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ARTICLES

THE EUROPEAN UNION CRISIS RESPONSES AND THE EFFICIENT CAPITAL MARKETS HYPOTHESIS

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The hypothesis that capital markets naturally function in an efficient way—possibly one of the widest accepted dogmas of contemporary liberalism—has for many years encouraged politicians and regulators in the United States and Europe to refrain from regulating too strictly or even to deregulate the financial industry. Moreover, by leaving Member States with the final responsibility for the soundness of their public finances, the Efficient Capital Markets Hypothesis (ECMH) underpins the constitutional framework of the Economic and Monetary Union (EMU). The recent financial and sovereign debt crises, however, have highlighted the limits of the ECMH and the dangers for market actors, financial institutions, regulators and politicians of relying on the efficiency of financial markets without any qualification. In reaction to the financial and sovereign debt crises, the European Union and its Member States have proposed or adopted a vast set of measures, which range from new mechanisms of solidarity within the Eurozone to a banking union. While the overarching goal is to relieve the stress that financial markets continue to exercise both on the stability of the financial system and the EMU, these measures have been designed in urgency and tend to focus on specific issues. The overall vision and coherence of these measures are far from obvious. The

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present paper proposes to assess the extent to which the European Union has learned from the lessons taught by the crises relating to the ECMH and its impact on regulation.

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I. INTRODUCTION

The Efficient Capital Markets Hypothesis (ECMH) is one of the dogmas of economic liberalism. It means that markets integrate, at any time, all available information on a financial asset into its price.¹ The efficiency is greater or lesser depending on the nature and abundance of information that markets have at their disposal. Oftentimes, it is inferred that the interplay of supply and demand on the market will successfully set an equilibrium price for every asset negotiated—a “fair price.” What we are undoubtedly dealing with here is an assumption that goes beyond the strict sense of the theory of informational efficiency of financial markets as developed by Eugene Fama,² but it is this interpretation that is the most widespread.

Even though the premises of the ECMH have, for some years now, been disputed by economists and are challenged, most of all, by those who adopt a more

¹ See EUGENE F. FAMA, FOUNDATIONS OF FINANCE: PORTFOLIO DECISIONS AND SECURITIES PRICES 132 (1977).

² See, e.g., Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN., no. 5 at 1575 (Dec. 1991), Eugene F. Fama, *The Behavior of Stock-Market Prices*, 38 J. BUS., no. 1 at 34 (Jan. 1965). See also Ray Ball, *The Global Financial Crisis and the Efficient Market Hypothesis: What Have We Learned?*, 21 J. APPLIED CORP. FIN., no. 4 at 8 (Fall 2009); Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Fall: Where Do We Stand Following the Financial Crisis?*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 456 (2012).

behaviorist approach,³ the belief in the efficiency of capital markets has deeply marked the attitude of regulators on both sides of the Atlantic and virtually all market economies.⁴ Thus it is commonly admitted that the policy adopted by the United States Securities and Exchange Commission (SEC) had, until the recent financial crisis, been largely founded on the ECMH when engaging in large-scale market deregulation.⁵ Since the 1960s, Europe has followed this policy of deregulation, characterized by the expansion of “Euromarkets” by the United Kingdom⁶ and Luxembourg. Encouraged by the European Union, other European countries followed suit.

Actually, the ECMH squares perfectly with the “principle of an open market economy with free competition” underlying the European construction. Explicitly expressed in the TFEU,⁷ this principle contributes to the fundamental objectives of the Union, in particular, to building an internal market that pursues the “sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment,”⁸ and to establishing the Economic and Monetary Union (EMU) based on a single currency. The market economy principle founded on price stability aims at an efficient allocation of resources,⁹ which should be aligned with the ECMH. By examining the rules governing banking and financial market integration as well as those governing the EMU, we can see that they are both largely predicated on the premise of an efficient capital market.

The very idea of creating and stimulating a single market for banking and financial services at the European level stems from, apart from the freedoms of movement, the hope of providing the European economy with effective financing structures based, to a growing degree, on capital markets. The United States capital markets, where enterprises are able to tap into vast resources, are used as a model. The single license introduced for the benefit of banks and investment service providers is aimed directly at opening domestic markets while encouraging the operations of international finance professionals. Harmonization of the prospectus for financial instruments and transparency requirements regarding issuers whose securities are offered to the public, sanctioning of insider trading or market abuse and the ban on measures that could interfere with the free interplay of supply and

³ See, e.g., Werner F. M. De Bondt & Richard Thaler, *Does the Stock Market Overreact?*, 40 J. FIN., no. 3 at 793 (July 1985); Werner F. M. De Bondt & Richard Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality*, 42 J. FIN., no. 3 at 557 (July 1987)..

⁴ See FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS (2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

⁵ See, e.g., Ronald J. Gilson & Reinier Kraakman, *Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715 (Summer 2003); Ronald J. Gilson & Reinier Kraakman, *Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

⁶ See FINANCIAL SERVICES AUTHORITY, *supra* note 4.

⁷ Consolidated Version of the Treaty on the Functioning of the European Union arts. 119 & 127, Sept. 5, 2008, 2008 O.J. (C 115) 96, 102 [hereinafter TFEU].

⁸ Consolidated Version of the Treaty on the European Union art. 3, Mar. 30, 2010, 2010 O.J. (C 83) 1, 17 (amending the TFEU).

⁹ Protocol on the Statute of the European System of Central Banks and of the European Central Bank, art. 2, Oct. 26, 2012, 2012 O.J. (C 326) 230, 230.

demand on financial markets in the presence of a takeover offer—all of the above examples are marked by the same attempt to favor an exchange of information on which the ECMH rests. It is undoubtedly not inaccurate to also link the efficient market assumption to the universal bank model, by which Europe can be distinguished from the United States. Insofar as banks continue to finance a substantial part of the European economy by refinancing in the market, doesn't the efficiency of the latter determine this model, and through this model also the soundness of the financial system? It seems clear in any case that the rules of prudence as well as the architecture of banking supervision must increasingly take into account the market risks that banks find themselves more exposed to the more they continue to act as intermediaries between the resources they find in the market, the positions they take in the market, whether for hedging purposes or for profit, and the financing of companies and households.

On the other hand, the EMU construction rests on the ECMH as it has given Member States who share the single currency responsibility for keeping a certain balance in their public finances. Of course the terms of this balance, in a broad sense, have been defined by common convergence criteria and by the commitment by Eurozone Member States not to exceed the debt and public deficit thresholds.¹⁰ However, they still hold the ultimate responsibility for keeping public finances sustainable, despite sharing the same single currency and forsaking any possibility of adjustment by devaluing a national currency shared by all Eurozone Member States. The Treaty on the Functioning of the European Union (TFEU) sanctions this responsibility through the “no bailout clause” by which the Union denies its liability for Member States’ public sector debts;¹¹ a related provision prohibits central banks, including the European Central Bank, from granting any credit facility to Member States or public authorities;¹² another clause imposes a ban on providing Member States or public authorities with privileged access to financial institutions.¹³ All of the construction rests on the supposition that financial markets sanction those Eurozone Member States that fail to keep their public finances in good condition by levying higher interest rates on their debt. This belief in the discipline enforced by the markets, in other words in the execution of the ECMH, explains the option adopted in the Treaty of Maastricht in favor of a light coordination of economic policies and of a stability pact, which all things considered, is not very restrictive.¹⁴

The financial crisis, which has afflicted the world for five years, surprised the Member States as well as markets and their players with its intensity and extent. Bankruptcies of many banks and insurance companies caused a chain reaction and brought about a general mood of distrust, which, on several occasions, threatened to

¹⁰ See, e.g., TFEU art. 126; *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, EUR. COUNCIL (Mar. 2, 2012), http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf (forming the basis for the so-called Stability and Growth Pact). See also *Stability and Growth Pact*, EUR. COMM’N (Sept. 5, 2013), available at http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm.

¹¹ TFEU art. 125.

¹² TFEU art. 123.

¹³ TFEU art. 124.

¹⁴ See, e.g., Jean-Victor Louis, *The No-Bailout Clause and the Rescue Packages*, 47 COMMON Mkt. L. REV. 971 (2010); René Smits, *L’Europe à l’Épreuve*, 2010 CAHIERS DE DROIT EUROPEEN, no. 1–2, at 7–8.

the collapse of the financial system. The sudden and abrupt increase in interest rates for public lending in many Eurozone Member States literally excluded them from the markets, for longer or shorter periods, shaking the foundations of the EMU. These prolonged turbulences have affected all of the economic sectors, hit hard many households, and unfortunately seem far from being entirely resolved. They are the focus of attention of governments that are trying to keep various aspects of the crisis in check and reassure public opinion by emergency measures while there is a growing opposition to the unbridled economic liberalism which, on both sides of the Atlantic, has tended to be regarded as “the end of history.”¹⁵

Without plunging into an overly political debate, the global financial crisis as well as the sovereign debt crisis in Europe have demonstrated not only that the hypothesis of continued efficiency of financial markets may be no more than an illusion¹⁶ but also that their awakening, after a period where the prices of some financial assets were not adjusted, taking account of all the available information, poses great risks. There seem to be various reasons why financial markets may, over a certain time, fail to set an equilibrium price for assets: approximate or inaccurate information from credit rating agencies, investors’ irrational and herding behavior, a lack of liquidity paralyzing financial transactions.¹⁷ The overvaluation of “subprime” debt structured products in the United States before the 2008 financial crisis or the failure of the markets to take into account the different risks posed by Eurozone Member States illustrate how markets can momentarily be inefficient. It seems that the moment the markets finally take account of all the available information to set a “fair price,”¹⁸ the adjustment is often abrupt, even exaggerated, as if to make up for lost time. The current financial crisis brings numerous examples—for instance, the sudden decline in credit ratings and the prices of structured financial products following new assessment models adopted by rating agencies after they recognized the flaws in previous models.

