deflation.⁹ Beginning in 2021, the economic crisis caused by Covid-19 has created the spectre of deflation.¹⁰ These developments have brought the secondary objectives of the ECB to the forefront, such as the objective of supporting the general economic policies of the EU, including "sustainable development", "full employment and social progress", and "a high level of protection and improvement of the quality of the environment".¹¹ The ECB's overall failure since 2001 to achieve its primary objective

⁷See Joseph Stiglitz, *The Euro: And its Threat to the Future of Europe*, 146-149 (USA, UK: Penguin/Random House, 2016). See discussion in Kern Alexander, *Principles of Banking Regulation*, 37-42 (Cambridge: CUP, 2019).

⁸ Ibid. See Statistical Data Warehouse ECB, *Inflation rate from 01 Jan. 2000 until 31 Dec. 2012*, <[ECB Statistical Data Warehouse \(europa.eu\)](https://www.ecb.europa.eu/press/pr/inf/20120101/index.html)> accessed 16 Sept. 2021.

⁹ ECB, *Economic Bulletin* 8, 30 (2020); Eurostat, *Inflation in the Euro Area* (2021) <[https://ec.europa.eu/eurostat/statistics-explained/index.php/Inflation in the euro area#Euro area annual inflation rate and its main components](https://ec.europa.eu/eurostat/statistics-explained/index.php/Inflation_in_the_euro_area#Euro_area_annual_inflation_rate_and_its_main_components)> accessed 16 Sept. 2021; Michael Heise, *The ECB Has Consistently Missed the Mark on Inflation – Here's How it Can Change That*, WEF (2019) <https://www.weforum.org/agenda/2019/07/the-ecb-needs-new-inflation-rules/> accessed 16 Sept. 2021. See also Stiglitz, n. 7, 63-71

¹⁰ See Martin Arnold, *Eurozone Slide into Deflation for the First Time in Four Years* Financial Times (1 Sept. 2020).

¹¹ Art. 3 (3) TEU, providing:

"The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy,

of price stability and to achieve adequate growth targets in comparison with other advanced developed economies raises questions regarding its accountability and independence. The ECB is vested with a high degree of independence, which is closely linked to its objective of maintaining price stability.¹² The primacy of price stability is based on the idea of monetary dominance which came to the fore in the 1980s and 1990s. Monetary dominance postulates apolitical, technical monetary policies targeting low inflation and can be seen as reaction to the experiences of the 1970s where central banks were pushed by governments for monetary stimuli for the economy. The idea behind monetary dominance was based on the notion that governments would be forced to abandon expansive monetary policies to stimulate demand and instead push economic growth by improving the supply side of the economy by incentivising investment and the training of the workforce through fiscal and other economic policies. The appeal of this idea that monetary policy should merely be concerned with technical issues in managing the value of the currency which is unrelated to economic policy was underpinned by the economic success of Germany and its independent *Bundesbank*.¹³ Accordingly, in the Maastricht Treaty monetary and economic policy were separated.¹⁴ Further, the Maastricht Treaty ensured strong independence for the ECB to protect its decision making from political influence.¹⁵

The separation of monetary from economic policy, however, created asymmetries between the monetary union and the economic union which have led to a divergence of monetary and economic integration causing systemic vulnerabilities.¹⁶ These tensions came to the fore when the ECB adopted expansive asset purchase programmes following the then ECB President Draghi's promise "to do whatever it takes" to protect the euro that had the effect of lowering funding costs for fiscally distressed euro area member states and to prevent macroeconomic

aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance."

¹² Michael Ioannidis, *The European Central Bank*, in Fabian Amtenbrink and Christoph Herrmann, *The EU Law of Economic and Monetary Union*, 14.51 (Oxford: OUP, 2020).

¹³ Darius Adamski, *Objectives of the EMU*, in Fabian Amtenbrink and Christoph Herrmann, *The EU Law of Economic and Monetary Union*, 9.15-9.18 (Oxford: OUP, 2020); for an overview of the critique on price stability as primary monetary objective see Tommaso Padoa-Schioppa, *Regulating Finance: Balancing Freedom and Risk*, 112 (Oxford: OUP, 2008).

¹⁴ See Adamski, *supra* n 13, 9.16-19.18.

¹⁵ See Ioannidis, *supra* n 12, 14.51-14.52.

¹⁶ Cornelia Manger-Nestler, *The Architecture of EMU*, in Fabian Amtenbrink and Christoph Herrmann, *The EU Law of Economic and Monetary Union*, 8.8-8.15 (Oxford: OUP, 2020); Christian Joerges, *Pereat Iustitia, Fiat Mundus, What Is Left of the European Economic Constitution After the Gauweiler Litigation* 23 *Maastricht Journal of European and Comparative Law* 108 (2016).

disparities across the Eurozone. Some of the ECB's asset purchase programmes were challenged on constitutional grounds as not falling within its mandate to promote price stability and as a violation of the prohibition on the ECB's monetary financing of member states as set forth in Article 123 (1) TFEU.¹⁷ Yet, in the *Weiss* case, the CJEU ruled in 2018 that one of the ECB's asset purchase programmes, the Public Sector Purchase of Bonds programme (PSPP), was indeed lawful.¹⁸ The ECB's expansion of its asset purchase programmes continued during the Covid-19 economic lockdown in 2020 with its adoption of the Pandemic Emergency Purchase Programme (PEPP).¹⁹ Although the PEPP is temporary in nature, it has paved the way for the adoption of future asset purchase programmes that provide a more systematic way of supporting and mainstreaming the ECB's pursuit of its secondary objectives as part of supporting the general economic policies of the EU.

