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Regulating Multinational Banks in Europe: An Assessment of the New Supervisory Framework

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Abstract

In this paper, we examine recent developments and new perspectives of European banking regulation from the viewpoint of multinational banks. Our approach is justified on at least three grounds. First, cross-border banking groups were at the centre of the recent financial turmoil, which seriously affected many of them. Second, and as a consequence, recent reforms in Europe and elsewhere were particularly addressed to cross-border banking groups and other systemically relevant institutions. Third, European harmonization was largely built along the model of the (stand-alone) cross-border bank mainly operating through branches, whereas European financial markets see cross-border banking groups with subsidiaries in several countries as major players. After introducing the mismatch between national banking supervision and international banking groups, we analyze the recent developments of EU cross-border supervision with respect to both branch and subsidiary structures of multinational banks. Subsequently, we examine the proposed new regulatory architecture, which is based on the distinction between macro- and micro-prudential supervision, and includes new European bodies and a network of European financial supervisors. We claim that the proposed new European supervisory architecture should be backed with an appropriate framework for crisis management and resolution. Due to the specificities of multinational banks and the unique features of their corporate governance, we argue for uniform rules and a set of tools for early intervention and resolution. Otherwise, fragmentation of ailing institutions along national borders will limit the scope for and possibly lead to a reversal of the European financial integration process. From this perspective, the steps taken so far in the EU, while remarkable, do not seem sufficient. Moreover, their effectiveness very much depends on how crisis management and resolution will be regulated.

Keywords: multinational banks, cross-border banking, banking regulation, prudential supervision, corporate governance of banks, crisis management, systemic risk, financial crisis

JEL Classifications: G21, G28, G33, G38, K23

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I. Introduction

In this paper, we examine recent developments and new perspectives of European banking regulation from the viewpoint of multinational banks[2]. Our approach is justified on at least three grounds. First, cross-border banking groups were at the centre of the recent financial turmoil, which seriously affected many of them. Multinational banks' are, relative to domestic banks, more exposed to wholesale funding and capital market related activities, which were most affected by the financial downturn[3]. Indeed, on the one hand the interbank market dried up during the crisis, making short term funding more difficult for multinational banks and thus causing major problems to their liquidity management. On the other hand, trading revenues, which made up a significant part of their total operating income, "fell as capital market conditions were very unfavourable, causing further substantial markdowns on structured finance portfolios"[4]. The collapse in 2008 of some of the largest multinational banks and financial institutions and the bail-outs which followed both in the United States and in Europe put the model of cross-border banking, which seemed to dominate over the last decade[5], under pressure[6]. Moreover, national fragmentation of regulatory

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[2] In this paper, we refer as 'multinational banks' to banking firms operating though branches and subsidiaries in several countries. See G Calzolari and G Loranth, "Regulation of Multinational Banks. A Theoretical Inquiry" ECB Working Paper Series No. 432/January 2005, available at: http://www.ecb.int/pub/pdf/scpwps/ecbwp431.pdf (last accessed March 2010); G Barba Navaretti, G Calzolari, A Pozzolo and M Levi, "Multinational Banking in Europe: Financial Stability and Regulatory Implications. Lessons from the Financial Crisis", March 2010, forthcoming, Economic Policy. While we focus mainly on banks, many of the observations we will touch upon in this paper may also apply to non-bank financial institutions and financial conglomerates.

[3] See ECB, "Financial Integration in Europe" April 2009. Available at http://www.ecb.eu/pub/pdf/other/financialintegrationineurope200904en.pdf (last accessed March 2010).

[4] See ECB, Financial Stability Revue, December 2008. Available at http://www.ecb.int/pub/pdf/other/financialstabilityreview200812en.pdf. (last accessed March 2010)

[5] G Barba Navaretti, G Calzolari, A Pozzolo and M Levi, (cit. note 2) 5 et seq.

[6] See J Dermine and D Schoenmaker, "In Banking, Is Small Beautiful?", in Financial Markets, Institutions & Instruments, Vol. 19, Issue 1, February 2010, reporting that calls are being heard to 'cap the size of domestic banks': see, for example P Volker, "Statement before the Committee on Banking, Housing, and Urban

requirements and supervision made the identification and assessment of risks more difficult and, consequently, cross-border crisis management and resolution measures could not be effectively taken. Therefore, the only feasible option to address crisis situations, in order to avoid systemic disruption, was the national bail-out of ailing institutions. This, in turn, threatens to reverse the financial integration process, as national solutions prevail over international cooperation and credit and liquidity risks affect cross-border activities more profoundly than domestic ones, due to increased information asymmetries[7].

Second, and as a consequence, recent reform proposals in Europe and elsewhere were particularly addressed to cross border banking groups and other systemically relevant institutions[8]. The proposed reforms include regulatory measures imposed on cross-border institutions, such as higher capital requirements; limitations to their size or to the activities banks may engage in (i.e. return to narrow banking); organizational and governance requirements, such as better risk and liquidity management and recovery plans; and measures addressed to regulatory and supervisory infrastructures, such as a single rule book, (more) centralized supervisory architecture, cross-border cooperation and coordination mechanisms between authorities, resolution plans and burden sharing agreements. While not denying that certain changes in regulatory requirements may be justified, and that there is still room for enhancements in the governance of financial institutions, we argue that major reforms in the regulatory and supervisory architecture are essential to fill the gap between the cross-border scope of multinational banks' activities and the national character of their regulation and supervision.

Affairs of the United States Senate", Washington, DC February 2, 2010, available at: http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=ec787c56-dbd2-4498-bbbd-ddd23b58c1c4 (last accessed March 2010).

[7] See ECB, "Financial Integration in Europe" April 2009, for an empirical analysis of the impact of the recent financial turmoil on the financial integration process.

[8] For a definition of systemic importance, see IMF, BIS, FSB, "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments", November 2009.

Third, traditional European harmonization was largely built along the model of the (stand-alone) cross-border bank mainly operating through branches, whereas European financial markets see cross-border banking groups with subsidiaries in several countries as major players. Economic literature shows the costs and benefits of cross-border operations through branches and subsidiaries[9]; however, current regulation neither allows for institutions to grasp the full benefits of subsidiary structures, nor makes them internalize the full costs due to branch structures. In particular, centralized group management and (fully) consolidated supervision are not permitted for European multinational banking groups with a subsidiary structure. Conversely, the European single license and mutual recognition do not take into consideration risks and possible negative externalities in host Member States, due to the crisis of foreign owned and supervised branches. The newly proposed European regulations partially address similar loopholes, providing for more convergence of subsidiary and branch structures.

In the next section, after introducing the mismatch between national banking supervision and international banking groups, we analyze the recent developments of EU cross-border supervision with respect to both branch and subsidiary structures of multinational banks. We argue that the lack of an appropriate framework for effective cross-border supervision and crisis management and resolution is itself a major source of systemic risk. Since the1975 Basel Concordat cross-border and consolidated supervision have been addressed at international and European level. However, the progress achieved did not keep pace with market globalization and cross-border activity of multinational banks and financial institutions. The recent crisis has underlined the weaknesses of the current regulatory and supervisory framework, based on minimum harmonization of prudential requirements and supervisory powers and cooperation between national authorities. Similar

[9] See, for example, G Dell'Arriccia and R Marquez, "Risk and the Corporate Structure of Banks", (March 1, 2008), forthcoming, Journal of Finance. Available at SSRN: http://ssrn.com/abstract=1124528. (last accessed March 2010).

shortcomings have been addressed at European level, providing European authorities with enhanced mechanisms of cooperation and, to a certain extent, more centralized powers to the consolidating supervisor of cross-border groups. In the third section, we examine the proposed new regulatory architecture, which is based on the distinction between macro- and micro-prudential supervision, and includes new European bodies and a network of European financial supervisors. This new architecture will be addressed to the banking and financial system in general, but its impact will be felt particularly by multinational banks and systemically relevant institutions. In the fourth section, we examine the current regulatory framework for cross-border early intervention, crisis management and resolution and comment upon new possible tools which should be made available to authorities. We suggest that, due to the specificities of multinational banks and the unique features of their corporate governance, similar devices would be essential for effective cross-border (and consolidated) supervision. Moreover, they would complement supervisory powers in the going concern with a set of regulatory actions in the gone concern. Furthermore, governments and authorities should be provided with alternatives to the bail-out of ailing institutions, which could allow for a reduction of systemic disruption without hampering market discipline. This, in turn would preserve the stability of the financial system without increasing moral hazard in systemically relevant institutions and their creditors. The fifth section concludes.

II. Cross-border supervision of banks

1. A lesson from the crisis: global in life, but national in death

The recent financial crisis highlighted the mismatch between cross-border banks' business operations and the national scope of their supervision[10]. Financial markets integration[11] and globalization contributed to the creation of cross-border banks and banking groups, which became major players in the global financial sector[12]. In Europe cross-border banks and banking groups played a significant role in promoting the integration and competitiveness of the retail banking sector[13], contributing to the development of the European Single Market. Nonetheless, supervision

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[10] See the European Commission "Commission Staff Working Document to the Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management" (COM (2008) 602 final) 102, recognizing the "misalignment between nationally-based supervision and cross-border nature of banking groups". The document is available at http://ec.europa.eu/internal_market/bank/docs/regcapital/impact_assessment_en.pdf (last accessed March 2010).

See also G-30, "The structure of Financial Supervision Approaches and Challenges in a Global Marketplace" (2008), acknowledging that "a number of supervisors interviewed expressed concern that the international architecture of supervisory coordination and communication has not kept up with the changes in the nature and structure of the global financial marketplace. Supervisors worry that the current ad hoc international coordination system may not be able to handle the failure of a systemically important global financial firm and the concomitant tremors such an event would send around the world" (p.12), available at: http://www.group30.org/pubs/GRP30_FRS_ExecSumm.pdf (last accessed March 2010).

[11] See the European Commission, Financial Integration Monitor, Background document (2005), defining financial integration as "a process, driven by market forces, in which separate national financial markets gradually enter into competition with each other and eventually become one financial market, characterised by converging prices, product supply and converging efficiency/profitability among the financial services providers. Several distinct and parallel channels can further financial integration, namely: cross-border ownership, establishment or cross-border service provision" 1. Available at: http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/050708background.pdf (last accessed March 2010).

[12] See the European Commission (COM (2008) 602 final), cit. (note 1) 12, underlining how "in 2006, total assets of credit institutions in the EU were €36,894 billion (almost thrice the GDP of the entire EU). The European banking landscape is dominated by large cross-border groups: in 2005, 46 groups held about 68% of EU banking assets".

[13] See the European Commission "Report on the retail banking sector inquiry" Commission Staff Working Document accompanying the Communication from the Commission – Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report) [COM(2007) 33 final], 31 January 2007, available at: http://ec.europa.eu/competition/sectors/financial_services/inquiries/sec_2007_106.pdf, (last accessed March 2010). Evidence shows how retail banking is the less integrated financial sector at European level. See also ECB, 'Indicators of Financial Integration in the Euro Area', (September 2006) http://www.ecb.int/pub/pdf/other/indicatorsfinancialintegration200609en.pdf,(last accessed March 2010); L

and, to some extent, regulation[14] of banks were considered essentially a national matter. This was even more true for crisis resolution and winding up of banks[15]. Although coordination and cooperation mechanisms between national supervisory authorities were in place, those have proven ineffective and/or politically unfeasible[16]. During the recent crises of cross-border banks, fragmentation at national level was a great obstacle to the prompt identification and addressing of risks and efficient crisis management and resolution[17]. Members States were forced to bail out cross-border banks to avoid the worsening of the crisis, with great costs to deposit guarantee schemes and the disruption of payment systems. This led to the consideration that bailout would be the only viable way, due to the size of banks (too big to fail)[18], their complexity (too complex to

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Vajanne, 'Integration in euro area retail banking markets', (2007) Bank of Finland Research Discussion Papers 27/2007 http://www.bof.fi/NR/rdonlyres/DF1FAB26-F911-4796-9E71-8084D0462A7F/0/0727netti.pdf, (last accessed March 2010).

[14] Harmonization of prudential regulation through international standards set by the Basel Committee and implemented by the European Directives (in particular the Capital Requirement Directive 2006/48, hereinafter CRD), still leaves Member States with wide discretionary powers in implementing the rules. See the European Financial Services Round Table (EFR), "Monitoring Progress in EU Prudential supervision" (September 2007) 29 et seq. Moreover, relevant areas (e.g. insolvency law) have not been harmonized yet.

[15] As the Governor of the Bank of England Mervyn King pointed out "global banking institutions are global in life, but national in death". See FSA, 'The Turner Review: A regulatory response to the global banking crisis' (the Turner Review) (March 2009) http://www.fsa.gov.uk/pubs/other/turner_review.pdf, (last accessed March 2010) 36.

[16] For an assessment of the effectiveness of the coordination and cooperation framework in Europe for the safeguard of financial stability, see: M Nieto, G Schinasi, "EU Framework for Safeguarding Financial Stability: Towards an Analytical Benchmark for Assessing its Effectiveness", IMF Working Paper, WP/07/260 (2009).

[17] See the cases of Fortis and Dexia. For a brief case study on Fortis see: M Cihack and E Nier, "The Need for Special Resolution Regimes for Financial Institutions – The Case of the European Union", IMF Working Paper, WP/09/200 (2009). The main facts of the Fortis case can be retrieved from: http://www.holding.fortis.com/general/history.asp (last accessed 31 Oct. 2009). For brief case studies on Fortis, Dexia, Kaupthing and Lehman Brothers see Basel Committee, "Report and Recommendations of the Cross-border Resolution Group" (September 2009) 10 et seq.

[18] See W Buiter, "Too big to fail is too big", FT of 24 June 2009, emphasising that while complexity, interconnectedness and international scope of business may contribute to the creation if systemic risks, the fundamental issue is size. The article is available at: http://blogs.ft.com/maverecon/2009/06/too-big-to-fail-is-too-big/ (last accessed March 2010). For the debate on this issue in the US, see: D Delamaide, "Size

fail) and systemic implications (too interconnected to fail)[19] or, even, the number of ailing banks (too many to fail)[20]. The perception that, under those circumstances, governments were to bail out banks in any case generated moral hazard problems in banks and their creditors, harming market discipline[21]. Moreover, the absence of an adequate supervisory framework caused market participants and consumers to lose confidence in the cross-border banking model, so compromising its survival.

The size of a cross-border bank can be (and in fact was) an obstacle to its resolution and bail out by a single Member State (too big to save)[22], especially where the Member State and its deposit guarantee scheme are relatively small as opposed to the size of the ailing bank[23]. Complexity, on the

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matters: Washington debates limits, divisions and breakups for banks", FinReg21 (posted 12 November 2009). Available at: http://www.finreg21.com/news/size-matters-washington-debates-limits-divisions-and-breakups-banks (last accessed March 2010).

