Ivana Bajakić
Marta Božina Beroš
Editors

EU FINANCIAL REGULATION AND MARKETS

Beyond Fragmentation and Differentiation

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EU FINANCIAL REGULATION AND MARKETS

Beyond Fragmentation and Differentiation

Zagreb, 26-27 November 2020

Conference Proceedings

Faculty of Law University of Zagreb

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Igor Gliha, Full Professor, Dean, Faculty of Law, University of Zagreb

Editor of the Publishing Department:

Siniša Zrinščak, Full Professor, Faculty of Law, University of Zagreb

Editors of the Publication:

Ivana Bajakić, Associate Professor, University of Zagreb

Marta Božina Beroš, Associate Professor, Juraj Dobrila University of Pula

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Technical Editor:

Lovre Božina, Full Professor

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Luka Gusić

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Ivana Bajakić

Marta Božina Beroš

Editors

EU FINANCIAL REGULATION AND MARKETS

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Zagreb, 2021

Preface

Over the last decade the European Union (EU) has been pressured by multiple troubling crises: from the Euro crisis to Brexit and more recently, the Covid-19 pandemic. This "polycrisis", as accurately captured by the President of the European Commission, Jean-Claude Juncker in 2016, has pressured the EU integration process, straining the societal, political, and economic strings that piece together the intricate knitting of the Union. The tension caused by some of these various challenges was so profound that it steered the EU towards "unchartered waters" of political disintegration concerning one of its member states, while the pressure created by other crisis-events has informed – and continues to do so – our common, European policies and thus the political and economic discourse and practices, which are radically different from the ones European citizens envisaged, favored and supported back in 2010.

Indeed, at the beginning of the second decade of the 21st century European citizens, but also policymakers, did not imagine that – apart from political disintegration – in the decade before them the Union's knitting will also be strained by differentiation demands and consequently, by fragmentation effects that will profoundly affect the field of economic governance and challenge, at times, the financial stability of the Union. Still, even though faced with unprecedented challenges, the EU economy and the financial system in particular, demonstrated great resilience to pressures of differentiation and fragmentation. The ambitious and skillful guidance of the EU political and policymaking community allowed preserving the integrity of the European financial system while accommodating the preferences and capacities of its very diverse membership (e.g. Euro "Ins" and "Outs", "North" and "South" countries) thanks to the establishment of new mechanisms for the stabilization of finances or closer cooperation of EU member states, such as the Banking Union or the Capital Market Union. To add further complexity, each of these crisis-driven mechanisms has to fulfill its integrative scope while remaining responsive to current market challenges that – at the end of the decade – are primarily presented by a fast-developing FinTech industry and a (currently) underdeveloped RegTech response.

This is the societal, political and economic backdrop against which the Jean Monnet European Module on "EU Financial Markets and Regulation" emerged with an ambition to create a specialised teaching module that will enable law students to understand the complexity of the global and European post-crisis financial architecture, multi-level governance regime and the importance of stability and integration of European financial markets. One of the module's

planned deliverables was the Jean Monnet Module International Scientific Conference on "EU Financial Regulation and Markets: Beyond Fragmentation and Differentiation" (the EUFRM conference) that wished to gather theoretical and empirical reflection on the future of EU financial markets and their regulation in the decade to come – a reflection that looks beyond the current pressures of differentiation and fragmentation, toward a future with perhaps less uniform political integration but more societal and economic solidarity. Although the EUFRM conference call for papers coincided with the unravelling of the Covid19 pandemic, the response received was exceptional, both in terms of the number of papers and in terms of their scientific broadens. From the received papers seventeen manuscripts were selected, written by European researchers as well as practitioners from the EU and national supervisory community and whose theoretical scope and methodological approach cut across different scholarship strands: from political economy, finance, to legal and political sciences, and therefore allowed a comprehensive and far-reaching reflection of the future of EU financial markets and regulation.

Given the limitations imposed by the Covid19 pandemic, the EUFRM conference took place on the 26th and 27th November 2020 as an "online event". During this two-day conference, the papers presented were grouped under four broad(er) topics in order to systematize our reflection on the evolution of EU finance: (I) Perspectives on current EU prudential developments, (II) The evolution of SSM and SRM, (III) The emerging banking and payment landscape in the SEE, and (IV) European Capital Markets, FinTech and RegTech. Thanks to the merits of digitization, we were able to secure participants from eleven European countries. We were also particularly pleased to ensure that each conference day begun with the finest intellectual nourishment delivered by the keynote and plenary speakers. On the first day, we had the honour to host the Vice Governor of the Croatian National Bank, Mr. Bojan Fras, as our keynote speaker on the topic of "Road and roadblocks of Croatian membership in the Eurozone" providing appealing insights of the unique experiment of the Close Cooperation process. On the conference's second day, Professor Dalvinder Singh from the University of Warwick urged us to consider the intricacies of "European cross-border banking and banking supervision" in his sharp and knowledgeable plenary speech. Both speakers masterfully created an intellectual atmosphere beneficial to insightful and critical discussions of the paper presented later in the day.

Our ambition as editors of this book of conference proceedings that you read is to convey some of the brilliant conference atmosphere and results that defined the two days of our Jean Monnet Module International Scientific Conference on

"EU Financial Regulation and Markets: Beyond Fragmentation and Differentiation". We hope that our selection of eleven conference papers, which underwent double blind-peer review each, will provide intellectual encouragement needed to venture into reflection on the motives of, and solutions to, differentiation demands and fragmentation effects that will surely continue to shape European economic and financial governance.

The Editors

Zagreb, Croatia — Ivana Bajakić

Pula, Croatia — Marta Božina Beroš

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A TEMPORARILY AMENDED VERSION OF PRECAUTIONARY RECAPITALIZATION[1]

Prof. Christos Gortsos
National and Kapodistrian University of Athens
Akadimias 45, Athens – 10672
Greece
professor.gortsos@gmail.com

Prof. Michele Siri
University of Genoa
Via Balbi 22, Genoa – 16128
Italy
michele.siri@unige.it

Dr. Marco Bodellini
Queen Mary University of London
67-69 Lincoln's Inn Fields, London – WC2A 3JB
United Kingdom
m.bodellini@qmul.ac.uk

ABSTRACT

Credit institutions are expected to pile up a relevant amount of non-performing loans (NPLs) as a consequence of the current crisis. Thus, one of the most critical issues at stake is whether they currently hold an amount of capital which is sufficient to absorb the inherent losses. If this will not be the case, then they will have to undergo recapitalisations. In a context of global and prolonged economic crisis, nevertheless, it could turn out to be extremely challenging to find private investors able and willing to invest in their equity. Therefore, a new solution capable to balance conflicting, yet legitimate, needs, such as credit institutions' recapitalisation without recurring to excessive and generalised public bail-outs, might have to be found.

Accordingly, what we propose is a temporary, revised and standardised form of privately and publicly funded precautionary recapitalisation, designed beforehand and operating on a quasi-automatic basis. Thus, this paper advocates a temporary amendment of the precautionary recapitalisation under the Single Resolution Mechanism Regulation (SRMR) with the major

[1] This paper is part of a broader research on how to tackle the consequences of Covid-19 on the banking system; see Christos Gortsos – Michele Siri – Marco Bodellini, 'A proposal for a temporarily amended version of precautionary recapitalisation under the Single Resolution Mechanism Regulation involving the European Stability Mechanism', 2020 EBI Working Paper Series, 2020 no. 73, 8 September 2020, *passim*, <https://ebi-europa.eu/publications/working-paper-series/> accessed 3 December 2020.

involvement of the European Stability Mechanism (ESM). Such proposal should build on the regime currently in place in light of the European Commission's (Commission) decision to temporarily suspend the application of the state aid prohibitions.

Accordingly, for a limited period of time, some of the conditions currently required by the SRMR for the precautionary recapitalisation should be amended in line with the recent measures adopted by the Commission to facilitate public intervention to support the economy. This should be combined with an ESM facility allowing it to buy hybrid instruments issued by the credit institutions that would need to be recapitalised.

Keywords: precautionary recapitalization, European Stability Mechanism, Covid-19, Single Resolution Mechanism Regulation, Bank Recovery and Resolution Directive

1. THE NATURE OF THE COVID-19 CRISIS AND ITS IMPACT ON CREDIT INSTITUTIONS

Despite having an economic nature, the current crisis provoked by the Covid-19 pandemic is expected to sooner or later negatively affect credit institutions as well. Due to the close and numerous interconnections between the banking system and the real economy it is, indeed, very likely that the former will be hit soon. Against this background, the main question arising is thus whether the levels of capital currently held by credit institutions will be enough to absorb the losses that they might soon end up suffering.

If the banking system were to succeed in absorbing such future losses, it would also manage to avoid a systemic crisis; if, by contrast, this were not to be the case, recapitalizations will be necessary to prevent the submission of many institutions to either resolution or liquidation. Yet, in a context where private investors (in turn individually hit by the crisis) might be unwilling and/or unable to subscribe to extensive increases of credit institutions' capital, if such increases were to prove necessary, then the creation of a mechanism enabling to recapitalize credit institutions before they formally cross the line of 'FOLF', which also relies on public intervention, will be key to limiting spill-over effects. However, for the injection of public money to take place on a large scale, a legislative reform of the SRMR might be necessary. In this regard, it is worth noting that the Commission has already adopted a number of measures aimed at facilitating public intervention with a view to supporting private businesses struggling because of the crisis caused by the pandemic. On the one hand, it has enabled Member States to deviate from the State aid general prohibition and accordingly has permitted them to rescue failing firms; on the other hand, through its Communication of 20 March 2020, it has activated, for the first time ever, the so called 'general escape clause' of the Stability and Growth Pact (SGP), which allows the Council to derogate from some of the SPG's prescriptions in the event of 'a severe economic downturn in the euro area or in

the Union as a whole'. In so doing, the Commission, with the approval of the Council, managed to remove the main legal constraints refraining Member States from supporting their economies through the use of public money.

On this basis, this paper supports an amended, temporary version of precautionary recapitalization, which would also rely on the involvement of the ESM.

2. THE CREATION OF A PRECAUTIONARY RECAPITALIZATION STANDARDIZED PROCEDURE BASED ON THE DUAL INVOLVEMENT OF PRIVATE INVESTORS AND THE EUROPEAN STABILITY MECHANISM

Because of the high bar set in the recent past by the SRB for the submission of FOLF credit institutions to resolution (unless a different interpretation of the public interest criterion in light of the current crisis is put forward), and with a view to avoiding credit institutions' liquidation financed thorough public resources, this paper proposes a temporary, revised and standardized form of privately and publicly funded precautionary recapitalization, designed a priori and operating on an quasi-automatic basis. Indeed, since, as previously mentioned, credit institutions will likely need to recapitalize but, at the same time, private investors might be either unwilling and/or unable to sufficiently invest in their equity instruments, we advocate an amended version of the precautionary recapitalization under the SRMR, based on the major involvement of the ESM, which should be kept in place until the crisis provoked by the pandemic is over. Such a revised instrument should be available for every credit institution under the SRB's remit whose resolution plan provides for resolution as the procedure to initiate in the event of the credit institution itself becoming FOLF. In such a case, it could be considered that it is the ECB in tandem with SRB which should be in charge of deciding which institutions are eligible to be precautionary recapitalized in accordance with the provisions of their resolution plans. Thus, the former could be the one ascertaining that the amended conditions for precautionary recapitalization are met on a case by case basis, while the latter could be the one checking if the institution concerned is eligible to be precautionary recapitalized on the basis of its resolution plan.

Obviously, such an approach would not entirely solve the issues that the banking system will soon face since the proposed instrument would not be available for the vast majority of credit institutions, even within the BU (i.e., all the non-significant credit institutions and those under the SRB's remit whose resolution plan provides for liquidation in the event of them being FOLF).

2.1. Precautionary recapitalization under the Single Resolution Mechanism Regulation

Currently, the SRMR (as well as the BRRD) enables the use of public money outside a resolution procedure and without the corresponding duty to bail-in at least 8% of the eligible liabilities through the so-called precautionary recapitalization under Article 18(4). Pursuant to this provision, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support can take the form of a precautionary recapitalization, prescribed as "an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution" where the latter is not FOLF.

Still, pursuant to this article, a number of conditions have to be met for a precautionary recapitalization to be conducted. In particular, such measures: are confined to solvent institutions; are conditional on final approval under the EU State aid framework; are of a precautionary and temporary nature; must be proportionate to remedy the consequences of the serious disturbance; and cannot be used to offset losses that the credit institution has incurred or is likely to incur in the near future. Also, this form of recapitalization is limited to injections necessary to address capital shortfall established in national, EU-wide or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, the European Banking Authority (EBA) or national authorities, where applicable, confirmed by the competent authority.

Accordingly, a precautionary recapitalization can take place when a credit institution, although in need to be recapitalized, is not deemed to be FOLF. In this regard, the underlying assumption justifying public intervention is that the capital shortfall of such a credit institution could quickly deteriorate as a consequence of 'a serious disturbance in the economy' of a Member State and then potentially create financial instability. It is still uncertain whether precautionary recapitalization, as currently regulated under the SRMR, could be a useful tool to face the crisis provoked by the pandemic. In this regard, it has already been indicated as a strong candidate for the granting of public financial support in the midst of the Covid-19 crisis. Yet, it has also been pointed out that it should not be used to the benefit of credit institutions that do not have "a sound business model simply to address legacy issues".[2]

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[2] See Elke König, 'Foreword', in Christos Gortsos and Georg Ringe (eds), *Pandemic Crisis and Financial Stability*, European Banking Institute, 2020, vi, who also states that she "*would be extremely concerned at any attempt to turn it into a bail-out in disguise*".

The Commission has already made some steps in that direction through the Temporary Framework, which, in relation to recapitalizations aimed at addressing issues provoked by the Covid-19 pandemic, allows for the application of the exception under point (45) of the Banking Communication of 2013.[3] Such an exception is of particular significance, since it empowers the Commission to exclude the application of the burden sharing mechanism when this would endanger financial stability or lead to disproportionate results. Thus, despite the use of public resources to perform the recapitalization, the burden sharing mechanism, affecting both shareholders and subordinated creditors, does not necessarily have to apply.[4]

2.2. The conditions requested for the proposed revised version of precautionary recapitalization

Building upon the framework currently in place, we hereby propose the amendment, for a limited period of time, namely until when the crisis provoked by the pandemic is over, of some of the conditions laid down in Article 18(4) SRMR to make this tool available on a larger scale, irrespective of the fiscal capacity of the Member State where the credit institution which needs to be recapitalized is established. This section discusses the requested conditions to be met in the current context and advances the proposal for the revision of some of them to enable a more widespread use of such a tool.

The first condition to be met is that precautionary recapitalization should take place in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability. If this condition was considered to have been met in 2017 when Monte dei Paschi was precautionary recapitalized by the Italian Ministry of Finance, it can be assumed that it can also be met in the current situation in which the entire world is facing the most violent economic recession since World War 2.

The second condition to be met is that such a measure should only be employed with regard to solvent credit institutions. The SRMR provisions require both that the institution is not FOLF and that it is solvent. Such requirements might soon become an issue. Indeed, depending on the amount of NPLs accumulated by credit institutions and due to the regulatory requirement to write them off, several

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[3] Communication from the Commission on the application, from August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (‘Banking Communication’), OJ C 216, 30 July 2013, pp. 1-15.

[4] See European Commission, Communication from the Commission, Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, OJ C 224, 8 May 2020, point 17.

institutions will likely end up being balance sheet insolvent, and thus FOLF, in the forthcoming future. To face this obstacle, there might be some alternative solutions to consider, i.e.: first, a more lenient approach of supervisory authorities and regulators allowing credit institutions to phase-in, over a reasonably long period of time, the write off of NPLs; and second, a narrower application (just for the purposes of the proposed temporarily amended precautionary recapitalization) of the concepts of insolvency and FOLF limited only to situations relating to institutions whose assets were already less than their liabilities before that recently accumulated stocks of NPLs will be written off.

In this regard, a practically feasible way to enable such a mechanism to work could be the introduction of a timeline (i.e. the World Health Organization's (WHO) pandemic declaration on 11 March 2020). For the purposes of the proposed revised precautionary recapitalization, only loans which have become non-performing due to repayment defaults occurred after the WHO declaration will be relevant. Accordingly, credit institutions which already had less assets than liabilities before 11 March 2020 will not be considered solvent, while the ones whose liabilities have exceeded the assets as a consequence of their requalification as NPLs due to defaults occurred after the WHO declaration will keep on being considered solvent for the purposes of the proposed temporarily amended precautionary recapitalization. Both solutions would in fact enable credit institutions to continue being considered solvent, hence not FOLF, and therefore potentially eligible for precautionary recapitalization.

The third condition to be met is that the measure must be of a precautionary and temporary nature. There should not be any specific issue with regard to the precautionary nature of the measure as far as it is put in place in advance to actually prevent credit institutions' insolvency (and the FOLF condition), which can in turn create (further) financial instability. The temporary nature of the measure, by contrast, might turn out to be more problematic on the basis of the experience gained from the Monte dei Paschi case, in which the Italian Ministry of Finance, more than 3 years after the recapitalization, has not been able to divest yet. Obviously, the issue relates to the exit strategy of the public entity recapitalizing the credit institution and, hence, some effective mechanism enabling the former to divest must be developed.

The fourth condition to be met is that the intervention needs to be approved by the Commission according to the State aid framework. In this regard, as previously mentioned, the Commission has adopted a 'Temporary Framework for State aid measures to support the economy in the current Covid-19 outbreak', which also deals with precautionary recapitalization. According to this

framework, as in force, if due to the Covid-19 outbreak credit institutions would need extraordinary public financial support in the form of liquidity, recapitalization or impaired asset measure, it would have to be assessed whether the measure meets the conditions of Article 18(4), first sub-paragraph point (d)(i), (ii) or (iii) SRMR. If these conditions were to be fulfilled, the credit institution receiving such extraordinary public financial support would not be deemed to be FOLF.[5]

Also, to the extent that such measures were to address problems linked to the Covid-19 outbreak, they would be deemed to fall under point (45) of the 2013 Banking Communication, which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors.[6]The Temporary Framework, therefore, potentially paves the way for widespread precautionary recapitalizations to be conducted through the injection of public money in light of the fact that, in this way, the authorities would be empowered to exempt both shareholders and subordinated creditors from the application of the burden-sharing requirement when the need for such a measure arises from the situation provoked by the Covid-19 pandemic.

The fifth condition to be met is that the measure should be proportionate to remedy the consequences of the serious disturbance. This requirement should not hinder the application of the measure in question, although the determination of what is proportionate and, therefore, of the amount of the capital increase, requires a discretionary assessment to be made by the involved authorities, i.e. the ECB and the SRB with the agreement of the ESM since the latter, according to the proposal, is supposed to provide the credit institutions concerned with (at least some of) the necessary resources for the recapitalization.

The sixth condition to be met is that the measure should not be used to offset losses that the institution has incurred or is likely to incur in the near future. This requirement might represent an issue since the proposal conceives the amended precautionary recapitalization tool as the instrument to prevent the bank from becoming FOLF and insolvent as a consequence of the Covid-19 provoked crisis. As previously discussed, the impact of such crisis on credit institutions will cause a significant increase of NPLs that, at some point, will have to be accounted and subsequently written off, thereby leading the institutions to record losses.

[5] See European Commission, Communication from the Commission, Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, 8 May 2020, *cit.*, para 7, first and second sentences.

[6] *Id.*, para 7, third sentence.

Whether it can be argued that these losses are not previous losses already incurred by the institution to recapitalize, it seems more difficult to claim that they are not to be considered as losses that the institution 'is likely to incur in the near future', according to the language of Article 18(4) SRMR.

As a consequence, in order to make the proposal operational, this requirement should be either temporarily removed or reformulated with a view to excluding from its scope losses resulting from the Covid-19 provoked crisis. A possible reformulation of this requirement could be based on the same time-line previously discussed. In other words, losses arising from loans which have become NPLs due to repayment defaults occurred after the WHO declaration on 11 March 2020 would not be considered likely future losses relevant to rule out the application of such tool.

Finally, the seventh condition to be met is that the capital increase should be limited to injections needed to address capital shortfall resulting from stress tests and asset quality reviews. In this regard, even though the EBA has decided that stress tests will be suspended until 2021, credit institutions should be encouraged to undergo a recapitalization to promptly react to their borrowers' inability to pay back their outstanding loans and credit lines. Therefore, a standardized, yet case-by-case, assessment of capital shortfall could be performed by supervisory authorities, as an alternative to system-wide stress tests, with a view to determining the amount of losses to cover.

2.3. The provision of resources for the precautionary recapitalization of credit institutions

Assuming that the conditions for applying precautionary recapitalization will be temporarily relaxed through an amendment of the SRMR, as proposed, an issue still remains. Notoriously, the fiscal capacity of Member States is different, with some having room for manoeuvre for further public expenses and others already overburdened with extremely high levels of public debt and therefore with little possibilities to rescue troubled credit institutions. This situation, which obviously does not only characterize the EU, might be particularly disruptive within the (still incomplete) BU, thereby threatening the same level playing field between credit institutions established in different countries.

Indeed, if every Member State were to be left free to intervene with no limitation and with no centralized mechanism in place, then only credit institutions established in the fiscally strongest countries would be publicly recapitalized, with the ones established in the fiscally weakest countries likely to be left in trouble. If this were to happen, the BU as such would potentially collapse and probably only credit institutions established in the fiscally strongest countries

would survive, possibly also taking over the good parts of the ones established in the fiscally weakest countries. To avoid such an outcome and considering that limitations to public intervention have just been correctly relaxed by the Commission, a tool centralized at supranational level should be developed to recapitalize credit institutions in need within the BU.

The most appropriate candidate to play such a function would be the ESM; this is even more so due to the well-known reluctance of euro area Member States to request credit lines under the 'Pandemic Crisis Support' instrument. This new temporary instrument was made operational by the ESM Board of Governors (the ESM's highest decision-making body composed of the euro area finance ministers)[7] on 15 May 2020 as a response to the Covid-19 pandemic to enable investments in the health sector and is based on the existing Enhanced Conditions Credit Line (ECCL).[8] Accordingly, in order for these resources to be fruitfully utilized to the benefit of Member States that do not actually feel comfortable in asking for a credit line under the new facility, the ESM could be the supranational player providing resources to precautionary recapitalize credit institutions within the BU that need an increase of capital.

Yet, since the role of the ESM is confined to Member States whose currency is the euro, the proposal is limited to credit institutions operating in the euro area, even though its centralized implementation at EU level and availability to every credit institution established in the EU Member States would potentially be even more effective to protect the EU single market. In addition, there would be a fragmentation even within the BU, since upon joining the SSM and the SRM later this year, Bulgaria and Croatia will not be signatories to the ESM Treaty.[9]

The direct recapitalization instrument (DRI) of the ESM has been operational since 8 December 2014 and is governed by the Guideline of the ESM Board of Directors "on Financial Assistance for the Direct Recapitalization of Institutions" (DRI Guideline). It is available to euro area credit institutions, which are of 'systemic relevance' or pose a serious threat to financial stability, but cannot be

[7] Article 5 of ESM Treaty.

[8] See European Stability Mechanism, ESM Pandemic Crisis Support, Explainer, Timeline and Documents, available at https://www.esm.europa.eu/content/europe-response-corona-crisis; the main legal basis is article 14 ESM Treaty.

[9] According to Article 44 (first sentence), the Treaty is open for accession by other Member States upon application for membership, in accordance with Article 2, filed with the ESM *only* after the adoption by the Council of the European Union of the decision to abrogate its derogation from adopting the euro in accordance with Article 140(2) TFEU (see also recital (7)).

used for the purpose of precautionary recapitalization.[10] It is only provided if the beneficiary credit institution is (or is likely in the near future to be) in breach of the capital requirements established by the ECB within the SSM; it is unable to attract sufficient capital from private sector sources to resolve its capital shortfall; and the contribution of the private sector by application of the 'bail-in' tool is not expected to address the capital shortfall fully.[11] The contribution of the requesting ESM Member to the recapitalization operation is determined by a burden-sharing scheme.[12]

The conditionality attached is detailed in a Memorandum of Understanding (MoU), in accordance with Article 13(3) ESM Treaty, addressing both the sources of difficulties in the financial sector and, where appropriate, the overall economic situation of the requesting ESM Member.[13] In principle, it must be conducted against the acquisition of common shares satisfying the requirements laid down in Articles 28-29 CRR on CET1 instruments.[14]

In view of these strict conditions attached and, in particular, of the fact that bail-in is a prerequisite, this instrument has never been used since its introduction. Nevertheless, its activation might be important in the context of supporting the involvement of the ESM according to the proposal advanced in this paper. In such a case, the requirements for its application, albeit within the limitations set by Article 15 ESM Treaty, could potentially be adjusted accordingly by means of the review clause laid down in Article 15(1) of the DRI Guideline.[15] Alternatively, the creation by the Governing Board of a new ad hoc facility could be envisaged, in accordance with a (prompt) procedure similar to that followed for the creation of the above-mentioned Pandemic Crisis Support instrument.[16]

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[10] Article 8(1) of DRI Guideline.

[11] Article 3(1) of DRI Guideline; the conditions laid down in Article 8(3) for the application of 'bail-in' are identical to those laid down in the BRRD (Articles 43-62).

[12] Article 9 of DRI Guideline.

[13] Article 4 of DRI Guideline.

[14] Article 10 of DRI Guideline.

[15] There is no doubt that the condition laid down in this clause for the review of the Guideline by the Board of Directors, at least every two years, to assess whether changes are required in light of developments related to the establishment of the BU is fully met under the current conditions.

[16] The legal basis nevertheless in such a case would not be Article 14 but rather Article 15 ESM Treaty. It is also noted that, in accordance with Article 19, the Board of Governors may review the list of financial assistance instruments provided for in Articles 14-18 and decide to make changes to it.

2.4. The precautionary recapitalization to be carried out by the European Stability Mechanism

The ESM could perform the above-mentioned task through raising resources by issuing senior bonds on the market in accordance with Article 21 ESM Treaty, also satisfying, in this way, the investment needs of those households and businesses that, paradoxically, during the lockdown have seen their stock of savings significantly increase mostly due to the impossibility to spend. The resources raised on the market could be then used to buy CoCos issued by credit institutions in need. Such CoCos should have a set of contractual clauses allowing them to be included, for regulatory purposes, within the CET1 of the institutions concerned, as happened in 2015 in Greece with regard to the precautionary recapitalization of Piraeus Bank and National Bank of Greece. CoCos are expected to permit the ESM to more easily exit from its investments in the investee institutions when this will be possible.

Against this background, and with a view to limiting the resources that the ESM is meant to disburse to recapitalize credit institutions, a publicly supported mechanism to manage NPLs centralized at European level and with a long-term view, thus hopefully less loss-making, should potentially, albeit under strict conditions addressing the inherent moral hazard problems, be developed as well.

Still another problem has to be considered. Since, according to this proposal, the ESM would issue senior bonds and use the proceeds to buy CoCos, a refinancing issue might arise when the ESM senior bonds would expire, and the bondholders would have to be reimbursed. A way to face this potential financing mismatch could be by issuing bonds cum warrants, i.e. senior bonds providing their holders with the call option to buy, at pre-determined conditions, CoCos previously purchased by the ESM.

A further alternative could be to enable ESM bondholders to convert CoCos in ordinary shares of the credit institution after a given timeframe. Obviously both these possibilities would work on a voluntary basis and, if bondholders were not to have the risk appetite to buy CoCos or convert their senior bonds into shares, the ESM should still be able to refinance its investments by issuing new bonds at the expiration of the previous ones.

The role of the ESM as holder of CoCos in potentially several credit institutions within the BU should be to monitor the investee institutions' senior management and board of directors and to provide them with some targets to meet. Obviously, such targets should be designed in such a way to encourage credit institutions to make efforts to become able to pay back the money invested by the ESM. Some penalizing mechanisms to put in place, in the event such targets are not met,

should also be developed. An example could be the prohibition of distributing dividends, buying back the credit institution's own shares and paying out bonuses and variable remunerations to senior management and material risk-takers for a given period of time and in any event until the institution becomes able to repay the ESM's investment.

The involvement of the ESM as an investor should in turn also encourage private investors to buy equity instruments of the investee credit institutions on the grounds that an institutional player is closely overseeing their operations. On top of this, a widespread presence of the ESM in the (regulatory) capital of several credit institutions in the BU, although without strong and formal prerogatives, could pave the way for a cross-border consolidation of the sector also through 'Europeanizing' the culture and the mentality of the investee credit institutions' senior management and board of directors.

3. CONCLUDING REMARKS

In light of the fact that credit institutions might soon have to undergo significant recapitalizations to react to the crisis provoked by the Covid-19 pandemic, this paper has advanced the proposal for a temporary amended version of the precautionary recapitalization under the SRMR based on the major involvement of the ESM. Such proposal builds on the regime currently in place and is conceptually aligned with the new Commission's temporary Framework.

Along with the ECB, a major role in the process is to be played by the SRB and the ESM, with a view to keeping as much as possible the same level playing field within the BU. The final goal is to strike a fair balance between the primary need to avoid the collapse of the whole banking system as a consequence of the Covid-19 crisis and the interest to discourage excessive moral hazard and unsound public policies.

Accordingly, for a limited period of time the conditions for the precautionary recapitalization should be relaxed and a new ESM facility (or a revision of the DRI) allowing it to buy hybrid instruments issued by the credit institutions that would need to be recapitalized should be developed. In this regard, the ESM could raise the resources needed by issuing senior bonds on the market to be then used to buy CoCos with characteristics enabling them to be included in the credit institutions' CET1 with a view to divesting as soon as the market conditions will allow it.

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EUROPEAN BANKING UNION: CHALLENGES AND OPPORTUNITIES ARISING FROM ITS INCEPTION, ARCHITECTURE AND ENVIRONMENT

Bozena Gulija

Financial regulation and risk management expert

former State Street, Nordea, European Court of Auditors,

Intesa Sanpaolo – PBZ, Croatian National Bank

bozena.gulija@outlook.com

Professor Dalvinder Singh

Professor of Law, School of Law, University of Warwick, United Kingdom

Adjunct Professor, University of Bologna, Department of Management

Managing editor, Journal of Banking Regulation

Member of the Advisory Panel of the International Association of Deposit Insurers (BIS)

dalvinder.singh@warwick.ac.uk

ABSTRACT

The European Banking Union (EBU) has had a complex strategic, political, economic and legal formation, and throughout the current turmoil there has been a special emphasis on preserving its stability and further development. The EBU formally consists of three interconnected pillars applicable to the euro area: (1) the Single Supervisory Mechanism (SSM) that encompasses European Central Bank's (ECB) direct and indirect prudential supervision; (2) the Single Resolution Mechanism (SRM) that provides for a harmonized resolution framework; and (3) an envisaged safety net in the form of the European Deposit Insurance Scheme (EDIS). A strong incentive for the EBU's creation originated both from the repercussions of the global financial crisis and the European sovereign debt crisis. The EBU has experienced constant challenges from its very beginning, including the opposition to any indication of a transfer union, and criticism related to its design. Although progress is recommended on all elements, the most compelling is timely completion of the EDIS. From its inception, the EBU's main goal has been to break the "vicious circle" between sovereigns and their banks – and that is in the focus of this article. Furthermore, this article explores the structure, achievements and inadequacies of the EBU pillars, and analyses potential threats and opportunities related to this segment of European integration.

Keywords: European Banking Union, supervision, resolution, deposit insurance

1. INTRODUCTION

The European Banking Union (EBU, Banking Union) may be the largest, and most comprehensive, single project related to the European Union (EU) integration since the adoption of the euro in a number of Member States.[1]

The Banking Union's impact is deep, as proven by its profound intervention in the regulatory and financial architecture, the significant resources it requires, and its potentially heavy effect on the underlying real economy. Such an integration process is also complex since the European financial markets have become intricate and interconnected, extending to European and global institutions. Furthermore, the development of the Banking Union requires a multi-phased approach and continuous adjustments because external circumstances and internal objectives are rapidly changing. Such a substantial amount of government interference is considered necessary because the risks it aims to prevent in the future were estimated to have materialized in more than EUR 4.5 trillion of taxpayers' money used to rescue the ailing banks.[2]

In order to put matters in perspective, the next section provides an outline of the crucial circumstances that led to the establishment of the Banking Union and it introduces its planned design. The following three sections refer to the structure and potential inadequacies of the EBU's pillars, focusing on their regulatory basis, scope and governance arrangements. Each of the two established pillars (the Single Supervisory Mechanism – SSM, and the Single Resolution Mechanism – SRM) is analyzed taking into account main current issues, whereas the envisaged (the European Deposit Insurance Scheme – EDIS is assessed with regard to the pending proposal. The sixth section scrutinizes the current state of affairs in relation to the Banking Union's main goal – breaking the "doom loop" between sovereigns and their banks. The seventh section brings together the potential challenges and opportunities facing the EBU, while recognizing that any strict delineation would depend on subjective perspectives and expectations. The main future concerns appertain to political and economic tensions, whereas opportunities include the establishment of the EDIS,

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[1] Andreas Dombret, 'European Banking Union - Where Do We Stand?' BIS Central bank speech 29 July 2014 <https://www.bis.org/review/r140729a.htm> accessed 12 October 2020.

[2] European Commission, 'Communication from the Commission to the European Parliament and the Council – A Roadmap Towards a Banking Union' (2012) <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0510&from=EN> accessed 12 October 2020.

additional building of the SSM and SRM capacities, as well as dealing with diverse national insolvency regimes and potentially problematic NPLs. The conclusion encapsulates the main points, while taking into account the accomplished contribution to the EU financial market integration and recognizing the remaining weaknesses. Emphasis is given to the current Covid-19 crisis and its potential to create a new impetus for change akin to the initial incentive that existed for the creation of the Banking Union in a similar crisis environment.

2. FORMATION PROCESS AND INTENDED DESIGN

The EBU is concerned with transferring sovereignty in terms of responsibilities for banking supervision and resolution, and potentially for deposit insurance, from the Member States to the EU level. This process extends to the point that it is sometimes referred to as a "federal model"[3] and contextualized with regard to the theoretical concept of a "fiscal union".[4]

From a broader point of view, prior to the last crisis there had been attempts to centralize banking supervision in the EU,[5] and the Banking Union is a continuation of the reforms initiated by Lamfalussy[6], de Larosiere[7], and Liikanen[8] as it aims to strengthen the EU's single financial market and its monetary union.

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[3] Jacopo Carmassi and others, 'Banking Union: A federal model for the European Union with prompt corrective action' (2012) 282 CEPS Policy Brief 1-5.

[4] Bruno Macaes, 'Fiscal Union, Banking Union: Two Opposite Paths for Europe' (2013) The EuroFuture Project Paper Series 1-8.

[5] Gianni Lo Schiavo, 'From National Banking Supervision to a Centralized Model of Prudential Supervision in Europe? The Stability Function of the Single Supervisory Mechanism' (2014) 21 Maastricht journal of European and comparative law 114-116.

[6] The Lamfalussy Group, 'Final Report of the Committee of Wise Men on the Regulation of European Securities Markets' (2001) <http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf> accessed 14 August 2018.

[7] The de Larosiere Group – High level group on financial supervision, 'The De Larosiere Report' (2009) <https://ec.europa.eu/economy_finance/publications/pages/publication14527_en.pdf> accessed 5 October 2020.

[8] The Liikanen Group – The High-Level Expert Group on Reforming the Structure of the EU Banking Sector, 'The Liikanen Report' (2012) <https://web.archive.org/web/20121003231405/http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf> accessed 7 October 2020.

Moreover, these reforms are part of a longer and wider process of consolidation in the financial services industry in addition to increasing cross-border activities accompanied by initiatives aimed at centralizing the European financial architecture.[9]

2.1. EU sovereign debt crisis as a historic momentum

The last financial crisis has had a huge impact on the regulation and supervision of European banks, and direct motivation behind the creation of the EBU can be linked to the fragility of many European banks and particularly to the importance of their connections with sovereigns. Thus, the first crisis since the euro´s introduction, which even questioned the future existence of the euro area,[10] highlighted the limitations of the decentralized approach and essentially national financial sector architecture. Following the global financial crisis, the European sovereign debt crisis deepened with the first Greek bailout in 2010, while in 2012 systemic problems arose both in the banking system and in the sovereigns' fiscal and economic sustainability; and therefore, the European "doom loop" between the banking system and the sovereigns became critical.[11]

Such a situation emphasized a few urgent needs: to reduce the fiscal cost of bank bailouts, to achieve a higher level of supervisory convergence and integration in the internal market, and to break the "vicious circle" between financial risks in the banking and sovereign sectors – which all resulted in the ultimate need for deep reforms that materialized in the creation of the Banking Union.[12]

Notwithstanding that the mentioned call for a suitable response to bank bail-outs and the subsequent crisis may have rendered the reforms inevitable, such an

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[9] Elisabetta Montanaro, 'The Process towards the Centralisation of the European Financial Supervisory Architecture: The Case of the Banking Union' (2016) 69 PSL Quarterly Review 135-172.

[10] Katarzyna Sum, *Post-Crisis Banking Regulation in the European Union: Opportunities and Threats* (1st edn, Kindle edn, Springer International Publishing 2016) ch 3.3.

[11] Corrado Moscadelli, 'European Banking Union – The New Palgrave Dictionary of Economics' (Palgrave Macmillan) <https://link.springer.com/referencework/10.1057/978-1-349-95121-5> accessed 3 October 2020; Emmanuel Farhi and Jean Tirole, 'Deadly Embrace: Sovereign and Financial Balance Sheets Doom Loops' (2018) 85(3) The Review of Economic Studies 1781–1823.

[12] Gianni Lo Schiavo, 'The European Banking Union and its impact on legal disciplines: a short introduction' in Gianni Lo Schiavo (ed), *The European Banking Union and the Role of Law* (Edward Elgar Publishing 2019) 2.

extraordinary regulatory development also required a strong political move toward European integration.

The creation of a banking union was postulated in a June 2012 report of the president of the European Council, Herman von Rompuy.[13] However, the central political turning point, and the critical milestone of the inception of the Banking Union, is considered to be the political declaration by the euro area heads of state and government at the end of their summit in Brussels on 28-29 June 2012, in which they affirmed that it was imperative to “break the vicious circle between banks and sovereigns”.[14] The developments that followed caused a gradual shift in expectations from stakeholders on both sides of that “vicious circle”. From the sovereign standpoint, it amounted to a commitment of support to each other by euro area Member States, which was immediately followed by an explicit statement of support by the European Central Bank (ECB).[15] From the banking standpoint, the shift to the European level gave credibility to the European policymakers’ claims that, in future, bank creditors would share losses in potential bank resolution cases.[16]

Gavin Barrett claims that the Banking Union is a unique reform project in the EU, and compares it to the story of *Cinderella* by arguing that while the EBU may have failed to make the original guest list when the Economic and Monetary Union (EMU) formally began in Maastricht in 1992,[17] its status has drastically changed.[18]

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[13] European Council, 'Towards a genuine economic and monetary union. Report by President of the European Council, Herman Van Rompuy’ 26 June 2012 EUCO 120/12' (The Four Presidents Report) <https://www.consilium.europa.eu/media/33785/131201.pdf> accessed 7 October 2020.

[14] Euro Area Summit Statement, 29 June 2012 <https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf> accessed 5 October 2020.

[15] European Parliament, 'Mario Draghi, Hearing at the Committee on Economic and Monetary Affairs of the European Parliament’ 9 October 2012 <http://www.ecb.europa.eu/press/key/date/2012/html/sp121009.en.html> accessed 8 October 2020.

[16] Nicolas Veron, ‘The Economic Consequences of Europe’s Banking Union’ in Danny Busch and Guido Ferrarini (eds), *European Banking Union (Oxford EU Financial Regulation Series)* (2nd edn, Oxford University Press 2020) 4.

[17] Consolidated version of the Treaty on European Union (2012) OJ C 326 13–390.

[18] Gavin Barrett, ‘The European Banking Union and the Economic and Monetary Union - A re-telling of Cinderella with an uncertain happy ever after?’ in Gianni Lo Schiavo (ed), *The European Banking Union and the Role of Law* (Edward Elgar Publishing 2019) 10-28.

2.2. EBU planned design

Motivated by the crisis and driven by the political support that had existed at the time, several legislative developments that lead to the establishment of the existing two pillars took place in the period from 2013 to 2014. However, after those initial activities, there has been no major milestone for the next six years.

The Banking Union is designed to be supported by three pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), and the European Deposit Insurance Scheme (EDIS). This structure is based on a common regulatory framework in the form of the Single Rulebook, which is applicable to the whole EU and primarily coordinated by the European Banking Authority (EBA). The SSM, fully established in 2014, is the supervisory pillar of the EBU that empowers the ECB to carry out prudential supervision of banks.

The SRM was introduced in 2015-2016 and operates through the Single Resolution Board (SRB), which has the authority to take a bank into resolution and to utilize resolution tools to restructure or, if necessary, recapitalize the institution in order to prevent a crisis and avoid a taxpayer-funded bailout, including drawing on the Single Resolution Fund (SRF).

The aim of the third pillar, the EDIS, is to create a supranational deposit insurance scheme, but it has not been implemented yet. The EBU can ultimately be seen as a result of economic and political logic[19] coupled with distributional conflicts,[20] and with an added layer of interconnectedness with the EMU, which is sometimes interpreted through the lens of the “bicycle theory”.[21]

3. SSM: STRUCTURE AND POTENTIAL GAPS

The SSM represents the fundamental building block of the Banking Union, and since it was the first pillar that has become fully operational, its creation marked the transition from the traditional principles of cooperation and coordination between national authorities to the supranational centralization of supervisory functions.

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[19] David G Mayes, ‘Banking union: the disadvantages of opportunism’ (2018) 21(2) Journal of Economic Policy Reform 132-143; David J Howarth and Lucia Quaglia, *The political economy of European Banking Union* (1st edn, Oxford University Press 2016) 206-214.

[20] David Howarth and Lucia Quaglia, ‘Theoretical Lessons from EMU and Banking Union: Plus ca change’ in David Howarth and Joachim Schild (eds), *The Difficult Construction of European Banking Union* (1st edn, Kindle edn, Routledge 2020) 45.

[21] Ibid 46.

3.1. Legal basis and regulatory framework

The SSM is based on Article 127(6) of the TFEU,[22] and according to this article, the Council is mandated to implement regulations regarding the conferral of specific tasks of prudential supervision upon the ECB through a special legislative procedure.

The most contested aspect is the fact that, pursuant to this article, only specific tasks may be conferred, which has raised arguments about how sufficient is the legal basis for the SSM. However, a number of elements support the position that the use of this provision is an appropriate legal basis to confer supervisory function to the ECB and that it establishes an adequate degree of legal certainty for the SSM.[23]

In this article's authors' opinion, this is not a question of legitimacy, but the one of ultimate limitations posed to the whole mechanism by the chosen legal basis. The main regulatory framework of the SSM comprises the following: (1) the SSM Regulation,[24] which confers specific tasks on the ECB concerning the prudential supervision of banks, (2) a regulation amending the EBA Regulation,[25] and (3) the SSM Framework Regulation,[26] in which the ECB further describes tasks and authorities delegated by the SSM Regulation. Additionally, the ECB adopted numerous internal acts to practically define and regulate the newly acquired area of competence, such as arrangements for: appointing representatives to the Supervisory Board, establishing an Administrative Board of Review and a Mediation Panel, establishing an Ethics Committee, laying down the principles of an Ethics Framework for the SSM,

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[22] Consolidated version of the Treaty on the Functioning of the European Union (TFEU) (2012) OJ C 326 47–390.

[23] Gianni Lo Schiavo, 'From National Banking Supervision to a Centralized Model of Prudential Supervision in Europe?: The Stability Function of the Single Supervisory Mechanism' (2014) 21 Maastricht journal of European and comparative law 122.

[24] Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (SSM Regulation) (2013) OJ L 287 63-89.

[25] Regulation (EU) 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) 1024/2013 (2013) OJ L 287 5-14.

[26] Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17) OJ L 141 1–50.

formulating the methodology for the calculation of supervisory fees, and implementing the separation between its monetary policy and supervisory functions.[27]

3.2. Scope

In the geographical sense, the SSM's scope is limited to the participating Member States that mandatorily include the EU Member States that are part of the euro area, and optionally the Member States that have established a close cooperation[28] with the ECB and by doing so have voluntarily joined the SSM.

The institutions supervised by the SSM include credit institutions, banking groups, financial holding companies, mixed financial holding companies, and branches established in the participating Member States by banks established in non-participating Member States.

The institutional scope is not explicitly defined with reference to the type of covered institutions but is implicitly deduced from the definitions provided in other legislative sources.

Pursuant to the significance criteria, the SSM banks are divided into: (1) significant institutions – SIs, and (2) less significant institutions – LSIs. The six significance criteria include the size of bank's assets (whether they exceed EUR 30 billion or 20% of the Member State's GDP), importance for the Member State's economy, cross-border activities, and the EFSM or ESFS funding.

Based on these criteria, as of 1 October 2020, there were 113 SIs,[29] whereas other banks were classified as LSIs.

3.3. Governance structure and organization

The SSM comprises a dual model for exercising supervisory competences: (1) "the ECB's direct supervision" applying to SIs, and (2) "the ECB's indirect supervision" applying to LSIs that are directly supervised by the national competent authorities (NCAs). Such a dual system is consistent with the

[27] European Central Bank, (2015) 2 Legal framework for Banking Supervision 4-80; European Central Bank, (2015) 3 Legal framework for Banking Supervision 3-260; For example, see Rene Smits, 'Interplay of Administrative Review and Judicial Protection in European Prudential Supervision - Some Issues and Concerns' (2017) <https://ssrn.com/abstract=3092805> accessed 13 December 2020.

[28] Niamh Moloney, 'Close Cooperation: the SSM Institutional Framework and Lessons from the ESAs' (ECB Legal Conference, Frankfurt, December 2019).

[29] See Full list of supervised entities (cut-off date for changes: 1 October 2020), <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.listofsupervisedentities202011.en.pdf> accessed 6 December 2020.

principle of "centralized control and decentralized operational framework"[30] where the ECB is assigned the ultimate responsibility for the overall effectiveness and consistency of the SSM.

The SSM provides for a new organizational structure within the ECB and a critical change occurred with the establishment of an independent and autonomous internal body that undertakes the ECB's supervisory function – the Supervisory Board. Pursuant to the SSM Regulation, the ECB's decisions related to the prudential supervision of the banking system should be taken by the Supervisory Board. Nonetheless, the attribution of tasks within the ECB has to comply with the legal requirement that the ultimate responsibility of any act taken by the ECB is retained by the Governing Council[31] and, to this end, a non-objection procedure has been designed.[32] The fact that the Supervisory Board is not fully separated from the Governing Council responsible for monetary policy, has raised questions in relation to the proper separation of the supervisory function from the ECB's monetary policy and other central banking functions.

The separation principle between monetary policy and prudential supervision is an important and somewhat controversial issue, and it largely drove the SSM's design process. The underlying idea is that the two tasks should be kept separate in order to avoid any potential conflict of interest, and if they are both assigned to a central bank, its internal organization should include appropriate "Chinese walls".[33] The prevailing position is that sufficient delineation has been implemented within the ECB, and that the current functional and organizational structure should not be seen as static since the balance between the supervisory and monetary policy functions of the ECB may further evolve over time.[34] The European Court of Auditors (ECA) also emphasized that the ECB must carry out supervisory tasks separately from its tasks relating to monetary policy.[35]

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[30] Angelo Baglioni, *The European Banking Union: A Critical Assessment* (1st edn, Kindle edn, Palgrave Macmillan 2016) ch 3.1.3.

[31] Article 129 TFEU.

[32] Angelo Baglioni, *The European Banking Union: A Critical Assessment* (1st edn, Kindle edn, Palgrave Macmillan 2016) ch 3.1.1.

[33] Ibid ch 3.1.2.

[34] Nicolas Veron, 'The Economic Consequences of Europe's Banking Union' in Danny Busch and Guido Ferrarini (eds), *European Banking Union (Oxford EU Financial Regulation Series)* (2nd edn, Oxford University Press 2020) 23.

[35] European Court of Auditors, 'Special report No 29/2016: Single Supervisory Mechanism - Good start but further improvements needed' (2016).

According to the ECA's findings, the SSM's decision-making process is considered to be quite complex and with numerous layers of information exchange.[36]

Furthermore, the governance and organizational set-up with regard to the ECB's considerably inconsistent and complex macroprudential tasks are not considered completely adequate in terms of mandate and independence from the monetary function.[37]

The initial findings of the ECA explicitly pointed out that the ECB lacked the resources for adequate execution of its supervisory function, and that it was too reliant on the resources of the NCAs.[38] In relation to ECB's crisis management, the ECA found that the overall framework has been substantially established, but they recommended that the ECB should enhance co-ordination with external actors and adopt an internal framework for the supplementary supervision of financial conglomerates.[39] Since the mentioned ECA's reports, the ECB has improved its operational capabilities and has, for example, recently undertaken a comprehensive reorganization of its supervisory function, which will facilitate bank-specific supervision organized according to banks' business models and supported by teams of risk or subject matter experts.[40]

3.4. Accountability

Accountability in banking supervision can be defined in terms of "internal accountability", which refers to the decision-making processes within the organization, and "external accountability", consisting of the supervisors' obligation to explain the impact of their activities to external stakeholders.[41]

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[36] Ibid.

[37] Ester Faia and Isabel Schnabel, 'The road from micro-prudential to macro-prudential regulation' in Ester Faia and others (eds), *Financial Regulation: A Transatlantic Perspective* (1st edn, Kindle edn, Cambridge University Press 2015) 13-14.

[38] European Court of Auditors, 'Special report No 29/2016: Single Supervisory Mechanism - Good start but further improvements needed' (2016).

[39] European Court of Auditors, 'Special report no 02/2018: The operational efficiency of the ECB's crisis management for banks' (2018).

[40] European Central Bank, Press release 'ECB announces organisational changes to strengthen banking supervision' 29 July 2020 <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200729~e5c783c499.en.html> accessed 7 December 2020.

[41] Basel Committee on Banking Supervision, 'Report on the impact and accountability of banking supervision' (2015) <https://www.bis.org/bcbs/publ/d326.pdf> accessed 6 December 2020, 25-34.

Given its independence and supranational concentration of powers, the Banking Union must also ensure its accountability.[42] These two topics are considered to be "two sides of the same coin"[43] and, therefore, particularly robust accountability arrangements are needed in order to legitimize the high degree of independence of the SSM and ECB. The two-fold nature of these principles indicates that the Supervisory Board members must act independently and not take instructions from any government member; while the ECB is (externally) accountable for banking supervision to the European Parliament, the Council, and the national parliaments of the participating Member States.

The accountability design is further operationally underlined by the fact that the chair of the Supervisory Board has to be approved by the European Parliament.

In addition to the SSM Regulation provisions, in order to facilitate practical modalities of the exercise of democratic accountability and oversight, the ECB concluded an interinstitutional agreement with the European Parliament,[44] and a memorandum of understanding with the European Commission.[45] Furthermore, with the aim of specifying (somewhat contested) access to information and confidentiality, the ECB also signed a memorandum of understanding with the ECA.[46]

Within the EU framework, the SSM's accountability has been assessed as mostly adequate, and the main initial weak point – access to information by the ECA[47] – has been resolved via the mentioned MoU. However, there are still

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[42] Douglas J Elliott, 'Key issues on European Banking Union. Trade-offs and some recommendations' (2012) 52 Global Economy and Development at Brookings – Working Paper 23-28.

[43] European Parliament, 'Mario Draghi, Hearing at the Committee on Economic and Monetary Affairs of the European Parliament' 9 October 2012 <http://www.ecb.europa.eu/press/key/date/2012/html/sp121009.en.html> accessed 8 October 2020.

[44] Interinstitutional Agreement between the European Parliament and the European Central Bank on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism (2013) OJ L 320 1–6.

[45] Memorandum of Understanding between the Council of the European Union and the ECB on the cooperation on procedures related to the SSM, December 2013, MOU/2013/12111.

[46] Memorandum of Understanding between the ECA and the ECB regarding audits on the ECB's supervisory tasks, October 2019, MOU/2019/10091.