In addition, the COVID-19 pandemic and the ECB's increasing use of asset purchase programmes and other financing measures to support bank lending during the pandemic-induced slowdown demonstrates how the ECB can support national governments with the use of monetary policy measures to support the stabilisation and recovery of the Eurozone economy. Under Article 3 TEU, an important aspect of this is for the ECB to ensure that its monetary policy tools seek to promote price stability and while supporting broader EU policies in the areas of climate adaptation and mitigation and the effects of the COVID-19 crisis, in line with the principle of solidarity. But the *Weiss* case holds that the ECB's use of such measures must accord with the EU constitutional principle of proportionality as developed within the confines of the Article 123 (1) CJEU jurisprudence.²⁰ In spite of the legal focus on proportionality in assessing the legal validity of the ECB's use of monetary policy tools to address economic policy challenges that threaten the price stability objective, there is a growing body of research challenging the distinction between monetary and economic policy as not reflecting economic reality.²¹ According to this view, monetary policy that focuses on price stability has distributional consequences for society. Hence, it cannot be separated from economic policy and thus cannot be

¹⁷ Alicia Hinarejos, *Gauweiler and the Outright Monetary Transactions Programme: The Mandate of the European Central Bank and the Changing Nature of Economic and Monetary Union* 11(3) European Constitutional Law Review 563-576 (2015).

¹⁸ Judgment, *Weiss and Others v ECB*, C-493/17, EU:C:2018:1000, supra n 6, upholding the programme as meeting the proportionality requirement of EU law.

¹⁹ The ECB adopted PEPP in March 2020 at €750 billion and increased it to €1.3 trillion on 4 June 2020.

²⁰ See Judgment, *Weiss and Others v ECB*, C-493/17, EU:C:2018:1000, supra n 6.

²¹ Fabian Amtenbrink and René Repasi, *The German Federal Constitutional Court's Decision in Weiss: A Contextual Analysis* 45(6) European Law Review 757, 759-763 (2020); Kathleen McNamara, *Rational Fictions: Central Bank Independence and the Social Logic of Delegation* 25(1) West European Politics 47, 54 (2002); Joseph Stiglitz, *Central Banking in a Democratic Society* 146(2) De Economist 199, 210-212 (1998).

deemed apolitical.²² Consequently, rethinking the balance between the ECB's asymmetric architecture of the monetary union and the pursuit of other objectives such as supervisory objectives to support financial stability while supporting the general policies of the EU appears necessary.

2.2 ECB's Secondary Objectives

The ECB's secondary objectives are referred to in Article 127 (1) TFEU which makes clear reference to Article 3 (3) TEU that defines broadly the secondary objective of the European System of Central Banks (ESCB) to support the economic policies of the EU, including to 'establish an internal market' which, among other things, supports 'the sustainable development of Europe', 'a highly competitive social market economy', 'a high level of protection and improvement of the quality of the environment', and 'shall promote scientific and technological advance.'

The Treaty provisions are less clear in defining the ECB's role in supporting the general economic policies of the EU – also known as the ECB's "secondary objectives". It can be maintained, however, that the starting point for analysing the ECB/ESCB's support for the general economic policies of the EU forms both an implicit part of the ECB's primary price stability objective and an explicit part of its secondary objectives. For instance, regarding the ECB's pursuit of its secondary objective in Article 3 (3) TEU to support "a high level of protection and improvement of the quality of the environment", the objectives of price stability and environmental sustainability are interlinked. Price stability is a precondition for environmental protection policies to succeed. Stable nominal prices are key to enabling the market to interpret correctly relative price signals. Simultaneously, timely and forceful environmental mitigation policies will diminish the effects on inflation and growth of environmental degradation. Hence, from a medium to longer-term perspective, one may surmise that price stability and environmental sustainability are mutually reinforcing policy objectives. Similarly, another secondary objective to support financial stability can be interpreted in Article 127 (5) TFEU that states: "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to prudential supervision of credit institutions and the stability of the financial system." While the GFC demonstrated the importance of financial stability for central banks, financial stability was not considered at the time the Maastricht Treaty was signed in 1992 as

²² McNamara, n. 21, 54-55; and Stiglitz, supra n. 7, 149-150.

relevant to the “primary” goal of price stability.²³ Indeed, while the wording of the Treaty is clear: “The primary objective of the European System of Central Banks shall be to maintain price stability”, the language of Article 127 (5) TFEU is much less forceful and suggests that the Treaty language adopted in 1992 simply reflected the division of responsibilities at that time.

The “basic” task conferred by the Maastricht Treaty onto the ECB was monetary policy (one goal: price stability, one instrument: monetary policy) while prudential supervision remained decentralised at the level of the member states. However, there is now a consensus that the neglect of financial stability considerations in the early 2000s and inadequate supervision by member state national competent authorities (NCAs) contributed to the GFC. So consideration of the ECB’s role in financial stability (recognised in Articles 127 (5) TFEU and 3.3 of the ESCB Statute), including any role it may exercise as a bank supervisor, should be assessed in terms of how it supports the ECB’s principal objective of price stability. In other words, the ECB’s role in financial stability is secondary to its primary mandate of price stability. Indeed, as discussed below, even with the Banking Union, the ECB’s secondary objective of financial stability is shared with other member state authorities and European institutions and bodies, which have a more primary and direct responsibility for financial stability, including member state authorities having explicit competences for financial stability, including the use of macro-prudential supervisory tools. In the EU, the pursuit of financial stability transcends geographic boundaries and institutional mandates. It is a fundamental public good for the euro area and also for the single market in financial services.

The other condition mentioned in Article 127 (1) TFEU, namely to act in accordance with the principle of an open market economy with free competition and favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119 TFEU is a general statement of respect for market economics in the workings of the ESCB.²⁴ The potential limitations imposed by the Treaty principle of an open market economy – also referred to as market neutrality – should be considered in the context of the secondary objective of “protect[ing] and improve[ing] the quality of the environment”. In light of the climate change debate, in which environmental sustainability risks continue to be mispriced because of multiple market failures in the European financial system, it is questionable whether the market neutrality principle applies at all. The legal rationale of the principle of an open market economy, namely, that it

²³ See Rosa M. Lastra, *International Financial and Monetary Law*, 1265 (2nd ed, Oxford: OUP, 2015).

²⁴ This is also the case for the EU and the member states under Arts 119 and 120 TFEU.

favours “an efficient allocation of resources”, no longer holds true in the face of dysfunctional markets, which arise from the physical and transition risks of environmentally unsustainable economic activity. Moreover, the absence of market neutrality is demonstrated most clearly by the distortions that the ECB itself directly creates in the financial system through its extensive asset purchase programmes and related quantitative easing measures that have substantially disrupted the market price of financial assets. But even if this vague principle were applied, monetary measures to counteract existing market failures and other distortions may still be necessary and proportionate in that their benefits for price stability may outweigh the costs or obstacles posed to an open market economy.