[19] See an incisive summary of these issues and possible solutions in an article by Bob Wessel, "Three Theories on Solving the 'Too Big to Fail' Problem", WSJ 29 Oct. 2009, page A12, available also online at: http://online.wsj.com/article/SB125668497563411667.html (last accessed March 2010). For the recently debated definition of systemic significance of banks, due to size but also other factors such as complexity and interconnectedness see J Thomson, "On Systemically Important Financial Institutions and Progressive Systemic Mitigation," Federal Reserve Bank of Cleveland Policy Discussion Paper 27 (August 2009) available at: http://www.clevelandfed.org/research/policydis/pdp27.pdf ; and J Thomson an J Haubrich, "Too Big to Fail and the Definition of Systemic Significance" on FinReg 21, available at: http://www.finreg21.com/news/too-big-fail-and-definition-systemic-significance (both last accessed March 2010).

[20] See V Acharya and T Yorulmazer, "Too Many to Fail - An Analysis of Time-Inconsistency in Bank Closure Policies", Bank of England Working Paper No. 319; London Business School IFA Working Paper (2007). Available at SSRN: http://ssrn.com/abstract=626242 (last accessed March 2010).

[21] See J E Stiglitz, "Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions" (21 April 2009) available at: www.jec.senate.gov (last accessed 31 Oct. 2009).

[22] Ibid., Stiglitz argues that the largest financial institutions have reached a size that made them "not just too big to fail but also too big to save and too big to manage" (p. 5).

[23] In the crisis of Icelandic banks, the government was not able to meet the liabilities arising to the Icelandic deposit guarantee scheme. In the case of Landesbanki, given the size of its cross-border operations though branches (£4.5 billion of retail deposits outstanding at the time of failure in the UK only), the total initial costs of retail depositor protection arising from the collapse of Landsbanki's UK branch were therefore met by the UK government and the UK Financial Services Compensation Scheme (FSCS). See the Turner Review (cit. note 15) 37. In the case of Kaupthing, a bank operating mainly across borders through

other hand, can make coordination of public intervention among Member States very difficult[24], with collective action problems. This can lead to delays where urgent decision-making is required and to under-provision of public funds, with increased social costs from the crisis[25]. The absence of an appropriate supervisory framework and crisis management for cross-border banks, therefore, is itself a major cause of systemic risk[26]. Recent proposals for either increased regulatory capital requirements[27] or break-up of large cross-border banks try to address this problem[28]. However, similar measures increase the overall cost of banking services[29] (which will be shifted to

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subsidiaries and branches, the group's business was split along national lines and ring fenced, with the national deposit guarantee schemes having to cover the bank's liabilities vis-à-vis depositors within national borders, irrespective of the legal structure of the established entity (branch or subsidiary). See Basel Committee (2009) cit. (note 17) 12-13.

[24] Complexity is recognized as an obstacle to effective crisis management and orderly resolution by the Basel Committee (2009) cit. (note 17) Recommendation 5.

[25] M Nieto, G Schinasi (2009) cit. (note 16).

[26] See the IMF, BIS, FSB, cit. (note 8) 7, acknowledging that "robust crisis resolution frameworks and clearing and settlement systems can mitigate the potential externalities on the rest of the financial system due to failures in institutions and markets. The presence (absence) of such elements may act as potential mitigants (amplifiers) of the systemic importance of institutions, markets or instruments in the financial system". The document is available at: http://www.bis.org/publ/othp07.pdf?noframes=1 (last accessed March 2010).

[27] A similar solution has been adopted in Switzerland, where the two largest banks will be required to hold in "good times" 200% of the minimum capital ratio required by Basel (i.e. 16%). The buffer will then be (partially) available in "bad times" when the ratio is reduced to 150% (i.e. 12%). Such additional capital requirements will have to be complied with gradually until the year 2013. See the Swiss Federal Banking Commission Decree, November 2008. Available at: www.finma.ch/archiv/ebk/e/publik/medienmit/20081204/mm-em-leverageratio-20081204-e.pdf (last accessed March 2010).

[28] Similar solutions are discussed by the FSA, "Turner Review Conference Discussion Paper, October 2009", available at: http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf (last accessed 14 Nov. 2009). See also the literature and comments cited above (notes 17-18).

[29] See C. Furfine, "Evidence on the response of US banks to changes in capital requirements", BIS Working Papers 88 (2000), available at: http://www.bis.org/publ/work88.pdf (last accessed March 2010). Also FSA "Turner Review Conference Discussion Paper, October 2009", cit. (note 28) in the Annex 2 "A possible approach to the CBA of prudential requirements" (page 2) admits that "higher prudential standards affect the cost of capital in the economy by increasing the gap between borrowing and lending rates in the UK

consumers) and hamper market integration. Effective cross-border supervision and crisis management would be a more efficient solution, as it could allow for risky banks to be identified earlier and more properly. Measures would be taken ad hoc and only where needed, making risky banks (their managers, share- and bondholders) internalize the (social or systemic) costs of their risky activities.

2. Cross-border consolidated supervision

Cross-border supervision of banks was addressed both at international and European level, seeing its importance increase over the last decades. Starting with the 1975 Concordat, the Basel Committee set guidelines for consolidated supervision of cross-border banks[30]. These were aimed, initially, at emphasizing the importance of cooperation between authorities in the supervision of banks operating internationally. The 1975 Concordat pointed out the different responsibilities of home (or parent) and host authorities, depending on the legal structure of cross-border banking establishments[31] and the different areas of prudential supervision[32]. The 1983 Concordat (which replaced the 1975 one) underlined the importance of adequate consolidated supervision, as a result

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economy and the ultimate cost of financial intermediation in the economy (the 'lending wedge'), which in turn may lower UK capital formation and production".

[30] See the Basel Committee, "Report to the Governors on the Supervision of Banks' Foreign Establishments" (1975); Id. "Consolidated Supervision Of Banks' International Activities" (March 1979); Id. "Principles for the Supervision of Banks' Foreign Establishments" (May 1983); Id. "Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments" (July 1992); Id. "The Supervision of Cross-Border Banking. Report by a working group comprised of members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors" (1996); Id. "High-level principles for the cross-border implementation of the New Accord" (August 2003); Id. "Home–host information sharing for effective Basel II implementation" (June 2006).

[31] The relevant establishments might consist of either branches, subsidiaries or joint ventures.

[32] Reference is made to liquidity, solvency and foreign exchange positions.

of the right allocation of responsibilities between home and host authorities, cooperation and information exchange. In 1992, the Basel Committee set "Minimum standards for the supervision of international banking groups and their foreign establishments" suggesting that (i) each cross-border bank or banking group should be supervised by a home country authority that capably performs consolidated supervision; (ii) the creation of cross-border establishments should be authorized by the host country, the home country and (if different) the consolidating authority; (iii) home country authorities should possess the right to gather information from cross-border establishments and host authorities; (iv) the host authority should be able to impose restrictive measures (including denying or revoking authorization) on cross-border establishments, if it determines that the home authority does not satisfy minimum standards of prudential supervision. Moreover, the relevant flows of information within group entities and home and host supervisors were specified, the relevant obstacles addressed[33] and criteria for the assessment of effective capability of supervision by foreign home authorities laid down[34].

More recently, the impact on consolidated supervision of centralized key functions within a banking group was addressed. The Basel Committee suggested in 2003 that, where "mind and management" are centralised in a banking group, "the host country supervisor may choose to rely entirely on approval work conducted by the home country supervisor" so as to avoid overlaps in supervision, preserve authorities' supervisory resources and reduce implementation burdens for cross-border banks[35]. Indeed, in similar circumstances "the home country supervisor will probably be better placed to lead approval work"[36].

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[33] See Basel Committee (1996), 8; and Id.(2006), cit. (note 30).

[34] Ibid., 17.

[35] See also the European Commission (COM (2008) 602 final), cit. (note 10) 12, suggesting that "current nationally-based supervision risks delivering a collection of customized and 'goldplated' national rather than a single set of best EU prudential policies and practices. This generates additional compliance costs for large

At European level, those guidelines were implemented through the Banking Directives and are now contained in the CRD[37]. Moreover, the Treaty's fundamental freedoms (concerning movement of capital, provision of services and right of establishment), as reflected by the single license and mutual recognition regimes, further contributed to the extension of banking services across borders[38]. This was accomplished mainly through the establishment of subsidiaries and branches by cross-border banks[39]. While subsidiaries are legally separated entities, facing limited liability under their national law, branches are not legally separated from their head office and face joint liability. The choice between subsidiaries and branches for cross-border operations has a deep impact on the supervision of the entities involved[40] and their regulation, particularly in crisis. In fact, subsidiaries are regulated and supervised by the authorities of their State of incorporation, and to a limited extent by the consolidating supervisor of their parent credit institution[41]. Full consolidation of supervision on a cross-border group[42], with prudential requirements applying to the group as a

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cross-border financial institutions that have increasingly reorganised their internal organisational set-up, especially by centralising important business functions such as risk and liquidity management".

[36] See Basel Committee (2003), cit. (note 30), Principle 5, p. 7.

[37]The Capital Requirements Directive (CRD), comprising Directive 2006/48/EC and Directive 2006/49/EC, was published in the Official Journal on Friday 30 June 2006. In the following, if not otherwise specified, we will refer as CRD to Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.

[38] See M Dassesse, S Isaacs and G Penn, "EC Banking Law" (2nd edn, LLP, London 1994) 77 et seq.

[39] Subsidiaries are controlled companies that are incorporated within (and authorized by) the State where their registered office is located, whereas branches are offices (without legal personality) that operate in the host Member State under the laws and upon authorization of the home Member State where the head office of the bank is incorporated.

[40] See recital 21 of the CRD stating: "Responsibility for supervising the financial soundness of a credit institution, and in particular its solvency, should lay (sic) with its home Member State. The host Member State's competent authorities should be responsible for the supervision of the liquidity of the branches and monetary policies. The supervision of market risk should be the subject of close cooperation between the competent authorities of the home and host Member States."

[41] See articles 124 et seq. of the CRD

[42] See article 69 of the CRD.

whole on a consolidated basis rather than to subsidiaries individually[43], is left to Member States as an option and subject to several conditions, including that assets are promptly transferable between group entities[44]. However, Member States may limit the consolidated application of prudential requirements to nationally authorized parent institutions and their domestic subsidiaries, while asset transfers between group entities face several obstacles in the banking, company and insolvency laws of Member States[45]. Moreover, in the case of a crisis, separate insolvency procedures may be started for each subsidiary according to the laws of its State of incorporation (as foreseen by Directive 2001/24 on the reorganization and winding up of credit institutions), with ring fencing of assets at subsidiary level.

Branches, on the contrary, are supervised by the home state authority[46] and only to a limited extent by the host supervisor[47]. Areas in which host authorities retain responsibility (together with the

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[43] Article 69 of the CRD exempts subsidiaries from compliance on an individual basis with the following prudential requirements: governance and organizational structure (article 22 of the CRD), minimum level of own funds (article 75 of the CRD) and large exposures (Section 5 of the CRD).

[44] The following conditions are foreseen by article 69 CRD:

(a) 'there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities by its parent undertaking;

(b) either the parent undertaking satisfies the competent authority regarding the prudent management of the subsidiary and has declared, with the consent of the competent authority, that it guarantees the commitments entered into by the subsidiary, or the risks in the subsidiary are of negligible interest;

(c) the risk evaluation, measurement and control procedures of the parent undertaking cover the subsidiary; and

(d) the parent undertaking holds more than 50 per cent of the voting rights attaching to shares in the capital of the subsidiary and/or has the right to appoint or remove a majority of the members of the management body of the subsidiary'.

[45] See the European Commission, "Commission Services' Feasibility Report on 'Asset Transferability' Within Cross Border Banking Groups" (14 November 2008). Available at: http://ec.europa.eu/internal_market/bank/docs/windingup/rep141108_en.pdf (last accessed March 2010).

[46] See article 40 of the CRD. For a more detailed list of competences of the home supervisors in relation to branches see Committee of European Banking Supervisors (CEBS), "CEBS' Advice on information required

home supervisor) for the supervision of branches are liquidity management[48] and monetary policy. However, in the Euro Area, this responsibility is limited as a result of centralization of monetary policy to the European Central Bank (ECB), whereas the importance of liquidity supervision of branches was shown by the recent financial turmoil. Indeed, the borders between illiquidity and insolvency are often blurred[49], as a liquidity crisis can turn into a solvency one very rapidly[50]. Nonetheless, in the case of a crisis, the main procedure for reorganization or winding up of a bank applies also to its (European) cross-border branches, under the supervision of the home country authorities (see Directive 2001/24).

In conclusion, home supervisors of cross-border banks centralize supervision to a greater extent when a branch structure is in place. This does not reflect economic reality, as cross-border banks are

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to be exchanged under Article 42 CRD" (June 2009) 2. Available at http://www.c-ebs.org/Supervisory-Colleges/Publications/CEBS-today-published-its-advice-on-the-information.aspx (last accessed March 2010).

[47] See article 41 of the CRD. For a more detailed list of the responsibilities of host authorities in relation to branches see CEBS, "CEBS' Advice on information required to be exchanged under Article 42 CRD" (June 2009), cit. (note 46) 3.

[48] According to article 41 of the CRD, subparagraph 1, host country authorities shall retain responsibility for the liquidity supervision of branches, "pending further coordination" and "in cooperation with the competent authorities of the home Member State".

[49] See E Huepkes, "Insolvecy - why a special regime for banks?" in Current Developments in Monetary and Financial Law, Vol 3. International Monetary Fund, Washington DC, 2003; J Gordon, C Mueller, "Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management", 2010, Columbia Law School WP N. 369, available at: http://ssrn.com/abstract=1553880 (last accessed March 2010); C Cox, "Testimony Concerning Recent Events in the Credit Markets by Christopher Cox Chairman U.S. Securities & Exchange Commission Before the Senate Committee on Banking, Housing, and Urban Affairs" (April 3, 2008), referring how the Bear Stearns' crises occurred while the company was well capitalized, due to a drying up of it liquidity sources and the temporary impossibility (due to lack of sufficient liquidity buffers) to fund its liabilities. Available at: http://banking.senate.gov/public/_files/CoxOpeningStatement.pdf. See also Cox's letter to several Senate Committees (April 16, 2008), available at: http://finance.senate.gov/press/Gpress/2008/prg042308.pdf (both last accessed March 2010).

