

Yves Mersch: Financial stability and the ECB

Speech by Yves Mersch, Member of the Executive Board of the ECB, ESCB Legal Conference, Frankfurt, 6 September 2018

Introduction

The growing importance of “financial stability” in the post-crisis public debate

The recent crisis put financial stability at the centre of public discussions on how to improve economic resilience. What should the institutional architecture of financial stability look like and what should be the role of central banks in this context? While such questions have largely been settled regarding *price* stability, no similar consensus exists when it comes to *financial* stability. There is neither a settled institutional template for financial stability nor a consensus about the role of central banks. The economic literature has suggested various models, some of which have been tested around the world.^[1] In my speech today, however, I will not go into the economics of financial stability. I will instead approach the issue from a *legal* perspective. The question I will address is: what role does EU law ascribe to the ECB in contributing to the stability of the financial system?

The general constitutional framework

When we talk about the *role* of the ECB from a legal perspective, we are essentially referring to its tasks, mandates and competences. In the compound EU legal order, these are covered by a set of basic principles. First and foremost, the EU is a union based on the rule of law.^[2] This means that every action taken by EU institutions needs to be founded on Union law and ultimately on the Treaties. This fundamental constitutional value has two manifestations.

First, the *principle of conferral* requires that the EU should act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein.^[3] Moreover, in exercising its competences, the EU must respect the principles of subsidiarity and proportionality.^[4] Second, the *principle of institutional balance* provides that all EU institutions must act in accordance with the powers conferred on them by the Treaties and respect the competences of other EU institutions. These two principles should guide the discussion on the role of the ECB in financial stability. They also highlight the fact that getting the answer right is ultimately a rule-of-law issue.

As I will argue today, the authors of the Treaties did not make financial

stability an ECB objective. The ECB's only primary responsibility is price stability. The Treaty-makers did not provide either for specific financial stability-oriented instruments or for a dedicated financial stability institutional set-up at the Union level, if I abstract from the coordination role of the European Systemic Risk Board (ESRB). And without an objective and dedicated instruments, the Treaties could not have conferred on the ECB a stand-alone task. In financial stability, thus, the ECB has only a limited, contributory role according to the Treaties.

Financial stability in ECB law

Financial stability: a protean concept

The Treaties do not contain a definition of financial stability. Like price stability, financial stability is an objective of public policy. Unlike price stability, however, financial stability remains a protean concept, with various manifestations and different understandings of its basic aspects.

First, the notion of financial stability is nebulous and much more difficult to capture than price stability. The term financial stability is sometimes used in a very broad way to cover objectives and institutions that encompass the stability of the economy as a whole and also include the financial stability of governments, as in the Treaty establishing the European Stability Mechanism or in the title of the European Financial Stability Facility (EFSF). In my speech today, I will use the term financial stability in a narrow sense to refer to the "stability of the financial system", which is the wording used in Article 127(5) of the TFEU.

But even within this narrow meaning, there is no single or even widely accepted definition of financial stability.^[5] Some authors and institutions have tried to arrive at a positive definition of financial stability by describing its essential features, while others start from its absence – financial *instability*. The ECB approaches financial stability in terms of systemic risk: financial stability is a state whereby the build-up of systemic risk is prevented.^[6] In turn, systemic risk is "the risk that the provision of *necessary financial products and services* by the financial system will be impaired to a point where economic growth and welfare may be materially affected". Simply put, financial stability means that the financial system is expected to withstand unforeseeable events or shocks without major disruption and to continue providing its services to the economy.^[7] Compare this definition with the much more concrete ECB definition of price stability, which is a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below 2%. In the pursuit of price stability, the ECB aims to maintain inflation rates below, but close to, 2% over the medium term. These two definitions clearly illustrate that, when it comes to financial stability, we are operating at a much more abstract level, with considerably vaguer metrics.^[8]

Financial stability and monetary policy also differ in terms of the instruments they use to pursue their objectives. Monetary policy has a fairly settled set of tools – first and foremost, at least in conventional times,

the short-term interest rate. Financial stability, however, has neither a primary instrument nor a standard taxonomy of instruments. Instead, there are various different instruments, ranging from those from the toolbox of the supervisory regulations (Article 5 of the SSMR), such as maximum loan-to-value limits and countercyclical capital buffers, to taxation, as well as interest rates. Could this become an example of policymaking with other people's instruments?

