Tilburg Law and Economics Center (TILEC) Law and Economics Research Paper No. 2009-001

Amsterdam Center for Law & Economics Working Paper No. 2009-01

European Corporate Governance Institute (ECGI) - Finance Working Paper No. 262/2009

Paolo Baffi Centre on Central Banking and Financial Regulation Research Paper No. 2009-58

August 2009

Empowering the ECB to Supervise Banks: A Choice-Based Approach

Gerard Hertig
ETH Zurich; European Corporate Governance Institute (ECGI)

Ruben Lee
Oxford Finance Group

Joseph A. McCahery
Tilburg University – Tilburg Law and Economics Center
Tilburg University – Law School
European Banking Center (EBC)
European Corporate Governance Institute (ECGI)

This paper can be downloaded free of charge from the Social Science Research Network at:
http://ssrn.com/abstract=1327824

european corporate governance institute

ecgi

Empowering the ECB to Supervise Banks: A Choice-Based Approach

Finance Working Paper N°. 262/2009

August 2009

Gerard Hertig
ETH Zurich and ECGI

Ruben Lee
Oxford Finance Group

Joseph A. McCahery
University of Amsterdam, Tilburg University and ECGI

© Gerard Hertig, Ruben Lee and Joseph A. McCahery 2009. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
http://ssrn.com/abstract_id=1327824

www.ecgi.org/wp

european corporate governance institute

ECGI Working Paper Series in Finance

Empowering the ECB to Supervise Banks: A Choice-Based Approach

Working Paper N°. 262/2009

August 2009

Gerard Hertig
Ruben Lee
Joseph A. McCahery

We are grateful to John Armour, Christine Benesch, Sylvester Eijffinger, Luca Enriques, Bruno Frey, Charles Goodhart, Paul Goldschmidt, Alain Hirsch, Henry Hu, Lewis Kornhauser, Maria Nieto, Donato Masciandaro, Alan Schwartz, Luigi Spaventa, Nicolas Véron, Eddy Wymeersch and to the participants at the AsLEA, Finlaw, Infiniti conferences and seminars in Oxford and Zurich/St. Gallen for their comments on an earlier draft.

© Gerard Hertig, Ruben Lee and Joseph A. McCahery 2009. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

The reform of bank supervision represents one of the great institutional challenges for the European Union. The recent pattern of cross-border failures in supervision reflects the extent to which a better functioning system of supervision is critical for the safe operation of the banking system in the EU. Within this framework, the main institutional reforms currently being proposed are likely to fail. It is thus worth considering alternatives. This paper explores the merits of a choice-oriented approach under which individual Member states have the option to delegate prudential supervision of their largest banks to the European Central Bank, while still retaining the right to re-assume such a role at a later date. Responsibilities, commitments and costs would be allocated by means of a binding agreement with the ECB that can be tailored to Member states' specific circumstances, to the extent permitted by supervisory coherence and equal treatment. The proposal offered here is superior to existing supervisory arrangements, and is likely to produce a more socially desirable outcome than the proposed alternatives.

Keywords: Banking supervision, European Central Bank, European integration, harmonization, legal options, prudential supervision, opt-in, supervisory colleges.

JEL Classifications: D02, E42, E58, G21, G28, K23

Gerard Hertig
ETH Zurich
ETH-Zentrum HG E65
CH-8092 Zurich Switzerland
phone: (011)-41-44-6324008 , fax: (011)-41-44-6321097
e-mail: gerard.hertig@recht.gess.ethz.ch

Ruben Lee
Tilburg University
Oxford Finance Group
25 Hugo Road, Tufnell Park
Oxford OX4 1QD United Kingdom
phone: (011)-44-20-77002917 , fax: (011)-44-20-77002201
e-mail: rubenlee.ofg@btinternet.com

Joseph A. McCahery*
Tilburg University--Tilburg Law and Economics Center
Warandelaan 2
Tilburg 5000 LE
Netherlands
phone: +31-(0)13-466-2306 , fax: +31-(0)13-466-2323
e-mail: j.a.mccahery@uvt.nl

*Corresponding Author

“Paolo Baffi” Centre on Central Banking and Financial Regulation

“Paolo Baffi” Centre Research Paper Series No. 2009-58

Empowering the ECB to Supervise Banks: A Choice-Based Approach

by
Gerard Hertig,
Ruben Lee
and
Joseph A. McCahery

This Paper can be downloaded without charge from
The Social Science Research Network Electronic Paper Collection:
http://ssrn.com/abstract=1460527

Electronic copy available at: http://ssrn.com/abstract=1460527

I. INTRODUCTION

Empowering the European Central Bank (ECB) to supervise banks is not a new proposal. All previous attempts to make the ECB the pan-European supervisor have, however, failed, due to various economic and political considerations. The deficiencies in supervision unveiled by the recent credit crisis have indicated the conflicts between economic and non-economic objectives of banking supervision, and now provide the opportunity for a new approach. The purpose of this paper is to propose a choice-oriented model of ECB banking supervision that will result in a credible institutional structure without the need to create a complex model of coordination. The key rationale for the choice-based approach is that the ECB is a more effective manager of Member state banking systems dominated by large cross-border banks, and will be less expensive in resolving crises than other systems of oversight proposed.

Whilst the European Community (EC) has harmonized banking regulation, banking supervision remains decentralized. This has the advantage of empowering the agency closest to the main domain of activity of most banks. However, it also implies the need for close international collaboration in the supervision of those banks that have significant cross-border operations. Consequently, EC law requires Member states to enter into written coordination and cooperation agreements not only for banks with branches outside the home Member state, but also for those with subsidiaries in other Member states. Many bilateral Memoranda of Understanding (MoU) establish regular exchanges of information and procedures for on-site inspections. In addition, European Union (EU) banking supervisors have signed three multilateral Memoranda of Understanding on financial crisis management which also involve central banks and treasuries. The efficiency of these non-legally binding arrangements, especially their robustness in times of crisis, has long been questioned, and the credit crisis has shown that these concerns were justified.

It thus comes as no surprise that a number of institutional reform proposals have emerged, including the establishment of a ‘global’ regulatory body, of ’European’ supervisory colleges, and of a European System of Financial Supervisors. There is little enthusiasm for participating in a global body and increasing consensus that European supervisory colleges will not prove more effective than the supervisory colleges previously established by the Member states. As a result, the European Commission has proposed to set up a European Systemic Risk Council and to reinforce existing supra-national institutions by replacing the Committee of European Banking Supervisors by

Electronic copy available at: http://ssrn.com/abstract=1460527

a European Banking Authority operating within a European System of Financial Supervisors. While this architecture reflects a more centralized approach, it is only a first step on the way towards supervision at the European level and there is widespread scepticism about its likely effectiveness.

Our alternative starting point is that Member states will find advantages to delegate prudential supervision powers to the European Central Bank for the forty or so banks that have large cross-border operations within the EU. We illustrate the supervisory quality, reputation, politics, cross-border and bail-out incentives that Member states have to opt into ECB supervision and show that, for a significant number of Member states, these incentives dominate the sovereignty, regulatory arbitrage and bail-out disincentives to enter into such an opt-in agreement. We similarly examine the political, reputational, cross-border and bail out incentives that influence the ECB's motivation to undertake the supervision of large cross-border banks. Here too, these incentives dominate the ECB's independence, credibility and monetary disincentives to enter in an opt-in agreement.

The effectiveness and efficiency of ECB supervision will depend upon the design of the opt-in agreement.[1] Supervisory coherence and equal treatment require that all opting-in agreements share the same structure and build upon common principles. However, given that the economic and political environment varies from Member state to Member state, the parties must have some discretion as to the exact content of a specific opt-in agreement (one size cannot fit all). It would be unduly complicated to discuss the full details of the arrangements the parties may choose. We focus on four aspects that are critical for any opt-in agreement: the allocation of responsibilities (who does what), the commitments (what happens in financial distress situations), the costs (who pays for what), and termination arrangements.

We specify how the opt-in agreement's core provisions can ensure the effectiveness of the ECB and Member state cooperation and coordination. We also show how the opt-in agreement can contribute to beneficial cooperation with other Member states (or non-EU jurisdictions) in normal times and in periods of financial distress — something which has not always occurred in the current system of coordination. In particular, we suggest that financial distress be dealt with *ex ante* through provisions that 1) require banks covered by the opt-in agreement to submit a rapid resolution plan, 2) set triggers for early ECB corrective action, 3) make Member state bail-outs

---

[1] We refer to the opt-in as an agreement to emphasize its negotiated and binding nature. Technically, however, it may take the form of an ECB decision. See *infra* 5.1.

contingent upon an ECB financial stability assessment, 4) specify burden sharing among opting-in Member states, and 5) yield to the ECB the power to file for resolution under the Member state's laws.

In addition, we specify that the banks falling within the scope of the opt-in agreement will not be allowed to opt-out, unless they stop satisfying the thresholds for ECB prudential supervision, become fully insured by a supra-national institution, or reincorporate in a Member state that has not opted into ECB supervision. Member states, for their part, will be allowed to opt out of ECB supervision at the end of the first five year period and every three years thereafter.

Finally, we analyze the principal benefits of the opt-in agreement from an EU perspective. The main positive feature is that Member states will, if they choose, belong to a regulatory framework that is appropriate for overseeing large cross-border banks, and is able to provide market discipline and support in the context of a banking crisis. There are questions whether the additional positive feature of decreasing transaction costs (bilateral relations are easier to manage) is sufficient by itself to make our approach superior to the alternatives proposed. We do not claim that our approach is perfect, merely that it is superior to both existing supervisory arrangements and the main proposed alternatives, and also the best feasible choice in the present circumstances. The comparative advantages of choice-based ECB supervision are its flexibility, immediate implementation, legal robustness, contribution to financial stability and political acceptability. Opt-in agreements take advantage of existing Member state laws and require no Treaty amendment, provide *ex ante* solutions to bail-out situations, are less interventionist than competing proposals and provide for better supervisory accountability.

Whilst a number of objections can be raised to a choice-based approach, we believe them to be unpersuasive as they do provide no empirical or theoretical support for why our proposal would not significantly improve cross-border supervision. It will not make the administration of banking supervision more expensive. There is no reason to fear that the ECB's supervisory powers will interfere with its monetary policy duties given the increasing link between financial stability and monetary policy. Nor is there a risk that the opt-in agreement will put the ECB balance-sheet at risk, as its financial contributions in bail-out situations will be similar to those under the *status quo*, namely ensuring the provision of unlimited liquidity against almost any collateral. Finally, there would no significant disadvantages in having just a few or even no Member state opting-in. If even only a couple of Member states opt-in, the EU would still benefit from a diminution of its

(excessive) number of banking supervisors, and if no Member state opts in, the costs would be minimal.

The rest of the paper is organized as follows. Section II describes the circumstances that have led to calls for institutional change. Section III analyses the incentives for Member states to opt into ECB supervision and the ECB's incentives to undertake such a task. Section IV assesses the other main institutional reform proposals. Section V frames a choice-oriented alternative, makes the case for adopting it and argues that possible objections are not persuasive. Section VI concludes.

II. WHY CHANGE THE SUPERVISION ARCHITECTURE?

2.1 Banking supervision design: a historical perspective

Banks are typically subject to state supervision in most, if not all jurisdictions. In theory, banks generally perform four basic functions: offering liquidity and payment services; transforming assets; managing risks; and processing information and monitoring borrowers (Freixas and Rochet 2008). There is disagreement, however, over whether and how banks should be supervised. For a few, there is no good reason to supervise banks at all (Hayek 1978; Dowd 1989; Glasner 1989). Others would limit supervision to making sure that banks with state deposit insurance invest only in very liquid assets (Tobin 1985; Litan 1987). However, most theorists now favour a broader supervisory domain, although there is significant divergence about the extent to which supervisory discretion should be constrained (compare Friedman 1959; Dewatripont and Tirole 1994; Benston and Kaufmann 1995; Spencer 2000; Calomiris 2003).

It is sometimes suggested that historical evolution can explain the differences in these various models. During the 19th century, many countries favoured a predominantly laissez-faire approach to banking supervision—often cited examples being the U.S., Sweden and Scotland. Increases in bank-size and financial inter-actions as well as ownership dilution resulted in a more interventionist approach. This development was driven by the realization that it had become more likely for losses at one bank to spread across banks, hurting depositors and, ultimately, the real economy. The threat to financial stability was tackled by the adoption of "prudential" supervision aimed at reducing the risk of bank runs and disruption in payment systems. Over the years, this original goal was supplemented by two additional goals, consumer protection (to prevent banks from acting opportunistically vis-à-vis depositors) and financial market efficiency (by improving financial transaction transparency and orderliness).