[47] Marco Lamandini and Ramos Munoz, David, 'Banking Union's Accountability System in Practice. A Health Check-Up to Europe's Financial Heart' (2020) <http://dx.doi.org/10.2139/ssrn.3701117> accessed 8 December 2020, 12-27.

some shortcomings in respect to the ECB's transparency,[48] which is critical for ensuring that adequate information is provided to all relevant stakeholders.

It can be hypothesized that the procedural accountability arrangements of an independent institution, such as the ECB, may be a false promise and tend to amount to an empty administrative exercise, and that in fact "the trade-off between independence and accountability has been obfuscated through a complex administrative structure of accountability that provides the impression that ECB decisions can be substantively challenged".[49]

Likewise, it is not entirely certain whether the institutions in charge of holding the ECB accountable are truly in a position to do so, seeing as the ECB's mandate has become increasingly broad and the issues are very technical in nature.[50]

Furthermore, when compared to some global practices, there might still be possibilities for the ECB/SSM accountability enhancements, especially regarding the performance audit of supervisory activities by an independent supreme audit institution (SAI) as it is the case, for instance, in the United States,[51] Australia,[52] and Canada.[53]

Also, some of the good practices for SAI's access to national banking supervision can be found in the EU Member States (e.g. Denmark, the Netherlands, and Sweden).

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[48] Marta Bozina Beros 'The ECB's accountability within the SSM framework: Mind the (transparency) gap' (2019) 26(1) Maastricht Journal of European and Comparative Law 122-135.

[49] Mark Dawson, Adina Maricut-Akbik and Ana Bobic, 'Reconciling Independence and accountability at the European Central Bank: The false promise of Proceduralism' (2019) 25(1) European Law Journal 75-93.

[50] Diane Fromage, 'Guaranteeing the ECB's democratic accountability in the post-Banking Union era: An ever more difficult task?' (2019) 26(1) Maastricht Journal of European and Comparative Law 61.

[51] See Government Accountability Office (GAO) and their audits of the Fed and the FDIC <https://www.gao.gov/> accessed 5 December 2020.

[52] See Australian National Audit Office (ANAO) and their audits of the Australian Prudential Regulation Authority <https://www.anao.gov.au/work?query=australian+prudential+regulation+authority> accessed 5 December 2020.

[53] See Auditor General of Canada and their audits of the Office of the Superintendent of Financial Institutions Canada <https://www.oag-bvg.gc.ca/internet/English/admin_e_41.html> accessed 5 December 2020.

4. SRM: STRUCTURE AND POTENTIAL GAPS[54]

The SRM, as the second pillar of the EBU, was established to achieve a deeper supervisory convergence and integration of the resolution function across euro area countries, and thus to ensure orderly resolution of failing banks.

4.1. Legal basis and regulatory framework

The SRM is based on Article 114 of the TFEU, which states that the European Parliament and the Council may approximate the legislative measures adopted to serve the internal market. Therefore, establishing an agency on this legal basis is only exceptionally allowed if the agency poses a substantial benefit to achieving an internal market, and that is claimed to be the case with the SRB.[55] In a similar sense as with the SSM's legal basis, in this article's authors' opinion, the chosen TFEU provision may present certain limitations for the development of the SRM.

The SRM is based on two legislative acts: the SRM Regulation[56] that establishes the uniform rules for bank resolution within the SRM, and an intergovernmental agreement[57] on the transfer and mutualization of contributions to the SRF.

4.2. Scope

In terms of geographical and institutional scope with significance delineation, the SRM reflects the dual system of the SSM. It includes all the entities that participate in the SSM, as well as other cross-border groups where both the parent and at least one subsidiary bank are established in two different EBU Member States. The remaining institutions fall under the responsibility of the national resolution authorities (NRAs), except if a bank required access to the SRF. As of 4 December 2019, there were 128 banks under the SRB's remit.[58]

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[54] In many aspects the SRM follows and builds upon the first EBU pillar, the SSM, and therefore topics in this section should be considered in connection with the section '3. SSM: STRUCTURE AND POTENTIAL GAPS'

[55] Giuseppe Boccuzzi, *The European Banking Union: Supervision and Resolution* (1st edn, Kindle edn, Palgrave Mcmillian 2016) ch 4.2.

[56] Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) 1093/2010 (SRM Regulation) (2014) OJ L 225 1-90.

[57] Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund, Council of the European Union, Brussels, 14 May 2014.

[58] See 'Banks under the SRB's Remit' <https://srb.europa.eu/en/content/banks-under-srbs-remit> accessed 7 December 2020.

4.3. Governance structure and organization

The organization of the SRM partially mirrors that of the SSM, with regard to the division of responsibilities between the SRB and the NRAs, and the SRB's responsibility for the overall functioning of the SRM.

It should be noted that, compared to the SSM, there is a much greater operational reliance by the SRM on the NRAs, and the SRB's decisions largely need to be implemented by the NRAs.[59] Furthermore, the overall governance and decision-making rules of the SRM are rather complex as they involve several bodies – the SRB, the ECB, the EU Commission, and the EU Council – which is understandable in the context of an EU legal framework that does not allow a new agency to be endowed with wider discretionary powers.[60] For the SRB's procedures to work well, they have to be executed swiftly and in the required form by EU-level participants and NRAs, but sufficiently adequate cooperation in this area has not yet been achieved.[61] The ECA's initial findings concluded that there were general shortcomings in the SRB's operations, and that significant improvements were needed, including developing procedures and methodologies, as well as acquiring additional resources across all tasks and categories.[62]

The second building block of the SRM is the SRF. It is financed through contributions from the banking sector, and should gradually replace national resolution funds of the participating Member States. The creation of an EU-level resolution fund has been a much debated topic because of the loss-mutualization aspect,[63] and a special intergovernmental agreement was needed to overcome the controversial issues relating to the SRF.

The target size of the SRF is set at 1% of the covered deposits, which is equivalent to EUR 55 billion, and the deadline set for reaching that target is the beginning of 2024. When comparing the SRF's size to resolution cases of

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[59] Olina Capolino, 'The Single Resolution Mechanism: Authorities and Proceedings' in Mario P Chiti and Vittorio Santoro (eds), *The Palgrave Handbook of European Banking Union Law* (Kindle edn, Palgrave Macmillian 2019) ch 11.3.

[60] Angelo Baglioni, *The European Banking Union: A Critical Assessment* (1st edn, Kindle edn, Palgrave Macmillan 2016) ch 5.2.3.

[61] David G Mayes, 'Banking union: the problem of untried systems' (2018) 21 Journal of Economic Policy Reform 178-189.

[62] European Court of Auditors, 'Special report no 23/2017: Single Resolution Board: Work on a challenging Banking Union task started, but still a long way to go' (2017).

[63] Giuseppe Boccuzzi, *The European Banking Union: Supervision and Resolution* (1st edn, Kindle edn, Palgrave Macmillan 2016) ch 4.4.

individual institutions – such as Hypo Real Estate, which required public assistance of over EUR 100 billion – concerns have been raised as to whether EUR 55 billion could suffice for the whole euro area. Huertas and Nieto claim that this is possible, but only within a well-designed framework for regulation, supervision, and resolution, which makes banks not only less likely to fail but also safe to fail.[64]

5. EDIS: PROPOSAL

The third Banking Union pillar, the EDIS, is yet to be created, and the only achievements in this area remain within the domain of EU-wide harmonization of national rules, as part of the Single Rulebook. According to the existing regulatory framework, all EU banks are required to join a national deposit insurance scheme, but there is no construct at the supranational EU level, and consequently no EBU arrangements.

In 2015, the Commission published a proposal for an EDIS Regulation[65] in order to establish the EDIS that would apply to all EBU participating Member States based on geographical and institutional scopes defined for the two existing pillars.

The EDIS Regulation Proposal can be characterized as a bold document, which focuses on risk mutualization (i.e. risk sharing), and has therefore sparked a broad debate. The main argument is that any additional risk sharing among euro area Member States should be preceded by a significant risk reduction reflected in lower banks' sovereign exposures and NPLs.[66]

The boldness of the EDIS Regulation Proposal is also proven by the envisaged creation of a Deposit Insurance Fund (DIF) with a target size equivalent to 0.8% of the covered deposits, as already foreseen by the national deposit guarantee schemes.[67] According to the proposal, the overall EDIS structure would develop

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[64] Thomas Huertas and Maria J Nieto, 'How much is enough? The case of the Resolution Fund in Europe' VOX CEPR Policy Portal (2014) <https://voxeu.org/article/ensuring-european-resolution-fund-large-enough> accessed 11 October 2020.

[65] European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, Strasbourg, 24.11.2015, COM/2015/0586 final - 2015/0270 (COD) (EDIS Regulation Proposal).

[66] Pery Bazoti, 'The missing European Deposit Insurance Scheme' (2020) 9 Region & Periphery 151-158.

[67] Jacopo Carmassi and others, 'Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?' (2020) 208 ECB Occasional Paper Series 1-57.

in three stages (re-insurance, co-insurance, and full insurance) and contributions at the EBU level would increase progressively over time.

6. ACHIEVEMENT OF THE MAIN GOAL

The EBU was primarily aimed at resolving immediate problems relating to the sovereign debt crisis, as well as strengthening the single market for financial services in the long term.

To declare the Banking Union project successful, it must include an effectively functioning framework in which the bank-sovereign "vicious circle" is broken, and that is evidently not yet the case because many linkages have remained essentially intact.[68] Although significant progress has been made with the establishment of the first two pillars, the EDIS pillar is still only hypothetical. Additionally, in the context of the SRM, there is a lingering problem with banking nationalism that leads to an almost universal preference for bail-outs.[69] Moreover, breaking the negative feedback loop between banks and sovereigns has to counter certain legacy issues related to the ineffectiveness of previous reforms.[70]

While the priority should be the establishment of the EDIS, it must be remembered that the mentioned "vicious circle" cannot be completely broken as long as banks continue to hold large amounts of national government debt.[71] Therefore, another yardstick against which the success of the EBU should be assessed is the accumulation of domestic public debt in banks' balance sheets, which could strengthen the unwanted link between public finances and banks' solvency.[72]

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[68] Isabel Schnabel and Nicolas Veron, 'Completing Europe's Banking Union means breaking the bank-sovereign vicious circle' VOX CEPR Policy Portal (2020) <https://voxeu.org/article/completing-europe-s-banking-union-means-breaking-bank-sovereign-vicious-circle> accessed 11 October 2020.

[69] Nicolas Veron, 'The Economic Consequences of Europe's Banking Union' in Danny Busch and Guido Ferrarini (eds), *European Banking Union (Oxford EU Financial Regulation Series)* (2nd edn, Oxford University Press 2020) 7.

[70] Katarzyna Sum, *Post-crisis banking regulation in the European Union: Opportunities and Threats* (1st edn, Kindle edn, Springer International Publishing 2016) ch 3.4.4.

[71] Joaquin Maudos, 'Differences between the European banking sectors: an obstacle to banking union' in Fernando Fernandez Mendez de Andes (ed), *Euro Yearbook 2018: Completing Monetary Union to forge a different world* (Fundación de Estudios Financieros and Fundacion ICO 2018) 162.

[72] Fernando Restoy, 'The European Banking Union: achievements and challenges' in Fernando Fernandez Mendez de Andes (ed), *Euro Yearbook 2018: Completing*

The rating agency S&P Global has warned that Europe could be facing a new sovereign-bank "doom-loop" if the Covid-19 crisis surge in government bond buying by banks persists.[73]

It is noted that banks have concentrated more risk to their home countries by buying more sovereign debt, and this is considered to be especially problematic for the banks in the euro area "periphery", which have the highest exposure to their governments' debt.[74]

The ECB has also stressed that the rising sovereign debt in the wake of the pandemic has renewed concerns about the euro area sovereign-bank nexus, which is a major amplifier of the sovereign debt crisis.

Although, in the recent years, many euro area countries had a decline in sovereign-debt interlinkages, in 2020 to date euro area banks' exposures to domestic sovereign debt securities have risen by almost 19% (the largest increase since 2012), and the fiscal measures to support the economy are likely to prompt an even greater increase in sovereign debt.[75]

7. CHALLENGES AND OPPORTUNITIES AHEAD

At present, many challenges and opportunities are open to debate, and how the Banking Union will evolve remains to be seen, as there are numerous possible scenarios.

7.1. Political and economic tensions

Some of the political turbulences facing the EBU encompass global and regional geopolitical shifts, a general trend away from multilateralism, the crisis in EU supranationalism, as well as uncertainties surrounding Brexit. From a political and economic perspective, the Covid-19 crisis has contributed to the dialogue on cohesion and mutualization, which has already materialized in the Recovery Fund and Next Generation EU package, and which can also be seen as a historic step forward in relation to the European integration processes.

Monetary Union to forge a different world (Fundación de Estudios Financieros and Fundacion ICO 2018) 225.

[73] S&P Global Ratings, 'The European Sovereign-Bank Nexus Deepens By €200 Billion' 21 September 2020 <https://www.spglobal.com/ratings/en/research/articles/200921-the-european-sovereign-bank-nexus-deepens-by-200-billion-11643135> accessed 9 December 2020.

[74] Ibid.

[75] Silvia Lozano Guerrero, Julian Metzler and Alessandro D. Scopelliti, 'Developments in the sovereign-bank nexus in the euro area: the role of direct sovereign exposures' (November 2020) ECB Financial Stability Review 59-63.

Making use of the crisis as a new impetus for reforms, Ignazio Angeloni proposes six measures aimed at reviving the Banking Union: (1) overhauling the crisis management framework and granting the SRB responsibilities and instruments comparable to those of the US FDIC; (2) assigning additional responsibilities to the SRB; (3) allowing state support and use of the SRF; (4) enhancing the SSM's flexibility; (5) adopting a proactive and coordinated macroprudential framework; and (6) encouraging a gradual cross-border diversification of bank sovereign exposures.[76]

7.2. EDIS – completion as a sign of progress and confidence

The completion of the EDIS is an important challenge faced by the euro area governments. Reaching an agreement would be a significant step forward in breaking the bank-sovereign "doom loop" and would be considered a sign of optimism. However, developments in late 2019 remind us that strong political support is still lacking, and that divisions within the EU are still too wide.[77]

Recently, the ECOFIN reaffirmed the need to strengthen the Banking Union, which includes "design[ing] features of a European deposit insurance scheme (EDIS) on the basis of the so-called hybrid model",[78] but it remains to be seen whether this statement will be followed by concrete actions.

With regard to the prevailing obstacles to the EDIS, it can be argued that – in the same way that differences in the macroeconomic imbalances in EMU countries have prevented progress towards a fiscal union – the differences in variables such as default rate, efficiency, solvency, and profitability also draw a picture of a dual EU banking system and prevent mutualization of risks through a common deposit guarantee fund.[79]

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[76] Ignazio Angeloni, *Beyond the Pandemic: Reviving Europe's Banking Union* (1st edn, CEPR Press 2020) 25-50.

[77] See for example Justin Pugsley, 'Germany paves way for completing European banking union' Global Risk Regulator 2 December 2019; Sam Fleming and Miles Johnson, 'Eurozone ministers divided over banking union negotiations' Financial Times 5 December 2019.

[78] ECOFIN, Video conference of economics and finance ministers – Main results 1 December 2020 <https://www.consilium.europa.eu/en/meetings/ecofin/2020/12/01/> accessed 8 December 2020.

[79] Joaquin Maudos, 'Differences between the European banking sectors: an obstacle to banking union' in Fernando Fernandez Mendez de Andes (ed), *Euro Yearbook 2018: Completing Monetary Union to forge a different world* (Fundación de Estudios Financieros and Fundacion ICO 2018) 161.

The latest risk reduction monitoring report[80] shows a decrease in NPLs in 2019 and Q2 2020, but four Member States – Greece, Cyprus, Portugal and Italy – reported NPL ratios above the relevant benchmarks.

The report also mentions that future NPLs are difficult to predict because they depend on uncertain macroeconomic developments, such as the severity of the pandemic, the extent to which economies can mitigate an adverse impact, and the speed of economic recovery after the crisis.[81] Another aspect that can be relevant for NPL prospects relates to high dispersion among different loan categories and across EU countries, based on benchmarks calculated by asset class taking into account recovery rates, time to recovery, and judicial cost to recovery.[82]

7.3. Common insolvency framework

In the EU, there is a strict distinction between resolution (governed by EU law) and insolvency (governed by domestic law). However, that distinction is less clear–cut in some other jurisdictions.[83] For example, in Brazil, Mexico, Switzerland, and the United States, the resolution authority is also the authority in charge of insolvency procedures.[84] Additionally, national insolvency regimes within the EU vary significantly, and in some jurisdictions (e.g. in France, Germany, and Spain) banks' insolvency is governed by ordinary bankruptcy law, while in others there are specialized regimes for banks (e.g. in Greece, Ireland, Italy, Luxembourg, and the UK).[85]

Keeping in mind that differences in insolvency regimes have already proven to be an obstacle to efficient crisis management in the Banking Union, it could be

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[80] Eurogroup, 'Monitoring report on risk reduction indicators' November 2020 <https://www.consilium.europa.eu/media/46978/joint-risk-reduction-monitoring-report-to-eg_november-2020_for-publication.pdf> accessed 4 December 2020.

[81] Ibid.

[82] European Banking Authority, 'Report on benchmarking of national insolvency frameworks across the EU' <https://eba.europa.eu/eba-publishes-report-benchmarking-national-insolvency-frameworks-across-eu> accessed 7 December 2020.

[83] Fernando Restoy, 'The European Banking Union: achievements and challenges' in Fernando Fernandez Mendez de Andes (ed), *Euro Yearbook 2018: Completing Monetary Union to forge a different world* (Fundación de Estudios Financieros and Fundacion ICO 2018) 228.

[84] Ibid; See also, Jens-Hinrich Binder, Michael Krimminger, Maria J Nieto and Dalvinder Singh, 'The choice between judicial and administrative sanctioned procedures to manage liquidation of banks: a transatlantic perspective' (2019) 14(2) Capital Markets Law Journal 178.

[85] Ibid 229.

reasonable to consider the creation of a common EU administrative regime in order to deal with the crisis of financial institutions that are not subject to resolution.[86]

7.4. Asset management company/companies for NPLs

While many parts of the European financial architecture have undergone significant reforms since the last crisis, NPLs have remained a persistent problem. Due to projections of the potential rise of Covid-19 related NPLs,[87] some stakeholders have shown an increasing interest in the available options to comprehensively deal with this issue.

The ECB has estimated that in a severe scenario NPLs in euro area banks could reach EUR 1.4 trillion (above the levels of the global financial and European sovereign debt crisis), and has proposed the creation of an asset management company (AMC) or alternatively a network of AMCs.[88]

In contrast, the SRB has rejected suggestions from the ECB that the EU needs a “bad bank” to handle higher NPLs.[89] In the context of this debate, it is important to stress that the ECB has no legal mandate to set up an AMC, and the European Commission would have to make a proposal.

Currently, there is a mixed appetite for such a solution among the EU and national stakeholders.[90] Singh, argues a supervisory approach is needed to place the responsibility on individual banks to efficiently deal with their NPL problem *ex ante*.[91] This would aid transparency of the NPL problem and improve pre-insolvency decision making and possibly reduce the level of forbearance at the supranational and national levels to exercise resolution and insolvency-liquidation proceedings.[92]

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[86] Ibid 230.

[87] Anil Ari, Sophia Chen and Lev Ratnovski, ‘COVID-19 and non-performing loans: lessons from past crises’ (2020) 7 ECB Research Bulletin 1-7.

[88] Andrea Enria, ‘ECB: the EU needs a regional ‘bad bank’’ Financial Times 26 October 2020.

[89] Sam Fleming and Jim Brunsden, ‘EU banks urged to prepare for bad loans as pandemic hits economy’ Financial Times 11 November 2020.

[90] Farah Khalique, ‘Can the ECB’s bad bank idea work?' Global Risk Regulator 7 December 2020.

[91] Dalvinder Singh, *European Cross Border Banking and Banking Supervision* (Oxford University Press 2020) 110-113.

[92] Ibid.

An interesting alternative proposal is to establish a common and centralized AMC as the fourth pillar of the Banking Union, which would be comprised of a temporary assistance facility operated by a single management agency.[93]

7.5. Common fiscal backstop

According to the EBU design, both the SRM and the EDIS are linked to the possibility of accessing a common fiscal backstop.

Based on the recently agreed reform of the ESM Treaty,[94] the common backstop to the SRF should enter into force by the beginning of 2022, which marks an important step towards the completion of the Banking Union. The ESM has strong market presence, and (with additional EUR 60 billion) it will double the resources for bank resolution and ensure their immediate availability.[95] This is especially important at a time when the pandemic has stalled improvements to banks' health, and – although banks emerged better equipped from the last crisis – their residual vulnerabilities, combined with the effect of the pandemic, require implementation of the backstop.[96]

8. CONCLUSION

The Banking Union can be understood as a far-reaching, ongoing project with great importance for the European internal market. Based on such a premise, this article provides an overview of the EBU's creation, analyses its pillars, and scrutinizes its main goal and identified gaps. Finally, several potential challenges and/or opportunities are discussed, providing a forward-looking perspective.

The ultimate priority for deepening the EBU integration processes is to adopt an adequate legislative and operational framework for the EDIS.[97] This should

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[93] Huertas, Michael, 'Tackling Non-performance: Does the Banking Union Need a Pillar IV in the Form of a Single Asset Management Company – Could covid-19 Now Be the Catalyst for Change?' (2020) 35(11) Journal of International Banking Law and Regulation 433-437.

[94] Eurogroup, 'Statement of the Eurogroup in inclusive format on the ESM reform and the early introduction of the backstop to the Single Resolution Fund' 30 November 2020 <https://www.consilium.europa.eu/en/press/press-releases/2020/11/30/statement-of-the-eurogroup-in-inclusive-format-on-the-esm-reform-and-the-early-introduction-of-the-backstop-to-the-single-resolution-fund/> accessed 8 December 2020.

[95] Nicoletta Mascher, Rolf Strauch and Andres Williams, 'A backstop to the Single Resolution Fund now!' (2020) <https://www.esm.europa.eu/blog/backstop-single-resolution-fund-now> accessed 7 December 2020.

[96] Ibid.

[97] Margarita Delgado, 'Crisis highlights need for banking union: Still lacks European deposit insurance scheme, a fundamental pillar' (2020) OMFIF - the Official Monetary

significantly contribute to the full achievement of the main purpose declared when the EBU was created, namely to break the "vicious circle" between sovereigns and their banks, and thus create a better environment for achieving financial stability and dealing with potential crises. It has been shown that prevailing political circumstances and national economic logic play key roles in achieving this goal. The existing dilemma for completing the EBU lies in prioritizing either risk-sharing or risk-reduction; and therefore, finding a middle path would be an optimal strategy for establishing a common deposit guarantee fund, but with an implementation period for the full mutualization of risks and with restrictions progressively imposed on banks' exposures to public debt in order to truly break the sovereign-banking risk loop.[98] However, to improve the effectiveness of those supranational initiatives it has also been shown significant attention is also needed to improve the management of NPLs, consistency of approaches to insolvency-liquidation proceedings and rates of recoveries.

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[98] Joaquin Maudos, 'Differences between the European banking sectors: an obstacle to banking union' in Fernando Fernandez Mendez de Andes (ed), *Euro Yearbook 2018: Completing Monetary Union to forge a different world* (Fundación de Estudios Financieros and Fundacion ICO 2018) 162.

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THE FUTURE EVOLUTION OF THE SINGLE SUPERVISORY MECHANISM[1]

Prof. María Lidón Lara Ortiz
Universitat Jaume I
Avda. Sos Baynat s/n, 12071, Castellón, Spain
mlara@uji.es

ABSTRACT

This paper proposes a review of the first years of application of the Single Supervisory Mechanism (hereinafter, SSM), since it began on November 4, 2014. Furthermore, in February 2020, eleven years were completed since the issuance of the Larosière Report, a report performed by a group of high-level experts, which was the forerunner of the current system of European banking supervision. The Larosière Report made reference to the need to implement some mechanisms and to create an organizational structure that would allow addressing the aspects of supervision, restructuring and resolution of financial operators in a unified European framework, to better avoid the effects of future financial crises and overcome them, when necessary, offering several recommendations that, to a large extent, have been incorporated into the banking union. For the purpose described, a unified European supervision system was implemented that was no longer merely harmonizing, as was the previous system, but that was built on part of the pre-existing organizational structure, although adapting it to the proposals of the report that sought to achieve the objectives of general financial stability of the single currency, preservation of sovereign economies, and absorption of financial losses by the same system.

On article 32 of Regulation (EU) number 1024/2013 of the Council of October 15, 2013, that entrusts the European Central Bank with specific tasks regarding policies related to the prudential supervision of credit institutions, which is the basic regulatory standard of the SSM, it is provided the periodic review of the SSM functioning by the European Commission. This work aims to reflect the assessment of its first years of functioning, in order to highlight the possibilities of its future evolution from the perspective of its effectiveness and greater utility.

Keywords: Single Supervisory Mechanism, European Central Bank, assessment, evolution, banking union.

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1. INTRODUCTION: THE INITIAL STATE OF THE ISSUE

Since November 4, 2014, the Single Supervisory Mechanism (hereinafter, SSM) has been active[2], a harmonized banking supervision system that was devised by the high-level group of experts, which issued the Larosière Report[3], as a precursor document to the current European banking supervision system, and that proposed the need to implement some mechanisms and create an organizational structure that would allow to face the aspects of supervision, restructuring and resolution of financial operators in a unified European framework. This framework tends to avoid and improve the abilities to overcome the effects of potential future financial crises, offering some recommendations that, to a large extent, have been incorporated into the current banking union. The banking union is actually made up of five elements: a Single Regulatory Code[4], the Single Supervisory Mechanism, the Single Resolution Mechanism, the Stability Mechanism -this mechanism was approved outside the EU, through the enhanced cooperation system-, and a planned European Deposit Guarantee Fund. Due to its breadth, we cannot address all aspects of the banking union in this paper, so we will stick to the SSM, referring to the supervision system understood in a strict sense[5].

The Larosière report highlights the idea that sets its essential objectives: "The Group believes that monetary authorities around the world and their financial supervisory and regulatory authorities can and should do much more in the

[2] In accordance with the forecast included on article 33 of Regulation (EU) number 1024/2013 of the Council of October 15, 2013.

[3] The High-level Group on financial supervision in the EU Report, *Larosière report* (2009) <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> accessed 1 October 2020

[4] The Single Normative Code or Single Rulebook includes three normative aspects. The first contains the regulations on capital requirements which are the introduction of the Basel III rules to European law (Directive 2013/36/EU, and EU Regulation No. 575/2013). The second includes Directive 2014/59/EU, on bank recovery and resolution. The third focuses on the Directive on Deposit Guarantee Systems 2014/49/EU of the European Parliament and of the Council of April 16, 2014 relating to Deposit Guarantee Systems. Maldonado L., 'La Unión Bancaria: ahora empieza de verdad', in *Informe del Centro del Sector Financiero de PwC e IE Business School*, (Centro del Sector Financiero PwC e IE Business School 2014), p. 11. <http://csf.ie.edu/publicaciones>, accessed 15 October 2017.

[5] Vega Serrano, J.M., *La regulación bancaria* (La Ley 2011), p. 15; and Zunzunegui F., *Derecho del Mercado Financiero* (Marcial Pons 2005), p. 45. And the Judgment of the National Court (Spain) of February 9, 2006.

future to reduce the possibility that events such as this happen again. This is not to say that all future crises can be prevented. That would not be a realistic goal; but what could and should be prevented is the kind of interconnected and systemic weaknesses that we have witnessed that have brought such contagious effects. In order to prevent this type of crisis from repeating itself, a series of fundamental political changes must be introduced that concern the European Union, but also the world system as a whole"[6].

For this purpose, a unified European supervision system was implemented that was no longer merely harmonizing, as the previous system was, but that was built over part of the pre-existing organizational structure, although adapting it to the proposals of the report that sought to achieve the objectives of general financial stability and of the single currency, preservation of sovereign economies, and absorption of financial losses by the same system.

All the measures introduced to achieve these purposes exceed the former system that only established some criteria closer to soft law than to hard law[7], which was not compatible with the fact that financial activity took place in a globalized financial system, and with the existence of a single currency in Europe.

To begin with, the reform introduced a control system for both the macroeconomic and microeconomic aspects. Until now, macroeconomic regulation had not been taken into account in a general way.

The consideration of the macroprudential perspective is extremely important to avoid the absorption of the risks of the financial system by the States, thus avoiding that the sovereign economies are compromised through the processes previously sustained by the moral hazard which favored the rescue of financial institutions of systemic importance under the premise of too big to fail[8].

Macroprudential control is essential "to contain the systemic risks derived from procyclicality and the interconnection between financial institutions"[9]. These are

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[6] The High-level Group on financial supervision in the EU Report, *Larosière report* (2009)
<http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> accessed 1 October 2020.

[7] Jimenez-Blanco Carrillo De Albornoz, A., *Regulación bancaria y crisis financiera* (Atelier 2013), pp. 37 y ss.

[8] González Mota E. and Marqués Sevillano J.M., 'Dodd-Frank Wall Street Reform: Un cambio profundo en el sistema financiero de Estados Unidos', in *Revista de Estabilidad Financiera*, n. 19 (Banco de España 2010), p. 74-75.

[9] Basel Committee on Banking Supervision, *Basel III: Global Regulatory Framework to Strengthen Banks and Banking Systems* (Bank for International Settlements 2010), p. 2.

circumstances that boost the systemic nature of these risks. Thus, macroprudential control tries to avoid these adverse effects on the economic stability of the States, given the link between the financial crisis and sovereign debts and other major weaknesses in the economies of different Member States[10], which really posed a danger of systemic imbalance for the single currency.

With the introduction of macroprudential control, it is an accepted approach to the "twin peaks"[11] financial supervision model (in which macro and micro-prudential supervision is differentiated), and yet this is not purely accepted, as it continues including sectoral supervision (within the microprudential control, the system differentiates a control by sectors). With that it has been given rise to its own system in the European Union, of a mixed nature, which we hope will serve to combine the advantages of each one of them, minimizing the respective defects. The twin peaks model is clearly reflected in the functions attributed to the European Systemic Risk Board - hereinafter ESRB -, which is entrusted with macroprudential supervision, in comparison with the functions of the three European Supervisory Authorities in the scope of Banking, Stock Market, and Securities, Insurance and Pensions, which represent the component of the sectorial model by adopting the control of the activity of each one of the sectors in a specialized way. Perhaps this mixed model fulfills the double function of harmonizing supervision in the Member States that host different supervision models, and making up for the defects of each one of them, since none of the pure models followed by the different States was adequate to prevent the crisis that began in 2007-2008[12]. One thing that must be highlighted is that the macroprudential and the microprudential scopes are not completely disconnected.

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[10] López, Rodriguez y Agudelo, 'Crisis de deuda soberana en la eurozona', in *Perfil de Coyuntura Económica* n. 15 (Universidad de Antioquia 2010) pp. 33-58.

[11] The so-called "twin peaks" model assumes the coexistence of: a supervisor of the general solvency of the entities and their "systemic risk"; and another supervisor who oversees the performance of entities in the markets, their relationship with clients and everything that affects transparency. De Hoces J.R, and García-Perrote G., 'La nueva arquitectura europea para la regulación y supervisión financiera', in *Working Paper IE Law School*, AJ8-174 (2010), p. 6.

[12] Lastra R.M., 'Modelos de regulación financiera en el Derecho comparado', in Muñoz Machado and Vega Serrano (dirs.), *Regulación económica, vol. X: Sistema Bancario* (Iustel 2010), pp. 271-272. And Garicano and Lastra, 'Towards a new architecture for Financial Stability: Seven principles', in *Journal of International Economic Law*, vol.13, nº 3 (2010), pp. 597-621.

Another issue to consider is that an early warning system and a single bank resolution system were also implemented, through the Single Resolution Mechanism (hereinafter, SRM), which was subsequently activated to the SSM, since it began its activity on January 1, 2016, existing between both systems an inevitable parallelism, since the SRM stands as a necessary complement to the SSM, being considered by some part of the literature as an instrument derived from it, or a necessary consequence of it[13], although there is no lack of opinions that conceive it, conversely, as the rationale for the SSM, understanding that the justification for the reform of European supervision, and the consequent attribution of functions to the ECB, does not make so much sense by itself, but as a link in a whole that should culminate in a bank bailout that allows the direct transfer of funds to banks[14].

In any case, what can be said is that both systems are necessary, complement each other and therefore have a parallelism, since the SRM will be applied in the euro area member states and in the EU member states that are not a part of the euro zone, when they voluntarily join the banking union, a scope of application that coincides with the SSM, as it is provided on article 2.1 of EU Regulation 1024/2013.

The SRM is the system devised with the purpose of serving as a firewall to interrupt the process by which the risks of the financial system pass to the sovereign economies, preventing bank bailouts from being borne by the States, and aiming the financial system itself absorbs the losses. The European Supervision, Resolution and Stability Mechanisms are not only interrelated, but the effectiveness of each one of them depends on the other mechanisms[15].

The system is complex, but its assessment is very positive. However, its current configuration allows it to be considered as an evolving or unfinished system, since its own regulation provides for the periodic review of its bases. Thus, article 32 of Regulation (EU) number 1024/2013 of the Council of October 15,

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[13] González García, J.V., 'Mecanismo único de resolución bancaria. Aspectos institucionales', in Alonso C. (dir.), *Hacia un sistema financiero de nuevo cuño: Reformas pendientes y andantes* (Tirant lo Blanch 2016), p. 161.

[14] García-Alvarez G., 'La construcción de una unión bancaria europea: La autoridad bancaria europea, la supervisión prudencial del Banco Central Europeo, y el futuro Mecanismo Único de Resolución', in Tejedor Bielsa y Fernández Torres (coords.), *La reforma bancaria en la Unión Europea y España* (Civitas – Thomson Reuters 2014), p. 79.

[15] Benzo A., 'Construir una Unión Bancaria', in *Papeles de Economía Española*, n. 137 (2013), p. 29.

2013 that entrusts the European Central Bank with specific tasks regarding policies related to the prudential supervision of credit institutions, which is the basic regulatory standard of the SSM, imposes on the European Commission the periodic review of the SSM, every three years, having to refer to the most relevant issues of its operation, repercussions and effectiveness and having to present this report to the European Parliament and the Council. So, implicitly, the SSM it is being considered as a process that has not been completed from the moment of its creation and that can be improved yet.

In the following sections we will reflect on all of this, in order to highlight the possibilities of future evolution of the SSM, always from the perspective of its effectiveness and greater utility and in relation with the ERSB and the SRM.

Efficiency is one of the guiding principles of all administrative activity and, furthermore, the Basel Committee indicated that an effective banking supervision system is one that is capable of developing, implementing, monitoring and enforcing supervisory policies under normal economic and financial conditions, and under tension, so that a minimum control must also be applied regardless of the situation of bonanza or crisis in the markets, and its effectiveness implies the ability to face and redirect all kinds of situations by deploying that control activity[16].

Consequently, microprudential supervision will be effective if it makes possible to detect weaknesses in the system, contain them, and solve them in both scenarios, in times of boom and stress, without the effect of compromising the stability of the financial system, and without affecting the sovereign economies. We will reflect on these issues to evaluate where the future evolution of the SSM could address to.

2. ASSESSMENT OF THE FIRST STAGE OF THE SSM FUNCTIONING

To assess the effectiveness of the current European banking supervision system, it seems appropriate to determine how the SSM has functioned during this initial period in the areas set out on article 32 of EU Regulation 1024/2013. In this regard, it should be noted that the European Commission issued its first report on the operation of the SSM on October 11, 2017, however, some of the points provided therein have not been evaluated by the Commission. In particular, the interaction between the ECB and the competent authorities of non-participating Member States and the effects of the SSM in those Member States is an issue on

[16] Basel Committee on Banking Supervision, *Basic Principles for an effective banking supervision* (Bank for International Settlements 2011), p. 15.

which the Commission indicates that it is not possible to assess due to the lack of cooperation agreements with non-participating member states. On the other hand, the mandate to assess the tax effects that supervisory decisions may have on participating Member States and the impact of developments in relation to the resolution financing arrangements, is a matter that, due to the fact that it must be assessed taking into account the SRM, has some issues that must be related to the comparison with the data resulting of the assessment of the SRM functioning.

Furthermore, there are some points where the Commission's report highlights some operational weaknesses, which will be improved in practice, without the need of regulation amending, pointing out:

- In relation with the effectiveness of the ECB's supervisory powers when categorizing supervised entities into significant and non-significant, which is based on quantitative criteria, but which, indeed, the ECB complements with other possible "particular circumstances" that would justify a departure from those criteria, it must be considered that the ECB only can use these other criteria exceptionally. Regarding that, it has been indicated the need for greater transparency about the justification for reclassification. In relation to this issue, what we propose is that it would be mandatory to include the motivation of the reclassification decisions when they are not based on one of the objective criteria predetermined on Regulation 1024/2013[17].
- In relation with the functioning of the joint supervision teams, some weaknesses have been detected that could affect their practical efficiency, such as uncoordinated reporting lines, language problems and insufficient staff allocation. In order to face such weaknesses, it is proposed by the Commission that the ECB should apply operational solutions to ensure the efficient functioning of the joint supervisory teams, which may be adopted exercising its regulatory function in accordance with article 4.2, second paragraph of the SSM Regulation.
- On-site inspections are an essential tool for supervisors to examine compliance and gather the necessary information to perform their tasks.

[17] The classification is carried out according to the criteria of article 6.4 of EU Regulation 1024/2013: the importance for the economy of the Union or of any participating Member State, the significant nature of cross-border activities, and the size of the entity. Their size determines their significance if the total value of their assets exceeds € 30,000,000,000 or the ratio of their total assets to GDP of the participating Member State of establishment exceeds 20%, unless the total value of their assets was less than 5,000,000,000 euros.

> However, the implementation of harmonized procedures still shows divergences, especially in relation with the quantification of the findings of the inspections by the research teams. The ECB should promote a consistent implementation of common procedures for on-site inspections, ensuring that also the outcome of such inspections is properly harmonized.

The Commission accepts that the ECB occasionally relies on external consultants[18], especially when specific technical expertise is required, which is sometimes not easily found in the resources of the SSM. But its allowance must be limited (no more than 50% of the staff) and accompanied by safeguards to avoid potential reputational risks and confidentiality issues for the SSM. The need to limit the intervention of external experts actually transcends the reasons stated by the Commission, since in reality, with it, they are being attributed a wide catalog of public powers of an instrumental nature, which can affect some fundamental rights contained in the Charter of Fundamental Rights of the European Union, an attribution that does not have legal basis for admitting the delegation by contractual means to private entities of the functions that mean the exercise of public power or the exercise of a discretionary power.

3. SOME POINTS TO IMPROVE IN THE FUTURE EVOLUTION OF THE SSM

3.1. Functioning of the SSM within the European System of Financial Supervisors

The single supervisory mechanism rests on the European System of Financial Supervisors (hereinafter, ESFS), as a network of national financial supervisors that works in coordination with the new European Supervisory Authorities and the European Central Bank (ECB), and where there is an attribution of shared competences between the European supervisors and the nationals of the Member States that are integrated into the system. On this basis, the envisaged role of the European supervisors is "the centralization of some tasks at European level, with a view to promoting harmonized standards and consistent supervisory practices". In fact, it has been pointed out that the reason for its creation has been the lack of former coordination of national supervisors[19]. From a broader perspective, it could be considered that the integration of national regulators in the ESFS is part

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[18] Izquierdo Carrasco M., 'La discutible utilización por el BCE de entidades auditoras y consultoras en la inspección *in situ*', in Ureña Salcedo J.A (coord.) *Unión bancaria europea. Lecciones de Derecho público* (Iustel 2019), p. 59.

[19] Minguez Hernández F., 'Las Autoridades Europeas de Supervisión: Estructura y funciones', in *Revista de Derecho de la Unión Europea* nº 27 (2014), p. 125.

of a gradual process[20], built on the previous supervisory system that was merely harmonizing.

From the point of view of the functioning of the SSM, the Commission highlights the need of an effective cooperation to ensure greater supervisory convergence in the international order and for the management of banking crises. Cooperation and coordination are a constant in the regulatory establishment of the ESFS, of the SSM, and of the SRM, and in general, in the set of all regulatory structures and authorities of the banking union. Regarding the ECB's cooperation with the ESRB, its interaction is assessed, considering that it should be improved regarding the sharing of information and the need of avoiding duplication of the work, although it could still be improved. Its improvement is projected through the reform of the institutional representation of the ECB in the structure of the ESRB, which for the moment is a simple proposal to reform the regulation of the ESRB. In relation with the cooperation of the ECB with the SRB, the signing of a Memorandum of Understanding for the exchange of information between the SSM and the SRM should be highlighted, in order to be able to prepare, within the framework of the SRM, bank resolution actions[21], when necessary.

The 2017 Commission report, in this case, considers that the cooperation of both authorities has worked well in view of the actions undertaken in the cases in which in the same year 2017 several supervised banks were the object of intervention (Banco Popular –Spanish entity-, Monte dei Paschi di Siena, Veneto Banca and Banca Popolare di Vicenza –Italian entities-), although the difference in treatment in relation to the measures adopted has been criticized, because they are based on differences in the appreciation of the general interest concurrent in the adoption of the decision.

Although it is not reflected in the 2017 Commission Report, since some credit institutions have had to be intervened, activating the SRM, it should be reconsidered whether this has been due to an inefficiency of the SSM, or due to external causes. In our opinion, if a bank has been intervened, either to liquidate

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[20] Fernández Rozas J.C., 'El laberinto de la supervisión financiera en la Unión Europea: Nuevas fronteras del Derecho de la Unión Europea', in *Liber amicorum José Luis Iglesias Buhigues*, (Tirant Lo Blanch 2012), p. 911. And also, Fernández Rozas J.C., 'El sistema bancario español ante el Mercado Único', *Estudios de Derecho bancario y bursátil*, *Libro Homenaje a Evelio Verdera y Tuells*, T. I (La Ley 1994), pp. 745-770.

[21]Alonso Ledesma C., 'La resolución de entidades de crédito', in Tejedor Bielsa J. C. and Fernández Torres I. (coords.), *La reforma bancaria en la Unión Europea y España* (Civitas 2014), pp. 345-346.

it or to adopt other capital restructuring measures, it is because the microeconomic supervision with respect to such bank has not worked well, since its financial data show lack of liquidity or solvency or the near possibility of illiquidity or insolvency, a situation that should have been redirected with the activation of the regulatory functions that in the SSM are attributed to the regulatory authorities.

For this reason, the SRM review should contain a section that allows the SSM to be reviewed in this regard, relying on the data obtained from the periodic evaluation of the SRM.

In this sense, we consider advisable to homogenize the concept of viability, since the viability of the banks is an essential concept to activate the SRM[22], but it is part of the scope of supervision, and is controlled by the National Competent Authorities (hereinafter, NCA), in accordance with the prudential supervision regulations.

3.2. Division of tasks between the ECB and the National Competent Authorities

The assessment of this aspect of the SSM is in accordance with the provision of article 32.b) of Regulation (EU) number 1024/2013. This is a matter of great importance because it involves an arduous task of administrative cooperation and coordination, due to the high degree of competence distribution between the ECBs and NCAs that share competences as determined in Regulation (EU) number 1024/2013, and in the way developed by Regulation (EU) 468/2014 of the ECB, of April 16. The complex distribution of powers is based on legal and practical reasons. For legal reasons, since the ECB is assigned with prudential supervision functions, as a result of Regulation (EU) number 575/2013 and Directive 2013/36/EU, which are based on Article 127.5 and 6 TFEU and Article 25 of Protocol number 4 regulating the ESCB Statute, so that what should not be included as a scope of this prudential supervision will be the regulatory powers of the NCAs.

Also for practical reasons, because the large number of entities to supervise (approximately 6,000), would make it very difficult that this task could be completely centralized, and because complete centralization might result in

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[22] Fernández Torres, I., 'La inviabilidad como presupuesto de la resolución de las Entidades de crédito a la luz de la Ley 11/2015 de recuperación y resolución de entidades de crédito y empresas de servicios de inversión. Primera Aproximación', in *Documentos de Trabajo del Departamento de Derecho Mercantil UCM,* nº 95 (Ed. Universidad Complutense de Madrid 2015).

supervisory defects, just because until the activation of the SSM[23], the ECB had no experience on prudential supervision.

As a consequence of the distribution of powers, a high degree of coordination and cooperation is required. The general configuration of the SSM attributes to the ECB the mission of guaranteeing the general operation and efficiency of the system, which is why it stands as the axis of the system, and the NCAs are configured as decentralized elements of the structure.

The ECB, with the assistance of the NCAs, carries out direct supervision of significant institutions, and takes decisions related to common procedures, monitors the consistency of the supervision of the NCAs of less significant institutions, and gives instructions to the NCAs.

However, some weaknesses in the system linked with the distribution of powers have been highlighted as the Commission warns that the ECB would not have powers over investment firms or branches of EU institutions based on third countries, which may constitute a legal vacuum in its general mandate and open the gate to regulatory and supervisory arbitration.

The Commission considers that this type of investment entity should be under the same prudential treatment as credit institutions, considering that they are similar in nature.

This issue has been solved differently in the United States, where the separation of credit activity (strictly banking) and investment activity (more typical of the stock market sector), has been implemented, not without some controversy, in the Dodd-Frank Wall Street Reform and Consumer Protection Act of January 5, 2010, through the Volcker Rule that was subsequently introduced as an amendment to that law. However, this solution, which was discussed in the early construction of the banking union, was not finally accepted by the EU.

On the other hand, reference is made in the Commission Report to the ECB's duty to apply national legislation transposing the relevant directives and its ability to derive specific powers from such national legislation.

The ECB's powers can only be exercised within the limits of the tasks conferred to the ECB, but it must be determined on a case-by-case basis, and there is a need to apply clear principles that must be defined to underpin a situation without precedents.

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[23] Tomás-Ramón Fernández, 'El mecanismo único de supervisión, pieza esencial de la Unión Bancaria Europea: Primera aproximación', in Alonso C. (dir.), *Hacia un sistema financiero de nuevo cuño: Reformas pendientes y andantes* (Tirant lo Blanch 2016), p. 150.

3.3. The effectiveness of the ECB's supervisory and sanctioning powers

This issue is reviewed on application of Article 32.c) of Regulation (EU) number 1024/2013, and it is extended to the evaluation of the effectiveness of the supervisory and sanctioning powers of the ECB and the advisability of conferring new sanctioning powers to the ECB. The Commission highlighted that the ECB's powers over the tasks of authorization, revocation of a license and evaluation of significant holdings in relation to all credit institutions of the banking union, are special not only because of the broad scope of the entities covered, but also because of the prominent role given to the NCAs in carrying out the preparatory work. These procedures have some practical difficulties because they are intrinsically dependent on close cooperation between the ECB and the NCAs, and require good faith on all the supervisors, during all the stages of the administrative proceeding. During the first years of its operation, the ECB and the NCAs have done a remarkable job and have managed to create tools and procedures that help the ECB to fulfill its tasks. The evolution of common procedures shows that mutual trust between the ECB and NCAs is increasing, and constructively supporting the operation of the SSM.

The supervision that the ECB has deployed in relation to significant entities is also evaluated regarding that some issues have been delegated. Delegation is a measure that had already been previously accepted in cases of excess workload by the Court of Justice of the European Union (hereinafter, CJEU), always respecting some legal limits and the principle of proportionality[24].

Likewise, the exercise of prudential supervisory powers and the application of the sanctioning power with respect to the supervised entities reveal some asymmetries derived from the different scope of the sanction powers of the supervisory authorities. In the future evolution of the SSM these asymmetries should be overcome.

3.4. The supervision unfolded by the NCA regarding less significant entities

The supervision deployed by the NCA is object of evaluation on application of article 32.b) of Regulation (EU) number 1024/2013, and it is focused on assessing how the SSM has functioned in relation to the NCA. Thus, due to the breadth and diversity of less significant entities, the SSM left their supervision to national jurisdiction, and in a pyramidal manner, the ECB was given the

[24] Vid. Judgments of the Court of Justice of September 23, 1986, AKZO Chemie BV and AKZO Chemie UK Ltd v Commission, Case 5/85, ECLI: EU: C: 1986: 328, paragraph 37, and of May 26, 2005, Carmine Salvatore Tralli v European Central Bank, Case C301/02 P, ECLI: EU: C: 2005: 306, paragraph 59.

competence to supervise the activity of national authorities to ensure the consistency of the results and the supervisory standards applied, since in accordance with article 6.1 of the EU Regulation number 1024/2013, the ECB will be responsible for the efficient and coherent operation of the SSM.

In general, this aspect has been valued positively, and there have been numerous regulations implemented and guidelines approved by the ECB, which can exercise its regulatory power in accordance with article 6.5.a) and b) of the EU Regulation number 1024/2013. The CJEU in the case T-122/15, of May 16, 2017 (Landeskreditbank Baden-Württemberg - Förderbank v. the ECB), in paragraph 24, stated that the ECB is competent to request jurisdiction for itself that initially held an ANC, to exercise them directly with respect to one or more entities. So that, we must highlight that the ECB is entrusted with the capability to modify the original powers distribution.

3.5. Adequacy of macroprudential functions and instruments

This aspect is assessed on application of article 32.d) of Regulation (EU) number 1024/2013. Regarding macroprudential powers and tools, it is noted that experience is limited, because as we have indicated, before the Larosière Report framework were implemented, the macroeconomic aspect was not subject of control in the field of European financial supervision, but there does not seem to be any significant obstacles for the ECB to participate in the coordination of macroprudential measures within the banking union, or in the exercise of its powers.

There are only a few doubts about the tools that can be used for macroprudential purposes and the corresponding powers of the relevant authorities in this scope. To clarify this point, there is a proposal for regulatory amendment that the Commission raised on November 2016 when discussing the review of the capital requirements regulation[25].

Finally, regarding coordination with other authorities that have responsibilities on macroprudential supervision, we must refer to what is indicated in this paper, in the sections regarding the relationship between the ECB, the ESRB and the EBA.

3.6. The effectiveness of the provisions on independence and accountability

From the point of view of Administrative Law, this question is extremely relevant, since the independence and accountability of the supervisors result in

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[25] European Commission, Report of the European Commission on the operation of the SSM dated October 11, 2017, COM (2017) 591 final, p. 15.

the good work of the regulators. The evaluation of this issue is carried out by application of article 32.e) of Regulation (EU) number 1024/2013.

The procedures established to ensure accountability to political bodies such as the European Parliament, the Council, the Eurogroup and national parliaments are used frequently in practice in a large experience. The Court of Justice of the European Union (CJEU) controls the legality of the ECB supervisory decisions, and from the point of view of its control at an administrative level, there are diverse channels, such as the controls carried out by the Commission, the Court Audit Office (ECA), the European Banking Authority (EBA) and the European Ombudsman.

All these channels are consolidated, as they have been used in a general way to control the acts and decisions of the Institutions in other areas. However, it is worth to make an indication regarding the control carried out by the ECA in relation to the SSM. Thus, in accordance with the Treaty on the Functioning of the European Union, the ECB is obliged to provide the ECA with any document or information needed to carry out the task corresponding to the ECA legal mandate. The European Commission recommended that the ECB and the ECA conclude an interinstitutional agreement to specify the arrangements for the exchange of information in this scope. This agreement crystallized in a Memorandum of Understanding between the ECA and the ECB that was announced on August 28, 2019, and was signed in Luxembourg on October 9, 2019.

In another scope, the compliance with European regulations is carried out through the convergence reports prepared by the ABE.

One of the issues that is not treated in the Report and that is another structural element for assessing the effectiveness of any public body or institution, is the configuration of its responsibility. At a European level, the activity of the ECB may give rise to non-contractual liability due to possible damages arising from its operation in accordance with article 35 in its third paragraph, of Protocol N. 4 on the Statutes of the European System of Central Banks and the European Central Bank, which refers to article 340 of the Treaty on the Functioning of the European Union. Article 340 TFEU states that "the European Central Bank shall repair the damage caused by it or by its agents in the exercise of their functions, in accordance with the general principles common to the Rights of the Member States". The interpretation of what should be considered common rules could generate doubts to determine the scope of this responsibility, although the CJEU has been defining each one of the elements for such responsibility to occur, which is objective, although with the influence of certain subjective elements.