The major imbalances likely to be brought about by such market deficiencies and the fears or even waves of panic they provoke easily push politicians to take control of the markets, restricting their ability to function. Reactions to the present crisis, both at the international and European level, demonstrate this very well. It would seem that after having displayed no interest in the world of finance, the political spheres now continually assert the necessity to subordinate the financial markets and its players to the needs of society and the imperatives of democracy. One might think that these declarations, at the same time, could be interpreted as

¹⁵ See Francis Fukuyama, *Reflections on the End of History, Five Years Later*, 34 HISTORY AND THEORY, no. 2 at 27 (May 1995); FRANCIS FUKUYAMA, THE END OF HISTORY AND THE LAST MAN (1992).

¹⁶ See, e.g., JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET (2009); GEORGE SOROS, REFLECTIONS ON THE CRASH OF 2008 AND WHAT IT MEANS: THE NEW PARADIGM FOR FINANCIAL MARKETS (2009); ANDREW SMITHERS, WALL STREET REVALUED: IMPERFECT MARKETS AND INEPT CENTRAL BANKERS (2009); RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009).

¹⁷ Various characteristics of market inefficiencies play a role here. A more comprehensive analysis would distinguish between market imperfections and the natural limits of the ECMH.

¹⁸ For a more detailed analysis of the ECMH see Gilson & Kraakman, *supra* note 2. This article relies on the common, non-technical understanding of market efficiency underlying most policy decisions and regulation.

politicians admitting to a certain helplessness in confronting the global financial markets. The reality is obviously more complex. On the continent, and particularly in the European Union, there is no question of challenging the principle of economic liberalism or putting the Member States under the yoke of financial markets.¹⁹ The issue here is to find the state of balance in which the Member States, whether separate or united, and market forces can successfully combine to foster social progress.

For the European Union, this challenge is made even worse by the close intertwining of the sovereign debt crisis and the fragility of the banking and financial system, as well as by their combined repercussions on the economy. One keeps feeding the other, so their resolution must inevitably come from a strategy that fully embraces both issues, taking due account of the need for economic growth.

Considering how urgent it was to prevent overly intense market reactions and minimize systemic risks, the need to include relevant measures in the package to ensure their complementarity and coherence with one another and with the European legal order was often given a lower priority. The solutions and mechanisms devised to protect the EMU were therefore decided without fully safeguarding their compatibility with the Treaties, at least *a priori*. This question is hotly debated. Questions raised by the measures taken to mitigate the risk of the collapse of the financial system and to prevent other banking crises are of a more technical nature even though the planned and partially launched reform of the banking supervision system will have deep consequences for the internal market's functioning in this sector.

The object of this paper is not to add arguments to the extensive discussion of the constitutionality of some measures, nor is it to list an inventory of the numerous acts adopted or being developed, let alone to analyze their technical aspects. The question we would like to focus on here is the overall vision that is or should be guiding the concerted reactions of the European Union as a whole or of its Member States acting collectively to overcome the financial and the sovereign debt crises. Surely there exist different criteria to judge the objectives and the indispensable coherence of the arsenal of measures chosen.²⁰ Among these criteria there is one that seems to us worth pointing out, as it would allow us to assess whether or not the different solutions envisaged fit well with one another, whether they rest on the economic premises of the European construction or whether they tend to bend them. This standard of assessment is the efficient capital market postulate, which we suggest using to verify if the European measures intended to combat the financial crisis, in its dual dimension, share an overall logic.

¹⁹ See, e.g., SHEILA BAIR, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF (2012).

²⁰ Another consideration would be the avoidance of systemic risk.

II. THE EUROPEAN REACTION TO THE BANKING CRISIS

A. Lessons Learned From The Crisis Regarding The Efficient Capital Market Hypothesis in the Banking Sector

The recent banking crisis broke out in September 2008, with the loss of confidence on the interbank market after the investment bank Lehman Brothers filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code and the United States Federal Reserve Bank had to grant a secured credit facility to American International Group (AIG), then the world's largest insurance company, to prevent its collapse. The credit spreads between interbank lending and lending granted by central banks widened abruptly to the point of drying up the source of interbank finance necessary for lending institutions, which created a serious systemic risk.²¹

There are undoubtedly many reasons for that crisis, but one is generally considered to be paramount: the banks' excessive exposure to derivatives and the popping of the subprime housing credit bubble, which constituted its major ingredient. What seems to be a crucial point is not the overvaluation of claims for repayment of subprime loans granted to American households to financing real estate projects, which is after all, a well-known phenomenon, but the impressive growth of this bubble through securitization techniques and the related synthetic hedging products and the risks spreading in the banking sector on a global scale. Here, the financial innovation and the lure of gain played havoc with the ECMH principle by creating an illusion of abundance both in the eyes of the banks that invested heavily in those financial assets and in the eyes of the regulators that were supposed to ensure their soundness.²²

Rating agencies are regularly indicated as those principally responsible for this mess by failing to accurately value collateralized debt obligations (CDOs), credit default swaps (CDSs) and other derivatives generated in large volumes by a series of banks and other financial intermediaries. Their evaluation models were, for a long time, merely approximate and did not rely on enough statistical data because most of these products were relatively new. Moreover, the manner in which the rating agencies were remunerated cast doubt on their independence from those who generated the financial products. Being unable to evaluate the inherent risks of these products on their own, most banks blindly trusted credit ratings.

²¹ Scholars have since developed a substantial body of literature exploring the causes of the financial crisis. For an overview of the crash in Europe, see THE DE LAROSIERE GROUP, HIGH LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU: REPORT (2009), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf; THE LIIKANEN GROUP, HIGH-LEVEL EXPERT GROUP ON REFORMING THE STRUCTURE OF THE EU BANKING SECTOR (2012), available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf. A fascinating chronological narrative of the crash can also be found in JOHAN A. LYBECK, A GLOBAL HISTORY OF THE FINANCIAL CRASH OF 2007–10 (2011).

²² See GILLIAN TETT, FOOL'S GOLD: HOW UNRESTRAINED GREED CORRUPTED A DREAM, SHATTERED GLOBAL MARKETS AND UNLEASHED A CATASTROPHE (2009); FINANCIAL SERVICES AUTHORITY, *supra* note 4.

The pressure felt by publicly listed financial institutions to continually report strong earnings encouraged them to take greater risks in the financial markets, particularly by increasing their exposure to derivatives.²³ The phenomenon was fuelled by fierce competition between the management of highly ambitious financial institutions and strong profit orientation among the traders, incentivized by the promise of bonuses.²⁴ The bubble of direct or indirect derivatives of subprime loans kept growing, with banks and regulators not fully aware of the fact until the sudden drop in ratings occurred. The loss of confidence in banks was echoed by their clients, who were concerned that their deposits were under threat. It is remarkable that depositors, just like banks, follow herding behavior under such circumstances, rather than a rational approach as presupposed in the efficient market principle.

Like previous crises,²⁵ the recent banking crisis is associated with an abrupt adjustment of the value of financial assets that had long been overvalued. Therefore, it was caused by the banks and regulators' misguided belief that there would be a continuous, and therefore smooth, adjustment of the asset prices as quoted in the market. While this is a simplified and incomplete explanation, it will suffice for the purposes of our study as it underlines the role of the shared and mistaken trust in the ECMH as one of the major causes of the financial crisis.

Three elements need to be emphasized in this respect. The new generation of derivatives presents the level of complexity never seen before. Based on increasingly sophisticated mathematical models and relying on previously unavailable computing power, they involve risks that are extremely difficult to assess. Their underlying calculations are extremely difficult to follow, even for most professional investors and financial institutions, while the availability of historical data is often too limited. Investing in such products is therefore highly risky.

By its very structure, these derivatives make it possible to take highly leveraged positions while maintaining minimal capital allocation to meet equity ratios that banks must comply with, sometimes even by keeping these risky assets off the balance sheet by means of ad hoc structures (conduits). Some of those instruments, such as CDSs, are specifically intended to lighten a bank's balance sheet and allow it to increase its exposure to other risky assets.

Unlike classic derivatives—futures contracts and options—that are mostly traded in organized markets, these new derivative instruments are traded over the counter in large volumes outside regulated markets and through hedge funds, private equity funds and other special investment vehicles (SIVs), to which prudential rules that govern banks do not apply. This created a vast market, not limited by the constraints faced by banks, which developed right next to the regulated banking sector. At the beginning of the crisis, the importance of this “shadow banking

²³ See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 692 (2010).

²⁴ Some expressed concern for these potentially dangerous incentives well before the crisis. See Patrick Bolton, José Scheinkman & Wei Xiong, *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 REV. ECON. STUD., no. 3 at 577 (July 2006).

²⁵ See YOUSSEF CASSIS, *CRISES AND OPPORTUNITIES, 1890–2010: THE SHAPING OF MODERN FINANCE* 6, 23 (2011).

sector” rivaled that of the US banking sector.²⁶ Even though one should be careful not to denounce this shadow banking sector altogether, its rapid expansion certainly increased banks’ exposure to risks related to derivatives.

Never before has financial innovation been so tightly intertwined with a banking crisis the way derivatives are with the current crisis.²⁷ For the reasons outlined above—flawed theoretical assumptions, complexity, their novelty and insufficiency of historical data to allow for fair evaluations, financial institutions’ fascination with their supposed advantages, the unregulated channels through which these products were traded, and the staggering increase in their volume—these products seem to defy the ECMH.

As we have observed above, the banking crisis was caused by a chain of circumstances, and not only by banks’ use of derivatives and excessive exposure to the associated risks. More generally, the illusion of efficient capital markets led banks to continually gun for quick profits in the belief that they would be able to liquidate their positions if the market turned. This same illusion misled regulators, who, instead of questioning the ECMH, accepted banks’ use of the “fair value” of financial assets through mark to market accounting when it came to determining the value of banks’ assets on their trading books, while reserving favorable prudential treatment of proprietary trading activities. In a period of a strong economic growth, the downsides of subordination to market mechanisms were not readily apparent. But as soon as the situation reversed, as was the case when the United States’ mortgage market bubble popped, the fair value accounting method rapidly eroded asset values, leading to dire consequences.