[50] See the European Commission (EC), 'Commission services' feasibility report on "asset transferability" within cross border banking groups' cit. (note 45) 14.

generally organized along business lines[51], irrespective of whether a branch or a subsidiary structure is adopted. Moreover, cross-border supervision must rely on cooperation and coordination mechanisms between national authorities[52]. As shown by the recent crisis, however, the allocation of responsibilities between home and host supervisors does not reflect the complexity of group structures and functioning. This is also true of the division of tasks relating to crisis management and resolution. The Basel Committee recently recognized that "these complexities and the potential confusion regarding responsibilities may affect the effectiveness and even the willingness of authorities to cooperate and share information"[53].

3. The current European framework for cooperation

The current European framework for cooperation between supervisory authorities is based on (a) information exchange; (b) consultation on supervisory action; (c) joint model validation under the

[51] See the European Commission (COM (2008) 602 final), cit. (note 10) 12, acknowledging that "in pan-European institutions, risk, liquidity and capital management are increasingly executed centrally for all organisational units, and groups are increasingly organized according to business lines. Consequently, it is becoming increasingly difficult to organize supervision on a predominantly national basis".

[52] See C Holthausen, T Rønde, "Cooperation in International Banking Supervision", ECB Working Paper No. 316 (2004), arguing that the current framework for cooperation and especially information exchange is insufficient and will necessary lead to inefficient (sub-optimal) supervisory actions and closure policies. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=301961 (last accessed March 2010).

[53] See the Basel Committee (2009) cit. (note 17) 33. See also the European Commission (COM (2008) 602 final), cit. (note 10) 13, highlighting that, "as financial supervision under the current framework is organized on a predominantly national basis (despite the fact that the 46 largest cross-border groups held about 68% of EU banking assets) with each Member State responsible for ensuring financial stability in its jurisdiction, Member States' incentives to develop EU principles and procedures for cross-border crisis prevention may be limited".

consolidating supervisor; and (d) written cooperation and coordination agreements between supervisors[54].

(a) Information exchange

As regards information exchange, article 132 of the CRD states that home and host authorities "shall cooperate closely with each other" providing one another with "any information which is essential or relevant for the exercise of the other authorities' supervisory tasks". Information shall be considered essential if it "could materially influence the assessment of the financial soundness of a credit institution or financial institution in another Member State"[55]. Such information has to be provided by authorities on their own initiative to other competent authorities, while other relevant information shall be delivered upon request. Competent authorities responsible for the supervision of group entities placed in different Member States shall "communicate to each other all relevant information which may allow or aid the exercise of supervision on a consolidated basis"[56]. Essential and relevant information for the purposes of consolidated supervision in going concern or

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[54] See CEBS, "Guidelines for Co-operation between Consolidating Supervisors and Host Supervisors" (25 January 2006) 2. Available at: http://www.c-ebs.org/getdoc/97971c09-3afe-4f9d-a482-a24ae1b022ce/GL09.aspx (last accessed March 2010).

[55] Article 132.1 subparagraph 4 states that "the essential information referred to in the first subparagraph shall include, in particular, the following items:

(a) identification of the group structure of all major credit institutions in a group, as well as of the competent authorities of the credit institutions in the group;

(b) procedures for the collection of information from the credit institutions in a group, and the verification of that information;

(c) adverse developments in credit institutions or in other entities of a group, which could seriously affect the credit institutions; and

(d) major sanctions and exceptional measures taken by competent authorities in accordance with this Directive, including the imposition of an additional capital charge under Article 136 and the imposition of any limitation on the use of the Advanced Measurement Approach for the calculation of the own funds requirements under Article 105."

[56] Article 139.2 of the CRD.

emergency situations shall be gathered from and disseminated to the competent authorities concerned under the coordination of the consolidating supervisor[57]. The CRD provides for cooperation and information exchange also among home and host supervisors of branches. Article 42 requires an on going flow of information from host to home, and from home to host supervisors, necessary to enable each of them to perform their respective tasks timely and effectively[58].

Relevant information for the purposes of the group's consolidated supervision has also to be exchanged between group entities, and Member States shall remove obstacles to the information exchange[59].

(b) Consultation on supervisory decisions

In addition to exchanging information, relevant competent authorities shall consult each other, under article 132.3 of the CRD, before taking decisions which could significantly impact the supervisory tasks of other competent authorities. In particular, they shall consult prior to enacting changes in the shareholder, organisational or management structure of group entities and before the adoption of major sanctions or exceptional measures by competent authorities[60]. Consultation may be avoided in the case of urgency or where it may jeopardise the effectiveness of the relevant decisions, but in similar circumstances the competent authority shall inform the other competent authorities without delay[61].

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[57] See article 129.1 a) of the CRD.

[58] See CEBS, "CEBS' Advice on information required to be exchanged under Article 42 CRD" (June 2009), cit. (note 46) 4, also for a list of information that has to be provided from home to host supervisors (page 8) and from host to home supervisors (page 19).

[59] Article 139.1 of the CRD.

[60] Article 132.3 of the CRD includes among exceptional measures "the imposition of an additional capital charge under Article 136 and the imposition of any limitation on the use of the Advances Measurement Approaches for the calculation of the own funds requirements under Article 105".

[61] See article 132.3, subparagraph 3 of the CRD.

(c) Joint model validation

Another significant area where the consolidating supervisor and the authorities responsible for the supervision of single group entities shall closely cooperate is the process of joint model validation set by article 129 of the CRD. In this case competent authorities shall consult each other to reach a joint decision on whether (and under which terms and conditions) to grant permission to a banking group to use advanced modelling of credit[62], market and operational risks for regulatory purposes[63]. The application for permission shall be submitted to the consolidating supervisor by the relevant consolidated entity. During the consultation on whether to grant permission to the applicant "the competent authorities shall do everything within their power to reach a joint decision" within six months from the receipt of the application. The joint decision shall be explained in a document and provided to the applying entity.

Should no joint decision be reached within six months, despite the best effort of the competent authorities, the consolidating supervisor shall take its own decision on the application, taking into account the views and reservations of other competent authorities expressed during the six months period. Again, the decision shall be explained in a document to be provided by the consolidating supervisor to the applicant and to other competent authorities. Whether taken jointly by all competent authorities or separately by the consolidating supervisor, the decision shall be recognised as determinative and applied by the competent authorities in the Member States concerned.

(d) Written cooperation and coordination arrangements

In view of facilitating more effective consolidated supervision, article 131 of the CRD requires competent authorities to engage in "written coordination and cooperation arrangements". These arrangements, also known as Memoranda of Understanding (MoUs), are used to delegate

[62] See articles 84.1 and 87.9 of the CRD, regarding internal ratings based approach.

[63]See article 105 and Annex III, Part 6, of the CRD.

supervisory tasks and specify the procedures for adoption of joint decisions and for cooperation between competent authorities. MoUs usually establish colleges of supervisors[64], aimed at facilitating information flows and consultation processes between relevant authorities in order to reach consensus on supervisory actions and decisions on subjects of common interest. Although effective in ordinary times, MoUs did not prevent, throughout the recent crisis, ring fencing and the split up of cross-border banks along national borders[65]. Indeed, MoUs were not legally binding and enforceable[66], while colleges of supervisors lacked the powers and political influence to perform effective coordination of national supervisors in times of crisis.

4. Strengthening the framework

In an attempt to address the weaknesses of the European supervisory framework shown by the recent crisis[67], the European Commission proposed and the Parliament and Council recently

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[64] See CEBS, "Template for a Multilateral Cooperation and Coordination Agreement" (December 2007) available at: http://www.c-ebs.org/getdoc/863e6b2e-5047-4dc1-b746-78a89dd2e36c/Template_December-2007.aspx; and its revised version (January 2009) available at: http://www.c-ebs.org/getdoc/aaafdb97-f131-4af6-96b5-34720c1bd2ad/CEBS-2007-177-rev-4-_template-for-written-agreemen.aspx (both last accessed March 2010).

[65] See Huepkes, cit. (note 49), pointing out that "while such memoranda provide an adequate framework for cooperation in normal times, in a crisis situation they may not ensure that all necessary information is exchanged on a timely basis and that action is coordinated accordingly". This was confirmed in the cases of Fortis and Dexia.

[66] See the "Memorandum Of Understanding On Cooperation Between The Financial Supervisory Authorities, Central Banks And Finance Ministries Of The European Union On Cross-Border Financial Stability" (1 June 2008), which affirms that "as the provisions of this Memorandum are not legally binding on the Parties, they may not give rise to any legal claim on behalf of any Party or third parties in the course of their practical implementation". Moreover, "the provisions of the Memorandum do not prejudge or assume any particular decisions or remedies to be taken in crisis situations" (page 10).

[67] Recital (1) of the "Directive 2009/111/EC of the European Parliament and of the Council amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions,

adopted a Directive[68] amending (amongst others) the CRD as to coordination and cooperation of home, host and consolidating supervisors (the "Amendment Directive"). The Amendment Directive emphasizes the role of consolidated supervision and of the relevant authorities by introducing the definition of "consolidating supervisor"[69]. It also requires supervisors to duly consider cross-border externalities and spillover effects of their decisions on other Member States' financial systems, especially in crisis situations[70]. The Amendment Directive further addresses the problem, also raised by the Turner Report[71], of a more effective involvement in supervision and increased powers of host supervisors with respect to systemically relevant branches. For this purpose, the Directive entitles the host Member State to make a reasoned request to the home or consolidating supervisor for a branch of a credit institution to be considered as significant[72]. The competent authorities shall do everything in their power to reach a joint decision on a similar request. Should a joint decision not be reached within two months, the host authority concerned shall take the decision individually

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certain own funds items, large exposures, supervisory arrangements, and crisis management" (hereinafter "Amendment Directive") states that "this Directive represents a first important step to address shortcomings revealed by the financial crisis". The press release IP/09/1347 "Commission adopts legislative proposals to strengthen financial supervision in Europe" of 23 September 2009 recognizes that "the current financial crisis has highlighted weaknesses in the EU's supervisory framework, which remains fragmented along national lines despite the creation of a European single market more than a decade ago and the importance of pan- European institutions". It is available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1347 (last accessed March 2010).

[68] The Amendment Directive was adopted on 16 September 2009 and has yet to come into force. It is available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF (last accessed March 2010).

[69] See article 1.2 c) of the Amendment Directive, which adds the following point to article 4 of the CRD:

"(48) "consolidating supervisor" means the competent authority responsible for the exercise of supervision on a consolidated basis of EU parent credit institutions and credit institutions controlled by EU parent financial holding companies.".

[70] See article 1.3 of the Amendment Directive, which adds a third paragraph to article 40 of the CRD.

[71] See FSA (2009) cit. (note 15) pointing out the need for "Gathering far more extensive information from banks and from home country supervisors on the whole bank liquidity of banks operating in the UK, including those operating as branches", p. 99.

[72] See article 1.4 of the Amendment Directive, which introduces article 42a of the CRD.

within the following two months. The procedure laid down for the joint model validation applies mutatis mutandis[73]. Upon the designation of the relevant branch as significant, the host competent authority shall be provided with all necessary information and consulted according to article 132. The same authority shall be alerted by the consolidating supervisor if an emergency situation arises potentially jeopardizing the market liquidity and stability of the financial system concerned[74]. It shall also be included, with other competent authorities and if necessary with central banks, in the planning and coordination of supervisory activities in preparation for and during the emergency situations referred to by article 129.1(c)[75]. The host authority shall take part in the relevant colleges of supervisors and shall be taken into consideration by the home supervisor when assessing the cross-border impact of supervisory decisions under article 40.3[76].

The Amendment Directive enhances supervisory convergence by emphasizing the role of CEBS as a standard setter. Under new article 42b, relevant authorities are required to participate in CEBS' activities and, despite their national mandate[77], follow the latter's guidelines, recommendations and standards or explain any deviation from the same. Moreover, the Directive strengthens cooperation and coordination between supervisors by extending the joint decision making process to other issues regarding consolidated supervision. In particular, new article 129(3) of the CRD[78] establishes that joint decisions shall be taken by the consolidating supervisor and each competent authority with

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[73] Again, the competent host supervisor shall take the views and reservations expressed by the other relevant supervisors and provide them with a fully reasoned decision on a written document.

[74] See the article 130.1 of the CRD, as replaced by article 1.32 of the Amendment Directive.

[75] The emergency situations referred to by the newly introduced article 129.1(c), include "adverse developments in credit institutions or in financial markets". Thus, they relate to micro- and macro-prudential issues, respectively. See article 1.31(a) of the Amendment Directive.

[76] For a more detailed list of the implications related to the designation of a branch as significant, see CEBS, "CEBS' Advice on information required to be exchanged under Article 42 CRD" (June 2009), cit. (note 46).

[77] See article 1.4 of the Amendment Directive, introducing article 42b of the CRD.

[78] See article 1.31 (b) of the Amendment Directive, which adds paragraph 3 to article 129 of the CRD.

reference to the risk management assessment process[79], review and evaluation[80]; the decision of imposing additional own funds requirements on a group entity as a result of the breach of certain prudential requirements[81]; a negative determination under the risk management review and evaluation [82] of the group entity concerned[83]. Again, relevant authorities shall do what is in their power to reach a joint decision. Should they fail to do so within four months, despite their best efforts:

(a) the consolidating supervisor shall be entitled to adopt its decision on a consolidated basis, after duly considering the risk assessment of subsidiaries performed by each competent authority on an individual basis; and

(b) each authority responsible for the supervision of subsidiaries on an individual or sub-consolidated basis shall take their decisions regarding each respective subsidiary (for which they are responsible), after duly considering the views and reservations expressed by the consolidating supervisor. A written document providing the fully reasoned decision shall in any case be drafted and handed to each competent authority and group entities concerned.

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[79] See article 123 of the CRD.

[80] See article 124 of the CRD that requires at least an annual review and evaluation of the credit institution's risk management procedures. Supervisory review and evaluation is part of the Pillar 2 of the CRD, which "covers the review and evaluation of the credit institution's fulfilment of the requirements of the CRD by the supervisor and any resulting action; new rules include requirements for an 'internal capital assessment' by financial institutions, whereby they would need to assess their capital needs considering all the risks they face. These rules also require supervisors to evaluate institutions' overall risk profile to ensure that they hold adequate capital". See the European Commission (COM (2008) 602 final), cit. (note 10), 4 - 5. The division in Pillars of the CRD reflects and implements Basel II.

[81] Those prudential requirements relate to organizational structure and governance (article 22 of the CRD); administrative and accounting procedures (article 109 of the CRD); and the risk management assessment process (article 123 of the CRD).

[82] See article 124.3 of the CRD.

[83] See article 136.2. of the CRD.