In any case, it is relevant to bear in mind that the same ECB in its Opinion dated on November 27, 2012 on a proposal for a Council regulation that attributes specific functions to the ECB regarding measures related to prudential supervision of credit institutions, and a proposal for a regulation of the European Parliament and of the Council to modify Regulation (EU) number 1093/2010, indicated in its number 1.7 the convenience of limiting the liability of the ECB and the NCAs to cases where the regulator is guilty, identifying this element with illegality or regulatory non-compliance of their functions attributed to them. The patrimonial liability of financial regulators is an issue not yet addressed and that should be considered in future amendments[26].

3.7. The interaction between the ECB and the EBA

In accordance with article 32.f) of Regulation (EU) number 1024/2013, the relationship between the ECB and ABE must be assessed, since the functions of a genuine regulator are distributed between both of them. The SSM Regulation did not alter the role and powers of the EBA, which remains as the regulatory agency responsible for completing and administering the single rulebook for the banking sector in the EU, as well as ensuring its consistent application. But, indeed, the EBA's functions are limited and focused on regulatory improvement, that is, its function is essentially harmonizing. Although the European Commission in its 2017 report indicates that the ECB must comply with the EBA rules like all other authorities and market operators, the truth is that the position of the ECB is qualified as it has to implement the EBA rules through its own instruments. This is a consequence of the fact that the normative function of the EBA does not have a legal basis in the TFEU, and since it is not legitimized, it requires the European Institutions to validate the results of the functions assigned to it.

Thus, although the EBA has normative functions, these are only collaborative or advisory, since the rules cannot be approved outside of the ordinary processes provided in the TFEU, and regarding others functions it continues being limited to consultation and advisory functions. It has control functions too, but without real enforcement capabilities, in this scope its activity is being limited to collecting and processing information resulting from the stress tests. And finally, it has mediating functions attributed, but the agreements reached in this area, in most cases having a lack of executive capacity. The explanation for all this limitations lies on the fact that the construction of the banking union and,

[26] Lara Ortiz M.L., *La supervisión bancaria europea. Régimen jurídico* (McGraw-Hill e Instituto Nacional de Administración Pública 2018).

particularly of the SSM, was carried out without modifying the TFEU, and the ECB must be the prudential supervisor in accordance with the current Article 127.6 TFEU, but to preserve the independence of the ECB in the exercise of the prudential supervisory function with respect to monetary policy, which the ECB also has as the axis of the ESCB, some functions were attributed to the EBA, but these functions are not supported by a specific attribution of the required competence, and that is why the functions of the EBA that are basically harmonizing.

Despite all this, the European Commission advises that the ECB closely coordinate its own implementation initiatives with those of the EBA regarding the contents and the timing of their initiatives, with the finality of avoiding overlaps and inconsistencies in the interpretation of the single rulebook. In some way, the functions of the EBA and the ECB complement each other to carry out functions that are normally concentrated in a single supervisor and, for this reason, their close cooperation and collaboration are essential. The separation of functions is a consequence of the desire to preserve the independence of the regulator, but the deconcentration of powers between the ECB and the EBA seems to increase the distribution of competences and the administrative complexity of the SSM.

3.8. The effectiveness of the appeal mechanism against ECB decisions

The Commission assesses the effectiveness of the administrative appeal against ECB decisions by application of Article 32.i) of Regulation (EU) number 1024/2013. Pursuant to Article 24.1 of the SSM Regulation, the Administrative Board of Review was created as a control mechanism for the decisions adopted by the Supervisory Board of the ECB, which can review the acts of the ECB adopted as a regulator, not only in relation to the independence of the same, but in any other aspect, and especially in the "scope of the internal administrative examination shall be limited to the procedural and material conformity of the decision in question." Although it is not declared openly, it is configured as a particular means of administrative review that can be initiated by any natural or legal person who is concerned or directly and individually affected by the decision to review, which does not eliminate the possibility of filing, if appropriate, a challenge in the CJEU (article 24.11). The purpose of this review is not the declaration of nullity of the administrative decision of the ECB, but its revision, since it is intended to maintain the act, correcting it.

In any case, its usefulness lies on the generation of administrative precedents for banking supervision, since the decisions of the Administrative Board of Review have had an influence on the supervisory practice of the ECB.

3.9. The effectiveness of the separation between the supervisory and monetary policy functions within the ECB

In order to avoid conflicts of interest between the tasks of the ECB about monetary policy and all other tasks exercised by the ECB, the SSM Regulation imposed the separation between the monetary and supervisory functions[27]. This aspect is evaluated by the Commission, by application of article 32.l) of Regulation (EU) number 1024/2013, and focuses on the tasks of the ECB in both aspects, since, according to the TFEU, the two functions are assumed by the ECB, because the core functions as a prudential supervisor correspond to the ECB, and the EBA only have powers to promote harmonization.

The ECB implemented measures to separate both functions through a set of procedural rules, ensuring the organizational separation of staff, differentiated meetings and decision-making procedures by the Governing Council, establishing differentiated complaint lines, confidentiality rules and mediation of conflicts of interest. However, certain services, such as legal service, internal audit, or human resources are "shared" by the two functions, which is not considered to affect the principle of separation as they only perform support functions. However, when such shared services provide advice that is a key to the ECB's political decision-making, reinforced separation measures should be applied to avoid conflicts of interest.

3.10. The possibilities of further development of the SSM

Finally, article 32.n) of Regulation (EU) number 1024/2013, indicates that periodic reports on the operation of the SSM must include an assessment of the possibility of continuing the development of the SSM, taking into account possible modifications to relevant provisions, including framework of primary law, and with the possibility of full harmonization of the rights and obligations of the Member States whose currency is the euro and the other participating Member States.

In relation to this issue, the Communication of October 11, 2017, COM (2017) 592 final, offers a slightly broader view as it considers how to complete the banking union and not just the SSM, which is a part of it. In this sense, the relationship of the SSM with the other elements of the banking union is assessed, and how it is included to finish the process to implement the pending measures that was already indicated in the conclusions of the roadmap to

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[27] Lastra R.M., ‘Modelos de regulación financiera en el Derecho comparado’, in Muñoz Machado and Vega Serrano (dirs.), *Regulación económica, vol. X: Sistema Bancario* (Iustel 2010), pp. 268-269.

complete the banking union of June 2016, of the Council and the European Parliament.

Specifically, with regard to the SSM, there are certain unmet regulatory challenges that should be considered in the future, because potential loopholes could undermine the effectiveness of the SSM. In particular, the trend that has been detected is that banking groups operate with complex structures that escape European banking supervision, although similar activities to those of credit institutions are being carried out through investment entities, and it could be a problem for the general financial stability, so the Commission should make proposals to regulate these entities considering a prudential point of view. To some extent, this problem finds a solution on the Directive (EU) 2019/2034 of the European Parliament and of the Council of November 27, 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU because the former prudential regimes under Regulation (EU) number 575/2013 and Directive 2013/36/EU were largely based on successive iterations of the international regulatory standards set for large banking groups by the Basel Committee on Banking Supervision and only partially addressed the specific risks inherent to the diverse activities of a large number of investment firms. The Directive (EU) 2019/2034 foster the harmonisation of supervisory standards and practices between authorities and takes into account the amendment to the definition of 'credit institution' in Regulation (EU) number 575/2013 by Regulation (EU) 2019/ 2033 so, it covers activity of investment firms that are already operating on the basis of an authorisation issued in accordance with Directive 2014/65/EU.

Undoubtedly, in addition to the phenomenon known as shadow banking, understood as banking activity carried out by non-supervised entities or through products that are left out of supervision[28], another unavoidable challenge is the regulation of new ways of credit activity that have their origin in technological innovation formulas that lead us to the digitization of the financial system[29] and

[28] Sáinz de Vicuña y Barroso, A., 'La nueva función de macro-supervisión. La Junta Europea para Riesgos Sistémicos' (2010).
<http://www.mjusticia.gob.es/cs/Satellite/1292338908469?blobheader> accessed 15 November 2019, pp. 4-5.

[29] The digitalization of the financial system is being considered yet in the European Union, as it is pointed out by Belando Garín, B., 'El nacimiento incierto de la herramienta regulatoria "sandbox" en España', in Paniagua M. (ed.), *El sistema jurídico ante la digitalización. Estudios de derecho privado* (Tirant lo Blanch 2020), p. 595.

that will also have to be solved in future amends of European banking regulation.

4. CONCLUSIONS

The implementation of the banking union, and more specifically of the SSM, has involved the application of mechanisms including European and national authorities with an unprecedented level of integration. The efforts made to make the system work well, in terms of efficiency, have been uncountable, and the overall assessment is positive. However, the current SSM can be improved and developed, being an evolving control system. Article 32 of Regulation (EU) number 1024/2013, provides some parameters that have already been the object of a first reflection for the revision of the SSM, providing ideas on how the current system can be improved. But, in its initial configuration no other formal issues were foreseen, such as the digitization of the products offered by the operators or the contracting processes, which increases the material scope of what can potentially be developed in the future financial regulation of the European Union, and that will undoubtedly lead to new levels of cohesion and integration of financial market supervisors.

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LEGAL CHALLENGES RELATED TO CLOSE COOPERATION – CROATIAN EXPERIENCE[1]

Ivana Parać Vukomanović
Croatian National Bank
Trg hrvatskih velikana 3, Zagreb
Croatia
ivana.parac@hnb.hr

ABSTRACT

The purpose of this paper is to describe the path towards close cooperation between the European Central Bank and the Croatian National Bank. The content of this paper is primarily focused on the amendments to national legislation, but it also describes the comprehensive assessment of five Croatian banks, which has been a precondition for the establishment of close cooperation. The paper explains the reasons, the legal basis and the conditions for establishing close cooperation between the European Central Bank and the Croatian National Bank. It also describes amendments which have been made to Croatian legislation in 2019 (amendments to the Credit Institutions Act), as well as in 2020 (second round of the amendments to the Credit Institutions Act, and the amendments to the Act on the Croatian National Bank and the Act on the Resolution of Credit Institutions and Investment Firms). Thereafter a description of the comprehensive assessment conducted by the European Central Bank and its results is given. Finally, the establishment of close cooperation between the European Central Bank and the Croatian National Bank is described, followed by the description of the significance assessment of Croatian credit institutions and the concluding remarks. The paper demonstrates that, although the legal challenges related to close cooperation are considerable, the most challenging part remains yet to be seen. The establishment of close cooperation between the European Central Bank and the Croatian National Bank or the Bulgarian National Bank, respectively is a precedent and shall likely serve as an example from which other non-euro area central banks shall draw conclusions about the risks and benefits of close cooperation.

Key words: Single Supervisory Mechanism, Close Cooperation, Croatia

1. INTRODUCTION

Croatia became a Member State of the European Union on 1 July 2013. Six years later, the Croatian government decided to take the next step in the process of European integration, and to file a request for entering into the ERM II.

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[1] Views expressed herein are personal to the author and not necessarily attributable to the Croatian National Bank.

Entering the ERM II is the next step towards the adoption of the euro as an official currency in Croatia and becoming a part of the European Monetary Union.

The purpose of the ERM II is, on the one hand, to help non euro-area countries to prepare for participation in the euro area. On the other hand, ERM II also ensures that the appropriate level of convergence with the relevant economic and legal criteria has been achieved by the candidate Member State. The participation in ERM II is completely voluntary and Member State chooses freely when to file a request for entering the ERM II.

In order to enter ERM II, an applicant Member State has to fulfil the so-called 'Maastricht criteria' (convergence criteria). Convergence criteria have been defined in Article 140 of the Treaty on the Functioning of the European Union[2] (hereinafter, the TFEU). However, an additional request has been set before Croatia and Bulgaria: the establishment of close cooperation between the European Central Bank (hereinafter, 'the ECB') and the Croatian National Bank (hereinafter, 'the CNB') or Bulgarian National Bank, respectively. Close cooperation is a modality in which non-euro area countries can participate in the Single Supervisory Mechanism (hereinafter, 'the SSM') as the first pillar of the Banking Union.

2. LEGAL BASIS OF THE SINGLE SUPERVISORY MECHANISM AND CLOSE COOPERATION

A few remarks about the SSM as the first pillar of the Banking Union are apposite at this point.

Namely, the global financial crisis of 2008 has shown that the banking supervision in the Union needed to be further harmonised. Although the rules and requirements, which needed to be followed and fulfilled by the banks, have been harmonised in the EU legislation (by the virtue of the so called 'Capital Requirements Directive'), this has not been the case with the procedural aspect of banking supervision.

The standards of banking supervision varied greatly among Member States. Consequently, due to different standards applied by the national supervisors, the level of preparedness for the stress caused by the global financial crisis and the resilience of banking sector have varied greatly among different Member States.

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[2] Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ L C 326/47

This has proven that a greater level of harmonisation in the supervision of the banking sector of the EU was needed.

All of the above led to the establishment of the SSM, coordinated by the ECB.

Regarding the role of the ECB in the SSM, the tasks of the ECB have been defined in the main body of the TFEU, as well as in its Protocol No 4[3] (hereinafter, 'the Statute').

At the time of the adoption of the TFEU, banking supervision had not been one of the tasks directly assigned to the ECB. However, several articles of the Statute referred to the role of the ECB in banking supervision. Furthermore, Article 25(2) of the Statute foresaw the possibility for the ECB to perform specific tasks concerning policies relating to the prudential supervision of credit institutions. The manner in which the ECB would perform such tasks has not been elaborated in the Statute and the reference has been made to the decision of the Council adopted under Article 105(6) of the TFEU.

The abovementioned Article 105(6) of the TFEU further prescribed that the decision of the Council had to be adopted unanimously and as a regulation, following a special legislative procedure, and after consulting the European Parliament and the ECB.

In accordance with all of the above, Council Regulation (EU) No 1024/2013[4] (hereinafter, 'the SSM Regulation') has been adopted. The SSM involves primarily the ECB and national competent authorities of Member States whose currency is the euro. However, the SSM is open also to competent authorities of Member States whose currency is not the euro[5].

In accordance with Article 7 of the SSM Regulation, close cooperation can be established between the ECB and a national competent authority of a Member State whose currency is not the euro. The legal basis for the establishment of close cooperation is a decision adopted by the ECB and published in the Official Journal.

However, prior to the adoption of such a decision, several conditions need to be met.

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[3] The Statute of the European System of Central Banks and of the European Central Bank OJ L C 202/230

[4] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L 287/63

[5] Cf. recital 10 of the Council Regulation (EU) No 1024/2013

2.1. Request made by the Republic of Croatia to enter into close cooperation

Conditions for the establishment of close cooperation have been laid down in Article 7 of the SSM Regulation.

The first condition is that the Member State concerned notifies the other Member States, the Commission, the ECB and EBA and request to enter into a close cooperation with the ECB.

This condition has been met on 27 May 2019 when the Republic of Croatia filed a formal request to the ECB for the establishment of close cooperation between the CNB and the ECB. In addition to Article 7 of the SSM Regulation, legal basis for this request is also to be found in the Decision of the ECB (ECB/2014/5)[6] (hereinafter, 'the Decision on close cooperation'). In accordance with the Decision on close cooperation, such a request needs to be made using the template in Annex I of the Decision on close cooperation and at least five months before the date from which the Member State intends to participate in the SSM.

In accordance with both SSM Regulation and Decision on close cooperation, the Republic of Croatia has undertaken: (1) to ensure that the Croatian National Bank as its national competent authority will abide by any guidelines or requests issued by the ECB, and (2) to provide all information on the credit institutions established in Croatia that the ECB may require for the purpose of carrying out a comprehensive assessment of those credit institutions.

3. FIRST AMENDMENTS TO NATIONAL LEGISLATION FOR THE PURPOSE OF CLOSE COOPERATION (2019)

Croatian national legislation has been amended for the first time shortly after filing the request to enter into close cooperation. The Act on Amendments to the Credit Institutions Act (hereinafter, 'the 2019 Amendments') has been adopted on 12 July 2019 by the Croatian Parliament. The 2019 Amendments have been published in the Official Gazette No 70/2019 and the majority of provisions came into force on the eighth day after the publication in the Official Gazette.

Measured by the number of articles that have been inserted into the Credit Institutions Act, the 2019 Amendments have not been extensive. However, taking into account their substance, the 2019 Amendments introduced significant change into Croatian national legislation.

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[6] Decision of the European Central Bank of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro (ECB/2014/5), OJ L 198/7, 5.7.2014

Only two new provisions have been inserted into the existing Credit Institutions Act. Article 11a has introduced the obligation of the CNB to abide by any guidelines or requests issued by the ECB and to adopt any measure in relation to credit institutions requested by the ECB. As already stated above, abiding by guidelines or requests issued by the ECB is one of the obligations of the CNB in close cooperation. The other significant novelty introduced by the 2019 Amendments is that all of the legal acts adopted by the ECB pursuant to the SSM Regulation have been made directly applicable in the Republic of Croatia. This amendment is probably the most significant, since in accordance with Article 139(2)(e) of the TFEU acts of the ECB are not to envisaged to be applied in Member States with a derogation (i.e. Member States whose currency is not the euro).

Second of the two articles introduced by the 2019 Amendments has been Article 11b. The main purpose of this article has been enabling comprehensive assessment of Croatian banks (which will be described in more detail in chapter 5 of this paper).

4. SECOND AMENDMENTS TO NATIONAL LEGISLATION FOR THE PURPOSE OF CLOSE COOPERATION (2020)

The second set of amendments to national legislation has been a lot more exhaustive than the first one. As noted above, initially only the Credit Institutions Act needed to be amended. However, the second group of amendments included several other acts. Croatian Parliament has adopted amendments to three separate legal acts (as described below) on 7 April 2020.

4.1. Amendments to the Credit Institutions Act

Amendments to the Credit Institutions Act[7] (hereinafter, the 2020 Amendments) have been much more extensive and detailed than the 2019 Amendments.

As explained above, the 2019 Amendments enabled the conduct of comprehensive assessment. However, 2020 Amendments enabled a different type of assessment: identifying significant credit institutions in Croatia by the ECB. The difference between significant and less significant credit institutions in the SSM is very important, and the extent of ECB's competences depends on this differentiation. In fully-fledged SSM significant institutions are directly supervised by the ECB. However, direct supervision by the ECB is not possible in close cooperation. Therefore, in close cooperation significant institutions formally remain supervised by their national competent authorities (in Croatia

[7] The Act on the amendments to the Credit Institutions Act (Official Gazette No 47/20)

this is the CNB), but in accordance with instructions issued by the ECB. On the other hand, the ECB (in principle) does not issue instructions in relation to less significant credit institutions. However, even in relation to less significant institutions, ECB has competences related to issuing and withdrawing authorisations and assessing acquisition of qualifying holdings. In principle, less significant institutions are supervised by the CNB, but under the oversight of the ECB[8].

It follows from the above that classification of a credit institution as significant or less significant determines a manner in which it will be supervised. Eight credit institutions in Croatia have been assessed as significant, which will be explained in more detail later in the text.

The second big novelty introduced by the 2020 Amendments is the new competence of the CNB in relation to imposing administrative sanctions.

Namely, prior to establishment of close cooperation, the CNB has not been authorised to impose sanctions on credit institutions. If the CNB in the course of banking supervision concluded that a credit institution has breached a legal act and that there are grounds for suspicion that such a breach constitutes as a misdemeanour, misdemeanour proceedings would have been initiated before the Municipal Misdemeanour Court in Zagreb. The ruling of the Municipal Misdemeanour Court in Zagreb (in principle) would not be final and the party which has not been satisfied by the Court's ruling (either the bank in question, or the CNB) had the possibility to file an appeal to the High Misdemeanour Court of the Republic of Croatia.

However, in order to increase effectiveness in close cooperation, the described setup needed to be replaced by the one in which sanctions are imposed by the CNB. Firstly, it is important to note that the procedure for imposing sanctions has been radically changed, and that judicial misdemeanour proceedings have been replaced by the administrative proceedings[9] conducted by the CNB.

Consequently, on proceedings conducted by the CNB, General Administrative Procedure Act[10] is to be applied. In accordance with Article 69(1) of the Act on the Croatian National Bank[11], decisions taken by the CNB on matters within its

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[8] Explanation on the ECB's website 'ECB oversight of less significant institutions' <https://www.bankingsupervision.europa.eu/banking/lsi/html/index.en.html> accessed on 30 October 2020

[9] Article 359c(1) of the Credit Institutions Act

[10] Official Gazette, No 47/2009

[11] Official Gazette, No 75/2008, 54/2013, 47/2020

competence may not be appealed, but an administrative dispute may be instituted against such decisions. Article 359.k of the Credit Institutions Act further prescribes that the Administrative Court in Zagreb has exclusive territorial jurisdiction in such disputes.

Therefore, another important novelty is related to the competence of courts for judicial review of imposed sanctions.

The types of administrative sanctions, which can be imposed in accordance with the 2020 Amendments are: fines, periodic penalty payments and warnings[12].

The imposition of administrative sanctions (penalties) in close cooperation is governed by Article 113 of the Regulation (EU) No 468/2014[13] (hereinafter, the SSM Framework Regulation). The said Article prescribes that the "provisions on administrative penalties shall apply *mutatis mutandis* in respect of supervised entities and supervised groups in participating Member States in close cooperation".

The expression "*mutatis mutandis*" is partly explained in the following paragraph of Article 113, which states that the ECB shall not address a decision (i.e. impose administrative sanction/penalty) to a supervised entity. Instead of addressing the decision directly to a supervised entity, the ECB shall issue an instruction to the CNB. Thereafter, the CNB shall address a decision to a supervised entity in accordance with such instruction. As explained above, this principle applies only to significant supervised entities. In relation to less significant supervised entities, the CNB is exclusively competent to impose administrative sanctions, without an instruction issued by the ECB.

4.2. Amendments to the Act on the Croatian National Bank

The Act on the Croatian National Bank needed to be amended in order to reflect the new role of the CNB in close cooperation. A reference needed to be made to the new decision-making process in close cooperation and the duty of the CNB to abide by the guidelines and requests issued by the ECB.

Furthermore, establishing close cooperation also entailed the participation of Croatia in the Single Resolution Mechanism (the second pillar of the Banking Union; hereinafter, 'the SRM'). This further affects the tasks and competences of

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[12] Article 359b(2) of the Credit Institutions Act

[13] Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014], OJ L 141/1

the CNB, which needed to be reflected in the amendments to the Act on the Croatian National Bank[14].

Apart from aligning the role of the CNB with the participation in the SSM (i.e. close cooperation) and the SRM, the Amendments to the Act on the Croatian National Bank, among other things, aimed at: (1) addressing issues identified by the ECB in Convergence Reports for 2014, 2016 and 2018; (2) allowing application of negative interest rates on monetary policy instruments and (3) implementing Guideline (EU) 2016/2249[15] and applying its provisions to financial statements of the CNB.

4.3. Amendments to the Act on the Resolution of Credit Institutions and Investment Firms

In accordance with Article 4(1) of the Regulation (EU) No 806/2014[16] (hereinafter, 'the SRM Regulation') participating Member States within the meaning of the SSM Regulation (this includes Member States in close cooperation) are considered to be participating Member States for the purposes of the SRM Regulation as well. For this reason, provisions of the Act on the Resolution of Credit Institutions and Investment Firms[17] (hereinafter, ' the Resolution Act') needed to be amended as well, and they needed to provide a legal basis for implementation of the SRM Regulation.

Based on these amendments, Croatia became part of the SRM as the second pillar of the Banking Union. Central institution in the SRM is the Single Resolution Board (hereinafter, 'the SRB').

Together with national resolution authorities of participating Member States, SRB forms the SRM. SRM is supported by a Single Resolution Fund.

Very important difference between close cooperation in SSM and participation in the SRM is that the SRB exercises its powers directly in Croatia, without the need to issue instructions to national resolution authorities.

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[14] The Act on the amendments to the Act on the Croatian National Bank (Official Gazette No 47/20)

[15] Guideline (EU) 2016/2249 of the European Central Bank of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), [2016], OJ L 347/37

[16] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, [2014], OJ L 225/1

[17] Official Gazette No 19/2015, 16/2019, 47/2020

In Croatia, we currently have two resolution authorities for credit institutions: the Croatian National Bank and the State Agency for Deposit Insurance and Bank Resolution[18] (hereinafter, 'DAB'). The purpose of the Amendments to the Resolution Act has therefore been enabling the SRB to exercise its powers directly in Croatia. As in close cooperation, SRB exercises its powers in relation to the entities, which are deemed significant.

The SRB operates in executive and plenary sessions[19]. Since Croatia (as explained above) has two national resolution authorities, the issue of voting in these sessions needed to be carefully regulated. In accordance with the Amendments to the Resolution Act, the representative of the CNB has the right to vote at the plenary and executive sessions of the SRB. With regard to issues within the competence of the DAB, the opinion of the DAB needs to be taken into consideration when casting a vote[20].

Another important novelty introduced by the Amendments to the Resolution Act is the transfer of part of the funds from the national Resolution Fund to the Single Resolution Fund.

The Single Resolution Fund has been established by the SRM Regulation and is owned by the SRB[21]. In order to meet obligations related to the establishment of the SRM, the Croatian Parliament has also ratified the Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund[22].

5. COMPREHENSIVE ASSESSMENT

On 7 August 2019 the ECB published a press release, stating that a comprehensive assessment of five Croatian banks will be conducted in the months to come[23]. At that time (prior to the Covid-19 pandemic), results of comprehensive assessment have been expected by May 2020.

The comprehensive assessment (i.e. positive outcome of it) is prescribed as one of the preconditions for close cooperation in the SSM Regulation.

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[18] Article 8(1) of the Act on the Resolution of Credit Institutions and Investment Firms

[19] Recital 32 of the SRM Regulation

[20] Article 8(23) of the Act on the Resolution of Credit Institutions and Investment Firms

[21] Article 67 of the SRM Regulation

[22] Official Gazette, International Part No 1/2020

[23] Press release on the ECB website ' ECB to conduct comprehensive assessment of five Croatian banks' <https://www.bankingsupervision.europa.eu/press/pr/date/2019/html/ssm.pr190807~7d4af2bef0.en.html> accessed on 25 October 2020

Comprehensive assessment entailed two parts: asset quality review (so called 'AQR') and a stress test. Five Croatian banks have been subject to this assessment[24].

The threshold ratios applied for identifying capital shortfalls were a Common Equity Tier 1 (CET1) ratio of 8% for the AQR and the stress test's baseline scenario, and a CET1 ratio of 5.5% for the stress test's adverse scenario. The assessment did not reveal any capital shortfalls in any of the banks included in the exercise [25]. None of the banks has fallen below the relevant thresholds.

Comprehensive assessment and its positive outcome have been a vital part of the path towards close cooperation. On 5 June 2020 the ECB completed a comprehensive assessment of certain credit institutions established in Croatia. On the same date, the CNB endorsed the results of the comprehensive assessment.

6. CONCLUDING REMARKS

On 24 June 2020 the Governing Council of the ECB had adopted the Decision on the establishment of close cooperation between the ECB and the CNB[26]. The decision had been made public on 10 July 2020[27]. In the recitals of the said Decision, the amendments to national legislation described in this paper, as well as the results of comprehensive assessment have been stressed as relevant for the establishment of close cooperation.

The said Decision determined 1 October 2020 as a starting date of close cooperation between the ECB and the CNB.

In September 2020 eight Croatian credit institutions have been assessed as significant, three of them on the basis of being the largest banks in Croatia:

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[24] Five banks which have been subject to comprehensive assessment are; Zagrebačka banka, Privredna banka Zagreb, Erste & Steiermärkische Bank, OTP banka Hrvatska nad Hrvatska poštanska banka

[25] Press release on the ECB website ' ECB concludes comprehensive assessment of five Croatian banks'

<https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200605~ca8b62e58f.en.html> accessed on 25 October 2020

[26] Decision (EU) 2020/1016 of the European Central Bank of 24 June 2020 on the establishment of close cooperation between the European Central Bank and Hrvatska Narodna Banka (ECB/2020/31), [2020] OJ L 224 1/4

[27]Press release on the ECB's website 'ECB establishes close cooperation with Croatia's central bank'

<https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200710_1~ead3942902.en.html> accessed on 1 November 2020

Zagrebačka banka, Privredna banka Zagreb, and Erste & Steiermärkische Bank. The remaining five credit institutions have been assessed as significant on the basis of belonging to significant groups: PBZ stambena štedionica, Raiffeisenbank Austria, Raiffeisen stambena štedionica, Sberbank and Addiko Bank.

Decisions determining significant credit institutions have been adopted by the CNB, but on the basis of an instruction issued by the ECB.

Therefore, all of the preconditions for effective conduct of close cooperation have been met. The most important part remains still to be seen, i.e. how will close cooperation affect banking supervision in Croatia. The CNB and Bulgarian National Bank are the first central banks to establish close cooperation with the ECB.

Therefore, the prospective Croatian and Bulgarian experience shall be the first to test close cooperation in practice. The outcome of this experience will most probably affect other non-euro central banks in deciding if they want to follow the same path or not.

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THE INFLUENCE OF THE EU BANKING UNION ON THE DEVELOPMENT OF SERBIAN MONETARY LAW[1]

Ass. Prof. Marko Dimitrijević
University of Niš, Faculty of Law
Trg kralja Aleksandra 11, Serbia
markod1985@prafak.ni.ac.rs

Full Prof. Srdjan Golubović
University of Niš, Faculty of Law
Trg kralja Aleksandra 11, Serbia
golub@prafak.ni.ac.rs

ABSTRACT

The subject of the analysis in this paper is the review of the qualitative and quantitative impact of the legal mechanisms of EU banking policy centralization on the traditional postulates of Serbian monetary law, especially in the part concerning the implementation of the lex monetae and the current jurisdiction of the national central bank, which become not only a guardian of monetary, but also of general financial stability in the conditions of the financial crisis. The influence of European economic and monetary integrations and economic policy coordination process on the development of the Serbian monetary law framework and the fulfillment of legal and economic convergence criteria is an indisputable and unavoidable factor in creating good domestic monetary and financial management. The subject of particular interests of the authors in this paper is the implications of centralization of European banking policy on domestic monetary law subjects' accountability, financial legitimacy, derogations and abrogations of existing banking conduct rules in domestic monetary legislation, and the frequency of monetary disputes in which the procedural legitimacy of the central bank gains new legal-economic consequences. By applying dogmatic, axiological, and comparative legal methods the authors will attend to identify the mentioned influence de lege lata and also try to provide some de lege ferenda guidelines for domestic monetary legislators.

Keywords: monetary law, EU, banking union, the central bank, lex monetae.

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1. INTRODUCTION

The crises in the eurozone are not only internal problems for the monetary union because the external dimension of the crisis implicates the legal obligations of the eurozone countries under international monetary law.[2] This obligation leads to the emergent closing of legal gaps in primary law and further integration within EMU in the sense of fiscal and banking union. Banking Union is an expression of deeper financial integration that is implemented under the auspices of the European Council and includes a set of legislative mechanisms that are used for the centralization of banking policy by creating an integrated European banking system. The formation of a banking union is not a goal *per se*, but together with the concept of fiscal union, EU competitiveness and political union make the conditions for the final realization of economic and monetary union.[3]

Conditions relating to the formation of a banking union is stemming from the results of economic policy coordination in the field of fiscal union. The centralization of banking supervision and control at the EU level requires limiting some dimensions of fiscal sovereignty and a certain form of political union, which would provide an answer to the problem of the political structural deficit in the EU.

Although Serbia is not a member of the EU, the impact of the banking union is evident in the banking and monetary law derogation (especially in the segment of central bank legislation) which resulted in a concluding *agreement between the National Bank of Serbia (NBS) on Cooperation with the Single Resolution Board* and new domestic bank management legislation.

2. BANKING UNION AS THE NEW RANGE IN EU ECONOMIC POLICY COORDINATION (NEW ECONOMIC GOVERNANCE)

The legal basis for the creation of the banking union is article 114 & 127(6) of the EU Treaty. The structure of a banking union is based on three pillars: 1) *Single Supervisory Mechanism* 2) *Single Resolution Mechanism* and 3) *Common Deposit Guarantee Fund*. The Banking Union in the EMU is not required solely to solve the problem of insolvent banks and depositors' protection, but also to strengthen the overall concept of monetary union. In a situation where there is a sufficient degree of freedom of movement of labor and product markets, coordination of economic policies within the banking union can strengthen the

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[2] A Feibelman, "Europe and Future of International Monetary Law" (2012) 22 *TLCP* 101,137.

[3] M Dimitrijević, "Normative Regulation of Banking Union" (2015) 2 *TEME* 517, 528.

function of stabilizing the financial sector, which, as a rule, absorbing at least two-thirds of all shocks in the successful transfer unions.[4] In this sense, *we agree* with the views that a lesser degree of centralization of fiscal policy is necessary for the successful operation of the SSM. A Single Resolution Mechanism is a second-best solution for the coordination of fiscal policies in times of crisis for which the Member States must adopt certain legislative acts that create conditions for effective decision-making and implementation of decisions in all three pillars of the banking union.

The global financial crisis revealed a high degree of correlation between bank financing and the public debt crisis. The decentralized supervision of bank operations by the national agencies had to be replaced by centralizing supervision.

In financial law theory, it is referred the *three forms* of centralization of banking supervision: a) the model of cooperation and coordination between state authorities, b) the model of consolidated (lead) supervisor and v) the model of supranational leaders.[5] These models differ both in terms of political and legislative feasibility and in terms of their efficiency. The model of cooperation does not require substantial changes in the allocation of tasks and responsibilities of the subject of economic policy, which is the scope of the model loaded with diverse interests of national authorities.

The model of the lead supervisor is difficult to accept in practice because it requires that the main supervisor is delegated to other supervisors' group of related banks. The above-mentioned shortcomings of national supervision can be replaced by the model of supranational audit institutions, which includes certain modifications of *acquis communautaire* and territorial application of restrictive monetary and financial legislation.

The successful concept of economic policy coordination in the banking union must be based on an integrative approach which includes the sphere of monetary policy and macroprudential revision and a unique program to exit the crisis. The consequences of the global economic and financial crises have highlighted that the traditional notion that the primary objective of the ECB (in means of monetary stability) requires review, as the supreme monetary institution

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[4] H Geeroms, P Karbowink, *A Monetary Union Requires Banking Union* (2013), Bruges European Economic

Policy Briefings, No. 33, 3.

[5] G Ferrarini, L Charel, *Common Banking Supervision in the Eurozone: Strengths and Weaknesses* (2013), LWP No. 223, ECGI Working Paper Series in Law, 22.

occupies a central place in achieving financial stability. The objectives of monetary policy are focused on price stability, while the objectives of micro-prudential revision focused on consumer protection.[6] On conditions of the crisis, the banks have a key role in maintaining the stability of the system. No matter what the monetary policy objectives focused on retail consumer prices, and the objectives of financial stability at the price of the property, it is logical that the ECB in determining the interest rate has to take into account the financial conditions (regardless of whether we admit it or not fiscal responsibility.[7] When a banking union is flourished to the full extent it will contribute to the relocation flows credit risk of weak banks in the balance of government bonds. However, a big challenge for policymakers will be to establish procedures for the proper treatment of venture capital and the provision of liquidity risk government bonds.[8]

The central place in the future banking union belongs to the European Central Bank, which must have more control to solve the problem of coordination. In this sense, it must be the "*bank of last resort*" (which makes monetization of public debt), even if this increases the risk of the occurrence of moral hazard. However, the ECB has the authority to decide on the bankruptcy of an insolvent bank or has information to make such decisions. On the other hand, the ECB may be subject to significant waste when performing this function, as this cost may be unsustainable.

3. THE SERBIAN MONETARY LAW AND EUROINTEGRATION PROCESS

Monetary law as a positive branch of law (understood as a set of legal rules which determine a monetary unit for the denominated amount of public debt) has a significant impact on the broadly established field of Serbian long term economic policy goal on its euro integration and important effect on human rights because it determines all segments of the living (economic) standard and general life quality of citizens who live under the area of specific monetary

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[6] MA El-Agraa, *The European Union: Economics and Policies* (9th edn, Cambridge University Press 2011), 110

[7] D Schoenmaker, An Integrated Financial Framework for the Banking Union: Don't Forget Macro-Prudential Supervision (2013) European Commission, European Economy, Economic papers No. 495.

[8] VV Acharya, Banking Union in Europe and Other Reforms (2012), in Thorsten Beck (ed), *Banking Union for Europe: Risks and Challenges* (Centre for economic policy research).

jurisdiction.[9] For this reason, Serbian legal science must pay greater attention to identifying causal and consequential connections between postulates, institutes, and subjects of national and supra-national international monetary relations in the European Union (on the one hand) and transmission and their feed-back mechanisms in the field of social and economic rights where that influence is most pronounced (on the other hand).

On Serbia's road to joining the European Union, the harmonization of domestic legislation with the *acquis communutaire* receives a special character. An optimal program of long-term economic policy is possible only with the determination of the essential elements of coordination mechanisms of communitarian economic policy. Based on the survey results can be seen at certain recommendations *de lege ferenda*, which the national economic policymakers should comply it to achieve a higher level of consistency of the constituent elements and different segments of economic policy.[10] The conclusion is that before the national economic policymakers on the path of European integration continue to face significant challenges that even although complex to solve, they are not invincible and if between competent state institutions and citizens' associations establish a credible relationship with clearly defined responsibilities to achieve economic and legal advantages that EU membership brings. Although the process of economic integration requires and limitation of some components of the monetary, fiscal, and financial sovereignty, this should not mean that the country is on the path of European integration entirely subordinating national interests to supranational demands, taking into account the recent experience of Member States during the debt crisis and the failure to maintain stability in the eurozone.

The National Bank of Serbia is an independent financial institution responsible for conducting monetary and foreign exchange policy, as well as for carrying out other tasks entrusted to it by law. Such legal status protects the NBS from political influence and guarantees its freedom in drafting and implementing monetary policy programs. Of course, the independence of the central bank is not absolute. This means that it does not have the freedom to choose the goals it

[9] Monetary legislation represents *sui generis* legal sources, whose object of social protection as a specific legal case is determined by the need for optimal regulation, management, and protection of relations in which monetary agents (public entities) participate.

[10] M Dimitrijević, The Institutional Aspects of European Economic Policy Mechanism: The Implication for Serbia, In *EU and Comparative Law Issues and Challenges Series: EU 2020 – Lessons from the past and Solutions for the Future* (2020) 993, 1015.

will pursue and that the concept of independence is accepted only in the part relating to the performance of entrusted tasks. The specificity of the position of the monetary authority about executive and legislative power imposes the need to create a legal basis for democratic control and accountability of the central bank. In this way, the central bank alleviates the problem of democratic deficit and makes its legitimate status (defined by the constitution and law). According to domestic legislation, the central bank is subject to supervision and is accountable to the national assembly for the realization of the established goals.

In addition to the right to timely information on the monetary policy program (including the submission of work reports), the National Assembly may activate the instruments for eventual suspension of the implemented measures, or initiate the procedure for dismissal of the central bank officials in cases where the results differ significantly from the projected value of the main objective. The responsibility of the central bank also includes the obligation of cooperation with the government, as the creator of economic policy.

The global financial crisis of 2007 showed that of all the institutions, only the central bank has the necessary capacity to use certain instruments to prevent the collapse of the financial system. Several reasons justify the responsibility of central banks for financial stability. First, the central bank is the only institution authorized to issue money as legal tender and affects the level of immediate liquidity. Second, the central bank is responsible for the smooth functioning of payment operations. And finally, the central bank is, by the nature of things, interested in sound financial institutions and a stable financial market, which facilitates the transmission of monetary policy.[11]

In response to the global financial crisis, the range of goals for which the central bank is responsible is expanding so that, in addition to price stability as a priority goal, the responsibility of the central bank for financial stability is increasingly clear. The mandate of the NBS for conducting macroprudential policy is defined by the amendments to the Law on the National Bank of Serbia (NBS) from 2010, establishing the obligation to, within its competence, take activities and measures to preserve and strengthen the stability of the financial system. With this defined competence, the NBS joins a group of central banks whose responsibility for financial stability is almost equal to responsibility for conducting monetary policy. Achieving this goal implies the synchronized action of several different factors. The first line of defense includes the activities of banks and other financial institutions undertaken to minimize the risks they

[11] G Schinasi, Safeguarding Financial Stability: Theory and Practice (IMF 2006), 88.

face in their operations. The second line of defense is leadership macroprudential policies. In practice, different solutions can be distinguished, starting from the transfer of competencies for supervisory functions to special institutions to the transfer of this function to the central bank. According to the Law on the NBS (Article 8a), a special body - the Supervisory Board - is formed to perform the function of supervision over financial institutions within the National Bank. Finally, the third level of defense of financial stability includes macroprudential policy. The Law on the NBS entrusts the central bank with the authority to conduct macroprudential policy.

According to Article 4, item 4 of the Law, the National Bank of Serbia "determines and implements, within its competence, activities, and measures to preserve and strengthen the stability of the financial system". What should be borne in mind is that the realization of the goals in terms of financial stability implies full commitment not only to the central bank but also to other entities whose actions affect financial flows. Monetary and financial stability are fundamental goals of the central bank. But some goals have a big impact on the success of other segments of economic policy. Therefore, the monetary policy pursued by the central bank cannot be viewed in isolation from the economic policy pursued by the government. Recognizing this connection, modern monetary legislation seeks to regulate not only the responsibility of the central bank for monetary and financial stability but also provides for its obligation to support the realization of other economic policy goals.[12]

Thus, the Law on the National bank (Article 3, paragraph 3) also stipulates that the National Bank is obliged to provide support to the government's economic policy without compromising monetary and financial stability. What is missing in the domestic legislation is the concretization of the goals of economic policy that the NBS supports with its policy. The process of supervisory assessment is emphasized, which combines the results of all conducted supervisory activities aimed at an individual bank. This process is characterized by the establishment of a single assessment for the bank, and, if necessary, the undertaking of supervisory measures by the National Bank of Serbia. Also, the principle of dialogue with banks in case certain irregularities in operations are identified, division of banks into groups, monitoring of basic risk indicators, analysis and review of business model, adequacy of corporate governance, assessment of

[12] S Golubović, "The Legal Basis of the National Bank of Serbia’s Responsibility for Preserving Monetary and Financial Stability" (2018), *Collection of Papers of Nis Law Faculty*, 81-82.

capital adequacy, and liquidity. Special activities of the NBS are aimed at the adoption of legal changes regarding the restructuring of banks. The aim was to minimize the use of budget and other public funds to preserve financial stability. This primarily refers to the regulatory tendencies embodied in the concept of the EU Banking Union.

Therefore, potential losses due to the bank's failure will be borne first by the bank's shareholders and creditors, in compliance with the prescribed restrictions and protection mechanisms, so that the bank's shareholders and creditors will have to be aware of the risk of losses they will suffer in the event of bank failure. In the restructuring process, the NBS may choose instruments or a combination of instruments that could best achieve the objectives of the restructuring. It is expected that this will significantly contribute to market discipline.[13]

It is important to emphasize the fact that since the beginning of the process of Serbian European integration, the National Bank of Serbia (NBS) has been a credible and accountable participant in all its phases, and the harmonization of the monetary legal and institutional framework (monetary conduct) with EU convergence criteria and standards is one of the priorities of the NBS.

The participation of NBS representatives is envisaged in all bodies of the RS coordination structure for the EU accession process. For negotiations in the area of Financial Services and Economic and Monetary Policy, the NBS is the presiding institution, while for negotiations in the area of Free Movement of Capital it is second.

During the regular annual meeting (2019) within the Economic and Financial Dialogue of the EU member states, the Western Balkans and Turkey, as well as the European Central Bank and the European Commission, the European Central Bank and the European Commission assessed that the domestic banking sector is well-capitalized and liquid. Significant results of Serbia in terms of reducing the share of problem loans, with further dynamic growth of lending activity to both the economy and the population, were especially emphasized, as well as measures related to unsecured non-purpose lending to households after long repayment periods.

On July 25, 2018, the NBS signed an *Agreement on Cooperation with the Single Resolution Board*, the European regulatory body responsible for the restructuring of financial institutions.[14] With this agreement, the NBS and the

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[13] <https:// www.nbs.rs, accessed 20.04.2020.>

[14] Cooperation Arrangement between the National Bank of Serbia and the Single Resolution Board, 25.08.2018, 1-2.

Single Restructuring Board reaffirmed their true commitment to further improve their mutual communication and cooperation to improve and facilitate the restructuring of banks and banking groups with a cross-border element, and to preserve financial stability in the event of a crisis.[15] Amendments to the domestic Law on Banks ("Official Gazette of the RS", No. 107/2005, 91/2010 and 14/2015), which came into force on 1 April 2015, established a comprehensive legal framework for restructuring of banks, and the National Bank of Serbia has been entrusted with the function of the body responsible for bank restructuring.

The main aim of this agreement is to provide a basis for the exchange of information and coordination in planning and implementing the restructuring of financial institutions operating in Serbia and within the Banking Union in the European Union. By signing the Agreement, in terms of the growing globalization of the world's financial markets and the increase in cross border operations and activities of financial institutions The NBS and the SRB express their willingness to cooperate in the interest of fulfilling their respective statutory objectives, enhancing communication and cooperation, assisting each other in the planning and conduct of an orderly Resolution of an Entity, and maintaining confidence and financial stability in Serbia and the European Banking Union.

In that capacity, the NBS is responsible for planning, initiating, and implementing the restructuring of banks and banking groups under its jurisdiction, to protect the public interest in crises. Restructuring of the bank and the banking group implies the application of restructuring measures and instruments by the National Bank of Serbia, to avoid the negative impact of the bank's closure on financial stability, economy and household while minimizing budget costs and other public funds. Restructuring of a bank or banking group is an alternative to bankruptcy and liquidation proceedings, which are resorted to when it is estimated that the public interest would not be adequately protected in these proceedings, or when it is estimated that the termination of the bank through regular bankruptcy or liquidation proceedings caused significant negative consequences for financial stability, the economy, and the population.

The NBS is, according to the Law on Banks, responsible (among others) for the resolution planning, assessment of resolvability, determination of the minimum requirement for own funds and determining whether conditions for initiating resolution have been met. Besides that, the NBS is responsible for ensuring

[15]< https:// www.nbs.rs.>, accessed 19.01.2019.

independent, fair and realistic valuation of the bank's assets and liabilities, deciding on the initiation of resolution procedure, deciding on the application of resolution tools and activities, effective conducting of resolution procedure and determining whether resolution procedure has been successful or not.

When we speak about central bank responsibility as an important aspect of NBS role, we need to be aware that monetary policy is not just an ordinary set of administrative activities that must be brought under judicial control to exercise and protect individual rights but implies the use of complex techniques and models aimed at sustainable economic growth which judges usually don't understand.[16] In the field of monetary law, as a *hybrid branch of law* with represented, private and public interest, the requirement of normative efficiency is further complicated, because at the same time, monetary legal norms, because of their dialectical connection with economic law, must satisfy the condition of economic efficiency.

The central bank is the main subject of national monetary law, and as such the principal interpreter and addressee of all components arising from monetary sovereignty delegated to it by the state. Its institutional *sui generis* position signifies that the central bank also emerges as a creator of its law, which undoubtedly confirms the process of disintegration of monetary law, in which the law of central banks is the first and oldest special legal discipline that has developed from it. Such a position of the central bank certainly does not mean that its work is taking place outside the positive legal order, which also involves regulating the issue of legal (tort) liability for the cause of damage when performing activities within its scope. The legal regulation of such liability is a direct manifestation of its passive procedural legitimation and the increasing frequency of monetary disputes in which it participates.

Although there are no uniform legal solutions regarding the nature and type of tort liability of the central bank and the mechanism of redress, *we must emphasize* that in all monetary jurisdictions there are legal solutions that recognizing and concretizing such liability to a greater or lesser extent. *Our opinion is* that according to the new role of the central bank in the area of financial supervision and macroprudential policy, it is necessary to set transparent rules that will not violate the right to equal compensation for the caused damage and the consistent application of constitutional provisions, but at the same time, it is important to explain that the central bank is an institution *sui*

[16] M Dimitrijević, "The Evolving Concept of Lex Monetae in European and International Monetary Law" (2019), 4 *Foreign Legal Life* 81, 92.

generis and that its officers act *de lege artis*, which does not mean that they are infallible.[17]

When it comes to the legal protection of the National Bank of Serbia, it should be noted that it has traditionally been limited to liability for damage that bank employees may cause through their work. Interestingly, the amendments to the National Bank's law introduced in 2010 include a provision that foreclosed the *objective liability* of the bank, its organs, and employees and imposed the principle of *subjective liability*, which effectively prevented injured persons from receiving compensation for damage caused by illegal acts of the central bank. banks (Art. 86b). On that occasion, the complainant pointed out that the constitutional rights of the potentially injured persons were seriously violated, which (if the said provision had remained in force), would have been obliged to prove the intention or extreme negligence for the damage which is contrary to the principle established in Article 35 of the *Constitution of the Republic of Serbia*. Interestingly, the earlier (2003) Law on the National Bank did not contain a provision that would regulate the liability of the National Bank for damage arising from the performance of its operations, as amended by the new Law of 2010, where for the first time it is deciduously established. We believe the legislator has shown a willingness to put the supreme monetary institution on the same responsibility pattern with other state agencies in the manner prescribed by the Law of Contract and Torts, which was a significant monetary-legal qualitative shift.

4. CONCLUSION

On its way to the European Union, Serbia must respect the achievements in the field of coordination of all segments of economic policy, which are the basis of normative and economic efficiency of domestic monetary legislation. The impact of the so-called "New economic governance" on the process of harmonization of economic and monetary law of Serbia with the EU *acquis* is very present in the segment of banking policy. Maintaining not only monetary, but also general financial stability, with intensive cooperation with the European Central Bank and a commitment to European integration as a primary goal, is also present in the adoption of new domestic solutions concerning bank bankruptcy and liquidation, consumer protection, and cooperation with a Single Resolution Board to reduce the effects of monetary instability, the collapse of

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[17] M Dimitrijević, S Golubović, "About Legal Responsibility of the Central Bank in Monetary Law" (2020), 1 *TEME* 1, 16.

the monetary system, and the relativization of monetary (state) management functions which are not territorially limited within concrete monetary legislation, but also to other countries that are connected with the affected one in geographical terms or rather represent their foreign trade partners. The position of National Central bank on the euro integration path is indispensable in creating optimal public monetary conduct, establishing credible macroeconomic dialogue and sound fiscal framework in accordance with EU values and standards. Its new monetary jurisdiction in the field of macro prudential policy and maintaining general financial stability will contribute to the consistent fulfillment of monetary stability as an important public good and protection of lex monetae.

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THE BANKING UNION AS AN INSTRUMENT FOR PREVENTING CRONY CAPITALISM IN THE BANKING SECTOR

Assoc. Prof. Ozren Pilipović
University of Zagreb, Faculty of Law
Trg Republike Hrvatske 14, 10 000 Zagreb, Croatia
opilipovic@pravo.hr

ABSTRACT

The Banking Union is viewed as one of the final chapters in total harmonization of the European Single Market along with the tax harmonization incentives. The Financial Crisis of 2007 showed that a single supervisory mechanism was needed in order to keep an eye on the banks in Euro area and thus the Banking Union was born. While states jealously guard their tax sovereignty they are more than willing to give up their monetary sovereignty when they join the Euro area. The Banking Union today is made of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The third pillar in the full Banking Union is going to be the European deposit insurance scheme (EDIS). The aim of this paper is to show that the Banking Union rules for managing failing banks will significantly prevent a possibility of crony capitalism in banking sectors in CEE EU member states. CEE countries have some historical experience with bank failures which can be dated to the period of transition during the 1990s. Some of them also have experience with crony capitalism. Many of them had combined experience of crony capitalism and bank failures. This was possible because of two reasons: in the 1990s they were not members of the EU and later there were no rules that dealt with bank failures at a European level and each state could intervene as it wanted. Today these states can intervene only according to the Banking Union rules which will hopefully reduce crony capitalism in their banking sectors.