The scope of banking supervision has also varied over time and across jurisdictions (Padoa-Schioppa 2004). One restrictive approach, implemented in the U.S. during much of the 20th century, constrained banks from undertaking almost all activities, except those linked to deposit-taking and loan-making. A more liberal approach, operating until recently in France and Germany, allowed banks to undertake a wide range of activities, with the ultimate result that all financial services providers were considered banks and supervised as such. Under an intermediate approach, adopted in the European Union and in many other jurisdictions, only deposit-takers and loans-makers are considered banks, but the latter are allowed to undertake a wide range of activities.

The design of supervisory institutions is continuing to evolve. State supervision was originally imposed as a *quid pro quo* for banks being granted access to central bank liquidity support in times of emergency. As a result, it was generally central banks rather than specialized agencies that first supervised banks. In most jurisdictions, this model is still applicable (Arnone and Gambini 2007). However, various major jurisdictions have redesigned the model in a way that curtailed the supervisory powers of central banks in favour of various specialized agencies (see di Girogio and Di Noia 2007). Over time, the integration of the banking, securities and insurance markets brought some of these jurisdictions to integrate financial supervision within a single authority.

The single authority supervision model was first adopted in Scandinavia and the UK (in 1998), with other European and Asian jurisdictions—including Austria, Belgium, Germany, Japan, Korea, Ireland and Poland—doing so thereafter (Masciandaro and Quintyn 2009a and 2009b). The single supervisor is responsible for overseeing all financial industry segments and its appearance generally coincided with further declines in central bank supervisory involvement (Masciandaro 2007). Other major jurisdictions, including Italy, The Netherlands and the U.S., have adopted supervisory models that combine the so-called 'silos' model (separate agencies for the banking, securities and insurance sector) and the so-called 'peaks' model (separate agencies for financial stability, consumer protection and financial market transactions). Central banks continue to play an important role under this hybrid model, as they are often the agency in charge of prudential supervision, at least for larger banks.[2]

[2] Note that empirical studies have yet to show that one of these institutional models is clearly superior to the others. See Masciandaro and Quintyn 2009.

2.2 Deficiencies in EU banking supervision architecture

The EC has enacted several banking directives.[3] However, banking supervision effectively remains decentralized. Member states must subject banks (or to use EC terminology "credit institutions") to prudential, market and consumer protection supervision, but remain free to adopt the institutional design that they deem best suited to their needs. Nevertheless, harmonization is "complete" enough for banks supervised in one Member state (the home state) to be able to offer banking services or establish a branch in another Member state (the host state) without becoming subject to prudential supervision by that state. Under this "home country control" approach, a bank can essentially do business throughout Europe under the banking law of its home state. The host state remains, nevertheless, empowered to impose branch liquidity requirements and additional compliance with rules it has adopted in the interests of the general good.

Decentralized banking supervision has the advantage of empowering the agency closest to the main domain of activity of most banks. But it requires close international collaboration in the supervision of those banks that have significant cross-border operations. Therefore, EC law requires Member states to enter into written coordination and cooperation arrangements for banks with branches outside their home Member state. [4] The same requirement also applies for banks with subsidiaries in other Member states: while a subsidiary is supervised by the Member state in which it is incorporated, the parent bank's home Member state is responsible for consolidated supervision at the group level.[5]

Many bilateral Memoranda of Understanding between Member states establish regular exchanges of information and procedures for on-site inspections. In addition, EU banking supervisors have signed three, non legally-binding, multilateral Memoranda of Understanding on financial crisis management which also involve central banks and treasuries. The efficacy of these cooperation arrangements and their robustness in times of crisis, has been questioned for some time by commentators (e.g. Schinasi and Teixeira 2006). The credit crisis justified such concerns by

---

[3] See, in particular, Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, OJ [2006] L 177/1.

[4] See Art. 131 of the Credit Institution Directive, *supra* note 3, and Art. 38 Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions, OJ [2006] L 177/201.

[5] See Art. 125 Credit Institution Directive, *supra* note 3.

revealing the arrangements' failure to address properly conflicts of interests among supervisors, diversity in deposit insurance schemes, and financial distress situations.[6]

Conflicts of interest. Banking supervisors across Europe have often downplayed financial difficulties faced by banks operating in their jurisdictions. This can be understood as an effort to prevent a downward spiral in confidence that could lead to bank runs and payment system disruptions. As will be illustrated below for financial distress situations, however, it is also likely to reflect opportunistic behaviour (Olson 1965; Holthausen and Roende 2004). When the supervisor of a parent bank downplays the financial difficulties it faces, he normally makes it harder for the supervisors of the group's subsidiaries or branches to take preemptive measures to protect local depositors—for example by constraining the transfer of liquidity or assets from branches or subsidiaries to the parent bank. Similarly, when the supervisor of a subsidiary or a branch downplays the financial difficulties they face, he normally reduces the probability of early corrective actions by the parent's supervisor (for example, by constraining subsidiary or branch activity), or increases the probability of obtaining a free ride (for example, by having the parent supervisor support the monetary and reputation costs of corrective actions). In other words, deficiencies in information exchange and cooperation agreements among supervisors are likely to have been motivated by, or at least to have facilitated the unilateral, self-interested exploitation of information asymmetries.

Deposit insurance. EC law originally provided that Member states had to implement deposit-guarantee schemes covering a minimum of €20,000 per depositor.[7] At first, most Member states adopted schemes to deal with the failure of a mid-sized bank, but there were differences in coverage—both in general, and in the treatment of foreign branches and depositors.[8] Hence, the decentralized approach to deposit insurance added regulatory competition issues to the usual cross-border regulatory conflicts of interests (Eisenbeis and Kaufman 2008; Huizinga 2008). In past years, there were indications that new Member states were engaging in a race to the bottom, by

---

[6] See, for example, High-Level Group on Financial Supervision in the EU, *Report* 39-42 (February 2009, available at europa.eu) (hereafter de Larosière Report); Financial Services Authority, *The Turner Review* 36-7, 96-7 (available at fsa.gov.uk).

[7] See Directive 94/19/EC on deposit-guarantee schemes, OJ [1994] L 135/5. The minimum amount has now been raised to €50,000, with a further increase to €100,000 becoming effective by the end of 2010. See Directive 2009/14/EC amending Directive 94/19/EC, OJ [2009] L 68/3.

[8] See European Commission, *Report: Investigating the Efficiency of EU Deposit Guarantee Schemes* (May 2008, available at ec.europa.eu).

trying to attract international depositors with lower insurance premiums (Nenovsky and Dimitrova 2008). The trend was reversed post August 2007. Ireland and Germany launched a race to the top, trying to improve the competitiveness of their banks by introducing unlimited state deposit guarantees.[9]

These measures did have their intended effect, as other Member states quickly responded with their own deposit guarantee measures. The Irish and German actions did, however, provide examples of Member states acting in what they consider their best interest, even though this may have negative effects for banks in other Member states. In the case of Ireland, regulators tried to give the six major Irish-owned banks a first mover advantage by providing them with blanket deposit guarantee coverage for private and corporate depositors. The (real or perceived) impact on the competitiveness of non-Irish-owned banks led many Member states, including Germany and the UK, to object strongly — forcing Ireland to soften its policy by extending the blanket guarantee to subsidiaries owned by various banks incorporated in other Member states. Another consequence of the Irish favourable treatment of domestic banks was to prod leaders of Europe's largest economies to meet to discuss greater coordination of deposit guarantee schemes. Ironically, one of the participants, Germany chose to announce unilaterally a blanket deposit guarantee the very day following the meeting, reportedly blindsiding and definitely angering the other summit participants.

The extent to which coordination and cooperation has been further weakened by these events remains unclear. However, given that cross-border banking supervision requires mutual trust, it is unlikely that these public rows among senior public officials have reinforced it.

Financial distress. Cross-border financial distress situations present additional direct evidence of supervisory coordination and cooperation failures. Member states have generally set up dedicated supervisory colleges for each bank with cross-border activities, with the home Member state supervisor serving as the chair.[10] Prior to the recent credit crisis, these colleges were expected to respond to any financial distress in a swift and efficient manner.

---

[9] Albeit not strictly a EU example, the UK's seizure of the UK assets of failing Icelandic banks to protect UK depositors against the risk of Iceland refusing to make deposit guarantee payments to depositors outside Iceland is another way of racing to the top.

[10] These colleges are based upon *ad hoc* agreements or the Memoranda of Understanding mentioned above.

In practice, the available evidence suggests that this was not the case (Véron 2008). To highlight the ineffective coordination efforts of the colleges, a good example is provided by the rescue of Fortis, a major bank based in Belgium, with significant operations also in Luxemburg and the Netherlands. It has been reported that financial distress information was not properly shared and supervisory authorities waited for each other to initiate emergency contacts.[11] As a result, decisive action was delayed, forcing a last-minute emergency bail-out to prevent a bank run. Similar issues apparently plagued the rescue of Dexia, a French bank with operations in Belgium and Luxembourg. To be sure, the evidence remains scarce. But the general view is that the involvement of multiple supervisors and the lack of clarity regarding financial burden-sharing resulted in coordination and cooperation failures, with many bail-outs being very close calls.

It thus comes as no surprise that the European Commission, supported by the European Council, is proposing to establish a European Systemic Risk Council (ESRC) and reinforce existing supra-national institutions by replacing the Committee of European Banking Supervisors (CEBS) by a European Banking Authority (EBA). However, the ESCRC will only have the power to issue recommendations and the EBA will not be able to take decisions that impinge in any way on the fiscal responsibilities of Member states.[12]

This soft 'reinforcement' approach has led academics, journalists and even regulators to express scepticism about its workability.[13] We share this view and, in addition, claim that it would be preferable to give Member states the option to delegate prudential supervision of their largest banks to the ECB. However, any discussion of the respective pros and cons of the reinforcement and optional approaches presupposes that at least some Member states would opt into ECB supervision if given a choice and that the ECB is prepared to play such a role.

---

[11] See Pascal Dendooven, *Arrogante Bank in Crisis*, DE STANDAARD, November 15, 2008, at 34-35.

[12] See *infra* Section IV.

[13] See, for example, Lorenzo Bini Smaghi, *Europe Cannot Ignore Its Financial Trilemma*, FINANCIAL TIMES, June 22, 2009 at 7 (criticizing the reluctance to strengthen supervisory powers at the European level); Callum McCarthy, *Britain is not a Regulatory Island*, FINANCIAL TIMES, April 1, 2009 at 11 (the present position is unsustainable as far as branches are concerned); Xavier Vives, *Europe's Regulatory Chaos*, WALL STREET JOURNAL (European ed.), March 18, 2009 at 15 (Europe needs a single supervisor for large cross-border groups); Nikki Tait, *Brussels Left to Finish 'Mission Impossible'*, FINANCIAL TIMES, February 26, 2009 at 2 (whether the proposed structure will iron out the regulatory confusion that could occur if big cross-border banks got in trouble is open to question).

III. ECB SUPERVISION INCENTIVES AND DISINCENTIVES

In what follows, we propose a choice-oriented model of supervision, under which a Member state, within or outside the Euro zone, can opt into ECB supervision of the Member state's "part" (namely any parent, subsidiary or even branch, operating in the pertinent Member State) of a bank with significant cross-border activities. Hence, the opt-in cannot cover all banks operating in the Member state, but only those large or 'risky' enough to endanger EU financial stability in case of insolvency.

Taking advantage of this opt-in procedure is straightforward because it will become effective upon the conclusion of an agreement between the Member state and the ECB. Whilst impossible to design as a fully standardized contract (we assume that no one size fits all), each opt-in agreement will allocate responsibilities (who does what), commitments (what happens in financial distress situations), and costs (who pays for what), and also specify how the agreement itself can be terminated.[14]

How easy would it be to transfer this power to the ECB? Self-evidently, a Member state will only choose to do so, and the ECB be willing to act as a banking supervisor, where there are clear factors supporting the shift to a centralized institutional arrangement.

3.1 *Member state willingness to opt-in*

When system-wide problems and domestic problems of individual banks converge, Member states are uniformly inclined to guarantee liabilities, to buy illiquid assets and to provide capital injections to deal with problems at troubled banks. However, moral hazard and differences in the sizes and resources of national regulators make it unlikely that Member states have similar incentives when the troubled bank has extensive cross-border activities.