Some of these instruments are used at national level, while others are deployed in a certain sector or with regard to an individual financial institution. Many of these instruments which have financial stability as their stated aim advance macroprudential policies. And so macroprudential policies, like financial stability, are often a concept onto which "anyone could project their own sense of priorities"^[9] – priorities that often compete with each other.

Third, unlike price stability, financial stability does not fall under the exclusive competence of a single institution. Instead, various actors at national, supranational and international level are given different roles and responsibilities in pursuing financial stability. Finance ministries, supervisors, expert bodies (the ESRB, national macroprudential committees and/or regulators which diverge widely in terms of their powers and composition), central banks and the Basel-based Financial Stability Board have all been ascribed a role in financial stability.

Thus, in all these respects, financial stability is still not a settled field of public policy in the same way that price stability is. And this is not just a matter of theoretical interest. It also has a bearing on the question of who should ultimately be responsible in this field: experts or political bodies. I will come back to this point at the end of my speech.

What is the role of the ECB in the field of financial stability?

Let me now come to my basic question. *What role does EU law, and especially primary EU law, foresee for the ECB in the field of financial stability?*

The basic Treaty provision to start from is Article 127 of the TFEU under the chapter on monetary policy, which contains the objectives and tasks of the ECB/ESCB. This Article does not explicitly point to any clear, unambiguous role for the ECB regarding financial stability. Financial stability is *not* among the objectives of the ECB enshrined in the first paragraph of Article 127. The primary objective is defined there as being the maintenance of price stability. And, without prejudice to this objective, the ECB has a mandate to support the general economic policies in the Union with a view to contributing to the general objectives of the Union. Nor is financial stability one of the four basic tasks referred to in the second paragraph of Article 127. First in the list is, of course, the basic task of defining and implementing the monetary policy of the Union. This basic task is accompanied by certain monetary tools, specifically provided for in primary law.^[10] As I already mentioned, *no* such tools are provided for in the area of financial stability.

The ECB's contributory role in financial stability

The only explicit reference to financial stability in Article 127 is in the fifth paragraph. This paragraph sets out the ESCB's duty to "contribute" to the smooth conduct of policies pursued by "competent authorities" relating to the stability of the financial system. Thus, the ESCB is given a contributory role in the field of financial stability. That contribution can be exercised through its monetary policy task or its supervisory task, both of which embed financial stability as a contribution to competent authorities.

What is the scope of the ECB's contributory role?

The concept of a "contribution" appears not just in Article 127 of the TFEU. It is also used by the Treaties to describe the allocation of powers and to demarcate competences between the Member States and the EU in a variety of fields. For example, Article 170(1) of the TFEU provides that "the Union shall *contribute* to the establishment and development of trans-European networks in the areas of transport, telecommunications and energy infrastructures". The same formulation is used in Article 169(1) of the TFEU regarding consumer protection. In these fields, the EU has a shared competence with the Member States. There is, however, a significant difference between these Articles and Article 127(5). In the case of such shared competences, the EU is given the power to contribute directly *to the achievement of the objectives*. When it comes to financial stability, however, the ECB is tasked with contributing to the *smooth conduct of policies pursued by the competent authorities*. There is a critical difference here.^[11] If the ECB were tasked with contributing to the attainment of financial stability, it would – like the EU in the field of networks – have leeway to identify policies that better serve the achievement of this aim. However, the ECB's role in contributing to financial stability would instead seem to be equivalent to the category of Union competences with the narrowest possible scope, namely supplementary or supporting competences.^[12] In these fields, the EU can only support *actions of the Member States*^[13] "without thereby superseding their competence in these areas".^[14]

Thus it is clear that the ECB has *neither exclusive powers* in the field of financial stability nor competence to act on its own. "Contribution" does not establish a competence for independent and stand-alone action. To contribute to the attainment of an aim is to *support* it; the basic identification of how the aim of financial stability is to be achieved thus lies with other "competent" institutions. And so does the primary responsibility.