Many political reactions to the financial crisis, whether on the international or European level, focused on the financial markets’ domination and, at the same time, took this opportunity to emphasize the often theoretical nature of their supposed efficiency, reproaching both banks and regulators for having relied on it so blindly. Even though not all of those statements were followed up with actions, the challenge to the ECMH marks a turning point in the regulation of financial activities that we suggest the European Union should acknowledge.

B. Position Adopted in the New Banking Sector Regulation Towards The Efficient Capital Market Hypothesis

The interplay of supply and demand on markets that operate transparently and smoothly is the most direct means of determining the value of traded financial assets at any given moment. When highlighting the ECMH’s limitations and shortcomings, there is obviously no question of rejecting the natural adjustment of the market. The challenge for market regulation and governance of banking activity is to ensure that the premises of the ECMH are realized. More fundamentally, it is about making sure that the efficient market dogma does not keep up illusions of

²⁶ See PAUL R. KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008 160–61 (1st ed. 2009).

²⁷ See CASSIS, *supra* note 25, at 101; Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1020 (2007).

wealth resulting from bubbles in the market, misleading both banks and their supervisory authorities.

1. Stimulating the Efficiency of the Market

The functioning of financial markets is an underlying preoccupation of the majority of European secondary legal provisions regulating those markets in pursuit of European integration and the harmonization of rules governing entities that issue traded securities. The recent crisis, however, has brought to light some obstacles to the execution of the ECMH that have drawn the attention of European legislators.

The markets' reliance on approximate or insufficient information and ratings by private agencies was quickly stigmatized and continues to worry the European Union and national governments. Both the European Union and national governments have discovered for themselves the particular influence wielded by private rating agencies following the downgrades to the credit ratings of some Member States, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). The decision to scrutinize rating agencies illustrates the change in perspective on the regulation of financial activities. Before the crisis, there was wide consensus in favor of voluntary discipline of agencies based on a code of conduct developed under the aegis of the International Organization of Securities Commissions (IOSCO). In the summer of 2008, the Committee of European Securities Regulators (CESR), the predecessor to the new European Securities and Markets Authority (ESMA), even reiterated its warning against European regulation of credit agencies.²⁸ The group of European securities markets experts counseling the Commission endorsed the CESR's opinion.²⁹ However, politicians' determination to correct the inefficiency of the financial markets prevailed over those misgivings. In less than a year, Regulation (EC) No. 1060/2009 of the European Parliament and of the Council on credit rating agencies was adopted. Since then, it has been amended twice and become more specific with technical norms and standards implemented.³⁰ A similar regulation was implemented in the United States.³¹ Without delving into details, we must note that ratings publication has since then been subject, both in Europe and across the Atlantic, to agency registration requirements as well as agency supervision. In the European Union, the organization of this scrutiny differs from what has previously characterized the European integration of the banking and financial markets, as it is performed directly by a European agency, ESMA, excluding this subject matter from the competence of Member State authorities. It is also at the European level that decisions recognizing the legal framework and the

²⁸ Lucia Quaglia, *The Regulatory Response of the European Union to the Global Financial Crisis*, in CRISIS AND CONTROL: INSTITUTIONAL CHANGE IN FINANCIAL MARKET REGULATION 171, 179–80 (Renate Mayntz ed., 2012).

²⁹ *Id.* at 180.

³⁰ For further details, see *The EU Single Market: Rating Agencies*, EUR. COMM'N (Sept. 25, 2013), http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

³¹ Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006), amended by Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

supervision systems implemented in non-EU states are taken,³² which is one of the most critical issues in European regulation given that the ratings market is essentially concentrated in the hands of three large agencies in the United States. It is too early to tell what effect the new regulatory framework for rating agencies will have on the efficiency of the market. Still, one can wonder whether the role of verifying the compliance of rating methods with the models developed by agencies entrusted to ESMA will lend stronger credibility to credit ratings; it may be more appropriate to encourage investors, especially professional investors, to form their own opinions on the value and risks associated with a given security because their positions contribute to the determination of the market price.³³ With the new framework in place, are we not at risk of clinging to the illusion that credit ratings reflect exactly and completely the strength of a security or of its issuer, therefore partially short-circuiting the ECMH mechanism? The continued reference to credit ratings by risk-weighting and equity ratio calculation rules that are in place poses a similar threat.

Market efficiency may also suffer as a result of practices that disrupt the normal course of trading or heighten speculation, causing the trading price of a financial asset to deviate from its intrinsic value. Hence, in the draft revision of the Markets in Financial Instruments Directive, the Commission suggests regulating and monitoring entities that perform high frequency or algorithmic trading. A draft regulation provides for the extension of the applicability of the penalty for market abuse to include high-frequency trading strategies such as quote stuffing, which has the sole purpose of disrupting trading systems without the true intent to trade a security.³⁴ Increased regulation suggests that public authorities are reconsidering the supposed self-discipline of market actors.

So-called “naked” short selling, where the seller has neither borrowed the securities nor taken measures to ensure that he will hold them at the time of delivery, has also been indicated as a source of disruption of market efficiency as it allegedly threatens to aggravate downward trends. However, the circumstances under which naked short selling should be prohibited are far from general agreement.³⁵ Taking into consideration the unilateral initiatives of some Member States and pressures that naked short selling activity places on the prices (and yields) of sovereign debt, the European Union decided to define a harmonized framework meant to prevent non-concerted actions of European and national regulators.³⁶

³² The European Commission acknowledged in a decision on October 5, 2012 that the regimes in Australia, Canada, and the United States are equivalent to the European standards. *The EU Single Market*, *supra* note 30.

³³ For a more thorough discussion, see André Prüm, *Les Agences de Notation dans la Ligne de Mire des Politiques*, in *REVUE DE DROIT BANCAIRE ET FINANCIER* 1 (Jan.–Feb. 2009) (Fr.).

³⁴ See Press Release, European Commission, Getting Tough on Insider Dealing and Market Manipulation (Oct. 20, 2011), available at http://europa.eu/rapid/press-release_IP-11-1217_en.htm.

³⁵ See generally Oscar Bernal et al., *Which Short-Selling Regulation is the Least Damaging to Market Efficiency? Evidence from Europe* (Ctr. Emile Bertheim Working Paper, Dec. 2012).

³⁶ See, e.g., Parliament and Council Regulation 2012/236, On Short Selling and Certain Aspects of Credit Default Swaps, 2012 O.J. (L 86) 1 (EU). For an application of this rule to the short selling of sovereign debts see *infra* and Patrick Wautelet, *Vulture Funds, Creditors and Sovereign Debtor: How to Find a Balance?*, in *INSOLVABILITÉ DES ÉTATS ET DETTES SOUVERAINES* 103 (Mathias Audit ed., 2011) (Fr.).

The fact that very large volumes of financial assets, especially of derivatives, are traded over the counter makes these exchanges especially opaque both to investors and regulators. Prices of these products are therefore extremely difficult to measure and contribute to the mood of distrust, which has fueled the crisis since 2008 and, in itself, represents a major systemic risk. This practice also hides information necessary for markets to be efficient. During the Pittsburgh summit, G20 countries and the European Union agreed to put an end to this development by requiring exchanges of standardized derivatives to go through market channels that are placed under at least a minimal level of control.³⁷ This is the shared guiding objective of the draft revision of the Markets in Financial Instruments Directive³⁸ and of Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on the OTC derivatives, central counterparts and trade repositories. Apart from strictly regulated markets and multilateral trading platforms, a new market category is planned to be introduced for that purpose—organized trading facilities (OTF)—modeled on the American swap execution facilities created by the Dodd-Frank Act which impose transparency rules that must contribute to efficient prices. The same logic underlies the provisions that the draft revision of the Markets in Financial Instruments Directive reserves for “dark pools,” where significant quantities of the same security are traded, often by banks, without any information made available to the public. According to that proposition, such trading will be permitted in the future solely to the extent that it does not undermine overall market efficiency and market price setting mechanisms.

2. Protection Against The Efficient Market Dogma

In the years of economic growth that preceded the banking crisis, the general feeling that markets worked efficiently encouraged credit institutions to look for profits there, while neglecting not only the risk of overvaluation of traded securities and the resulting abrupt drop in quoted prices, but also the fact that the mechanism itself could get jammed by the sudden lack of liquidity. Prudential rules that largely trusted in market efficiency and did not urge banks to reduce their exposures to market risks encouraged this attitude. Moreover, supervision of the financial sector was limited to monitoring solvency and strength of credit institutions, neglecting the macroeconomic dimension which would probably have allowed earlier detection of the imbalances and tensions on the entire financial system. When governments of many Member States had to come to the aid of banks facing bankruptcy to avoid a chain reaction both in the banking sector and in the rest of the economy, taxpayers, whose money was spent on those rescue measures, could not help but harbor the impression that they had borne the costs of excessive and poorly-monitored risks, to the benefit of shareholders, managers and traders.

Today, there is a favorable climate to adjust the paradigm in the regulation of the financial sector, which is clearly indicated by measures taken or discussed at the

³⁷ See Gerard Hertig, *Post-Financial Crisis Trading and Clearing Reforms in the EU: A Story of Interest Groups with Magnified Voice*, in *FINANCIAL REGULATION AND SUPERVISION: A POST-CRISIS ANALYSIS* 321, 321 (Guido Ferrarini, Klaus Hopf & Eddy Wymeersch eds., 2012).

³⁸ See Press Release, European Commission, New Rules for More Efficient, Resilient and Transparent Financial Markets (Oct. 20, 2011), available at http://europa.eu/rapid/press-release_IP-11-1219_en.htm.