This may not be a problem for a larger Member state with a large number of parent banks with branches in other Member states or for a smaller Member state where financial activities are mostly domestic. Generally, within this setting, home bias in banking supervision is unlikely to result in the Member state incurring significant costs because of deficient supervision of banks incorporated in another jurisdiction.

[14] See *infra* 5.1.

A Member state with a large number of parent banks with branches in other Member states is likely to have significant banking supervision expertise and cross-border clout. This will reduce not only information asymmetries between the home and host supervisors, but also limit the potential for and attractiveness of opportunistic behaviour by the host Member state. The parent's Member state has considerable prudential powers over both the parent and the branch, whereas the host Member state has only liquidity and public good supervisory powers over the branch. As a result, the host supervisors knows much less than the home supervisors and its intervention possibilities are much more limited than those of the home supervisors. And, by definition, a smaller Member state where financial activities are mostly domestic is less likely to be affected by the home bias of supervisors located in other Member state.

By contrast, the stakes will be different in a larger Member state where financial activities by foreign parent banks play a significant role, or for a smaller Member state with a few parent banks with subsidiaries or branches in other Member states. Within this setting, deficient supervision by the parent bank's home supervisor or deficient coordination and cooperation with foreign supervisors may result in the Member state incurring significant costs in terms of economic disruption, bail-out contributions, deposit insurance and resolution procedures. We hypothesize that it is primarily this class of Member states that will have significant incentives to opt into ECB supervision.

As illustrated in Table 1, a Member state's willingness to subject the constituents of banking groups with significant cross-border activities to ECB supervision will depend upon the impact of such a decision on several key issues: supervisory quality, Member state reputation, political factors, and, most importantly, cross-border supervision and bail-out situations.

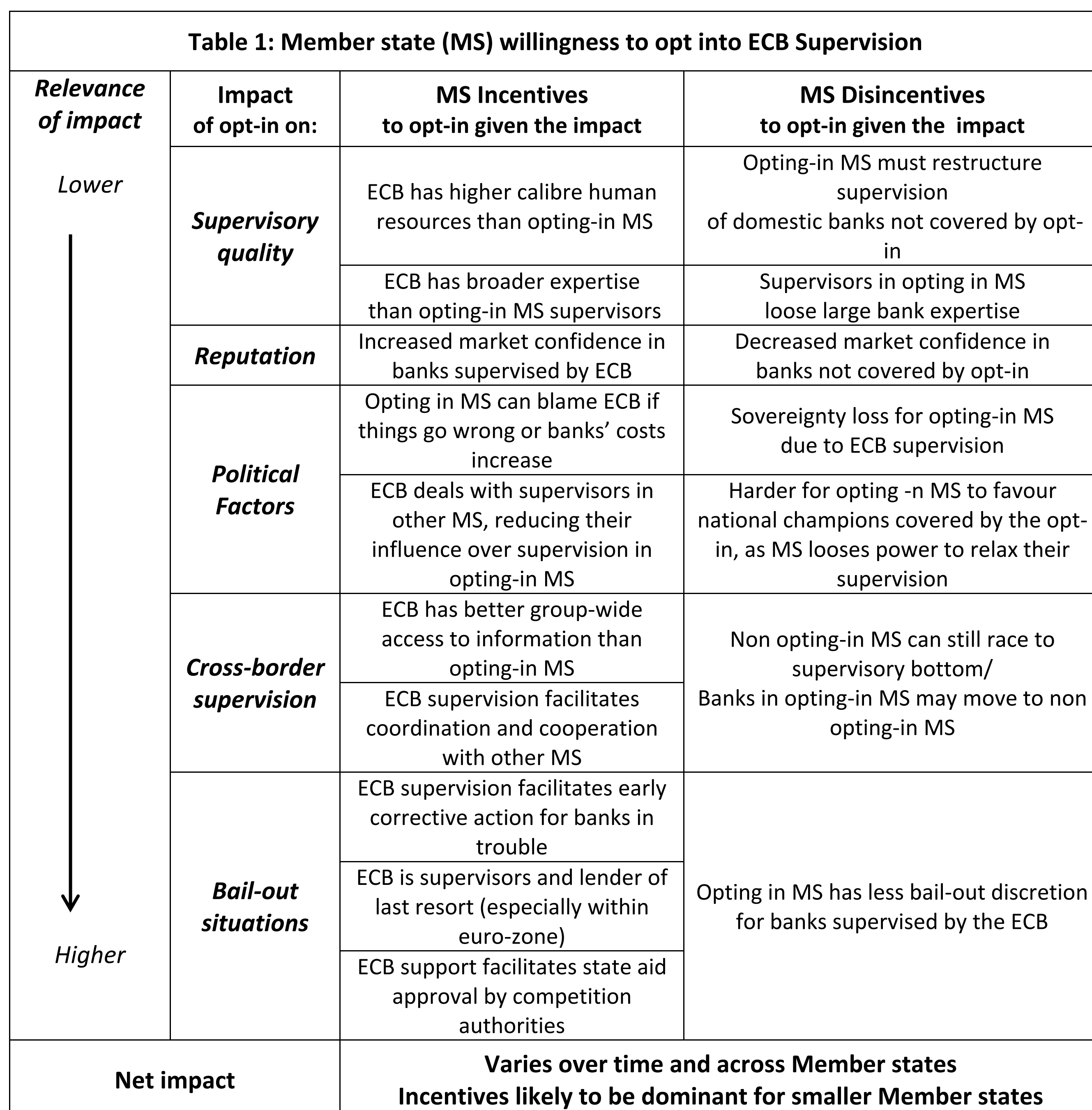

Table 1: Member state (MS) willingness to opt into ECB Supervision

Relevance of impact	**Impact of opt-in on:**	**MS Incentives to opt-in given the impact**	**MS Disincentives to opt-in given the impact**
Lower	***Supervisory quality***	ECB has higher calibre human resources than opting-in MS	Opting-in MS must restructure supervision of domestic banks not covered by opt-in
		ECB has broader expertise than opting-in MS supervisors	Supervisors in opting in MS loose large bank expertise
	Reputation	Increased market confidence in banks supervised by ECB	Decreased market confidence in banks not covered by opt-in
	Political Factors	Opting in MS can blame ECB if things go wrong or banks' costs increase	Sovereignty loss for opting-in MS due to ECB supervision
		ECB deals with supervisors in other MS, reducing their influence over supervision in opting-in MS	Harder for opting -n MS to favour national champions covered by the opt-in, as MS looses power to relax their supervision
	Cross-border supervision	ECB has better group-wide access to information than opting-in MS	Non opting-in MS can still race to supervisory bottom/ Banks in opting-in MS may move to non opting-in MS
		ECB supervision facilitates coordination and cooperation with other MS	
	Bail-out situations	ECB supervision facilitates early corrective action for banks in trouble	Opting in MS has less bail-out discretion for banks supervised by the ECB
		ECB is supervisors and lender of last resort (especially within euro-zone)	
Higher		ECB support facilitates state aid approval by competition authorities	
Net impact		**Varies over time and across Member states Incentives likely to be dominant for smaller Member states**	

Supervisory Quality: The ECB is more likely to attract high calibre supervisors that have the expertise required for effective supervision than domestic supervisors in some Member states, in particular new Member states (Goodhart 2000). The ECB is better placed to get qualified supervisors because it can recruit within a broader talent pool, it is a prestigious institution and does not face political opposition to hiring on a pan-European basis. Also it is more likely to be an effective supervisor, as it can draw upon expertise developed for monetary policy purposes either

directly (by reallocating employees) or indirectly (by training new hires). Furthermore, it has a better chance to get its employees to undertake supervision-specific investments due to the higher likelihood they can use this human capital outside the ECB.

In short, we can presume that ECB supervision will be of high quality and provide an incentive for Member states to opt-in. This incentive may, however, be less compelling for Member states which have to significantly downsize their domestic supervisory agency if they opt-in. Some of the supervisors that used to monitor banks now supervised by the ECB will be needed for liaison with the ECB (so as to ensure consistency in supervisory approaches across the Member state's regulated banks) or, as we will see below, routine supervision for the ECB. But at least part of national agency's personel will have to be reallocated or made redundant. This raises the short term financial costs, and it could also imply some loss of expertise in large bank supervision, which may make it more difficult to opt-out of ECB supervision should the arrangement prove unsatisfactory.

Member State Reputation: ECB supervision may enhance the reputation of an opting-in Member state as a banking centre. Even if ECB supervision were not to increase supervision quality, customer and counterparties' confidence in ECB supervised banks is likely to increase. Third parties will not expect supervision to be tainted by purely national considerations, be they economic or political, and will assume that the ECB's priority is to minimize the risk of financial distress. This reputation incentive could be lowered if increased confidence in ECB supervision goes hand-in-hand with decreased confidence in the banks that continue to be supervised by the Member state. Such a decrease is unlikely to be significant, however, unless the quality of ECB supervision is in effect superior to the domestic supervision—in which case the incentive to opt-in would certainly become much stronger than that assumed above.

Political Factors: Member states that enter into an opt-in agreement can blame the ECB to the extent that something goes wrong or tough actions create a chilling effect on voters. This is especially attractive for the government and its top civil servants as they are normally the main victims of scandal-related supervisory fallouts. In addition, it is politically easier to justify cross-border prudential measures ordered by the ECB than similar measures adopted by a domestic supervisor. In the latter case, there would be suspicions that such measures reflect another Member state's agenda, especially when they are coordinated with those taken by the supervisory authority of a larger Member state. Such suspicions are unlikely to arise for ECB initiated measures.

Being a European institution, the ECB's incentives are likely to be more closely aligned with the Member state's goals than those of other national supervisors. While the latter are primarily concerned by the impact of their intervention (or lack thereof) on their domestic markets, cross-border externalities are high on the ECB's priority list.

Here again, these incentives can be lowered if ECB supervision is politically costly in terms of sovereignty loss (if domestic voters perceive the ECB as becoming excessively powerful) or of constraints in the fostering of national champions. In addition, for Member states outside the euro zone, ECB supervision may be perceived as weakening the status of the national central bank as it will have to cooperate with a powerful rival. Such costs are not to be underestimated, but they are more likely to be significant for larger than for smaller Member states—the latter having limited political and financial power to begin with. In addition, political costs can be minimized by the terms of the opt-in agreement with the ECB, for example by provisions allocating some of the day-to-day supervision to the Member state's central bank or by provisions on ECB accountability.

Cross-border Supervision: The ECB will have stronger cross-border supervisory clout than many if not most domestic supervisors. It is notoriously difficult for Member states to make sure that the domestic subsidiaries and branches of banks incorporated in another Member state are properly supervised. For example, even a major financial centre like the UK has proven unable to achieve this result for one branch and one subsidiary of parent banks incorporated in Iceland.[15] This has become a source of significant concern for Member states where such subsidiaries and branches dominate the domestic banking sector. The converse is, at least to some extent, true also. It is notoriously difficult for smaller Member states to supervise properly domestic parent banks with significant activities in other Member states. In part, this is because foreign subsidiaries are primarily supervised by the local authorities, which are more interested in protecting domestic customers than those of the banking group as a whole. The difficulty also often has a domestic dimension, however, if the parent banks have significant political influence in their (smaller) Member state of incorporation.

It follows that incentives to opt into ECB supervision will be higher for Member states where the banking sector is dominated by branches and subsidiaries of parents incorporated in another Member states or smaller Member states where local parents have significant cross-border

[15] See John Kay, *Do not Depend on Otherland to Apply the Rules*, FINANCIAL TIMES, April 8, 2009 at 11.

activities. As the ECB is a pan-European institution, it is likely to be better able to gather group-wide information—especially within the euro-zone where it is also in charge of monetary policy—and is less likely to be hampered by Member state level politics. More importantly, opting into ECB supervision will improve cross-border supervision coordination and cooperation. This will clearly be the case with other Member states that also have opted into ECB supervision, as there will be only one supervisor for the whole banking group. But coordination and cooperation will also be facilitated if a parent or a subsidiary is incorporated in a non-opting in Member state. Here again, this is due to the ECB being a European institution — and thus less inclined to distort competition— and also being in charge of monetary policy — and thus interested in financial stability across the EU. For example, we would expect coordination and cooperation to function better between the ECB acting as the supervisor of Irish banks and the UK supervisory authorities, than between the latter and the Irish supervisory authorities.