Key words: Banking Union, bank failures, rules for managing bank failures, crony capitalism

1. INTRODUCTION

Crony capitalism in the financial sector in any member state of the European Union should either be part of a distant or not so distant past or a plot in some good thriller novel or movie. This might have been the picture during the 2000s in most member states of the EU or at least it might have seemed like that. First in 2007, a financial crisis hit the World financial markets. Then in 2010, the Greek sovereign crisis hit the EU banks and a bail out was needed for some of the most important banks in France and Germany since they had lent heavily to Greece which was no longer able to service its obligations due to the financial

crisis of 2007. Because of these crises and bank failures, a banking union was developed by the EU.

Populist parties like FIDESZ in Hungary, Law and Justice party in Poland, ANO in the Czech Republic, came to power during the 2010s in new member states of the EU from Central and Eastern Europe (CEE). These parties challenged some of the *acquis communitaire* values in their respective states, like independence of the Central Bank in Hungary or judicial independence in Poland. The new EU member states of Visegrad group (the Czech Republic, Slovakia, Hungary and Poland) like to promote something that Viktor Orban, the prime minister of Hungary, terms illiberal democracy[1]. Each of these countries rejects certain common European values which they see as contrary to their national spirit[2]. The rejections of checks and balances to power in case of Hungary and of judicial independence in Poland, make a return or resurgence of crony capitalism in these countries more than likely. The aim of this paper is to inquire if the banking union rules will prevent or limit the possibility of crony capitalism in the financial sectors of these countries with regards to failing banks. We are going to do this by using the political economy and institutional economics approach to this question.

2. METHODOLOGY

The explanations of European Union, European Monetary Integration and Banking Union in Political Science and Political Economy can be grouped under three main approaches: neofunctionalism, constructivism, and

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[1] As Bíró-Nagy explains "Orbán's own understanding of illiberal democracy is most likely a combination of certain socioeconomic and political objectives. As he noted, he envisions a work-based society in which holding down a job will be paramount, implying that those who cannot or do not want to work will forfeit certain rights. He was most likely drawing on his oft-repeated admiration for what he broadly calls the Asian model, by which he means high levels of social discipline and low levels of public dissent. Based on Fidesz's actual policies, it is also fair to deduce that illiberal democracy also features measures aimed at eliminating checks on executive powers and limiting, through a variety of means rarely employed in Western democracies, genuine opportunities for opposition voices to be heard" Andras Bíró-Nagy, Illiberal democracy in Hungary: the social background and practical steps of building an illiberal state [2017] CIDOB https://www.cidob.org/en/articulos/monografias/illiberals/illiberal_democracy_in_hungary_the_social_background_and_practical_steps_of_building_an_illiberal_state. accessed 15 October 2020.

[2] See more in Stephan Holmes and Ivan Kravtsev, *The Light That Failed: Why the West Is Losing the Fight for Democracy* (1st edn, Pegasus Books 2020), CopyCat Mind

intergovernmentalism. Neofunctionalism is the oldest theory dealing with the process of European integration and "predicts an 'ever closer union'—that is, the deepening of political and economic integration in Europe over time. It emphasizes the concept of economic and political 'spillovers' from previous integration and from one policy area to another. Finally, it assumes the shifting of the loyalty of interest groups from the national level to the EU level"[3]. Constructivism on the other hand puts a great emphasis on the power of ideas. It "generally emphasize the importance of socialization in international or EU as a way to facilitate ideational convergence"[4].

Finally, there is the intergovernmentalist approach to European integrations which is best explained by Moravcsik. In his words: "My central claim is that the broad lines of European integration since 1955 reflect three factors: patterns of commercial advantage, the relative bargaining power of important governments, and the incentives to enhance the credibility of interstate commitments.

Most fundamental of these was commercial interest. European integration resulted from a series of rational choices made by national leaders who consistently pursued economic interests-primarily the commercial interests of powerful economic producers and secondarily the macroeconomic preferences of ruling governmental coalitions-that evolved slowly in response to structural incentives in the global economy.

When such interests converged, integration advanced"[5]. When talking about the European integrations, the EMU and the BU, in this paper we will follow the intergovernmentalist approach. On the other hand, when talking about crony capitalism we will use the institutional approach. According to North, institutions are: "rules of behavior that structure human relationships: one man's opportunity is another man's constraint"[6]. Institutions lower the uncertainty by providing a structure for human behavior be it social, economic or religious. Institutions can be formal (law codes and constitutions) and informal (customs). Institutional analysis will help us identify how legal rules can reduce crony capitalism.

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[3]David Howarth and Lucia Quaglia, *The political economy of European banking union* (Oxford University Press, 2016) 9

[4] Ibid, 10

[5] In Robert Gilpin, *Global Political Economy* (Princeton University Press 2001) 354-355

[6] Douglass North, Institucije, institucionalna promjena i ekonomska uspješnost (Masmedia, 2003)

3. CEE TRANSITION, ROAD TO THE EU AND CRONY CAPITALISM

Central Eastern Europe seemed to be buzzing with different ideas in those magical years from 1989 to 1992, which only had two things in common: first one being that the communist system had to be reformed and done with and second one that it had to be replaced with a market economy and a democratic political system[7].

Before they could join the EU, these countries had to undertake political and economic transitions from a politically authoritarian system, which was complemented with a command economic system, to a democratic political system and market economy.

The conditions that CEE countries had to fulfil in order to join the EU were: a) Stability of institutions (political criteria) consisting of democracy, rule of law, human rights, and respect for and protection of minorities; b) Functioning market economy and capacity to cope with competitive pressure and market forces within the European Union (economic criterion); c) Adoption of the *acquis communautaire*.

The Madrid European Council meeting in December 1995 added another criterion: Expansion of administrative structures for effective adoption of the *acquis*[8].

In order to do all this the countries in question had to privatize most of their state-owned enterprises. Mickiewicz broadly outlined the objects of economic transition and privatization regarding the financial sector: "Bank reform and interest rate liberalization: Full interest rate liberalization; no preferential access to cheap refinancing; banking laws and regulations consistent with Bank for International Settlements (BIS) standards related to capital requirements, supervision and market discipline (Basel Committee on Banking Supervision

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[7] Many former Central East European Communist countries wanted to enter EU in order to attain better economic results. Some of the political and economic goals of membership of EU were: a) return to the Western cultural and political space to which these countries belonged for majority of their history; b) locking in political and economic reforms which were needed in order for transformation of these societies to succeed; c). these countries wanted better financial and trade links with developed countries in Western Europe market, which was quite lucrative for some of their companies. These links were needed to substitute for the loss of trade links with the former USSR and to enable greater rates of domestic economic growth. See more in Ozren Pilipović, *Politička ekonomija regionalnih ekonomskih integracija: ograničenje ekonomske suverenosti kao prilika za ekonomski rast* (Sveučilište u Zagrebu doktorska disertacija, 2011)

[8] Peter Poole, Europe unites: The EU`s Eastern Enlargement (Praeger, 2003) 38.

2004); availability of a full set of banking services; financial deepening; significant provision of lending to private enterprises, privatization of banks”[9].

Privatization was supposed to create an efficient capitalist system with level playing fields for everyone. The problem with privatization was that in most of the CEE countries it led to some sort of crony capitalism.

The Croatian privatization process was especially “shady” since as Bićanić and Ivanković point out „The decision on sales, in an environment where there is no functional capital market, is utterly unfair, since it is not possible to determine the opportunity cost of that which is being sold, or bought. The value assessment system was very vague and unfair, since it was prone to adjustments in order to achieve the desired result. Other than that, it was non-transparent because different assessment criteria were applied”[10]. The access to privatization was not open to all it was limited to a selected few and the outcome was always biased in favor of politically chosen businessmen. Similar things happened in other former socialist countries[11].

Crony capitalism can be defined as a system where businessmen will not make a profit from their ventures while they expose themselves to market risks but will

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[9]Tomasz Mickiewicz, Economic Transition in Central Europe and the Commonwealth of Independent States. (Palgrave Macmillan 2005) 27-28

[10] Ivo Bićanić, Željko Ivanković, Agrokor. A Case Study of the Rise and Function of Crony Capitalism in Croatia (2017) Friedrich Ebert Stiftung 41, 46. <https://www.fes croatia.org/fileadmin/user_upload/171109_Agrokor_WEB.pdf> accessed 1 October 2020.

[11] Rančić for example points out that “The results of the two and a half decades of transition, transformation and privatization in Croatia, show a noticeable lack of development of functional institutional framework needed for normal functioning of the market economy. The transition, of course, represents and assumes a significant institutional change ”. Nenad Rančić, Agrokor – a case of controlled collapse in Marta Bozina Beros, Nicholas Recker, Melita Kozina (eds) *Social Development 27th International Scientific Conference on Economic and Social Development, book of proceedings* (Varazdin Development and Entrepreneurship Agency, Varazdin, Croatia, Faculty of Management University of Warsaw, Warsaw, Poland , University North, Koprivnica, Croatia, 2018) 760; Nahtigal agrees that “the entire process was less than optimal. It was a transparent and well-regulated process with much conceptual and strategic confusion. It did not create strong and accountable institutions of public and private law and it did not lead to competitive economies and societies on par with the Western Europe. Instead, it widely opened the door to foreign investors to take over many firms in transition economies”, Matjaž Nahtigal, "Does Ownership of Banks in the CEE Countries Matter?," in Suzana Sedmak and Suzana Laporsek and Matjaž Nahtigal (eds) *MIC 2018: Managing Global Diversities; Proceedings of the Joint International Conference* (University of Primorska Press 2018) 358.

make a profit as a result of their good relations with politicians[12]. Crony capitalism in Central Europe developed from something we could call "crony" socialism where socialist managers had good ties with Communist Party leaders. Since socialism guaranteed maximum employment, the state was ready to help wayward enterprises by injecting money into them[13]. Hungarian economist Janos Kornai called it the soft budget constraint where the state would finance economically failed enterprises thus shielding them from closure and enabling their managers to behave irresponsibly[14]. Bićanić and Frančević for example offer the following explanation of crony capitalism "The term CC is used to describe a capitalist economy based on cronyism, clientelism and populism, a system in which financial markets do not dominate the allocation of capital, where markets (nascent or established) provide ample opportunity for quasi-rent generation so that the rent seeking behavior, redistributive coalitions and the protection of rents dominate agents behavior and optimization, where the weak state is hijacked and there is policy capture and in which there is, of course, a large institutional and democratic deficit"[15]. During the 1990s the Croatian government had to undertake two consecutive bank bailouts. The first bail out happened in 1996. The causes of the first financial crisis were the failure of banks to operate in the market economy and that their bad loans were higher than their capital[16]. This can be partly blamed on the socialist mentality in bank management at the time, which was used to the socialist banking system, and

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[12] Similar in Anne Krueger, "Why Crony Capitalism Is Bad for Economic Growth" in Stephen Haber (ed) *Crony Capitalism and Economic Growth in Latin America: Theory and evidence* (Hoover Press; 1st edition, 2002) 2

[13] Kruger for example explains the failures of crony capitalism „owners of companies receive credit and may expand because their size is a political asset (too big to fail). They may mislocate in the country's capital to be close to those they wish to influence regardless of cost; since the owners receive subsidized credit regardless of the prospective real returns, cronies can persist in business even when their activities are no longer economic; and since they receive subsidized credit, they in effect have soft budget constraints" Krueger (n12) 22

[14] Janos Kornai, "The Soft Budget Constraint "(1986) Volume 39 Issue1 Kyklos 3.

[15] Ivo Bićanić and Vojmir Frančević, "Understanding Reform: the Case of Croatia" (2003) The wiiw Balkan Observatory working papers 033/2003, 16 <https://wiiw.ac.at/understanding-reform-the-case-of-croatia-dlp-3287.pdf> accessed 15 September 2020

[16] On this see more in Ljubinko Jankov, "Problemi banaka: uzroci, načini rješavanja i posljedice" (2000) HNB, 3-5. <https://www.hnb.hr/documents/20182/121876/p-002.pdf/906d6547-d78f-4e2f-8c08-483894fec84b> accessed 2 October 2020 and in Gordan Družić, "Bankarski sustav" (2001), Vol. 52 No. 3-4, Ekonomski pregled 293, 293.

which knew that the state would always bail out the banks[17]. Because of the socialist heritage, a sort of moral hazard behavior regarding loans developed in the banks. 90 % of all the bad loans at the time were given to the few big state firms[18]. Therefore, the state was obliged to intervene. In 1998 a new financial crisis erupted. It was triggered by the crisis in Dubrovačka Banka which had a strong political background since there were speculations that the bank was ruined intentionally so that the so called "secret partners" could get the valuable hotel real estate that the bank owned. This was a typical example of crony capitalism. The government had to intervene again, and it bailed out the failing banks according to the 1996 model[19]. The major banks were now sold to foreign strategic partners since it was thought that they would manage the banks with more prudence and that the government would have less political influence on the banking sector. The Slovenian banking crisis and the restructuring[20] of the banks during the 1990s also had roots in their socialist banking heritage, but unlike the banks in Croatia they suffered more from the break-up of Yugoslavia and from the loss of the Yugoslav market[21]. The majority of banks in Slovenia remained in national ownership until the financial crisis of 2007.

Unfortunately, most of the EU member states from Central and Eastern Europe suffer from different levels of crony capitalism (not necessarily in the financial sector). As Krueger points out one of the reasons that crony capitalism in banking is dangerous is "that cronies can be favored through the granting of

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[17] And there was the fact that the general manager (Božo Prka) of one of the largest banks at the time (Privredna banka Zagreb) was a former minister of finance who was also member of the governing party (something similar would happen in the USA during the financial crisis of 2007). It was crony capitalism *par excellance*. As Bičanić and Frančević point the most important cause of the economic and financial crisis in Croatia during the 1990s was crony capitalism. In their words "Networking between members of the new political and economic elite was based too much on strong traditional social capital and identification which was only cemented by the common acceptance of nationalist fundamentalism. In some networks the Mafia-type morality of 'binding through crime and corruption' was present as well" Bičanić and Frančević (n15) 18.

[18] Jankov (n16) p. 4

[19] Družić (n16) 295-300.

[20] On the strategies of restructuring of Slovenian banks in early 1990s see more in Franjo Štiblar, "Finančni sektor v socialističnih gospodarstvih v prehodnem obdobju (2) "(1992) 40 12 Bančni Vestnik 387, 387-388.

[21]See more in Franjo Štiblar, "Finančni sektor v socialističnih gospodarstvih v prehodnem obdobju (1) "(1992) 40 11 Bančni Vestnik 348, 351. and Franjo Štiblar "Sanacija slovenskega bančništva -prehojena pot in pogled naprej" (1994) 4 Bančni vestnik 3, 4-5.

domestic credit when that credit is allocated at rates significantly below market. If cronies then use the proceeds to undertake investments that have the highest possible rates of return, the net effect of credit allocation is simply to transfer income to them; growth is unaffected"[22].

Hungary is probably the worst example of crony capitalism in the EU since it has been built by using EU funds. Oligarchs close to the prime minister Viktor Orban and his FIDESZ party control a lot of business ventures in Hungary and they use the services from state owned development banks. Some political scientists view the illiberal democracy that Orban is promoting as sort of cover for the establishment of crony capitalism in Hungary[23]. Populist governments in the Czech Republic, Slovakia, Hungary and Poland which fight against European values like the rule of law and judicial independence are probably making it easier for crony capitalism to survive and even to flourish in them.

The rule of law and the system of checks and balances it puts on the government makes a necessary precondition for a long term economic growth by lowering the uncertainty (asymmetry of information) not only between the government and citizens but also between the parties engaging in business related activities[24]. It is also a necessary precondition for the fight against corruption.

4. THE EUROPEAN MONETARY UNION: A BRIEF OVERVIEW

The Banking Union (BU) would be impossible without the European Monetary Union (EMU). Scherf points out that "The crisis frequency since 1973 has been twice that of the Bretton Woods and classical gold standard periods, only comparable to 'crisis-ridden 1920s and 1930s' (Bordo, Eichengreen et al., 2001). Crises are not longer or more severe in terms of output loss (this was prior to the most recent financial crisis) but certainly more frequent[25].

To understand the Banking Union, we need to understand the EMU first. It was made by the Treaty of Maastricht (TEU) and came into being in 1999. Howarth

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[22] Krueger (n12) 14

[23] On illiberal democracy in Hungary see more in Holmes and Kravtsev (n2), CopyCat Mind

[24] On the importance of rule of law for economic development see more in Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (Basic Books, 2000) and in David Landes, *Bogatstvo i Siromaštvo Naroda: Zašto su neki tako bogati a neki tako siromašni* (Masmedia, 2003)

[25] Gundbert Scherf, Financial Stability Policy in the Euro Zone: The Political Economy of National Banking Regulation in an Integrating Monetary Union (Springer Gabler 2014) 14

and Quaglia (2016) emphasize that the issue of moral hazard was very important in the design of the EMU since countries with financial and economic stability wanted to make a monetary system which would make it almost impossible for states to behave irresponsibly. During the TEU negotiations German negotiators insisted upon inserting a 'no bail-out' clause and a 'no monetary financing' clause in the TEU[26]. The Stability and Growth Pact[27] was negotiated in order to guarantee this. The original requirements for countries which wanted to join Euro area according to the treaty of EU were: "a) Maintain inflation rates within one percentage point of the average of the three lowest inflations within the EU; b) Maintain the interest rates within one percentage point of the average of the lowest rates of interest on long-term government bonds within the EU; c) Maintain the exchange rate of national currency within +/-15% of parity with the euro for at least two years; d) Maintain a government deficit equivalent to less than 3% of GDP; e) Maintain a ratio of government debt to GDP of less than 60 %"[28].

TEU created the European Central Bank (ECB). The European System of Central Banks (ESCB) is the framework within which the ECB acts. The EMU design established by the TEU was asymmetric. This means that a full monetary union was not accompanied by a full economic union. Some economists like Feldstein, said that the EMU was not an optimal currency area since it did not have the tools to deal with asymmetric shocks that were bound to happen at some time[29]. ECB lacked the instruments to deal with these crises since there was no *one size fits all solution* to it[30]. From the TEU it is clear that EMU had two pillars. The first pillar was (and it still is) the establishment of single currency and the establishment of ECB whose main objective was to pursue

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[26] Howarth and Quaglia, (n3) 12.

[27] Pilipović (n7) points out that the problem with these rules was that they were not enforced. EU Commission had at its disposals instruments to punish the states which ran larger deficits. The only state that was punished in the period up to 2010 was the Netherlands, while both Germany and France, not to mention Greece, ran substantial deficits.

[28] Larry Neal, *The Economics of EUROPE and the EUROPEAN UNION* (Cambridge University Press, 2007) 9-10

[29] Martin Feldstein, "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability" (1998) NBER Working Papers 6150, National Bureau of Economic Research.
<https://www.nber.org/system/files/working_papers/w6150/w6150.pdf> accessed 3 October 2020.

[30] See more in Howarth and Quaglia (n3) 12.

price stability[31]. The second pillar was the subordination of national fiscal policies to a common monetary policy through the rules of the Stability and Growth Pact. The Banking Union was seen by many as complementing the EMU and as its missing third pillar.

Among them, Schreff offered the following vision of the banking union; "To complement its monetary union, the Euro Zone could move towards regulatory union as well. This requires countries to surrender more regulatory and supervisory sovereignty to new European-level institutions such as the European Banking Authority and the European Systemic Risk Board"[32] .

The financial crisis of 2007, which later caused the sovereign debt crisis in Greece and some other European countries, is best summarized by Horwath and Quagila (2016) as "having roots in excessive international macroeconomic imbalances; a pursue of a relatively loose monetary policy (especially in the USA)—and unfit for purpose financial regulation while the international macroeconomic imbalances had been building up over the decade preceding the crisis. Also "inadequate 'light-touch' financial regulation is widely considered to be another main cause of the international crisis"[33]. This was one of the main reasons why the Banking Union came into existence[34] . Prior to this crisis the supervision of banks in the Euro area was left either to national central banking authorities or to separate national bodies for banking supervision if they existed [35]. As Arnobaldi argues "One of the main challenges for the supervisory authority is not to apply a one-size-fits-all approach, that is, to tailor the supervisory activity to the specific issues each bank faces. This is particularly challenging because a tailored approach may reduce comparability and add

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[31] Pilipović (n7); Jean Pisani-Ferry and others, "What kind of European banking union?", Bruegel Policy Contribution, No. 2012/12, 3. <https://www.bruegel.org/wp-content/uploads/imported/publications/pc_2012_12_Banking.pdf> accessed 16 October 2020

[32] Schreff (n26) 209

[33] See more in Howarth and Quaglia (n3) 30

[34] Goldner Lang and Lang point out that "The Banking Union was launched in order to break the link between banks and sovereigns and to strengthen the resilience of national economies to potential future crises. Isolating public finances from [problems in] commercial banking systems and vice versa is considered as a necessary step to improve the resilience of all EU Member States, regardless of the euro membership". Iris Goldner Lang and Maroje Lang, FIDE 2016 Hungary "EU banking union national report – Croatia" (FIDE 2016 Hungary) 2

[35] Pilipović (n7).

complexity to the system"[36]. The idea behind the banking union was that if you have strong European banks operating in multiple EU countries than you would have to have equally strong European regulatory institution(s) that could supervise and restructure banks in the EU.

5. THE BANKING UNION

The Banking Union was EU`s answer to the economic troubles that the financial crisis of 2007[37] caused. Pisani-Ferry et al (2012) point out that "the main purpose of banking policy is to ensure a proper functioning of financial intermediation of the banking system. To achieve this goal, banking policy aims to prevent banking crises and, when a crisis occurs, to intervene to prevent the crisis of an individual bank giving rise to a crisis of the banking system"[38].

Schoenmaker brings up the question of the "financial trilemma" in international finance-the interplay of financial stability, international banking, and national financial policies. He points out that any two of the three objectives can be combined—but not all three: one must be given up[39]. In his opinion the European Banking Union was a sort of regional response to this trilemma[40].

The European commission on the other hand, sees the Banking Union as an instrument that "ensures that EU banks are stronger and better supervised"[41]. The commission also points out that "initiatives form a single rulebook for all financial actors in the 27 EU countries. They include stronger prudential requirements for banks improved protection for depositors and rules for

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[36] Francesca Arnaboldi Risk and Regulation in Euro Area Banks: Completing the Banking Union, (Palgrave Macmillan,2019) 10

[37] Jašovič and Tomc for example find that "providing financial stability by resorting to state intervention measures has proven to be a crucial measure during the recent crisis by enabling faster exit from the crisis and returning to economic growth". Božo Jašovič and Matej Tomc, "Financial instability, government intervention and credit growth" (2014) 11 Bančni Vestnik 64, 73.

[38] Pisani-Ferry and others (n32) 4.

[39]"three features that could not all simultaneously hold. First, there was the prohibition on direct monetary financing of the debts of member states, which prevented the ECB's direct purchases of sovereign debt. Second, there was no collective responsibility for public debt or common borrowing capacity, which exposed member states in fiscal difficulty to considerable market pressure (and market volatility). Third, the interdependence between sovereigns and banks in each member state resulted in the 'vicious loop'" Howarth and Quaglia (n3)17.

[40] Pisani-Ferry and others (n32) 4

[41]European Commission <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/what-banking-union_en> accessed 12 October 2020.

managing failing banks. This single rulebook is the foundation for the banking union"[42]. Euro area banks are very heterogeneous in terms of size, scope and geographical provenance.

Arnobaldi emphasizes that "Differences in performance and efficiency ratios remain striking among Southern and Northern euro area countries. In 2017, though the cost-to-income ratio of Southern European banks was 55.2 per cent, compared with 60.4 for Northern banks, the return on equity was 2.24 per cent compared with 8.5 per cent in the North"[43].

The Banking Union comprises all the Euro Area Member States and EU Member States which are not members of Euro Area that decide to join it. Non-Euro area Member States may join the Banking Union by entering a close cooperation agreement.

The objectives of the Banking Union are: "ensure banks are robust and able to withstand any future financial crises; prevent situations where taxpayers' money is used to save failing banks: the cost of bank resolution is borne by shareholders and creditors and the Single Resolution Fund; ensure that problems in the balance sheets of banks are not negatively reflected in public finance, and vice versa; reduce market fragmentation by harmonising the financial sector rules; and strengthen financial stability in the euro area and the EU as a whole"[44]

Moral hazard is a cause of a good number of financial crises. Moral hazard arises when two parties engage in an activity where one party, called the agent, is performing some task on behalf of another party, called the principal. If the principal cannot adequately supervise the agent's behavior, the agent tends to undertake less effort than would normally be expected. The phrase moral hazard therefore refers to the risk, or "hazard," of inappropriate or otherwise "immoral" behavior by the agent[45]. Schreff points out that "regulators and politicians need to tackle the structural problems of moral hazard that affect all large leveraged financial institutions that are allowed to engage in risky business activities.

[42] On this see more in Dirk Schoenmaker, "The Financial Trilemma" (2011) Duisenberg School of Finance-Tinbergen Institute Discussion Paper TI 11-019/DSF 7, 1. <https://www.ft.com/content/ecf6fb4e-d900-11e7-a039-c64b1c09b482> accessed 13 October 2020; Dirk Schoenmaker, *"Governance of International Banking: The Financial Trilemma"* (Oxford University Press, 2013)

[43] Arnaboldi (n37) 8

[44] HNB, <https://www.hnb.hr/en/-/sto-je-bankovna-unija-> accessed 12 October 2020.

[45] Similar to Gregory Mankiw *Principles of Economics* (Seventh Edition, Cengage Learning,2015) 462.

Banks in the presence of deposit insurance are subject to strong problems of moral hazard"[46].

The Banking Union has three pillars. The first pillar of the Banking Union is "the single supervisory mechanism (SSM). Under the SSM, the European Central Bank (ECB) is the central prudential supervisor of financial institutions in the euro area in non-euro EU countries that choose to join the SSM. The ECB directly supervises the largest banks, while the national supervisors continue to monitor the remaining banks.

The ECB and the national supervisors work closely together to check that banks comply with the EU banking rules and tackle problems early on"[47]. The EU legislative that deals with the SSM are Council Regulation (EU) No 1024/2013 [OJ L 287][48] which establishes SSM as a system that will supervise banks in euro and in those non euro countries which chose to participate in it and Regulation (EU) No 1022/2013 which modifies the legislation on the establishment of the European Banking Authority (EBA) in order to have better framework for banking supervision[49].

The second pillar of the Banking Union is the Single Resolution Mechanism (SRM). SRM deals with the orderly restructuring of a bank "by a resolution authority when the bank is failing or likely to fail. This procedure ensures that a bank failure does not harm the broader economy or cause financial instability. The single resolution mechanism (SRM) applies to banks covered by the single supervisory mechanism. It is the second pillar of the banking union. If a bank fails despite stronger supervision, the SRM allows bank resolution to be managed effectively through a single resolution board and a single resolution fund that is financed by the banking sector. The purpose of the SRM is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the

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[46] Schref (n26) 213.

[47]European Commission, <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-supervisory-mechanism_hr#purpose-of-the-single-supervisory-mechanism> accessed 12 October 2020.

[48] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L 287

[49] Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013 [2013] OJ L 287

real economy”[50]. SRM regulation establishes the framework for the resolution of banks in EU countries participating in the Banking Union.

The third and final part of the Banking Union will eventually be the deposit insurance scheme (EDIS). The goal of EDIS is to deepen the economic and monetary union and complete the banking union. The European Commission points out that “the EDIS proposal builds on the system of national deposit guarantee schemes (DGS) regulated by Directive 2014/49/EU.

This system already ensures that all deposits up to €100 000 are protected through national DGS all over the EU. EDIS would provide a stronger and more uniform degree of insurance cover in the euro area. This would reduce the vulnerability of national DGS to large local shocks, ensuring that the level of depositor confidence in a bank would not depend on the bank’s location and weaken the link between banks and their national sovereigns. EDIS would apply to deposits below €100 000 in all banks in the banking union.

When one of these banks is placed into insolvency or in resolution and it is necessary to pay out deposits or to finance their transfer to another bank, the national DGS and EDIS will intervene”[51].

Proposals made in 2016 incorporate the remaining elements of the rules agreed within the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). They include: ”more risk-sensitive capital requirements, in particular in the area of market risk, counterparty credit risk, and exposures to central counterparties (CCPs);a binding Leverage Ratio (LR) to prevent institutions from building up excessive leverage; a binding Net Stable Funding Ratio (NSFR) to address banks' excessive reliance on short-term wholesale funding and to reduce long-term funding risk; a requirement for Global Systemically Important Institutions (G-SIIs) to hold minimum levels of capital and other instruments which bear losses in resolution. This requirement, known as 'Total Loss-Absorbing Capacity' or TLAC, will be integrated into the existing MREL (Minimum Requirement for own funds and Eligible Liabilities) system, which is applicable to all banks, and will strengthen the EU's ability to resolve failing G-SIIs, while protecting financial stability and minimising risks for taxpayers; a harmonised national insolvency ranking of unsecured debt

[50]European Commission <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-resolution-mechanism_hr >accessed 18 October 2020.

[51]European Commission <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/european-deposit-insurance-scheme_hr> accessed 18 October 2020.

instruments to facilitate banks' issuance of loss-absorbing debt instruments for resolution purposes"[52].

5.1. Single Resolution Mechanism

Resolution is a process by which the authorities intervene to manage the failure of a bank.[53]SRM is probably the most or should be the most interesting part of the Banking Union to the taxpayers in the euro area. They could be the ones paying for the mismanagement of the failed banks. SRM is basically a political solution to conflicts that surround bank failure. It answers the question of who should bear the financial burden of a collapsed bank? Should it be the banks, their shareholders, or the taxpayers?

Horwath and Quagila point out that "during the international financial crisis it was mainly taxpayers who propped up banks through state-led bailouts, after the crisis, resolution regimes were reformed with the explicit aim of making shareholders, bondholders, and large depositors pay for the bulk of the resolution of banks through 'bail-in' and resolution funds, rather than forcing governments (and thus, ultimately, taxpayers) to do so"[54]. This change of view happened because of the public displeasure at the governments bail out of private banks especially in the USA and EU with public money and not holding the management of the banks responsible for the moral hazard in managing their operations[55]. Some economists and lawyers see SRM as a "third way" between

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[52]European Commission, <https://ec.europa.eu/commission/presscorner/detail/en/MEMO_17_3722> accessed 18 October 2020

[53]Howarth and Quaglia (n3) 115

[54]ibid115.

[55] Article 15 of the REGULATION (EU) No 806/2014 [2014] OJ L 225 makes the following order of priority of who bears the costs of resolution " (a) the shareholders of the institution under resolution bear first losses; (b) creditors of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims pursuant to Article 17, save as expressly provided otherwise in this Regulation; (c) the management body and senior management of the institution under resolution are replaced, except in those cases where the retention of the management body and senior management, in whole or in part, as appropriate to the circumstances, is considered to be necessary for the achievement of the resolution objectives; (d)the management body and senior management of the institution under resolution shall provide all necessary assistance for the achievement of the resolution objectives; (e) natural and legal persons are made liable, subject to national law, under civil or criminal law, for their responsibility for the failure of the institution under resolution; (f) except where otherwise provided in this Regulation, creditors of the same class are treated in an equitable manner; (g) no creditor shall incur greater losses than would have been

the two extreme solutions that have traditionally been applied to banking crises: either a "bailout" or an insolvency procedure. As Baglione points out "On the one hand, the first solution is costly for taxpayers and it creates the wrong incentives for bankers (moral hazard effect). On the other hand, the second one can have a much negative impact on the stability of other intermediaries and of financial markets, with harmful consequences for the real economy as well (remember Lehman Brothers)"[56].

In order to safeguard against these situations sometimes the banks may be called to contribute funds to a resolution fund in advance, which can be activated in case bank failure happens in some future times. SRM is basically a second line of defense in case of a financial crisis. It only kicks in if SSM has not done the job properly or if somehow financial troubles could not be detected during the supervision itself[57]. The rational for SRM was summed up nicely in article 12 of REGULATION (EU) No 806/2014 as "Ensuring effective and uniform resolution rules and equal conditions of resolution financing across Member States is in the best interests not only of the Member States in which banks operate but also of all Member States in general as a means of ensuring a level competitive playing field and improving the functioning of the internal market"[58].

During the negotiations on the Banking Union one of the most controversial issues was the issue of creating national resolution funds and the means of their financing (*ex post* or *ex ante*). The possibility that national funds could be borrowing money from each other made the negotiations harder. Horwath and Lucia point out that "the discussions focused on one specific tool for bank recovery and resolution, namely the bail-in of creditors, whereby the controversial issues were the flexibility left to national authorities and the

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incurred if an entity referred to in Article 2 had been wound up under normal insolvency proceedings in accordance with the safeguards provided for in Article 29; (h) covered deposits are fully protected; and (i) resolution action is taken in accordance with the safeguards in this Regulation".

[56] Angelo Baglioni, *The European Banking Union A Critical Assessment* (Palgrave Macmillan, 2016) 82

[57] Think about the possible financial crisis that could be triggered by the coronavirus pandemic.

[58] REGULATION (EU) No 806/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ L 225

hierarchy in the bail-in of creditors, in particular the treatment of non-insured personal deposits and deposits by SMEs"[59]. This clearly shows that member states were not that keen to transfer more of their sovereign rights to EU.

The negotiations showed that the states did not want to cede too much power to central European authority so national resolution authorities were set up where it was needed (some member states already had agencies that dealt with bank failures among other issues). The Single resolution board (SRB) at the European level was set up „For participating Member States, in the context of the Single Resolution Mechanism (SRM), a centralised power of resolution is established and entrusted to the Single Resolution Board established in accordance with this Regulation ('the Board') and to the national resolution authorities"[60].

The European Commission points out that "the SRB is the central resolution authority within the Banking Union. Together with the National Resolution Authorities (NRAs) of participating Member States (MS), it forms the Single Resolution Mechanism (SRM). The SRB works closely with the NRAs, the European Commission (EC), the European Central Bank (ECB), the European Banking Authority (EBA) and national competent authorities (NCAs)[61]

National resolution authorities under the auspices of Regulation (EU) No 806/2014 would take responsibility for executing resolution actions in their member state while they would still be supervised by the SRB. If the national authorities did not comply with SRB decisions "the board would have the power to 'directly address executive orders to the troubled banks' (European Commission 2013)"[62].

The role of the SRB is proactive: rather than waiting for resolution cases to manage, the SRB focuses on resolution planning and enhancing resolvability, to avoid the potential negative impacts of a bank failure on the economy and financial stability. The SRB would prepare the resolution of a bank and would be 'responsible for the key decisions on how a bank would be resolved' (European Commission 2013)[63]. Its mission is to ensure an orderly resolution of failing banks with minimum impact on the real economy, the financial system, and the public finances of the participating MS and beyond.

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[59] Howarth and Quaglia (n3) 116

[60] Regulation (EU) No 806/2014 [2014] OJ L 225

[61] European Commission <https://srb.europa.eu/en/mission> accessed 18 October 2020

[62] Howarth and Quaglia (n3) 122

[63] Regulation (EU) No 806/2014 [2014] OJ L 225

The Single Resolution Fund (SRF) was established by the Regulation (EU) No 806/2014 (SRM Regulation) under the control of the SRB to provide financial support during the restructuring process. It was envisioned that this fund would be created from contributions of the banking sector through the pooling of resources of national resolution funds of member states participating in the Banking Union. As the Regulation (EU) No 806/2014 emphasizes SRF "is an essential element without which the SRM could not work properly"[64]. Furthermore, "The Fund should help to ensure a uniform administrative practice in the financing of resolution and to avoid the creation of obstacles for the exercise of fundamental freedoms or the distortion of competition in the internal market due to divergent national practices"[65]. The Fund should "be financed by bank contributions raised at national level and should be pooled at Union level in accordance with an intergovernmental agreement on the transfer and progressive mutualisation of those contributions (the 'Agreement')"[66].

The contributions to the SRF were established *ex ante*. The European Commission "established a fixed part of the contribution on the basis of the institution's liabilities, excluding own funds and guaranteed deposits (thus, the larger the bank, the higher the fixed part of the contribution), and a variety of risk indicators to be used to adjust the basic contribution to the risk posed by each bank. Finally, it established a special lump-sum regime for small banks that were seen as having a lower risk profile and hence less likely to use resolution funds. Banks representing 1 per cent of the total assets would pay 0.3 per cent of the total contributions (in the euro area)"[67]. The Regulation (EU) No 806/2014 makes it mandatory for every member state of EU to create national resolution funds. These funds should be used by the resolution authorities for the following purposes:

a) to guarantee the assets or the liabilities of the institution under resolution, or those of the bridge bank or bad bank

b) to make loans to the institution under resolution, or to a bridge bank or bad bank

c) to purchase assets of the institution under resolution

d) to make contributions to the bridge bank or bad bank

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[64] ibid

[65] Ibid.

[66] Ibid.

[67] Howarth and Quaglia (n3) 128

e) to make a contribution to the loss absorption, when the bail-in tool is applied and the resolution authority decides to exempt some classes of creditors (with the above-mentioned limitations)[68].

All of this has led to the centralization of supervision and crisis management at the EU level and it should have a positive impact on the stability of financial markets[69].

5.2. The Banking Union and CEE member states

Of the new EU member states which find themselves in Central Eastern Europe, namely the Czech Republic, Slovakia, Poland, Hungary, Slovenia and Croatia, only Slovenia and Slovakia are members of the Euro area and banking in them is *ipso facto* subject to rules of the Banking union.

In a way anticipating some of the problems with crony capitalism in some EU member states Regulation (EU) No 806/2014 makes the following statement “As long as supervision in a Member State remains outside the SSM, that Member State should remain responsible for the financial consequences of a bank failure. The SRM should therefore extend only to banks and financial institutions established in Member States participating in the SSM and subject to the supervision of the ECB and the national authorities within the framework of the SSM. Banks established in the Member States not participating in the SSM should not be subject to the SRM. Subjecting such Member States to the SRM would create the wrong incentives for them. In particular, supervisors in those Member States may become more lenient towards banks in their jurisdictions as they would not have to bear the full financial risk of their failures”[70].

This ensures that resolution authorities in non-participating member states cannot count on the solidarity of other member states if the banks in their countries fail. If ECB can`t supervise the banks operating in certain member states, the states in question will not be able to use joint European finances through SRM. Also, by making clear rules for the resolution of the banks it prevents shady deals between politics and the banking sector. The set of rules provided by the Single rulebook “provides legal and administrative standards to regulate, supervise and govern the financial sector in all EU countries more efficiently. It includes rules on capital requirements, recovery and resolution

[68] Baglioni (n56) 92-93

[69] Giuseppe Boccuzzi, The European Banking Union: Supervision and Resolution (Palgrave Macmillan, 2016) 175

[70] Regulation (EU) No 806/2014 [2014] OJ L 225

processes and a system of harmonised national Deposit Guarantee Schemes"[71]. Regulation (EU) No 806/2014 makes it clear that "The Board, the Council where relevant, and the Commission should replace the national resolution authorities designated under Directive 2014/59/EU in respect of all aspects relating to the resolution decision-making process. The national resolution authorities designated under that Directive should continue to carry out activities relating to the implementation of resolution schemes adopted by the Board".

We should also bear in mind that the state-owned banks in CEE member states are now a rarity since during the privatization process most of the banks were sold to foreign banks from Italy, Austria or Germany. The exception to this rule was Slovenia where national owned banks were more common till the financial crisis of 2008[72]. The most important causes of the 2008 financial crisis in Slovenia were that banks were exposed because they had granted real estate credits to individual citizens and that the banks were financing big Slovenian firms (especially the ones in construction), particularly those with good political connections[73]. It could be said that this was crony capitalism at its worst.

With the majority of banks being foreign owned and with rules of the Banking Union applied in every member state (not only members of the euro area) that join it, the possibility for crony capitalism in the banking sector is significantly lowered though not eliminated.

6. CONCLUDING REMARKS

As we have seen the basic motivations "leading the European policymakers to introduce the banking union, are the following: (1) reduce the fiscal cost of bank bailouts, (2) break the two-way link between the financial risks in the bank and sovereign sectors, and (3) achieve a higher level of supervisory convergence"[74]. The true test of the Banking Union will come when another financial crisis appears. Regarding the CEE member states most of the financial sector in them is privately owned with the exception of state owned development banks (DB)

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[71]European Commission, <https://www.bankingsupervision.europa.eu/about/bankingunion/html/index.en.html> accessed 18 October 2020

[72] On history of Slovenian banking and on Slovenian banks till the financial crisis of 2008 see more in Franjo Štiblar, *Bančništvo kot hrbtenica samostojne Slovenije* (Založba ZRC, 2010).

[73] France Arhar and Matej Tomec, "Prestrukturiranje sistemskih bank EMU v primerjavi s Slovenijo" (2013) 11 Bančni Vestnik 8, 14.

[74] Baglione (n 56) 125

like Bank Gospodarstwa Krajowego in Poland, Hungarian Development Bank Private Limited Company, Czech-Moravian Guarantee and Development Bank, Slovak Guarantee and Development Bank or HBOR in Croatia. The role of DBs is "to mitigate market failures arising from a variety of sources including (i) the presence of costly and asymmetric information that for example hampers access to finance for first time borrowers; and (ii) the existence of externalities that result in underfunding of socially valuable projects (as financial profitability does not reflect the overall value of the project)"[75]. State development banks usually have members of their executive and supervisory boards chosen by the executive government or parliament. Yet, with the raise of illiberal democracies in CEE with scant or no regard for the rule of law, crony capitalism could flourish again since the loans would go to businessman with the best political connections. The roots of the potential banking crisis might be found in these banks if they provide enough "bad" loans. The first good news is that most of the banks in the EU fall under the SSM and are being supervised by ECB and national Central banks. European bank authority and ECB annually run a stress test "as part of comprehensive assessments (a large-scale financial health check of banks, consisting of a stress test and an asset quality review, that helps to ensure banks have enough capital to withstand losses)"[76]. This is the first line of defense against a potential financial crisis. If this line of defense fails, then SSM comes into action[77]. The European Commission can also ask for clarification on granting state aid or loans through state owned development banks. The second good news is that these banks do not give loans to private individuals nor are they giving loans to majority of businesses, so their failure would not have a significant impact on the banking sector and on the economy in general. The other good news it is that the state is the majority shareholder in these banks and that it will not allow them to fail. Even better news is that the bank failure will have to be handled according to the rules prescribed by the REGULATION (EU) No 806/2014 [2014]. This means that all the national resolution authorities are under the supervision of Board and that they serve as its executive arm in their respective states so it would be almost impossible for national authorities to run bank resolutions on their own without the approval of the Board. The only

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[75] Eva Gutierrez and others, "Development Banks Role and Mechanisms to Increase their Efficiency" (2011) World Bank Policy Research Working Paper 5729 4.

[76]ECB
<https://www.bankingsupervision.europa.eu/banking/tasks/stresstests/html/index.en.html
>accessed 20 October 2020

bad news is that if the state is not part of the banking union and if the state-owned development bank fails it would probably be financed by the taxpayer's money. The main idea behind the Banking Union was, as we have already mentioned, that if you have strong European banks operating in multiple EU countries than you would have to have equally strong European regulatory institution(s) that could supervise and restructure the banks. Thanks to its regulations of the financial sector and the powers it vested in EBA, ECB and SRB the likelihood of crony capitalism in the European financial sector has been minimized even in the CEE member states.

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TWO NOTES ON THE PROGRESS OF CAPITAL MARKETS UNION: ACTIVE APPROACH TO TECHNOLOGY AND THE NEW ACTION PLAN[1]

Beatriz Belando Garín

Lecturer in Administrative Law

University of Valencia-Estudio General

Av. de los Naranjos s/n, 46021 Valencia (Spain)

Beatriz.Belando@uv.es

ABSTRACT

The consolidation of the Capital Markets Union became a reality difficult to achieve with the United Kingdom's departure from the European Union, forcing a new scenario of cooperation for national supervisory authorities. This obstacle was compounded by the emergence of technology in the financial markets, to which there had been no uniform response among member countries to date. The digitization of finance generated not only new products, but also new company formats, which did not fit into traditional legal frameworks. From the Initial Coins Offer (ICO), to the technology-based companies commonly called FinTech, the irruption of technology went beyond the regulatory limits on which the supervisory architecture is based. In this context, the initial response of the European authority was to use soft law instruments instead of creating a concrete regulatory framework. Aware of the benefits that these new companies or services could bring to market liquidity or company financing, the European authority left it up to each Member State to anchor them. This led once again to a phase of the financial market that has now been overcome, namely that of harmonization. However, the Union of Capitals required a common European standard for all national supervisory authorities, and the convergence of supervisory practices. Two measures had been finally taken in response: Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-Assets amending Directive (EU) 2019/1937, and the Second European Commission Capital Markets Union Action plan (Brussels, 24.09.2020).

Keywords: Fintech, Capital Markets Union, Crypto-Assets, regulatory sandboxes, innovation hub

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1. INTRODUCTION

The COVID-19 pandemic has had a relevant impact on financial markets in the European Union (EU) and has forced the member states to overcome their political and legal differences in order to achieve the ultimate goal: The Capital Markets Union (CMU). This pandemic makes necessary to rethink the elimination of the obstacles that prevent the consolidation of this CMU, especially the fragmentation of this market. There are two main obstacles to this CMU: the digitalization of markets and Brexit. The closer the United Kingdom's departure from the European Union, the more likely it will open a new scenario of cooperation for national supervisory authorities. With a "Hard Brexit", the United Kingdom would become a third country in the Community area, which will endanger the instruments of supervision and cooperation on which the European financial system is based[2]. The regulations to be applied in the markets will not be common, so neither will their supervisory response.

The national supervisory authorities have warned of the risk of regulatory arbitrage, where the United Kingdom could try to attract companies and investors with more flexible rules. However, the need to work together in areas of systemic risk, such as central counterparties, cannot be ignored.

The European Securities and Markets Authority (ESMA) is trying to highlight the significant impact of cooperation in securities markets in this new context and it has agreed some Memoranda of Understanding (MOUs) with the Financial Conduct Authority (FCA) and the Bank of England in order to achieve this objective[3]. It should be remembered that as a soft law tool or atypical act, the MOUs is a non-binding instrument although can produce excellent results by supporting regulatory convergence[4]. Its effectiveness does not come from its legal nature, since it is not an international treaty, it's just a declaration of intentions of the signatories to cooperate. EU authorities in charge of financial sector regulation and supervision use these tools to face the risks or global markets, and it has been also the ESMA's solution for the UK's decision to leave the EU[5]. It's a well-known solution to face the upcoming situation.

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[2] Pablo Iglesias-Rodriguez, "Supervisory Cooperation in the Single Market for Financial Services: United in Diversity", (2018) 41 Fordham International Law Review, 656, 657.

[3] ESMA, Brexit – the regulatory challenges, (ESMA71-319-91), 4.

[4] Anastasia Karatzia and Theodore Konstadinies, "The legal nature and character of Memoranda of Understanding as instruments used by the European Central Bank", (2019) 40 European Law Review, 227.

[5] Its effectiveness is opened to legal discussion trying to determinate some kind of consequence of such soft law instrument, although financial sector MoUs almost always

From another perspective, Brexit has also generated some competition among Member States (e.g. France, Irland, Spain, Netherlands or Germany) in order to attract investment firms currently located in the UK which wish to remain within the EU framework. This is undoubtedly disturbing in the context of the centralization of supervision of functions that is currently under way.

On the other hand, beyond Brexit, the UK's withdraw has increased supervisory convergence and EU is moving to a more integrated European financial market.

However, apart from Brexit, it is in digitalization where the European Union is now focusing its efforts. Small companies require funding through alternative channels and technology provides new services that can help them to overcome this new economic crisis having access to these funds.

But public regulators and administrative authorities, National and European must pay attention to ensure the protection of individual rights, specially the protection of those groups excluded from traditional financial services, which now have access to certain digital services but are still vulnerable.

If one of the difficulties for the development of technology is the fragmentation of laws and legal frameworks, the European Union is moving towards a more regulated scenario to promote the digital financial market and to a CMU.

Therefore, two different facts, the UK's decision and the impact of Digital economy during the pandemic had required more integrated European financial markets.

2. THE ARRIVAL OF TECHNOLOGY IN FINANCE

2.1. Initial response

Fintech[6] is a set of technological innovations that has produced what some call "seismic innovations[7]", by altering the whole structure of the previous market,

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expressly deny their legally binding nature, Dariusz Adamski, "Memoranda of Understanding in the Governance of European Financial Institutions" (2020) 45 European Law Review, 105.

[6] 'FinTech' is defined at the EU and international standard-setting levels as 'technologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services', EUROPEAN SUPERVISORY AUTHORITIES, *Fintech: Report on Regulatory Sandboxes and Innovation Hubs*, (2018), 3.

[7] María Gracia Rubio de Casas, "Fintech & Insurtech", in De la Quadra Salcedo Fernandez Del Castillo and Piñar Mañas (eds), *Sociedad Digital y Derecho* (BOE 2018), 684.

by not having any borders, by not fitting with the current regulation and by requiring an international approach. This international response began with the IOSCO, which in its *Research Report on Financial Technologies (Fintech)*[8], summarized the Fintech panorama in eight categories: payment services, insurance, planning, lending/crowdfunding, blockchain, trading and investment, data and analytics and security. But regardless of their identification, the main question for regulators was how to approach the fintech ecosystem and facilitate its development. Since 2016 there have been several ways to support innovations from a regulatory point of view that can be summarized in three types of regulatory approaches. The first one could be called as the "no action[9]". The national regulators just supervised the new services or technologies to declare them illegal or trying to fit them in the traditional regulation but not promoting special rules for the new fintech ecosystem.

This has been the Spanish position and the position of many national supervisors during 2016-2018. The second approach is the informal authorization ("no action letter") of the American model, where innovation is allowed case by case[10]. There's not a special regulation and neither a public authorization of that service, just a public declaration of the Consumer Financial Protection Bureau (CFPB) that is not going to bring an enforcement action against the company[11]. This solution gives certainty to companies and facilitates innovations allowing the companies to avoid some regulations but provides a broad discretion to the supervisor.

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[8] IOSCO, Research Report on Financial Technologies (Fintech), (FR02/2017), 4.

[9] See, Dirk A. Zetzsche, Ross P. Buckle, Janos N. Barberis and Douglas W. Arner, "Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation", (2017) 23 Fordham Journal of Corporate & Financial Law, 50-53.

[10] Aurelio Gurrea and Nydia Remolina, "Una aproximación regulatoria y conceptual a la innovación financiera y la industria fintech", in Aurelio Gurrea, and Nydia Remolina (eds), *Fintech, Regtech y Legaltech: Fundamentos y desafíos regulatorios,* (Tirant 2020), 155.

[11] In 2019 CFPB published just one no action letter (September 10, 2019, https://files.consumerfinance.gov/f/documents/cfpb_HUD-no-action-letter.pdf), the reason of this it's that the national regulator is moving to a financial regulatory sandbox. Other legislation as German bank act also allow this, see, Dirk A. Zetzsche, Ross P. Buckle, Janos N. Barberis and Douglas W. Arner, "Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation", (2017) 23 Fordham Journal of Corporate & Financial Law, 60.

The last regulatory solution has been the special license regimes: the "sandboxes" or the "innovation hub[12]".

The regulatory sandboxes are safe spaces where in one hand the companies get in contact directly with the supervisor and get a special license in a short time and on the other hand, the national authority can see the impact on public interest of the new service or product and avoid some situations[13]. From a regulatory approach, the principal reasons for establishing regulatory sandboxes include their potential to support consumer-benefitting financial innovation, facilitate financial inclusion, improve the efficiency and competitiveness of domestic financial institutions, and enhance regulators' understanding of the emerging innovative technologies[14]. The sandbox is now the Spanish regulatory answer to fintech (Law 7/2020).

An innovation hub is defined as a scheme whereby regulated or unregulated entities can engage with competent authorities on FinTech-related issues and seek non-binding guidance on the conformity of innovative financial products, services, business models or delivery mechanisms with licensing, registration and/or regulatory requirements[15]. This approach is closer to the second one because here there's not a special license for the innovation.