European level to bring credit institutions under closer supervision. Beyond this general objective, the number of such initiatives demonstrates a more realistic attitude towards the ECMH and its limitations. This dimension first appears in the reform of prudential rules and of rules of governance. It was also manifest in the revision of supervisory architecture for credit institutions and indisputably represents one of the key motivations behind the recent propositions of isolating classical banking operations from proprietary trading operations.

a. Reforming Prudential Rules and Rules of Governance

The fragility of many banks revealed by the crisis also stems from the fact that weak prudential rules only partially accounted for risks to which they were exposed.³⁹ The revision of those rules therefore became a priority for the Basel Committee⁴⁰ and the European Union. In 2009, and then once again in 2010, two new European directives on capital requirements were adopted (CRD II and III).⁴¹ At the same time, the Basel Committee agreed in December 2010 on a third generation of its standards,⁴² on which the Commission has based its draft directive and draft regulation in order to implement the new requirements in the European legal order (CRD IV).⁴³

The management of risks associated with derivatives, especially with securitization and re-securitization, tightening of capital requirements for traded portfolios, management of liquidity risk, and recalibration of remuneration policies are at the heart of the provisions of CRD II and CRD III. These measures are particularly aimed to remedy the preferential treatment reserved by the previous rules to proprietary trading operations compared to classical banking operations, which accompanied the general trend among banks to increase their exposure to market risks. And yet, the banking crisis clearly revealed that the majority of losses were recorded on trading books and on off-balance-sheet transactions which benefited from excessively low risk-weights and were not at all taken into account by risk management rules. The obligation imposing a duty on banks to adjust their remuneration policies with respect to their officers and employees with a view to the medium or long-term health of the bank constitutes another key measure to limit risks motivated by personal gains rather than the corporate interest.⁴⁴

The new generation of prudential standards (Basel III and CRD IV) fine-tuned these rules and raises the general level of capital required. This higher level of required capital is strengthened by two security buffers, one of which—the “counter-

³⁹ For an overall presentation of the European prudential rules and current reforms see LARISA DRAGOMIR, *EUROPEAN PRUDENTIAL BANKING REGULATION AND SUPERVISION: THE LEGAL DIMENSION* (2010).

⁴⁰ The Basel Committee is responsible for defining international standards on bank supervision.

⁴¹ See Quaglia, *supra* note 28, at 175–77.

⁴² See Romain Goldbach & Dieter Kerwer, *New Capital Rules? Reforming the Basel Banking Standards after the Financial Crisis*, in *CRISIS AND CONTROL*, *supra* note 28, at 247, 253.

⁴³ See European Commission, The EU Single Market: Capital Markets Directive, Legislation in Force (July 17, 2013), available at http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm.

⁴⁴ See André Prüm, *L'Étau se Resserre Autour de la Rémunération des Traders et des Dirigeants des Établissements de Crédit et des Entreprises d'Investissement*, in *REVUE DE DROIT BANCAIRE ET FINANCIER* 1 (Jan.–Feb. 2010) (Fr.).

“cyclical capital buffer”—serves to mitigate the potentially pro-cyclical effects of derivatives risk assessment rules, which were widely disparaged following the crisis. Another significant change was the introduction of liquidity reserves, which require banks to protect themselves against the risk of illiquid markets—in other words, when the market mechanism freezes.

Whether we talk about rules already adopted by the European Union or those still being discussed, one of their goals is definitely to ensure that the efficiency of prudential rules is not dependent on market efficiency, as was previously the case. A similar discussion is now open as to the accounting principles applied to banks’ portfolio assets at “fair value,” which is, in principle, their market value. The “fair value” accounting standard has been favored over the historical or amortized value since the 1980s. This shift was advocated by the U.S. Financial Accounting Standards Board, followed by the International Accounting Standards Board (IASB), first in response to scandals in the United States lending market, then to the growing importance of trading books and the securitization market. Although banks were largely in favor of this accounting method pre-crisis—since it allowed them to quickly determine their unrealized profits—the use of mark to market accounting in the post-crisis period where there is a major slump in asset prices only serves to aggravate their problems. The debate is far from over.

b. Revising the Supervisory Architecture

Reports ordered by the Commission from two expert groups headed by Jacques de Larosière and Erkki Liikanen both insist on the flaws in banking supervision at the time of the crisis. Moreover, the second group’s report includes several case studies which reveal the limitations of the supervision architecture. According to those analyses, the supervision system based on the home country control was overly fragmented and lacked coordination, which made it incapable of effectively encompassing multinational banks’ operations and had a strictly micro-prudential dimension. The introduction of colleges of supervisors⁴⁵ and efforts made, particularly by the European Banking Committee, over many years to overcome these shortcomings were inadequate.

The revision of the supervision system, decided in 2010 and implemented in 2011 following the Larosière report, was a halfway compromise between the previous solution, where supervision was divided among national authorities, and an integrated supervision structure giving jurisdiction to one or more European authorities, whether one follows a sectorial or cross-sector approach.⁴⁶ It naturally is a result of a delicate compromise.⁴⁷ The new European Banking Authority (EBA) and ESMA play key roles in defining common supervision standards that the Commission is empowered to pass. The new sequencing of this regulation at various

⁴⁵ See André Prüm, *La Crise Financière Défie les Autorités Européennes et Américaines de Surveillance*, in REVUE DE DROIT BANCAIRE ET FINANCIER 5, 7 (May 2009) (Fr.).

⁴⁶ See e.g., Sir Howard Davies, *Unfinished Business: an Assessment of the Reforms*, in FINANCIAL REGULATION AND SUPERVISION, *supra* note 37, at 48, 55; Carmine Di Noia & Maria Chiara Furlò, *The New Structure of Financial Supervision in Europe: What’s Next?*, in FINANCIAL REGULATION AND SUPERVISION, *supra* note 37, at 172.

⁴⁷ See André Prüm, *En Voie Vers une Supervision des Marchés et des Acteurs Financiers à l’Échelle Européenne*, in REVUE DE DROIT BANCAIRE ET FINANCIER 5 (Sept. 2009) (Fr.).

levels is (excessively) complex and undoubtedly will be open to debate.⁴⁸ The EBA was granted enforcement powers and competence to settle conflicts among national supervision authorities. How it actually exercises these powers will reveal its true authority. Even though these are undoubtedly considerable improvements, supervision over banks and financial conglomerates remains, under the arrangements agreed in 2010, within the exclusive competence of each Member State.⁴⁹

What is more innovative is the introduction of financial sector supervision at the macro-prudential level. Granted to the European Systemic Risk Board (ESRB), which is headed by the president of the European Central Bank, this new dimension of supervision is meant to guarantee the soundness of the financial system by detecting systemic risks and preventing them from materializing.⁵⁰ The addition of macro-prudential supervision and organizations for information exchange, absent at the beginning of the crisis, probably represents the most noticeable development of the reform of 2010.⁵¹ However, the ESRB has no other means of action other than to draw the attention of the parties involved and the public to situations it deems critical. In fact, it has no legal personality or binding authority.

In the face of the unfolding banking crisis, aggravated by European banks' exposure to sovereign debt and of the importance of public funds mobilized to prevent the bankruptcy of some banks or at least to organize their restructuring, the need for a more in-depth reform of the banking supervision architecture grew increasingly urgent. On September 12, 2012, following the conclusions of the European Council and the June 2012 Eurozone summit, the Commission presented a series of legislative proposals to create a single banking supervision mechanism, marking the first step towards an integrated banking union operating under a "single rule book."⁵² The idea of a banking union was accepted in principle by the Economic and Financial Affairs Council on December 13, 2012. Two Regulations adopted on October 15 and 22 of 2013 finally enacted the Single Supervisory Mechanism, granting the European Central Bank the responsibility for the supervision of all banks of the Eurozone.⁵³ Further integration of the scrutiny of credit institutions follows the logic of strengthening the single market for banking services. The current proposal, however, covers only banks established in a Eurozone Member State,⁵⁴ leaving London, Europe's largest financial center, outside

⁴⁸ See e.g., Niamh Moloney, *Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action,' A Challenge for the EU*, in *FINANCIAL REGULATION AND SUPERVISION*, *supra* note 37, at 71; Eilis Ferran, *Understanding the New Institutional Architecture of EU Financial Market Supervision*, in *FINANCIAL REGULATION AND SUPERVISION*, *supra* note 37, at 111.

⁴⁹ See e.g., Guido Ferrarini & Filippo Chioldini, *Nationally Fragmented Supervision over Multinational Banks as a Source of Global Systemic Risk: A Critical Analysis of Recent EU Reforms*, in *FINANCIAL REGULATION AND SUPERVISION*, *supra* note 37, at 193, 195, 198.

⁵⁰ For a discussion of the advantages and disadvantages of placing supervisory authority at the central bank-level, see David Green, *The Relationship Between Micro-Macro-Prudential Supervision and Central Banking*, in *FINANCIAL REGULATION AND SUPERVISION*, *supra* note 37, at 57.

⁵¹ See Chryssa Papathanassiou & Georgios Zagouras, *A European Framework for Macro-Prudential Oversight*, in *FINANCIAL REGULATION AND SUPERVISION*, *supra* note 37, at 528.

⁵² See European Commission, *The EU Single Market: Commission Proposals for a Single Supervisory Mechanism* (Sept. 12, 2012), http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm.

⁵³ See Parliament and Council Regulation 1022/2013, 2013 O.J. (L 287) 5 (EU).

⁵⁴ It includes, however, an option for non-Euro Member States to join the banking union.

the scope of its application. The ECB, in taking over the devolved competences from Member States' central banks, would become the central supervisory entity in the Eurozone. For banks that run their operations both within and without the Eurozone, one would have to resort to cooperation mechanisms currently in place, with all the associated and oft-disparaged shortcomings. With a view towards protecting the European financial system and considering the key role played by the City of London, the proposed separation does not sound convincing. Was it not investments in structured products that were developed and sold, in a major part, in London, which exposed some German *Landesbanken* to the risks of the United States subprime housing market, bringing them to the verge of bankruptcy?