The incentive for a Member state to contract with the ECB due to its superior cross-border clout would likely decrease, however, if this could lead to its banks reincorporating abroad. Should ECB supervision considerably increases the banks' compliance costs, they may move to a non-opting Member state where compliance costs are lower (regulatory arbitrage). This reincorporation risk will increase if, in addition, the non-opting in Member state respond to the opt-in agreement by further lowering the compliance costs for banks it supervises (regulatory competition). The opting in Member state will not be able to match such a move (it has delegated its supervisory powers) and the ECB is unlikely to do so if its more costly requirements are justified by EU financial stability consideration (the financial competitiveness of the opting in Member state as a lower priority). However, it does not appear likely that banks will reincorporate abroad because of an opt-in. First, they may benefit either from an ECB-led race to the top (as tougher supervision is likely to increase their depositor and counterparty confidence), or from other Member states racing to the bottom (laxer supervision is likely to reduce other banks' depositor and counterparty confidence). Second, it is questionable whether Member states will engage in a race to the bottom that may upset a European player with considerable interest rate setting and liquidity provision powers. Furthermore, there may also be some non-EU banks that are inclined to incorporate in a Member state that has a stronger institutional environment due to its having opted for ECB supervision, which could have significant beneficial consequences for financial market development.

Bail-Out Situations: ECB supervision could reduce the risk of financial distress or, at least, the costs bail-outs may generate. To begin with, EC supervision should improve cross-border information flows and make it more difficult for supervisors in other Member states to act opportunistically—for example, by favouring local depositors or by hampering supervisory actions that are in the interest of the group but not in the interest of the parent or subsidiary in their jurisdiction. Consequently, corrective action will be taken sooner and in a more effective manner then under the current regime.[16] The fact that the ECB is in effect, even if not legally, the lender-of-last resort for banks incorporated in the euro-zone (see Boot 2007; Padoa-Schioppa 2004), may also be beneficial. This means that the number of agencies involved in bail-out negotiations will be reduced —a significant advantage in view of recent credit crisis experiences—, and also facilitates *ex ante* agreement on the conditions governing Member state fiscal support in bail-out situations. [17] Finally, Member state financial aid to banks in bail-out situations is less likely to raise competition objections at the EC level if it occurs at the request, or with the approval, of the ECB.

These incentives supporting an opt-in decision could be reduced by the loss of bail-out discretion implied by ECB supervision. In particular, the ECB is likely to object to bail-outs that are in the interest of a Member state—for example, because they prevent local lay-offs—, but detrimental to the overall interests of the EU. However, the bailing-out a bank merely to protect local interests is likely to occur only if preceded or accompanied by significant curtailing in the bank's cross-border activities. This should mean that the bank is not falling within the scope of ECB supervision anymore, restoring domestic supervision and bail-out discretion.

Overall, the incentives to opt-into ECB supervision are likely to vary over time and across Member states. But the main disincentives—in particular, the loss of sovereignty, regulatory competitiveness and bail-out discretion—seem unlikely to prove significant for Member state where financial activities by foreign parent banks play a significant role or for a smaller Member state with a few parent banks with subsidiaries in other Member states. This assessment is reinforced by sketching a few scenarios that cast light on the circumstances that would lead a Member state to consider opting into ECB supervision.

---

[16] See also *supra* 2.2 (discussing conflicts of interests among Member states).

[17] See also *infra* 5.2.1 and 5.2.2 for the indirect impact of ECB lending of last resort on burden sharing by Member states outside the euro zone.

Our first scenario is one under which the level of domestic banking activity is low relative to the size of the cross-border banking activities of the one or two parent banks incorporated in that Member state—Belgium being a prototypical example. Such a Member state will find it difficult to devote the resources necessary to the supervision of the banking group headed by the parent as this would essentially benefit non-citizens and foreign jurisdictions. At the same time, foreign supervisors are likely to under invest in cooperation and coordination efforts, as they will not reap the full benefits of their efforts. The likely outcome is obvious: supervisory arrangements will prove inadequate and the risk of a banking meltdown will be very significant in case of a financial crisis. We deem the probability of an opt-in by such a Member state to be high.

Our second scenario is one under which a large Member state essentially relies on subsidiaries with parent banks in other member state to finance its economy—Poland being a prototypical example.[18] In this situation, the Member state in which the parent is incorporated may under-invest in supervision as to invest an appropriate amount would disproportionately benefit market participants outside its jurisdiction. At the same time, the supervisor of the subsidiary may not be able to off-set this imbalance through cooperation and coordination efforts due to a lack of expertise or political clout. This supervisory arrangement is likely to prove inadequate and increase the risk of a credit crunch in the Member state in which the subsidiaries are incorporated (Calzolari and Loranth 2005). Here we deem the probability of an opt-in by the latter Member state to be significant.

Our third scenario is one under which a medium-sized Member state where the level of domestic bank activity is high enough to make it a financial centre and several parent banks with significant cross-border operations are incorporated—Ireland being the prototypical example. For reasons similar to the ones mentioned in the first two scenarios, both the Member state where the parents are incorporated and jurisdictions where they have subsidiaries will under-invest in supervision. Again, this supervisory arrangement is likely to prove inadequate in case of financial crisis, with significant economic and reputation costs for the parents' Member state. Here we deem the probability of an opt-in by the latter Member state to be moderate.

[18] In Central and Eastern Europe, the banking sector is generally dominated by foreign (mostly Western European) financial groups: see de Larosière Report, *supra* note 6, at 71; for Poland, see Bednarski and Bielicki 2006.

3.2 ECB willingness to supervise cross-border banking

Recent supervision coordination and cooperation failures have resulted in several disordered bail-outs.[19] This has not only put EU financial stability at risk. It also showed that the ECB was not in a position to do much more on this fundamental issue than urging Member state supervisors to reinforce their coordination and cooperation efforts.[20]

Concerned ECB officials have since repeatedly suggested that the ECB be given responsibility for supervising large banks with operations in several Member states.[21] This indicates that the ECB has significant incentives to supervise banks with important cross-border activities.

As shown in Table 2, ECB willingness to supervise members of banking groups with significant cross-border activities will depend upon the impact of such a decision on several key issues: political factors, reputation and, most importantly, cross-border supervision and bail-outs.

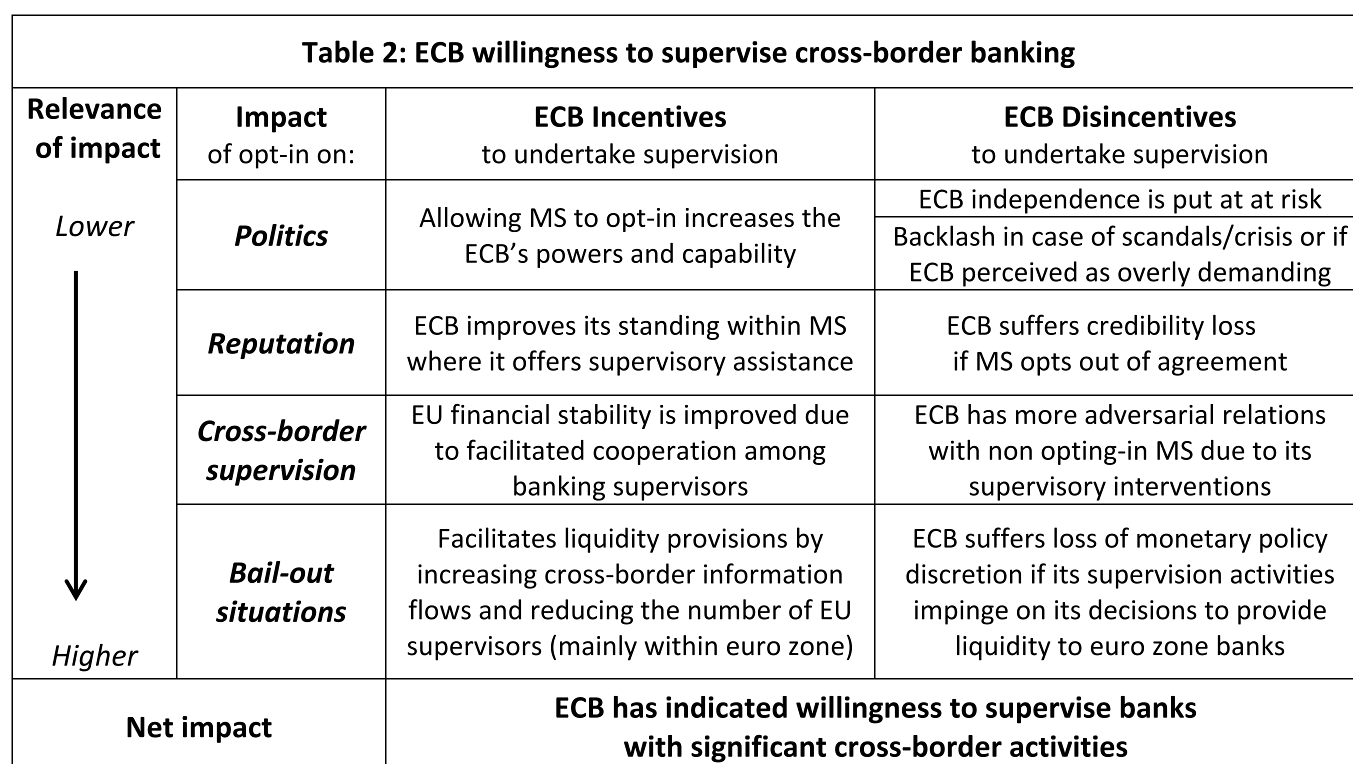

Table 2: ECB willingness to supervise cross-border banking

Relevance of impact	**Impact** of opt-in on:	**ECB Incentives** to undertake supervision	**ECB Disincentives** to undertake supervision
Lower	***Politics***	Allowing MS to opt-in increases the ECB's powers and capability	ECB independence is put at at risk
↓			Backlash in case of scandals/crisis or if ECB perceived as overly demanding
	Reputation	ECB improves its standing within MS where it offers supervisory assistance	ECB suffers credibility loss if MS opts out of agreement
	Cross-border supervision	EU financial stability is improved due to facilitated cooperation among banking supervisors	ECB has more adversarial relations with non opting-in MS due to its supervisory interventions
Higher	***Bail-out situations***	Facilitates liquidity provisions by increasing cross-border information flows and reducing the number of EU supervisors (mainly within euro zone)	ECB suffers loss of monetary policy discretion if its supervision activities impinge on its decisions to provide liquidity to euro zone banks
Net impact		**ECB has indicated willingness to supervise banks with significant cross-border activities**	

---

[19] See *supra* 2.2.

[20] See Joellen Perry, *Trichet Shifts Gears on Euro-Zone Policy*, WALL STREET JOURNAL (European ed.), December 5-7, 2008 at 10.

[21] See, e.g., Ralph Atkins, *ECB Seeks Wider Policing Role*, FINANCIAL TIMES, January 5, 2009 at 1; Enza Tedesco and Luca di Leo, *ECB Official Urges Greater Role in Bloc*, WALL STREET JOURNAL (European ed.), January 8, 2009 at 19; Ralph Atkins, *Trichet Ready to Supervise Banks*, FINANCIAL TIMES, January 22, 2009 at 4.

Political Factors: Acquiring supervisory powers adds to the prominence of the ECB, a result that is generally favoured by bureaucracies. To be sure there are trade-offs. The ECB's increase in powers may be balanced by accountability requirements. Such a banking supervisor may be hurt by any difficulty of maintaining its independence, not only in supervision but also in the monetary policy area.[22] This could prove relevant not only for Member states within the euro zone, but also for those outside—as ECB supervisory intervention may create tensions that are detrimental to monetary cooperation with the national central bank. Besides autonomy, the ECB may also be subject to a backlash effect if a banking scandal or financial crisis were to reveal supervision deficiencies.

Reputation: A Member state can be expected to opt into ECB supervision when its supervision of banks (with significant cross-border activities) is perceived as being less effective than ECB supervision. In such a setting, the opt-in related increase in customer and counterparty confidence[23] should have a positive effect on the ECB's reputation in that Member state. On the other hand, the ECB could lose credibility if the Member state subsequently opts-out of ECB supervision. However, opt-outs are as likely to increase the credibility of the ECB (for example, when they are perceived to reflect protectionist considerations) than to decrease it (when they are perceived to reflect ECB supervisory failure). Reputation effects are thus likely to make the ECB more, rather than less, willing to supervise banks with cross-border activities.