Decisions under new article 129.3 (taken either jointly or separately, as stated under (a) and (b) above) shall be reviewed on an annual basis. Only in exceptional circumstances, can decisions on the application of article 136.2[84] be reviewed upon a fully reasoned request to the consolidating supervisor by the competent authority responsible for the subsidiary's supervision. In a similar case, the requesting authority and the consolidating supervisor may address such update on a bilateral basis, without the participation of other authorities.

The joint decision-making process under new article 129.3 reflects those laid down by articles 129.1 and 42a, besides CEBS's possible involvement in the decision. In fact, the Amendment Directive introduced a voluntary consultation of CEBS, upon the initiative of any competent authority concerned, in the case of disagreement. The advice expressed by CEBS, though not binding, shall be taken into consideration by national authorities, which shall explain any significant deviation from the same in the written document providing their fully reasoned decision.

Another area where the Amendment Directive strengthened the framework for cooperation and coordination are emergency situations, including adverse developments either in financial markets, which might jeopardize market liquidity and the stability of the financial system, or in individual institutions[85]. When the consolidating supervisor has notice of similar adverse developments in the financial markets of any Member State, where a subsidiary or a systemically significant branch is

[84] Article 136.2 states that: "A specific own funds requirement in excess of the minimum level laid down in Article 75 shall be imposed by the competent authorities at least on the credit institutions which do not meet the requirements laid down in Articles 22 [organizational structure and governance], 109 [administrative and accounting procedures] and 123 [risk management assessment process], or in respect of which a negative determination has been made on the issue described in Article 124, paragraph 3 [review and evaluation of risk management], if the sole application of other measures is unlikely to improve the arrangements, processes, mechanisms and strategies sufficiently within an appropriate timeframe".

[85] Recital (6) of the Amendment Directive emphasises that "for the purpose of strengthening the crisis management framework of the Community, it is essential that competent authorities coordinate their actions with other competent authorities and, where appropriate, with central banks in an efficient way, including with the aim of mitigating systemic risk. In order to strengthen the efficiency of the prudential supervision of a banking group on a consolidated basis, supervisory activities should be coordinated in a more effective manner".

located, it shall promptly communicate all relevant information to the competent authority[86]. Moreover, consistently with the possible macro-prudential impact of similar adverse developments, Member States shall allow competent authorities to hand such information to central banks of the ESCB when it is deemed "relevant for the exercise of their statutory tasks, including the conduct of monetary policy and related liquidity provision, oversight of payments, clearing and settlement systems and the safeguarding of financial stability"[87] and to "other departments of their central government administrations responsible for legislation on the supervision of credit institutions"[88].

Furthermore, in the case of adverse developments regarding either financial markets or individual credit institutions, the consolidating supervisor shall plan and coordinate supervisory activities in cooperation with the competent authorities involved, and if necessary with central banks[89]. This can result in exceptional measures being taken under article 132.3[90], joint assessments, implementation of contingency plans and communication to the public. However, according to article 129.1(c), the consolidating supervisor shall, where possible, use "existing defined channels of communication for facilitating crisis management". These "channels", although not defined by the Amendment Directive, may be the "written arrangements" required by article 131 of the CRD and colleges of supervisors[91].

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[86] See article 130.1 of the CRD, as replaced by article 1.32 of the Amendment Directive.

[87] See article 49.2 of the CRD, introduced by article 1.5(b) of the Amendment Directive.

[88] See article 50.2 of the CRD as introduced by article 1.6 of the Amendment Directive.

[89] See article 129.1(c), as replaced by article 1.31(a) of the Amendment Directive.

[90] Article 132.3 of the CRD includes among exceptional measures "the imposition of an additional capital charge under Article 136 and the imposition of any limitation on the use of the Advanced Measurement Approaches for the calculation of the own funds requirements under Article 105". Note that those measures have to be adopted in consultation with competent authorities involved. See above, paragraph 3(b).

[91] See CEBS "Template for a Multilateral Cooperation and Coordination Agreement" (January 2009), for a list of the possible issues addressed in "written arrangements" according to article 131 of CRD, including the tasks of colleges of supervisors in going concern and in crisis situations.

This leads to the last significant change to the CRD brought about by the Amendment Directive. Colleges of supervisors[92], under new article 131a, are now mandatory for banks and banking groups with significant cross-border branches and/or subsidiaries. The consolidating (or the home[93]) supervisor shall establish them to facilitate the exercise of the tasks referred to in articles 129[94] and 130.1[95] of the CRD. Moreover, colleges of supervisors shall provide a framework for the competent authorities to perform the following tasks: information exchange; voluntary delegation of supervisory responsibilities; supervisory examination programs based on risk assessment of the group[96]; more efficient direction of requests of information[97]; consistent application of prudential requirements, without prejudice to discretional implementation of Community legislation left to

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[92] CEBS "Good Practices On The Functioning Of Colleges Of Supervisors For Cross-Border Banking Groups" (April 2009) 3, defines colleges of supervisors as "permanent, although flexible, structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different components of cross-border banking groups. Colleges provide a framework for the consolidating supervisor and the other competent authorities to carry out the tasks established in the CRD". Available at: http://www.c-ebs.org/getdoc/2d057c7c-da56-4f7e-a575-ed58cbcba1fe/College-Good-Practices-Paper_2-April-2009.aspx (last accessed March 2010).

[93] See article 42a.3 of the CRD, requiring the establishment of colleges of supervisors by the competent authorities of a credit institution with significant branches in other Member States. The establishment and functioning of the college shall be based on written arrangements determined by the home supervisor after consultation with the competent host authorities. The home supervisor also determines which authorities shall participate to meetings and activities of the college.

[94] Article 129 of the CRD refers to the following tasks by the consolidating supervisor: gathering from and disseminating to competent authorities of relevant or essential information in going concern and emergency situations; planning and coordination of supervisory activities in cooperation with other competent authorities in going concern and emergency situations; joint decisions with competent authorities in relation to review and evaluation of the credit institution's fulfilment of prudential requirements according to Pillar 2 of the CRD in addition to imposing an additional capital requirement in the case of negative determination of the review and evaluation.

[95] Article 130.1 of the CRD relates to the duty of the consolidating supervisor to alert as soon as possible competent authorities (including, where necessary, central banks and other bodies) in an emergency situation which could potentially harm the market liquidity and the financial stability of the financial system of the Member States where subsidiaries or significant branches of the group are located.

[96] See article 124 of the CRD.

[97] See articles 130.2 and 132.2 of the CRD.

Member States; consideration of relevant fora that may be established in the area of crisis management. The consolidating supervisor has a central role within colleges[98], which are established and function according to written agreements determined by the consolidating supervisor after consultation with relevant competent authorities. The consolidating supervisor chairs the meetings of the college, decides which competent authorities shall each time participate and is responsible for keeping competent authorities fully and timely informed of actions and measures carried out by the college.

However, colleges of supervisors are solely aimed at facilitating the cooperation and coordination of supervisory decisions and activities between competent authorities in going concern and emergency situations[99]. They have no powers to adopt binding resolutions, nor an explicit role on joint decision making processes or direct supervisory responsibilities[100]. It is therefore questionable whether, under the current European supervisory architecture, colleges of supervisors introduced by the Amendment Directive will prove more effective than those that were in place in the past. The absence of direct supervisory responsibilities of colleges and of binding mediation mechanisms in cases of disagreement between authorities might provide the same with insufficient incentives for effective cooperation, especially in crisis situations.

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[98] Among a set of different policy options the one based on "formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor" was preferred as it is deemed more effective with regard to the objective of reducing compliance burden. See the European Commission (COM (2008) 602 final), cit. (note 10) 113.

[99] See recital (6) of the Amendment Directive, suggesting that "in order to strengthen the efficiency of the prudential supervision of a banking group on a consolidated basis, supervisory activities should be coordinated in a more effective manner. Colleges of Supervisors should therefore be established. The establishment of Colleges of Supervisors should not affect the rights and responsibilities of the competent authorities under Directive 2006/48/EC. Their establishment should be an instrument for stronger cooperation by means of which competent authorities reach agreement on key supervisory tasks. The Colleges of Supervisors should facilitate the handling of ongoing supervision and emergency situations".

[100] See article 131a.1 of the CRD, inserted by article 1.33 of the Amendment Directive, affirming that "the establishment and functioning of colleges of supervisors shall not affect the rights and responsibilities of the competent authorities under this Directive".

Nonetheless, as recognized by the Amendment Directive, "cooperation between supervisory authorities, dealing with groups and holdings and their subsidiaries and branches, by means of colleges is a phase in a development towards further regulatory convergence and supervisory integration"[101]. The EC Commission has recently adopted proposals for a new European supervisory framework, which are aimed at fostering regulatory convergence and supervisory integration, and will be commented upon in the next section.

III. The new European supervisory architecture

1. Context of the reform proposal

The recent draft legislation proposed by the EC Commission[102] to reform the European supervisory architecture represents an essential step towards regulatory convergence and supervisory integration[103]. Also the Amendment Directive, despite introducing enhanced cooperation and coordination arrangements in the CRD, acknowledged that "in order to achieve the necessary level

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[101] Recital (12) of the Amendment Directive.

[102] For an overview of the reform proposals and other relevant documents of the European Commission on the reform of the European supervisory framework see http://ec.europa.eu/internal_market/finances/committees/index_en.htm#communication (last accessed March 2010). See also the European Commission "Commission Staff Working Document" accompanying the proposals with an impact assessment, available at: http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/sec2009_1233_en.pdf; and the Impact Assessment of the proposals, available at: http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/20090923_impact_en.pdf (both last accessed March 2010).

[103] See recital (13) of the Amendment Directive suggesting that "the crisis in international financial markets has demonstrated that it is appropriate to examine further the need for reform of the regulatory and supervisory model of the European Union's financial sector".

of supervisory convergence and cooperation at the European Union level, and to underpin the stability of the financial system, further wide-ranging reforms of the regulatory and supervisory model of the European Union's financial sector are highly needed and should be put forward swiftly by the Commission, with due consideration of the conclusions presented by the de Larosière Group[104] on 25 February 2009"[105].

The de Larosière Report[106] suggested a distinction between macro-[107] and micro-prudential[108] supervision emphasizing that, although intertwined, these two types of prudential supervision focus

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[104] The group of experts, chaired by Jacques de Larosière (the de Larosière Group), was set up by the Commission with the aim of assessing the organizational structure of European financial institutions and propose appropriate measures "to ensure prudential soundness, the orderly functioning of markets and stronger European cooperation on financial stability oversight, early warning mechanisms and crisis management, including the management of cross-border and cross-sectoral risks, and also to look at cooperation between the European Union and other major jurisdictions to help safeguard financial stability at the global level". See the European Commission "From financial crisis to recovery: A European framework for action" (29 October 2008). Available at: http://ec.europa.eu/commission_barroso/president/pdf/press_20081029_en.pdf (last accessed March 2010)

[105] Recital (15) of the Amendment Directive.

[106] Report by the High-level Group on Financial Supervision in the EU chaired by Jacques de Larosière (hereafter the de Larosière Report) (25 February 2009). Available at: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (last accessed March 2010). For a comment, see G Ferrarini and F Chiodini, "Regulating cross-border banks in Europe: a comment on the de Larosière report and a modest proposal" Capital Markets Law Journal (2009) I S123-S140.

[107] See the European Commission, "Commission Staff Working Document accompanying document to the Communication from the Commission 'European financial supervision' impact assessment" (27 May 2009) 9, which defines macro-prudential supervision noting that "macro-prudential supervision focuses on limiting risks to the financial system as a whole that may arise from broad developments in the economy (e.g., excessive domestic credit expansion)". Available at: http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/impact_assessment_fulltext_en.pdf (last accessed March 2010). A slightly different and more comprehensive view is offered by R Herring, J Carmassi, "The Structure of Cross-Sector Financial Supervision", Financial Markets, Institutions & Instruments, Vol. 17, No. 1 (2008) 52, arguing that macro-prudential supervision, while pursuing the same objectives described above, "focuses on systemically important institutions and the consequences their behaviour may have for financial markets. It tends to be top down surveillance with emphasis on the exposures of systemically important institutions to a variety of shocks. This involves not only monitoring the compliance of these institutions with safety and soundness standards, but also evaluating whether these standards are sufficient to protect the rest of the economy adequately from financial distress in a systemically important firm". The Authors admit, however, that "the microprudential function is closely

on different objectives. The former type is aimed at monitoring and assessing potential threats to the stability of the financial system as a whole that derive from macro-economic developments, global systemic risks and correlated shocks triggered by common exposure of numerous financial institutions to the same risk factors. The latter is concerned with the soundness of individual financial institutions and aims at limiting the contagion effects and systemic impact deriving from the crisis of an individual institution, especially if large or significantly interconnected[109].

The European Commission accepted[110] the supervisory architecture proposed by the de Larosière Group[111] and adopted EC Regulation proposals[112], assigning macro prudential supervision to a

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related to the macroprudential function, but focuses on the solvency of individual institutions rather than the financial system as a whole" (p. 53).

[108] For a definition of micro-prudential supervision, ibid.: "the main objective of micro-prudential supervision is to supervise and limit the risk of distress in individual financial institutions. By preventing the failure of individual financial institutions, micro-prudential supervision attempts to protect the clients of the institutions and prevent (or at least mitigate) the risk of contagion and the subsequent negative externalities in terms of confidence in the overall financial system".

[109] See the de Larosière Report, cit. (note 106) 38, para. 146-147.

[110] The reform proposals of the de Larosière Group, were specified in the Commission's Communication of 27 May. See "Communication from the Commission. European financial supervision" (27 May 2009) 3, stating that "this Communication is a key milestone and sets out the basic architecture for a new European financial supervisory framework". The document is available at: http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf (last accessed March 2010).

The Commission also conducted two open consultations on the proposed macro- and micro-prudential supervisory framework. A first consultation was launched following publication of the de Larosière report and extended from 10 March to 10 April 2009, as input to the Commission Communication 27 May 2009, cit. (note 110). A summary of the public submissions received can be found at http://ec.europa.eu/internal_market/consultations/docs/2009/fin_supervision/summary_en.pdf. A second consultation was conducted over the period from 27 May to 15 July 2009, inviting all financial services sector operators and their representative bodies, regulators, supervisors, other interested parties, to comment on the more detailed reforms presented in the May 2009 Communication. See the summary of the submitted responses at: http://ec.europa.eu/internal_market/consultations/docs/2009/fin_supervision_may/replies_summary_en.pdf (last accessed March 2010).