Apart from centralizing oversight functions, the banking union project also introduces a single bank resolution mechanism. In connection with this mechanism, the Commission has developed a draft directive⁵⁵ and a single deposit guarantee scheme.⁵⁶ The former must, among other things, keep in check the expectation that some banks are "too big to fail;" an expectation fueled by numerous state interventions in Europe since the beginning of the crisis. As a result of these initiatives, banks must reckon with more clear-cut market supervision going forward.

c. Proposing a Separation Between Banking Operations and the Market

The Liikanen report, in its assessment of the European banking sector, insists that European commercial banks have strayed more and more from a customer-oriented model where lending granted is held to maturity in the balance sheet, towards an "originate and distribute model," where lending activities are refinanced through securitization. This change, as the report concludes, makes banks more dependent on shadow banking and the associated chains of intermediation. The alleged result is a heightened concern with short-term profits, deeply rooted in the investment banking culture, spurred on by shareholders' expectations of profitability.⁵⁷ With this observation in mind, founded on a detailed analysis of different business models that characterize the European banking landscape, the Commission's High-level Expert Group on Bank Structural Reform recommended a functional separation of trading operations beyond a certain threshold, from traditional deposit and lending operations by creating a distinct legal structure for the latter. The solution was inspired by the United States' Volcker Rule⁵⁸ and the United Kingdom's Vickers proposals.⁵⁹ The three solutions rely on the same general logic of bringing the focus of banks back to their main role—collecting deposits and transforming them into loans—even if they take slightly different paths toward that goal. They also share the same objective of preventing banks from being exposed to

⁵⁵ *Commission Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms*, at 1, COM (2012) 280/3 final (June 6, 2012).

⁵⁶ See Daniel C. Hardy & Maria J. Nieto, *Cross-Border Coordination of Prudential Supervision and Deposit Guarantees*, 7 J. FIN. STABILITY, no. 3, 2011, at 155 (discussing the usefulness of such a common guarantee system).

⁵⁷ See THE LIIKANEN GROUP, *supra* note 21, at 89.

⁵⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–31 (2010); see also THE LIIKANEN GROUP, *supra* note 21, at 84.

⁵⁹ See THE LIIKANEN GROUP, *supra* note 21, at 85.

excessive market risks with respect to their essential credit function in the economy. These measures are presently the object of a hot debate as to their appropriateness and effectiveness, which we will not get embroiled with here. For the purposes of our remarks on the new regulatory tendencies, these proposals mark a loss of trust in the relationship forged between banks and financial markets. More accurately, they mean that the business model of credit institutions must not be dictated mainly by the alleged market efficiency and, above all, that the stability of the bank sector cannot rely entirely on that efficiency.

From this quick review of the main European regulatory initiatives post-financial crisis, it is not surprising to find that they fit squarely with the general movement towards tighter regulation of the banking sector and stricter supervision over financial markets. While trust in efficient markets has, in the last 40 years, stimulated deregulation and liberalization of financial operations, this trend has clearly reversed.

Does this mean that the efficient market hypothesis is being demoted to the level of a postulate that is not reliable enough or even too dangerous to be taken into account by legislative policy? This would certainly be an exaggerated conclusion. Surely this efficiency does not always seem to be a given and is sometimes artificial. Measures aimed to protect market from practices that disturb its natural course, like “quote stuffing,” are welcome in this respect. However, regulatory intervention in the operation of markets remains an extremely delicate matter, as demonstrated, for example, by the discussions on the potential pernicious effects of the ban on naked short selling. Nevertheless, prudence is recommended when trying to influence information on which the ECMH is premised by controlling the quality of stock listings at the risk of increasing the dependence on synthetic, and therefore approximate, data. Financial crises naturally tempt politicians to intervene in the market. Ambitions should remain realistic when it comes to stimulating its efficiency.

On the other hand, the financial crisis certainly helped regulators become more aware of the extent to which the banking sector has been exposed to market risks and realize that the situation was encouraged by the regulatory and supervisory framework based on the ECMH. The ongoing revision of this framework, intended to prevent the stability of the financial sector from depending too much on the efficiency of markets in the future, is useful. Still, the right balance between safeguarding the role of banks as credit providers, even as they inevitably have interactions with financial markets and protecting depositors is not easy to find. Regulators have to be particularly careful that the limitations imposed at this level do not compromise the growth prospects of European banks or distort competition to the benefit of the shadow banking sector, banks established outside the European Union, or even within it but outside the EMU. The necessary strengthening of the surveillance framework will drastically transform the structure of the internal market for banking services, upsetting the mutual recognition principle within the EMU by pushing aside the country of origin rule and creating different systems for banks in the Eurozone and for those outside of it. One needs to carefully consider whether the proposed banking union can be built on such a divide.

III. THE EUROPEAN REACTION TO THE SOVEREIGN DEBT CRISIS

A. Lessons Learned from The Crisis Regarding The Efficient Sovereign Debt Market Hypothesis

Unlike the majority of previous sovereign debt crises, which were brought about by a state's decision to cease paying bondholders, the present crisis in Europe arose from a sudden loss of market confidence brought about by disclosures made in October 2009 by the new Greek government regarding the "true" situation of the country's public finances. In response to the announced adjustments of previously published figures, rating agencies dramatically lowered Greece's credit rating, immediately triggering a noticeable drop in the value of Greek bonds in the secondary market and a corresponding increase in interest rates required from Greece to borrow in the market. This loss of confidence spread to other Member States of the Union: first to Ireland, then to Portugal, Spain and Italy, and recently to Cyprus, destabilizing the EMU as a whole and casting doubt on the strength of the single currency.

Like in any crisis, mistrust suddenly followed with investors taken by surprise and reacting en masse, in a powerful, if not exaggerated, manner. Difficulties experienced today by some European countries in honoring their debts, or at least in financing themselves on sustainable terms, obviously stem from imprudent fiscal policies, which, despite the inaccuracy of some figures, were an open secret. Therefore, the most fundamental cause of the present crisis is a wrong bet made by those who invested in bonds issued by over-indebted Member States, with the expectation that the European Union would not allow one of the EMU Member States to become insolvent. Yet, this assumption conflicts with the EMU's founding principles, expressed in the Treaty of Maastricht, which excludes financial solidarity between Eurozone Member States and the possibility of a European Union bailout. The EMU was actually built on the premise that Member States, while transferring their monetary sovereignty to the Union, keep full sovereignty of national tax and economic policy. This asymmetry is surely disparaged today, but it used to be the condition for a political agreement on the EMU. It crystallized in the so-called convergence criteria, and then in the Stability and Growth Pact pursuant to which Eurozone Member States agreed that sharing a single currency implies an obligation for each of them to respect deficit levels and maximum debt limits. Budget discipline nevertheless remains the responsibility of each Member State, with the Pact having no binding effect. The Treaty of Maastricht contains, above all, rules intended to encourage Eurozone Member States to take their responsibilities seriously; it banned monetary financing and privileged access of Member States to financial institutions and excluded the possibility for the European Union or a community of other Member States to bail out a Member State in difficulty.⁶⁰

⁶⁰ See Matthias Ruffert, *Der Rechtliche Rahmen für die Gegenseitige Nothilfe innerhalb des Euro-Raumes*, 64 BERLINER ONLINE BEITRÄGE ZUM EUROPARECHT 1 (2011) (Ger.); Christian Callies, *Das Europäische Solidaritätsprinzip und die Krise des Euro: Von der Rechtsgemeinschaft zur Solidaritätsgemeinschaft?*, 62 BERLINER ONLINE BEITRÄGE ZUM EUROPARECHT 1 (2011) (Ger.). This does not include the assistance granted to Greece through bilateral agreements by the *sui generis* decision of the ECOFIN Council on May 2, 2010.

It is worth remembering that the terms of relevant TFEU provisions are the result of bitter negotiations.⁶¹ In the Commission's proposal, only unconditional guarantees for a Member State's debts were excluded and support for a Eurozone Member State should be possible to allow for economic rapprochement. Member States with weaker economies called for a more general support mechanism; Germany and France were against it. The possibility of mutual assistance was only kept for the benefit of non-Eurozone Member States,⁶² the no-bailout clause for Eurozone Member States provided no exceptions⁶³ and assistance was only envisaged for difficulties caused by "natural disasters or exceptional occurrences beyond its control."⁶⁴ Therefore, since exceptional aid to a Eurozone Member State was not absolutely ruled out, the Treaty of Maastricht clearly aimed to submit each Eurozone Member State to the discipline of the financial markets to which they usually look for financing.

This meant supposing that markets actually take into account different financial situations of respective Member States, and in particular, of the spreads between their debt ratios and public deficit. And yet, the Eurozone has long been considered by investors and rating agencies to be perfectly homogenous, with the most indebted Member States able to raise funds at the same interest rates as the more financially prudent ones. The ECMH was simply inaccurate,⁶⁵ or at least based on a risky assumption of solidarity among Eurozone Member States. Additionally, the fact that markets failed to adjust the cost of credit to Member States' different solvency ratios inevitably encouraged some Member States to increase their indebtedness far beyond the capacity of their economy, further widening the spread between risk and borrowing rates, between the perceived creditworthiness and the true market price of a Member State's credit. It was inefficiency of markets that triggered the insolvency risks, which later caught the same markets off guard.

As it was in the case of the banking crisis, rating agencies had for years partaken in the market overvaluation of over-indebted Member States' bonds before contributing to their fall by suddenly lowering their ratings. The phenomenon worsened due to speculation, namely by investment funds⁶⁶ and their naked sales of default hedging products such as CDSs—that is, trading such hedging products independently of their underlying sovereign bonds.⁶⁷ The fact that the ECB encouraged banks to hold large amounts of sovereign debt through loose monetary policy, thereby artificially supporting sovereign debt prices, certainly did not help.

⁶¹ See, e.g., Ulrich Häde, *Haushaldsdisziplin und Solidarität im Zeichen der Finanzkrise*, 20 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [EuZW], Dec. 2009, at 399 (Ger.); Case C-370/12, Pringle v. Gov't of Ir., 2 C.M.L.R. 2 (2013) (offering the position of Advocate General J. Kokott).