Cross-Border Supervision: More importantly, ECB supervision reduces the risk of financial distress at banks with cross-border activities.[24] This, in turn, contributes to reinforcing EU financial stability, both because of its impact on investor perceptions and on moral hazard problems. Investor confidence will rise because they expect the ECB to have higher supervisory clout and less of a home bias than a domestic supervisor. Banks will have less room to act opportunistically because the ECB will have better information, more clout and lower incentives to protect local interests than a domestic supervisor. To be sure, the resulting constraints on bank activities may lead to conflicts with the Member states in which the banking group operates, in particular non-opting in Member states, but this a rather small price to pay for improving EU financial stability.

---

[22] See also *infra* 5.2.

[23] See *supra* 3.1.

[24] See *supra* 3.1.

Bailout and Resolution: Crucially, ECB supervision will reduce the risk of bail out and resolution situations or, at least, minimize their impact. As indicated when discussing Member states' incentives, it will reduce the existing home bias in banking supervision, ensure earlier corrective action, facilitate coordination between lending-of-last-resort and fiscal or resolution interventions, as well as reduce the risk of competition distortions. This may come at the cost of some reduction in ECB monetary discretion as the latter may be influenced by decisions taken by the ECB as a banking supervisor. However, the current credit crisis shows that financial distress in the banking sector is having a significant effect on monetary policy even when the ECB is not a banking supervisor. There is no reason to believe that this effect would have been higher if the ECB had had banking supervision powers (Nier 2009).

Financial stability and bail-out incentives are straightforward and justified by the credit crisis. It is, therefore, unsurprising that the ECB has expressed a willingness to undertake banking supervision tasks. Needless to say, the extent to which the ECB has the clear ability to undertake supervisory tasks quickly will depend on the Bank's own commitment and on the level of co-supervision activity by the national supervisors that choose to opt-in.

Summing-up, a number of Member states may have significant incentives to opt into ECB supervision. The degree to which the ECB is willing to undertake such a task will depend on its own policy effectiveness and on the influence on economic policy. These developments are at least partly driven by efficiency considerations and should reduce the number of banking supervisors. A choice-based approach to ECB banking supervision is, therefore, worth exploring more in depth.

IV. DEFICIENT COMPETING PROPOSALS

The supervisory failures revealed since August 2007 have generated various institutional reform proposals. European policy makers have, however, only paid scant attention to whether national supervisory authorities possess adequate powers to deal with the large-scale risk intrinsic to the activities of major banks with significant cross-border activities. The main policy debate has been about the establishment of new international bodies or the reinforcement of existing ones. The key reason for the interest in such approaches is that no domestic supervisor saw the crisis coming or was able to minimize its impact significantly, despite the existing diversity in supervisory models at the national level. Domestic institutional reform is, therefore, deemed likely to fail to target the real

problem: the globalization of financial activities and its negative impact in terms of information and decision-making capabilities by national supervisors.[25]

Taking into account their political backing and institutional coherence, three reform proposals deserve particular attention: the establishment of a 'global' supervisory body in the form of global supervisory colleges, the establishment of European supervisory colleges, and the creation of a European System of Financial Regulators.

'Global' Supervisory Colleges. Various bodies have called for the creation of a "global" regulator.[26] The idea is not new. Commentators have been suggesting for some time that a single international agency be empowered to supervise or, at least, monitor financial institutions (Kaufman 1994; Dale and Wolfe 1998). The most prominent and detailed proposal is the one submitted by the European Union to the fall 2008 G-20.[27] It proposed that supervisory colleges for all large cross-border financial companies be set up. The colleges would be composed of representatives of regulatory agencies from major countries and financial centres. Approximately 30 firms would be targeted, the aim being to enhance communication among national regulators and develop response plans for financial distress situations.

This proposal seems very unlikely to be adopted, both because major countries have signalled their opposition to it, and in view of past failures to set up such 'global' regulatory bodies (see Eichengreen 1999, pointing out that politics will always remain local). In addition, even if it were adopted, the proposal would not resolve many of the deficiencies identified above due to its limited ambitions: it essentially boils down to greater information-sharing.

European Supervisory Colleges. The "regional" version of the proposal discussed above is not a new idea either. Supervisory colleges for banking institutions were set up by Member states several years ago, and committees of supervisors have proliferated at the European level in the wake of the 2001 Lamfalussy report.[28] However, deficiencies in information-sharing and the decision-making

---

[25] See Group of Thirty, *The Structure of Financial Supervision* (2008) (available at group30.org).

[26] See Financial Stability Forum, *Enhancing Market and Institutional Resilience* 52 (Report 2008, available at financialstabilityboard.org); European Council, Economics and Financial Affairs (ECOFIN), 4 November, 2008, *Main Results* (15067/08, available at consilium.europa.eu).

[27] See Tony Barber, *EU Calls for Tighter Financial Controls*, FINANCIAL TIMES, November 5, 2008.

[28] See *Final Report of the Committee of Wise Men on The Regulation of European Securities Market* (2001, available at ec.europa.eu).

effectiveness of existing supervisory colleges and committees have been thought serious enough to warrant an evolutionary step on the Lamfalussy Report path.[29]

The main institutional proposal is a plan promoted by the European Commission in fall 2008. EC law would require that each bank with cross-border activities has to answer to a supervisory college formed of representatives from supervisory authorities from each country in which it operates. The college would share information, discuss risks and coordinate policy in case of problems under the leadership of the bank's home country supervisor. The proposal has not been received with much enthusiasm within the European Council, which merely agreed to have regulatory colleges meeting at least once a month to exchange information — a possible second step being the development of common information formats.[30]

These are very modest developments. Whether colleges should have decision-making powers has been left open, as has the crucial issue of whether the head of the college — namely the home supervisor — should have the authority to ensure that its members exercise their separate sovereign powers in an identical way.[31] It follows that European supervisory colleges are unlikely to prove much more effective than the current supervisory colleges set-up by Member states.

European System of Financial Supervisors. Given a more centralized approach to European supervision, a variety of proposals have been advanced to go beyond supervisory colleges and establish a European System of Financial Supervision (ESFS) (Schoenmaker and Oosterloo 2007; Speyer and Walter 2007; Véron 2007; Lannoo 2008). This is a quantum rather than an evolutionary step on the Lamfalussy Report path. In its most elaborate form, this proposal requires deep institutional changes, similar to those that resulted in the creation of the European System of Central Banks. Prudential supervision of large and systematically important banks and insurance companies would be conducted at the European level, with Member state supervisory authorities working under a single institutional roof while maintaining plurality in their operational structure. Under this approach, prudential supervision of other banks and insurance companies, as well as

---

[29] See also Tommaso Padoa-Schioppa, *Europe Needs a Single Financial Rule Book*, FINANCIAL TIMES, December 11, 2007 at 13.

[30] See also Financial Stability Forum, *Principles for Cross-Border Cooperation on Crisis Management* (July 2009, available at financialstabilityboard.org).

[31] Howard Davies and David Green, *A Better Way to Regulate European Finance*, FINANCIAL TIMES, September 11, 2008 at 11.

conduct of business supervision (consumer protection and market transactions) would remain the province of Member states.

While there are unsolved issues, this proposal has the clear advantage over the other two of addressing more credibly the above mentioned effectiveness issues. There are, however, several fundamental problems with its implementation. First, a Treaty amendment would be required to establish an ESFS, which would be both time consuming and politically risky due to the likelihood of popular referenda. Second, the ESFS would have to be built from scratch following a step-by-step approach, which makes the final framework difficult to predict. This is probably why proponents of this approach are very discreet when it comes to crucial issues like decision-making authority and procedures at the European level, cooperation and coordination with supervisory and treasury authorities at the Member state level, as well as relationships with central banks.[32] Finally, implementation of the proposal would require a mandatory, one-size-fits-all approach: Member states would be left with no choice other than subject their largest banks to centralized crisis management and macro-prudential oversight.

The new regulatory framework proposed by the European Commission, and supported by the European Council, is based on the de Larosière Report, which broadly reflects the European System of Financial Supervisors (ESFS) model.[33] However, consistent with the model's step-by-step approach, the European Commission is only concerned with the implementation of measures involving what can be described as an initial stage of the ESFS model.[34] While full implementation would mean the centralization of the supervision of banks with cross-border operations, the European Commission proposes to create a European Systemic Risk Board (ESRB) and to reinforce existing supra-national institutions, i.e. supervisory colleges and the Committee of European Banking Supervisors (CEBS) by integrating them within a (first stage) European System of Financial Supervisors .

---

[32] Coordination and cooperation is very generally dealt with, and only in terms of information sharing and consolidation failure. It is suggested to create a European Resolution Trust (as a safety net for short term problems in financial institutions of a certain size) and a Federal Deposit Protection Fund, but neither *ex ante* rules for Member state fiscal contributions nor insolvency procedures are addressed.

[33] See Communication from the Commission, European Financial Supervision, COM(2009) 252 final (available at ec.europa.eu); Council of the European Union, Presidency Conclusions of the Brussels European Council, 18/19 June 2009, (11225/2/09 REV 2, available at consilium.europa.eu). Compare de Larosière Report, *supra* note 6, 42-4, 48.

[34] See also Forum on Financial Cross-Border Group, *Cross-Border Banking in Europe: What Regulation and Supervision?* (UniCreditGroup Discussion Paper, March 2009).

The European Systemic Risk Board would be a Europe-wide council to monitor and assess potential threats to financial stability and, where necessary, issue risk warnings and recommendations for action (macro-supervision). Within the (first stage) European System of Financial Supervisors, the European Banking Authority (EBA) would strengthen oversight of cross-border banking groups by supervisory colleges and establish a European single rule book. It would have binding and proportionate decision-making powers in case of rule book infringement by national supervisors or of disagreement between the home and host state supervisors, including within colleges of supervisors—provided such decisions do not impinge in any way on the fiscal responsibilities of Member states.[35]

Many have voiced their criticisms of the European Commission proposals.[36] Most objections have challenged whether the European Systemic Risk Board and the European Banking Authority are likely to prove effective prudential supervisors. A number of considerations are offered. First, these bodies will comprise representatives of all Member states and the sheer number and diversity of opinions will make it very difficult to agree on hard choices in a timely fashion. Second, the European Systemic Risk Board will only have the power to make recommendations. In good times, its warnings will, at best, be ignored and, at worst, give it the reputation of crying wolf for nothing. In times of crisis, the chances are high that its warnings will come too late or have to remain muted for fear of sparking a financial panic.[37] Third, the European Banking Authority cannot impinge upon the Member states' fiscal responsibilities. In good times, this means that it cannot take decisions that may have costly consequences at the national level. In times of crisis, *a fortiori*, it will not be able to force a bail out or an early resolution upon a Member state as both measures will have burden sharing and, thus, fiscal consequences.[38]

V. A CHOICE-BASED INSTITUTIONAL ALTERNATIVE

So far we have discussed the deficiencies of institutional reforms spurred in response to the failure of banking supervision in the EU. In this section, our proposed alternative, namely that Member states be given the option to subject their largest banks to supervision by the ECB, will be

---

[35] See Presidency Conclusions, *supra* note 33, at 8.

[36] See *supra* note 13.

[37] See also *Divided by a Common Market*, THE ECONOMIST, July 4, 2009 at 69.

[38] See also Marek Belka and Wym Fonteyne, *A Banking Framework to Secure the Single Market*, FINANCIAL TIMES, June 4, 2009 at 9 (pointing out the resolution and fiscal deficiencies of the proposed regime).

explained.[39] Our alternative will first be analyzed in terms of its implications on the institutional environment. We will then show that our proposal is superior in terms of flexibility, implementation, and legal robustness, provides a significantly better way to improve cross-border financial stability, and is more acceptable politically than other reform proposals. Finally, we will assess the possible objections to our reform proposal and conclude that they are not persuasive.

5.1 Basic institutional design

Under our choice-oriented approach, Member states will be able to opt-in and out of ECB banking supervision. The approach is based upon an established EC regulatory technique, which has been implemented within as well as outside the financial services area.[40] The legal authority for ECB banking supervision is Article 105 (6) of the Treaty, according to which specific tasks concerning policies relating to the prudential supervision of EU credit institutions (including those incorporated outside the euro zone) may be conferred upon the ECB.[41]

Scope. ECB supervision will be limited to managing EU-wide prudential risks (see also Masciandaro 2007). The primary threshold will be set in terms of total assets (Schoenmaker and van Laecke 2007) and minimum deposits within a single bank or banking group. Additional criteria may be used to expand or limit the scope of ECB supervision, possibly on a Member state by Member state basis. They could be quantitative, based on the importance of a bank's cross-border operations for example, or qualitative, using a bank's risk profile for example.[42] Overall, around 40 EU banking groups are likely to satisfy these thresholds.[43]

---

[39] Our proposal builds upon Hertig and Lee 2003; Hertig and McCahery 2006.