The ECB’s Monetary Policy Strategy Statement,²⁵ published in July 2021, recommended only marginal changes for the ECB in its conduct of monetary policy including adopting a more flexible range in its inflation target that is symmetric - protecting against deflation as well as inflation.²⁶ The ECB also observed that “[c]limate change has profound implications for price stability through its impact on the structure and cyclical dynamics of the economy and the financial system.”²⁷ Crucially, the ECB further stated that “the Governing Council is committed to ensuring that the Eurosystem fully takes into account, in line with the EU’s climate goals and objectives, the implications of climate change and the carbon transition for monetary policy and central banking.”²⁸ It further stated that the Governing Council would commit “to an ambitious climate-related action plan” that would involve a “comprehensive incorporation of climate factors in its monetary policy assessments” and that the Governing Council “will adapt the design of its monetary policy operational framework in relation to disclosures, risk assessment, corporate sector asset purchases and the collateral framework.”²⁹ This marks a potentially significant shift in the ECB’s recognition of secondary objectives that are EU economic policies, such as mitigating climate change risks, and how they might impact the ECB’s pursuit of its primary objective of maintaining price stability. Nevertheless, it remains to be seen what monetary tools the ECB will use to support European economic recovery from the COVID-19 crisis and the use of supervisory tools to stabilise and support the banking sector in providing

²⁵ European Central Bank, *ECB’s Monetary Policy Strategy Statement* (2021) <https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html> accessed 16 Sept. 2021.

²⁶ *Ibid*, para. 5.

²⁷ *Ibid*, para. 10.

²⁸ *Ibid*, para. 10.

²⁹ *Ibid*, para. 10.

more credit to sustainable economic sectors. In the euro area, the different jurisdictional domains of the EU and the member states (of the euro area) make it difficult for the ECB to reconcile the pursuit of the primary and the secondary objectives, as well as for the ECB to coordinate its pursuit of its secondary objectives in a decentralised manner with member state economic and fiscal policies.

As already noted, whilst price stability in the euro area is an EU objective pursued by a single centralised monetary policy, the pursuit of the secondary objectives, including environmental protection and financial stability, relies upon decentralised fiscal policies and financial stability measures (subject to coordination). During the Covid-19 crisis, member state fiscal mechanisms and funding have been challenged but the adoption of the EU Recovery Plan consisting of the Multiannual Financial Framework (€1,074 bn ordinary budget) and the Next Generation EU (€750 bn extraordinary budget) demonstrates improved member state fiscal coordination in comparison with the post-crisis response to the GFC.³⁰ In contrast, in countries such as the United Kingdom, where the jurisdictional domain of monetary, financial and fiscal policy is coordinated, the support of the economic policy of Her Majesty's Government, including its objectives for growth and employment, is aligned more directly with the Bank of England's use of monetary policy tools to support its price stability mandate or its use of macro-prudential tools to promote financial stability.³¹ In this regard, the Banking Union has created new challenges for the ECB in coordinating and reconciling its pursuit of the price stability objective with its tasks to ensure the stability of banking institutions in the Banking Union. As discussed below, these challenges seem to be of a substantive and institutional nature. Substantively, the ECB's pursuit of its prudential supervisory tasks for banking institutions can only be assessed within the constraints created by its pursuit of its principal objective of price stability. Its institutional challenge is to ensure that within the ECB its SSM tasks (ie., prudential supervision) are carried out effectively – and quite possibly pursued independently – from its other principal task (ie., monetary policy). Part 3 will address this issue by exploring the interface between monetary policy and banking supervision in the SSM.

3. The Banking Union and the Single Supervisory Mechanism

³⁰ See Fabio Panetta, *ECB Executive Board Member Interview*, ECB (17 Oct. 2020), stating that “[m]onetary policy and fiscal policy reacted rapidly to the shock and have mutually reinforced each other. Together, monetary policy and fiscal policy have increased confidence.” <<https://www.ecb.europa.eu/press/inter/date/2020/html/ecb.in201017~bf95ed5b54.en.html>> accessed 16 Sept. 2021.

³¹ See Silvana Teneyro, *Covid-19 and the Economy: What Are the Lessons so Far?*, speech at a London School of Economics webinar, 5 (15 July 2020), <www.bankofengland.co.uk/speech/2020/silvana-teneyro-speech-as-part-of-the-lse-covid-19-policy-response-webinar-series> accessed 16 Sept. 2021.

The European Banking Union was established in 2013 in order to restore the financial health and stability of the European banking system and to sever the link between weak euro area banking systems and fragile sovereign debt finances.³² The Banking Union consists of three pillars: the SSM, Single Resolution Mechanism (SRM), and the European Deposit Insurance System (EDIS).³³ The SSM became operational in November 2014 and forms the supervisory pillar of the Banking Union and empowers the ECB to carry out prudential supervision of credit institutions and certain financial holding companies that are established in participating member states.

3.1 Rationale and Objectives of the Banking Union

The creation of the European Banking Union was a recognition of the inadequacy of the institutional structure of European Monetary Union in which the ECB had no direct supervisory control over the Euro area banking system but was nevertheless expected to implement its monetary policy through the banking system whilst expecting that member states would engage in effective supervision. This division of responsibilities – monetary policy at the ECB level and supervision at the member state level – had the effect of creating moral hazard on the part of the banks on account of supervisory forbearance to take excessive risks that would threaten financial stability.³⁴ Inadequate supervision by member state authorities contributed to the Eurozone sovereign debt and banking crisis of 2012-2013. The crisis led the European Council to propose a Banking Union in June 2012 that was a turning point in European financial policy in which the functions of banking supervision, resolution, and deposit guarantee schemes, along with a Eurozone bailout fund (the European Stability Mechanism) were deemed necessary in order to justify politically the ECB embarking on a more ambitious monetary policy involving

³² Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63 (SSM Regulation); European Parliament and Council Regulation (EU) 806/2014 of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) 1093/2010 [2014] OJ L225/1 (SRM Regulation).