Also the European Council agreed to the supervisory architecture suggested by the de Larosière Group and the Commission, and invited the Commission to present "all necessary proposals by early autumn 2009 at the

newly established European Systemic Risk Board (ESRB)[113] and micro-prudential supervision to a new European System of Financial Supervisors (ESFS), i.e. a network of national supervisors coordinated by the new European Supervisory Authorities, deriving from the transformation of existing European Supervisory Committees[114]. The creation of a centrally coordinated network is

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latest". See ECOFIN "Council conclusions on Strengthening EU financial supervision" (9 June 2009) 6. Available at: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/108389.pdf (last accessed March 2010). See also the "European Council Conclusions of 18/19 June", Annex 5 to the Impact Assessment of the proposals, cit. (note 102).

[111] The de Larosière Report proposed to assign macro-prudential supervision to an independent, newly established European Systemic Risk Council, working in connection with the ECB and the ESCB. This body is not charged with micro-prudential supervisory responsibilities, which would be left to national authorities, forming a European System of Financial Supervisors coordinated by European Supervisory Authorities resulting from the conversion of existing level 3 committees.

[112] The proposals were adopted by the Commission on 23 September 2009. The legal basis of the proposed regulations is provided by article 95 of the EC Treaty, which allows the Council through co-decision procedure (following article 251 of the EC Treaty) with the European Parliament to take "the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market". As clarified by the European Court of Justice, similar measures include the establishment of new European bodies, provided that the same are "responsible for contributing to the implementation of a process of harmonisation" and their "tasks [are] closely linked to the subject-matter of the acts approximating the laws, regulations and administrative provisions of the Member States". See the European Court of Justice, Case C-217/04 "United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union", paras. 44-45. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62004J0217:EN:HTML (last accessed March 2010). The tasks assigned to the newly established authorities are closely linked to the measures of further integration and enhancement of cooperation required as a response to the current crisis for a more stable and well functioning European financial system. They comply, therefore, with the conditions set forth by the ECJ under article 95 of the Treaty.

[113] See the: "Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board"; available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0499:FIN:EN:PDF (last accessed March 2010); and its organization under the auspices of the ECB: "Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board"; available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0500:FIN:EN:PDF (last accessed March 2010).

[114] As far as micro-prudential supervision is concerned, the European Commission adopted a set of proposals on 23 September 2009 for the establishment of a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities and Markets Authority. For the purposes of this paper, we will refer mainly to the "Proposal for a Regulation of the European Parliament and of the Council

aimed at enhancing effective cooperation between competent authorities in the supervision of cross-border financial institutions, while leaving day-to-day supervision to national authorities[115], in conformity with the principles of subsidiarity and proportionality laid down in Article 5 of the Treaty.

The remainder of this section will analyse, in some detail, the tasks and responsibilities of the new European bodies.

2. Macro-prudential oversight. The European Systemic Risk Board (ESRB)

A widely shared view of the financial crisis argues that the current supervisory framework relies excessively on (nationally fragmented) micro-prudential supervision. Indeed, prudential supervisors seriously misunderstood macro-economic trends by focusing on individual institutions rather than

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establishing a European Banking Authority"; available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0501:FIN:EN:PDF (last accessed March 2010); and the version as amended by the European Council, available at http://register.consilium.europa.eu/pdf/en/09/st16/st16748-re01.en09.pdf (last accessed March 2010). See also the "Proposal for a Directive of the European Parliament and of the Council Amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority", available at: http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20091026_576_en.pdf (last accessed March 2010).

[115] The MEMO/09/404 "European System of Financial Supervisors (ESFS): Frequently Asked Questions" (23 September 2009) clarifies that: "day-to-day supervision is best done on national level, close to the ground, where there are strong local traditions. There will always be a pivotal role for national supervisors". Available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/404&format=HTML&aged=0&language=EN&guiLanguage=en (last accessed March 2010).

on common exposures generating systemic risk[116]. Given the degree of integration and interconnectedness of European financial markets[117], cross-sectoral macro-prudential oversight of systemic stability[118] should be performed by a European body[119] with the involvement of central banks[120].

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[116] Lord Turner at his "Speech at the City of London Corporation's Annual Reception for the City Office 6 October 2009", pointed out that: "one of the most crucial things that went wrong in the run-up to the crisis was that the global central banking and regulatory community, those in different ways responsible for financial stability, failed to see the big picture of emerging financial risks: the regulators too exclusively focused on institution by institution threats, and the central banks too exclusively focused on meeting the sole objective of low and stable inflation over the medium term". Available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1006_at.shtml (last accessed March 2010). See also F Recine and P G Teixeira, "Towards a new regulatory model for the single European financial market" RTDF N. 4/2009, 1; C Stephanou, "The Reform Agenda: Charting the Future of Financial Regulation" (June 29, 2009), The World Bank Group, Financial and Private Sector Development Vice Presidency, Crisis Response Policy Brief 2. Available at SSRN: http://ssrn.com/abstract=1427398, (last accessed March 2010); C Goodhart and D Schoenmaker, 'De Larosiére Report: Two Down, Two to Go' (30 March 2009) on FT.com/economistforum. Available at: http://blogs.ft.com/economistsforum/2009/03/the-de-larosiere-report-two-down-two-to-go/ (last accessed March 2010).

[117] M Schueler, "How do Banking Supervisors Deal with Europe-wide Systemic Risk?" (2003) ZEW Discussion Paper No. 03-03 19. The author suggests that similar macro-prudential tasks shall be coupled with an LOLR function. Available at: ftp://ftp.zew.de/pub/zew-docs/dp/dp0303.pdf (last accessed March 2010).

[118] E Nier, "Financial Stability Frameworks and the Role of Central Banks: Lessons From the Crisis" IMF Working Paper WP/09/70 (2009), available at: www.imf.org/external/pubs/ft/wp/2009/wp0970.pdf (last accessed March 2010); See also: Lorenzo Bini Smaghi, "Macro-prudential supervision", speech at the CEPR/ESI 13th Annual Conference on "Financial Supervision in an Uncertain World", European Banking Center at Venice International University, Venice, 25-26 September 2009. Available at: http://www.ecb.int/press/key/date/2009/html/sp090925.en.html (last accessed March 2010).

[119] Such a body would be essential for a cross-sectoral, integrated EU macro-prudential supervisory structure "necessary to promote timely and consistent policy responses among Member States thus preventing diverging approaches and so improve the functioning of the Internal Market". See the "Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board", cit. (note 113) 3.

[120] See F Recine and P G Teixeira, cit. (note 116) for a list of countries which decided, following the crisis to entrust the central bank (or related authorities) with prudential supervisory powers. Note that in Germany, where the supervision of banks was shared between the Bundesbank (the German central bank) and the Bafin (Bundesanstalt für Finanzdienstleistungsaufsicht – the financial markets supervisory authority), the government has recently decided to appoint the central bank as sole supervisor over the banking sector. See FT, "Bundesbank to have sole banking oversight" published online 8 October 2009 and available at:

Accordingly, under current proposals, the European Systemic Risk Board[121] should be responsible for macro-prudential oversight over the EU financial system. The ESRB should develop a common approach to the identification of systemic risks, solving the problem of nationally fragmented individual risk assessment. It should also establish effective early warning mechanisms and allow for greater interaction between micro- and macro-prudential analyses, promoting micro-prudential supervisory actions of competent authorities upon the identification and assessment of systemic risks[122].

The ESRB shall have no legal personality, nor binding powers; however, given the high profile of its members[123], it shall function as a "reputational" body, influencing the action of policy makers

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http://www.ft.com/cms/s/0/e7bd8cc8-b43e-11de-bec8-00144feab49a.html?catid=4&SID=google (last accessed March 2010).

The same measure is currently debated in the UK, where the Conservatives propose to assign banking supervision to the Bank of England, thereby excluding the FSA. See Bloomberg: "U.K. Conservatives Would Hand FSA's Power to Bank of England" published online 20 July 2009 and available at: http://www.bloomberg.com/apps/news?pid=20601102&sid=anlPi89bQgfs (last accessed March 2010).

[121] The ESRB's core decision making body will be the General Board, assisted by a Steering Committee and possibly by an Advisory Technical Committee, and supported by a Secretariat provided by the ECB. Central bankers' membership of the General Board shall be significant, on the assumption that they should possess the required expertise and experience in systemic risk assessment. See article 2 of the "Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board" cit. (note 113). See also R Beetsma, S Eijffinger, "The restructuring of financial supervision in the EU", European View (2009) 8:3–12. Available at: http://www.springerlink.com/content/26mp87320u76x36v/fulltext.pdf.; Eijffinger, "Adjustments to the accountability and transparency of the European Central Bank", European Parliament, Economic And Monetary Affairs, (2009). Available at: http://www.europarl.europa.eu/activities/committees/studies.do?language=EN.; E Nier, cit. (note 118); M Lamandini, "Towards a new Architecture for European Bank Supervision" Paper presented at the ABI International Conference on "The future of the European Banking Supervision Architecture", Rome, 17th October, 2008. Available at: http://works.bepress.com/marco_lamandini/10 (last accessed March 2010).

[122] See article 4 of the "Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board" cit. (note 113).

[123] The Board shall consist of the following voting members: Governors of the twenty-seven national central banks; President and the Vice-President of the ECB; a member of the European Commission; the Chairpersons of the newly established three European Supervisory Authorities; and of the following non-voting members: one high level representative per Member State of the competent supervisory authorities

"by means of its moral authority"[124]. The ESRB shall issue risk warnings and, where appropriate, recommend remedial actions and prompt answers.

The Board's warnings and recommendations[125] are not legally binding, though the addressees are expected to conform to the same and communicate the measures adopted in response, eventually explaining deviations. Warnings and recommendations shall in principle be confidential, but can be made public in specific cases[126]. This reflects the main objective of issuing a public warning or recommendation, namely increasing the pressure for prompt corrective actions. The relevant tradeoff, however, is to be carefully evaluated on a case-by-case basis. Certain information contained in warning and recommendations could have a negative impact on financial markets and would therefore be better kept confidential[127]. Confidential warnings and recommendations shall nonetheless be transmitted to the Council, where addressed to Member States, and to European Supervisory Authorities, where addressed to national supervisors[128]. This should enhance convergence and information exchange at European level. Moreover it should guarantee a certain

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and the President of the Economic and Financial Committee. A chair, elected within the Members that are also Members of the ECB General Council (i.e. central bankers), shall preside the General Board and the Steering Committee and instruct the Secretariat on behalf of the General Board. The Chair and the Vice-Chair shall be in charge for five years and represent the ESRB externally.

[124] See the "Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board" cit. (note 113) 5.

[125] Recommendations shall be either general or specific and shall include a specified timeline for the policy response. They may be addressed to the Community as a whole, individual Member States, national authorities or the European Supervisory Authorities.

[126] The General Board shall decide whether to derogate from this general rule by a qualified majority of two-thirds. Should the decision fall on making the warning or recommendation, the ESBR shall inform the addressee in advance.

[127] See the "Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board", cit. (note 113), and articles 2 and 5 of the "Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board" cit. (note 113) 5.

[128] Ibid. article 16.3.

degree of peer review, thus making reputational sanctions and moral suasion more effective, while preserving markets from negative reactions.

As supervisory activity by the ESRB would not be directly addressed to financial institutions, but to national and European supervisory authorities, a decisive role in enhancing its effectiveness of the ESRB's actions is played at micro-prudential level. The follow up of early warnings and recommendations addressed by the ESRB to national supervisors shall be ensured by the European Supervisory Authorities, which have binding powers[129]. It remains to be seen whether those powers will be used, where needed.

3. Micro-prudential supervision. The European Banking Authority (EBA) and the European System of Financial Supervisors (ESFS)

a. Objectives of the EBA and the ESFS

On the micro-prudential side, greater integration of the supervisory framework and cooperation between authorities, reflecting the nature of the business of cross-border institutions and largely interconnected markets, is essential to guarantee the soundness and stability of the financial system[130].

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[129] See article 21.3 of the "Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority", cit. (note 114).

[130] See Recital (6) of the Proposal for a Regulation establishing a European Banking Authority (hereafter the EBA Regulation), emphasizing that "the Community cannot remain in a situation where there is no mechanism to ensure that national supervisors arrive at the best possible solution for cross-border institutions; where there is insufficient cooperation and information exchange between national authorities; where joint action by national authorities requires complicated arrangements to take account of the patchwork of regulatory and supervisory requirements; where national solutions are most often the only

The new proposed micro-prudential supervisory architecture, based on the creation of the ESFS and European Supervisory Authorities, is aimed at establishing a strong European network coordinated by centralized authorities with legally binding powers and a European single rulebook[131]. The network would ensure effective cooperation and coordination between national authorities, which would retain day-to-day supervisory powers[132]. A central role in the supervision of cross-border institutions, however, would be played by colleges of supervisors[133]. Their effectiveness would be enhanced by greater harmonization and consistent application of prudential rules and requirements. Authorities constituting the college would be provided a greater incentive to cooperate with each

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feasible option in responding to European problems, where different interpretations of the same legal text exist".

[131] See D Masciandaro, M Nieto and M Quintyn, "Will they sing the same tune? Measuring Convergence in the new European System of Financial Supervisors", IMF Working Paper WP/09/142, arguing that due to the complexity of the three layered supervisory architecture and the heterogeneity of national supervisors comprised in the ESFS, the creation of a single rule book and common supervisory practices will be essential for the functioning of the system. Available at: www.imf.org/external/pubs/ft/wp/2009/wp09142.pdf (last accessed March 2010).

[132] A European System of Financial Supervisors is one of the options for reform of the European supervisory architecture proposed by D Schoenmaker and S Osterloo, "Cross-Border Issues in European Financial Supervision" in D Mayes and G Woods (eds), The Structure of Financial Regulation (Routledge, London 2007) 14. The Authors suggest as a possible framework "to give the home supervisor full responsibility for the EU-wide operations, both branches and subsidiaries. [t]he home supervisor has a European mandate to ensure that the interests of all depositors/countries are taken into account. In some form of European System of Financial Supervisors, national supervisors can work together with a decision-making body or agency at the centre (see below). Within the System, the supervisor in the country where the bank is head-quartered can then act as consolidated or lead supervisor. Accordingly for financial stability purposes, the home country authorities (supervisor and central bank) within the European System of Financial Supervisors and the European System of Central Banks (ESCB) can act within their respective Systems".

The same Authors have also proposed an ESFS coordinated by a European Supervisory Authority. This "two tier" structure is different from that proposed in the draft EBA Regulation, to the extent that cross-border banks would be directly supervised by the European Supervisory Authority, while local banks would remain subject to national supervisors. See D Schoenmaker and S Ostreloo, "Financial supervision in Europe: Do we need a new Architecture?" Cahier Comte Boel, No. 12 (2006).