⁶² TFEU art. 143.

⁶³ TFEU art. 125.

⁶⁴ TFEU art. 122.

⁶⁵ See, e.g., Alain Bernard, *Le Marché de la Dette Souveraine: La Régulation de l'Information sur le Marché des Dettes Souveraines ou la Religion de la Valeur*, in *INSOLVABILITÉ*, *supra* note 36, at 177, 204 (Fr.).

⁶⁶ It may be an exaggeration, in the context of the European debt crises, to suggest that vulture funds speculated against the restructuring of certain developing country debts. See Wautelet, *supra* note 36, at 103.

⁶⁷ See Wautelet, *supra* note 36, at 103; Jérôme Da Ros, *Les Credit Default Swaps, Incidence des CDS sur les Dettes des Etats: Bilan et Prospective*, in *INSOLVABILITÉ*, *supra* note 36, at 89 (Fr.).

More than other investors, large European banks thought twice before selling off sovereign bonds, which would cause a sharp drop in prices and a corresponding rise in interest rates that harmed their home countries' ability to borrow while generating losses for themselves. We should not forget that the debt of some Member States increased following the emergency support they had to provide to banks facing liquidity shortages during the financial crisis. There are many interactions between the sovereign debt crisis and the financial crisis.

In summary, the paradox is that the EMU, as designed by the Treaty of Maastricht, relied on the efficient market dogma to give force to convergence rules and budget discipline—both necessary for the proper functioning of a single currency—while the financial markets, for many years, did not truly believe in the lack of solidarity within the EMU as sanctioned by the Treaty of Maastricht. The question is therefore whether the measures taken by the European Union, or the collective action of the great majority of Member States, have made it possible to solve this paradox.

B. Measures Taken to Prevent the EMU from Being Threatened by the Effect of the ECMH

Market pressures on the sovereign debt of many Member States—first those from outside the Eurozone, then the Euro Member States, and then on the EMU as a whole—pushed the European Union to react in parallel in two areas. In the financial markets, the Union decided to defend the EMU and its single currency against all speculations and did not contemplate that a Eurozone Member State could be forced to leave it. Member States that could no longer get financing on sustainable terms in the market had to be reminded that solidarity efforts by others were exceptions and conditioned on improvements in their domestic finances. At the same time, the agreements establishing true economic governance in the Eurozone was a call to order, addressed to all EMU Member States obliged to respect the Stability and Growth Pact and European Union authorities competent to enforce Member States' compliance.⁶⁸

Compelled by the urgency of the situation and confronted with complex geometry resulting from an EMU in which not all Member States take part—the United Kingdom's absence is particularly notable, given that it is home to Europe's most important financial center—the European Union was faced with the difficult task of having to develop adequate solutions to face those challenges.⁶⁹ Furthermore, the Treaties had created a strict framework, which clearly did not envision a crisis of the scale faced by the European Union. Moreover, recent history cautioned against impulses to reform the constitutional foundations of the Union.

⁶⁸ See Jacques Ziller, *The Reform of the Political and Economic Architecture of the Eurozone's Governance: A Legal Perspective*, in GOVERNANCE FOR THE EUROZONE: INTEGRATION OR DISINTEGRATION 115 (Franklin Allen et al. eds., 2012).

⁶⁹ See, e.g., Bruno De Witte, *Treaty Games: Law as Instrument and as Constraint in the Euro Crisis Policy*, in GOVERNANCE FOR THE EUROZONE, *supra* note 68, at 139; André Prüm, *L'Union Economique et Monétaire dans la Tourmente*, in REVUE DE DROIT BANCAIRE ET FINANCIER 19 (July 2011) (Fr.).

To try and solve the abovementioned paradox, the European Union and its Member States had no choice but to integrate the financial market mechanisms in their assistance and support program for the Member States in difficulty and to protect the Stability and Growth Pact. Although some measures attempt, embracing the logic of the ECMH, to influence market prices, the main objective of this program is to exploit the market.

1. Attempts to Reorient the Market

Tensions associated with Greek sovereign debt and the concern that these problems would spread to other Eurozone Member States convinced the ECB to urgently adopt a temporary program to allow national central banks of the ESCB to intervene directly in the bond markets and buy large quantities of sovereign debt securities on the secondary market.⁷⁰ These interventions artificially supported the prices of the securities in question in order to combat speculation, changing the natural course of the market.⁷¹

The same objective was behind the decision to authorize the ESM to purchase troubled Member States' sovereign debt.⁷² Terms and conditions of such purchases must be determined by the ESM's Board of Governors.

Considering the financial capacity of the ESCB and the ESM, such interventions are certainly effective. As part of its program, the ECB acquired debt instruments worth EUR 209.5 billion, not to mention that it accepted the same securities as a guarantee for lending granted to private financial institutions.⁷³ The legality of the ECB's program however, has been hotly debated since Article 123 of the TFEU explicitly prohibits the acquisition of a Member State's debt securities by the ECB or national central banks.⁷⁴ While there may be plausible legal interpretations to find the ECB's actions compatible with the text of the TFEU,⁷⁵ the principal argument in favor of the program was the pressing need to save the EMU. On September 6, 2012, the ECB announced the end of the program and replaced it with outright

⁷⁰ See Decision of the European Central Bank ECB/2010/5 (2010/281/EU), Establishing a Securities Markets Programme, 2010 O.J. (L 124) 8; Kaarlo Tuori, *The European Financial Crisis: Constitutional Aspects and Implications* 16 (EUI Working Papers, Paper No. LAW 2012/28, 2012).

⁷¹ See, e.g., Paul De Grauwe, *The European Central Bank: Lender of Last Resort in the Government Bond Markets?*, in GOVERNANCE FOR THE EUROZONE, *supra* note 68, at 17; Frank Smets, *Imbalances in the Euro Area and the ECB's Response*, in GOVERNANCE FOR THE EUROZONE, *supra* note 68, at 41.

⁷² Treaty Establishing the European Stability Mechanism, art. 17, July 11, 2011, 2011 O.J. (L 91) 1, 6 [hereinafter ESM Treaty].

⁷³ See Press Release, European Central Bank, Consolidated Financial Statement of the Eurosystem (Oct. 9, 2012), <http://www.ecb.europa.eu/press/pr/wfs/2012/html/fs121009.en.html>.

⁷⁴ Norbert Horn, *Die Reform der Europäischen Währungsunion und die Zukunft des Euro*, 64 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 1398 (2011) (Ger.).

⁷⁵ See Francesco Martucci, *Le Défaut Souverain en Droit de l'Union Européenne: Les Instruments de Droit de l'Union Européenne pour Remédier à l'Insolvenabilité des Etats*, in INSOLVABILITÉ, *supra* note 36, at 223 (Fr.).

monetary transactions.⁷⁶ Since the TFEU is not applicable to the ESM (elaborated below), the ESM has since evaded criticism on constitutional grounds.

One way of influencing the natural course of the market involves investors negotiating a sacrifice in the event the issuing state is unable to honor its debt. Collective Action Clauses (CAC) allow for the restructuring of debt based on the consent of the majority of creditors. Binding on all parties involved, such consents aim to avoid the situation where a small group of creditors can prevent restructuring by threatening the insolvent state with lawsuits to recover the value of their claims, which is of particular concern, given that such lawsuits outside the jurisdiction of the State involved have met with some success.⁷⁷ The potential pressure on creditors is one of the risks investors take. The introduction of CACs for European Union Member States' bonds could therefore impact their market value. To neutralize this impact, the CACs that Eurozone Member States must include in all issued securities with maturities greater than one year must correspond to those generally accepted on the United States and United Kingdom bond markets.⁷⁸ Moreover, the European Council provided for exceptions to the obligation to include a CAC for issues intended to guarantee liquidity of old bonds.

The possibility to rely on CACs will be particularly important for states that apply for ESM assistance in the future, as the ESM requires private sector participation in "adequate and proportionate" form.⁷⁹ The specific terms of such participation, the very idea of which is hotly debated, will obviously have to be defined on a case-by-case basis and according to the level of debt acceptable for the insolvent state. However, the introduction of CACs reflects the European Union's desire to allow itself some room to maneuver in times of crisis, rather than to subject itself to the strict operation of the free market.

2. Exploiting the Market

Whether we are thinking about granting mutual assistance—a possibility already provided for in the Treaty of Rome—or about the new, recently introduced European stability mechanisms, the funds lent to a struggling Member State are essentially raised in the financial markets. All of these solutions rely on markets being efficient. In order to assess the extent to which they succeed in doing so, it may be useful to briefly summarize their principal characteristics.

The mutual assistance mechanism was founded pursuant to Article 143 of the TFEU, accompanied by Regulation (EC) No 332/2002 establishing a "facility providing medium-term financial assistance for Member States' balances of

⁷⁶ See Mario Draghi & Vitor Constâncio, President & Vice-President of the European Central Bank, Press Conference at the European Central Bank (Sept. 6, 2012), <http://www.ecb.europa.eu/press/pressconf/2012/html/is120906.en.html>; Tuori, *supra* note 70, at 16.

⁷⁷ See MICHAEL WAIBEL, SOVEREIGN DEFAULTS BEFORE INTERNATIONAL COURTS AND TRIBUNALS 320 (2013).

⁷⁸ See Council Conclusions of 24–25 Mar. 2011, 2011 EU CO 10/1/11, at 31.