³³ See Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish in the medium term a European Deposit Insurance Fund, COM(2015) 586 final. EDIS represents a common scheme to insure bank deposits across the Banking Union, but is still under negotiation and faces strong political opposition in Germany and other countries primarily because its future implementation will likely involve some form of cross-border pooling of resources to provide deposit guarantees for banks located in Banking Union jurisdictions. This article, however, does not address the ECB's functions in connection with the SRM and SRF and possible interaction with a future EDIS.

³⁴ See Silvia Allegranza, *The Single Supervisory Mechanism: Institutional Design, Punitive Powers and the Interplay with Criminal Law*, in Silvia Allegranza, *The Enforcement Dimension of the Single Supervisory Mechanism*, 4-5 (Milan: Wolters-Kluwer Italia, 2020).

the use of extraordinary financing tools to support – and prevent the implosion of - the European banking system and to prevent deflation in the Eurozone.³⁵ Prior to taking up its role as bank supervisor in November 2014, the ECB conducted an asset quality review in 2013 along with stress tests of Eurozone banks that measured exactly what losses were on their balance sheets and to assess what level of support the banks required to resume normal market functions and to operate so as to allow the ECB to pursue effectively its monetary policy functions.

3.2 ECB's Competences and Tasks as a Bank Supervisor

Under the Banking Union's first pillar (the SSM), the ECB is fully responsible to supervise and inspect credit institutions and certain financial groups based in participating EU states to ensure their solvency and liquidity and overall compliance with prudential regulatory standards. These new and wide-ranging powers were for the ECB a major expansion of its competences that went significantly beyond monetary policy. The SSM's overriding objectives are to ensure safety and soundness of the European banking system and to ensure the unity and integrity of the EU internal market. The ECB's supervisory tasks are enumerated in Articles 4 and 5 of the SSM Regulation. Before discussing these powers, it is important to bear in mind that, generally, banking regulation consists of developing and adopting principles, standards and rules that govern, among other things, minimum capital levels, disclosure requirements, conduct standards for bankers, including senior management and board members. Whereas, banking supervision involves monitoring and surveillance of compliance by both institutions and individuals and with investigations and enforcement against institutions or individuals allegedly in violation of regulations.³⁶ Under the SSM Regulation, the ECB is a bank supervisor responsible for oversight and surveillance of individual credit institutions but does not promulgate the regulatory and technical implementing standards, which are adopted by the European Banking Authority (EBA) and approved by the European Commission.

The SSM Regulation provides specifically in Article 4 (1) that the ECB shall have competence and the powers to supervise credit institutions and banking groups by applying and enforcing the relevant provisions of EU banking law, such as the Capital Requirements Directive IV.³⁷

³⁵ See Kern Alexander, *European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism* 40(2) *European Law Review* 154, 159-160 (2015).

³⁶ See Kern Alexander and Rosa M. Lastra, *Banking Regulation and supervision: a UK Perspective*, in Peter Conti-Brown and Rosa M. Lastra, *Research Handbook on Central Banking*, 380-397, 381 (Cheltenham UK, Northampton USA: Edward Elgar Publishing, 2018) discussing the differences between banking regulation and supervision.

³⁷ The Capital Requirements Directive IV consists of a Directive and a Regulation. See European Parliament and Council Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential

The subject matter or area of competence for the ECB is enumerated in Article 4 of the SSM Regulation that empowers the ECB with competence to authorise credit institutions (licensing), monitor capital adequacy, liquidity buffers and leverage limits³⁸ and to approve bank recovery plans and asset transfers between affiliates within banking groups or mixed financial conglomerates.³⁹ The broad scope and extent of the ECB’s supervisory powers is probably most robustly expressed in Article 4 (3), first subparagraph, which specifies:

*“the ECB shall apply all relevant Union law, and where this Union law is composed of Directives, the national legislation transposing those Directives. Where the relevant Union law is composed of Regulations and where currently those Regulation explicitly grant options for Member States, the ECB shall apply also the national legislation exercising those options.”*⁴⁰

This so-called “cornerstone” provision, in conjunction with Article 9 (1) of the SSM Regulation combined with Recitals 34 and 35, sets forth the legal basis establishing the ECB’s “direct” supervisory powers in respect of significant entities and the exercise of options and discretions granted to member states which are implemented into national law in accordance with EU prudential supervisory law.⁴¹ This provision, among other things, allows the ECB to apply the domestic law that may apply specific rules or requirements (or not) to banks in that particular jurisdiction. The supervisory discretion permitted under domestic law may vary between member states and therefore the ECB may have different rules and requirements to apply in different member states.

These provisions have dramatically restructured the traditional decentralised system of member state competences in the area of banking supervision under EU law by vesting centralised authority with the ECB to exercise not only exclusive competence in approving the authorisation of institutions and their acquisition of qualifying holdings in other credit institutions along with

supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338 (CRD IV) (which repealed Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions, 14 June 2006); see European Parliament and Council Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms amending Regulation (EU) No 648/2012 [2013] OJ L176/1 (CRR).

³⁸ SSM Regulation, Article 4 (1)-(3), especially Article 4 (1)(d) and (e).

³⁹ SSM Regulation, Article 4 (1)(g) and (h) mention “mixed financial holding companies” and “financial conglomerate”, respectively, over which the ECB has certain supervisory powers.

⁴⁰ Article 4 (3)(1) SSM Regulation.

⁴¹ See discussion in Giovanni Bassani, *The Centralisation of Prudential Supervision in the Euro Area: The Emergence of a New “Conventional Wisdom” and the Establishment of the SSM* 31(6) European Business Law Review 1001, 1007-1009 (2020), discussing how Article 4 (3) provides the ECB with competence to interpret the scope of and to apply these options and discretions of member state law, which may vary between member state legislation and regulation.

the enumerated competences in Article 4 (1) – (3), but also the prudential bank requirements found in EU Regulations, such as the CRR, including their discretions and options, but also the supervisory powers set forth in member state domestic law that derive from EU prudential banking law, such as the CRD. In carrying out these prudential supervisory powers, the SSM allocates day-to-day supervisory duties to the NCAs of participating member states for less significant institutions to be discharged under the oversight and direction of the ECB.⁴²