Knowing all these approaches, in the initial stage the European Supervisory Authorities and many or the national supervisors were included in the first one. "No action" has been the message that has been sent to the market from the European regulators, as they understand that:

"The ESAs consequently consider that a legislative intervention at this point would be premature, given that some key pieces of legislation are yet to be

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[12] Aurelio Gurrea and Nydia Remolina, "Una aproximación regulatoria y conceptual a la innovación financiera y la industria fintech", in Aurelio Gurrea, and Nydia Remolina (eds), *Fintech, Regtech y Legaltech: Fundamentos y desafíos regulatorios,* (Tirant 2020), 179.

[13] A regulatory sandbox is a scheme set up by a competent authority that provides regulated and unregulated entities with the opportunity to test, pursuant to a testing plan agreed and monitored by a dedicated function of the relevant authority, innovative products or services, business models, or delivery mechanisms, related to the carrying out of financial services, EUROPEAN SUPERVISORY AUTHORITIES, *Fintech: Report on Regulatory Sandboxes and Innovation Hubs,* (2018), 16.

[14] Saule T. Omarova, "Dealing with Disruption: Emerging Approaches to Fintech Regulation, 61 Wash. U. J. L. & Policy 25 (2020), 37.

[15] European Supervisory Authorities, Fintech: Report on Regulatory Sandboxes and Innovation Hubs, (2018), 7.

implemented or have just entered into application. However, the ESAs believe that it is very important for supervisors across various policy areas to coordinate better to ensure that these requirements are effectively complied with[16]".

For these reasons, on March 8, 2018, the Commission presented *An action plan for financial technology*[17], which urged the various Member States to integrate technological innovation into their regulatory and supervisory functions, based on the importance of techno-finance in the international context. This first document was still quite approximate, but it was the starting point for the creation of a working group of experts who produced a report at the end of 2019.

This document has been used as a reference in future Commission documents: "*30 Recommendations on Regulation, Innovation and Finance*[18]". This working group specified thirty recommendations for the approach to techno-finance, which the Committee itself summarized in four categories. The first of these was the need to adapt the regulation to respond to the new challenges and risks generated by the use of new technologies, such as artificial intelligence or blockchain or the new opportunities that arise with respect to Regtech or Suptech. Technology does not necessarily imply risks for the financial market but it can imply new opportunities[19] from the regulatory point of view, both for market participants and supervisors. In the first case we would be facing the Regtech phenomenon (Regulatory Technology, which seeks to streamline the regulatory compliance processes of financial sector entities) and the second case would be the case of Suptech (i.e., the technology emerged to facilitate the supervision tasks[20]). The second is to end the regulatory fragmentation and ensure the regulatory framework for FinTech start-ups and BigTech.

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[16] ESMA, Joint Committee Final Report on Big Data (JC/2018/049), 7.

[17] COM (2018)109 final.

[18]https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/191113-report-expert-group-regulatory-obstacles-financial-innovation_en.pdf

[19] The possibility of using a blockchain system for the exchange of information between supervisors can be of great use in fulfilling the regulators' obligation to coordinate and exchange information, María Lidón Lara Ortiz, "Retos de la era digital para la regulación bancaria europea" in PANIAGUA M. *El sistema jurídico ante la digitalización. Estudios de derecho privado*, (2020), 577-595, 569; Auer, R., “Embedded supervision: how to build regulation into blockchain finance”, 811 BIS Working Papers, (2019), 20.

[20] Financial Stability Board (FSB) has recently published the impact of this technology (Regth and suptech) in global financial markets. Its report *The Use of Supervisory and Regulatory Technology by Authorities and Regulated Institutions* (2020), explains the

The third need is to reconcile the regulation of personal and non-personal data with the risk opportunities offered by FinTech. Fourthly, the need to consider the potential impacts of FinTench from the perspective of financial inclusion and ethical use of data. This requires an examination of both the collection of data and its use or access.

On the basis of these recommendations, it is possible to understand the new steps being taken by the European Union.

2.2. The change of model: towards a flexible regulation

The objective clearly defined by the European Union is not to interrupt innovation by imposing diverse legal frameworks that generate fragmentation and regulatory arbitrage. One of the complaints collected by the members of the sector has been the effect that the different national legal framework imposed on technology-based companies or new digital products has had on the implementation of the fintech ecosystem. Several legal solutions to the same technology stop innovation and create legal borders. This situation also generates insecurity, damages the single capital market and weakens it in its ability to obtain funding. Digital companies or products are global and an orderly response from all Member States is essential to facilitate their development. A European legal framework is therefore necessary.

European regulators have already noted that it is important that both legislators and supervisors know and understand the applications of technology and its effects. At the same time, they must be aware of the risks of regulatory intervention that hinders the proper development of the technology and puts European markets at a disadvantage vis-à-vis the United States. The European premise is not to stifle innovation with excessive regulation, but starting from a regulatory framework of minimums. This option is a step forward from the initial position of no action position towards technology. As Professor LEMMA recently commented: "*it can be expected that at the present time the tendency to promote innovation hubs and regulatory sandboxes will soon be overcome by the practices of regulating innovative financial products and data analysis services*[21]".

At this stage, the current European Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-Assets amending Directive

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ongoing implementations of this tools and reveals the interest of supervisory autorithies for them after COVID-19.

[21] V. Lemma, (2020), *FinTech Regulation*, 185.

(EU) 2019/1937[22] which has been accompanied by the Proposal for a regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology, suggest a new attitude to technology[23]. A regulatory approach where regulations are developed to promote new services, programs or entities, given them a harmonized regulation that help them to implement the new activity or entity in an integrated Financial European market. A regulation that covers their special elements but also gives them the opportunity to have access to a European market.

The need for a legal framework must not forget the need not to fragment the market, which has led to a European regulatory response to innovation but not to stifle it. This is the case with cryptoactive products, which, once authorized, can be accessed in all Member States. A passport regime is being advocated for cryptoactive issuers and service providers in this sector. This is the line marked by the European Union[24], which seeks to achieve a Community passport that facilitates interoperability and the implementation of new services and companies, thus avoiding the fragmentation of the digital market[25]. It is intended to respond to one of the demands of the companies in the sector and constitutes one of the risks identified in comparison with other markets.

Both Proposals, the Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-Assets and the Proposal for a regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology, represent just one of the steps in order to achieve that integrated markets have harmonized regulation.

One of the Proposals, the Proposal for a regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology, has also been called as an example of the

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[22] This reform is in line with what has been pointed out by international bodies, specifically by the IOSCO. IOSCO (2020), *Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms,* (FR02/2020).

[23] COM (2020) 594 final, 2020/0267(COD).

[24] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *On a Digital Finance Strategy for the EU* (COM/2020/591 final), 8.

[25] See, Maria Lidón Lara Ortiz, "Criptomonedas ¿riesgos o ventajas?", in *Retos del Mercado financiero digital*, (forthcoming 2021).

requested European sandboxes[26], solution included in the recommendation of 2019[27].

The aim was to create a "European testing framework", which would increase the confidence and portability of test results to other European jurisdictions and the effects of the network through better and more formalized coordination between limited security environments. The results of the sandbox tests would also be jointly monitored by the European Commission and European supervisors to ensure that initiatives that have been successfully evaluated are carried out smoothly and quickly outside this sandbox and that regulation or other standards, if necessary, are quickly adapted accordingly[28].

3. NEW ACTION PLAN

In parallel with the drive for digital finance through the Digital Finance Strategy and the change in its approach to technology by already proposing European regulatory frameworks coupled with a determined drive for supervisory convergence, the Commission is launching[29] "*A Capital Markets Union for people and businesses-new action plan".* The plan is the result of a period of consultation with experts, industry members and consumer representatives that finally resulted in a report in June 2020[30] whose main recommendations (17) are those contained in this new Action Plan. For the European Commission, the urgency of consolidating the CMU is essentially due to four factors, some of which we have already outlined here. The first of these is the need to recover the European economy and prepare it for the future. It is essential to obtain strong markets in order to be able to face the new challenges. Public Administrations

[26] Reyes Pala, "Luces y sombras de la Ley sandbox" in *Retos del Mercado financiero digital*, (forthcoming 2021).

[27] European Union, Expert Group on Regulatory Obstacles to Financial Innovation, 30 Recommendations On Regulation, Innovation and Finance, https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/191113-report-expert-group-regulatory-obstacles-financial-innovation_en.pdf, 70.

[28] It is also a solution that have been proposed by some authors, see RINGE, Wolf-Georg and RUOF, Christopher, "Keeping up with innovation: Designing a European Sandbox for Fintech", (2019) 58 European Capital Markets Institute Commentary.

[29] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *A Capital Markets Union for people and businesses-new action plan*, COM (2020) 590 final.

[30] High-Level Forum (2020), Final report on the Capital Markets Union 'A new vision for Europe's capital markets' https://ec.europa.eu/info/files/200610-cmu-high-level-forum-final-report_en.

also require liquidity and funds to cover new infrastructure and needs, since public investment alone cannot meet the financing challenges generated by COVID 19, so private capital must be mobilized.

The second factor is the digital and green transition. The digital reform has already been analyzed previously, but in a parallel way the European Green Pact[31], together with the "Sustainable finance strategy" is on the Commission's agenda, seeking to ensure that markets mobilize the capital that is needed to achieve climate change mitigation and social values.

"Environmentally sustainable investments[32]" are thus conceived as tools to make the financial world a lever for social inclusion and sustainable development. The capital markets thus become a complement to subsidies and public contracts for companies in these sectors, providing them with a new public function: "environmental sustainability". The market must not only be transparent and efficient, but also achieve environmental and social values. This new public function, different from the traditional one, generates application problems that will undoubtedly have to be solved. In the European Green Pact, signed on December 11, 2019 (COM (2019 640 final), the Commission committed itself to "integrate the perspective of sustainability in all its public policies" for which it has announced the approval of an Investment Plan for a Sustainable Europe "combining specific financing to support sustainable investments and proposals that favor a framework that encourages green investments".

Public and private, again to promote projects that achieve an intelligent but environmentally sustainable development.

Thirdly, the Action Plan proposes a more inclusive economy able to meet the challenges of an ageing population and a more inclusive Europe. This means reforming consumer protection and the dissemination of real, transparent and comprehensive information.

Fourthly, a more competitive Europe, bearing in mind the global nature of the capital markets and the significant impact of Brexit on the European market.

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[31] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions 'Stepping up Europe's 2030 climate ambition', COM (2020)562 final.

[32] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019, on sustainability-related disclosures in the financial services sector, and Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

This action plan proposes 16 actions, all organized according to the objectives described above, some of which would stand out. In the case of the objectives connected to the digital, sustainable and inclusive market, the bet is to create an EU- wide platform (European single access point) that provides investors with seamless access to financial and sustainability-related company.

This will generate confidence in investors and allow cross-border investments between States. This simple access for investors is accompanied by other European measures that seek to standardize the criteria of sustainable finance and avoid regulatory barriers between different states. With regard to the inclusive aspect, Action 7 on financial education should be highlighted, which is basic for adequate investor protection and needs to be strengthened in a context of digital products and a progressively ageing population.

This is accompanied by measures to reinforce and improve the regulatory framework for the advice actually received by small investors (action number 8). In the block, concerning market integration and the removal of obstacles to CMU, greater standardization is sought in areas such as taxes that require significant harmonization.

It also focuses attention on the need to strengthen and harmonize the various national rules to recover investments in case of insolvency or bankruptcy processes that hinder cross-border investments.

4. CONCLUSIONS

The year 2020 has been a definitive year for the European Union and its economy. Many of the initiatives that are being implemented were already in their early stages, but were being hampered in their implementation by political or bureaucratic differences that have exploded in the wake of the needs caused by COVID-19. All of this has meant that processes that have already been initiated, such as the digital finance strategy, must be tackled without delay, given that it could mean a draught of air for the financing of SMEs or for certain groups to access financial services. The same has happened with the inclusion of the environmental perspective in finance, which has become an essential element for financing clean technologies, new infrastructures or simply new production models.

With this scenario and with a growing public debt, the European response has been forceful: regulation and a step forward in favor of the expected CMU.

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AN OVERVIEW OF REGULATORY STRATEGIES ON CRYPTO-ASSET REGULATION - CHALLENGES FOR FINANCIAL REGULATORS IN THE WESTERN BALKANS

Full Prof. Tatjana Jovanić
University of Belgrade, Faculty of Law
Bulevar kralja Aleksandra 67, Belgrade, Serbia
tanja@ius.bg.ac.rs

ABSTRACT

The rise of the crypto-asset market has opened up a number of questions on their benefits and risks. As a new form of virtual property, cryptocurrencies and tokens of investment nature are characterized by specific technological infrastructure. In order to understand the regulatory perspective of the crypto-asset market, it is necessary to briefly present the issues related to digital assets infrastructure and the forms of crypto-assets, which blur the line between financial products and virtual property. Crypto-assets represent a form of fintech innovation that could materially affect the financial landscape (notably payments, investments and capital raising), may have impact on the financial sector and therefore may create conditions for regulatory arbitrage where regulated participants operate in a highly regulated environment. The Paper aims to identify the basic issues of the crypto-assets regulatory framework and the extent of applicable regulatory approaches. Comparative regulatory practices of selected countries, as well as the global regulatory perspective of this market, serve as a guide to assess the existing regulatory framework and regulatory challenges, in order to assess urging issues which the regulators in Western Balkan countries are facing. Regulators are confronted with a dilemma: how to promote financial innovation while preserving financial stability and protecting investors. That is why many regulators have adopted a regulatory stance in regulating distributed ledger (blockchain) technologies and tend to formulate regulatory strategies which are risk based, phased and adaptive. Regulatory responses vary from a complete ban on issuing or trading crypto-assets, warnings and principles-based regulation, to extending existing rules on the capital markets and payment systems to specific intermediaries which are licensed almost as financial institutions per se. A tendency towards developing a new set of legislation specifically aiming to register and/or license providers of services connected to virtual property based on cryptography may be observed, and a proposal for an EU regulation on Markets in Crypto-Assets is a clear example.

Keywords: crypto-assets, virtual currencies, blockchain technology, fintech, financial regulation

1. INTRODUCTION

The increase in the number of virtual currencies and other forms of virtual assets is accompanied by an increase in the volume of trading and the use of the new

technology on which they are based. Regulators' concerns about the risks arising from the use of new technologies and the wider use of crypto-assets are growing. Regulators around the world face the challenge of achieving balance between the need to regulate a new phenomenon and stifle innovation, or fostering innovation and taking a balanced regulatory stance with regards to the new technologies.

Whereas some already existing risks in the financial system are an inherent characteristic of modern forms of financial intermediation (e.g. risk of use for money laundering purposes), the use of new technologies raises questions of new risks that are specific to digital property. Crypto-assets represent one item among various technological advancements which drive the change in the modern financial sector. The underlying blockchain/ digital ledger technology (DLT) by itself creates a number of problems that regulators face in defining the appropriate regulatory strategy. Therefore, setting the regulatory agenda should be based on the analysis on the risks and the most important legal challenges arising from that technology, as well as the basic infrastructure elements of the crypto-asset industry. One of the key issues is the following: to what extent the existing regulations applicable to financial instruments may be applicable to emerging forms of new assets?

States, national and international regulators are striving to encourage the development of innovative technologies, while on the other hand facing public expectations to protect consumers and investors, businesses participating in this market, and the financial system. Many countries react gradually or adopt the "wait and see" approach, to get some extra time to consider how other countries react to crypto-evolution.[1] Because the nature of international finance is global, national and regional initiatives have limited maneuver for intervention. The basic problem national regimes are facing is the dispersed or distributed architecture of DLT based systems underlying crypto-assets. Reaching a consensus at the international level is a tantamount to developing national regulatory responses. The fragmented nature of FinTech tools dictates the emergence of at least the minimum requirements of a transnational regime with regard to the most important risks. An excellent example of transnational

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[1] Wulf A. Kaal, 'Initial Coin Offerings: The Top 25 Jurisdictions and Their Comparative Regulatory Responses' (2018) 1 Stan J Blockchain L. & Pol'y 41, 63.

initiatives to combat money laundering and terrorist financing are the recommendations of the Financial Action Task Force on virtual currencies.[2]

The regulatory response or the approach to the regulation of the crypto asset market from a public law perspective, occupies a primary place in this paper. It explores the basic issues of a normative nature that are introduced to help in managing risks stemming from the use of new financial technologies in issuing and providing services related to trading in crypto-assets. Public law regime sets out minimum standards for establishment, operation, internal organization and risk management, as well as requirements on fair dealing, customer care and consumer protection. In that sense, issues related to private law aspects, e.g. the issuance, management and servicing of claims on virtual property, mutual relations of transactors, as well as issues of criminal liability for abuse in the virtual currency market have not been explored, and neither have tax policy issues.

The Paper explores the basic settings of public regulation of the market in crypto-assets and the main principles for an appropriate choice of a regulatory strategy. It does not aim to portray a comparison of the existing regulations. The basic principles of crypto-asset regulation and regulatory approaches to regulation will be portrayed, with a special reference to alternatives to traditional "command and control" regulation. Innovation in the financial sector implies not only adjustments and innovations in rules, but also approaches to regulation. This is particularly challenging for the countries of the Western Balkans, where the focus has long been on firm rules and a rigid concept of the role of regulators. The final part of the paper will focus on addressing the challenges that legislators and regulators in the Western Balkan region are facing in developing an approach to crypto market regulation.

2. CRYPTO-ASSET IN THE REALM OF FINTECH AND RECONCEPTUALIZATION OF REGULATION

The past decade was marked by and unprecedented rise of a new type of financial intermediaries and providers, often referred to as "*fintech*", which offer innovative services. In the broader sense, fintech refers to "incremental or disruptive innovations in or in the context of the financial services industry

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[2] FATF, Guidance for a risk-based approach ‛Virtual assets and virtual asset service providers’, June 2019, <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets.html> accessed 15 August 2020

induced by IT developments resulting in new intra- or inter-organizational business models, products and services, organizations, processes and systems".[3] Unlike traditional financial institutions, often finance giants, innovative firms as a rule are smaller players, predominantly focused on competitive and innovative products.

The digital setting and use of artificial intelligence challenged the incumbent financial infrastructure. Financial intermediation has shifted from conventional banks to non-depository financial institutions that do not have to comply with detailed prudential and conduct of business rules. Fintech is therefore able to avoid intermediation costs and minimum capital requirements. Fintech stimulates financial sector development, and is pivotal in increasing the diversity and accessibility of financial services.[4] Crypto-assets are a form of fintech innovation that could materially affect the financial landscape (notably payments, investments and capital raising), may have impact on the financial sector and may create conditions for regulatory arbitrage where regulated participants operate in a highly regulated environment.

Regulation usually goes behind technological innovation and is often tardy in responding. Elevated complexity of the financial landscape brought new challenges for the regulatory framework and urged regulators to react, as the current legal framework is unable to respond to such challenges. The intersection of technology and functional powers of the fintech industry, emerging business models, novel services and consumer expectations, challenged the regulators and in many different ways reconceptualized financial regulation.[5] One of the main issues in the context of fintech regulation is regulatory uncertainty, and therefore the fundamental question is how to create regulatory certainty and provide flexibility to react to unknown risks and novel business models. Overly precautionary approach, prohibition of certain types of fintech and premature changes in hard law may impede innovation and make national financial system uncompetitive. The challenge is thus to design a regulatory environment that is flexible enough to accommodate new fundamental changes to markets and, at the same time, is able to create

[3] Thomas Puschmann, 'Fintech' (2017) 1 Business & Information Systems Engineering 59, 69, at 74.

[4] Daniela Gabor, Sally Brooks, 'The digital revolution in financial inclusion: International development in the fintech era' (2017) 4 New Pol Ec 22, 423.

[5] Douglas W. Arner, Janos Barberis, Ross P. Buckley, 'FinTech, RegTech, and the reconceptualization of financial regulation' (2017) 3 NW J Int'l L & Bus 37 371.

regulatory certainty for all market participants.[6] This has lead to the reconceptualization of regulation and innovations in the regulatory process reflected in a more flexible approach based on the application of principles, rather than hard law, as well as innovations in the process of regulation in the form of testing environments based on dialogue, enabling regulators to decrease uncertainty through learning.

Most laws on financial intermediation were written before rising fintech innovations occurred.[7] Rules may conflict with the new setting of innovative means and some fintech may not fit categories formerly determined by applicable laws. Moreover, some innovations prompted structural changes and regulators must firstly assess those risks and determine whether they are encompassed by the existing framework. The sooner regulators are introduced to innovation, the better they will identify risks, whereas financial innovators will get the opportunity to adapt their service while costs of compliance are still reasonable.

3. THE CORE RATIONALES FOR REGULATING CRYPTO-MARKETS

3.1. The risk of new technologies and regulatory adaptation

Cryptocurrencies, as the first forms of crypto-assets, appeared in 2008, when Bitcoin was created as a specific electronic payment system without traditional financial intermediaries to guarantee that the transaction will be completed.[8] Through a local network of Internet-connected computers ("peer-to-peer network"), in which participants can see all transaction data at any time (without participant identification), participants agree to verify the chronology of transactions by solving complicated cryptographic algorithms, which form blocks of time-grouped transactions. Such a chain of block is visible in a publicly available database of unique transaction history. In this sense, blockchain technology represents the documentation of records of all transactions, grouped into blocks and provided by cryptography, within a decentralized alternative electronic system, which takes the form of a publicly available fragmented general ledger. Hence it is also called distributed ledger

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[6] Wolf-Georg Ringe, Cristopher Ruof,'Regulating Fintech in the EU: the Case for a Guided Sandbox' (2020) 3 EJRR 11 604, 613.

[7] Mark Fenwick, Erik P Vermeulen, Wulf Kaal, 'Regulation Tomorrow What Happens When Technology is Faster than the Law' (2017) 3 Amer Uni Bus LR 6 561.

[8] Satoshi Nakamoto, *Bitcoin: A peer-to-peer electronic cash system* (2008) <https://bitcoin.org/bitcoin.pdf> accessed 20 September 2020

technology (DLT).[9] Somewhat later, new forms of transaction verification have been developed. Instead of mining (the process of solving algorithms that create a chain of blocks), new technological innovations enabled verification of transactions among parties ("proof-of-stake"), on the basis of automated decisions and smart contracts. The development and application of technological innovations through Decentralized Autonomous Organizations (DAO) altered the world of alternative finance.[10]

Although initially used in cryptocurrency schemes, blockchain technology has a much wider potential for application because it allows various documents to be encrypted, including those whose existence can be proven in secure publicly distributed books. Many potential uses of this technology raises an important question: whether the transfer of value without the intervention of banks and central authorities that the state can control implies a specific new governance model?[11]

The theory proposes to recognize a new type of right over virtual property. [12] De Filippi and Wright believe that these autonomous systems of rules based on codes create an order without law, something that could be called private regulatory frameworks, which they called the *lex cryptographica*. Such frameworks allow people to communicate, organize and exchange value without the participation of intermediaries, centralized bodies and the state.[13] Public

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[9] Government Office for Science, *Distributed ledger technology: beyond block chain,* A report by the UK Government Chief Scientific Adviser (2015), 36. <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/492972/gs-16-1-distributed-ledger-technology.pdf> accessed 20 September 2020.

[10] Garrick Hileman, Michel Rauchs, *Global Cryptocurrencies Benchmarking Study*, University of Cambridge, Centre for Alternative Finance (2017)
<https://cointelegraph.com/storage/uploads/view/2017-global-cryptocurrency-benchmarking-study.pdf> accessed 20 September 2020.

[11] Primavera De Filippi, Benjamin Loveluck, 'The invisible politics of Bitcoin: governance crisis of a decentralised infrastructure', (2016) 3 *Internet Pol Rev 5* 1 <https://policyreview.info/articles/analysis/invisible-politics-bitcoin-governance-crisis-decentralised-infrastructure> accessed 15 August 2020; Aaron Wright, Primavera De Filippi, 'Decentralized Blockchain Technology and The Rise of Lex Cryptographica' (2015) <http://ssrn.com/abstract=2580664> accessed 25 September 2020.

[12] Carla L. Reyes, 'Moving Beyond Bitcoin to an Endogenous Theory of Decentralized Ledger Technology Regulation: An Initial Proposal' (2016) 61 Vill L Rev 191, 193; Katie Szilagyi, 'A Bundle of Blockchains? Digitally Disrupting Property Law' (2018) 48 Cum L Rew 9, 24.

[13] Wright and De Filippi (n 11).

blockchain networks enable creation and functioning of rule based systems which are forerunners of new institutional forms of economic governance based on rule-system for economic coordination between various actors.[14] Blockchain systems can be controlled in areas where they intersect with regulated entities such as network operators that communicate with a blockchain-based system and all those who develop or support technology. This is one of the basic hypotheses of crypto-asset regulation.

Given that blockchain technology is still in development, there is a danger that premature and excessive regulation may prevent the emergence of novel applications of technology. Premature introduction of a licensing system and control could prevent participants in this market from freely experimenting with new technology, which essentially hampers innovation. At the same time, the lack of regulations would leave those who want to apply the technology in a gray area, where they are not sure if what they are doing is legal. Applied to the crypto-asset market, this paper will cast a light on innovations in the regulatory approach. Considering that virtual currency schemes are based on technology the use of which may circumvent financial intermediation, its postulates such as aggregation and netting, the role of financial institutions as traditional intermediaries seems to be somewhat diminished. It certainly poses a potential risk to financial stability. The functioning of the classic payment system could be jeopardized if a larger number of users of virtual currency schemes appeared. However, the risk posed by innovation can encourage financial institutions to adapt to new technologies. Central banks and financial regulators are increasingly noticing the need to adjust regulations and enable the so-called tokenization of securities through the procedure of initial public offering of coins.[15] The legal framework should also ensure technological neutrality with

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[14] Sinclair Davidson, Primavera De Filippi, Jason Potts, Disrupting governance: The new institutional economics of distributed ledger technology, SSRN Working Paper Series (2016) at 6-7, < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2811995 > accessed 20 October 2020.

[15] For instance, France had taken the lead as early as 2016, with the Ordonnance n°2016-520 of April 28th 2016

("Minibons" *ordonnance*) setting out the conditions for using "shared electronic recording devices". Ordonnance was amended by the Decree of December 24th 2018 (known as the "Blockchain Decree"). In Luxembourg, the Law of 1 March 2019 amending the Law of 1 August 2001 concerning the circulation of securities and other financial instruments, provides that securities can be held using distributed ledger technologies and these technologies can also be used to register transfers (Loi du 1er mars 2019 portant modification de la loi modifiée du 1er août 2001 concernant la circulation de titres).

regard to various protocols on which the infrastructure of the blockchain may be based. The flexible approach through technological neutrality principle is necessary to differentiate a legal regime from rapidly evolving technologies.

3.2. Risks related to the stability of financial system and public order

Numerous reasons on the supply and demand side of virtual currencies have contributed to their development.[16] Digital currencies based on the use of DLT represent the evolution of payment systems, with reduced transaction costs and increased speed, including in the areas of e-commerce and cross-border transactions. The success of Bitcoin and other cryptocurrencies has motivated the emergence of start-up financing through Initial Coin Offerings as an alternative to debt and capital market instruments. However, crypto-assets also enable the financing of companies which "bypass" the regulations that regulate financing on the capital market, which provide certain legal protection to investors and issuers. The immediate character of transactions, i.e. the absence of intermediaries and the direct execution of transactions with the use of keys, allows greater discretion compared to other payment systems. Due to insufficient regulation, these transactions were of interest to owners of suspicious capital and were used to finance criminal activities, which is one of the main reasons for regulating virtual currency schemes.[17] Examples of cryptocurrency fraud and abuse are numerous: hacker attacks, money laundering, terrorist financing, crypto extortion, theft, abuse of women and children, Ponzi schemes, phishing, scams, fake sites, etc.[18]

The lack of a regulatory framework allows for "circumvention" of regulations and makes it difficult to implement official public policies. The most obvious example is tax avoidance, as tracking and identifying transaction participants is difficult, these virtual currencies represent new "super tax havens." Also, the free exercise of cross-border payments may be in conflict with foreign exchange regulations or regulations restricting capital flows. The lack of regulation places

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[16] Bank for International Settlements, Committee on Payments and Market Infrastructures, *Digital Currencies*, (2015), 7-12 <https://www.bis.org/cpmi/publ/d137.pdf> accessed 15 August 2020.

[17] Lawrence C, 'Virtual Currencies; Bitcoin & What Now After Liberty Reserve, Silk Road, and Mt. Gox?' (2014) 20 Rich. J. L. & Tech 4, 1, 3; Tara Mandjee, 'Bitcoin, Its Legal Classification and Its Regulatory Framework' (2014) 15 J. Bus & Sec. L 2 157.

[18] Homeland Security Studies and Analysis, *Risks and Threats of Cryptocurrencies*, Publication Number: RP14-01.03.03-02 (2014), <https://www.anser.org/docs/reports/RP14-01.03.03-02_Cryptocurrencies%20508_31Dec2014.pdf> accessed 15 August 2020.

cryptocurrency owners mostly outside the reach of national fiscal and monetary policy, which can make their implementation more difficult and negatively affect the efficiency of economic policy.

Central banks closely monitor the development of the cryptocurrency market, as well as the development and application of new technologies that have the potential to reshape the world of finance, especially in terms of achieving their basic goals and objectives.[19] The growth of the cryptocurrency market could lead to the displacement of conventional currencies. This would raise the question of the monetary risks of using cryptocurrencies, since their supply does not depend on the monetary authorities, unlike the supply of traditional currencies. Impossibility of the central bank to influence the flow of assets could cause a loss of confidence in the national currency and prevent the central bank from carrying out its basic monetary function and effectively performing the role of lender of last resort. The potential of cryptocurrencies to affect financial stability depends on their connection to the real economy and financial markets. Given that they have not yet reached a critical volume of trade and a wider circle of users, the prevailing view is that they cannot affect financial stability.[20]

The emergence of new services related to the application of new technologies opens new risks beyond the control of central banks and regulatory bodies, which can lead to the loss of confidence in the financial system. Recorded cases of collapse of cryptocurrency exchanges and theft from electronic wallets clearly indicate dangers for investors and consumers. Encompassing different forms of assets and intermediaries, crypto-markets are prone to various different legal risks.[21] Emerging forms of cryptocurrencies carry various risks from the point of view of consumers, starting from the fact that they are unsuitable products, i.e. that due to their characteristics they are not adapted to consumers. Consumers

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[19] International Monetary Fund, *Virtual Currencies and Beyond: Initial Considerations*, IMF Stuff discussuion note, SDN/16/03 (2016), 31-33; Gina C. Pieters, "The Potential Impact of Decentralized Virtual Currency on Monetary Policy," Fed Res Bank of Dallas, Globalization and Monetary Policy Institute, 2016 Annual Report (2017);

[20] Financial Stability Board, Crypto-asset markets, Potential channels for future financial stability implications, (2018); <http://www.fsb.org/wp-content/uploads/P101018.pdf> accessed 10 October 2020; Financial Stability Board, FSB Chair’s letter to G20 Finance Ministers and Central Bank Governors (2018), <http://www.fsb.org/2018/03/fsb-chairs-letter-to-g20-finance-ministers-and-central-bank-governors/> accessed 10 October 2020.

[21] European Central Bank, Impact of digital innovation on the processing of electronic payments and contracting: an overwiev of legal risks (Frankfurt am Main 2017) <https://www.ecb.europa.eu/pub/pdf/scplps/ecb.lwp16.en.pdf?3f7054a2a21c98ba0560cadc8ff329d6> accessed 15 August 2020.

are often unaware of their risks or do not have enough information to make a rational decision, and fraudulent practices as well as various forms of market manipulation are common.[22] It is a difficult task for an average consumer to determine the value of investing in crypto-assets. Given that their price is primarily based on speculation that consumers often overestimate the expected profit without paying attention to what is necessary to consider when assessing investment risk.[23] A special type of consumer abuse or price manipulation are the so-called pump and dumps, where the price and value of a crypto-asset is systematically increased by a collective buying of that crypto-asset, followed by the abrupt sale of that crypto-asset at the increased price. The overemphasis on benefits and lack of information on potential losses especially characterizes the IPOs of coins and other tokens, where unrealistic expectations of success and risks are often presented to consumers in the form of a shortened prospectus (White Paper), which makes it impossible to understand the risk profile. Some authors claim that cryptocurrencies often represent a form of fraudulent practices, comparing them to financial bubbles, and therefore suggest limited access to these schemes for a wide range of investors, primarily consumers as non-professional investors.[24]

4. SETTING THE SCENE: BASIC ISSUES IN DEFINING THE REGULATORY STRATEGY

4.1. The key principles and forms of crypto-assets regulation

Up to date, national regulators responded in different ways ranging from the "wait-and-see" approach, issuing warnings, to sanctioning the avoidance of conforming to capital market rules. Regulatory response was mostly concerned with illicit transactions, market integrity and customer protection.[25] Despite the activities undertaken in individual countries, where regulatory intervention often cuts across various different regulators, crypto markets operate at a global level within a regulatory void, and no globally harmonized position has been reached

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[22] Trautman (n 17) 3.

[23] De Nederlandsche Bank, AFM, *Cryptos - Recommendations for a Regulatory Framework*, (December 2019), p. 16-17.
<https://www.afm.nl/en/nieuws/2019/jan/adviesrapport-crypto> accessed 20 August 2020.

[24] Chung Baek, Matt Elbeck, 'Bitcoins as an Investment or Speculative Vehicle? A First Look' (2014) 20 App Econ L 1 30.

[25] Raphael Auer, Stijn Claessens, 'Regulating cryptocurrencies: assessing market reactions' (2018) BIS Quart Rev 51; Primavera de Filippi, 'Bitcoin: a regulatory nightmare to a libertarian dream' (2014) *3* Int Pol Rev 2 43.

yet. The fragmented approach with varying degrees of national regulatory scrutiny may lead to the race to the bottom, as crypto-asset related activities might migrate towards less stringent regulatory regimes. In addition to the EU institutions as representatives of regional integrations, several standard-setting international organizations are involved in considering the risks of using cryptocurrency and reviewing their regulatory approaches. The Committee on Payments and Market Infrastructures of the Bank for International Settlements (BIS) focuses on central bank digital currencies, the International Organization of Securities Commissions on ICOs and investment crypto-assets, the Basel Committee on Banking Supervision (BCBS) on banks' exposure to crypto-assets, the Financial Action Task Force (FATF) on anti-money laundering and anti-terrorism financing measures. Regarding the scope of the adopted standards in national legislations, the role of the FATF is most emphasized, which will be shortly presented in this paper, since it has grown into a transnational regime and most countries strive to harmonize national legislation with the FATF recommendations. Fearing hard regulation and a command-and-control regulatory approach, self-regulatory organizations, created to represent the interests of the fintech industry, are increasingly engaged in promoting self-regulatory rules. Self-regulatory organizations aim to formulate a common set of guidelines and professional standards of conduct to promote the integrity, fairness, and efficiency of markets in crypto-assets. One of the best examples is the Code of Conduct developed by the Association for Digital Asset Markets (ADAM).[26] Another example is the Virtual Commodity Association (VCA) that has recently announced a project to form a self-regulatory organization to issue guidance on best practices for crypto-assets, with the aim to form a basis for the future regulation of the sector and cooperation with existing regulatory bodies.[27]
When the choice of forms of regulation and regulatory instruments is set as a criterion for the selection of the regulatory approach, somewhat modified classification proposed by the Committee on Payments and Market Infrastructure differentiates between the following: 1) information regulation and moral pressure; 2) regulation of specific financial intermediaries; 3) application of existing regulations; and 4) expansion of the scope of application of regulations, including the adoption of new regulations.[28]

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[26] <http://www.theadam.io/code/>

[27] <www.virtualcommodities.org>

[28] Bank for International Settlements, (n 16) 1; Gerard V. Comizio, *'Virtual Currencies: Growing Regulatory Framework and Challenges in the Emerging Fintech Ecosystem'* (2017) 21 N. C. Banking Inst. 131, 168-170.

1) Moral pressure as a form of influence on the virtual assets market and information regulation are focused on the risks and dangers of investing in virtual assets and opening this market to the general public. Typical examples of this approach are public warnings about the risks of investing in cryptocurrencies, information campaigns on virtual currency schemes and the like. This form of regulation, with the least pressure on the markets, is often a precursor to the introduction of other forms.
2) Within the virtual currency system, some of the new intermediaries are providers of specific services that represent core elements of the market infrastructure. Examples of specific regulation of financial intermediaries are cryptocurrency exchanges and digital wallet service providers. Licensing systems for other intermediaries in cryptocurrency markets, which have similar roles to existing financial intermediaries, may impose a number of obligations such as minimum standards of investor protection (especially for consumers), risk reporting obligations and the like.
3) Cryptocurrency schemes may be regulated through the existing regulations, so that certain forms of intermediation and certain services are covered by already existing rules. This applies in particular to the rules on markets in financial instruments and regulations prohibiting market manipulation in the issuance and trading of investment tokens, as well as the application of rules on payment services to virtual currency schemes that have dominant payment system characteristics.
4) Expanding the scope of application of existing regulations and eventual adoption of new regulations is an option that seems necessary in situations when it is not possible to apply existing regulations due to the specific features of crypto-assets or the national regulators opt to harmonize rules with the transnational regime. For example, regulations on the prevention of money laundering and terrorist financing have been expanded to include cryptocurrency transactions as a result of the FATF recommendations. In addition to the need to include new service providers and new infrastructure (e.g. virtual wallets), digital assets are specific in relation to a number of other issues such as settlement finality, custody services, specific obligations towards customers, etc.
One of the key dilemmas in defining the generic approach to crypto-asset regulation i.e. the need to adjust regulations or adopt a new regulation, refers to determining the nature of crypto-assets. That is why one of the leading principles in regulating crypto-assets rests on the notion of equal status. The principle may

be summarized as follows: "same services, same risks, same rules and same supervision". The application of this principle would lead towards an inclusive ecosystem where all actors are subject to similar rules, to ensure integrity of the financial system. Another principle derives from this attempt to constrain regulatory arbitrage. If the same risks attract the same rules, the regulation should be neutral regarding business models and technological neutrality. To harmonize regulatory standards on a risk basis, crypto-assets as financial instruments should be aligned with existing regulation, with considerations for a possible exemption regime. Fintech requires the regulatory framework to be based on the specific activity or function, rather than specific entity or the type of underlying technology. The principle of technological neutrality goes along with the principles-based regulation. Principles, as general requirements that express fundamental obligations that all market operators should observe, could be supported by more detailed standards. In general, principles-based regulation denotes a shift from reliance on detailed, prescriptive rules, towards more high-level, broadly formulated principles.[29] In a changing environment, regulatory approach should be resilient and adaptive. This implies that all new legislation and guidance and future amendments should provide for rapid changes and be adaptive to allow application to emerging technologies with no or limited amendment. Adopting a phased and unified approach based on risk is in line with this principle. Regulatory actions should be timeously assessed before stringent requirements are imposed. Safety, stability and integrity of the financial system is an underlying rationale for intervention and measures should commensurate with the level of risks, taking into account potential benefits. Unified approach means that all affected regulatory authorities should jointly determine their actions to ensure clear and consistent treatment of market participants.[30] The emergence of crypto-assets significantly contributed to disintermediation of traditional regulated intermediaries, such as commercial or investment banks. As middlemen, traditional financial intermediaries acted as gatekeepers to which semi-regulatory functions were attributed.[31] Traditional

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[29] Julia Black, Martin Hopper, Christa Band, 'Making a success of principles-based regulation' (2007) 3 Law and Fin. Markets Rev. 1 191.

[30] South African Intergovernmental Fintech Working Group (IFWG), Crypto-assets Regulatory Working Group, Position Paper on Crypto-Assets (2020) at p. 22-23. <http://www.treasury.gov.za/comm_media/press/2020/20200414%20IFWG%20Position%20Paper%20on%20Crypto%20Assets.pdf> accessed 15 September 2020.

[31] For the instances of failure of gatekeepers in conducting their semi-regulatory functions, *see* Jennifer Payne, 'The Role of Gatekeepers' in Niamh Moloney, Eilís Ferran Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (OUP 2015).

intermediaries were subject to direct and centralized regulation of their establishment and activities. The nature of open-sourced technologies and its constant evolution calls into question the possibility of applying a direct approach to regulation. Whereas potential externalities within crypto-market ecosystem are governed by the rule of the code, main risks may emerge in interactions with the real world. The emergence of various forms of new middlemen in the digital industry calls for a shift in the policy approach. Instead of regulating crypto technology, which is often not feasible due to its inherent characteristics, regulatory strategy could be implemented through the emerging middlemen and traditional intermediaries, such as banks, exchanges and payment institutions.

Traditional intermediaries were often regulated by regulatory measures focused on the industry structure, strategies or the activities performed by regulated entities. In regulating crypto-markets, direct regulation would be focused on the code or industry design and design features of the blockchain (i.e. node operators, miners), whereas indirect regulation would predominantly target interactions with counterparties and the real world.[32]

These are, for instance, exchanges where cryptocurrencies are exchanged for a legal tender, merchant points, electronic wallet providers etc. A tool for direct regulation of crypto-assets may be the design-based regulation which aim is to remove the possibility of non-compliance by elimination of the possibility of human discretion.[33]

However, internal self-regulation of the cyberspace and the code as architecture is a direct self-regulatory system. Direct regulation of the intersection of decentralized crypto world with the real world makes it a hard case for a centralized governance scheme. That is why a direct regulatory approach to crypto-markets would be a difficult endeavor, although it would not be completely ineffective. Centralized direct regulation of cryptocurrencies could face the same challenges that the traditional command-and-control regulation in an environment where the regulated industry is not sufficiently motivated to comply with such rules.

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[32] For the application of the concept of direct and indirect regulation in the regulation see: Hossein Nabilou, Alessio M. Pacces, 'The Hedge Fund Regulation Dilemma: Direct Vs. Indirect Regulation' (2015) 6 Wm & Mary Bus. L. Rev 183.

[33] Karen Yeung, 'Towards an Understanding of Regulation by Design' in Roger Brownsword and Karen Yeung (eds.) *Regulating Technologies: Legal Futures, Regulatory Frames and Technological Fixes*, (Portland, Oregon: Hart Publishing 2008), 80, 106.

From among all the challenges that centralized direct regulatory approaches face, three of them particularly stand out in regulating crypto-markets: limitations on the competence of public authorities, determination of the regulated entities, and regulatory arbitrage.[34] Since crypto-assets often encompass the traits of different products, the surveillance would cut across the traditional competences of various regulators, and traditional division on regulatory and supervisory tasks could be obsolete.[35] The lack of consensus on the nature of crypto-assets (*what* to regulate) prevents the emergence of a uniform approach to regulation. Consequently, another practical question emerges: *whom* to regulate? In a decentralized blockchain structure, an entity towards which the regulation could be directed could not be identified easily. There is a certain number of middlemen playing distinct roles, such as issuers of coins, miners, exchanges and various other actors.[36] Hence, it seems that indirect regulation is a more appropriate way, as it could be focused on the intersection of crypto world with the real world and target intermediaries such are exchanges and wallet providers.[37] Regulation could be deployed at the point where cryptocurrencies intersect with banks and payment institutions. Direct regulation, however, may face a number of challenges, such as regulatory arbitrage, which could only be mitigated through global regulatory coordination.[38]

The decentralized nature of underlying technologies makes indirect regulation particularly convenient for a technology based "polycentric co-regulatory" regime.[39] Under this approach, financial supervisors would supervise the entities enabling the interface and interaction between crypto-assets and money, financial instruments or real assets. For instance, banks and payment institutions offering cryptocurrency accounts or investors buying ICOs may be subject to

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[34] Hossein Nabilou, ‘How to Regulate Bitcoin? Decentralized Regulation for a Decentralized Cryptocurrency’, (2019) 27 Int J. on Law and Tech 3 266.

[35] Bank for International Settlements, ’Cryptocurrencies: Looking Beyond the Hype’, *Annual Econ Report* (Basel, Switzerland 2018), 108.

[36] European Central Bank, *Virtual Currency Schemes - a Further Analysis* (Frankfurt 2015), 7-8, <https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemesen.pdf> accessed 15 September 2020.

[37] Bank for International Settlements (n 35) 107.

[38] Ibid.

[39] Julia Black, ’Decentring Regulation: The Role of Regulation and Self Regulation in a ‘Post Regulatory’ World’ (2001) 54 CLP 1 103.

prudential measures set in place to manage liquidity risks. Such an approach would presuppose adjustments in the corpus of prudential rules.

4.2. Information campaigns and moral suasion as alternatives to regulation

In pursuing regulation of innovative markets, regulators consider a laddered approach to regulation. First forms of intervention in cryptocurrency markets have been limited to moral suasion, user and investor-targeted information campaigns. In the initial stages of scrutinizing cryptocurrency markets, central banks were often the first authorities to issue warnings and papers in which they aimed to clarify the legal tender laws to explain that cryptocurrencies do not constitute legal tender.

National regulators then launched information campaigns as an alternative to information regulation. Such milder forms of intervention in the regulatory process were primarily focused on the risks and dangers of using and investing in cryptocurrency. Consumer-focused information campaigns usually give a brief overview of the concept of virtual currencies, and then dedicate the most space to identifying the risks that consumers should keep in mind when buying, using or trading virtual currencies. Warnings as forms of information campaigns may also contain recommendations on ways to protect or reduce the risks to which consumers are exposed.

One of the first examples of an information campaign is the Warning for Virtual Currency Users issued by the European Banking Agency in 2013, which presented several main risks to consumers. [40]

Written in a clear language, the Warning explains what are the virtual currencies, how they function and what characteristics and risks should consumers be aware of when buying, holding, or trading virtual currencies, including the risk of being subject to tax liabilities. In countries where the use of cryptocurrencies of an investment nature has been developed, regulatory authorities issue special warnings about investments in the so-called initial public coin offerings (ICOs). For instance, the UK Financial Conduct Authority (FCA) published Consumer Warning about the Risks of ICOs in September 2017,[41] and somewhat later a Guidance on Cryptoassets.[42]

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[40] European Banking Authority, *Warning to Consumers on Virtual Currencies*, EBA/WRG/2013/01, (2013).

[41] Financial Conduct Authority, Consumer Warning about the Risks of Initial Coin Offerings ('ICOs'), (2017), <https://www.fca.org.uk/news/statements/initial-coin-offerings> accessed 20 October 2020.

In the comparative regulatory practice of information campaigns, a difference can be noticed between countries whose campaigns were focused on warning consumers to refrain from investing in cryptocurrencies and not to use them as a method of payment for goods or services and those which focus on explaining core risks. Supervisors often warn consumers that rules on regulated financial products which functionally correspond to the types of virtual assets are not applicable. To conclude, a similar feature of all campaigns is the warning against potential risk and recommendation to consumers to be cautious when buying and trading in crypto-assets. On the other side, the publication of research papers and other informative studies to raise awareness of the risk of crypto-currencies may also be considered as an informational approach and an alternative to regulation.

4.3. Rules vs Principles and Regulator's Guidance

To increase the efficiency of regulation, regulators may consider a following step in the laddered approach to regulating crypto-markets. In direct or indirect form of regulation, regulators could restrict the issuance of crypto-assets, focus on market capitalization of assets and regulate the ones that pass certain thresholds in terms of size. In its extreme form, the regulator could ban the issuance and trading in crypto-assets and impose sanctions on crypto-based financial activities.

In a general way, the approach to crypto-assets may be classified within the restrictive or permissive model. The restrictive model, as its name suggests, is where regulation prohibits some or all the activities relating to virtual assets. It is likely to stifle innovation, prevent the development of good market standards, drive activity underground and thus increase the risk of criminal activities related to virtual assets. This model should clearly delineate what is permitted and what is not, to encourage business to understand the scope of restrictions. The permissive model sets out, by way of hard or soft law, the scope of permitted activities. It could be based around overarching principles or mandated outcomes, which must be achieved in order for the activity to be permitted. Enforcement is a challenge to this approach, particularly due to the extra-territorial character of crypto markets. To avoid confusion on the application of principles and achieving outcomes, and to deter businesses from operating in gray areas, rules and standards should be formulated in a clear way and interaction with existing laws should be achieved to decrease the risk of

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[42] Financial Conduct Authority, *Guidance on Cryptoassets*, Consultation Paper 19/3, (January 2019). <https://www.fca.org.uk/publication/consultation/cp19-03.pdf> accessed 20 October 2020.

enforcement. When based on principles and guidance, the permissive regime ensures flexibility to participants as to how they would comply.

When hard law is taken as a criterion, primarily in the context of the so called command-control regulation, we can distinguish between regimes of complete or partial prohibition, as well as partial and complete regulation. For some authors, the establishment of separate legal framework applicable only to crypto-asset activities is a "bespoke regulation", whereas under "bespoke regulatory regime" they refer to a distinct regulatory framework applied to a set of a wider fintech activities or DLT.[43]

Full or partial ban on activities imposed through hard law is based on consideration that the risky crypto market should be banned, due to its decentralized nature and the fact that the authorities cannot block internet access. However, a total ban on the use of virtual currencies would probably fail in practice or drive activities underground. Some countries have explicitly banned cryptocurrencies, i.e. Bitcoin: Bangladesh, Nepal, Kyrgyzstan, Bolivia, Ecuador, Indonesia and Algeria. For example, Algeria passed a Law in late 2017 banning the "purchase, sale, use and holding of so-called virtual currencies" within the country.[44] China banned ICOs and crypto-assed exchanges and blocked access to all domestic and foreign cryptocurrency exchanges in 2017, and subsequently 2018 China also prohibited financial institutions from handling cryptocurrency transactions and ordered banks and payment institutions to close Bitcoin trading accounts. Partial prohibition, viewed from another standpoint, could be presented as partial or selective regulation. In order to reduce the impact of cryptocurrencies on the real economy, regulators in some countries prohibit certain ways of using cryptocurrencies. For example, the exchange of products and services could be prohibited, or the establishment of cryptocurrency exchanges based in the country could be forbidden.

These include bans aimed at preventing the use of cryptocurrencies for illegal activities (money laundering), which is the most common form of the partial prohibition. Partial prohibitions are, as a rule, instruments of direct regulation.

[43] Appoline Blandin et al., Global Cryptoasset Regulatory Landscape Study, Cambridge Centre for Alternative Finance (2019) <https://www.jbs.cam.ac.uk/wp-content/uploads/2020/08/2019-04-ccaf-global-cryptoasset-regulatory-landscape-study.pdf> accessed 25 October 2020.

[44] Art. 117, Loi N° 17-11 du 8 Rabie Ethani 1439 Correspondant au 27 Decembre 2017 portant Loin de Finances pour 2018; <https://www.mfdgi.gov.dz/images/pdf/lois_de_finances/LF2018F.pdf> accessed 15 August 2020.

Additional grounds for indirect regulation are, for instance, when regulator focuses on regulating liquidity providers in cryptocurrencies, and impose stricter collateral eligibility requirements on the acceptance of cryptocurrencies as collateral by financial intermediaries.[45] Higher prudential requirements could apply to offset the higher risks of cryptocurrencies. Qualitative and quantitative prudential rules on credit or payment institutions in their relations with participants in crypto-markets is an alternative to ring-fencing the traditional banking and payment systems, which could be considered as a policy option.

Partial regulation implies the adoption of regulations regarding cryptocurrencies which enable their regulated use and clear treatment in certain aspects, important for the state. One example could be to prescribe tax treatment of using cryptocurrencies. Comparative legal analysis reveals that most countries are moving towards a moderate approach, where, as a rule, more detailed transactions within cryptocurrency markets are not regulated (e.g. exchange of one cryptocurrency for another), and attention is focused on preventing the use of virtual currencies to financial stability or harm public interest. In this sense, partial regulation can be identified with a partial prohibition (e.g. a special regime to prevent the use of cryptocurrencies as a measure to prevent money laundering and terrorist financing).

Detailed regulation of cryptocurrencies can be focused on participants, the services they provide, as well as possible risks. Organizers of cryptocurrency schemes and service providers are given the status of financial intermediaries (usually through various licensing schemes). More or less supervised, they are assigned various obligations by which the regulatory authorities try to uncover the risks of using cryptocurrencies.