⁷⁹ *Id.* at 29.

payments.”⁸⁰ Before becoming a community-wide mechanism in 1988, it allowed the grant of aid to Italy and Ireland in 1976, to France in 1983 and to Greece in 1985. Greece and Italy benefited from further assistance in 1991 and in 1993 respectively. Since the launching of the third phase of the EMU, the mechanism has only been used to support Member States that have not yet adopted the Euro. In 2008, Hungary was granted medium-term financial assistance. Latvia and Romania were given similar grants in 2009. Mutual assistance has helped some Member States overcome financial difficulties that had as much to do with the poor condition of their public finances as the financial crisis.⁸¹ The use of the mutual assistance mechanism after fifteen years demonstrates that this solution is still fully able “to restore confidence of financial markets in a currency of a Member State that has not adopted euro.”⁸²

From the outset, support provided to a Member State by way of mutual assistance has depended on community loans. The first regulation adopted pursuant to Article 235 of the TEC was adopted in 1975 to put in place the EEC loan mechanism, which allowed for the financing of the first assistance measures.⁸³ The same structure can be observed under Regulation (EC) No. 332/2002, with lending to a Member State always backed by capital raised by the European Union in the financial markets or from financial institutions.⁸⁴

To address the sovereign debt crisis, the European Union established the ESM, which was the result of a merger of the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The EFSM was created on May 11, 2011 by Regulation (EU) No 407/2010 based on Article 122(2) of the TFEU, pursuant to which the Council may grant financial assistance to a Member State facing difficulties or a serious threat of difficulties, caused by natural disasters or exceptional occurrences beyond its control. All Member States are eligible for this mechanism, but the funds available are limited at a relatively modest EUR 60 billion. Ireland and Portugal have benefited from aid under the EFSM. Again, financing for this mechanism came primarily from capital raised by the Union in the financial markets, although the Union’s budget could also have been used.⁸⁵

The mutual assistance and the EFSM mechanisms rely on the same technique of lending backed by capital raised in the markets. The ECB provides technical assistance to both mechanisms by managing the issuance of the debt instruments in the markets. In both cases, the objective is to benefit a Member State facing high credit risk premiums when borrowing in the market by allowing it to borrow funds at

⁸⁰ Council Regulation 332/2002, Establishing a Facility Providing Medium-Term Financial Assistance for Member States’ Balances of Payments, 2002 O.J. (L 53) 1, 1 (EC) (replaced by Council Regulation 682/81).

⁸¹ See Martucci, *supra* note 75, at 246.

⁸² *Id.*

⁸³ Council Regulation 397/75, Concerning Community Loans, 1975 O.J. (L 46) 1, 2 (EEC) (establishing a Community Loan Mechanism to help some EC countries overcome unsustainable current account imbalances caused by the first oil shock).

⁸⁴ Council Regulation 332/2002, *supra* note 80, art. 1.

⁸⁵ See Council Regulation 407/2010, Establishing a European Financial Stabilization Mechanism, art. 2, 2010 O.J. (L 118) 1, 2 (EU).

preferential rates applicable to the European Union. By acting as an intermediary between the market and the Member State in difficulty, the European Union lends its credibility to debt security offerings.⁸⁶ The direct application of the ECMH to a borrowing State is displaced by an instrumentalization of market mechanisms.⁸⁷ This is compliant with the prohibition on bailouts imposed by Article 125 of the TFEU since the Union lends money to a troubled Member State on the same terms—with respect to the amount, maturity, payment rate, and due date of interest and capital—that it borrows on.⁸⁸ The European Union’s budget balancing constraint, as set out in Article 310(1) of the TFEU, is not breached since fully refinanced support measures impose no burden on the Union’s public finances, at least as long as the interest and capital are repaid.⁸⁹

The specific challenges of the sovereign debt crisis for the EMU and the inadequate solidarity within the European Union obliged Eurozone Member States to devise a temporary bailout mechanism with significantly greater financial capacity that was separate from the Treaties. In 2010, the EFSF was constituted between EMU Member States in the form of an investment vehicle, governed by the laws of Luxembourg. The conditions for intervention and conditionality of the EFSF were set out in a framework agreement concluded by Member State shareholders.⁹⁰ However, the European Commission and the ECB had to be involved in any decisions regarding grants of assistance and the management of such assistance.

The EFSF’s capacity to raise funds on the market is estimated at EUR 440 billion and relies on guaranteed commitments by the Member States involved in the total amount of EUR 780 billion, defined according to their share of the ECB’s paid-up capital. The mechanism relies on the same intermediary concept as the mutual assistance mechanism or the EFSM, except that the intermediary is not the European Union but the EFSF—*i.e.*, all the Eurozone Member States—playing the role of the intermediary. Although the EFSF was initially given a AAA rating by the three major rating agencies—Fitch, Moody’s and Standard & Poor’s—all subsequently downgraded the EFSF’s credit rating following the downgrade of France’s rating.⁹¹ EFSF assistance may take the form of a loan to the state in difficulty—it was used in December 2010 for Ireland. However, the EFSF has more extensive means of action, which distinguishes it from previous mechanisms. The EFSF may finance the acquisition of securities on the secondary market, provide liquidity to allow a subscription of securities on the primary market, or lend amounts necessary to

⁸⁶ See Martucci, *supra* note 75, at 262.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *European Financial Stability Facility Framework Agreement*, C-No 1189 OFFICIAL J. GRAND DUCHY LUX., June 7, 2010 [hereinafter EFSF Agreement], available at http://www.efsfeuropa.eu/attachments/2011019_efsf_framework_agreement_en.pdf.

⁹¹ Frank Gill & Moritz Kraemer, *European Financial Stability Facility Long-Term Ratings Cut to AA+*, STANDARD & POOR’S (Jan. 16, 2012), <http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245327337060#ContactInfo>; Dietmar Hornung & Bart Oosterveld, *Moody’s Downgrades ESM to Aa1 from Aaa and EFSF to (P)Aa1 from (P)Aaa*, MOODY’S (Nov. 30, 2012), https://www.moodys.com/research/Moodys-downgrades-ESM-to-Aa1-from-Aaa-and-EFSF-to-PR_261114; *Fitch Downgrades European Financial Stability Facility to AA+*, FITCH (July 15, 2013), <http://www.efsfeuropa.eu/attachments/Fitch%202013-07-15.pdf>.

recapitalize financial institutions established within the territory of a Eurozone Member State, including a Member State that is not covered by the support program.

In early 2010, there was so much pressure on sovereign debt markets that EMU Member States had no other choice but to respond urgently. The EFSF is the result of that reaction. Intended to quickly send a strong message to the market that Member States were determined to protect the EMU from speculations about a Greek exit, the EFSF was designed as a temporary mechanism to be later transformed into a long-lasting solution. Negotiations to establish this solution began closely after the creation of the EFSF. At the meeting of the European Council on March 24 and 25, 2011, the Union amended Article 136 of the TFEU to include a new third paragraph enabling Eurozone Member States to create a bailout mechanism which can be activated in case of a threat to the stability of the Eurozone as a whole; Member States also signed the Treaty establishing the European Stability Mechanism on March 2, 2012. The decision to adopt an international treaty and structure the ESM as an international organization governed by public international law instead of structuring it as a European Union entity was dictated by the refusal of the United Kingdom and the Czech Republic to sign the agreement. The structure of the ESM is reminiscent of the structure of the International Monetary Fund, the practices of which are considered to have inspired it.⁹²

Officially created on October 8, 2012, the ESM will have an authorized capital of EUR 700 billion,⁹³ subscribed to by the signatory states according to the same distribution key as the one in the ESFS, for a total lending capacity of EUR 500 billion. A large part of this capital will only be paid up only if a specific need arises. To finance its assistance to Member States in difficulty, the ESM will first turn to financial markets. Guidelines for those loan operations have been adopted.⁹⁴

Meant for Member States that find themselves excluded from financial markets, or at the risk of being so excluded, the assistance can, like the one provided by the EFSF, take different forms: financial assistance for recapitalizing financial institutions, lending facilities or interventions on secondary or primary markets.⁹⁵ It could also materialize as lines of credit granted as a precaution and to restore market confidence.⁹⁶ All of those forms of assistance involve “signature lending,” where the ESM acts as an intermediary for the Member State facing high interest rates in the market. The ESM must, however, ensure a security margin to cover its own costs of financing. The treaty signatory states committed to grant the ESM the status of a privileged creditor, over which only the IMF shall prevail. This structure should allow states receiving aid under the ESM to benefit from financing at the best market rates. Obviously, the cost of capital will depend on the extent to which markets trust in the ESM itself. In this respect, the abovementioned decision by the three leading rating agencies refusing to give the EFSF and ESM triple A credit ratings must have increased their cost of capital.

⁹² See ESM Treaty pmbL.

⁹³ ESM Treaty art. 8.

⁹⁴ See *ESM Borrowing Guidelines*, EUROPEAN STABILITY MECHANISM (Oct. 9, 2012), <http://www.esm.europa.eu/pdf/ ESM%20borrowing%20guidelines.pdf>.

⁹⁵ See ESM Treaty arts. 15–18.

⁹⁶ See ESM Treaty art. 14.

As both the ESM and the EFSF aim to guarantee the financial stability of the Eurozone as a whole as well as that of EMU Member States,⁹⁷ they both contribute to a wider plan of measures comprising of a strengthening of the Stability and Growth Pact, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (signed March 2, 2012), and a series of more technical but no less effective measures, such as the new national budget review procedure (the “European semester”).⁹⁸ All these measures as a whole have complex architecture with interdependent components. In practice however, this structure raises some questions, especially relating to the differences in character and scope between the provisions of European law and those of public international law, and to the interdependence of decisions taken strictly pursuant to the EMU and those based on the ESM. For the purposes of this paper’s analysis, it is not necessary to describe the nuances of this structure in detail. It is enough to point out that they are all intended to indicate to financial markets that EMU Member States, supported by almost all European Union Member States consider the EMU and Euro to be public goods which they are determined to protect, while embracing the logic of markets, whose confidence they wish to earn. Compared to the previous approach where Member States that had adopted the Euro had to confront the markets individually, which led to the aforementioned paradox, the new method seems more realistic. The circular reasoning of “no bailouts” for States in difficulty, which the markets never truly believed, has been replaced by a solidarity mechanism which, while limited, manages to tap the market for the benefit of the stability of the EMU.