3.3 The Supervisory Board

The ECB acts through an executive board – the Supervisory Board (SB)⁴³ – that is responsible for supervising directly and licensing the euro area’s largest cross-border banks and the top three banks by size in each participating member state. The SB is also responsible for overseeing the supervisory actions of participating NCAs who directly supervise small and medium sized credit institutions in the SSM regime.⁴⁴ The SB takes final supervisory decisions (with ultimate approval by the ECB Governing Council) against larger, systemically important institutions regarding compliance with and enforcement of prudential regulatory requirements set forth by EU secondary law, including capital adequacy requirements, liquidity buffers, leverage limits, oversight of bank governance and stress testing.⁴⁵

The SB is responsible for overseeing supervision of “significant” banks (ie., large cross-border euro area banks), which constitute about 85 per cent of banking assets in the euro area. The criteria used to define a bank as significant are: total value of assets, whether it is one of the top three largest banks in its home member state; its importance to the economy of its home state or the EU as a whole; and whether it has requested or received direct public financial assistance from the European Stability Mechanism (ESM) or the European Financial Stability Facility (ESFS).⁴⁶

The SB utilises joint supervisory teams (JSTs) to oversee the operations of the significant banks. Under the SSM the ECB acting through the SB is also indirectly responsible for overseeing the supervisory actions of NCAs responsible for supervising small and medium sized

⁴² Article 1 SSM Regulation.

⁴³ SSM Regulation, Article 26 (“planning and execution of the tasks conferred on the ECB shall be fully undertaken by an internal body composed of its Chair and Vice Chair”).

⁴⁴ SSM Regulation, Article 6 (7)(a)-(c). See also Article 25 (8) (SSB shall adopt “draft decisions” “to be transmitted to the NCAs of the member states concerned.”)

⁴⁵ SSM Regulation, Article 4 (1)(b), (d)-(i) and Article 6 (4)-(6) *e contrario*.

⁴⁶ SSM Regulation, Article 6 (4)(i)-(iii).

(less systemically important) banks in participating member states.⁴⁷ The SB has ultimate discretionary authority to decide whether to intervene and to take supervisory decisions that could supersede the decisions of NCAs with respect to smaller credit institutions which the ECB does not directly supervise. Essentially, the ECB's competence (based on Article 127 (6) TFEU and as defined more precisely in the SSM Regulation) is to ensure that its tasks (as enumerated in Article 4 of the SSM Regulation) are fulfilled by direct supervision of "significant" credit institutions and the financial groups in which they operate. Moreover, the ECB is also indirectly responsible for ensuring that the supervisory tasks set forth in Article 4 SSM Regulation are carried out by national competent authorities and that supervise smaller credit institutions. This latter power may entail the ECB deciding to take direct supervisory oversight of a small and medium sized institution if the ECB determines that the relevant NCA is not ensuring that the tasks set forth in Article 4 are being fulfilled.⁴⁸

The SSM regulatory system is complex because of its federal structure, which needs to incentivize information sharing among national regulators and the central coordinating regulator (as well as the interaction with the countries outside the Eurozone). The shift towards ECB supervision represents a toughening of enforcement, since national regulators had incentives to be more lenient with their national banks. By comparison, the enforcement of competition policy by the European Commission is likewise perceived to be tougher than enforcement by national authorities.

Even with the creation of the EBA to promote a more harmonised system of supervision across member states and to oversee the implementation and application of harmonized technical and regulatory standards for banking supervision, the challenge of coordination among decentralized regulators and supervisors within the EU remain acute. Indeed, a supervisor based in another EU state is less likely to consider the consequences (systemic or not) for domestic residents of failure, or restructuring of a local branch or subsidiary, but only the consequences in terms of systemic stability at home. For example, a consequence of the GFC was that some host member state regulators limited or even forbade the local subsidiaries of EU/EEA-based banks from transferring liquidity across jurisdictions.⁴⁹ This is why the creation of the Banking

⁴⁷ SSM Regulation, Article 4 (1).

⁴⁸ SSM Regulation, Article 6 (5)(b), "when necessary to ensure consistent application of high supervisory standards, the ECB may at any time, or on its own initiative after consulting with NCAs or upon request by a NCAs, decide to exercise directly itself all the relevant powers for one or more credit institutions."

⁴⁹ See Sharlene Goff and Elaine Moore, *Bank of Cyprus Seeks FSA Cover for UK Savers* Financial Times (6 June 2012) <www.ft.com/content/b1121e20-afd9-11e1-b737-00144feabdc0> accessed 16 Sept. 2021; Sharlene Goff,

Union in 2014 with the ECB taking full responsibility for supervising the largest Eurozone banks and for overseeing the supervision of smaller banks by the NCAs has been an important innovation in the development of EU banking supervision. Indeed, it is an important policy objective for the ECB that the SB governance structure therefore allows national supervisors to play a significant role in any supervisory plan for participating states.

All euro area member states are automatically SSM members, while non-euro area members can decide to participate in the SSM through a procedure involving the NCAs entering into a “close cooperation” with the ECB.⁵⁰ In 2020, for example, Bulgaria and Croatia – two non-euro area member states – joined the Banking Union and the SSM as participating member states. For the other member states that do not participate in the SSM, the ECB has adopted a memorandum of understanding with the relevant NCAs that explains how the ECB will cooperate with the non-participating member state authorities in performing their respective supervisory tasks.⁵¹ The ECB will also conclude memoranda of understanding with each competent authority of jurisdictions where systemically important financial institutions based in BU?what is BU? member states operate.⁵²

Also, some critics argue that the ECB has acquired too much power based on its strong-form independence as defined under Article 301 TFEU. Indeed, wide-ranging competence extends not only to monetary policy but also to banking supervision where it now supervises directly the 132 largest banks in the SSM. The smaller banks - some 8,000 of them - are still overseen by the NCAs because they are best placed, but under the direct oversight and within the legal competence of the ECB as supervisor. This can potentially lead to frictions between the ECB and NCAs because the NCAs are politically in tune and can be pressured more directly by local politicians and banks, whereas the ECB is perceived as being more independent of political influences and not as vulnerable to undue banking lobbying for more lenient treatment.⁵³ However, this has arguably created a two-tier system of regulation.