[133] In the framework introduced by the Amendment Directive the creation of colleges of supervisors is mandatory for each cross-border banking group (new art. 131a of the CRD), and is suggested for banks operating across borders with systemically significant branches (new art. 42a of the CRD).

other by the EBA's participation in the college[134] and the settlement of possible disagreements by the same[135].

b. The EBA

The EBA shall have legal personality and legal, administrative and financial autonomy. Its governance will consist of a Board of Supervisors; a Management Board; a Chairperson and an Executive Director. The Board of Supervisors is the main decision making body, with the heads of the 27 national banking supervisory authorities as voting members[136]. EBA's main tasks are to (i) create a single rulebook and more harmonized regulatory and supervisory standards throughout the Community; (ii) ensure a consistent application of the standards by competent authorities; (iii) act in emergency situations and ensure the follow up of ESRB's warnings and recommendations; and (iv) enable effective coordination and cooperation between authorities.

[134] See article 12.2 of the EBA Regulation.

[135] Ibid. article 11.

[136] The Board will also include, as non-voting members, the Chairperson of the EBA; one representative of the Commission; one of the ECB, one of the ESRB and one of each of the remaining European Supervisory Authorities (namely the EIOPA and the ESMA). As for the ESRB, management will be delegated to a Management Board with the task of ensuring that the EBA regularly performs its duties. The Management Board shall consist of the EBA Chairperson, a representative of the Commission, and four members elected by and from the members of the Board of Supervisors. Their term of office shall be of two and a half years, and may be renewed only once. Decisions shall be taken by simple majority and without a quorum, with each member having a single vote. The Executive Director shall participate to the Management Board's meetings without voting right. The Board shall meet at least bi-annually, or upon initiative of the Chairperson or of a third or more of its members. The Chairperson and the Executive Director of the EBA shall be full time professionals appointed by the Board of Supervisors on the basis of merit, skills, knowledge of financial institutions and markets, and experience.

(i) As to the single rulebook and harmonization of regulatory and supervisory standards, the draft Regulation provides for the adoption of technical standards[137] where specifically set out by European legislation[138].

(ii) Harmonized rules may not be sufficient to level the playing field if applied differently by national authorities. One of the EBA's tasks, therefore, is to ensure the consistent application of Community rules and standards by national supervisors. The EBA may decide on the alleged breach of EU Banking law, when informed that a competent authority does not correctly apply it[139]. Should the authority fail to comply with its decision[140] within a specified term[141], the EBA shall adopt individual measures directly addressed to the financial institution(s) concerned, provided that the

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[137] Technical standards shall be endorsed by the Commission upon proposal of the EBA, which shall, where appropriate, conduct public consultations and cost benefit analysis. The Commission shall decide on the endorsement of EBA's standards within three months (extendable to four) from receipt of the same, and may refuse or endorse them with amendments only when required by Community interest. The endorsed standards are published in the Official Journal of the European Union and are legally binding. See article 7 of the EBA Regulation.

[138] This legislation (hereafter referred to as EU Banking Law) includes: credit and investment institutions' capital requirements and adequacy, financial conglomerates, money laundering, distance marketing of consumers financial services and deposit guarantee schemes. The EBA may, however, also contribute to harmonization in areas other than technical standards through non-binding guidelines and recommendations, which national authorities may adopt on a "comply or explain" basis. See article 8 of the EBA Regulation.

[139] The EBA shall conduct investigations on the alleged breaches and acquire all relevant information by the authority concerned, either on request of the Commission or other competent authorities or upon its own initiative. See article 9.2 of the EBA Regulation.

[140] Note that in the EBA Regulation as amended by the European Council, cit. (note 114), the term "decision" is replaced with the term "formal opinion". However the consequences of non compliance are similar.

[141] Within two months from the beginning of its investigation, the EBA shall recommend the actions that the national authority should take to comply with legislation. The latter shall inform the EBA of the measures adopted or to be adopted in conformity with the recommendation, within ten days of receipt. Should the authority fail to comply within one month from the recommendation's receipt, the Commission - acting on the EBA's request or on its own initiative, within three months (extendable to four) from the adoption of the recommendation - shall adopt a decision requiring the competent authority to comply with EU Banking Law, save for the latter's right to be heard. Ibid. article 9.4

requirements set out in the relevant EU Banking Law are directly applicable[142] and that compliance is urgently required[143].

The EBA's power to address decisions to financial institutions directly is remarkable. However, the case of a national supervisor failing both to follow an EBA recommendation and to comply with a Commission decision (or formal opinion) appears to be highly unlikely. Moreover, the EBA's power to address measures directly to financial institutions is questionable, given that it requires a cumbersome procedure to be followed in advance (possibly lasting up to six months[144]). The Commission's version[145] of the draft Regulation envisages, however, the possibility for the EBA to follow a fast track in specific circumstances, which will be briefly commented upon below.

(iii) Indeed, prompt action in emergency situations is crucial to prevent the worsening of a crisis. The draft Regulation by the Commission[146] empowers the EBA to adopt, in the event of a crisis, binding decisions vis-à-vis national authorities, requiring the same to take measures in compliance with EU Banking Law. Should the competent authorities fail to comply, within the time limit set

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[142] This does not prejudice the right of the Commission to start an infringement procedure under article 226 of the Treaty against the Member State of the addressed authority. See article 9.6 of the EBA Regulation.

[143] This additional requirement was introduced by the European Council, cit. (note 114), in article 9.6 and allows for the adoption of individual decisions directly addressed to financial institutions "where it is necessary to remedy in a timely manner the non compliance in order to maintain or restore neutral conditions of competition in the market or ensure the orderly functioning and integrity of the financial system".

[144] The procedure is as follows: two months from the beginning of investigation for the first recommendation of the EBA; a further month from the receipt of the recommendation of the addressed authority to check if it has complied; further three or even four months from the adoption of the recommendation for the Commission to take its decision, which sets out a time limit for compliance itself. This means that from the beginning of the investigations to the adoption of the decision by the Commission can take up to six months, plus the time limit set out by the decision.

[145] In its revised version, the European Council, cit. (note 114), has abolished the possibility for the EBA to address individual decisions directly to financial institutions following a "fast track". Indeed, in the case of non compliance of a competent authority with the decision addressed to it in an emergency situation, the standard rule for direct application to financial institutions applies, following article 9.6 of the EBA Regulation.

[146] See previous note.

out in the decisions, the EBA may address the measures in question directly to individual institutions, provided that the relevant requirements of EU Banking Law are directly applicable to the same. This procedure allows for a more rapid adoption of the relevant measures, but is conditional on the Commission's deciding (on its own initiative or upon request of the EBA, the Council or the ESRB) that an emergency situation exists "which may seriously jeopardize the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system of the Community"[147].

In both versions of the EBA Regulation[148], experience will show under what circumstances the Commission (or the Council) feels empowered to act under this rule, upon the assessment of an emergency situation. However, even assuming that the crisis of a systemically significant bank may be sufficient, the scope of the EBA's powers is questionable. In fact, the EBA is only entitled to take decisions vis-à-vis the competent authority (and possibly individual credit institutions[149]) to ensure compliance with existing provisions of EU Banking Law, provided that they are directly applicable to the institutions concerned. The EBA, therefore, is not provided with autonomous powers of crisis management and resolution to use in emergency situations, other than those already provided to national authorities under existing Directives.

In an area still related to emergency situations, the EBA shall ensure the proper follow-up of the ESRB's warnings and recommendations[150]. When these are addressed directly to the EBA, its Board of Supervisors shall take the relevant measures in compliance with the relevant warning or

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[147] See article 10 of the EBA Regulation.

[148] As proposed by the Commission or as revised by the Council, cit. (note 114).

[149] In the Commission's proposal a similar power is directly foreseen by article 11.4, whereas in the revised version of the Council, the power to address decisions directly to financial institutions has to be exercised by the EBA upon the (more restrictive) conditions set forth by article 9.6.

[150] Ibid. article 21.3.

recommendation. Otherwise, it shall explain the reasons for not doing so[151]. When the ESRB's decisions are addressed to national authorities and copied to the EBA, the latter shall ensure a timely follow-up, possibly using its powers under the EBA Regulation[152].

Although the EBA may use its powers to ensure the follow-up of the ESRB's warnings and recommendations[153], the same shall not be strictly enforceable, being addressed to national authorities on a "comply or explain" basis. Nonetheless, the EBA may issue, possibly upon indication of the ESRB, binding decisions if national authorities do not comply with EU Banking Law. As a result, warnings and recommendations drawing on macro-economic developments (such as the common exposure of credit institutions to the same risk factors, or a 'bubble' in asset prices) that do not fall under EU Banking Law requirements would not be enforceable by the EBA and their follow-up may be difficult to ensure.

(iv) Coordination and cooperation between authorities is essential to the functioning of the ESFS. The recent Amendment Directive introduced rules to enhance the relevant mechanisms, while the EBA shall play a significant role in making them more effective[154], with the purpose of enhancing information exchange, scope and reliability. In addition, the EBA shall provide, on its own initiative or upon request, a mediation function between competent authorities[155] and contribute to the promotion of the effective functioning of colleges of supervisors[156].

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[151] Ibid. article 21.4.

[152] Should the authority decide not to follow the ESRB's recommendation, the matter shall be discussed by the Board of Supervisors. The relevant authority shall take the views expressed by this Board into account when informing the ESRB about the reasons for not conforming to the recommendation. See article 21.5 of the EBA Regulation.

[153] Ibid. article 21.6.

[154] In fact, the proposed regulation assigns to the EBA a general coordination function with respect to competent authorities. See article 16 of the EBA Regulation.

[155] Coordination shall also involve macro-prudential supervision, as the ESRB must be notified without delay of any potential emergency and provided with all relevant information. See article 21 of the EBA Regulation,

Cooperation will be ensured by a procedure for the settlement of disagreements between authorities[157]. In areas where EU Banking Law requires cooperation, coordination or joint decision making by authorities from different Member States[158], a competent authority disagreeing on the procedure or content of an action or inaction of another competent authority may request the EBA's assistance in reaching an agreement[159]. Should no agreement emerge, the EBA shall enjoin the competent authority to take or refrain from a specific action, in conformity with EU Banking

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which states that the EBA shall provide the ESRB will information necessary to perform its tasks on a regular basis in summary or collective form, while upon a reasoned request of the latter it shall deliver the data not in summary or collective form, according to article 15.4 of the "Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board", cit. (note 113).

[156] The EBA shall participate in colleges as an observer, as it deems appropriate, and shall establish and coordinate a central system of information sharing between the authorities, which are part of the college. See article 12 of the EBA Regulation.

[157] Ibid. article 11. Moreover, cooperation shall be facilitated by a common supervisory culture and consistent practices fostered by the EBA though the provision of opinions, the promotion of bilateral and multilateral exchange of information, training programs and periodical peer review. The framework for enhanced cooperation shall allow for the delegation of tasks and responsibilities between authorities, either through bilateral or multilateral agreements. The EBA shall smooth the progress of delegation by identifying possible tasks and responsibilities which may be delegated or exercised jointly by competent authorities and by encouraging best practices. It shall be informed of any such agreement and possibly give an opinion on it within one month from being informed. Similar measures should further improve cooperation and best practices.

[158] For cases where cooperation, coordination and joint decisions are required by the CRD see above, section II, paragraphs 3 and 4.

[159] See article 11.1 of the EBA Regulation. The EBA may assign the parties a deadline for conciliation, taking EU Banking Law into account, together with the complexity and urgency of the matter. Ibid. article 11.2. Examples where the EBA can adopt measures to settle disagreements applying different time limits for conciliation depending on EU Banking Law are, without limitation: the joint decision on the designation as systemically significant of a branch between the home and the host supervisor, following article 42a of the CRD. In this case, the time limit of two months where the competent authorities "shall do everything within their power to reach a joint decision" shall also be deemed the conciliation period for the purposes of the EBA Regulation. On the same token, the period of six months for the joint decision on the internal model validation according to article 129.2, and the period of four months for the joint decision on group's risk assessment under article 129.3 of the CRD, shall be considered as conciliation within the meaning of article 11 of the EBA Regulation.

Law[160]. Should the authority in question not comply with the EBA's request and should this result in a credit institution not complying with EU Banking Law, the EBA may (without prejudice to the Commission's infringement procedure under article 226 of the Treaty) adopt an individual decision requiring the financial institution to comply with the requirements of EU Banking Law that are directly applicable[161].

c. The ESFS

The ESFS is a network of financial supervisors facilitating cross-sectoral coordination and cooperation, and ensuring consistency in supervisory policies and practices of the participating authorities[162].

The ESFS shall establish a Joint Committee of European Supervisory Authorities (hereafter the Joint Committee) to serve as a forum for the regular and close cooperation between EBA, EIOPA

[160] Ibid. article 11.3.

[161] Ibid. article 11.4. In the version revised by the European Council, cit. (note 114), any decision addressed to competent authorities has to be taken following the decision procedure under article 29.1 of the EBA Regulation (i.e. on proposal by the consolidating supervisor, by simple majority, but with a blocking minority vote). In any case individual decisions addressed directly to financial institutions are subject to the conditions of article 9.6.

[162] Ibid. article 39.3. The ESFS shall comprise the following members: authorities responsible for the supervision of banks, insurance companies and pension funds and financial markets, as set out in article 1.2 of each of the proposed regulations establishing a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA) and a European Securities and Markets Authority (ESMA), respectively; the three European Supervisory Authorities (EBA, EIOPA and ESMA), a Joint Committee of Supervisory Authorities and, for specific purposes, the Commission. Article 39.2 (f) mentions the Commission's tasks referred to in articles 7, 9 and 10 of the EBA Regulation, namely: the endorsement of technical standards adopted by the EBA; the decision addressed to national authorities not complying with EU Banking Law (and eventually the start of an infringement procedure of Community law under article 226 of the Treaty); and the decision determining the existence of an emergency situation, respectively.

and ESMA[163], with the aim of promoting joint positions and common decisions of the three European Supervisory Authorities in areas falling within their competence[164]. Moreover, a Sub-Committee on Financial Conglomerates shall be established (without prejudice to the establishment of further sub-committees, where appropriate) for the coordination of cross-sectoral supervision of institutions under Directive 2002/87/EC[165].

Another relevant body of the ESFS is the Board of Appeal[166], aimed at ensuring a consistent review of decisions and coherent application of Community rules, action in emergency situations and settlement of disagreements[167] across supervisory sectors[168].

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[163] The Joint Committee shall be composed of the Chairperson of each European Supervisory Authority and of the Sub-Committee(s) established under article 43 of the EBA Regulation. The Chairperson of the Joint Committee shall be appointed on an annual rotational basis among the Chairpersons of the European Supervisory Authorities. The Executive Directors of the European Supervisory Authorities, the Commission and the ESRB shall be invited to participate as observers to the meetings of the Joint Committee and eventually of Sub-Committees. See article 41 of the EBA Regulation. Same provisions can be found in the proposed regulations establishing the EIOPA and the ESMA.