[40] See, for example, Directive 2204/25/EC on Takeover Bids, [2004] OJ L 142/12 (allowing Member states to opt-out of its board neutrality and breakthrough provisions); Fourth Directive 78/660/EEC on Annual Accounts, [1978] OJ L 222/11 (adopting a menu approach to accounting standards and providing Member states with select opt-outs). These opt-outs have generally been exercised by many Member states when not doing so would have required amendments to existing national law.

[41] For further discussion of this legal basis and its comparative robustness, see *infra* 5.2.2.

[42] For example, the credit risk, liquidity credit and earning profile (see Čihák and Poghosyan 2009). The impact of the bank's default on its country of incorporation's cross-border interbank claims could also be considered. For simulations of cross-border spillovers of such a credit shock, see International Monetary Fund, *Global Financial Stability Report* (April 2009, available at imf.org) 78-86.

[43] According to the de Larosière Report, *supra* note 6, at 71, approximately 70% of EU banking assets are held by 43 banking groups with substantial cross-border activities. In 2006, the ECB had identified 36 Large and Complex Banking Groups in Europe, 21 in the euro zone and 15 outside: see ECB, *Financial Stability Review* (December 2007) at 98-99 and Box 10. See also Schoenmaker and Oosterloo 2005.

Opting-in agreement. An opt-in will become effective upon the conclusion of an 'agreement' between the ECB and the Member state. Technically, the opt-in will occur within the framework of the Council's decision to empower the ECB to undertake supervisory activities and take the form of an ECB decision (see Zilioli and Selmayr 2001). However, this decision will essentially give binding character to the result of the negotiations with the Member state and is the functional equivalent of a contract—and we will thereafter refer to it as an agreement.

Member states will be able to opt into different arrangements, so as to tailor them to Member state-specific circumstances—within the constraints set by supervisory coherence and equal treatment.[44] The standard 'contractual' template delegating supervision from a Member state to the ECB will consist of several key elements that seek to ensure a robust allocation of responsibilities (who does what), commitments (what happens in financial distress situations) and costs (who pays for what) and also specify how the agreement itself can be terminated. More specifically, the agreement's core provisions will have to address cooperation and coordination between the ECB and the Member state as well as with other Member states (or non-EU jurisdictions), and this in normal times as well as in periods of financial distress or crisis.

Decision-making and cooperation authority. Decision-making and cooperation within the opt-in agreement will be agreed upon in accordance with the governance provisions generally applicable to the ECB (see Zilioli and Selmayr 2001) and the Member state's involved entities, in particular the national central banks. One specific issue will be to allocate policy decision-making within the ECB. While policy decisions are taken by the Governing Council in the monetary area, the General Council seems a more appropriate body in the supervisory area for several reasons. First, it includes the governors of the central banks that are not part of the euro zone. Second, it the Council has advisory functions only.[45] This is sufficient for policy making purposes (the ECB's Executive Board is unlikely to disregard the General Council's opinion) while preventing excessive political meddling.

Normal times provisions. The agreement will clarify the operational distinction between ECB supervision and monetary activities in terms of reporting lines, personnel and geographical location. It will also allocate day-to-day supervision powers between the ECB and the Member state's banking supervisor—macro-prudential (systemic risk) responsibilities remaining within the

[44] Equal treatment and supervisory coherence across Member states will, in particular, be of significant importance when it comes to implementing the substantive framework set by EC banking directives.

[45] See Article 47.1 of Statute of the European System of Central Banks and of the ECB.

ECB—and state the relationship between prudential and market supervisors. Both the ECB and the Member state are likely to have an interest in having some monitoring activities at the Member state level, as it allows the ECB to minimize the size of its supervision workforce and the Member state to reduce domestic employment and sovereignty objections to an opt-in. The sharing of day-to-day supervision should, however, be designed so as to allow for optimal information flows and keep policy, regulatory and major decision making at the ECB level. This could, for example, be achieved by allocating Member state monitoring responsibilities to its national central bank, as the close relationship, common interests and comparable supervisory cultures (Masciandaro, Nieto and Quintyn 2009) of the national central bank and the ECB should allow for optimal monitoring cooperation.

On the other hand, cooperation and coordination with other Member states or non-EU jurisdictions in which the Member state's banks have activities will be handled by the ECB. This should be easy to agree upon. One of the main incentives for a Member state to enter into an opt-in agreement is that it facilitates cross-border supervision due to the ECB being better placed to deal with foreign supervisors. This can only be achieved by granting exclusive cooperation and coordination powers to the ECB—which would, of course, only act after consultation with the Member state.

Finally, the costs of supervision under normal conditions will be borne by the Member state so as to avoid discussion about why it should be subsidized by the ECB. This is a rather minor issue, as these costs should not prove significant (Member states will neither object nor use the burden as a means to constrain ECB independence) and could be carried by the supervised banks—after all, they are likely to get reputation and, possibly, compliance benefits from ECB supervision.

Financial distress provisions. In circumstances of financial distress, the parties will have to agree on 1) when and how a failing bank will be taken over by a third party or bailed out, and 2) orderly winding-up/resolution procedures in case of insolvency. This raises delicate issues. First, intervention levels must be set, as banks go through several stages of financial trouble before bail-out or resolution becomes inevitable (see also Kick and Koetter 2007). Second, supervisory intervention in distress situations will often require fiscal support, which can only be provided by the Member state's taxpayers. Third, several Member states may need to get involved when a bank has cross-border activities, which implies that they should share the fiscal burden. Fourth, winding-up decisions are hampered by insolvency laws that remain diverse and are often inadequate (Bliss 2007 and Lastra 2007). But these difficulties are not specific to an opt-in approach. As we have

seen, one of the main deficiencies of the European Commission's proposals is that *no* decision taken at the European level may have fiscal implications for Member states. By contrast, fiscal and resolution issues can, be addressed within an opt-in agreement framework, as the latter is voluntary and involves two parties only.

In addition, the observations made during the recent credit crisis will facilitate agreement drafting. In particular, the ECB as well as Member states are better aware of the issues they face and more willing to address them *ex ante*. As a result, familiar pre-crisis objections to having the ECB acting as lender-of-last resort or making the agreement specify bail-out or resolution procedures are unlikely to carry much weight. Member states have also realized that financial distress at a major bank could have major cross-border spillover effects. Hence, they will acknowledge that the agreement must take into account the pan-European impact of a bank's financial distress.

The manner in which an opt-in agreement takes into account the pan-European impact of a bank's financial distress, in particular its potential costs for other Member states, can be addressed in four ways. First, the opt-in agreement can facilitate financial distress decision-making by clarifying winding-up scenarios within the existing Member state bankruptcy framework. A simple way to do so is for the parties to agree that the banks covered by the agreement will have to submit a rapid resolution plan.[46] Such a plan would detail all the steps needed to dismantle the institution—including the unravelling of contractual obligations and the shutting down or reorganization of activities in other jurisdictions—and the respective timeframes. This would make it harder for the distressed bank to object to early corrective action or an efficient resolution scheme while facilitating crisis negotiations between the ECB and the Member state (Nieto and Wall 2006).[47]

Second, the parties can agree on triggers that justify more forceful ECB intervention, the idea being that early corrective action will prevent or minimize the consequence of financial distress. The ECB would be able to use such powers effectively, as it will have information about the bank's condition that is currently lacking at the Member state level. The triggers could be modelled upon those used under the prompt corrective action system that is applicable in the U.S. (capital falls below certain thresholds—Krimminger, 2007), based upon market signals (such as the pricing of credit default

---

[46] See Department of the Treasury, *Financial Regulatory Reform, A New Foundation* (June 2009) 25 (proposing that banks prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress).

[47] See also Anil Kashyap, *A Sound Funeral Plan Can Prolong a Bank's Life*, FINANCIAL TIME, June 30, 2009 at 11.

swaps) or rely upon specific risk indicators (such as liquidity and transformation risks (Dewatripont and Rochet 2009).

Third, the agreement will specify the parties' contributions in bail-out situations, taking into account the Memoranda of Understanding on financial crisis management and the core Economic and Financial Affairs Council (ECOFIN) principles on equitable and balanced fiscal burden sharing among affected Member states.[48]The main purpose will be to coordinate the ECB's and Member state's bail-out role, so as to keep the ECB within the boundaries of its supervision and lender of last resort functions and prevent the Member state from dodging (making) fiscal contributions when they are (are not) in the EU interest. One way to do so is for the parties to agree that a Member state bail-out is contingent upon an ECB financial stability assessment. Recall that ECB supervision should improve cross-border information flows and make it more difficult for supervisors in other Member states to act opportunistically. These advantages are likely to make such a provision acceptable for the Member state.

Moreover, the combination of the ECB's supervisory involvement and capability to (directly or indirectly)[49] provide almost unlimited liquidity as a lender of last resort make it unlikely that the Member state will disregard the ECB's assessment in a financial distress situation. In particular, the assessment is likely to facilitate a high degree of cooperation among Member states that are not a party to the agreement, but in which the distressed bank is incorporated or has a branch. Unless they incur high costs, supervisors and monetary authorities in these Member states are likely to both trust and support the ECB, with which they will have been in constant contact pre-financial distress, and political authorities will be keen to avoid confrontation with the ECB.

In short, the proposed mechanism will not only contribute to equitable and balanced fiscal burden sharing among Member states, but also to efficient recapitalizations (Freixas 2003). As noted, ECB assessments will not necessarily prevent Member states from acting opportunistically in some circumstances (see, e.g., Goodhart and Schoenmaker 2006). In addition, one cannot exclude that

[48] See also ECOFIN, 14 May 2008, *Conclusions on the EU supervisory framework and financial stability arrangements* (8850/08, available at consilium.europa.eu): if public resources must be involved, direct budgetary net costs will be shared among affected Member states on the basis of equitable and balanced criteria, which take into account the economic impact of the crisis in the countries affected and the framework of home and host countries' supervisory powers.

[49] Even if the Member state is not part of the euro zone, it is highly likely that the distressed bank's parent or one of its subsidiaries will be incorporated in the euro zone and, thus, benefit from ECB liquidity provision.

ECB lender-of-last resort interventions will favour banks covered by opt-in agreements so as to insure the success of ECB supervisory activities. To minimize these risks, the agreement could provide for specific burden sharing schemes by pre-determining the opting-in Member state's fiscal burden, for example by using share of the bank's assets in the Member state as the allocation key (Goodhart and Schoenmaker 2009).[50] Admittedly, some Member states may have difficulties bearing even only part of the burden (Dermine 2000). But this is also the case under the *status quo* and ECB supervision should minimize this issue by increasing the likelihood of early corrective action. It is also true that the provision will only be binding for the parties to the agreement, but this will increase the pressure to cooperate on other Member states in which the bank has activities. The ECB could also pledge to have such a sharing provision in any opt-in agreement it enters into.

Fourth, the agreement will specify the conditions under which a bank in financial distress will be subject to resolution proceedings (see also Ayotte and Skeel 2009) and the potential role of the Member state's deposit insurer. Given the heterogeneity of European insolvency laws and the multiplicity of reform proposals related to deposit insurance, nationalization and resolution schemes,[51] the agreement must be kept flexible and compatible with multiple legal frameworks. On way to approach the issue could be to yield to the ECB the power to file for resolution under the Member state's laws.[52] Presumably, such an arrangement will be tougher on the Member state. It limits its discretion in financial distress situations by giving the ECB the right to put an end to informal work-out negotiations and bring into play formal reorganization or liquidation procedures. On the other hand, it is a necessary complement to the early corrective action mechanism discussed above and will permit to limit the Member state's fiscal burden by allowing for an efficient resolution (Mayes, Nieto and Wall 2008).

---

[50] See also the de Larosière Report, *supra* note 6, 36: burden sharing arrangements could be based upon the following criteria: deposits; assets; revenue flows; payment system flows; division of supervisory work (if a Member state's supervisory responsibilities are larger, that Member state's carries a larger share of the fiscal burden).