Some regulatory systems are mostly focused on the so-called risk hubs, such as digital wallet providers and cryptocurrency exchanges.[46] Finally, the algorithms themselves used in fintech innovations could be regulated in order to control their correctness and transparency.

The scope of a permissive and more detailed form of regulation of crypto-market intermediaries, services and infrastructures, depends on the typology of crypto-assets as a diffuse concept. As will be explained further in this Paper, the principle "same activity, same regulatory framework", is being applied by an increasing number of regulators.

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[45] Bank for International Settlements (n 35), 108.

[46] International Monetary Fund, *Fintech and Financial Services: Initial Considerations*, IMF Staff Discussion Note 17/05, (Washington 2017).

It indicates that economic function of one crypto-assets must be compared to the other forms of crypto-assets, or other financial products. Therefore, the starting point in defining the rules and regulating the market should be their dominant economic function (payment, investment, realization of some benefits), as well as similarities and differences compared to other forms of real and financial assets.

Due to their evolving nature and complexity, indirect regulation of crypto-assets appears to resemble more closely standards, as opposed to rules.[47] The indirect approach to regulation shifts the focus from rules based regulation into principles based regulation, when intermediaries who transact with providers of crypto infrastructure or services implement it. This is due to the fact that such intermediaries, as surrogate regulators, will enforce rules in a more decentralized way, with more flexibility in implementation, which is conditioned by the very nature of the fintech that is constantly evolving.[48] However, overreliance solely on rules or only on principles is a "black or white" approach, as principles serve to retain a greater degree of congruence in comparison with static prescriptive rules. It is important to acknowledge that fintech regulation should be a set of complex norms containing both rules and principles, as the majority of complex risk regimes in practice contain a mixture of both rules and principles.[49]

If the primary goal of the regulatory strategy is to encourage innovation as well as resource savings, the guidance model allows for a more flexible approach. However, this regulatory model faces one key problem: its effective implementation. Excessive generalization of principles and their vagueness may deter operators from innovating in areas that are not regulated, or motivate them to circumvent rules relating to services that have a similar economic function and are subject to detailed regulation (e.g. regulations on electronic money, payment services, securities market, etc.).

Within this model, guidelines are determined either by laws and bylaws, or by interpretative acts of administrative bodies that, as a rule, do not represent a formal source of law. Regulatory guidance has predominantly been focused on applicability of securities laws, and to a lesser extent rules on electronic money and payment services. The guidelines determine the scope of activities related to

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[47] On this issue see, for example, Cass. R. Sunstein, ’Problems with Rules’ (1995) 83 Cal. L Rev 4 1021; Luis Kaplow, ’Rules Versus Standards: An Economic Analysis’ (1992) 42 Duke L Jour. 2 557.

[48] Hossein Nabilou, Alessio M. Pacces (n 32).

[49] Christie L. Ford, ‘New Governance, Compliance, and Principles-Based Securities Regulation’ (2008) 45 Am. Bus L. J. 1, 10; Julia Black et al. (n 29) 193.

virtual assets and set requirements in the form of principles and results, that must be achieved by their application in order for a certain activity to be performed. Gibraltar is a good example of a broad-based model based on guidelines, that encompasses the entire field of distributed ledger technologies.

The license of the Financial Services Commission of Gibraltar is required for all activities based on DLTs, if used to store or transfer value which belongs to third parties. However, the coverage is set more restrictively, given that qualified intermediaries cannot be entities that intend to use virtual currencies to pay for goods and services, nor financial institutions that have already been licensed to operate in Gibraltar.

The broad nine principles, each of which is accompanied by a more detailed instruction, leave the supervisory authority more flexibility in deciding whether to grant a license and revoke it.[50] However, it is possible for guidelines to regulate only one activity or service provision within virtual currency schemes that have a specific economic function. As mentioned already, the UK Financial Conduct Authority - FCA has published a Guidance on Cryptoassets.[51]

The FCA formulated recommendations to financial intermediaries regarding the risk of application of existing regulations in the field of capital markets that refer to regulated financial investments and instruments. The Guidance, in the same time, represents a guideline for determining the so-called regulatory perimeter, which represents the boundary separating regulated from unregulated activities.

All activities falling within the FCA regulatory perimeter domain require the permission of this body or the Prudential Regulatory Authority, which is issued in accordance with the Law on Financial Services and Markets and the accompanying Regulation.[52]

The significance of this Guidance is to provide clarification, with practical examples, in which situations payment tokens, investment tokens and utility tokens will be subject to existing regulations or be outside the competence of regulatory authorities.

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[50] Gibraltar Financial Services Commission, Distributed Ledger Technology Providers - Guidance Notes,
<https://www.gfsc.gi/downloads?section=19&type=0> accessed 20 October 2020

[51] Financial Conduct Authority, Guidance on Cryptoassets, Consultation Paper 19/3, January 2019. <https://www.fca.org.uk/publication/consultation/cp19-03.pdf> accessed 20 October 2020

[52] <http://www.legislation.gov.uk/uksi/2001/544/part/II/made> accessed 20 October 2020

4.4. Measures to promote innovations in the Regulatory Process

New technologies have introduced a new chapter in economic history and represent an example of how advances in technology pose challenges to regulators and supervisors. Many regulators are procrastinating with regulations to observe the potential benefits of DLT technology. Not to be in touch with the fintech revolution, or following a precautionary approach is risky.

For instance, prohibiting financial engineering, before having observed its functioning, could heavily impede innovation in the financial sector, lose fintech companies to other jurisdictions, and ultimately slow down the economic growth.[53]

Regulators who keep a track in fintech face a challenge on how to design a flexible regulatory environment to accommodate fundamental changes to the financial market and foster competition in financial services. Such regulators understand that high market barriers in the financial sector and a lack of competitive pressure are deterrent to development of financial intermediation, and therefore have an increased focus on competition and innovation in financial system. In order to make new entrants more attractive, governments and financial regulators are developing and/or sponsoring innovation facilitatory units dedicated to foster financial innovation. Innovation facilitators emerged as an alternative and experimentalist governance model to promote technological innovations. Innovation hubs operate as a prompt information desk providing a non-binding guidance, clarification and support regarding regulator's expectations.

On the other hand, it enables regulators to monitor market integrity and investor protection, and provides relevant data on innovations and potential risks.[54] In most countries, innovation hubs are established within financial regulators or in a networked mode of cooperation among financial regulators and other authorities. Malta is an example where the legislative package of 2018 resulted in setting up the Digital Innovation Authority, which closely cooperates with Malta Financial Services Authority.[55]

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[53] John Armour et al., Principles of Financial Regulation (OUP 2016), 51.

[54] Ivana Bajakić, ’Transformation of financial regulatory governance through innovation facilitators - case study of Innovation Hub in Croatian Capital Markets’, (2020) 4 *EU and comparative Law Issues and Series (ECLIC)*, 917, 922-923.

[55] The Virtual Financial Assets Act, Chapter 590 of the Laws of Malta (the VFA Act); the Innovative Technology Arrangements and Services Act, Cap 592 of the Laws of Malta (ITASA); the Malta Digital Innovation Authority Act, Cap 591 of the Laws of Malta (the MDIA Act).

Many modern regulators aim to waive unnecessary regulatory burdens and facilitate an enabling environment for mutual learning. The new regulatory approach allows regulator to foster a dialogue between fintech operators and better understand new technologies, which supposedly provides the flexibility to react to unknown risks. This institutionalized dialogue is a controlled space in which fintech firms may test and validate innovative products, infrastructure and services, for a limited time, and where regulators provide interpretations and help them to comply, is known as "regulatory sandbox".[56]

Although there are differences and variations between them in different countries, sandboxes share common policy objectives with regards to ensuring consumer and investor protection, market integrity and promoting innovation and competition.[57] Each regulator may define requirements under which firm are granted access and safety requirements that should be met by the potential participant. Testing periods are as a rule limited typically from 6 to 12 months, set on a case-by-case basis. Most differences among national approaches are related to the level of the compromise and the extent of the relief of regulatory requirements for firms. In any way, the sandbox reduces regulatory uncertainty and encourage fintech firms to experiment within a grey zone.

The main benefit of this approach is to prevent premature regulatory actions and to accelerate the assessment of risks of new technologies. However, the importance of regulators learning based on observance is limited, as some risks may emerge as the test time lapses. Sandbox approach may be resource-intensive and presupposes experienced staff in well-equipped and financially sound regulators. Liberal approach of those regulators who do not have expertise and resources may lead them to undertake unacceptable risks.[58]

Therefore, in countries where regulators do not want to hinder the development of financial innovations, but aim to actively monitor the effects of new technologies, a restricted environment called a “regulatory sandbox” has been

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[56] European Banking Authority (EBA), Discussion Paper on EBA’s approach to financial technology (FinTech), (EBA/DP/2017/02, 4 August 2017), <eba.europa.eu/sites/default/documents/files/<documents/10180/1919160/7a1b9cda-10ad-4315-91ce-d798230ebd84/EBADiscussionPaperonFintech(EBA-DP-2017-02).pdf?retry=1> accessed 15 October 2020.

[57] Financial Stability Board, Financial Stability Implications from Fintech: Supervisory and Regulatory Issues that Merit Authorities’ Attention (27 June 2017) 4f <www.fsb.org/wp-content/uploads/R270617.pdf> accessed 10 September 2020.

[58] Dirk A. Zetzsche et al., ’Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation’ (2017) 23 Fordham J Corp & Fin. L. 1 31, 79.

put in place. Up to date, regulatory sandboxes exist in around 40 countries.[59] Such an approach allows companies starting a business based on blockchain technology to operate in a relatively favorable and controlled environment at a given time, in order to test the advantages and disadvantages of applying new technologies. This achieves that participants in the development of new technologies are not too limited in a situation when the risks of using new technologies are not clear enough. On the other hand, they are given the opportunity to continue with financial innovations. This approach could be a form of supervised self-regulation of markets for innovative financial products.

5. BASIC ISSUES IN DETERMINING THE FOCUS OF REGULATORY INTERVENTION

5.1. *Ratione materiae*: functional approach to crypto-assets

The starting point in regulating crypto-assets is to determine the scope of application of the regulatory regime. The first challenge that regulators face is to be aware of the host of legal consequences in determination of what should be regulated.[60] Regulators and supervisors should be cautious in legal categorization of cryptocurrencies. With this in mind, the regulatory authorities as a rule take a functional approach and scrutinize the economic activities performed by digital assets. This may be complicated due to the fact that crypto assets may perform certain functions similar to those of fiat currencies, financial instruments and commodities, and may be subject to different activities and services.[61] That is why an all-encompassing term "crypto-assets" or digital assets is best to encapsulate different crypto-asset forms under one umbrella.

In short, the creation of cryptocurrencies is one of the most important applications of the blockchain technologies in finance. As the value of crypto-assets primarily depends on cryptography and DLT, crypto-asset is considered to be a digital mean based on cryptographic functions which is recorded in the

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[59] An updated list of existing sandboxes is compiled by the DFS Observatory, “Regulatory Sandboxes” <dfsobservatory.com/content/regulatory-sandboxes> accessed 10 October 2020.

[60] Rosa Maria Lastra and Jason Grant Allen, "Virtual Currencies in the Eurosystem: Challenges Ahead," (Brussels, Belgium: ECON Committee, European Parliament, 2018), 9.

[61] For an overview of crypto-asset activities see: Global Cryptoasset Regulatory Landscape Study, the Cambridge Centre for Alternative Finance, 2019, 23-26, <https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2019-04-

ccaf-global-cryptoasset-regulatory-landscape-study.pdf> accessed 15 September 2020

distributed ledger.[62] The classification of crypto-assets is contested. The complex issue of the legal nature of crypto-assets, which no previous acquis can clearly classify within a taxonomy defined by the Law of property, has been the subject of numerous publications and scientific papers published in the past few years. It seems that it has become clear that it is not possible to apply the existing concepts, but it was necessary to create a new concept of digital assets.[63]

Depending on the specific characteristics and functions of its forms, as well as the types of services offered by intermediaries in the crypto market, crypto-assets may be divided into three groups according to their economic function. The first group represents payment tokens or cryptocurrencies a means of exchange or payment. Some regulators use the term exchange tokens.[64] The second broad group of cryptocurrencies includes investment tokens or security tokens, and the third group represents utility tokens which holders are entitled to access specific products or services. Stablecoins may also be included as a specific category of more secure forms of digital property. The distinction between exchange tokens and utility tokens is not clear-cut, as a group of hybrid tokens combine elements of investment tokens as financial instruments and various benefits and advantages that do not have the character of a financial investment. Finally, the use of blockchain technologies and distributed records has led to the creation of platforms which record any data on physical or financial assets, such as precious metals, agricultural products, financial assets (stocks, bonds), etc. The process of "tokenization", the goal of which is to speed up the settlement of transactions and eliminate transaction costs, has urged the development of new forms of tokens called asset-backed tokens, i.e. tokens secured by property.[65] The following graph illustrates the distinction based on the economic function of crypto-assets.

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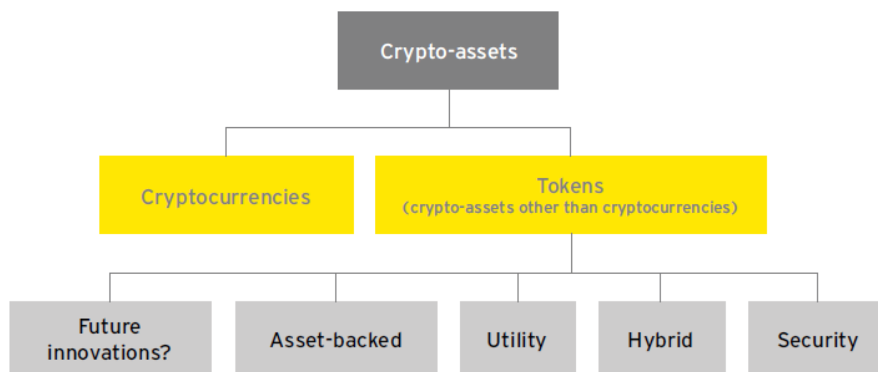
[62] European Banking Authority, Report with advice for the European Commission on "crypto-assets" (January 2019).

[63] Shawn Bayern, 'Dynamic common law and technological change: the classification of Bitcoin' (2014) 71*Wash. & Lee Rev Online*, 22.

[64] HM Treasury, FCA, Bank of England, *Cryptoassets Taskforce: Final Report* (October 2018), <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf> accessed 10 October 2020.

[65] A broad concept of asset-based tokens is adopted by the Swiss regulator, as both tokenization of debt and securities instruments are encompassed, Swiss Financial Market Supervisory Authority, *Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)*, (February 2018)



Source: Ernst & Yeung, *Life of a coin: Shaping the future of crypto-asset capital markets*, 2019, at p. 9; <https://www.ey.com/Publication/vwLUAssets/ey-life-of-a-coin/$File/ey-life-of-a-coin.pdf> accessed 10 August 2020

The above taxonomy, based on the economic function, roughly encapsulates similar risks that arise due to their use. Albeit not entirely objective, it allows to determine the legal qualification of virtual assets based on blockchain technologies and DLT. At EU level, most of these forms and associated services are not subject to a specific regulatory regime and it is not entirely clear which rules of the broad acquis of European financial regulation could be applied.[66]

The need to harmonize regulations with the requirements of modern technologies was recognized in the Action Plan for Financial Technologies,[67] which mandated European agencies to assess the applicability of the existing regulatory regime of financial services to cryptocurrency.

The advisory reports emphasized that some provisions of European legislation may negatively affect financial engineering, but also that in most cases regulations on consumer and investor protection are not applicable to transactions related to certain types of virtual assets.[68]

<https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/> accessed 10 October 2020.

[66] Phillip Hacker, Chris Thomale, ‘Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law’ (2018) 15 Eur. Co. Finan. Law Rev. 645.

[67] European Commission, Communication: *FinTech Action Plan: For a more competitive and innovative European financial sector* (March 2018),<https://ec.europa.eu/info/publications/180308-action-plan-fintech_en>

[68] European Securities and Markets Authority, European Securities and Markets Authority, *Advice on Initial Coin Offerings and Crypto-Assets*, (January 2019), Reference No. ESMA50-157-1391;

Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets (MiCA), and amending Directive (EU) 2019/1937 on the protection of persons who report breaches of Union law[69] has chosen to provide a baseline regulation for the general regime of crypto-assets (catch-all category of crypto assets) and exceptional regime for the specific crypto-asset types (asset-referenced tokens and e-money tokens). The increased specificity enters into the picture with asset-referenced tokens, electronic money tokens and utility tokens, which are all types of crypto-assets categorized under the regulatory framework of the Proposal. The Proposal has foreseen an important subclass of asset referenced tokens (significant asset-referenced tokens), as well as significant e-money tokens.

When defining cryptocurrency, special attention should be paid to the following two aspects, which necessarily affect the legal qualification and application of the existing rules applicable to financial markets. The first aspect refers to the coverage of financial instruments regulated by capital market regulations, which implies that some types of investment tokens may represent regulated financial instruments. Another aspect refers to the regime of electronic money and payment services, since some forms of cryptocurrency have great similarities with electronic money, and some payment systems based on blockchain may represent quasi-payment institutions.

From the point of view of the enforcement of existing regulations, one group of crypto-assets is especially important as it enables one or more rights in digital form to be stored, deposited or transferred through DLT, with the possibility of directly or indirectly identifying the property owner. It is created through so called "initial coin offering procedure" (ICO). From the point of view of comparative law and practice, many regulatory bodies are trying to extend the application of regulations regulating public offer financial instruments to these forms of crypto-assets. In its advisory report from January 2019, the European Securities and Capital Markets Agency pointed out that the key determinant of the legal status of virtual assets is the qualification of tokens as a financial instrument, in the sense of the Markets in Financial Instruments Directive (MiFID II).[70] Financial instruments are defined in Art. 4 (1) (15) of this

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<https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf>

[69] Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937.

[70] European Securities and Markets Authority (n 68).

Directive and listed in more detail in Annex I. The scope of financial instruments set out in MiFID conditioned the application of a number of other regulations, such as the Market Abuse Regulation[71] and the Prospectus Regulation.[72]

Receiving and sending cryptocurrencies within virtual currency schemes of bidirectional flow is not considered a payment service in terms of regulations on payment services. As a note, according to Directive 2015/2366 on payment services in the internal market, cash means banknotes and coins, demand deposits and electronic money within the meaning of Directive 2009/110/EC on the supervision of electronic money institutions.[73]

Issuers of virtual currencies are not considered issuers of electronic money.

The key challenge in defining the object of regulatory intervention is to shift from a traditional "entity based" approach, as different entities may carry out similar types of activities and hence similar risks, which may not be subject to the same licensing and conduct of business regulation. Activity based approach, on the other side, is technology neutral and focuses on similar services.

This approach has another benefit: it helps regulators not to overlap their responsibilities. Coordination and determination of competencies is primarily based on the economic function of the token, usually determined on the basis of financial instrument tests. These tests aim to determine the so-called "financial perimeter", or the extent of applicability of existing laws. The regulatory perimeter refers to the types of financial services activity to which the existing regulation is applied. Financial instrument test favor substance over form. As crypto-asset services may fall within the regulatory perimeter of several regulators who have mandates to regulate financial market and monitor financial stability, regulators facing fintech innovations need to coordinate their activities.[74]

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[71] Regulation (EU) 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse.

[72] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

[73] Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

[74] An example of regulatory coordination established to avoid the overlap of activities is the UK Cryptoasset Taskforce (n 64).

5.2. Licensing regime: establishing requirements for licensing institutions and activities

The model of licensing, as approval of performing a certain activity by a supervisory body (usually the one that regulates financial services), usually involves registration or issuance of a permit to operate, upon meeting prescribed requirements and the required criteria. Certain activities carried out in the country of origin of the participants in the crypto-asset markets, or in the country in which the transactions take place, are subject to a licensing or authorization regime, and the duty to reporting to supervisors. Licensing coverage varies from country to country, but intensive activities on changes to the legal framework and the adoption of special regulations on crypto-assets in recent years share some common characteristics.

One of the pioneers of virtual currency licensing schemes is the State of New York, whose New York Department of Financial Services launched a BitLicense regulatory framework in 2015, applicable to THE activities related to virtual currencies that take place in New York or are offered to its residents.[75]

Providers of services related to virtual currencies offered to resident citizens and legal entities with registered office, or those who undertake related business activities in the territory of the State of New York, are obliged to apply for a license, without de minimis exceptions.

The licensing procedure does not differ significantly from the licensing procedure for financial institutions. Such an approach by New York State authorities has resulted in a relatively small number of licenses issued, while some virtual currency service providers explicitly refused to provide services to New York residents in order to avoid licensing requirements.[76]

This law inspired the US Uniform Law Commission to propose a model law on the regulation of virtual currency transactions (the Uniform Regulation of Virtual-Currency Business Act) in 2017, which has so far been adopted in three US federal states.[77] The New York licensing requirements are applicable, in particular, to services related to the sale, exchange, deposit of funds in virtual

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[75] Virtual Currency Regulation, 23 NYCRR Part 200, New York Financial Services Law. <https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses/gn/adoption_listing_vc> accessed 20 August 2020.

[76] Gerard Comizio (n 28).

[77] Uniform Law Commission, Regulation of Virtual Currency Businesses Act, <http://www.uniformlaws.org/Act.aspx?title=Regulation%20of%20Virtual-Currency%20Businesses%20Act>

wallets, storage of keys necessary for transactions, control, management or issuance of virtual currencies.[78]

A license may be required in a detailed and partial regulation mode. Depending on the extent to which certain services and financial intermediaries are regulated within virtual currency schemes, a distinction could be drawn between pure and hybrid licensing models. The hybrid model is basically a model based on guidelines and often relies on principle-based regulation, because it involves registration with the supervisory authority, which has a more flexible approach and monitors whether the regulated entity adheres to the set principles. Even when the term "registration" is used within a certain national regulatory regime (including the absence of a discretionary assessment of the regulatory body), the registration process imposes a number of obligations on participants in crypto markets, such are the establishment of the internal control systems, identification of clients and implementation of procedures provided by regulations on prevention of money laundering, etc.

It is possible that a license is required for only certain activities or services, or in respect of specific financial intermediaries. One of the most common examples of such narrower licensing models is the requirement to license virtual currency exchanges, as is the case e.g. in Australia, Japan, the Philippines, etc. Registration by the financial regulator in these countries primarily refers to the operations of exchanges, while other activities are not regulated or may be subject to the application of general capital market regulations (e.g. issuance of investment tokens).

The main purpose of virtual currencies is to be means of payment. Payment institutions are increasing their involvement in the cryptocurrency business, whereas many cryptocurrency schemes have similar features and aim to become parallel payment infrastructure or alternative payment systems.[79] Licensing requirement is one of the first steps to bring virtual currencies within the regulated ecosystem, whether it is a specific license for activities on crypto-markets (e.g. BitLicense) or payment institution license for virtual currency exchanges. However, despite many benefits, such decentralized payment systems have unstable values, are subject to new operational risks, could be used

[78] N.Y. Comp. Codes R. & Regs. tit. 23, § 200.3 (2019)., New York Department of Financial Services, New York Codes, Rules and Regulations; Title 23, Department of Financial Services, Chapter I. Regulations of the Superintendent of Financial Services, Part 200, Virtual Currencies

[79] European Central Bank (n 36).

for illicit transfers and ultimately could jeopardize financial stability. Licensing crypto exchanges as payment institutions rises a number of risks, therefore directing the regulations towards the relationship of payment institutions and crypto-assets (alternative indirect regulation) could be a better strategy. A major setting where cryptocurrencies could be regulated is through prudential regime over regulated institutions which engage in the provision of payment services.[80]

The licensing model is basically often based on the method of partial or detailed regulation. The subject of normative regulation could be intermediaries and infrastructures; types of digital assets and activities or services related to crypto-assets; relations, especially relations with clients who represent non-professional investors (consumers), as well as public order requirements such as the issue of taxation and prevention of money laundering and the use of virtual currency schemes for illegal purposes. Crypto-asset regulation does not, as a rule, cover end-users of virtual currencies, such as traders who accept them when paying for goods or services, consumers who buy goods or services, as well as investors who invest in virtual currencies. The subject of regulation are primarily activities that are reflected in the transfer of virtual currencies and services related to transactions. Indirect regulation is considered to be a more appropriate way, as it could be focused on the intersection of crypto world with the real world and target intermediaries such are exchanges and wallet providers.[81] Targeting the interface of cyberspace and material world is in line with the old tradition in financial regulation which relied on regulated gatekeepers.[82]

As was the case with classifying crypto-assets, regulators struggle how to refer to different types of crypto-assets activities: creation, initial distribution and secondary trading. In relation to these activities, a variety of different infrastructures and services emerged, among which some perform tasks specific to the nature of crypto-assets (i.e. miners), while others have roles which exist in traditional financial services (i.e. exchanges). New activities are specifically enabled by the properties of crypto-assets and the underlying infrastructure, whereas mixed activities combine characteristics of both traditional and new activities. The majority of crypto-asset related activities carried out by intermediaries are quite similar to traditional activities (such as exchange and

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[80] Hossein Nabilou, "The Dark Side of Licensing Cryptocurrency Exchanges as Payment Institutions," *SSRN Working Paper Series* (2019),
<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3346035> accessed 07 November 2020.

[81] Bank for International Settlements, (n 35) 107.

[82] Jennifer Payne (n 31).

trading platforms, derivatives, custody, payment services etc.) Some activities were adapted to better correspond to the new characteristics of specific crypto-assets. A relatively small number of activities specific to crypto-assets intermediation can be considered completely new and uniquely enabled through crypto-assets.

Licensing of intermediaries and institutions that form part of the infrastructure of the cryptocurrency industry is usually based on the general requirements provided for financial intermediaries in the comparative financial systems. When applying for a license (and often registration), stakeholders must meet the requirements of fit and proper standards, which apply to owners, or persons with special powers and responsibilities, as well as to establish an adequate system of corporate governance and internal controls. In some countries, there are requirements for the existence of a minimum amount of founding capital, i.e. the minimum capital that financial intermediaries and service providers related to virtual currencies must have in their accounts in order to ensure the protection of customers' funds. Requirements are increasingly being set for persons who have a qualifying or controlling interest, as well as for persons associated with institutions that provide services related to virtual currencies. In this sense, in some countries the requirements are closer to the requirements set before payment institutions, and in the case of virtual currencies of an investment nature may reflect the main traits of the investment companies' regulation.

Licensing may be provided as mandatory for certain entities and activities, and in other cases optionally, which is a form of incentive and promotes good business practice, while at the same time encouraging innovation. France is an example where all providers of the purchase and sale of virtual assets for money as legal tender, as well as providers of digital wallets and storage of virtual assets, are subject to registration by the Financial Markets Agency (AMF), primarily due to the requirements of anti-money laundering legislation.[83] In addition, the consent of the Prudential Control Agency is required, which controls the fulfillment of minimum capital requirements. Other intermediaries do not need a license, which if obtained represents a marketing instrument that allows them to differentiate in the market.

Given the numerous and unpredictable risks, intermediaries offering infrastructure and services in crypto-markets are also required to develop internal control and risk management systems, especially IT system risk as a type of operational risk. From the regulator's point of view, the most important

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[83] L. 54-10-3 - L. 54-10-5 Code Monétaire et Financier.

reason for establishing internal control policies is to harmonize operations with the requirements set by regulations on the prevention of money laundering and terrorist financing. The EBA's "Opinion on Virtual Currencies" emphasizes the need for an agreement to be reached at EU level for participants dealing professionally with virtual currencies to be legal entities, and to be responsible for the integrity of the central ledger of transactions, protocols and other functional components of virtual currency schemes, as well as to meet all regulatory requirements through the functioning of the internal control system and adopt measures to protect individual users. The issue of internal controls is related to prudential requirements, as well as the regime of protection of public interest (anti-money laundering) and protection of users, which deserves to be addressed in the next title.

5.3. Core issues related to the protection of public economic order: measures to combat money laundering and customer protection

Cryptocurrencies have a number of features that are not yet covered by regulations, which means that there are numerous possibilities for abuse. The three key factors that influence this are the following: anonymity in the use of cryptocurrencies, their decentralized nature, and the lack of legal regulation in this area.[84] The biggest fears of violating the public economic order are the possibility of cross-border money laundering, legalization of property acquired through the commission of criminal acts, tax evasion, violation of regulations on foreign exchange operations and capital movements, and protection of consumer rights. A special issue is the operational risk of internet business, i.e. the sensitivity of virtual currency schemes and intermediaries to hacker attacks and various frauds.

There is a noticeable tendency of the emergence of transnational harmonized regime aimed at combating money laundering and terrorist financing, which is encouraged by the FATF recommendations. The amended Recommendation 15 requires jurisdictions to regulate crypto-assets and crypto-asset service providers for anti-money laundering, and to ensure that crypto-asset service providers are licensed or registered, and subject to effective systems for monitoring and supervision. FATF Guidance for a Risk Based approach represents an important policy document assisting countries and virtual asset service providers in understanding their anti-money laundering and counter-terrorist financing

[84] FATF/GAFI, *Virtual currencies – Key Definitions and Potential AML/CFT Risks*, 2014, <https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> accessed 17 October 2020.

obligations, and implementing the FATF's requirements as they apply to virtual assets.[85]

In its opinion of 2017, European Banking Agency[86] stressed that cryptocurrency exchanges and digital wallet service providers fall under the jurisdiction of the Fourth Anti-Money Laundering Directive,[87] which was an important step in limiting this risk. However, it was only with the adoption of the Fifth Money Laundering Directive[88] that the scope of application of the regulation was unequivocally extended to digital wallet service providers and virtual currency trading platforms.

Rules on crypto-assets adopted worldwide show that the regulation of crypto-asset-related activities exposes the main characteristics of regulating financial institutions. These include general principles of integrity, financial prudence, orderly market conduct, transparency, protection of clients' assets and avoidance of conflict of interest. Crypto-asset issuers and traders are subject to common fiduciary responsibilities, including in particular anti-money laundering provisions. Exchanges are increasingly obliged with the rules on orderly price discovery, segregation of client monies and formation and avoidance of front-running, collusion and in general market manipulation.

As a rule, the normative framework of virtual currency schemes does not include the relationship with end users, nor the relationship with traders who accept virtual currencies when paying for goods or services. The subject of regulation are primarily activities that are reflected in the transfer of virtual currencies and related services. One of the first examples of bespoke regulatory frameworks, which prescribed specific obligations to clients and consumer protection and specific procedures on client protection which are prerequisites for licensing, is

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[85] FATF (n 2).

[86] <https://www.eba.europa.eu/-/eba-publishes-an-opinion-on-the-commission-s-proposal-to-bring-virtual-currency-entities-in-the-scope-of-the-anti-money-laundering-directive > accessed 20 October 2020.

[87] Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC, OJ L 141.

[88] Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU, OJ L 156.

the above-mentioned American model law drafted by the Uniform Law Commission.[89]

The set of rules on consumer protection in crypto trading is dominated by information regulation. To a greater or lesser extent, there are also general provisions prohibiting dishonest or fraudulent acts or practices, in particular fraud or willful misrepresentation of material facts and market manipulation.

Among the obligations of pre-contractual information, the following dominate: the obligation to present data on service providers; the price of their use and the time frame of calculation; the user's right to be notified of changes in fees and other relevant elements relating to the transaction itself. In the case of investment-type cryptocurrencies, an abbreviated prospectus (the White Paper), as the equivalent to a more complex prospectus, is a condition for issuing financial instruments. Some regulations also provide mandatory warnings such as transfers irrevocability warnings, require the information on clients' rights in the event of a transfer error, and the right to proof of transaction execution. Information regulation in the phase of concluding the contract implies that the client has access to detailed data on the transaction and costs, but there are still no examples of detailed regulation of the contract itself.

More and more regulations stipulate an obligation, which is often a condition for granting a license, to establish a user protection policy which, among other, must include a procedure for resolving disputes, reporting unauthorized disposal of funds or errors; as well as informing the user about the manner of filing a complaint and the procedure for timely dispute resolution. However, there are opinions that the licensing requirements would not prove to be effective enough. In their recommendations for the cryptocurrency regulatory framework, the Central Bank of the Netherlands and the Financial Markets Authority have stated a number of reasons why they do not recommend the integration of obligations of service providers aimed at consumer protection, but suggest intensifying information campaign activities.

Among the arguments they stressed the fact that it would be difficult, almost impossible, to prevent cross-border trade in virtual space, given that in real space there is no international consensus on consumer protection standards that should be adopted in relation to cryptocurrency. On the other hand, the volatile value of virtual currencies and their speculative nature are an additional negative factor.[90]

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[89] Uniform Law Commission (n 77).

[90] De Nederlandsche Bank, AFM (n 23).

From a comparative perspective, the proposal for a Regulation on Markets in crypto-assets is an example of the most comprehensive specific standardization of rules on issuing, trading in crypto-assets and investor protection up to date. Particular emphasis is placed on the requirements regarding the publication of information, the prohibition of the use of insider information and other forms of market abuse. Requirements vary depending on the type of crypto-assets. The basic instrument of information regulation envisaged by the proposal of the Regulation on cryptocurrency is a Crypto-Asset White Paper (CAWP). Depending on the type of cryptocurrency in question, the Proposal set special requirements for publishing information about the offer, as well as the obligation of *ex ante* approval or notifications to the competent national supervisor. The most detailed information regulation obligations are provided for asset-referenced tokens. In addition to the general obligations of honest and professional conduct, the Proposal mandates a duty to communicate in a clear and unambiguous manner, advertising requirements (which must be in accordance with the mandatory data stated in the White Paper), as well as providing information on the value of issued coins and tokens, reserves and any event that may affect their value. The Proposal guarantees certain minimum rights to investors. Issuers of crypto-assets and related service providers are required to establish and maintain effective and transparent procedures for the prompt, fair and consistent resolution of investor complaints. European financial services regulatory agencies are expected to prescribe technical standards for dispute resolution procedures.

6. IN CONCLUSION: CHALLENGES FOR WESTERN BALKAN FINANCIAL REGULATORS

The above analysis, focused on the basic rationales for regulating the crypto market and basic principles on which the choice of regulatory strategy is based, should serve as a basis for the analysis of the challenges faced by the regulatory authorities in Western Balkan countries. Albeit the risks as a basis for regulating crypto-assets are very similar, the risk of violating national restrictions on capital movements and foreign exchange operations is more pronounced in these countries. Also, the bank-centered financial systems in this region and their leading role in the payment system is one of the additional factors that must be kept in mind. Over the past few years, fintech is a rising trend in South Eastern Europe.[91] Still, not many regulators have decided to take big steps, while most of

[91] See, for instance: Caroline Stern, FinTechs and their emergence in banking services in CESEE (2017) 3 Focus on European Economic Integration 17, 42.

them are aware of the developments and ready to prepare changes in money laundering regulations. Most regulators in Western Balkan countries are aware of the need to establish coordination between competent national authorities, create incentives in regulatory frameworks and adopt measures to encourage financial innovation. Overly concentrated banking sector, which predominantly owns payment systems, may provide a barrier to entry for non-bank financial services providers. Most WB countries have not yet implemented the pro-competitive requirements of the European Payment Services Directive aimed to improve access of smaller incumbents, which makes the regulatory response on fintech even more important. Given the shallow and underdeveloped financial market, where government bonds are the predominant financial instrument being traded, fintech is an opportunity for regulators to take measures to strengthen competition. To strengthen equity investments, it would be necessary to develop primary and secondary stock markets. For instance, in North Macedonia and Serbia Founderbeam, an Estonian fintech firm, enables trade and access to financial information on secondary markets through its platform.

In terms of principles underlying the design of a regulatory strategy, financial regulatory governance of NRAs in South-East Europe could be characterized as predominantly based on "command and control" and is characterized with a conservative focus based on rules, strong focus on controlling systemic risks as well as principal-agent relationship between regulators and regulated entities.[92] Paradigm shift is one of the basic prerequisites for achieving a balanced approach to financial intermediation. Reforming the approach to regulation is a gradual process, regulators need to base their actions on proportionate regulatory tools to help mitigate regulatory failures. Therefore, phased access to designing regulatory strategy on crypto-assets could be based on successive steps.

As was the case in comparative regulatory practice, the first step of financial regulators in the Western Balkans was to disseminate information and issue warnings to the public, especially service users, and initiatives focused on raising awareness on the risks of cryptocurrencies and other crypto-assets. Market conduct supervisors of financial services and central banks warned on the volatility of crypto-currencies, operational risks such as the risk of cyberattack, risks stemming from money laundering activities, data protection etc.[93]

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[92] Bajakić, 930.

[93]The Bank of Albania:
<https://www.bankofalbania.org/Press/On_the_risks_associated_with_the_use_of_virtua

The following step is related to the interpretation of AML/CFT laws and changes to the legal framework to accommodate rules on new intermediaries, in particular crypto-asset exchanges (trading platforms) and providers of digital wallets, whereas mining activities are usually out of the regulatory focus. Here the regulators are confronted with the dilemma on whether applicable know-your-customer methods are allowed and under which conditions. Laws on AML/CFT in WB countries are mostly in line with the Fifth Anti-Money laundering Directive. At minimum, providers of digital wallets and virtual currency exchange services should be subject to the AML/CTF rules. For instance, Montenegro transposed the Fifth Anti-Money Laundering Directive into Law on Prevention of Money Laundering and Terrorist Financing, establishing that natural and legal persons who are issuing or managing virtual currencies, as well as exchanging virtual currencies into fiat currencies, and vice versa, are subject to reporting duties. Serbian Law on Prevention of Money Laundering and Terrorist Financing extended the scope of legislation to include subjects providing services of purchasing, selling or transferring virtual currencies or exchanges of cryptocurrencies for money or other property through internet platform, devices in physical form or otherwise. The next step is to comply with the requirements of the amended FATF Recommendation No. 15 and ensure that crypto-asset service providers are subject to effective systems for monitoring and supervision, in line with a risk approach based on FATF guidance.[94]

As all those countries aim to join the EU, in an area where there is no harmonized transnational regime, as well as binding regulation at EU level, regulators in the Western Balkans have the opportunity to demonstrate their creative discretion and residual legal powers. While the warnings mainly

l_currency.html>; The Republic of Srpska Securities Commission: <http://www.secrs.gov.ba/Fajl.aspx?Id=579f9839-522c-4689-9eca-8a7522360b2f>; The FbiH Securities Commission: <http://www.secrs.gov.ba/Fajl.aspx?Id=579f9839-522c-4689-9eca-8a7522360b2f>; The National Bank of Serbia: <https://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=7605&konverzija=no>; <https://www.nbs.rs/internet/ cirilica/scripts/showContent.html?id=9604&konverzija=no>; Serbian Securities Commission: <http://www.sec.gov.rs/index.php/sr/index.php/sr/едукација/едукација-инвеститора/текстови/557-упозорење- улагачима-у-крипто-имовинска-права-криптовалуте-и-дигиталне-токене>; The National Bank of North Macedonia: <http://nbrm.mk/ns-newsarticle-soopshtieniie_na_nbrm_28_9_2016.nspx> all accessed on 05 November 2020.

[94] FATF (n 2).

referred to virtual currencies, regulators in the observed countries did not comment on the issue of investment tokens. As noted in previous sections of this Paper, regulators in more developed countries are issuing guidance and developing financial instrument tests, to ensure that investment tokens are covered by existing capital market laws, in particular in relation to initial coin offerings. Up to date, none of the regulators in the WB issued official guidance on how existing securities laws are applicable to crypto-assets.[95]

In the absence of more detailed guidelines from the regulator or rules adapted to new services, regulators in Western Balkan countries should depart from a sector based approach, in order to prevent legal uncertainty for firms experimenting with fintech, and promote competition based on innovation. The regulators could propose tho extend the regulation of traditional financial services by stretching the interpretation of existing rules, to include risks arising from new services. As a previous or next step, in order to better understand the challenges faced by new financial intermediaries, to better understand the risks to the financial system, and thus propose better legislation regarding crypto-asset business, regulators and/or supervisors should embark on the journey of regulatory innovations. It refers to central banks, bodies for the supervision of financial services that can be consolidated under the roof of an agency or sector specific (e.g. securities commissions), ministries in charge of finance, as well as other institutions such as central registers and securities clearings, bodies in charge of preventing money laundering, protection of personal data etc. For instance, setting up an innovation office is a good way to create a first point of contact, especially when unclear regulatory framework deters incumbents to offer innovative products and services. Innovation offices, at least in theory, should be composed of skilled staff from different departments, able to identify regulatory issues.[96]

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[95] Securities Commission of the Republic of Serbia issued a short statement which states that crypto-asset activities are not free from regulatory burdens, and hence may fall under the scope of existing rules on capital markets, foreign exchange and anti-money laundering. A regulatory guidance is expected, for instance, in Republika Srpska, to follow the new Law on Capital Markets which will contain some articles on regulating investments in crypto-assets.

[96] For instance, the Ministry for Scientific and Technological Development, Higher Education and Information Society of the Republic of Srpska, is supporting the establishment of a Centre for Digital Transformation. One of the domains of interest of the Innovation Office in the North Macedonia, operational since June 2019, is the crypto-asset market, as well as the development of central bank digital currency. It aims to issue legally non-binding opinions relevant for the fintech market, scan the existing regulatory framework and develop a Fintech Strategy.

Creating a regulatory sandbox is another option to allow potential new market entrants or existing financial innovators to test financial products and services within a controlled environment, especially when the regulatory framework is non-existing or its application is unclear. To date, the first regulatory sandbox was established in Montenegro, where the Securities Commission adopted rules on its objective, application process and criteria for application. However, whether it really works and what are the effects is not yet known. As already mentioned in this Paper, not much should be expected from this regulatory option, as it implies a high level of competence of regulators and more significant resources.

Being diverse and involving a number of new intermediaries, crypto-asset activities, as a rule, are not regulated by single legislative act or specific regulatory regime. Bespoke regulatory regimes like Malta, France, Gibraltar are rather rare. Some of the Western Balkan financial regulators focused on most pressing issues, such is the prohibition of certain activities related to crypto trading and issues related to the risk of money laundering. For instance, in its warning, the National Bank of Serbia clarified that crypto-assets could not be used for making payment transactions, in line with provisions stipulating that national payment transactions should be executed, with a few exceptions, in dinar as a national currency. If issuing detailed guidance specifying under which conditions financial intermediaries are allowed to trade in crypto-assets, or clarifications on how to distinguish between intermediaries and activities in novel services resemble the traditional financial services did not yield results, regulators may consider regulating activities which fall outside the perimeter of existing regulations. This should be based on the level of activity in the given country, risks associated with services and the institutional capacities for enforcing new rules. It should be accompanied with clear rules on intertwined competences and responsibilities of multiple national regulators.

Creating a specific regulatory framework with rules tailored to address the risks of crypto-asset markets as a particular fintech sector is a two-edged sword. Financial innovations are rapidly evolving and prone to circumvent regulations. On the other side, stringent rules may overregulate the sector and raise the burden of compliance. Specific regulatory regime shifts the focus from sector based to activity based object of regulation and ensures that similar activities or functions are subject to the same rules, in line with the reasonable expectations of market participants.

To date, only Albania has adopted the bespoke legislation. The Law on Financial Market based on Distributed Ledger Technology was twice subject to the

parliamentary process, as the Prime Minister refused to sign it in June 2020, arguing that its application could cause financial distress. The law aims to cover different activities and intermediaries, especially activities of DLT exchanges and wallet providers, and include rules on ICO, with the focus on information regulation. The Law has defined investigation competences of the Albanian Financial Supervisory Authority. At the time of preparing this manuscript, Serbian Draft Law on Digital Property has been subject to public consultations, and is currently forwarded to the Serbian Government to decide on the official Draft which will enter the parliamentary procedure for adoption, together with amendments to the Law on AML/CFT. The latter aims to further harmonize Serbian AML legislation with the FATF standards, encompassing a wider range of tokens than cryptocurrencies. The main aim of this bespoke regime, which resembles to a certain extent the French crypto legislative framework, is to bring more clarity in relation to investment type of crypto-assets. Given the limitation of the remaining space in this Paper, as well as the fact that this is a draft law, only a few key points should be pointed out. The draft sets a clear intention of the legislator to legally differentiate digital property (and its forms) as a new institute, different from electronic money and digitalized securities, and designates the National Bank of Serbia and the Securities Commission as supervisory bodies (regulators) in the application of the future law. This means that every startup in Serbia will be able to raise capital by issuing digital tokens in accordance with the law, but at the same time, the legal regulation of the process will also protect the investors.

As the initial offer of digital assets is only the beginning of trade in digital tokens, the Draft also regulates the conditions for providers of services related to digital assets who, in order to obtain the permission of the supervisory body, must meet personnel, organizational and technical requirements. The draft also prescribes the conditions for secondary trading that must be performed through a platform organizer licensed to provide services related to digital assets as well as for OTC trading that the parties can perform without intermediaries.

To conclude, many developed countries are trying to regulate crypto-assets as the new form of financial assets by applying and expanding existing regulations in the field of capital markets and payment services.

On the other hand, some smaller countries strive, often by adopting special regulations and designing novel regulatory regimes, to create more liberal frameworks and position themselves in the international innovation market. After all, this can be seen in the Western Balkans, where Albania and Serbia are pioneers in the legislative initiative. Each regulatory approach has its advantages

and disadvantages. Time will show how effectively the new framework will be applied and whether its implementation will ensure the strengthening of competitiveness in the national financial market, as well as the strengthening of competitive advantages in relation to foreign markets.

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CROWDFUNDING IN TURKISH AND EUROPEAN UNION LAW

Prof. Ali Paslı
İstanbul University Faculty of Law, Department of Commercial Law
İstanbul, Turkey
ali.pasli@istanbul.edu.tr

Res. Assist. Numan S. Sönmez
İstanbul University Faculty of Law, Department of Commercial Law
İstanbul, Turkey
numan.sonmez@istanbul.edu.tr

ABSTRACT

Crowdfunding is a tool that "connects those who can give, lend or invest money directly with those who need financing for a specific project". By crowdfunding, an entrepreneur would raise small amounts of money from thousands of investors for development of his enterprise without carrying any extra cost. Thereby, crowdfunding provides an opportunity for ordinary people to gather around new investments and for entrepreneurs to adapt, develop and succeed in new businesses models.

When it comes to legal regulation of crowdfunding, in the US, crowdfunding has gained substantive legal ground by virtue of Jumpstart Our Business Start-ups Act (JOBS) in 2012 with the amendment of Securities Act. On the other hand, Regulation 2020/1503 of the European Parliament and of the Council on European Crowdfunding Service Providers for Business has been published in the Official Journal of the European Union on 20.10.2020, entered into force in 10.11.2020 and will be applied from 10.11.2021. In the meantime, the Turkish legislator has taken steps for regulating crowdfunding. Crowdfunding platforms are described under Art. 35/A of Capital Markets Act and the Capital Markets Board has been given the authority to adopt regulations. The Board has adopted the Regulation for Equity-Based Crowdfunding on October 2019.

In this paper, we will examine crowdfunding regulation in comparison to the EU (and the US) law, point out differences-similarities between these legal systems and finally try to give predictions on the future of different sorts of crowdfunding.

Keywords: Crowdfunding, EU law, Turkish Capital Markets Act, Regulation 2020/1503

1. INTRODUCTION: CROWDFUNDING IN GENERAL

There are different methods by which investors and entrepreneurs come together in order for the investor to use his funds in the optimal way which will bring the most profit and for the entrepreneurs to collect as much funds as needed for facilitation of a particular project or venture. One of those methods that is recently rising among others is the crowdfunding system. With the help of

boosting technology, gathering investors and entrepreneurs has become gradually easier, which has brought forward the need for a faster and incisive tool for investment that can also be regulated and reliable. Crowdfunding has been one of the answers of technology for such a need. At this point, it should be added that the financial crisis discredited the banks and the traditional credit system in the eyes of the investors, and it caused a seek for a solution with less intermediation[1].

Crowdfunding can be defined as a tool that *"connects those who can give, lend or invest money directly with those who need financing for a specific project"*[2]. As it can be inferred from the definition itself, there are several ways in which the crowdfunding system can be facilitated, i.e. "funding" in a crowdfunding system can be realized by "giving", "lending" or "investing" money. From this standpoint, we can divide crowdfunding to four sublets based on the purpose of the fund; donation, rewards, equity and lending[3].

In a donation based system, investors do not gain any return for their contribution, therefore it is a single step process where the investor donates his funds for moral or tax reasons[4]. Similarly, in a rewards system, the investor does not gain a part of the revenue extracted from the project that he invested in, but there is a reward in exchange for the investment, such as meeting celebrities,

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[1] Mónika Kuti and Gábor Madarász, 'Crowdfunding' [2014] Public Finance Quarterly 355, 355 onwards; Nikki D. Pope, 'Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption' [2011] University of Pennsylvania Journal of Business Law 101, 102 onwards.

[2] This definition is made by European Commission, see https://ec.europa.eu/info/business-economy-euro/growth-and-investment/financing-investment/crowdfunding_en. For other definitions and explanations see C. Steven Bradford, 'Crowdfunding And The Federal Securities Laws' [2012] Columbia Business Law Review 1, 10 onwards; Dylan J. Hans, 'Rules Are Meant to Be Amended: How Regulation Crowdfunding's Final Rules Impact the Lives of Startups and Small Businesses' [2018] Brooklyn Law Review 1089, 1090; for Turkish law see Mehmet Kemalettin Çonkar and Muhammet Fatih Canbaz, 'Kitle Fonlaması Finansman Yöntemi: Türkiye'de Sistemin Geliştirilmesine Yönelik Öneriler' [2017] Optimum Journal of Economics and Management Sciences 119, 121-122; Çağlar Manavgat, 'Halka Açık Anonim Ortaklık Tanımı Bakımından Kitle Fonlaması' [2019] Prof. Dr. Sabih Arkan'a Armağan 765, 766-767; Sinan Yüksel, 'Sermaye Piyasasi Hukukunda Kitle Fonlamasina İlişkin Düzenlemelerin Değerlendirilmesi' [2019] Banka ve Finans Hukuku Dergisi 1933, 1934 onwards; Veliye Yanlı, 'Paya Dayalı Kitle Fonlaması Düzenlemesi' [2020] Banka ve Ticaret Hukuku Dergisi 31, 32 onwards.

[3] See Bradford (n 1) 14 onwards; Hans (n 1) 1090; Kuti and Madarász (n 1) 355; for Turkish law see Manavgat (n 1) 771 onwards.

[4] See Bradford (n 1) 15; Manavgat (n 1) 772.

receiving presents etc.[5]. When it comes to financially motivated investments, there are two methods: equity based or lending based funding[6]. In equity based funding, the investor gets shares from the company running the campaign and project[7], which will be elaborated below. In lending based funding however, the investor lends money and in exchange he gets the money back in due time with or without interest depending on the regulation.

In this paper we will focus on equity crowdfunding, which is separately regulated under Turkish law, and only from regulations' perspective. In this sense, we will try to give insight into rules governing investors, entrepreneurs/fundraisers and platforms under the Turkish Capital Markets Law, while briefly addressing the situation in the US and the EU and making a comparison when adequate.

2. CROWDFUNDING IN THE EU AND THE US LAW

The power of crowdfunding as an alternative funding tool is recognized by the EU and after long efforts, a unified Regulation at the EU level has been introduced in October 2020, alongside with national regulations[8]. First, the EU Commission published its "Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business" (*"the Proposal"*)[9]. Then, on 20.10.2020, the Regulation on European Crowdfunding Service Providers for Business (*"the Regulation"*)

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[5] See Bradford (n 1) 16-18; Manavgat (n 1) 772.

[6] See Bradford (n 1) 20 onwards.

[7] M. İbrahim Darian, 'Equity Crowdfunding: A Market for Lemons?' [2015] Minnesota Law Review 561, 569.

[8] For a general review on the new Regulation, see. Sebastian Niels Hooghiemstra, 'The European Crowdfunding Regulation–Towards harmonization of (Equity- and lending-based) Crowdfunding in Europe?' [2020]

<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3679142> accessed 25 November 2020. For the overview and comparison of national laws of member states see 'Commission Staff Working Document Impact Assessment Accompanying The Document Proposal For A Regulation Of The European Parliament And Of The Council On European Crowdfunding Service Providers (ECSP) For Business And Proposal For A Directive Of The European Parliament And Of The Council Amending Directive 2014/65/EU On Markets In Financial Instruments-Annex 4' SWD (2018) 56 final

'Crowdfunding And The Federal Securities Laws' [2012] Columbia Business Law Review 1, 10 onwards.