[164] Ibid. article 42.

[165] The Sub-Committee shall comprise, in addition to the Chairpersons of the European Supervisory Authorities, a high level representative of each Member State's competent authority. See article 43 of the EBA Regulation.

[166] It consists of six members and six alternates elected for a third by each of the European Supervisory Authorities from a short list proposed by the Commission. In particular, each Management Board of each European Supervisory Authority shall elect two Members and two alternates from a list proposed by the Commission following a public call for interest published in the Official Journal of the EU and after consultation with the relevant Board of Supervisors. See article 44.3 of the EBA regulation, but same provisions can be found in article 44.3 of the proposed regulations establishing the EIOPA and the ESMA. The President of the Board of Appeal is designated among its Members, whose term of office shall be five years, extendable once. In order to guarantee their independence and impartiality, Members may not have any other duty in supervisory authorities and shall not take part to decisions where they have any interest or (even previous) involvement. Article 45.2 provides that Members shall not take part in appeal proceedings of decisions to which they have participated of where they have been involved as representatives of one of the parties. In similar situations, which may also be objected by any party involved, the Member shall be replaced for the decision by the relevant alternate. However, Members shall not be removed during their term of office, unless for serious misconduct and upon decision of the Management Board which has elected them, in consultation with the Board of Supervisors of the same European Supervisory Authority.

d. Remedies and safeguards

Any decision taken by the EBA, either addressed directly to financial institutions or to national authorities, may be appealed by the addressee or any other natural or legal person directly and individually concerned by that decision[169]. As a general rule, the appeal may not suspend the decision, but a suspension may be granted by the Board of Appeal when it deems that circumstances so require[170]. The Board of Appeal shall take any measure and exercise any power within the competence of the EBA, or remit the case to the competent body for a new determination. The EBA shall be bound to its decision.

The composition of the Board of Appeal (two Members elected by each European Supervisory Authority) should guarantee high profile decisions, ensuring a broad vision of the financial system, from a cross-sector perspective. However, it remains to be seen whether the Board of Appeal will engage in technical details or leave them to competent authorities for (re)determination. In the latter case, the Board of Appeal should provide the authority concerned with binding guidelines[171].

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[167] The Board of Appeal shall vote with a qualified majority of two thirds and make public its rules of procedure. See article 46.6 of the EBA Regulation.

[168] See recital (40) of the EBA Regulation.

[169] The appeal may be filed with the Board of Appeal through a reasoned written document within two months of the notification to the addressee or (in absence) the publication of the decision by the EBA. The Board of Appeal may decide within two further months. See article 46 of the EBA Regulation.

[170] Ibid. article 46.3.

[171] A similar rule is not contained in the draft EBA Regulation (nor in the proposed regulations establishing the EIOPA and the ESMA). Nevertheless, it may be specified in the rules of procedure to be published by the Board of Appeal according to article 45.6 of the EBA Regulation.

The decision of the Board of Appeal may be contested before the European Court of First Instance or the ECJ under article 230 of the Treaty[172]. If a European Supervisory Authority fails to take a decision where it has an obligation to act, the relevant case may be filed before the European Court of First Instance or the ECJ, under article 232 of the Treaty[173].

In reality, decisions included in the competence of European Supervisory Authorities may also be taken by the Commission or the ESRB, either on their own initiative or by request of national supervisors. In no case, however, will financial institutions be entitled to ask for similar actions. Moreover, no appeal may be filed in the absence of a decision by the European Supervisory Authority. Therefore, a claim before the European courts under article 232 of the Treaty[174] shall protect financial institutions in the case of European Supervisors' inaction.

Moreover, European Supervisory Authorities shall ensure that no decisions addressing emergency situations or settling disagreements between national supervisors impinge on fiscal responsibilities of Member States[175].

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[172] See article 47.1 of the EBA Regulation or of the proposed regulations establishing the EIOPA and the ESMA.

[173] Ibid. article 47.2.

[174] In particular, article 232.3 of the Treaty states that "any natural or legal person may, under the conditions laid down in the preceding paragraphs, complain to the Court of Justice that an institution of the Community has failed to address to that person any act other than a recommendation or an opinion".

[175] As a safeguard, Member States may notify within one month the relevant European Supervisory Authority and the Commission that the decision will not be implemented by the competent national authority. Member States shall give clear reasons to demonstrate how the decision impinges on their fiscal responsibilities. As a result, the decision of the European Supervisory Authority shall be suspended, and the latter shall inform the Member State within one month of the receipt of the notification, on whether it intends to maintain the relevant decision, to amend or revoke it. In the case that the European Supervisory Authority maintains its decision, the Council, acting by qualified majority, shall determine within two months whether the decision is to be maintained or revoked. The suspension of the decision shall be terminated if the Council decides to maintain the same or does not revoke it within two months. Decisions of European Supervisory Authorities taken as a reaction to emergency situations (under article 10.2) are subject to similar safeguards. However, given the urgency, the procedure for determining whether the decisions impinge on the Member States' fiscal responsibility is significantly abbreviated: the Member State concerned shall notify the

IV. **What about crisis management?**

1. Early intervention measures

We have seen that, according to the proposed new supervisory framework, the EBA would have the power to act in emergency situations. Its action would be aimed at ensuring compliance of financial institutions with EU Banking Law, possibly overruling national authorities, if the same do not take appropriate measures[176]. Under the current regulatory framework, competent authorities may adopt similar measures (so called 'early intervention measures') with respect to financial institutions, which do not meet certain prudential requirements. Under article 136 of the CRD, competent authorities may require the ailing institution to raise its capital requirements above minimum standards; reinforce its organizational structure, governance and risk management arrangements; adjust the provisioning policy and the treatment of assets in terms of own funds; limit or restrict business activities and reduce their intrinsic risk[177]. Similar measures, when adopted at an early

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European Supervisory Authority, the Commission and the Council that the decision will not be implemented by the competent national authority within three working days of its notification or publication. The Council may revoke the decision within the following ten working days, otherwise the decision shall be deemed to be maintained and has to be enforced. See article 23 of the proposed regulations establishing the EBA, EIOPA and ESMA.

[176] See article 10 of the EBA Regulation, combined with article 9.6 of the version revised by the European Council.

[177]Similar measures are considered a type of early intervention also by the European Commission: "Communication from the Commission to the European Parliament, the Council, The European Economic and Social Committee, The European Court of justice and the European Central Bank. An EU Framework

stage, may help to provide the ailing institution with incentives to prevent the worsening of a crisis[178].

Indeed, loyalty to shareholders may induce the managers to shift value away from creditors[179]. This agency problem vis-à-vis the creditors[180], which is common to non-financial institutions, is exacerbated by the high leverage of banks. It can take the form of either excessively high dividend payments or of an exploitation of limited liability, which permits shareholders to profit of gains from risky activities, while protecting the same from losses determining a negative net value of their investment[181]. The cost of failure is, therefore, shifted to creditors and other stakeholders (the financial system as a whole, in the case of systemically significant institutions). In addition, moral hazard is more pronounced as the firm approaches insolvency[182].

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for Cross-border Crisis Management in the Banking Sector" [COM (2009) 561/4], 20 October 2009. Available at: http://ec.europa.eu/internal_market/bank/docs/crisis-management/091020_communication_en.pdf. See also the "Accompanying Commission Staff Working Document", available at: http://ec.europa.eu/internal_market/bank/docs/crisis-management/091020_working_document_en.pdf (both last accessed 19 Nov. 2009).

[178] See R Carnell, "A partial Antidote to Perverse Incentives: The FDIC Improvement ACT of 1991", (1993) 12 Annual Review of Banking Law 317. Also published in R Carnell, J Macey and G Miller, "The Law of Banking and Financial Institutions", 4° Ed. (2009) 280, Aspen Publishers, New York. The Author points out that the alignment of incentives of excessively risk taking institutions and forbearing supervisors may be particularly sensitive with deposit insurance.

[179] See M Cihak and E Nier, , cit. (note 17), 6.

[180] See M Jensen and W Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" in Journal of Financial Economics, October, 1976, V. 3, No. 4, 305-360, also available on SSRN, http://papers.ssrn.com/abstract=94043, 41 (last accessed March 2010).

[181] In other words, limited liability shareholders exercise for their investment a put option at strike price zero to other stakeholders.

[182] See J Macey and G Miller, "Bank Failures, Risk Monitoring, and the Market for Bank Control" (1988) 88 Colum. L. Rev 1162 et seq; Id. "Double Liability of Bank Shareholders: History and Implications" (1992) 27 Wake Forest Law Rev 32 et seq; M Keeley, "Deposit Insurance, Risk, and Market Power in Banking", in American Economic Review, V. 80, No. 5 December 1990, 1184; J Macey and M O'Hara, "The Corporate Governance of Banks" (2003) FRBNY Economic Policy Review, 97 et seq.; M Cihak and E Nier, cit (note 17) 6.

As a result, early intervention measures play a crucial role in preserving acceptable risk levels of ailing banks' operations. In particular, requiring the relevant institution to divest some of its riskier assets or business activities, in order to meet higher capital requirements, may prevent the same from engaging in asset substitution and shifting to even riskier activities, as a result of managers and shareholders' moral hazard. In fact, asset substitution and risk shifting can be put in place more rapidly at financial institutions than at non-financial firms[183]. This further supports the need for timely and effective early intervention measures at ailing financial firms. An additional reason is the speed at which bank liquidity crises turn into solvency ones, if appropriate measures are not taken at a sufficiently early stage[184]. A sudden loss of confidence can cause a "run" on the financial institution, also in the form of a drying up of its wholesale funding. This may cause difficulties in meeting short term liabilities and possibly the "fire sale" of assets, eventually leading to solvency problems. Once a similar point is reached (absent appropriate resolution tools), the only alternative to insolvency and the relative systemic and social consequences, is a public bail-out. This exacerbates moral hazard of banks' managers, shareholders and creditors. On the contrary, a credible threat of business closure at an early stage (in order to avoid the worsening of the situation and larger systemic and social costs of failure) may also offer incentives to improved risk management and sounder provisioning policy.

Under the currently proposed framework, the decision to apply early intervention measures at group level may be taken jointly by competent national authorities[185] under the coordination (including

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[183] See Ross Levine "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence", World Bank Policy Research Working Paper 3404, September 2004, 3, available at: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2004/10/08/000012009_20041008124126/Rendered/PDF/WPS3404.pdf (last accessed March 2010)

[184] See Huepkes, cit. (note 49).

[185] See article 1.31 (b) of the Amendment Directive, introducing paragraph 3 in article 129 of the CRD. For more details, see above, section 4.

binding mediation in case of disagreements) of the EBA[186]. However, such measures leave management in control and may therefore not be sufficient in resolving a crisis situation at the early stage. Moreover, should the credit institution fail to find adequate solutions and, as a result, to comply with prudential requirements, the likely outcome (other than a public bail-out) will be insolvency and eventually liquidation.

2. Insolvency

Insolvency of cross-border banks in the EU is regulated by Directive No. 2001/24/EC on the reorganization and winding up of credit institutions (Winding Up Directive)[187], following the principles of home State control and mutual recognition. This reflects the so called "universality" principle, under which home State insolvency rules apply to all cross-border branches throughout the EU[188]. This implies that a single bankruptcy procedure is opened in the home State and decisions taken by the home resolution authority are enforceable across-borders without the need

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[186] See article 9.24 of the "Proposal for a Directive Of The European Parliament And Of The Council Amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority", cit. (note 114).

[187] According to the press release by the Commission (IP/01/344) of 12 March 2001: "The Directive was first proposed in 1985, but adoption was held up for several years due to disagreements between the UK and Spain over Gibraltar". The press release is available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/01/344&format=HTML&aged=1&language=EN&guiLanguage=en (last accessed March 2009).

[188] See T Baxter, J Hansen and J Sommer, "Two Cheers for territoriality: An Essay on International Insolvency Law", in Am. Bank L.J 78 (2004) 58; R Lastra, "Northern Rock, UK bank insolvency and cross-border bank insolvency", Journal of Banking Regulation, 2008, Vol. 9, 3, 175.

for any further formality[189]. Accordingly, authorities from the Member State where the bank has its registered office are responsible for either the reorganization or the winding-up of the bank and its EU branches[190].

The same principles, however, imply that subsidiaries in a banking group are subject to insolvency procedures in their State of incorporation. Therefore, no common insolvency regime is available to cross-border banking groups, despite the centralization of group functions and the relative substitutability of branches and subsidiaries on operational grounds[191]. Coordinated resolution of cross-border banking groups relies, therefore, on domestic procedures (notwithstanding the universality principle, which is limited to branches) and voluntary cooperation of national authorities. The recent crises of multinational banks showed that voluntary (non binding) cooperation agreements between Member States did not prove effective when domestic financial stability and taxpayers' money were at stake. National authorities and governments, only indirectly accountable to national voters and taxpayers, did not have sufficient incentives to stick to

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[189] See A Gardella, "Cross-border banking insolvency: private international law and State aid rules", EUREDIA 1 (2009) 133.

[190] See article 10 of the Winding Up Directive, which includes in the areas subject to home State laws, regulations and procedures , in particular:

"(a) the goods subject to administration and the treatment of goods acquired by the credit institution after the opening of winding-up proceedings; (b) the respective powers of the credit institution and the liquidator; (c) the conditions under which set-offs may be invoked; (d) the effects of winding-up proceedings on current contracts to which the credit institution is party; (e) the effects of winding-up proceedings on proceedings brought by individual creditors, with the exception of lawsuits pending [which are subject to the rules of the Member State where the law suit is pending]; (f) the claims which are to be lodged against the credit institution and the treatment of claims arising after the opening of winding-up proceedings; (g) the rules governing the lodging, verification and admission of claims; (h) the rules governing the distribution of the proceeds of the realisation of assets, the ranking of claims and the rights of creditors who have obtained partial satisfaction after the opening of insolvency proceedings by virtue of a right in re or through a set-off; (i) the conditions for, and the effects of, the closure of insolvency proceedings, in particular by composition; (j) creditors' rights after the closure of winding-up proceedings; (k) who is to bear the costs and expenses incurred in the winding-up proceedings; (l) the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all the creditors".