Santander Seeks Cover from Pain in Spain Financial Times (29 Oct. 2010) <www.ft.com/content/3eedbc74-e388-11df-8ad3-00144feabdc0> accessed 16 Sept. 2021.

⁵⁰ SSM Regulation, Article 7 (1), (2)(a) – (c) providing the legal requirements for ECB cooperation with NCAs that enter “close cooperation” with the SSM, including rules that apply directly to banks established in participating countries.

⁵¹ SSM Regulation, Article 8.

⁵² SSM Regulation, Article 6 (7)(b).

⁵³ See Judgment, *Landeskreditbank Baden-Württemberg – Förderbank v ECB*, T-122/15, EU:T:2017:337.

In addition, as discussed in section 4, Article 25 of the SSM Regulation requires that there is a separation between banking supervision and monetary policy.⁵⁴ Specifically, Article 25 (2) provides that the Board’s organizational structure and operational functions are separate from the ECB’s monetary policy operations and related functions. For instance, the SSM tasks are further prohibited from interfering with or being determined by the ECB’s other mandates, whether in relation to the European Systemic Risk Board (ESRB) or to other ECB central bank functions, such as monitoring the solvency of financial institution counterparties with whom the ECB engages in open market operations.⁵⁵

3.4 Environmental and Social Sustainability

The European Commission adopted a Sustainable Finance Action Plan in 2018,⁵⁶ which proposed amendments to the Capital Requirements Directive V that delegate authority to the EBA to undertake assessments of the materiality of sustainability risks and to recommend how they should be included in prudential regulatory requirements (such as exposure limits) and for the EBA to report back to the Commission regarding several categories of risks between 2021 and 2025.⁵⁷ This has led to amendments to the EU bank regulatory rulebook that the ECB is required to apply as bank supervisor.

These developments at the EU level are having implications for how the ECB carries out its supervisory responsibilities under the SSM, particularly how it plans to carry out changes to incorporate climate and other sustainability risks into its supervisory review enhancement programme and what its input is likely to be in the forthcoming EBA Reports that will assess the

⁵⁴ SSM Regulation, Article 25 (“Separation from monetary policy function”). Article 25 (2) states “[t]he ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks.”

⁵⁵ Article 25 (2)(1).

⁵⁶ European Commission, *Action Plan: Financing Sustainable Growth* (2018) <<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN>> accessed 16 Sept. 2021; See also, Kern Alexander and Paul Fisher, *Banking Regulation and Sustainability*, in Frits-Joost Beekhoven van den Boezem, Corjo Jansen & Ben Schuijling, *Sustainability and Financial Markets*, 7-34 (Deventer: Wolters Kluwer, 2019), arguing that the EU prudential rulebook should remain risk based if and when it includes sustainability risk measures to calculate regulatory capital.

⁵⁷ The CRD V instructs to the EBA to report - by 28 June 2021 on inclusion of ESG risks in the SREP (Article 98 (8) CRD V) [and] - by 28 June 2025 “whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified”, if appropriate followed by a legislative proposal from the Commission ... (Article 501 c CRR 2). The CRR 2124 provides for - disclosure of ESG risks, as defined by the EBA report, by large institutions as of 28 June 2022 “on an annual basis for the first year and biannually thereafter” (Article 449a CRR 2). See also René Smits, *SSM and the SRM Accountability at European Level: Room for Improvements?* European Parliament Report (2020).

materiality of these risks. Although the ECB's expectations for banks regarding how they manage the financial risks associated with sustainability are evolving, it issued guidance in 2020 for banks regarding how climate change and other environmental sustainability risks are drivers of existing financial risks, including "credit risk, operational risks, market risk and liquidity risk, as well as (...) risks such as migration risk, credit spread risk in the banking book, real estate and strategic risk."⁵⁸ The SSM's 2020 risk map for the Eurozone stated that climate-related and environmental risks are expected to crystallise in the medium to long term.⁵⁹ Indeed, as the planning horizon and average loan tenor for banks is usually shorter than the time horizon over which the effects of climate change are expected to occur, the ECB recommends for financial institutions that they "take a forward-looking approach and consider a longer than usual time horizon" that allows them "to respond in a timely manner should the pace of the transition to a low-carbon economy accelerate and transition risks materialize more rapidly than expected."⁶⁰

Estimations suggest that the magnitude of climate-related and environmental risks are likely to be significant. On one hand, when it comes to physical risks, the Dutch National Bank affirms that one-fifth of assessed equity and loan exposures at Dutch financial institutions are to extreme water stress regions.⁶¹ Moreover, the Bank of England reports that some 8.8% of its mortgage exposures are situated in flood risk zones in other jurisdictions.⁶² On the other hand, regarding transition risks, the ESRB argues that the exposer of banks, pension funds and insurers in the EU to fossil fuel firms exceed 1€ trillion and estimates potential losses of between €350 billion and €400 billion, even under an orderly transition scenario.⁶³ Moreover, the ECB will have to comply with the amendments to the CRD that relate to the incorporation of sustainability metrics and other criteria into EU prudential financial regulation. These changes to EU banking regulation will place the ECB into the forefront of ensuring that credit institutions

⁵⁸ ECB, *Guide on Climate-related and Environmental Risks. Supervisory Expectations Relating to Risk Management and Disclosure*, 11 (2020) <https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf> accessed 16 Sept. 2021.

⁵⁹ ECB, *The SSM Risk Map for 2020* (2019).

⁶⁰ ECB, *Guide on Climate-related and Environmental Risks. Supervisory Expectations Relating to Risk Management and Disclosure*, 12-13 (2020) <https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf> accessed 16 Sept. 2021.

⁶¹ Dutch National Bank, *Values at Risk? Sustainability Risks and Goals in the Dutch Financial Sector*, 21 (2019).

⁶² Prudential Regulation Authority report, *Transition in Thinking: The Impact of Climate Change on the UK Banking Sector*, Bank of England (2018).