[51] See Matthew Dalton, *Europe Seeks Solutions for Troubled Banks*, WALL STREET JOURNAL (European ed.), July 15, 2009 at 17; the European Bank Treuhand proposal made by Posen and Véron 2009; the European Resolution Trust proposals made by Speyer and Walter 2007, at 17 and Lannoo 2008, at 27-28.

[52] See, however, Article 3 of Directive 2001/24 EC on the reorganization and winding-up of credit institutions, OJ [2001] L 125/15: it is only the authorities of the home Member state that can open winding-up proceedings for branches established in other Member states.

Under these opt-in conditions, there will be no discontinuities in the current MOU system that governs operational arrangements for crisis management in the EU. The agreement's simple structure allows for easy application, regardless of the bank in the opting-in Member state being a parent or a subsidiary. Moreover, it makes no difference whether host or home countries delegate supervision to the ECB. Of course, some Member states may object to the ECB getting significant coordination powers, as it may reduce their discretion even though they have not entered into an opt-in agreement or may even force them to do so. We will return to this issue when discussing the issue of ECB supervision from an EC perspective.[53]

Applicability to individual banks. A given Member state's opt-in will be applicable to all banks in its jurisdiction that satisfy the thresholds mentioned above, namely that create EU-wide risks on a standalone or consolidated basis. The ECB could thus end-up having prudential supervision over parents as well as over subsidiaries, including those with non-EU parents. Member states could make ECB prudential supervision mandatory for all banks that satisfy the relevant thresholds or adopt a default (opting-out) approach. Offering individual banks the possibility to opt-out is, however, likely to make contracting between the ECB and the Member state significantly more difficult. Therefore, such opt-outs should be limited to three situations: 1) when a bank stops satisfying the thresholds for ECB prudential supervision; 2) when a subsidiary or a branch has its debt fully insured by supra-national institution (Eichengreen 2009); or 3) when a bank reincorporates into a Member state that has not opted in and there is no branch left in the opting-in Member state (the cross-border provision of financial services would be allowed, even if it becomes significant—see Fidrmuc and Hainz 2009).

The framework presented differs from the one supported by dual banking advocates (Scott 1977; Benston *at al.* 1986; but compare Butler and Macey 1988). We consider this to be an advantage since proposals aiming at allowing individual banks to choose a 28th EU supervisory regime (Mortimer-Schutts 2005; Čihák and Decressin 2007)[54] would have significant drawbacks. In particular, they would generate significant regulatory, resolution and fiscal issues, which in turn is likely to create significant political opposition.[55]

---

53 See *infra* 5.2

54 See also Howard Davies, *Europe's Banks Need a Federal Fix*, FINANCIAL TIMES, January 14, 2009 at 13.

55 See also *infra* 5.2.1.

Appplicability to branches. Given the single passport approach adopted by the EC,[56] it may be inappropriate to delegate the supervision of branches to the ECB. The presumption is as follows: a Member state in which they are located can only impose compliance with liquidity requirements and other rules it has adopted in the interest of the general good. Yet, it is quite important to recognize, as the credit crisis has shown, that branches can inflict significant harm to domestic depositors and taxpayers. As a result, several Member states, in particular the UK, are considering using their (limited) powers over branches to restrict significantly their activities.[57]

To allow the ECB to supervise branches would provide an effective alternative to the current supervisory approach of protecting branch depositors. It should not prove more difficult for the Member state and the ECB to agree on branch than on subsidiary supervision for several reasons. First, it appears to be extremely important to treat branches like subsidiaries as they are functionally similar entities and, therefore, comparable in terms of systemic risk. Second, ECB supervision will be as effective, given that branches are likely to respond general good and liquidity constraints in the same way subsidiaries do to capital and other regulatory requirements. Third, the incentives of the branch's home Member to cooperate with the ECB are likely to be equivalent for subsidiaries and branches.

Member state opt-out. It is often asserted that financial supervision can only be efficient and effective if it is stable. However, many of the present "stable" arrangements have become so entrenched that they are obstacles to further market integration. Supplying a Member state an appropriately designed possibility to opt-out from its arrangement with the ECB is not only in line with the choice-oriented character of our approach. It is also likely to enhance the effectiveness of ECB supervision: giving a Member state a right to opt-out will give it greater confidence to opt-in.

Member states that opt-in will retain the freedom to recover supervisory sovereignty should the ECB performance fail to meet their expectations or unforeseen developments occur. At the same time, ECB and third party expectations will be protected against Member states reneging upon their commitments precisely when they become relevant, namely in the middle of a financial crisis. In the simple options contract that we describe, it is feasible to design an opt-out period that achieves both goals. In practice, the Member state could opt-out at the end of the first five year period if one

[56] See *supra* 2.2

[57] See Turner Review, *supra* note 6, 36-38.

year's notice is given. If the Member state does not exercise this option, the agreement would be deemed renewed for three year periods, a duration that takes into account the information and incentive advantages of continuing to constrain the possibility to opt out beyond the first period.

5.2 The overall case for a choice-oriented approach

We have argued that the key insight of our proposal is that some Member states have incentives to opt into ECB supervision and that the ECB is willing to undertake banking supervision activities. This, however, does not mean that the EU as a whole will benefit from allowing individual Member states to have their major banks supervised by the ECB.

We do not claim that our choice-oriented proposal is perfect. But it has clear advantages and, in the current state of the world, objections to its adoption are of limited relevance. More importantly, we believe that our approach is superior to both existing supervisory arrangements and the main proposed alternatives, and is also the best feasible choice in the present circumstances.

As summarized in Table 3 at the end of this section, choice-based ECB supervision has flexibility, implementation, legal robustness, financial stability and political acceptability advantages for the EC. Moreover, objections regarding duplication, monetary policy, lemons, resolution/fiscal issues or the absence of opt-ins are unpersuasive and do not provide a basis for objecting to our proposed reform. In the next section, we discuss these advantages and objections to a choice based approach.

5.21 Comparative advantages of a choice-based approach

Flexibility. An opt-in regime allows choice to a Member state about whether or not to transfer banking supervision powers to the ECB — which is a significant option and advantage over the compulsory nature of supervision under competing proposals. The opt-in agreement made with the ECB need also not be standardized and may indeed contain Member state-specific provisions. Again, this contrasts favourably with the one-size-fits-all approach adopted by competing proposals. Obviously, there are limits to the flexibility of such an agreement. The ECB must have the power to pursue a coherent EU supervision policy, and equal treatment (similar situations must be dealt with in a similar way) must be warranted. These constraints need not, however, prevent the creation of differentiated agreements.

A Member state that has opted in also keeps the option to opt out at relatively short intervals. Compared to alternative proposals, this will both improve its bargaining position and provide a

clean way out should the transfer of banking supervision powers prove to have been a mistake. Admittedly, opting out may be costly if the Member state has to rebuild a large bank supervisory capacity, but such costs are unlikely to prove significant in comparison to the costs of continued (and mistaken) ECB supervision.

One may ask whether granting a Member state such a continuous option may compromise good banking supervision. In particular, it could be argued that Member states will engage in strategic behaviour that prevents the ECB from efficiently exercising its powers or result in a return to (worsened) supervision by the Member state. In practice, however, allowing a Member state to opt out of ECB supervision is likely to lead to three benefits. First, strategic bargaining by Member states may force the ECB to take into account Member state-specific issues in order for mutual consent to be reached on an initial agreement, and to any subsequent changes to it. Second, returning to the *status quo ante* by way of an opt-out is unlikely to make banking supervision worse than it would have been had the Member state not opted into ECB banking supervision in the first place. Third, there is no reason to believe that providing Member states with a continuous opt-out choice would result in worse banking supervision outcomes than compulsory centralized supervision by a new ESFS—especially when taking into account the one-size-fits-all and the comparative lack of accountability vis-à-vis individual Member states that would necessarily accompany such a mandatory approach.

Speedy Implementation. Negotiating and implementing an opt-in agreement is an undertaking that can occur significantly faster than for most if not all steps towards a European System of Financial Supervision. With the possible exception of the first opt-in agreement, the contractual architecture will remain similar across agreements and Member state specificities are likely to be able to be taken into account with a rather simple menu of alternative provisions. In other words, there will be differences from agreement to agreement, but they are likely to affect a limited set of provisions in the opt-in agreement.

More importantly, the ECB will be able to enter into such agreements on the sole basis of the European Council's decision taken in application of Article 105(6) of the Treaty. The Member state may need to amend its banking regulation to delegate prudential supervision to the ECB. However, bail-out and fiscal burden sharing issues can be dealt with by the opt-in agreement while winding-up issues can be tackled on the basis of existing Member state insolvency laws. In other words, agreement flexibility not only allows for consistency with existing Member state law, it also permits

to use the latter as a complement—for example by providing that the EC can file for resolution under Member state law. By contrast, none of the competing proposals offer constructive solutions about fiscal contribution or insolvency matters.

Legal Robustness. According to Article 105(6) of the Treaty, the ECB may be empowered to undertake specific tasks concerning policies relating to the prudential supervision of credit institutions. According to some commentators, the reference to "specific tasks" means that the ECB cannot be made the sole supervisor for all credit institutions operating in the EC (Kempen 2003; Häde 2007). However, commentators that participated in the drafting of Article 105(6) have clearly stated that this provision provides a legal basis for "a form of direct Europe-wide supervision of financial institutions" (Louis 1995; Smits 2003). A *choice-based* approach is precisely such a form of ECB supervision, as confirmed by commentators recently pointing out the wide discretion the Council has under Article 105(6) (Howarth and Loedel; Koch 2006; Amtenbrink, Geelhoed and Kingston 2008) and submitting that only a broad scope mandatory approach would be beyond the scope of Article 105(6) (Glatzl 2009).

In other words, our approach does not require a Treaty amendment in order to be implemented. Moreover, and possibly more importantly, Article 105(6) of the Treaty provides a robust legal basis for the devolution of a choice-based prudential supervision to the ECB.

By contrast, full implementation of the ESFS approach will require a Treaty revision. It is the supervisory equivalent of the establishment of the ECB as a Europe-wide monetary institution (Eijffinger 2009). This is likely to require following the same institutional procedures as those adopted for establishing the ECB. In addition, it is even disputed whether there is sufficient legal basis for the adoption of the measures the European Commission describes as the first stage of the ESFS proposal.

The European Commission's plan is to empower the European Banking Authority to take decisions to settle matters in case of disagreement between national supervisory authorities or to adopt decisions directly applicable to banks to overcome inaction by national supervisors or if there is a need for urgent action.[58] According to the European Commission, Article 95 of the Treaty provides an appropriate legal basis for these (significant) decision-making powers, as this provision permits the setting-up of a Community body responsible for contributing to the implementation of a

[58] See Communication, *supra* note 33, at 10.

process of harmonization—for example the measures put in place by the EC as a response to the financial crisis.

The merits of this logic are unclear. The European Court of Justice has stated that Article 95 provides a legal basis to empower the Commission to require Member states to take product safety measures in emergency situations[59] or an agency to adopt non-binding advice to private sector actors operating in the field of network and information security.[60] Whether Article 95 allows for the establishment of (even limited) banking supervision decision-making at the EC level is quite another matter: this would imply that Article 95 has a scope that goes beyond the scope of Article 105(6), even though the latter provision specifically refers to banking supervision and the former does not. One can thus expect the allocation of supervisory powers to the European Banking Authority to be challenged, which makes this approach less legally robust than the one we propose and clouds the first phase of the European System of Financial Supervisors with legal uncertainty, which would significantly undermines the effectiveness of European Banking Authority decision-making.[61]

Cross-Border Financial Stability. Substituting decentralized by centralized banking supervision has a number of EU financial stability and crisis management advantages. First, the ECB will obtain better information on bank liquidity and solvency as well as a better grip on the payment system—especially if the Member state's central bank is associated with day-to-day supervision. This will facilitate the conduct of stability-oriented monetary policy and, in times of crisis, allow the ECB to impose corrective action in a timely manner and improve its lender-of-last-resort interventions.

Second, ECB supervision increases the likelihood that EU-wide risks rather than the protection of "national champions" are the main driver of prudential and fiscal interventions—not least because

[59] See C-359/92, *Germany v. Council* [1994] ECR I-3681.

[60] See C-217/04, *United Kingdom v. European Parliament and Council of the European Communities* [2006] ECR I-6295.