[191] See Huepkes, cit. (note 49); A Gardella, cit. (note 189) 135 et seq.

cooperation agreements and MoUs[192]. The non-cooperative dominant strategy led Members States to ring fence assets and split cross-border banking groups along national boundaries, eventually bailing-out the resulting domestic entity[193]. Moreover, cooperation was even more difficult due to deep differences amongst Member States' national insolvency regimes[194], which are closely linked to other areas of law (e.g. corporate and commercial law, but also civil law and procedure and constitutional law) and their legal traditions[195]. Indeed, the Winding Up Directive only harmonizes conflict of laws rules, leaving substantive insolvency rules untouched. Furthermore, the legal framework set out by the Winding Up Directive does not cover financial conglomerates, which make up a significant part of the systemically relevant financial institutions, as investment firms and e-money institutions are excluded from its scope of application[196]. Similar loopholes in the current framework are presently discussed. In a public consultation by the Commission on the reform of the Winding Up Directive[197], many responded that more centralized reorganization and insolvency

[192] See, e.g. the MoU of June 2008, cit. (note 66) which did not prevent the governments concerned from splitting up and separately bailing out the resulting parts of Fortis.

[193] Similar solutions imply a significant cost of breaking up, when addressed to financially integrated businesses. See M Cihak and E Nier, cit (note 17) 12.

[194] For an overview of the differences among bank insolvency procedures foreseen by Member States in the EU, see IMF, "Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency" (2009). Available at: https://www.imf.org/external/np/pp/eng/2009/041709.pdf (last accessed March 2009).

[195] See R Lastra, cit. (note 188) 175

[196] Note that both types of financial institutions are out of the scope of application also of EC Regulation 1365/2000, the other European legislative act harmonizing insolvency conflict of laws. See Huepkes, cit. (note 49); A Gardella, cit. (note 189) 135 for a critique.

[197] On 12 June 2007, the European Commission launched a public consultation on the Winding Up Directive aimed at examining whether the Directive completely fulfils its objectives, whether it could be extended to cross border banking groups, and how obstacles related to asset transferability within such groups can be addressed. See the consultation, and the answers at: http://ec.europa.eu/internal_market/bank/windingup/index_en.htm (last accessed March 2009).

proceedings for banking groups would be welcome, also allowing for asset transferability between group entities as a resolution tool[198].

3. The lack of adequate early intervention and resolution tools

Currently available early intervention measures, even if harmonized, are insufficient. Further tools to address the early stage of a crisis concerning cross-border banks are presently discussed in light of the recent financial turmoil[199]. Also asset transfers between group entities are being considered as an efficient bank-driven tool for risk and crisis management[200]. Indeed, the proper functioning of the internal capital market of integrated cross-border banking groups can be a source of stabilization and risk diversification, provided that effective coordination mechanisms for cross-border consolidated supervision are in place[201]. The current proposals enhance those mechanisms, but have to be completed with proper early intervention and resolution tools to cope with the crisis of integrated cross-border groups, without having to split the same along national boundaries and/or bail them out.

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[198] See the "Summary of the public consultation on the reorganisation and winding-up of credit institutions" (December 2007). Available at: http://ec.europa.eu/internal_market/bank/docs/windingup/spc_en.pdf (last accessed March 2009) 11 et seq.

[199] See the Communication of the Commission and the Accompanying Working Document for an EU Framework for Cross-Border Crisis Management in the Banking Sector, cit. (note 177).

[200] See the European Commission: "Feasibility study on asset transferability" (14 November 2008) 5. Available at: http://ec.europa.eu/internal_market/bank/docs/windingup/rep141108_en.pdf (last accessed March 2009).

[201] See G Barba Navaretti, G Calzolari, A Pozzolo and M Levi, (cit. note 2) 5 et seq.

a. Threshold conditions for early intervention

As bank crises typically tend to worsen very rapidly, it is essential that thresholds allowing for timely and effective early intervention[202] be defined and uniformly applied in Member States. Otherwise, conflicts between national supervisors could arise, notwithstanding the EBA's coordination efforts[203]. Two different approaches are possible: hard indicators, such as quantitative liquidity and solvency thresholds; and soft indicators, such as qualitative thresholds allowing for discretionary application by authorities. The first approach has the advantage of being clear and uniformly applicable by all authorities concerned. As discretion is reduced, also regulatory forbearance would be less probable[204]. This is particularly important where coordination of different authorities is needed and where the determination of a crisis situation triggering early intervention is left to national authorities. Indeed, under the currently proposed framework, early intervention measures in a cross-border group, are to be taken under the joint decision procedure set out by article 129 of the CRD. Too much discretion in the decision as to whether (and at which stage) to take similar measures could give rise to strategic behavior by competent authorities, rendering

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[202] See IMF, cit (note 194) 22, pointing out that "the regulatory threshold reflects the very essence of bank insolvency proceedings". See also M Cihak and E Nier, cit (note 17) 13, P Brierley, "The UK Special Resolution Regime for failing banks in an international context", Bank of England Financial Stability Working Paper No. 5, July 2009, 7..

[203] D Mayes, "Early intervention and prompt corrective action in Europe", Bank of Finland Research Discussion Papers 17 (2009). The Author argues that, as differences between early intervention tools and triggers are very different across the EU, the tasks for harmonization is even more important.

[204] The introduction of a hard threshold in the United States aimed at limiting regulatory forbearance by supervisory authorities during the Savings & Loans Crisis in the 1980s and early 1990s. See M Cihak and E Nier, cit (note 17) 14. However, also in the US, quantitative thresholds are not the only triggers to start a resolution regime and do not, therefore, eliminate supervisor's discretion in whether and how to exercise resolutions tools. This is due to the involvement in supervision and resolution of banks of the FDIC, which also acts as deposit insurer. Dual control of triggers (by the supervisor and by the resolution authority), however, mitigates the risk of regulatory forbearance. Incentives of the supervisor to delay the intervention of the resolution authority (as this would be an admission of regulatory failure) are counterbalanced by the fact that any forbearance by the supervisor would possibly make the resolution of the failing bank more difficult and complicating for the resolution authority the discharge of its responsibility. See P Brierley, cit (note 202) 7.

effective coordination and cooperation less likely. On the other hand, hard indicators will typically be under- or over-inclusive[205] and, possibly, more prone to elusion. Soft indicators, however, are less clear and more discretional, but more flexible and adaptive to each situation.

The relevant tradeoff is reflected in the policy debate over rules-based versus principles-based regulation. The former has the advantage of greater legal certainty and less costly (ex post) enforcement. However, it has larger (ex ante) costs in the determination of the right rule (or hard indicator, in the case at issue), and is more prone to elusion by financial innovation. Principles, on the other hand, have greater enforcement costs, while ex ante costs are reduced[206]. In the determination of thresholds triggering early intervention measures, however, enforcement costs might be further increased by lack of coordination of competent authorities and home country bias[207]. Therefore, the better coordination mechanisms are (e.g. through a greater involvement of the EBA), the more effective soft indicators might appear. On the contrary, if poor coordination mechanisms are in place, hard indicators might on the whole be more efficient. In any case, a combination of hard and soft thresholds could be a worthy compromise.

b. Resolution tools

Early intervention measures may not be sufficient to restore the soundness of a bank, so that a European bank resolution framework is also needed. This would complement the "centralization" of supervision on cross-border groups 'in life' with some degree of harmonization of the resolution

[205] These circumstances are commonly referred to as "Type I and Type II errors". D Mayes, cit. (note 203).

[206] See M Cihak and E Nier, cit (note 17) 14.

[207] For an assessment of the incentives of supervisory authorities to take regulatory actions in multinational banks depending on the its representation form though branches or subsidiaries see: See G Calzolari and G Loranth, cit. (note 2).

measures applicable 'in death', with the aim of reducing the systemic costs of bank failures[208] and possibly bailouts[209]. An analysis of the appropriate tools falls outside the scope of this paper. However, possible measures to be taken by competent authorities include: acquisition by a private sector purchaser; bridge bank created by the resolution authority to take over the operation of the failing institution and preserve its going concern value; partial transfer of deposits and assets to a "good bank", leaving the residual institution with the difficult-to-value or "toxic" assets as well as the cash raised by the transfer of the viable part; assisted sale to a private sector purchaser, possibly with guarantees to the acquirer (not to the shareholders and creditors of the ailing bank, as this would generate moral hazard); temporary public control, as a last resort[210]. Similar resolution tools would need to be adopted on a case by case basis, depending on the actual condition of the institution. Resolution authorities should be able to act swiftly and with a consistent set of discretionary powers. However, fully discretionary decisions by regulators, triggering measures which limit shareholders' and creditors' rights might conflict with the principles contained in the European Convention of Human Rights (ECHR)[211], as interpreted by the Strasburg Court (ECtHR).

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[208] See D Mayes, "Who pays for bank insolvency", Journal of International Money and Finance 23 (2004) 515–551.

J Macey and G Miller (1988) cit. (note 182) warn, however, that "methods devised for dealing with the problem of bank failures must therefore be sensitive to the concern that the current structure of banking regulation creates incentives for excessive risk taking" 1165.

[209] See M Cihak and E Nier, cit (note 17).

[210] Ibid. 15 et seq., for a more detailed analysis of the proposed resolution tools. Similar tools are foreseen by the UK Banking Act 2009. For a comment, see: See P Brierley, cit (note 202).

[211] Article 1 of Protocol 1 of the ECHR states:

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties".

In particular, companies shares[212] and creditors claims[213] fall within the concept of "possessions" as defined by the ECHR and limitations to proprietary rights should comply with three cumulative conditions: i) limitations must be in the public interest and must be foreseen by law (principle of legality); ii) fair compensation for the limitation must be provided to shareholders and creditors; and decisions (e.g. by regulators) on the limitation of rights must be subject to judicial review[214]. An excessive level of regulatory discretion by authorities could possibly conflict with the requirements set by the ECtHR and should therefore be carefully evaluated from the perspective of the three mentioned conditions. A consultation recently launched by the Commission aims at acquiring the views of market participants, but there seems to be already wide consensus on the need to adopt an EU framework for resolution of cross-border banks. Moreover, a similar task would not even necessarily require the harmonization of substantive (bank) insolvency rules[215]. Should the ailing bank's soundness not be restored, after the resolution of its systemically significant parts, the final liquidation of the residual assets of each subsidiary could take place under the laws of the relevant State of incorporation.

c. Changes to EU legislation

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[212] See ECtHR case law, along which a company share with an economic value can be considered a possession (Olczak v. Poland (dec.), no. 30417/96, § 60, ECHR 2002-X; Sovtransavto Holding v. Ukraine, no. 48553/99, § 91, ECHR 2002-VII).

[213] See ECtHR case law considering claims as "possessions" where they have a sufficient legal basis in national law: (Kopecký v. Slovakia [GC], no. 44912/98, §§ 52, ECHR 2004-IX; Draon v. France [GC], no. 1513/03, § 68, 6 October 2005; Anheuser-Busch Inc. v. Portugal [GC], no. 73049/01, § 65, 11 January 2007).

[214] K Alexander, "Bank resolution regimes: balancing prudential regulation and shareholders rights", JCLS April 2009.

[215] See Huepkes, cit. (note 49); L Scialom, "On the need of special rules dealing with bank insolvencies" (2006). Available at: http://economix.u-paris10.fr/pdf/workshops/2006_faillites/scialom_texte1.pdf (last accessed 19.Nov. 2009).

However, changes in EU company law may be necessary in order to make resolution tools more effective[216]. In particular, regulators should act swiftly in the interest of systemic financial stability and limit the consequences of the (worsening of the) crisis. Resolution tools aimed at restoring the viability of the ailing bank would need to be taken without shareholders' approval, in order to avoid lengthy bargaining (with the risk of strategic behavior by shareholders) and possible legal challenges[217]. The Second Company Law Directive[218], in particular, requires any increase or reduction of capital of a public company to be approved by the shareholders and does not allow pre-emptive rights to be suspended other than by a resolution of the shareholders' meeting. While measures taken during the company's liquidation would not be covered, early intervention and resolution measures aimed at restoring the soundness of an ailing bank would fall within the Directive's scope[219].

Moreover, the creation of a centralized European deposit guarantee scheme should be possibly considered[220], together with or as an alternative to a European Resolution Fund. A similar newly established Fund could be available to supervisors in order to temporary "finance" ailing

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[216] See M Cihak and E Nier, cit (note 17) 20; K Alexander, cit (note 214), 93.

[217] See K Alexander, cit (note 214), 66.

[218] Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, OJ L 26, 31.1.1977, p.1.

[219] See the European Court of Justice Case C-441/93 "Panagis Pafitis and others v Trapeza Kentrikis Ellados A.E. and others"(European Court reports 1996 Page I-01347), point 57, stating that: "The directive does not, admittedly, preclude the taking of execution measures intended to put an end to the company's existence and, in particular, does not preclude liquidation measures placing the company under compulsory administration with a view to safeguarding the rights of creditors. However, the directive continues to apply where ordinary reorganization measures are taken in order to ensure the survival of the company, even if those measures mean that the shareholders and the normal organs of the company are temporarily divested of their powers".

[220] However, a similar step, which is envisaged as a premise for the "more Europe" solution proposed by Lord Turner (see FSA, "The Turner Review" cit. (note 15) 101) could follow at a subsequent stage.

institutions and so allow the adoption of the appropriate early intervention and resolution measures[221]. It could provide liquidity and/or capital injections to systemically significant banks in emergency situations as defined by European Supervisory Authorities or the ESRB. Undoubtedly, the recent financial crisis and the (proposed) reform of the European supervisory architecture shall provide momentum for further European integration both in rule setting and supervision of cross-border institutions.

V. **Conclusions**

The recent financial crisis has underlined the differences between multinational banks and domestic ones. The former are relatively more exposed to wholesale funding and capital markets fluctuations which are cross-border in nature. The latter engage in more locally oriented and less integrated activities, such as retail lending. Similar operations are, compared with the multinational banking business model, less sensitive to cross-border risk factors. Multinational banks contribute to the integration of these market sectors, increasing competition and risk diversification, but are in general more exposed to cross-border externalities and spillovers. The current European regulatory and supervisory framework, which was developed under the traditional banking model, created the premises for the expansion of cross-border banks. However, it did not keep pace with their rapid development. The mismatch between the national scope of bank regulation and supervision and the

[221] See J Gordon, C Mueller, cit. (note 49).

cross-border nature of multinational banks' operations has been an obstacle for effective risk assessment and crisis management. Two possible approaches (not mutually excluding) to the growth of multinational banks have been suggested: (i) limiting the size or the scope of activities of banks, either through caps or through additional capital requirements; and (ii) strengthening the infrastructures for supervision and crisis management, while harmonizing and centralizing the same. We follow the second approach, on the assumption that it does not impose unnecessary costs on bank activities, which would be shifted to consumers and would negatively impact the lending capacity of banks. From this perspective, the steps taken so far in the EU, while remarkable, do not seem sufficient. The EBA's powers, while already too timid even in the Commission's proposal, have been further reduced by the Council. Moreover, the effectiveness of the regulatory and supervisory framework for multinational banks very much depends on how crisis management and resolution tools will be regulated.

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