Exactly how the ECB should carry out this contributory role is not specified in either the Treaty or the Statute of the ESCB – unlike monetary policy, for which the ECB's functions and operations are set out in detail. The ECB can use its usual tools, to the extent that they are suitable, to contribute to financial stability. The ECB's *advisory functions* are of great relevance in this context. Article 127(4) of the TFEU calls for consultation on the basic tasks listed in the preceding paragraph. Only then does paragraph (5) mention financial stability, but the Council decision implementing this part of the Treaty also included the obligation to consult on national acts that

influence the stability of financial institutions and markets. Regarding Union legislation, in the chapter on prudential supervision, Article 25 of the Statute of the ESCB states that the ECB “may offer advice to and be consulted by the Council and the Commission on the scope and implementation of Union legislation” relating to the stability of financial system. According to Article 141(2) of the TFEU, for Member States with a derogation the ECB “shall ... hold consultations concerning issues falling within the competence of the national central banks and affecting the stability of financial institutions and markets”.

In any case, the contributory role of the ECB needs to support its monetary policy tasks or the tasks conferred upon it relating to the prudential supervision of credit institutions and other financial institutions.

Monetary policy and financial stability

As Article 25 of the Statute of the ESCB refers to prudential supervision, Article 127(5) is the only reference to the ECB/ESCB. It is also interesting to note that the advisory functions are mentioned in the Treaty after the basic tasks and before financial stability, while in the Statute they follow Article 3.3.

This leads to the following considerations:

First, it should be noted that the ECB, when pursuing the objective of maintaining price stability, follows a two-pillar strategy that takes account of monetary and economic analysis, and includes financial stability considerations. The ECB’s two-pillar strategy forms the basis for the Governing Council’s overall assessment of the risks to price stability and its monetary policy decisions.

Moreover, the ECB may use its ancillary policy tools to address financial stability to the extent that this is necessary to carry out its basic tasks.^[15] Under such circumstances, financial stability is not the ultimate aim of ECB policy but a means to fulfil its basic tasks. In principle, this applies to all the basic tasks of the ECB listed in Article 127(2) of the TFEU, but it is most important for monetary policy. Financial stability, namely the proper functioning of the financial system, is necessary for the transmission of monetary policy.^[16] In *Gauweiler*, the Court accepted that measures intended to preserve the monetary transmission mechanism may be regarded as pertaining to the objective of maintaining price stability, thus falling within the mandate of the ECB.^[17] Addressing issues of financial stability in order to promote price stability is therefore possible with two caveats:

First, price stability enjoys primacy. Within the current legal framework, and by contrast with other jurisdictions, price stability is the ECB’s only primary objective. If there is a conflict between price stability, which is primarily concerned with the business cycle, and financial stability, which is more concerned with the financial cycle, and some trade-off between the two is required, the Treaties require primacy to be given to price stability. Financial stability cannot take precedence over price stability.

Second, financial stability-related policies need to comply with the principle of proportionality. According to Article 5(4) of the TEU, Union institutions shall observe the principle of proportionality when exercising the competences conferred on them. The principle of proportionality was also used by the Court of Justice to assess the legality of the ECB's Outright Monetary Transactions (OMT) programme as a means to achieve price stability. According to the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties.^[18] This means that ECB policies regarding financial stability that serve monetary policy need to be appropriate for maintaining price stability and should not go beyond what is necessary to achieve this objective.^[19]

In principle, therefore, financial stability-oriented instruments can be used if necessary to carry out the basic tasks, but subject to serving the primary objective of price stability and within proportionality limitations.