[9] Commission, 'Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business' COM (2018) 113 final.

has been published in the Official Journal of the EU[10]. The Regulation will be applied from 10 November 2021 as a part of domestic laws of member states without needing transposition. This document sets out a transition period until 10 November 2022 for crowdfunding service providers who are granted an authorization according to the existing national laws of member states. In order to provide crowdfunding services, aforementioned crowdfunding service providers shall obtain an additional authorization by 10 November 2022, showing the requirements laid down in Art. 12 of the Regulation are met. The transition period may be extended by the Commission once for a 12 month period.

According to Art. 2/1-a of the Regulation, crowdfunding service consists of either facilitation of granting of loans or placing transferrable securities and admitted instruments, and reception and transmission of client orders with regard to those. Therefore, we can conclude that the Regulation only concerns with the lending and equity based funding.

According to Art. 2/1-m and n of the Regulation, transferrable securities means securities as defined in point (44) of Article 4(1) of Directive 2014/65/EU; and admitted instruments for crowdfunding purposes means, shares of a private limited liability company without restrictions effectively preventing them from being transferred.

That creates a difference in comparison to Turkish law as we will see below, since equity based funding in Turkish law only permits issuing of shares of a joint stock company in exchange for investments.

As per Art. 3/1 of the Regulation, crowdfunding services are required to be provided by legal persons that have been established in the EU and authorized by competent authorities. Service providers have to be the impartial medium. Therefore, they shall not accept or offer any benefits for routing their clients' orders to a particular crowdfunding offer (Art. 3/3).

Moreover, they are prohibited from making any financial contribution to any crowdfunding offer on their platform (Art. 8/1) and from accepting parties as clients with whom they have a relationship described in Art. 8/2. In Art. 8 of the Regulation, other cautions to be taken against any concern regarding conflict of interest are explained, including public disclosure.

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[10] Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7 October 2020 on European Crowdfunding Service Providers for Business, and Amending Regulation (EU) 2017/1129 And Directive (EU) 2019/1937 [2020] OJ L347/1.

Articles 12 onwards of the Regulation deal with the authorization of crowdfunding service providers and the cases where such authorization can be withdrawn.

Art. 19/1 of the Regulation entails that all the information provided for the client should be fair, clear, and not misleading.

According to Art. 21 of the Regulation, non-sophisticated investors should be tested by service providers as they are required to provide information on their experience, investment objectives, financial situation and basic understanding of risk in investing, including their past investments and experience. If investors do not provide such information or the service provider finds that investor's knowledge is insufficient, investors are informed and issued a risk warning. However, even in that case investors are not prevented from investing in crowdfunding projects.

Article 25 of the Regulation covers the bulletin board. Crowdfunding service providers may operate a bulletin board that allow clients to advertise interest in buying and selling instruments which were originally offered on their crowdfunding platforms. A bulletin board cannot be operated in a way that brings together buying and selling interests that results in a contract. In case service providers also operate a bulletin board, they shall inform clients regarding the nature of that board and comply with the requirements prescribed in Art. 25/3. Service providers may also provide a reference price for such activities but they have to inform clients that the price is non-binding and have to substantiate the price (Art. 25/5 of the Regulation).

Chapter V of the Regulation regulates marketing communications, while Chapter VI governs European Securities and Markets Authority (ESMA) powers and competences, including administrative sanctions and other measures. ESMA and European Banking Authority (EBA) may adopt technical standards which may later become elaborated by delegated acts of the Commission according to Art. 7/5; 8/7; 12/16; 20/3; 21/8; 23/16; 31/8,9 and Art. 6/7; 19/7 respectively.

When it comes to the US legislation, the first legal ground for crowdfunding has been established in 2012 by the amendment of Securities Act with Jumpstart Our Business Startups Act (*"JOBS"*). Title III of the JOBS Act created a federal exemption under the securities laws enabling the usage of this type of funding method to offer and sell securities. Later in 2015, SEC Commission adopted Regulation Crowdfunding for the implementation of the requirements laid down in Title III.

If we are to briefly address to the JOBS, with the amendment; a limit has been introduced both on the side of the fundraiser and investor for crowdfunding,

fundraisers are subjected to liability for giving information to Securities and Exchange Commission (*"SEC"*), transfer of the shares that are sold by crowdfunding is prohibited for a one year period, and also liabilities of the service providers especially towards SEC are set forth. Before proceeding further we need to point out that, while the EU Regulation regulates lending and equity based crowdfunding, the US law only covers equity based funding. Considering the aim and scope of this paper, we will elaborate no further on US law and limit our work to EU and Turkish law.

3. CROWDFUNDING IN TURKISH LAW

After the amendment of Capital Markets Law (CML) Art. 3 on 28 November 2017, which covers definitions, crowdfunding has been introduced in the Turkish legal system. As per Art. 3/1-z; crowdfunding means *"collection of money via crowdfunding platforms in order to provide funds that a project or a venture capital company needs, within the frame of regulations set by the Board (the Capital Markets Board) and without being liable to investor compensation regulations prescribed within this Law"*. While we have already identified which types of funding the EU and the US laws permit, Turkish law does not make a direct restriction regarding types of funding as the definition covers all types of fund collection. However, as we will point out below, equity based funding is directly regulated under Turkish law with a communiqué and service providers/platforms that are established in accordance with the Communiqué, are prohibited to engage in lending based funding.

The definition itself gives the hint that crowdfunding is a separate mechanism for raising of funds from the other ones foreseen in the CML, therefore rules that are governing crowdfunding will also differ. In this sense, joint stock companies which raise funds by crowdfunding are exempted from; in Art. 3/1-e publicly-held joint stock company's definition, in Art. 3/1-h from the issuer's definition and in Art. 16/1 it is explained that, even if the number of shareholders exceeds 500 -which is the limit for a joint stock company to be accepted as publicly owned- a joint stock company which raises funds by crowdfunding will not be deemed as publicly owned.

Apart from these, the main regulation on crowdfunding is Art. 35/A of the CML. In Art. 35/A/1, crowdfunding platforms are described as institutions acting as an intermediary in crowdfunding and providing its services over electronic media. In the same paragraph, the Capital Markets Board (the Board) is vested with the authority to prefer between lending and equity based funding and lending based funding is exempt from Banking Law regulations. With Art. 35/A crowdfunding

platforms are subjected to the permission of the Board to provide their services. After Art. 35/A entered into force, the Board published the Communiqué on Equity Based Crowdfunding numbered III-35/A.1 (*"the Communiqué"*), which regulates only equity based crowdfunding but sets out the main principles of the crowdfunding system while prescribing detailed conditions and obligations that platforms need to follow.

In order not to go into depth of the Communiqué, we will try to give the main principles of crowdfunding regulation and try to reflect the system as clear as possible in comparison with EU Regulation.

The crowdfunding system in the Communiqué is regulated from three different perspectives: Crowdfunding platforms, investors and fundraisers, i.e. venture capital firms/entrepreneurs.

3.1. Platforms

First of all, platforms may engage in activities in the Communiqué only if they are listed by the Board (Art. 5/1). A platform applying to be listed has to be a joint stock company with a minimum of 1.000.000 Turkish Liras paid in share capital, whose shares are registered and whose commercial title contains the phrase "Crowdfunding Platform" (Art. 5/3-a,b,c). The Communiqué also brought requirements for the shareholders and directors of the platform (Art. 6). This requirement differs from the EU law, as the Regulation Art. 2/1-e defines service providers as legal persons and Art. 12/2-b requires a legal form of the service provider to be submitted for authorization, which means that there is no obligation to be founded in the form of a joint stock company.

One of the important sub-parts of the platform are the investment committee members who are to be assigned by the board of directors of the platform. Art. 9 of the Communiqué sets out the requisites that the members of the committee should satisfy. The crucial role of the investment committee is to approve or reject the information form submitted by fundraisers regarding their prospective campaigns. As per Art. 16/4 of the Communiqué; *"a campaign may be conducted in the platform only if and when the crowdfunding information form is approved by the investment committee and that form is published on the campaign page"* and Art. 17/2 of the Communiqué; *"duration of campaign shall start as of the date of publication of the information form approved by the investment committee on the campaign page"* (also see Art. 18/2,3). Therefore, although the process in general might have been started by an application for fundraising in accordance with the Art. 17/1 of the Communiqué, we can deduce that a campaign for fundraising will not start before getting an approval from the investment committee, therefore it is up to the committee to allow or not allow

for a campaign for fundraising to run (also see Art. 11/5). When it comes to EU law, the Regulation sets forward the principles for the key information sheet under Art. 23. As per Art. 23/12 of the Regulation; when a service provider identifies an omission, mistake and inaccuracy in the key investment information sheet, the project owner is informed and expected to compete or correct the information sheet promptly. When completion or correction is not made promptly, the service provider suspends the crowdfunding offer for no longer than 30 days, and if irregularity still continues, the crowdfunding offer gets cancelled. Therefore, we can conclude that, while service providers have the power of an ex ante examination and granting permission in Turkish law beside the ex post power of cancellation (see Art. 18/4), EU law provides power of ex post control and of suspension/cancellation. Lastly, Art. 30, the Regulation also provides a list of powers, including suspension and termination of the crowdfunding process, that competent authorities should be vested with by national laws.

As per Turkish law, while platforms act as an intermediary in crowdfunding activities, they do not economically control any of the securities or collected funds during the process. As we will explain below, securities in exchange for collected funds will be issued or transferred after the end of the campaign, on the other hand, collected funds will be kept by a depository in a frozen account in name of the platform. This part of the crowdfunding process, i.e. completion of the campaign and transfer of assets, is not regulated under EU Regulation.

Art. 12 of the Communiqué provides a list of activities that cannot be carried out by platforms. According to Art. 12/1; *"crowdfunding platforms may not act as an intermediary in crediting or lending businesses in consideration of interest or any other consideration under any name whatsoever or by taking a pledge therein for, and may not perform any crowdfunding activities against any capital market instruments, except for equity-based crowdfunding activities."*. This provision demonstrates that platforms cannot engage in lending based funding and intermediate for securities other than shares. In conflict with the EU Regulation, according to Art. 12/4 of the Communiqué, *"platforms are not permitted to make assessments, analyses and comments in the form of investment recommendations towards venture capital firms or investors of projects."*. However in the EU Regulation, platforms are explicitly permitted to give a price recommendation by operating a bulletin board for secondary sales and purchases of the instruments (Art. 25/5 of the Regulation). Lastly, as per Art. 12/6 of the Communiqué; platforms *"may not act as an intermediary in secondary market transactions. Enabling members to establish communication among themselves*

via platform websites does not constitute a violation of this provision.”. This provision is similar with the Regulation of the EU, since in Art. 25 of the Regulation; crowdfunding service providers are permitted to allow investors to advertise their interest on selling or buying instruments that are originally offered on crowdfunding platforms, however they cannot act as a tool for bringing together those interests which would result in a contract.

According to Art. 10/1 of the Communiqué; a platform failing to meet any one of the listing conditions might be delisted by the Board. If a platform gets delisted, it cannot apply for being relisted to engage in crowdfunding activities for one year after the decision of the Board (Art. 10/4). Campaigns that have already started will be deemed terminated and collected funds will be refunded (Art. 17/10, 11). Art. 17 of the Regulation also includes similar terms for withdrawal of authorization for the service providers.

3.2. Investors

In order to engage in crowdfunding, investors must become a member of the relevant platform (Art. 14/1). In Art. 14/1-d of the Communiqué, it is provided that platforms are required to make sure that members have enough knowledge and experience in order to comprehend the risks of crowdfunding, and in case a candidate is not found eligible, platforms can reject the application for membership. This provision differs from the EU Regulation, as according to Art. 21 of the Regulation, service providers shall test the investors for their basic information and understanding of risks, yet even if they are not found eligible, service providers can only issue them a risk warning and do not have the authority to reject providing services for such investors.

We also need to address the campaign process under this section, where investors facilitate their engagement into crowdfunding. According to Art. 17; investors deliver their funding orders to the platforms and platforms transmit these orders to the Central Registry Agency (*“CRA”*) and depository. At the same time, investors shall also fulfil their payment orders. The depository collects the funds, freezes those in an account name on the platform, to be transmitted to the venture capital firm after the campaign or to be refunded back to relevant investors (also see Art. 4/1-c). Therefore, for a venture capital firm to acquire the collected funds, the campaign has to be ended successfully. In order to achieve that, the aimed amount of funds has to be raised with the early or timely closure of the campaign, which cannot exceed 60 days after the publication of information form approval. Then, if the campaign was run by a venture capital company, collected funds get transferred to the company’s frozen account by depository and the company has to increase its capital within 30 days

for issuing new shares in exchange for the raised funds. If the campaign was run by a natural person, a venture capital firm has to be established within 90 days and its capital has to be increased within the following 30 days (Art. 17/7). If the campaign fails, i.e. raised funds do not reach the desired amount, or if mentioned obligations are not fulfilled by venture capital firms/entrepreneurs, funds get refunded to the investors (Art. 17/8, 9). This process of the crowdfunding process is not regulated under EU Regulation.

In Art. 20-22 of the Communiqué; principles on places of use of funds, requirements of venture capital firms and public disclosure are also regulated.

3.3. Venture Capital Firms

As per Art. 16/1 of the Communiqué, before transferring the raised funds, a venture capital firm must be established in the form of a joint stock company. Therefore, even though the fundraiser was a natural person, collected funds are not directly transferred to such a person as he also has to establish a venture capital firm. After the establishment of the firm, funds can only be transferred against shares to be issued through a capital increase by the firm. Additionally, the mentioned provision explicitly prohibits the funds to be deposited to the former shareholders of the firm against sales of their existing shares, in order to avoid from former shareholders of the venture capital firm to sell-out their shares and take all collected funds. Therefore, these funds will belong to the venture capital firm by means of capital increase and fundraisers and investors will both hold shareholder status. Finally, it is allowed to issue non-voting shares in exchange for funds, which is normally prohibited for joint stock companies according to the Turkish Commercial Code (*"TCC"*) (Art. 434). There are no such specific requirements for venture capital firms/project owners to receive collected funds in EU Regulation.

Art. 16/10 of the Communiqué provides that for three years after a campaign starts, entrepreneurs or venture capital firm partners may not transfer their shares, except under certain circumstances such as inheritance and share transfers between themselves or to the qualified investors. Therefore, entrepreneurs or venture capital firm shareholders are bound with the project for the first three years-for the development and maturing period. However, it is not clear whether investors/prospective shareholders are also subjected to this restriction.

There are also other prerequisites to be fulfilled in Art. 21 of the Communiqué for the venture capital firms. For example, venture capital firms have to engage in technology and/or production activities, have to be established within five years preceding the publication of the approved information form, have to have

registered websites that are regularly monitored and controlled and shall not be in the form of any of the following: Publicly-held corporations, companies with management controlled by another legal entity, companies where publicly-held corporations and capital market institutions are in the position of a partner having significant influence.

3.4. Legal Responsibility

Under this part, we will only elaborate on Turkish law, since the Communiqué brings a special form of responsibility for the persons involved in the crowdfunding process compared to the responsibility regime in TCC, while EU Regulation only provides information on persons and acts that should be covered by a responsibility regime by member states.

In the Communiqué, the Board has provided some provisions on the legal responsibility of the actors of crowdfunding. Art. 23 of the Communiqué which regulates liabilities is as follows:

"Members of the board of directors of platform are liable to ensure that the obligations stipulated for platforms in this Communiqué are fully performed, investment committee members and members of the board of directors of the platform are liable to ensure that the obligations stipulated for investment committee herein are fully performed, and members of the board of directors of venture capital firm are liable to ensure that the obligations stipulated for venture capital firms herein are fully performed."

The responsibility of members of the board of directors of the platform in the first sentence is in line with the responsibility regime of the board of directors of any joint stock company regulated under TCC. However, when it comes to violation of the obligations stipulated for the investment committee, alongside with committee members, members of the board of directors are also held liable, which seems to be contradicting with the framework of TCC.

According to TCC, members of the board of directors can escape responsibility in a case where they lawfully and with the utmost care transferred their duty - failure of which caused responsibility- to a third party (Art. 553/2). However, from the wording of the Communiqué, members of the board of directors seem to have no opportunity to be freed of liability, even if failure was made by the investment committee.

Although there is no investment committee within service providers according to the EU Regulation, Art. 9/3 of the Regulation provides that even though duties of the service providers are allocated on third parties, i.e. outsourced, responsibility for their acts remains with the service providers.

This demonstrates a similar situation in comparison with the Turkish law.

Last but not least, members of the board of directors of a venture capital firm are held liable for the fulfillment of obligations stipulated for venture capital firms. This provision brings into some questions, as a board of a venture capital firm is already liable in accordance with the TCC for violation of their duties under any law and can be sued by shareholders and creditors. However, with the mentioned provision, it might be argued that investors -who are not yet shareholders of a venture capital firm and have no contractual relationship with the company yet- can also apply against board members for compensation of their loss.

4. CONCLUSIONS

Crowdfunding is a prosperous field of fundraising and it has attracted more and more attention in recent years. While it has been introduced in US law by JOBS in 2012, there is still no unified regulation at the EU level. On the other hand, the Turkish legislator has vested the authority to regulate the crowdfunding system to the Board, and a Communiqué has been published which focuses on equity based crowdfunding. Considering all the information given, we can pick some of the interesting points of the Communiqué which are as follows:

First of all in Turkish law, although there has been no separation between types of funding in the definition, the Communiqué does not permit platforms founded under its provisions to operate by lending based funding and only covers equity based funding which only consist of shares of a joint stock company. On the other hand, EU Regulation covers both lending and equity based funding, while equity based funding might cover transferrable securities and admitted instruments, which are broader than the scope of Turkish law.

On the other hand, according to the Communiqué, campaign for fundraising does not start before getting an information form approved by the investment committee, therefore it is up to the committee to allow or not allow for a campaign for fundraising to run. There is no such requirement in EU Regulation, however key information sheets are observed and when there is a contradiction with the law the crowdfunding process might get suspended or cancelled.

Moreover, as per the Communiqué, platforms are not permitted to make assessments, analyses and comments in the form of investment recommendations towards venture capital firms or investors of projects and they are not permitted to act as an intermediary for secondary transfer of shares. According to the EU Regulation, crowdfunding service providers are permitted to announce a reference price and operate a bulletin board for advertisement of buying and selling interests of instruments that are originally offered on the

crowdfunding platform, without providing a tool for bringing together those interests which would result in the form of a contract.

In addition, the Communiqué entails that when investors do not satisfy the eligibility test of the platforms, their inclusion in the crowdfunding system can be rejected. However, according to the Regulation, service providers shall also test the investors and even if they are not found eligible, service providers can only issue them a risk warning and do not have the authority to reject providing services for such investors.

Besides that, the Communiqué provides that there has to be a venture capital firm in any case established until a prescribed period after the end of the campaign, for the depository to transfer collected funds from the account of the platform to the account of the firm. However, the depository shall freeze that account until a capital increase is made and new shares are issued for the investors in exchange for the collected funds. It is allowed to issue non-voting shares in this process, which is normally prohibited for joint stock companies under the Turkish Commercial Code. EU Regulation does not prescribe any rules for that part of the process.

Finally, the Communiqué also prescribes legal liabilities for members of the board of directors of the platform, venture capital firms and members of the investment committee, which are partly in line with TCC but partly contradicting. EU Regulation provides persons and acts that should be covered by a liability regime under member states' national laws.

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LEGAL STATUS AND CORPORATE GOVERNANCE OF DECENTRALIZED AUTONOMOUS ORGANIZATIONS

Ass. Prof. Antun Bilić
University of Zagreb, Faculty of Law
Trg Republike Hrvatske, 14, Zagreb, Croatia
abilic@pravo.hr

ABSTRACT

For the last couple of years legal aspects of blockchain technology have been a hot topic in academic circles. The focus has slowly shifted from cryptocurrencies to its other applications. One of the most important ones is a Decentralized Autonomous Organization (DAO). A DAO is an organization in the form of computer programs – smart contracts – which are coded on blockchain and upheld by a peer-to-peer network. The participants of a DAO interact in accordance with a set of predefined rules without a central authority or extraneous influences. While a DAO can serve various purposes, it usually operates a business. In exchange for their contribution, a DAO's participants receive governance tokens which enable them to vote and to receive dividends. The tokens are traded on a secondary market.

The law is unsure how to approach a DAO. It is not easy to pin down a DAO's exact legal status. Its organizational structure often resembles that of a company. Nevertheless, a DAO is usually is not registered as a company and it has no legal personality. In most legal systems a DAO is seen as a general partnership. If a DAO is a partnership, this opens many questions in regard to its establishing, membership, management and relationship with third persons. Perhaps most importantly, a DAO's participants could be jointly and severally liable for its obligations.

Keywords: Decentralized Autonomous Organization, general partnership, smart contract, governance token

1. INTRODUCTION

The development of distributed ledger technology (DLT), usually a blockchain, created lasting reverberations in the landscape of legal phenomena. The immutable nature of blockchain enables reliable recording of assets, contracts and, lately, organizations. After the headaches caused by cryptocurrencies, such as Bitcoin, one of the latest puzzles is a so-called Decentralized Autonomous Organization – DAO. A DAO is usually defined as an organization governed by virtue of smart contracts.[1] Smart contracts are immutable computer programs,

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[1] For definitions of DAO see Timothy Nielsen, 'Cryptocurrencies: A Proposal for Legitimizing Decentralized Autonomous Organizations', [2019] Utah L Rev 1105, 1110;

recorded on blockchain, which, as soon as predefined conditions are met, self-execute, i.e. undertake actions with legal consequences.[2]

A part of DAO's charm lies in the ambiguity of its name. The term "organization" implies a group of people which act in a coordinated way in order to achieve a common goal. In that sense a DAO resembles traditional entities recognized by private law – companies, partnerships and associations. However, unlike in traditional organizations, in a DAO people are coordinated by smart contracts.

The second term "decentralized", refers to the fact that smart contracts governing a DAO are not stored on a single server but across nodes on a peer-to-peer network, i.e. DLT. "Decentralized" also means that there is no central management organ such as a board of directors in a traditional company.[3] In a wider sense, "decentralized" denotes that there is no hierarchical governance and that no single source of influence can subject a DAO to its control.[4] The underlying idea is to ensure a democratic and efficient management, free from the trappings of traditional governance, such as a principal-agent problem and moral hazard.

Finally, the term "autonomous", begs the question – autonomous from what? On the one hand, a DAO is supposed to be autonomous from all influences

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Antonio Garcia Rolo, 'Challenges in the legal qualification of Decentralised Autonomous Organisations (DAOs): the rise of crypto-partnership?' (2019) 1 RDTec 33, 56; Kyung Taeck Minn, 'Towards Enhanced Oversight of "Self-Governing" Decentralized Autonomous Organizations: Case Study of the DAO and Its Shortcomings' (2019) 9 NYU J Intell Prop & Ent L 139, 141; Alexandra Sims, 'Blockchain and Decentralised Autonomous Organisations (DAOs): The Evolution of Companies?' (2019) 28 New Zealand Universities Law Review 423-458 <https://ssrn.com/abstract=3524674> accessed on 29 October 2020 1, 2; Laila Metjahic, 'Deconstructing the Dao: The Need for Legal Recognition and the Application of Securities Laws to Decentralized Organizations' (2018) 39 Cardozo L Rev 1533, 1543; Nathan Tse, 'Decentralised Autonomous Organisations and the Corporate Form' (2020) 51 Victoria U Wellington L Rev 313, 314; Maximilian Mann, 'Die Decentralized Autonomous Organization – ein neuer Gesellschaftstyp? Gesellschaftsrechtliche und kollisionsrechtliche Implikationen' [2017] NZG 1014.

[2] Stefan Möllenkamp and Leonid Schmatenko, 'Blockchain und Kryptowährungen' in Thomas Hoeren, Ulrich Sieber and Bernd Holznagel (eds), *Handbuch Multimedia Recht* (C. H. Beck 2020) pt 13.6, para 15; Markus Kaulartz and Jörn Heckmann, 'Smart Contracts – Andwendunged der Blockchain-Technologie' (2016) 32 Computer und Recht 618; Joachim Schrey and Thomas Thalhofer, 'Rechtliche Aspekte der Blockchain' [2017] NJW 1431, 1432; Nielsen (n 1) 1107; Garcia Rolo (n 1) 41; Tse (n 1) 317.

[3] Garcia Rolo (n 1) 61; Metjahic (n 1) 1542.

[4] Tse (n 1) 319.

extraneous to smart contracts and blockchain.[5] The code should be self-sufficient. However, such approach limits the applicability of a DAO. If a DAO wants to fully compete with traditional organizations it has to be able to reach the physical, off-chain world. Furthermore, "autonomous" means autonomous from any legal system, which is commonly illustrated by the phrase "code is law".[6] Although from a legal perspective this cannot stand scrutiny, it is true that a DAO evades simplistic legal qualifications. Moreover, "autonomous" could mean independent from any single source of influence. In that regard, "autonomous" overlaps with the term "decentralized".

Certain authors use the term "autonomous" in the sense that a DAO should be autonomous from human influence.[7] Every smart contract is partly autonomous from humans because it self-executes, without the need for additional human consent. However, full autonomy from human influence implies that AI could make a DAO almost completely independent from human race. In that sense, a true DAO is distinguished from a Decentralized Organization (DO), which is still run by people, albeit limited by smart contracts.[8] Since a true DAO is yet impossible to achieve,[9] and there are many transitional stages between a DAO and a DO, for the purposes of this paper the term DAO will primarily refer to an organization which is still governed by humans.

This paper will analyze a DAO's legal status and corporate governance. The expected first step of a legal analysis is to choose one or several jurisdictions as a lens for observing a particular legal phenomenon. In the case of a DAO, however, focusing too strictly on any particular jurisdiction would not be fruitful. Practically all jurisdictions are still unsure how to approach a DAO. Moreover, choosing a particular jurisdiction would make sense only if its laws would be applicable to a DAO. However, private international law is still undecided how to determine a DAO's *lex societatis*. Because of its blockchain

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[5] Metjahic (n 1) 1543.

[6] Sims (n 1) 1; Garcia Rolo (n 1) 62; Dennis-Kenji Kipker, Piet Birreck, Mario Niewöhner and Tim Schnorr, 'Rechtliche und technische Rahmenbedingungen der "Smart Contracts" Eine zivilrechtliche Betrachtung' [2020] MMR 509, 510.

[7] Vitalik Buterin, 'DAOs, DACs, DAs and More: An Incomplete Terminology Guide' (Ethereum Blog), <https://blog.ethereum.org/2014/05/06/daos-dacs-das-and-more-an-incomplete-terminology-guide/> accessed 8 October 2020; Garcia Rolo (n 1) 39; Metjahic (n 1) 1543; Sims (n 1) 2; Tse (n 1) 320, 321.

[8] Metjahic (n 1) 1541.

[9] Sims (n 1) 2 fn 15. Even "the DAO" is classified as a DO rather than a DAO (Metjahic (n 1) 1545).

existence and decentralized nature, a DAO almost entirely lacks typical connecting factors such as central administration, principal place of business or country of incorporation. Consequently, the courts will often be left with nothing better than to apply *lex fori*.[10] As the result, the same DAO could be "governed" by an unlimited number of laws.

For all those reasons, a DAO will be analyzed from a "transnational" legal perspective, i.e. by taking into account features which are common to most jurisdictions. Although this might lead to certain generalizations, the author believes that such bird's eye approach is best for capturing a DAO's true essence.

First, it will be discussed whether a DAO has or should have a legally recognized status (2). Afterwards, it will be discussed how a DAO is established (3), the role of a DAO's participants (4), managing of a DAO (5) and a DAO's relationship towards third persons, most importantly its liability (6). A conclusion will sum up the results of preceding analysis (7).

2. LEGAL STATUS OF A DAO

The initial question is – does a DAO need a legal status? Its creators and participants often intend the DAO to be governed exclusively by its code. Nevertheless, states have a sovereign right to regulate all types of human behavior and social phenomena. As a rule, the more important a phenomenon is for a society, the more likely is that a state will want to place it within its legal framework. If a DAO acts as an organization and engages in transactions, it can expect to be imposed a legal status, whether one of the existing organizational forms or a new, tailor-made form for crypto entities.

From the existing legal forms, at first glance a DAO might resemble a company.[11] It usually consists of participants who hold DAO governance tokens. Tokens are a type of smart contract which, similar to a share, grant their holders the right to vote and to receive dividends. DAO participants can trade their tokens on a secondary market, e.g. crypto-exchange.[12]

However, a DAO lacks the basic prerequisite for a company – it is not registered in a company register. Consequently, it does not acquire a legal personality and

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[10] Mann (n 1) 1019.

[11] Consequently, they are also called decentralized autonomous corporations (Buterin (n 7); Garcia Rolo (n 1) 55; Sims (n 1) 11.

[12] Nielsen (n 1) 1111; Tse (n 1) 349.

its participants do not obtain the privilege of limited liability.[13] It could be argued that DAO's registration on blockchain is at least as reliable as the one in a company register. Although this might be true, such registration would first have to be officially recognized by the legislator.

A DAO is, therefore, much closer to the most basic form of partnership, usually called general, civil or simple partnership (hereinafter: partnership). Without going into details of a particular jurisdiction, such partnership is an elementary organizational entity which does not require registration.[14] Usually it does not have a legal personality and even if it does,[15] its partners remain jointly (and severally) liable for the partnership's obligations.[16]

In almost all jurisdictions a partnership consists of two or more persons who act together to achieve a common purpose.[17] The partnership is usually based on a partnership agreement,[18] although in certain jurisdictions this is not a necessary requirement.[19] However, as long as partners' actions are deliberately coordinated and not merely accidental,[20] it could be said that there is at least an implied partnership agreement.

Consequently, it remains to be seen whether a DAO consists of two or more persons (2.1.), which are connected by an (at least implied) agreement (2.2.), who act together to achieve a common purpose (2.3.).

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[13] Garcia Rolo (n 1) 69, 70; Nielsen (n 1) 1113.

[14] In US such partnership is regulated by Revised Uniform Partnership Act 1997 (RUPA); in UK by Partnership Act 1890 (PA); in Germany by Bürgerliches Gesetzbuch (BGB) s 707-740; in Austria by Allgemeines Bürgerliches Gesetzbuch (ABGB) art 1175-1216e; in Switzerland by Obligationenrecht (OR) art 530-551; in France by Code Civil (fr CC) art 1871-1873; in Italy by Codice civile (it CC) art 2251-2290; in Croatia by Zakon o obveznim odnosima (ZOO) art 637-660. For an overview of US, UK, French and German law in regard to DAO see Garcia Rolo (n 1) 64-71.

[15] In US, according to RUPA s 201 (a), "a partnership is an entity distinct from its partners". German Supreme Court (BGH 2001, 1056) recognized the legal capacity of a partnership (albeit which is not the same as legal personality).

[16] RUPA s 306(a), PA s 9.

[17] RUPA s 102(11); PA s 1(1), BGB s 705; ABGB s 1175; OR art 530; fr CC art 1871(2); it CC art 2247; ZOO art 637.

[18] RUPA s 102(12); PA s 19, 20, 24; BGB s 705; ABGB s 1175; OR art 530; fr CC art 1871(2); it CC art 2247; ZOO art 637.

[19] For US and UK law Garcia Rolo (n 1) 64-66.

[20] Metjahic (n 1) 1551, 1557.

2.1 Two or more persons

The operation of a DAO would, at least for now, be impossible without human participants. No matter how sophisticated smart contracts might be, they still rely on human agency. Human participants might act in their own name or on behalf of a legal person. Participants are allowed to vote on a DAO decisions and to participate in the DAO's profit. This resembles the traditional role of partners who can amend the partnership agreement, engage in day-to-day management and share partnership profit.[21]

A DAO will usually have not only two, but a large number of participants, with an easy option of entering or exiting. This corresponds to an open partnership with fluid partners.[22] This is also similar to a public limited liability company with a dispersed shareholder structure, but altogether different from a closed limited liability company or a single shareholder company. Just one participant could not constitute a DAO but, at best, be a party in a smart contract.

A special feature of a DAO is that its participants remain pseudonymous, which is enabled by cryptographic code language. This means that other participants and third persons are not aware of participant's true identity. The true identity of a person is usually not a necessary prerequisite for entering into a valid agreement. However, pseudonymity causes problems when it comes to enforcement of claims and it facilitates the proliferation of illegal activities.

Even if one day AI largely replaces participants' activity, it does not necessarily mean that the DAO would cease to be a partnership. As long as token holders exist and share the DAO's profit,[23] they could still be considered as partners. After all, it is not necessary that partners indeed manage the partnership affairs. At least in certain jurisdictions it is possible that partners agree on a special management organ or body, usually consisting of a limited number of managing partners.[24] AI would then assume the function of such an organ.

A DAO would cease to be a partnership if it would have no participants at all. However, it is not clear why someone would create such a DAO in the first

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[21] RUPA s 102(12), 105(a)(3), 301, 401; PA s 19, 24 (1), 24(5); BGB s 709 (1), 722; ABGB s 1189(1), 1195; OR art 533, 535(1); it CC art 2252, 2258, 2263; ZOO art 642, 651.

[22] E.g. the German notion of "public partnership" (Publikumspersonengesellschaft) which denotes a partnership in which the circle of partners is not closed and the number of investors is not determined (Tim Walter, 'Die Publikumspersonengesellschaft' [2020] JuS 14, 15).

[23] Tse (n 1) 321.

[24] BGB s 714; ABGB s 1189(2); OR art 535(1); it CC art 2257(1); ZOO art 633(1).

place. Except in a dystopian scenario where rogue AI creates its own organizations, a DAO without participants would make sense only as a non-profit organization which acts in public interest. Even if such DAOs are created, there will always remain the need for organizations whose purpose is to make profit for the benefit of its participants.

2.2 Partnership agreement

Most jurisdictions require that a partnership is based on a partnership agreement.[25] Participants of a DAO will rarely enter into an explicit partnership agreement. However, there might exist an implied partnership agreement.

It is possible that an implied partnership agreement exists in a "white paper", a type of prospectus, which usually accompanies Initial Coin Offering (ICO) of DAO tokens.[26] In any case, most of the rules on DAO governance are contained within smart contracts. This raises another question – is smart contract an agreement or can it constitute an agreement? Much ink has been spilled arguing whether smart contracts are actually contracts.[27] Divergent approaches are often determined by different jurisdictions and legal schools of thought. Nevertheless, it seems that it is possible to reach the middle ground.

An agreement can be broadly defined as a meeting of parties' minds which produces legally relevant consequences.[28] It is true that smart contracts do not necessarily incorporate a meeting of minds. It can even be called into question whether the code is capable of recording human intent.[29] However, a smart contract is rarely independent of human agency. Humans either write a smart contract or they willingly accept its conditions,[30] often on the basis of a prior agreement. Furthermore, the basic purpose of a smart contract is to transfer

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[25] BGB s 705; ABGB s 1175; OR art 530; it CC art 2247; ZOO art 637.

[26] Garcia Rolo (n 1) 43.

[27] E.g., that smart contracts are contracts Garcia Rolo (n 1) 40, and that they are not Mann (n 1) 1016, 1017; Frank A Schäfer and Thomas Eckhold, 'Crowdfunding, Crowdlending, Crowdinvesting, Kryptowährungen und Initial Coin Offerings (ICOs)' in Heinz-Dieter Assmann, Rolf A Schütze, Petra Buck-Heeb (eds), *Handbuch des Kapitalanlagerechts* (C. H. Beck 2020) ch 16a, para 39.

[28] Garcia Rolo (n 1) 40, on the basis of European Draft Common Frame of Reference (DCFR). For English law Simon J Whittaker, 'Introduction' in Hugh Beale (ed), *Chitty on Contracts* (31st edn, Sweet&Maxwell Thomson Reuters 2012) para. 1-016; for German law Christian Fröde, *Willenserklärung, Rechtsgeschäft und Geschäftsfähigkeit* (Mohr Siebeck 2010) 5, 6; for Croatian law Klarić P, *Građansko pravo* (11th edn, Narodne novine 2008) 107.

[29] Kaulartz and Heckmann (n 2) 621; Mann (n 1) 1016; Tse (n 1) 317, 318.

[30] Which may be qualified as an offer and an acceptance (Garcia Rolo (n 1) 40).

cryptocurrencies and other tokens with the help of blockchain. Law recognizes the fact that cryptocurrencies and other tokens have market value, and, therefore, it treats them as assets.[31] Consequently, smart contracts are at least capable of transferring the assets in accordance with human intent.

Transferring the assets in accordance with human intent, in turn, implies an agreement. This means that, unless there is a separate agreement, which is then performed by a smart contract, a smart contract contains an implicit agreement within itself.[32] This conclusion is not limited to smart contracts. On the example of an ordinary sale of goods, when there is no explicit sales agreement, if one party sends the goods and the other pays the price, such performance implies a meeting of minds.

A problem could arise if there is a discrepancy between the meeting of minds and the conditions of a smart contract.[33] E.g. this could be a situation if there is a separate agreement, independent from smart contracts or if the parties expressed their intent in some other way. From a legal perspective, the meeting of minds, true agreement, should prevail.[34] The situation is similar if the true agreement is for any reason invalid or if there is some other legal obstacle. It is a different question whether it is possible to enforce such legally recognized outcome on blockchain. If a reverse transaction is not possible, the aggrieved party would have to resort to claiming damages.

In the context of a DAO, the person who acquired a token (during an ICO or on a secondary market) at least implicitly consented to participate in the DAO's governance together with other token holders. Therefore, it can be said that a DAO's participants are connected by an implied agreement.

2.3. Common purpose

The final prerequisite for a partnership is that partners act together to achieve a common purpose. The common purpose of a partnership is usually determined

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[31] For US law Evan Hewitt, 'Bringing Continuity to Cryptocurrency: Commercial Law as a Guide to the Asset Categorization of Bitcoin' (2016) 39 Seattle U L Rev 619. For German law, Möllenkamp, Schmatenko (n 2) para. 20-52; Schäfer, Eckhold (n 27) para. 31-52; Markus Kaulartz and Robin Matzke, 'Die Tokenisierung des Rechts' [2018] NJW 3278, 3279.

[32] Nikolas Guggenberger, 'Smart Contracts, ICOs und Datenschutz' in Thomas Hoeren, Ulrich Sieber and Bernd Holznagel (eds), *Handbuch Multimedia Recht* (C. H. Beck 2020) pt 13.7, para 8.

[33] Minn (n 1) 152 provides an example.

[34] Kipker and others (n 6) 510.

by the partnership agreement.[35] While certain jurisdictions require that such purpose is a continuous operation of a business,[36] others allow partnership to strive towards other, non-profit purposes.

A DAO is established in order to achieve a certain purpose. This purpose is determined by its white paper and smart contracts. The purpose of a DAO might be for-profit or nonprofit.[37] If a DAO is established to make profit, which is more common, it resembles a partnership that operates a business. If it is established for a nonprofit purpose, it resembles a nonprofit organization.

The purpose of a DAO might be of a temporary or a lasting nature. In some jurisdictions a partnership has to be established for conducting business for an indeterminate period of time. If it is established for a temporary purpose, it is classified as a joint venture.[38] Nevertheless, it seems that even in those jurisdictions there are no substantial differences between a partnership and a joint venture.[39]

Since a DAO exists on blockchain, in order to achieve its purpose, it has to rely on tokens and other crypto assets.[40] This will not represent a problem if the DAO's purpose is also limited to blockchain and crypto assets. Relying on tokens and crypto assets might present problems if the DAO has a purpose in physical, off-chain world. This will almost certainly require tokenization, i.e. tying the real-world assets to crypto assets.[41] This could be a problem under the applicable law because in many jurisdictions assets can be transferred only in a strictly prescribed way. E.g. real estate could be transferred only by registration in the land registry and movables could be transferred only by physical handover.

To conclude, most jurisdictions correctly classify the DAO as a partnership.[42] It remains open whether this is the optimal solution, or the legislator should create a new legal form for crypto entities. This new legal form could be a specialized

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[35] BGB s 705; ABGB s 1175; OR art 530; fr CC art. 1832; it CC art 2247; ZOO art 637.

[36] RUPA s 102(11), 202(a); PA 1890 s 1(1).

[37] Sims (n 1) 14. Although scholarly work usually focuses on for-profit DAOs, e.g. Garcia Rolo (n 1) 57 and Minn (n 1) 147.

[38] Nielsen (n 1) 1115; Metjahic (n 1) 1558.

[39] Metjahic (n 1) 1558, 1559.

[40] Garcia Rolo (n 1) 59.

[41] Sims (n 1) 6.

[42] For US Metjahic (n 1) 1547, 1553; Usha R Rodrigues, 'Law and the Blockchain' (2019) 104 Iowa L Rev 679, 684, for Germany Mann (n 1) 1017; for US, UK, France and Germany Garcia Rolo (n 1) 64-68.

crypto-partnership or even a full crypto-corporation with its own legal personality.[43]

3. ESTABLISHING A DAO

In order to establish a DAO, it is first necessary to write the smart contracts. A DAO usually uses two types of smart contracts – for DAO rules, which also include tokens and for transactions.[44] In other words the first step consists of coding and programming. This involves not only technical feats but also legal planning, because smart contracts determine DAO future governance. Consequently, it is almost impossible to create a DAO in a decentralized way, by a spontaneous activity of its participants. After all, the participants in a DAO do not necessarily know how to code. DAO's smart contracts are, therefore, usually created by a single person or an organization. This enables that a rational, comprehensive idea permeates a DAO's structure and governance. This person or organization is usually called the DAO's creator.

Only after smart contracts and rules are encoded, the creator attracts other participants. This is usually done through an ICO in which newly created tokens are offered to the public for the first time.[45] An ICO is accompanied by a white paper in which the creator explains the purpose and the rules of a DAO. The persons who acquire governance tokens become the DAO's participants. In exchange, they usually contribute some other asset to the DAO, most often a cryptocurrency such as bitcoin or ether.[46] In that way, the DAO accumulates the initial capital it will need to achieve its purpose.[47] Sometimes DAO governance tokens are offered for free, in so-called "airdrops".[48] This could happen if the creator wants to attract as many participants as possible and if the DAO is not in a dire need for capital. The creator itself might not even participate in the DAO or it can participate as an "ordinary" token holder.[49]

Such a method of establishing a DAO significantly differs from the typical way of establishing a partnership. In a traditional partnership, partners draft the partnership agreement themselves, with possible help from a lawyer. Usually

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[43] Nielsen (n 1) 1123, 112; Tse (n 1) 353, 354.
[44] Sims (n 1) 8.
[45] Garcia Rolo (n 1) 43.
[46] On the example of the DAO, Minn (n 1) 150; Metjahic (n 1) 1555; Sims (n 1) 12; Tse (n 1) 345.
[47] Garcia Rolo (n 1) 57.
[48] Sims (n 1), 16.
[49] Garcia Rolo (n 1) 61.

there is a limited number of partners and all of them have a similar influence on the drafting process. After the agreement is concluded the participation in a partnership is not offered to the public.

On the other hand, a DAO ICO closely resembles an initial public offering (IPO) of shares of a limited liability company. The articles of association of such a company are written by a few original shareholders and new shareholders have a "take it or leave it" option.

It would go too far as to say that the process of establishing a DAO is incompatible with its partnership status. After all, it is imaginable that one, dominant partner, or even a persuasive third person drafts the partnership agreement and then publicly invites people to join the partnership. In most jurisdictions the legal form of a partnership is sufficiently flexible to incorporate certain features of a company.

Nevertheless, such way of establishing a DAO is in a contradiction with its proclaimed values of decentralization and participatory democracy.[50] DAO participants might be free to govern a DAO and even to change its smart contracts, but they will first have to play by the existing pre-programmed rules. This problem is exacerbated if the creator retains control over an institutional role, such as that of a curator.[51] Although such a role might be purely administrative, as it will be demonstrated, the administration of the decision-making process can easily influence the content of a DAO's decisions.

4. PARTICIPATION IN A DAO

Participation in a DAO is determined by DAO governance tokens. In other words, a participant in a DAO is every person who has at least one DAO token. Conversely, a person who does not have a token is not a DAO's participant.

DAO's participants have certain rights and might also have certain obligations. In this section it will be more closely discussed what is a DAO governance token and how is it acquired (4.1.) and, what are the rights and obligations of DAO participants (4.2.).

4.1. DAO governance tokens

Since a DAO is a partnership, a DAO token represents a partnership interest.[52] Nevertheless, in certain aspects DAO tokens are more similar to shares in a

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[50] Tse (n 1) 328, 329.

[51] On the example of the DAO, Minn (n 1) 150, 153.

[52] Nielsen (n 1) 1111; on the example of the DAO, Metjahic (n 1) 1555.

company. Most importantly, the ownership of a DAO token is inseparable from its electronic recording. This resembles dematerialized shares, which also exist only as a recording in the electronic format,[53] usually at a central securities depository. Interests in a partnership, on the other hand, even if recorded electronically, are usually separable from the electronic record. Consequently, the transfer of a partnership interest can occur independently from the electronic bookkeeping.

There is, however, one significant difference between a DAO token and a share in a company. A share usually represents a part of the share capital, in the sense that share capital is equal to the nominal value of all issued shares.[54] By paying the contributions for their shares, shareholders pay up the share capital of the company. The function of the share capital is to protect the company creditors and compensate them for the shareholders' limited liability.[55] This is also the reason why shareholders have the obligation to maintain the share capital. They are allowed to receive dividends only if the net assets of the company are higher than the subscribed share capital and the mandatory reserves.[56]

On the other hand, as a partnership, a DAO does not have a share capital. Even if it accumulates assets during an ICO it does not have the obligation of capital maintenance. The flip side is that its participants are jointly and severally liable for its liabilities.[57] However, this also means that there are no strict rules on the number of tokens, their nominal value and paying-up the contributions. A DAO can issue new tokens whenever it deems necessary and distribute them for free. It is also allowed to acquire its own tokens without any limitations.[58] Further, this means that DAO tokens can be used for other purposes, e.g. for voting or even financing certain projects, similarly to a cryptocurrency.[59]

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[53] For EU law, Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 [2014] OJ L 257 art 3.

[54] For EU law, Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (Directive on certain aspects of company law) [2017] OJ L169, art 47, 48.

[55] John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63 ModLRev 355.

[56] Directive on certain aspects of company law art 56.

[57] See ch 6.

[58] Unlike with shares, e.g. Directive on certain aspects of company law, art. 59-67.

[59] Sims (n 1) 15; on the example of the DAO, Garcia Rolo (n 1) 49; Minn (n 1) 150.

The methods of acquiring a token and, thus, becoming a DAO participant, depend on the underlying smart contracts. As already mentioned, this often occurs through an ICO. After the ICO is over, tokens can be acquired on a secondary market where the existing participants are allowed to sell them. Secondary markets ensure a high liquidity of DAO tokens and enable the participants to freely enter and exit a DAO. Secondary markets usually take the form of a crypto-exchange, where DAO tokens are traded together with other tokens and cryptocurrencies.[60]

In this regard, a DAO token resembles a share. Namely, shares are also traded on a secondary market, usually run by a stock exchange. On the other hand, a traditional partnership is different from a DAO. The interest in a partnership cannot be transferred without the consent from all partners.[61] This is the reason why there is no secondary market of partnership interests.[62] However, those rules are usually not mandatory. In other words, the partnership agreement could allow an unobstructed transfer of partnership interests.

Sometimes smart contracts envisage that participants receive DAO tokens in exchange for some activity or service. Thus, the participants can acquire tokens by mining.[63] This will often be liquidity mining, i.e. facilitating trades by providing liquidity. Furthermore, tokens can be given as a reward for continuous voting, for curating DAO projects or some other service.[64] In that context, the often-used term is "reputation".[65] The reputation of a participant reflects its value or loyalty to a DAO. Participant's reputation will be especially important in a DAO where personal engagement is more essential than the investment of capital. In some cases, this may mean that tokens tied to a reputation cannot be sold on a secondary market or transferred to third persons.[66]

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[60] Ori Oren, 'ICO's, DAO's, and the SEC: A Partnership Solution' [2018] CBLR 617, 654; Nielsen (n 1) 1111.

[61] RUPA s 102(11); ABGB s 1182(1); PA s 24(7). For German law Carsten Schäfer, '§ 719 Gesamthänderische Bindung' in Franz Jürgen Säcker and others (eds), *Münchener Kommentar zum BGB* (8th edn, C. H. Beck, 2020) para 27. For Croatian law Jakša Barbić, *Društva osoba* (Organizator, 2019) 65.

[62] Nielsen (n 1) 1115.

[63] On the example of Dash, Garcia Rolo (n 1) 53; Sims (n 1) 15, Tse (n 1) 331.

[64] On the example of DigixDAO, Garcia Rolo (n 1) 54; on the example of Horizen, Tse (n 1) 327.

[65] Sims (n 1), 15 21.

[66] ibid 23.

In this respect, a traditional partnership is not much different from a DAO. The duties of a partner are not limited to money payments. Partners usually undertake to personally engage in partnership activities. They manage the partnership and try to bring about its purpose.[67] After all, this is the reason why a partnership interest usually cannot be transferred without the consent from all partners.

4.2. Participant's rights and obligations

DAO tokens grant their holders certain rights and, possibly, burden them with certain obligations. The exact content of rights and obligations depend on the underlying smart contracts. A DAO can issue different classes of tokens with different rights and obligations.[68] This is a further similarity between a token and a share.

Probably the most important participants' right is the right to vote.[69] At least for now, DAOs are governed by their participants. This is the reason why DAO tokens are also called governance tokens. Participants govern a DAO through their voting activity. Participants can vote on the issues of day-to-day management but also to change the existing DAO rules.[70] Therefore, every DAO must have participants with a right to vote. On the other hand, it is not necessary that every participant has a right to vote. Voting rights could be tied only to a certain class of tokens.[71] A likely example would be that the right to vote belongs only to participants with a strong reputation. Similarly, tokens of a certain class could grant more voting rights than the others.

Smart contracts determine the number of votes needed to reach a decision. Usually, a simple majority will be sufficient, but for structural changes of DAO rules, a supermajority might be required.[72] Potential abuses could be prevented if smart contracts require a certain minimum number of votes (quorum).[73]

The right to vote is also a typical right of a partner in a traditional partnership.[74] Unless partners are authorized to manage the partnership separately,

[67] PA s 24(5); BGB s 709 (1); ABGB s 1189(1); OR art 535(1); it CC art 2258; ZOO art 642.

[68] Sims (n 1), 15; on the example of Dash, Garcia Rolo (n 1) 53.

[69] Garcia Rolo (n 1) 59; Nielsen (n 1) 1111, 1112; Metjahic (n 1) 1554, 1555.

[70] On the example of the DAO, Minn (n 1) 151; Metjahic (n 1) 1555; Sims (n 1) 15.

[71] On the example of Dash, Sims (n 1) 14, 15.

[72] Tse (n 1) 329, 338.

[73] Nielsen (n 1) 1121; Tse (n 1) 335.

[74] BGB s 709; ABGB s 1191; OR art 534; fr CC art 1854; it CC art 2258; ZOO art 642.

management of partnership affairs implies reaching a joint decision by voting.[75] Partners will always have to vote on the basic organizational decisions such as the amendment of the partnership agreement or the dissolution of a partnership.[76] Similarly to DAO participants, traditional partners can have unequal voting rights. At least in certain jurisdictions it is possible to have partners with no voting rights at all.[77]

DAO participants can exercise their voting rights only after a decision has been proposed and submitted to voting. Consequently, the person who has a right to propose a decision wields a significant power. It would be in line with the democratic nature of a DAO that such power belongs to every participant.[78] However, this is not without its problems. If every participant could propose at any time voting on any decision, a DAO could become flooded with proposals.[79] It is likely that the quality of those proposals would not be very high. This could, in turn, lead to voting fatigue and apathy.[80] Malevolent participants could easily abuse such a system by deliberately overproducing nonsensical proposals.