⁶³ European Systemic Risk Board (ESRB), *Late, too Sudden: Transition to a Low-carbon Economy and Systemic Risk*, 12 (2006).

and connected financial groups are identifying and managing environmental and social risks. For instance, the ECB can help banks build stress tests based on forward-looking scenarios that will help the industry judge what its capital and liquidity requirements should be in the face of physical risks caused by intensifying environmental or social phenomena caused by climate change, loss of biodiversity and related pandemics and increasing social risks associated with growing inequality, inadequate health care, and intensifying migration patterns. Also, the ECB will be concerned with the sustainability challenges associated with the volatility in asset prices and sudden reallocation of capital away from unsustainable high carbon economic sectors to lower carbon sustainable sectors. Although the Banking Union has had an overall positive effect on European banking sector stability, serious challenges remain, including how to recognise losses from the COVID-19 lockdown period and supporting bank lending that supports an economic recovery whilst also addressing apparent and emerging environmental and social risks that pose important challenges to the Eurozone banking system. Despite the important role for the ECB in promoting price stability and its secondary objectives, including its important role as a bank supervisor in the Banking Union, this should not substitute for the important role that EU institutions and member states should play as fiscal authorities to take the lead in supporting economic policy and the recovery from the current pandemic crisis. EU institutions should be able to utilise economic policy tools, including taxation, expenditure, legislation and regulation to support the economic recovery. Nevertheless, the ECB has policy instruments that can be used to support its secondary objectives, such as environmental sustainability, to the extent that pursuit of the secondary objectives furthers the overall price stability mandate. In doing so, the ECB can utilise a variety of liquidity tools (ie., Long-Term Refinancing Operations (LTROs) and asset purchase programmes) to support financial institutions in lending more to the economy and also transitioning the purchase of corporate bonds to more sustainable and competitive sectors of the European economy. And ECB sovereign bond purchase programmes (ie., PEPP) can give member states the domestic policy space to adjust their fiscal policies to address the economic and social challenges posed by the COVID-19 pandemic, especially for investing in expanded health care services and an economic recovery.

4. The SSM and Monetary Policy - Managing Potential Conflicts

The ECB's role as a bank supervisor, however, might bring it into conflict with its main treaty objective of price stability.⁶⁴ According to this view, the ECB might be tempted to lower interest rates or to loosen conditions for bank access to liquidity in order to stabilize the banking sector, but this might lead to easier terms of credit thereby conflicting with its price stability objective.⁶⁵ This is why supervisory mandates for central banks tend to be controversial.⁶⁶ In general, the price stability mandate of central banks is obstructed by short-term goals, eg avoiding high interest rates and unemployment due to electoral and political pressures – hence the need for central banks to be independent so that they are immune from these pressures. Accordingly, a central bank receiving explicit or implicit employment or economic growth mandates will face the same conflict. A supervisory mandate thus potentially results in lenient monetary policies to prevent bank illiquidity and insolvency; central banks also enjoy easier “bureaucratic entrenchment” than a supervision-only agency would, making them less accountable for the moral hazard they create. The optimal governance architecture needed for such a double mandate is unclear: lawmakers struggle to combine an efficient relationship between the monetary and supervisory sides, whilst nevertheless ensuring adequate accountability. Other governance issues are both external (especially towards national resolution authorities) and internal, such as the transparency of central bank policies: while excessive transparency may potentially damage the credibility of central banks, eg when responding to temporary market disturbance, empirical evidence shows that higher transparency in forecasts is associated with lower average inflation, and to some extent both less inflation persistence as well as reduced inflation volatility.⁶⁷

As mentioned in 3.3, the SSM Regulation attempts to address the potential conflict in dual central bank mandates by requiring that bank supervision decisions and monetary policy is strictly separated by creating a SB which would have separate staff to work solely on banking

⁶⁴ TFEU, Article 127 (6) provides that “price stability” is the primary objective of the European System of Central Banks. In relation to the ECB's primary objective of “price stability”, a “financial stability” objective is mentioned incidentally in TFEU, Article 127 (5) as follows: “The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.”

⁶⁵ This is why Principle 2 of the Basel Core Principles for Effective Banking Supervision recommends that the functions of the bank supervisor and monetary policymaker be independent from one another.

⁶⁶ See Charles Goodhart, Philipp Hartmann, David T. Llewellyn, Liliana Rojas-Suarez and Steven Weisbrod, *Financial Regulation: Why, How, Where Now?* (London: Routledge, 2013).

⁶⁷ *Ibid.*

supervision matters and not to have links with staff involved with monetary policy.⁶⁸ To reinforce the independence of the SB, former ECB President Mario Draghi set forth conditions that were added as an amendment to the draft SSM Regulation, which he argued were necessary to make the plan work and protect the ECB's reputation for maintaining and achieving its monetary policy objective of price stability.

As mentioned above, the separation between monetary policy and supervisory tasks within the ECB is reinforced by a requirement to ensure the organizational separation of both the staff involved and their reporting lines.⁶⁹ Beyond the separation of the staff involved on both sides of these firewalls, the SSM Regulation now requires the ECB to ensure an operational separation for the Governing Council itself as regards monetary and supervisory functions, e.g., through separated meetings and agendas.⁷⁰ The procedure for appointing the Chair and Vice Chair of the SB also reflects this separation: rather than having the ECB Governing Council elect a member of the Supervisory Board as was proposed in the draft Regulation, the Chair is now appointed by the Economic and Financial Affairs Council (Ecofin) and cannot be a member of the ECB Governing Council.⁷¹ And the Vice Chair is also appointed by Ecofin, but only from among the members of the Executive Board of the ECB, which person must also be a member of the Governing Council, according to Article 283 (1) TFEU. This demonstrates that the SB's oversight of the SSM is ultimately accountable to the ECB's Governing Council, whose strong form of independence is guaranteed by the Treaty and whose overriding mandate is to maintain price stability, which under the Treaty arguably takes precedence over the ECB's banking supervision mandate. However, the Governing Council's dual oversight of monetary policy and banking supervision will be subject to separate agendas that rely on separate groups of staff and reporting channels respectively to maintain a semblance of independence for the Council whilst making decisions on monetary policy and banking supervision. However, the Council's oversight of these dual areas is subject to the "separation" requirement in Article 25 SSM Regulation, which requires that Council decision-making is based on separate agendas that rely on separate staff and reporting channels.

⁶⁸ Germany insisted on separation of the ECB's supervisory functions from its monetary policy functions in order to protect ECB monetary policy from being influenced by the pursuit of banking supervision mandates. See Peter Mülbart, *Presentation at European Company and Financial Law Conference* (7 November 2014) (on file with author).