The new paradox is that this change of paradigm took place without first having fully adapted the EMU’s constitutional foundations. The question here is not so much whether the different initiatives mentioned above are well-grounded in the provisions of the TFEU. Undoubtedly, urgency necessitated the adoption of these measures at the cost of a constructive or flexible interpretation of the TFEU, or even of reinforcing the legal basis of the Union’s market interventions *a posteriori*. This step is surely open to criticism from a legal standpoint, as many commentators have pointed out.⁹⁹ However, above all, it is a question of perspective. The threat of a financial crisis of this magnitude was clearly not envisaged by the drafters of the Treaty. Consequently, the meaning of the TFEU’s provisions should be read in light of the drastic change of the context that confronted the European Union. In this case, it becomes less justifiable to argue that some of these measures are incompatible with the TFEU.¹⁰⁰ As rightly pointed out by the President of the European Council after the October 29, 2010 meeting, “[p]olitics is not a zero-risk business.”¹⁰¹

⁹⁷ See ESM Treaty art. 3.

⁹⁸ See, e.g., *Making It Happen: The European Semester*, EUROPEAN COMMISSION: EUROPE 2020 (Nov. 12, 2013), <http://ec.europa.eu/europe2020/making-it-happen/>.

⁹⁹ See e.g., Giuseppe Bianco, *The New Financial Stability Mechanisms and Their (Poor) Consistency with EU Law* (EUI Working Papers, Paper No. RSCAS 2012/44, 2012) (providing a complete review of the criticism).

¹⁰⁰ See, e.g., René Smits, *The European Debt Crisis and European Union Law: Comments and a Call for Action*, 49 COMMON MKT. L. REV. 827, 827–32 (2012).

¹⁰¹ Press Release, Herman Van Rompuy, President of the European Council, European Council (Oct. 29, 2010), available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117489.pdf.

In its judgment of November 27, 2012,¹⁰² the Court of Justice of the European Union decided, not surprisingly, that the European Council Decision No. 2011/199/EU of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Eurozone Member States was valid. The Court also decided that neither the provisions of the abovementioned Treaties, nor the general principle of effective judicial protection, prevented Eurozone Member States from concluding the treaty establishing the ESM or from ratifying it, even before Decision 2011/199 becomes effective.

A more fundamental question raised by the introduction of new solidarity mechanisms, or transfers within the EMU, is one regarding the unavoidable transformation of the general foundations on which these mechanisms are based.¹⁰³ The Europeanization of monetary policy and the financial stability it requires are by no means compatible with strictly national fiscal and budgetary responsibilities.¹⁰⁴ Markets have probably overcome this asymmetry sanctioned by the Treaty of Maastricht. The new Treaty on Stability, Coordination and Governance of the Eurozone and, to a greater extent, the constraints imposed on Member States benefiting from aid within its conditionality affect national fiscal sovereignty, matching the responsibilities of Member States in this area. Still, commitments undertaken by all Eurozone Member States to save the stability of the EMU and prevent some states from going into insolvency have today reached amounts that unavoidably compromise their sovereignty and budgetary autonomy. This was a concern voiced by the German Constitutional Court when it required that, under some conditions, such commitments must first be approved by the Bundestag.¹⁰⁵

The largely intergovernmental approach used by these new measures is a harbinger of executive federalism, which still leaves little space for democratic debate.¹⁰⁶ In the long run, such a deficit certainly is unsustainable and financial stability mechanisms in this era of new economic governance will have to be founded in the democratic process at the European level.¹⁰⁷ Therefore it should be expected that resorting to intergovernmental solutions—by way of international treaties or by creation of a public international law organization, in the absence of

¹⁰² *Pringle v. Gov't of Ir.*, 2 C.M.L.R. 2.

¹⁰³ See, e.g., Tuori, *supra* note 70, at 1.

¹⁰⁴ See André Prüm, *EFSF, ESM, Nouveau Pacte Budgétaire: le Droit Européen mis à l'Épreuve*, in REVUE DE DROIT BANCAIRE ET FINANCIER 8 (Mar. 2012) (Fr.); *Communication from the Commission: A Blueprint for a Deep and Genuine Economic and Monetary Union, Launching a European Debate*, COM (2012) 777 final/2 (Nov. 30, 2012).

¹⁰⁵ See ENTSCHEIDUNGEN DES BUNDESVERFASSUNGSGERICHTS [BVERFGE] [Federal Constitutional Court] Sept. 7, 2011, 2 BVR 987/10 (Ger.); ENTSCHEIDUNGEN DES BUNDESVERFASSUNGSGERICHTS [BVERFGE] [Federal Constitutional Court] Sept. 12, 2012, 2 BVR 1390/12 (Ger.); ENTSCHEIDUNGEN DES BUNDESVERFASSUNGSGERICHTS [BVERFGE] [Federal Constitutional Court] Feb. 28, 2012, 2 BVE 8/11 (Ger.).

¹⁰⁶ See, e.g., JÜRGEN HABERMAS, ZUR VERFASSUNG EUROPAS: EIN ESSAY 79 (2011); Rose M. D'Sa, *The Legal and Constitutional Nature of the New International Treaties on Economic and Monetary Union from the Perspective of EU Law*, EUR. CURRENT L., May 2012, at xi; Tuori, *supra* note 70, at 46.

¹⁰⁷ See, e.g., Miguel Poiares Maduro, *A New Governance for the European Union and the Euro: Democracy and Justice* (RSCAS Policy Papers, Paper No. RSCAS PP 2012/11, 2012); Miguel Poiares Maduro, Bruno de Witte & Mattias Kumm, *The Democratic Governance of the Euro 3* (RSCAS Policy Papers, Paper No. RSCAS PP 2012/08, 2012).

unanimity within the European Union or due to the Treaties' lack of flexibility in case of an unforeseen crisis—is just a stopgap solution to be used until those solutions and mechanisms are integrated into European Union law. By submission to the transparency principle and adequate involvement of the European Parliament, these solutions will gain legitimacy, which will be a necessary condition for their long-term success. In the meantime, the involvement of the European Commission in launching them and a certain degree of control by the Court of Justice of the European Union must serve as a safeguard. The gap between Member States from the Eurozone and the others, particularly the United Kingdom and the Czech Republic, is the major obstacle to the incorporation of these measures into European Union law.

IV. CONCLUSION

What should be remembered from this brief review of European reactions to the financial and sovereign debt crises, and their confrontation with the ECMH? Is it possible to determine common characteristics and solutions that are part of a comprehensive and coherent approach? The two dimensions of the crisis are interrelated as to their origin, at least partly, and surely as to their scale. Measures taken to stamp out its consequences and, even more so, those aimed at preventing it from happening again cannot ignore this mutual relation. The new supervision of credit rating agencies concerns their solvency assessment of private and public entities. This affects not only the risks banks are exposed to, but also the efforts taken in most Member States to heal their public finances. If rating agencies take a longer term view instead of being influenced by the latest political developments, they should enhance the effectiveness of European solidarity mechanisms. Conditions to the prohibition on naked short selling of financial instruments must include their potential impact on the liquidity of markets, particularly of the sovereign debt market.

These examples, clearly limited, allow us to assume that European responses to the crisis, as generally understood, will no longer ignore its different faces and interrelations between them. This, however, does not mean that comparable problems necessarily imply the same solution. Writing down creditors' claims against failing financial institutions (commonly referred to as "bail-in" measures), as envisaged by the draft directive on resolution plans for banks is certainly less difficult to impose than having them take a significant haircut on sovereign debt owed by states that are technically insolvent.

The assessment of the ECMH following the crisis led to an understanding that the pre-crisis positive law was incompatible with the effective operation of the markets, stimulating a more holistic approach to the EMU. The crisis actually made it possible to realize that the ECMH—at least as it was understood by the drafters of the Treaties, European legislators or financial regulators—failed in practice, even before the crisis erupted. The rules established to ensure the soundness of the financial sector or the stability of the EMU proved to be, as a consequence, partially ineffective. What was worse was that some of these regulations, as an indirect result, made credit institutions take greater risks on financial markets, or encouraged EMU Member States to increase their debts. Who was to blame? The economists,

who constructed an imperfect hypothesis? Or the politicians, who embraced it without having measured its actual impact? That remains open to debate.

What seems certain is that the EMU's economic foundations as well as the prudential framework of supervision over the financial industry must be based on a realistic hypothesis on efficient capital markets. The stability of the EMU may be only accomplished if markets believe in the rules and, in particular, in solidarity mechanisms put in place among the Eurozone Member States and that both Member States and the European Union will comply with the strengthened Stability and Growth Pact while exerting without delay, as was too often the case, the necessary pressure on interest rates for public loans. It is, in consequence, up to the European Union to exploit the markets to guarantee solvency of each EMU Member State and to protect its single currency. As for the financial sector, the challenge is to ensure sufficient soundness of banks through the natural course of financial markets to avoid any risk of the system collapsing, but without compromising the profitability of the business sector, which holds major importance for Europe, despite being susceptible to growing international competition. These two perspectives, though not identical, support each other and are perfectly compatible insofar as they are based on the same realist understanding of the ECMH and its limitations. They both surely tend towards a more integrated Europe, as suggested, despite a certain intergovernmental dimension, with the new tasks assigned in both areas to the ECB, with the Commission and the Court of Justice of the European Union playing key roles. It remains to be seen if that orientation may include the European Union as a whole, or if it will widen the gap around the Eurozone.

The greatest challenge is not to forget, amidst the economic effects of the crisis, the political ambitions for which the European Union should stand.¹⁰⁸ In an era of globalization, more than ever before, Europe must build itself on the values of democracy and justice.¹⁰⁹

¹⁰⁸ See Catherine Barnard, *The Financial Crisis and the Euro Plus Pact: A Labour Lawyer's Perspective*, 41 INDUS. L.J., no. 1, Mar. 2012, at 98; Tuori, *supra* note 70, at 47.

¹⁰⁹ See generally Maduro, *supra* note 107.