One way to prevent those problems is to limit the right to propose decisions only to certain participants, e.g. those with higher reputation. The other way is to design a special function, a curator or an administrator, and authorize them to eliminate obviously harmful or abusive proposals.[81] However, the existence of such gatekeepers necessarily leads to centralization. Moreover, it raises the question who will supervise their actions.[82] Even if participants have the power to remove a curator,[83] it is doubtful whether they can make an informed decision on their removal.[84]

Furthermore, the participants of a DAO usually have a right to participate in its profits, i.e. to receive dividends.[85] This right will not exist in nonprofit DAOs. On the other hand, in for-profit DAOs this will be the principal reason for

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[75] BGB s 709, OR art 534; it CC art 2258; ZOO art 642(1, 2).

[76] It CC art 2252.

[77] ZOO art 642(3).

[78] Sims (n 1) 15; on the example of the DAO, Minn (n 1) 150.

[79] Sims (n 1) 22.

[80] Tse (n 1) 331.

[81] On the example of the DAO, Garcia Rolo (n 1) 49; Nielsen (n 1) 1110, 1121; Minn (n 1) 150.

[82] On the example of the DAO, Minn (n 1) 153.

[83] On the example of the DAO, Metjahic (n 1) 1555.

[84] On the example of the DAO, Minn (n 1) 154.

[85] Garcia Rolo (n 1) 58, 59; Nielsen (n 1) 1112; Metjahic (n 1) 1556.

participation. Since a DAO's profits will usually be in crypto assets, it is likely that dividends will be in crypto assets as well.[86] Corresponding right also exists in a traditional partnership.[87] Partners agree to jointly operate a business primarily because of the opportunity to share partnership profits.

One of the most distinctive DAO rights or privileges is participants' pseudonymity. Although not the same as anonymity, it enables participants to hide their true identity.[88] Pseudonymity gives DAO participants a unique opportunity to operate a business while retaining their privacy. For that reason, pseudonymity could be one of DAO's advantages when compared to traditional partnerships and companies.

On the other hand, pseudonymity complicates the enforcement of claims against the participants' assets outside of a DAO. In that regard, it has an effect similar to the limitation of liability.[89] Even more importantly, pseudonymity opens a window for nefarious activities.[90] It is not difficult to imagine that criminals could use DAOs to launder money or to finance illegal enterprises.

Pseudonymity might prove to be unsustainable if a DAO was to be recognized by a state legislator.[91] The difficulties in enforcement of claims are not in themselves an insurmountable problem. The legislator could recognize a DAO as a type of a limited liability company.[92] On the other hand, it is not probable that the legislator would want to give up prevention of illegal activities. A halfway solution might be a partial disclosure of identity – that DAO participants disclose their identity only to an official body (e.g. an anti-money laundering office) while remaining pseudonymous on the market. Although even such partial disclosure might go against the original spirit of a DAO, they will have to make certain concessions if they hope to become legally recognized.

In a traditional partnership, partners do not only have rights but also corresponding obligations.[93] One of the main obligations is to contribute to the partnership purpose. This could be done either by financial contributions or by

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[86] Sims (n 1) 19.

[87] RUPA s 202, 401; PA s 24(1); BGB s 722; ABGB s 1195; OR art 533; it CC art 2263; ZOO art 651.

[88] Nielsen (n 1) 1109.

[89] Garcia Rolo (n 1) 71, 72.

[90] Nielsen (n 1) 1110.

[91] Garcia Rolo (n 1) 75.

[92] Nielsen (n 1) 1125.

[93] RUPA s 409; PA s 28, 30; BGB s 705; ABGB s 1182(2), 1189; OR art 531, 5532; it CC art 2253; ZOO art 638.

providing services, usually in the form of managerial activities. This also implies the duty of loyalty and care towards other partners and the partnership itself.[94] Smart contracts will rarely impose obligations on DAO participants. However, they might condition certain results with certain actions. In exchange for a token DAO, participants will often have to transfer their assets to the DAO. Smart contracts might also reward participants with tokens in exchange for voting or providing some other service.[95]

Finally, participants will usually have the possibility to easily exit the DAO. Usually they will do it by selling their tokens on a secondary market. Sometimes, smart contracts enable participants to split from the DAO, and create a parallel organization, often identical to the original one.[96] For an individual participant it should be better to sell their token than to split from the DAO. Namely, if they split from the DAO, the value of their token will probably decrease.

Splitting from a DAO roughly resembles a split-off in a limited liability company and it creates similar problems.[97] Smart contracts will have to decide which assets are transferred to a new DAO and which assets remain with the original one.[98] Also, there is the question of liability for the obligations of the original DAO. At least for now, they should be solved in line with the general rules of joint and several liability in a partnership.[99]

5. MANAGEMENT OF A DAO

The most important feature of DAO governance is that there is no separation of ownership and management.[100] In other words, a DAO does not have a board of directors, a management board, a supervisory board or a comparable organ. A DAO's affairs are entirely managed by smart contracts and the decisions of its participants.

This system of governance is lauded as a DAO's unique advantage over traditional companies. It is designed to eliminate the ubiquitous principal-agent

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[94] RUPA s 409.

[95] On the example of Horizen, Tse (n 1) 327.

[96] Sims (n 1) 23-25; on the example of the DAO, Garcia Rolo (n 1) 50, 60.

[97] Nielsen (n 1) 1126.

[98] Sims (n 1) 25.

[99] ch 6.

[100] Garcia Rolo (n 1) 57; Tse (n 1) 321, 322.

problem and moral hazard.[101] Namely, in traditional companies there is a constant friction between the interests of the board of directors (agent) and the interest of the company (principal).[102] Since there is an information asymmetry in favor of directors, there is a danger that directors will put their personal interests ahead of company interests.[103] This problem is compounded by the possibility that a majority shareholder gains a decisive influence over the directors and that it imposes its will to the detriment of the company and the other shareholders.[104]

In contrast, since DAO's participants manage its affairs, they also bear the risk of their own actions. Consequently, they have an incentive to act in the DAO's best interest. Moreover, at least in theory, a DAO should not have a dominant or a majority token holder.[105] This can be achieved by putting a cap on the number of votes per participant.[106] For those reasons it is often stated that DAO's governance is decentralized and democratic. A DAO's governance is also thought to be meritocratic, especially if the number of votes is tied to a certain reputation.[107] In that way, the participants who are more active in a DAO would have a proportionally greater say in a DAO's affairs.

A closer look shows that the advantages of DAO governance are somewhat overblown. To begin with, the DAO's supposedly original features are not that original. It is true that, unlike in traditional companies, it does not separate ownership and management. However, as already established, a DAO is not a company, but rather an atypical partnership, and it is a standard solution that partners both own and manage the partnership. Moreover, it is quite common that there are no dominant, majority partners. Partners often have equal influence over the partnership affairs.[108] Therefore, from a purely organizational point of view, a DAO's system of governance is hardly new.

Furthermore, it is questionable to what extent a DAO can manage to avoid the centralization and the principal-agent problem.[109] DAO's smart contracts are

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[101] Minn (n 1) 147; on the example of the DAO, Garcia Rolo (n 1) 49.

[102] Shanthy Rachagan, 'Agency Costs in Controlled Companies' (2006) 2006 Sing J Legal Stud 264.

[103] Tse (n 1) 322.

[104] ibid 333.

[105] Sims (n 1) 14; Tse (n 1) 321.

[106] Tse (n 1) 335.

[107] ibid 341.

[108] For US law Garcia Rolo (n 1) 64.

[109] Minn (n 1) 161; Tse (n 1) 323.

usually written by a single organization, the DAO's creator. It can only be hoped that the creator will put the DAO's and its participants' well-being before its own personal interests. This is exacerbated by the fact that the participants will not always be able to understand the underlying smart contracts. Figuratively speaking, after they enter a DAO they are left to the mercy of the code.[110]

Moreover, a DAO will often have a curator or an administrator. Although such a role should be purely administrative, a curator might exert a significant influence by streamlining the decision-making process.[111] E.g. if a curator is authorized to eliminate or to give priority to certain proposals it can easily shape the future course of a DAO's affairs. Centralization will be especially significant if the position of the curator remains under control of a DAO's creator.[112] This problem is only likely to grow in the future when AI could have a greater role in relation to DAO participants.[113]

It also cannot be excluded that one or several participants take over a DAO to the detriment of others. Even if there is a cap to the number of votes or tokens, such limitation can be circumvented if several participants act in concert[114] or if one participant buys votes of the others[115]. As a matter of fact, pseudonimity might facilitate such development because it is difficult to verify the off-chain relationship between DAO participants. A DAO takeover could be especially dangerous because the majority participant(s) could potentially order a smart contract to transfer all of the DAO's crypto assets to its personal account.[116]

For all those reasons, it is not guaranteed that the interests of persons who manage a DAO will be completely aligned with the interests of the DAO itself. On a more abstract level, in every organization diverging interests of participants can lead to a power struggle. As long as human nature stays the same, there is no system of governance which could entirely eliminate those risks.[117]

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[110] Tse (n 1) 329, 330.

[111] On the example of the DAO, Garcia Rolo (n 1) 50; Nielsen (n 1) 1121.

[112] Minn (n 1) 153.

[113] Tse (n 1) 325.

[114] Acting in concert is a usual feature in limited liability companies' takeovers, e.g. Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJL142 art 2(1)(d), 5.

[115] Tse (n 1) 335, 336.

[116] Nielsen (n 1) 1121.

[117] Minn (n 1) 161 who argues that there is no such thing as fully decentralized organization, because even a slight disparity of power will be exploited by the stronger party.

Even if it is achieved that participants manage the DAO in a decentralized way, it is not guaranteed that such management will be optimal. Focusing on the problems between the principal and the agent tends to overlook its numerous advantages. Especially if there are many principals, delegating decision-making to a handful of agents can increase the efficiency and quality of the decisions.[118] It will not be necessary to hold lengthy deliberations and the agents can be chosen based on their expertise. It could even be said that the principal-agent problem is a necessary side effect to an otherwise perfectly rational governance solution.[119]

Technology on which a DAO is based ensures that participants quickly cast votes and that their decision is instantaneously enforced by a smart contract.[120] However, it cannot guarantee that participants are adequately informed[121] and that they have thoroughly discussed the consequences of their decisions. Even if there is a channel for discussion it is almost impossible to have a meaningful debate between hundreds or thousands of pseudonymous people.[122] Additionally, the participants in a DAO will often lack expertise to run a DAO. E.g. if the DAO is designed as an investment fund, most of the participants will lack the training of an investment fund manager. Consequently, it is imaginable that a perfectly decentralized DAO makes all the wrong business decisions.

Further possible problem of DAO governance is the inflexibility of smart contracts.[123] This is not without its purpose. Immutable smart contract ensure that the fulfilment of predefined conditions always leads to same consequences. Thus, smart contracts create a predictable business environment. On the other hand, the inflexibility of smart contracts might prevent a DAO to adapt to new circumstances not contemplated by its creator. The most famous example is one of the first DAOs, "the DAO", whose participants could do nothing to prevent an unknown person from exploiting a weakness in the code and draining its funds.[124]

Moreover, the ideal of decentralized DAO governance presupposes active engagement of its participants. However, this will not necessarily happen,

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[118] Tse (n 1) 323, 324.
[119] ibid 348, 349.
[120] Sims (n 1) 15.
[121] ibid 20.
[122] On the example of the DAO, Minn (n 1) 155.
[123] Tse (n 1) 337.
[124] Minn (n 1) 151; Garcia Rolo (n 1) 51.

especially if DAOs gain in popularity and attract investors who do not share the ethics of the original participants. Especially if there are too many of them, individual participants might conclude that their vote does not make a difference and abstain from decision-making.[125] This can be compared to large companies with dispersed shareholder structure where voter apathy is a common problem.[126] If this happens, a couple of active, coordinated participants could take the DAO over.

Even if it is ensured that participants vote, there is no guarantee that they will take the trouble to study the proposals. They might even vote randomly, just to gain reputational tokens.[127] For all those reasons there is high probability that the DAO's decisions will either be of poor quality or that they will be dictated from a centralized source of influence.

Finally, unlike in traditional companies with many safeguards for protection of the minority, DAO smart contracts will rarely offer minority participants a special protection.[128] If they feel that they cannot make a difference, their best chance might be to sell DAO tokens on a secondary market.[129]

All of the above suggests that a DAO governance model has more disadvantages than advantages. Much time will pass before DAOs become a viable alternative to traditional companies. However, one should also not be too quick to dismiss the DAO altogether. DAOs indeed have a unique advantage in the form of smart contracts' efficiency and their reduction of transaction costs.[130] Even if code is not law, and it cannot eliminate legal disputes, it could prevent a significant number of disputes and serve as an efficient enforcement tool. Consequently, DAOs could become a successful niche option for risk-tolerant investors.

6. RELATIONSHIP TOWARDS THIRD PERSONS AND LIABILITY FOR OBLIGATIONS

In order to achieve its purpose, a DAO will have to enter into legal relationships with third persons. Even if a DAO only invests in crypto assets, it will have to find someone with whom to trade. All the more so, if it undertakes activities in the real, off-chain world it will have to hire contractors, service providers and

[125] Sims (n 1) 22; Tse (n 1) 327.

[126] Tse (n 1) 331.

[127] ibid 22.

[128] Minn (n 1) 149; Tse (n 1) 333.

[129] Sims (n 1) 23; on the example of the DAO, Garcia Rolo (n 1) 50.

[130] ibid (n 1) 16-19.

oracles.[131] Legal relationships with third persons beg the question – who is liable for a DAO's outstanding obligations and debts?

As already demonstrated, in most jurisdictions a DAO satisfies prerequisites for a general partnership.[132] General partnerships usually do not have a legal personality and, as such, they cannot be liable to third persons.[133] Instead, partners are jointly and severally liable for partnership obligations.[134] This means that creditors can choose against which partner or partners to pursue their claim. Thus, it might happen that one partner ends up paying all of the partnership debts. Naturally, such a partner would then have a recourse against partnership assets and other partners.

DAO participants hold partnership interests (tokens), govern the DAO and share its profit. From a legal point of view, it makes perfect sense that they are also liable for its obligations. However, it is likely that DAO's participants would not want to assume such liability.[135] They might consider themselves closer to shareholders of a limited liability company.

There are several tactics DAO's participants might apply in order to escape their liability.[136] One of them is that DAO rules, either smart contracts or white paper, exclude the participants' liability. However, such strategy will probably not be successful. One of the basic rules is that partnership agreement cannot exclude partners' liability towards third persons, at least not without the consent of third persons.[137] Otherwise, third persons could be easily left empty handed, which would undermine the partnership's legitimacy.

Participants could try to exclude their liability through contracts between the DAO and third persons. In that way, third persons would consent to the exclusion of participants' liability. Even if this is allowed under the applicable law, such strategy would still face several problems. Since a DAO deals with third persons through smart contracts, the exclusion of liability would have to be put in code. Code is, however, not capable of recording statements such as the exclusion of liability. Even if the exclusion of liability was somehow coded, it is

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[131] Garcia Rolo (n 1) 60.

[132] See fn 41.

[133] Although see fn 15.

[134] RUPA s 306(1); PA s 9; ABGB s 1199; OR art 544(3); fr CC art 1850; it CC art 2267; ZOO art 648(4).

[135] Nielsen (n 1) 1115, 1116.

[136] Garcia Rolo (n 1) 71.

[137] RUPA s 306(1); ABGB s 1199; OR art 544(3); ZOO 648(3).

doubtful whether it would produce any effects if a third person was not able to understand it.[138] On the other hand, if a third person was able to understand the exclusion of liability, it is likely that it would not give its consent. Without participants' liability third persons would not be able to enforce their claims.

Furthermore, DAO participants could rely on pseudonymity. It would be difficult to file a lawsuit or to enforce a claim against participants if their true identity is not known. Although this strategy might be effective, it has its limits. First, pseudonymity is not the same as true anonymity, and it might be possible to determine participants' identity, especially with the help of the court or other public bodies. Second, the more forcefully a DAO defends full pseudonymity of their participants, more likely it is that state legislators will outright ban it. Although it might continue to exist on the other side of the law, if a DAO wants to gain legitimacy and compete with traditional companies it will have to make certain concessions.[139]

A DAO might choose to play along and establish a traditional limited liability company which would represent it towards third persons.[140] The connection between a DAO and the company could be either strong or weak. If the connection is strong, the company's articles of association could directly refer to DAO rules and DAO's participants could be shareholders in the company. The advantage of such a solution is that the DAO retains direct control over the company. The drawback is that it is questionable whether the applicable *lex societatis* would allow the referral to DAO rules, and, even if it does, the DAO would be affected by the restrictions of national company law. E.g. if *lex societatis* provides that company shareholders can transfer their shares only if the agreement is certified by a public notary, DAO tokens will not be able to circulate on a crypto-exchange.

Therefore, it is more likely that the connection between the DAO and the company will be weak. E.g. the company might have one or several "ordinary" shareholders who contractually agree to carry out DAO's instructions. The drawback of such a solution is that if those shareholders defy the instructions, the DAO and its participants would not have recourse as shareholders, but could only claim damages. In that scenario, the principal-agent problem returns with a vengeance.[141]

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[138] Tse (n 1) 344, 345.

[139] Similarly Oren (n 60) 652.

[140] Garcia Rolo (n 1) 72; Tse (n 1) 353.

[141] Garcia Rolo (n 1) 72.

The question of liability can arise not only towards third persons, but also within a DAO – in the relationship between participants, creator and administrator. It is impossible to anticipate all types of liability, especially because they depend on the applicable law. However, it is likely that the creator's liability could play a prominent role. Namely, the creator is the one who writes smart contracts, which are often unintelligible to DAO's participants. If smart contracts lead to consequences that diverge from what the participants legitimately expected, they might have a damage claim against the creator. Similarly, if it turns out that an administrator or a participant has managerial functions, it might be liable towards (other) participants as a fiduciary.[142] Unlike liability towards third persons, intra-DAO liability could be at least partially excluded by DAO rules.

7. CONCLUSION

The emergence of the DAO challenges many of the existing legal concepts. However, not every feature which purports to be novel is indeed such. Behind the veneer of new technology lurk many traditional governance issues. As long as a DAO is governed by its participants, it will be beset by problems inherent to human nature. People will sooner or later try to exploit the existing rules to promote their personal, selfish interests. Company law and corporate governance have for centuries tried to solve those problems. Although they have come up with admirable solutions, none of them is foolproof. It is illusory to believe that any technology could instantly create utopia in which ideals of participatory democracy reign supreme.

In most of the jurisdictions the DAO satisfies the prerequisites for a general partnership – it has at two or more participants who, at least implicitly consented to achieve its purpose. Apart from technology itself, the main difference from a traditional partnership is that the interests in a DAO are incorporated in the form of governance tokens which in many aspects resemble a share. Namely, tokens allow for a large number of dispersed participants who can easily enter or exit a DAO through ICOs and secondary markets.

DAO's corporate governance resembles that in a traditional partnership because participants both own and manage a DAO, albeit within the limits set by smart contracts. In theory, there should be no dominant source of influence and a DAO's decisions should be a product of participants' synergy. However, even a traditional partnership will sometimes be subjected to the will of a dominant managing partner. This is all the more possible in a DAO, where a single creator

[142] Nielsen (n 1) 1118, 1119, 1121, 1127; Minn (n 1) 161; Metjahic (n 1) 1547.

writes rules for an unknown number of future participants. In such constellation even a purely administrative function can affect a DAO's course of business. Inflexibility of smart contracts could prevent participants from defending against a potential takeover.

On the other hand, the inflexibility of smart contracts becomes advantage when dealing with anticipated situations. Their self-executory nature prevents legal disputes and circumvents the enforcement problems. DLT introduces an absolute transparency and keeps a safe record of all transactions.

It is imaginable that certain jurisdictions grant the DAO the status of a limited liability company. This would be in line with the original intentions of DAO participants and their pseudonymity. In turn, it will have to make concessions to ensure that it is not used for illegal activities. A halfway solution would be that the DAO discloses the identity of is participants to an official body which could vet them against money laundering.

Even if they get recognized by state legislators, it is likely that DAOs will remain a niche investment vehicle for risk-prone investors. In order to seriously compete with traditional companies and partnerships DAOs would have to bridge the gap between the blockchain and the real, off-chain world. Inter alia, states would have to recognize tokenization as a method for transferring real world assets. Hybrid models might also appear in order to mitigate some of the DAO's corporate governance problems. E.g. one could imagine a company with a traditional board of directors who are bound by the decisions of crypto shareholders.

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ALL ACTION, NO TALK? DETERMINING THE EURO'S POLITICAL SALIENCE IN CROATIA[1]

Ass. Prof. Ana Grdović Gnip
University of Primorska
Faculty of mathematics, natural sciences and information technologies
Glagoljaška 8, 6000 Koper, Slovenia
ana.grdovic@famnit.upr.si

Assoc. Prof. Marta Božina Beroš
Juraj Dobrila University
Faculty of economics and tourism "Dr. Mijo Mirković"
Preradovićeva 1/1, 52100 Pula, Croatia
mbozina@unipu.hr

Assoc. Prof. Ivana Bajakić
University of Zagreb
Faculty of Law
Trg Republike Hrvatske 14, 10000 Zagreb, Croatia
ibajakic@unipu.hr

ABSTRACT

The participation in the European Exchange Rate Mechanism (ERM II) in July 2020, marked the beginning of the final phase of Croatia's accession to the euro area. Besides its political significance, this development substantially impacts Croatia's economic and monetary sovereignty. For instance, for at least the next two years the country will undergo strict monitoring and scrutiny in terms of real compliance with the Maastricht convergence criteria. Because of its multifaceted implications this step should have been complemented by equally important debates and discussions about Croatia's 'euro status' between policymakers and the academia, prior to as well as after July 2020. Surprisingly, it seems that the ERM II participation has passed (almost) unnoticed. Against this backdrop, our study inspects the political reflections on euro adoption that took place in the Croatian parliament from January 2019 until September 2020 (included). By scrutinizing a total of 788 parliamentary debates, we present a review on the position and salience on the euro and euro-related topics across Croatian

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parliamentarians. Our results indicate that the euro and its adoption as topics had, and still have, very low salience among Croatian politicians, especially in the period prior to the ERM II accession when these topics were almost non-existent. Moreover, the sentiment toward the euro as a common European currency results to be merely negative across the opposition with the discussion often echoing potentially negative aspects of its potential introduction. Finally, we suggest that the surprising detachment of parliamentary representatives from euro-related topics comes in stark contrast with the government's energetic take toward a fast-track euro accession that we have observed in 2019 and 2020, which is best illustrated by the complete lack of critical reflection of the government's 2018 'Euro strategy'.

Keywords: euro membership, Exchange Rate Mechanism II, parliamentary debates

1. INTRODUCTION

In July 2020, after seven years of full EU membership and almost 30 years of regaining full monetary sovereignty, Croatia has joined the European Exchange Rate Mechanism II (or ERM 2) thus embarking on a new, seminal course on its EU integration trajectory that will, expectedly, lead the country toward euro area membership and therefore, closer political and monetary integration. It is important to note that the question whether Croatia should adopt the euro and therefore join the monetary union was never really an issue, namely, by virtue of international law EU Treaties which oblige all member states (MS) whose accession agreements came into force after the Maastricht Treaty, to adopt the euro and join the eurozone. In this sense, there has never really been a point of inflection for Croatia in terms of whether to join the monetary union, since the obligation is spelled out by Article 5, of Croatia's EU accession agreement, which states that: 'Croatia shall participate in the Economic and Monetary Union from the date of accession as a Member State with a derogation'.[2]

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[2] Treaty between the Kingdom of Belgium, the Republic of Bulgaria, the Czech Republic, the Kingdom of Denmark, the Federal Republic of Germany, the Republic of Estonia, Ireland, the Hellenic Republic, the Kingdom of Spain, the French Republic, the Italian Republic, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Grand Duchy of Luxembourg, the Republic of Hungary, the Republic of Malta, the Kingdom of the Netherlands, the Republic of Austria, the Republic of Poland, the Portuguese Republic, Romania, the Republic of Slovenia, the Slovak Republic, the Republic of Finland, the Kingdom of Sweden, the United Kingdom of Great Britain and Northern Ireland (Member States of the European Union) and the Republic of Croatia concerning the accession of the Republic of Croatia to the European Union [2013] OJ L 300, 11

In short, this means that euro-membership is mandatory for Croatia – as well as for other member states presently outside the euro area and ones who do not enjoy an 'opt-out' privilege (such as Denmark).

However, euro-membership can be postponed until Croatia fulfills all the specific economic, fiscal and legal requirements set out by the 1992 Maastricht Treaty, also known as the Maastricht convergence criteria, which have been designed to ensure economic convergence across member states and thus, a level playing field in the Single Market.[3] Every two years the European Commission assesses if these conditions have been met and publishes its findings in the 'convergence report'.

Regardless of the biannual fitness check, the Commission does not set forth a proscribed timetable to euro-membership, since 'it is up to individual countries to calibrate their path towards the euro' contingent to the 'thorough preparation of the economy' and 'high policy credibility'.[4]

This indicates that not only does euro-membership crucially impact a country's monetary and economic sovereignty, but the road to the euro affects its policy priorities, demanding stronger political engagement and advocacy in a distinct policy area. Considering that euro area participation is a future certainty, one would expect that 'euro area status' would receive extensive and thorough coverage – from an academic, as well as a political aspect, and at least in the years following Croatia's EU accession.

Yet the scholarship on the topic is modest while the political reflection on the complex and multifaceted implications of this crucial step in Croatia's EU trajectory is almost non-existent. It appears that in preparation to delegate monetary sovereignty the topic of euro-membership has seldom absorbed academic minds. It further appears that the larger part of academic literature discussing Croatia with/without the euro, has either been triggered by policymakers or originates directly from the policymaking community. [5]

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[3] For a quick reference guide to the criteria see European Commission, 'Convergence criteria for joining',<https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/convergence-criteria-joining_en> accessed 30 October 2020

[4] Ibidem

[5] See for instance: Mislav Brkić and Ana Šabić, 'Is the euro the optimum currency for Croatia: an assessment using the Optimum Currency Area Theory', HNB Surveys [2018], 18; Tomislav Ćorić and Milan Deskar-Škrbić, 'Croatian path toward the ERM2: why, when and what can we learn from our peers?' [2017] EP, 611; Marijana Ivanov, 'Odnos deviznog tečaja i kamatnih stopa u kontekstu uvođenja eura' [2017] HUB

At the same time, key political actors in Croatia have shown a concerning degree of detachment and almost complete lack of deeper discussion about the euro, which is truly surprising considering the political salience of the issue at hand. Moreover, the detachment comes in stark contrast with the government's energetic advocacy for a fast-track euro accession set in the government's 2018 'Euro strategy'.

Against this backdrop, and in an attempt to open a new venue of relevant scholarship, our paper examines the political reflections on euro adoption that took place in the Croatian parliament from January 2019 until September 2020 (included). Our analytical framework focuses on a very specific instance of one of the differentiation mechanisms in the EU – namely, the euro, and employs a text analysis in evaluating the salience of euro-related topics in Croatian parliamentary debates. Moreover, we dig into a qualitative analysis of the phonograms to grasp the sentiment and feeling toward the euro, differentiated between the ruling party and the opposition. By scrutinizing a total of 788 parliamentary debates we present a review on the position and salience on the euro and euro-related topics across Croatian parliamentarians. Our results indicate that the euro and its adoption as topics had, and still have, very low salience among Croatian politicians, especially in the period prior to the ERM II accession when these topics were almost non-existent. Moreover, the sentiment toward the euro as a common European currency results to be merely negative across the opposition with the discussion often echoing potentially negative aspects of its potential introduction.

2. POLITICAL ACTORS' EURO-RELATED COMMUNICATION IN CROATIA: AN ASSESSMENT FRAMEWORK

Even though euro-membership has been a future certainty from the very beginning of the country's EU trajectory, the first example of strategic political communication in connection to the euro happened only in May 2018, when the government adopted its 'Eurostrategy'.[6] In this document the government mostly argued that the costs of euro-membership are 'small and temporary while the benefits are large and permanent', concluding 'that the benefits of euro adoption

analize; Dubravko Radošević, 'Euro enlargement between convergence and (de)financialization', Social Europe 1 [2017]

[6] The strategy was first published in Autumn 2017, however. See Government of the Republic of Croatia-Croatian National Bank, *Strategy for the adoption of the euro in the Republic of Croatia* [Strategy, 2018]

outweigh the costs in the case of Croatia'.[7] In particular, the government highlighted that euro-membership will completely eliminate the currency risk stemming from the 'high indebtedness of all domestic sectors in foreign currency, predominantly in euros' as well as from the high euroization of the Croatian economy in general, which *in ultima linea* does not only reinforce borrowers' position but also minimizes the risk of a banking or balance-of-payments crisis.[8] Other important benefits such as: lowering interest rates, boosting investments, simplifying cross-border transactions, and so on are also identified. As for the costs of euro adoption, the government suggests that these are largely 'one-off' costs, whose significance is offset by the many long-term benefits that Croatia will enjoy as a euro area country. Yet, considering the political, monetary and legal implications of these costs they should have raised a few eyebrows among scholars in the field – not least political actors. For example, the national central bank's loss of (almost full) policy capacity, that in comparison to other euro area members has somewhat different implications in Croatia because of the high share of foreign ownership of its financial system. Similarly, one would expect that seigniorage or foreign exchange reserves-related revenue, could raise a few contestations or at least demand a more detailed reflection than the one laid down in the 'Eurostrategy'.

Arguably, the government's 'Eurostrategy' as part of a strategic communication measure has the potential to affect public perception on the subject 'in ways that position it not as part of a battle to win hearts and minds for solely political motives (…) but also as a way of building fruitful relations with citizens that have long-term beneficial effects'.[9]

In order to determine if the Croatian government and political actors in general understand the full ramifications and potential of strategic, euro-related communication we need to construct a conceptual and analytical assessment framework.

From the conceptual standpoint, in order to develop such a framework, it is first necessary to appraise how these actors talk about European issues and concerns

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[7] Katharina Allinger, Croatia on the road to euro adoption: Assessing the recent literature on exchange rate misalignments [Oesterreichische Nationalbank-Spezielle Kurzanalysen, 2018]

[8] See Government of the Republic of Croatia-Croatian National Bank, *Strategy for the adoption of the euro in the Republic of Croatia* [Strategy, 2018], 7-8

[9] Karen Sanders and María José Canel, 'Government Communication in 15 Countries : Themes and Challenges', in Karen Sanders (ed) *Government Communication : Cases and Challenges*, [Bloomsbury Academic 2014] 277, 280

in general. To this end, we 'take a step back' and contextualize first, who do we consider under the term 'political actor' and second, what their communication structure or strategy is.

By 'political actors' we consider core governmental actors such as the head of state, the head of government, ministers and all members of parliament irrespective of their partisan-affiliation (i.e. ruling party or opposition). At the national level, government programs are those that set the government's political, economic and societal vision with regard to a country's (European) trajectory, whilst at the intersection between national and supranational politics, heads of state or the government are more likely to discuss a country's distinct place and interests in the context of European affairs. Arguably political actors use different communication strategies to engage different audiences through different communication channels.[10] As we've already noted, in our paper we will focus on communication at a national level as engaged in by members of parliament (MEP). Indeed, parliamentary debates are the primary *loci* wherein one would expect deeper discussions, since this forum allows the government and opposition to confront (at times opposing) views about EU related issues, and therefore echo a wide spectrum of public sentiments concerning the subject of euro area accession in particular.

As for communication structure and strategy, these largely depend on a concrete European issue or concern at hand. For instance, political actors may debate broader, conceptual questions, such as the benefits and pitfalls of specific EU membership or what the future of the Union is. In respect of the latter, various political actors may debate specific mechanisms of integration, such as enhanced co-operation (more integration) and opt-outs (less integration). Finally, on a more practical note, political actors may make politically salient statements on concrete integration instances such as, enhanced co-operation (i.e. Pesco), of opt-outs (i.e. Schengen, Eurozone), EU internal agreements (i.e. ESM), or external agreements (i.e. TTIP). For the purpose of our paper, we focus exclusively on euro-membership as a politically salient but oftentimes contested, instance of the EU integration mechanism. And it is precisely in this context that parliamentary debates allow a better assessment of political actors' positions toward the euro. An additional reason is that parliamentary positions are one of

[10] Karen Sanders and María José Canel, 'Government Communication in 15 Countries : Themes and Challenges', in Karen Sanders (ed) *Government Communication : Cases and Challenges*, [Bloomsbury Academic 2014] 277, 297-280

the more important explanatory factors in the politicization of euro-membership.[11]

3. METHODOLOGY AND DATA

In order to assess the political reflections on euro adoption we used a word search and counting approach across all parliamentary debates from January 2019 until September 2020. We collected phonograms of the debates available on the official webpage of the Croatian Parliament[12] and used Voyant Tools[13] software to perform a quantitative text analysis, while a qualitative analysis followed close readings of specific and relevant debates. The quantitative analysis rests on word counts and word frequency distributions of essential keywords. Namely, we inspected how often the Croatian Parliament discussed euro adoption, the ERM II mechanism, the EMU or other euro-related themes. After we carefully examined the degree of parliamentary discussions about the euro as a currency and euro-adoption relative to other issues, we continued by evaluating if these discussions had a negative, positive or neutral sentiment. We looked at each particular instance when euro-related keywords were mentioned in a certain parliamentary discussion and accordingly evaluated if the 'talk' on the euro meant its rejection (negative sentiment), its embracement (positive sentiment) or whether it was not related to a specific judgment (neutral sentiment). Once this was carried out across all discussions, we presented an average valuation of sentiment as well as an average sentiment differentiated between ruling parties (coalition) and opposition.

Table 1 shows the main characteristics of our corpus. It is possible to note that our analysis includes 788 documents (phonograms), i.e. phonograms of all parliamentary debates in the period from January 2019 until the end of September 2020. This means we covered six sessions of the Croatian Parliament (from session 11 to session 16, to be precise) with session 16 having the largest number of phonograms included (218), while session 13 covers only 14 phonograms. If we consider the total number of words in the corpus, then it is worth mentioning that the whole corpus totals more than 14 million words, with the average number of words per phonogram being almost 15 thousand.

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[11] Anna Leupold, 'A structural approach to politicization in the Euro crisis' [2016] WEP 84, 84

[12] See Hrvatski sabor, 'Rasprave' (Informacijsko dokumentacijska služba) <edoc.sabor.hr/Fonogrami.aspx>

[13] Voyant Tools is an open-source web-based reading and analysis application that is freely available at: <voyant-tools.org>

Table 1. Basic statistics of the corpus

Parliamentary debates (I.2019-IX.2020)	Number of phonograms	Number of words	Average number of words per phonogram
Session 11	178	2.612.946	14.679
Session 12	135	1.666.074	12.341
Session 13	14	3.947	282
Session 14	173	4.463.359	25.800
Session 15	70	1.002.442	14.321
Session 16	218	4.695.634	21.540
Total	**788**	**14.444.402**	**14.827**

Table 2 emphasizes the keyword we look for in the parliamentary debates. Keywords are presented in the Croatian language along with their English translation.

Given that the phonograms of our corpus are in Croatian, it is worth emphasizing that we carefully considered all the declinations when performing the text analysis, therefore our word frequency is accurate in this respect.

The keywords included relate to the adoption and introduction of the euro as a national currency, as well as euro-related word forms such as the Economic and Monetary Union or the Exchange Rate Mechanism.

Table 2. Croatian-English translation of main words/phrases used in text

Croatian	English
Valuta euro	Euro currency
Europsk* valuta	European currency
EUR	EUR
Uvođenj* eur*	Euro introduction
Prihvaćanj* eur*	Euro adoption
Strategij* uvođenj* eura	Strategy for euro introduction
Ekonomsk* Monetarn* Unij*	Economic Monetary Union
Monetarn* Unij*	Monetary Union
EMU	EMU
Euro zon*	Euro Area

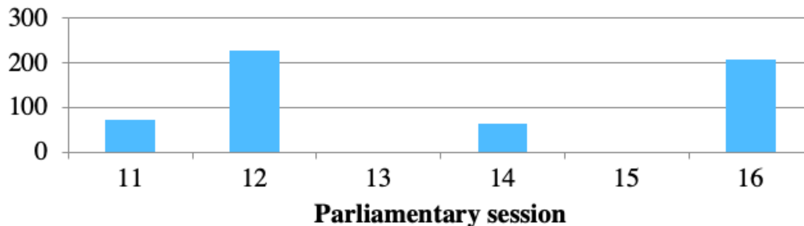
Devizn* tečaj*	Exchange rate
Tečajn* mehaniz*	Exchange rate mechanism
ERM II	ERM II
Čekaonic* za euro	Euro waiting room

Note: * refers to the fact that we consider all declinations of the words in our analysis.

4. RESULTS

Let's first focus on the absolute and relative importance of the word form 'euro introduction' in Croatian parliamentary debates. Figure 1 shows absolute word counts as they appear across the six analysed parliamentary sessions. It is possible to note that the peak occurs during session 12, which corresponds to the period between April and July 2019, followed by 209 instances during session 16, which corresponds to the year 2020. If we take all instances across all the sessions then 'euro introduction' is mentioned (only) 574 times.

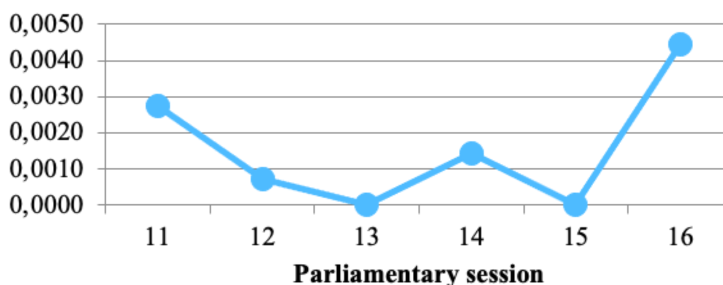
Figure 1 Word count on word form "euro introduction" in parliamentary debates across sessions



This absolute value of 574 times is very low, especially if we take into account the length of the debates that took place. For this purpose Figure 2 shows relative frequencies of the word form 'euro introduction'. Once we consider the total amount of words across Sessions, it is possible to note that euro introduction makes up less than 0,01% of the total words. This indicates that the topic of euro introduction had very low salience and passed almost unnoticed. The parliamentarians' detachment from this crucial subject – not only from the perspective of Croatia's distinct future within the EU integration, but also from the perspective of the future of monetary integration, is absolutely unexpected. Namely, the Economic and Monetary union finds itself at an inflection point considering that fewer countries are remaining as euro area 'outsiders' and there is a trend to deepening the monetary union (for instance, consider the establishment of the Banking union), but at the same time countries that are still

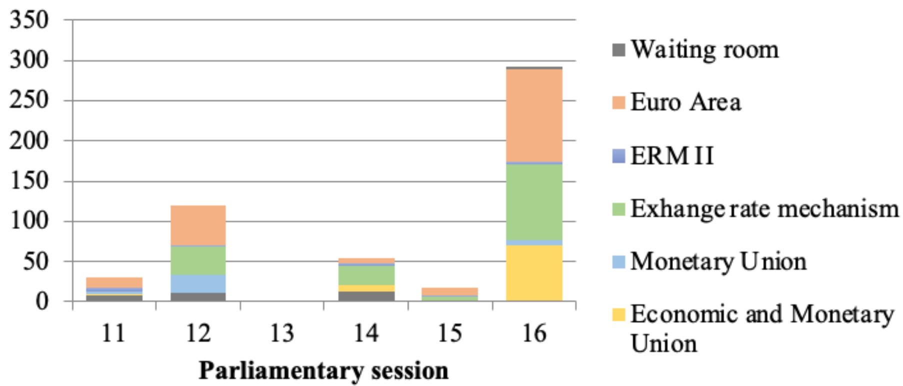
euro area 'Outs' either show no political intention to join the euro area or this possibility has been guaranteed to them by their accession agreements, all of which brings important political, economic and societal implications to the future of the monetary union. In this sense, the lack of parliamentary reflection on this subject in Croatia is concerning and it is a fact that other political actors (e.g. government) need to take into account in implementing the national 'Eurostrategy'.

Figure 2 Relative frequencies of word form "euro introduction"



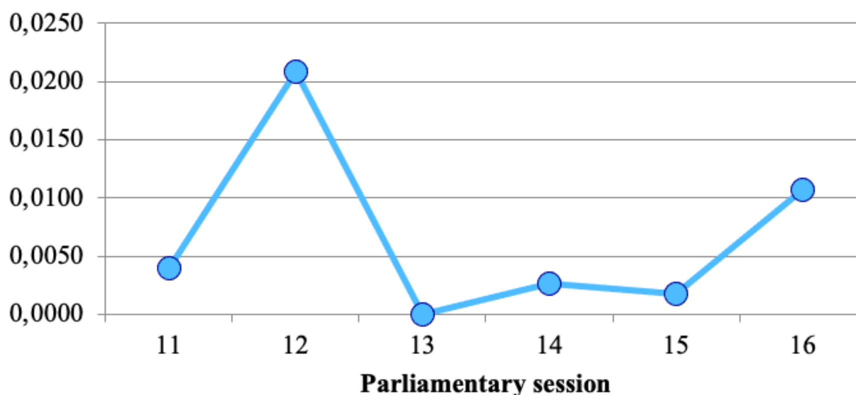
As noted in the previous Section, we analysed the parliamentary phonograms by also inspecting the appearances of other word forms we find linked to the introduction of the euro, such as the Exchange Rate Mechanism or Euro Area. Figure 3 presents absolute frequencies for the related word forms along the parliamentary sessions. It is possible to note, that most of the appearances are again related to sessions 12 and 16, with the word form 'Euro Area' exhibiting highest word counts (in particular, 115 in session 16 which corresponds to the year 2020). The discussions about the Exchange Rate Mechanism II (ERM 2) closely follow the euro introduction debates across all sessions (except session 13 when none of the euro-related topics took place in the Croatian Parliament). Nevertheless, once we include all of the euro-related word forms, salience on euro introductions remains very low given that all euro-related word forms are mentioned 1087 times during the whole period observed.

Figure 3. Word count on euro-related word forms in parliamentary debates across sessions



In relative terms, including all euro-related word forms shows that, relative frequencies are the highest for session 12, although in absolute terms the word count is highest for session 16 (compare Figure 3 and 4). When we inspected the word form 'euro introduction' solely, relative frequencies were then highest for session 16, although in absolute terms that word form appeared more times within session 12 (compare Figure 1 and 2). Once all word forms are included, salience is higher and reaches 0,02% of the word total in session 12, but remains very low, especially if compared to its economic importance. If we consider that parliamentary debates are opportunities to exchange views with parliamentarians about the direction of government policies and to argue in favour of the government's approach to concrete EU-related and economic matters, then it is possible to stress that euro introduction appears as a subject that is 'imposed' top-down, by the ruling party as imminent, rather than one that is primarily 'discussed' in the context of Croatia's preparation for this leg of its future European trajectory.

Figure 4. Relative frequencies for all euro-related word forms in parliamentary debates across sessions



A second step of our analysis aims to give a detailed framework for the quantitative numbers presented in the Figures above. In order to grasp the key political issues underlying the euro-related debates, this qualitative analysis focuses on parliamentary sessions 12 and 16 when most of the instances appear. The qualitative assessment focuses on the word form 'euro introduction' and brings to light the sentiment in which specific parliamentarians mentioned it. Namely, we scrutinize all the speeches where the introduction of the European currency is mentioned and classify the instance between positive, negative and neutral sentiment. Moreover, we distinguish between the sentiment of the ruling party (government) and the opposition, which sheds light on their particular positions regarding this important topic.

Table 3 shows the qualitative assessment regarding 'euro introduction' instances that occurred within session 12 of the Croatian Parliament. As expected, it is possible to note that the ruling party (as of 2020 these are the Croatian Democratic Union (CDU) supported by Croatian People's Party, Reformists and representatives of national minorities) discussed the introduction of the euro in a positive framework, pinpointing its advantages. Discussions of the government were mainly done by the CDU. The opposition results to be mainly against euro adoption, or to be more specific, the opposition's (led by the Social Democratic Party and Bridge of Independent Lists) negative sentiment is two-fold: on the one hand, the opposition is arguing the euro-introduction was not followed by a proper public discussion and eventual referendum but just imposed by the ruling parties, while on the other hand, the opposition expressed potential disadvantages of the introduction of the European currency. Neutral sentiments on both sides, government and opposition, involve parliamentarian's speeches

that do not provide for specific judgment but state facts on euro adoption in other countries and their paths toward such a decision.

Table 3. Qualitative context of 'euro introduction' instances, session 12 of the Croatian Parliament

Session 12 (n=229)	Sentiment		
	Negative	Neutral	Positive
Government	1	31	65
Opposition	94	28	10

If we focus on the opposition then it is important to single out:

- those in request of a proper public discussion:

> *Nikola Grmoja (Bridge of Independent list): "[...] so we believe that the strategy does not have enough legitimacy for the urgent introduction of new legislation because it has not been discussed by the Croatian Parliament. So this continues the practice of uncritically transposing the provisions of the directives of the European Parliament and the Council into Croatian legislation without a real autonomous discussion of their meaning. We believe that a broad consensus should be reached on all issues related to the introduction of the euro in Croatia with a meaningful public debate, and not to propose an important law under the urgent procedure that significantly changes the role and independence of the CNB."*

- those demanding a referendum about delaying the introduction of the euro, as a proper tool to grasp the opinion of the citizens:

> *Škibola Marin (Independent): "Croatian citizens should be offered a referendum on this issue, the referendum on the introduction of the euro was held by much more developed countries than we are, Sweden had it in 2003 and I see no reason why Croatia would not have a referendum on this issue, especially when we see the public does not support the current introduction of the euro, because the public believes that our economy cannot currently withstand such a process and that Croatian citizens will suffer from it."*

- those that are against the government's course of action toward euro introduction:

> *Zekanović Hrvoje (HRAST): "[...] So Sweden also had an obligation to introduce the euro and it did not introduce it, and it did not introduce it because it did not enter the European exchange rate mechanism and it has not entered yet, and still has no euro. And that's the point. So a few days ago, the Ministry of Finance voluntarily, of course with the blessing of Prime Minister Plenković, sent an official letter that we want to enter the European exchange rate mechanism ERM2 and we did not have to. So Croatian citizens were not asked, it was not discussed in the Croatian Parliament. So we have no obligation to introduce the euro, Sweden is the best example."*

If the same qualitative sentiment analysis is performed using the phonograms of the last, 16th session, the structure of points of view between the ruling and opposition parties remains very similar. As Table 4 shows, in 2020 the government speaks about euro introduction from an optimistic point of view, emphasizing its economic and social benefits, whereas the opposition (still) heavily discusses the way the process of introduction is implied and is accompanied with unnoticed discussion of its effects. Most of the instances occur in speeches of the parliamentarians that make the opposition (134 compared to 75), and, even more importantly, the bulk of these discussions include negative feelings about the introduction of the euro (77% of cases, to be precise).

Table 4. Qualitative context of 'euro introduction' instances, session 16 of the Croatian Parliament

Session 16 (n=209)	Sentiment		
	Negative	Neutral	Positive
Government	2	21	52
Opposition	103	21	10

If we single out the opposition's position, the points of view remain the same as the year before, i.e. within session 12. What the opposition additionally emphasises is that a proper discussion, which is lacking, cannot be performed under the exceptional pandemic circumstances and thus the process of the introduction of the euro adds in arguments in favour of its delay:

> *Škibola Marin (Independent): "Today, in this period of crisis with the pandemic, amendments to the laws related to the implementation of the euro in the Croatian monetary system are coming to the Croatian Parliament. This is not good at all because the introduction of the euro*

> *is a process that requires the involvement of citizens, the involvement of the profession and the involvement of all other relevant actors. Therefore, these discussions of the Croatian Parliament on the introduction of euro, when there is a great crisis with the corona virus and that the eyes of the public are focused on Covid-19 is very bad, very bad that you have chosen now this timing for these laws."*
>
> *Vesna Pusić (GLAS): "3 laws, the CNB, credit institutions and rehabilitation of credit institutions and investment companies. In my opinion, we should not be ashamed nor justify all 3 laws at all; they all go in the direction of accelerated harmonization with the European Monetary Union regulation and accelerated preparation for the introduction of the euro. As many have said of course we don't know what the world will be like after the corona virus, what will happen, anything can happen, this same no one could have predicted."*

Other parliamentarians from the opposition try to emphasize advantages of being an EU member, but not entering the Euro Area, implying economic benefits of not adopting the European currency:

> *Ivan Lovrinović (Change Croatia): "On the other hand, look at Poland, the Czech Republic, Hungary, which have kept their currencies, they have the highest GDP growth rates within the EU. Well, that's a strong message to us, so Britain didn't want to accept the euro, Sweden as well, the Czech Republic, Poland, Hungary don't talk about it at all, so let's be smart people. I call on you Social Democratic Party to resist this and say no to the euro for some time."*

To summarize, if we compare Tables 3 and 4 the position in the Croatian Parliament with respect to the topic of euro introduction did not change much. The majority of the speeches from the ruling party embrace positive views of how the government is processing this relevant economic decision, while most of the speeches given by the opposition argue the method, timing as well as a lack of involvement and discussion.

The opposition basically reiterates that the government's process toward euro introduction is too fast and does not follow the willingness of the majority but just the decisions of the 'political elites'.

5. CONCLUSION

The final phase of Croatia's accession to the euro area began in July 2020. Besides its political significance, this process impacts Croatia's economic and monetary sovereignty. Yet the scholarship on the topic is modest while the

political reflection on the complex and multifaceted implications of this crucial step in Croatia's EU trajectory is almost non-existent. It appears that in preparation to delegate monetary sovereignty, the topic of euro-membership has seldom absorbed academic minds. It further appears that the larger part of academic literature discussing Croatia with/without the euro has either been triggered by policymakers or originates directly from the policymaking community. Our study analyses parliamentary debates and discussions about Croatia's 'euro status', expecting that the multifaceted implications of euro introduction should have been complemented by equally important dialogues. Surprisingly, it seems that the ERM II participation has passed (almost) unnoticed. By scrutinizing a total of 788 parliamentary debates (from January 2019 until September 2020) we find that euro-related speeches in the Croatian parliament had low salience and very low frequency distributions (below 0,02% overall). Moreover, the sentiment toward the euro as a common European currency results to be merely negative across the opposition, with the discussion often echoing the lack of public debates and citizens' possibility to express their opinion on euro-introduction, both often supported by potentially negative aspects and other country-case studies. Surprisingly, the detachment of parliamentary representatives from euro-related topics comes in stark contrast with the government's energetic take toward a fast-track euro accession that we observed in 2019 and 2020, which is best illustrated by the complete lack of critical reflection of the government's 2018 'Euro strategy'.

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At the beginning of the second decade of the 21st century European citizens and policymakers did not imagine that in the years before them the Union's knitting will be strained by differentiation demands and fragmentation effects that will profoundly affect the field of economic governance challenging, at times, the Union's financial stability. The ambitious and skillful guidance of the EU political and policymaking community allowed preserving the integrity of the European financial system through the establishment of new mechanisms for closer cooperation of EU member states, such as the Banking Union or the Capital Market Union. At the same time, each of these crisis-driven mechanisms has to fulfill its integrative scope while remaining responsive to current market challenges that are primarily presented by a fast-developing FinTech industry and a (currently) underdeveloped RegTech response.

This is the societal, political and economic backdrop that framed the Jean Monnet International Scientific Conference on 'EU Financial Regulation and Markets: Beyond Fragmentation and Differentiation'. Held as an online event due to the 2020 global pandemic, the conference - a direct deliverable of the Jean Monnet European Module on "EU Financial Markets and Regulation" at the Faculty of Law, University of Zagreb – gathered international scholars and policymakers whose papers looked beyond the current pressures of differentiation and fragmentation, reflecting on a future with perhaps less uniform political integration but more societal and economic solidarity. Our ambition as editors of this book of conference proceedings is to convey the brilliant atmosphere that defined the Jean Monnet conference as well as to provide intellectual encouragement needed to venture into reflection on the motives of, and solutions to, differentiation demands and fragmentation effects that will surely continue to shape European economic and financial governance.