Financial stability and the prudential supervision of credit institutions

The other aspect of ECB involvement in financial stability is through the ECB's prudential supervisory role. Article 127(6) of the TFEU (also reflected in Article 25 of the Statute of the ESCB) permits the Council to confer specific tasks upon the ECB concerning the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. This provision was activated through the establishment of the Single Supervisory Mechanism (SSM) under the SSM Regulation. As made explicit in the SSM Regulation, the Union legislator conferred prudential supervisory tasks on the ECB with a view to contributing to financial stability within the Union and each Member State.^[20]

Article 5 of the SSM Regulation also makes provision for certain macroprudential tasks and tools. These competences to require capital buffers to be held by credit institutions in addition to own funds requirements, including countercyclical buffer rates and other measures aimed at addressing systemic or macroprudential risks, are conferred on national authorities. This reflects the fact that primary responsibility for macroprudential policies lies with national authorities. If deemed necessary, the ECB, instead of national authorities, may apply higher requirements for capital buffers than those applied by the national authorities and more stringent measures aimed at addressing systemic or macroprudential risks. The procedure for adopting these top-up ECB measures may be triggered only at the initiative of the national authorities, emphasising the national character of macroprudential competences.

The microprudential and macroprudential tools contained in the SSM Regulation are thus specific aspects of the financial stability mandate of the ECB, which is based on the specific authorisation in Article 127(6) of the TFEU. Neither the SSM Regulation in general, however, nor Article 5 in particular confers a general competence on the ECB in the fields of financial stability and macroprudential policy.

Democracy, independence and financial stability

When we interpret the competences of public institutions we are essentially discussing the limits of their powers. As with any discussion on public powers, the aspect of legitimacy also needs to be considered. In the field of financial stability and macroprudential policies, a multitude of institutions are involved, such as parliaments, EU political institutions, national governments, and expert bodies at both the European and the national level. Some of these actors derive their legitimacy from their independent expertise, others from their democratic accountability. What role each of them should play in achieving financial stability is intimately connected with the source of their legitimacy.

This brings me back to the first point of my speech: financial stability might be an objective less well suited to independent expertise-based bodies than a price stability objective. Even though the Treaty does not give a definition of price stability, it is an objective that is quantifiable. The ECB Governing Council aims to maintain inflation rates below, but close to, 2% over the medium term. Putting a figure on price stability makes monetary policy more transparent and provides a clear and measurable yardstick against which European citizens can hold the ECB accountable. For financial stability no such clear yardstick exists. Without clear objectives, however, it is much more difficult to measure the performance of independent, expertise-based institutions and hold them to account.^[21] Beyond that, the pursuit of financial stability often involves choices with stronger distributional implications. This is an additional argument in favour of the ultimate responsibility remaining in the political sphere. Financial stability is thus a policy area where expert bodies and politically accountable institutions are called on to cooperate, with no one having exclusive responsibility. In this field, expert bodies with strong guarantees of independence, such as the ECB, might be better suited to “contributing” in an advisory capacity while the “ultimate responsibility” is rather borne by institutions embedded in political accountability arrangements at the national level. Otherwise political pressures to adopt one or the other stance in questions of financial stability might also threaten central bank independence.

Conclusions

At the time the Treaties were drafted, financial stability and the potential differences between financial and business cycles were not a primary consideration. The Treaty provisions do not point towards a clear, unambiguous role for the ECB. Certain economic approaches may now suggest different ways of coping with financial stability challenges that, on some occasions, would involve a wider role for central banks. But the ECB, as an institution bound by the rule of law, has to operate within the limits set by the Treaties.

Article 127(5) of the Treaty implies that the ECB has only a contributory and supporting role with regard to financial stability. This role is partly discharged through its advisory role in the preparation of EU or national acts.

Beyond that, the ECB's financial stability role is embedded within the ECB's basic monetary policy task and the ECB's microprudential supervisory tasks. The specific macroprudential tasks contained in the SSM Regulation are supplementary in nature, and do *not* confer any general competence on the ECB in the field of macroprudential policy.

These are primarily legal conclusions that also reflect the relative positions of public institutions in terms of independence and accountability. Beyond these considerations, however, there are political and economic considerations that have not been addressed here.