⁶⁹ Article 25 (2).

⁷⁰ Article 25 (3).

⁷¹ *Ibid.*

Eurozone national authorities have recognised that the institutional challenges about the management of conflicts of interest by the ECB, which arise from having the Governing Council approve all substantive decisions of the SB, creates a conflict of interest within the ECB. For example, a Bundesbank official expressed doubt about the effectiveness of the governance structure, and suggested limiting the Governing Council's involvement in many supervision decisions.⁷²

In addition, despite the SSM's focus on independence and separation between the monetary policy function and banking supervisory mandate, it is submitted that the broader post-crisis focus of macro-prudential supervision and regulation requires some degree of coordination between monetary policy and banking supervision. Indeed, much of the literature justifying the separation of monetary policy from banking supervision arose in a period when monetary policy was seen to be independent from banking supervision and that the use of monetary policy instruments to increase bank lending in certain sectors of the economy (ie., small and medium size businesses) were considered not to be within the central bank's mandate.⁷³ Since the GFC, however, central banks have adopted extraordinary measures of monetary policy (ie., the ECB's LTRO and Outright Monetary Transactions (OMT)) that necessarily involve central banks in assessing the healthiness and viability of bank balance sheets in order to have a better understanding of whether the central bank is achieving its monetary policy objectives (i.e., price stability). This has particularly been the case in the euro area where the European Central Bank has adopted an array of monetary policy measures, including its role as the main purchaser of asset-backed securities issued by banks and bonds issued by non-bank corporates, in order to increase bank lending with an overall view of achieving the ECB's price stability objective of two percent inflation.⁷⁴ It is debateable whether the use of such broad measures of monetary policy requires the central bank to have more information and an opinion about the healthiness and ability of individual banks or groups of banks to lend in the broader economy. In a financial system where the central bank's use of monetary policy measures has grown to play such an important role in affecting bank lending and banking regulation, it calls into question the utility of the strict separation between monetary policy

⁷² See Andreas Dombret, *Plan B – where is the banking union heading?* Banken- und Unternehmensabend at the Deutsche Bundesbank's Regional Office (1 April 2018) <www.bundesbank.de/en/press/speeches/plan-b---where-is-the-banking-union-heading--732316> accessed 16 Sept. 2021.

⁷³ Kern Alexander, *The European Central Bank and Banking Supervision: The Regulatory Limits of the Single Supervisory Mechanism* 13 *European Company and Financial Law Review* 490-491 (2016).

⁷⁴ See discussion of ECB's unconventional monetary policy in Klaus Touri, *Monetary Policy (Objectives and Instruments)*, in Fabian Amtenbrink and Christoph Herrmann, *The EU Law of Economic and Monetary Union*, 615-698 (Oxford: OUP, 2020).

and the supervision of individual banking institutions. Therefore, the strict separation between the ECB's monetary policy function and its banking supervision mandate in the SSM should be reconsidered in light of modern notions of prudential regulation and monetary policy.

5. Summing up and Future Challenges

The article provides an analysis of the interplay between the ECB's primary mandate of price stability in Article 127 (1) TFEU along with its obligation to support the general policies of the EU and the relationship with its competences and tasks to carry out micro-prudential bank supervision as set forth in the SSM Regulation. Since becoming operational in 2014, the SSM has been credited with helping the European banking system to address some of its most pressing challenges and has contributed to the stabilisation of the European banking system. Although the ECB has persistently failed to achieve its inflation target by undershooting it in most years,⁷⁵ it has developed a reputation as a strict and independent supervisor of banks. As a treaty-based institution it has a strong form of independence, separated from direct political interference, to pursue its Treaty objective of price stability and now its legislative mandate to promote banking sector stability in the SSM. Nevertheless, the article argues that the ECB's fulfilment of these supervisory tasks in the SSM may be unduly constrained and hindered by the ECB's primary mandate to maintain price stability in Article 127 (1) TFEU?. The article also suggests that there is an imbalance between these legal mandates and that they should be interpreted in light of the ECB's (so-called) secondary objectives as set forth in Article 3 (3) TEU, that is, to support the general policies of the EU, including protecting the environment, promoting competitiveness, and supporting social solidarity. By doing so, the ECB can carry out its monetary policy and supervisory functions under the SSM in a more efficient and balanced manner so that it fulfils its primary mandate of price stability whilst supporting secondary objectives of the EU such as financial stability, environmental protection – particularly in the area of climate change risks, and social solidarity.⁷⁶ Moreover, by considering the ECB's mandate

⁷⁵ See also Stiglitz, n. 7, 146-149.

⁷⁶ Benoît Cœuré, *Monetary policy and Climate Change*, Speech at the Bundesbank-NGFS-CEP Conference on Scaling up Green Finance: The Role of Central Banks (8-9 November 2018) <<https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp181108.en.html>> accessed 16 Sept. 2021; Guy Debelle, *Climate Change and the Economy*, Speech Reserve Bank of Australia (2019) <<https://www.rba.gov.au/speeches/2019/pdf/sp-dg-2019-03-12.pdf>> accessed 16 Sept. 2021.

in this light, the ECB will have a stronger legal basis to support the EU's New Recovery Policy in the aftermath of the COVID-19 pandemic and related economic crisis.

The ECB's role as a bank supervisor and in monetary policy is evolving in response to evolving economic, social and environmental risks.⁷⁷ The ECB has begun monitoring these risks by working with banks in designing stress tests based on future scenarios that will help the industry judge what its capital and liquidity requirements should be in the face of these potential threats to stability caused by environmental or social phenomena. The analysis of the ECB's growing competences in the SSM and its expanded role in supporting EU policies to mitigate the risks of climate change and other sustainability risks, including most recently its role to support EU policies in reviving the European economy are harbingers of a more expansive and flexible monetary policy and supervisory approach. Evolving economic, environmental and social risks that affect the banking and financial sector confirm a more proactive role for the ECB in these areas.

⁷⁷ See Giovanni Bassini, *Of Viruses, Economic Crises, and Banks: the European Banking Union and the Response to Covid-19* 32(3) *European Business Law Review* 437–472 (2021).