[61] The effectiveness of European Banking Authority could be undermined even if one assumes the general validity of the allocation of banking supervision powers. Compare Regulation 713/2009 establishing an Agency for the Cooperation of Energy Regulators OJ [2009] L 211/1: the Agency only has decision-making powers when the competent national regulatory authorities have not been able to reach an agreement within a period of six months or upon a joint request from the competent national regulatory authorities (articles 8 and 9), and any person with a direct and individual concern may bring an appeal before the Board of Appeal, and then the Court of First Instance and the Court of Justice against such a decision (articles 19 and 20).

it reduces the risk of supervisory capture due to individual banks having less political influence at the EU-level than at the home Member state level.

Third, the existence of a binding agreement that clearly allocates decision-making powers and financial contributions will ensure effective bail-out and resolution action *within* opting-in Member states that have banks in financial distress. Similarly, bail-out and resolution cooperation will also be facilitated *among* Member states that have opted into ECB banking supervision as they will share the same banking supervisor.[62] Finally, and possibly most importantly, bail-out and resolution cooperation will be improved between opting-in and non-opting in Member states due to the number of involved supervisors being reduced to *one* (the ECB) for Member states that have opted in (Nieto and Schinasi 2007).

These advantages cannot be replicated within either the existing regulatory regime or the current European Commission proposals, and may also be harder to generate under a full ESFS regime as monetary policy powers would remain with the ECB.[63]

Political acceptability. There is no decisive legal objection to the centralization of banking supervision powers, as shown by the existence of a Treaty provision permitting the devolution of prudential supervision to the ECB. In fact, it has been argued that the Treaty did not directly empower the ECB to supervise banks mainly because the probability of a major EU-wide financial crisis was deemed to be low (Franck and Krausz 2008). However, all attempts to implement the Treaty by granting banking supervisory powers to the ECB have been systematically defeated.

Recent events have renewed interest in centralizing banking supervision in Europe, but the assertion that the transfer of supervisory powers from the Member state to the European level has significantly better chances of success if undertaken in a progressive way remains true (Bini Smaghi and Gros 2000). From that perspective, the European System of Financial Supervisors approach has the political disadvantages not only of being mandatory, but also of imposing a quantum step and requiring a Treaty amendment to prove effective To be sure, even a choice-oriented approach to ECB supervision will raise concerns due to Member states' reluctance to set centralization

---

[62] Compare the difficulties faced in trying to agree ex post on Iceland reimbursing the UK and the Netherlands for compensation provided to UK and Dutch depositors following the insolvency of Landsbanki (see Andrew Ward and Alex Baker, *Iceland Hits Impasse over Lost Savings*, FINANCIAL TIMES, August 11, 2009 at 4).

[63] On the importance of the existence of binding fiscal agreements, see Institute of International Finance, *Restoring Confidence, Creating Resilience* (July 2009, available at iif.com).

precedents and concerns about the ECB becoming overly powerful—an always present fear in European politics (Masciandaro, Quintyn and Taylor 2008; Masciandaro 2009). However, the optional, progressive nature of the approach is much more likely to overcome political opposition to granting supervisory powers to the ECB (see also Freytag and Masciandaro 2008—central bank supervision is more likely to be acceptable if of limited scope).

This is a crucial element considering that the granting of banking supervision powers to the ECB requires a *unanimous* Council decision.[64] Even Member states that do not wish to have the ECB supervise their larger banks are likely to find it in their interest to grant banking supervision powers to the ECB on a voluntary basis for several reasons. First, they will be able to keep supervision of the banks incorporated in their jurisdiction at the Member state level. Second, ECB supervision of some banks will facilitate supervisory cooperation by reducing the number of relevant institutions. Third, and most importantly, it will diminish the risk of opportunistic behaviour in crisis situations.

In short, a choice-oriented approach has the political advantages of being both less interventionist (there are no mandates) and more immediately effective (in terms of early corrective action, fiscal burden sharing and resolution procedures) than competing proposals. It is more considerate of Member State sovereignty while putting the focus on EU rather than Member interests.

5.22 Unpersuasive objections to a choice-based approach

Inefficient Duplication. It could be objected that the ECB has no track record in banking supervision and, in any event, does not eliminate the need for the supervision of smaller banks by Member states. This would result in inefficient duplication as valuable Member state supervisory experience would be wasted and economies of scale inherent to a single regime would be lost. Such objections are not compelling. Financial stability is a critical factor for both monetary policy and supervision of major banks, which means that the ECB would not have to start its supervisory activities from scratch. Similarly, there may be some overlaps between ECB and Member state supervision, but the resulting costs should remain marginal.

Conflict with Monetary Policy. It could also be argued that combining prudential supervision and monetary policy responsibilities within the same institution may lead to sub-optimal policies due to conflicts between supervisory and monetary objectives. Reasonable arguments have been made for

[64] Article 105(6) of the Treaty provides that the Council must act unanimously on a proposal from the Commission, after consulting the ECB and receiving the assent of the European Parliament.

and against central banks undertaking prudential supervision functions (Goodhart and Schoenmaker 1995; Padoa-Schioppa 2003; Eijffinger 2005). Central banks' supervision involvement has been declining in various Member states since the 1990's.[65] However, recent financial distress situations have made it clear that monetary policy and systemic stability are linked (Goodhart, Sunirand and Tsomocos 2009), whereas liquidity issues (which are core to monetary policy) and solvency issues (which are core to prudential supervision) are hard to untangle (Adrian and Song Shin 2008; Allen and Carletti 2008; Freixas and Parigi 2008). Hence, an orderly payment system is paramount for central banks: if depositors cannot access their cash, the banking system cannot continue to operate. Conversely, it is crucial for banking supervisors to prevent bank runs: if depositors race to get their cash, the banking system cannot continue to operate. In other words, central bankers and banking supervisors have overlapping responsibilities (the first dealing with money supply and the latter with money demand) and there is nowadays no strong case against central banks having prudential supervision powers.

The debate about banking supervision being allocated inside or outside the central bank has focused on individual countries, not on an international organisation like the EC. It could be argued that conferring supervisory powers to the ECB will affect its independence in the monetary policy area. Empowering the ECB to supervise banks will indeed come at the cost of accountability requirements and backlash effects should the ECB fail to fulfil its supervision tasks properly.[66] However, there is no clear reason why this conflict between supervisory and monetary policies will be different or worse than within a single country. On the contrary, the negotiation of an opt-in agreement allows this conflict to be minimized *ex ante*— an opportunity not available to national central banks. In addition, by minimizing the national orientation of supervision, the opt-in agreement is likely to improve the acceptability for other Member states of the ECB's monetary as well as supervisory interventions (Boot 2007).

Getting Lemons. Another objection could be that Member states with the weakest banks will be among those having the highest incentives to opt in, leaving the ECB with the supervision of lemons. However, we see this as a benefit of our approach. The combination of information provided by the Member state willing to opt-in and data collected for monetary purposes will enable the ECB to appraise the financial strength, or lack thereof, of the banks it is asked to

---

[65] See *supra* 2.1.

[66] See *supra* 3.2.

supervise. It will frame the agreement with the Member state accordingly, using this possibility to impose the necessary fiscal commitments by the Member state. In addition, even if the costs of supervising 'lemons' cannot be fully identified *ex ante*, it is likely to be in the wider interest of the EU to have weaker banks with significant cross-border activities looked after by the ECB rather than by a domestic supervisor with incentives to disregards the spillover effects of financial distress.

Fiscal Contributions and Resolution. It could also be objected that the existing legal framework does not empower the ECB to provide fiscal assistance to banks in financial distress and keeps core resolution procedures a Member state affair. It is true that the ECB cannot bail-out banks in financial distress. However, there is little risk of opt-in agreements trying to circumvent this prohibition as it is not a significant constraint. The ECB has shown that, in times of crisis, it will accept almost any collateral and provide unlimited liquidity to banks in financial distress. This does not differ markedly from providing fiscal assistance and may put the ECB's balance-sheet in as much as risk as an unsecured loan or a guarantee.

In contrast, the opt-in agreement may well reduce this ECB balance-sheet risk as it allows for *ex ante* negotiations on fiscal and resolution issues. As discussed above, it will encompass provisions on the Member state's fiscal contributions, on burden-sharing criteria and on resolution procedures. Admittedly, a Member state may prove unwilling or unable to provide adequate fiscal support. However, early corrective action by the ECB will reduce the probability of such a scenario. Moreover, should ECB liquidity and Member state solvency support prove insufficient to bail-out a bank in financial distress, the end-game would be the same as in today's environment or under reform proposals: the bank would have to be wound-up.

It is also true that Member states that have not opted in are not bound by similar provisions. But we have seen that even such Member states will have significant incentives to coordinate and cooperate with the ECB in case of financial distress or crisis. From this perspective, EU interests are much better protected by a choice-oriented approach than under the current state of affairs or by other reform proposals.

No Opt-Ins. Finally, one could object that even if our approach is adopted, it is likely that no Member state will opt-in. This seems an unlikely scenario. We have shown that many Member states have incentives to opt-in.[67] Moreover several Member states have incentives to be first

[67] See *supra* 3.1.

movers and other Member states are likely to follow. Smaller Member states or Member states where subsidiaries of banks incorporated in other Member states play a significant role are unlikely to see their competitiveness decrease following an opt-in. They have not much to lose—the subsidiaries are unlikely to close or reincorporate abroad—and much to gain—supervision and financial stability should improve and local constituencies are likely to favour ECB supervision. Member States with large parent banks but less powerful supervisors will have incentives to follow.

Let us assume, however, that our choice-oriented approach does not result in any Member state entering into an agreement with the ECB to supervise its banks. The costs of such a failure would be minimal in comparison to misguided mandatory approaches to supervision at the European level. They would mainly consist in the transaction costs generated in getting the European Council to agree to the opt-in proposal.

<table>
<tr><th colspan="2">Table 3: Choice-based ECB supervision from an EC perspective</th></tr>
<tr><th>Comparative advantages</th><th>Unpersuasive objections</th></tr>
<tr><td>Flexibility
No mandate
No one size fits all requirement</td><td>Inefficient Duplication
Supervisory overlaps are minimal
No waste of supervision resources</td></tr>
<tr><td>Speedy Implementation
Straightforward opt-in contract
Allows for consistency with existing MS law</td><td>Conflict with Monetary Policy
Not a critical objection
Reduced relevance post-crisis</td></tr>
<tr><td>Legal Robustness
Specific ECB provision in Treaty
No Treaty amendment required</td><td>Getting Lemons
Not obvious why likely
If so, the better</td></tr>
<tr><td>Cross-Border Financial Stability
Improved ECB information
Facilitated early corrective action
More coherent bail-out procedures</td><td>What about Resolution and Fiscal Support?
ECB already provides liquidity support
Can be dealt with ex ante
Agreement can build upon national insolvency law
EC insolvency powers not for tomorrow</td></tr>
<tr><td>Political acceptability
More effective or less interventionist than competing proposals
Positive supervisory externalities
Accountability</td><td>Not Opt-Ins
Several MS are first mover candidates
Other MS likely to follow-up
No costs for EC if no opts-in</td></tr>
</table>

VI. CONCLUSION

The current credit crisis has shown that the regulatory colleges set up to facilitate cooperation and coordination among EU Member states banking supervisors cannot properly address situations of financial distress involving banks with significant cross-border activities. Reforms are needed to improve the supervision of the larger banking groups operating within the EU.

This paper argues that the mandatory institutional proposals spurred in response are likely to fail and proposes a choice-oriented alternative. Under this approach, Member states will have the option to delegate the supervision of banks that pose EU-wide prudential risks to the ECB. The opting-in process requires a Member state to enter into a binding agreement with the ECB, which spells out coordination and cooperation in normal times as well as in periods of crisis, and which may also contain Member state-specific provisions.

We have shown that a number of Member states have incentives to enter into such an agreement and the ECB is willing to undertake banking supervision activities. In terms of its implication on the institutional environment, our alternative has several comparative advantages. It is superior in terms of flexibility, implementation, and legal robustness, provides a significantly better way to improve cross-border financial stability, and is more acceptable politically than other reform proposals. Moreover, objections regarding supervisory duplication, conflicts with monetary policy, the delegation of supervision for lemons, and resolution and fiscal difficulties are unpersuasive

We believe that our opt-in approach is the best feasible choice in the present circumstances and would significantly improve cross-border banking supervision within the EU.

References

Adrian, Tobias and Hyun Song Shin, 2008, *Financial Intermediaries, Financial Stability and Monetary Policy* (FRB of New York Staff Report, available at ssrn.com).

Allen, Franklin and Elena Carletti, 2008, *The Role of Liquidity in Financial Crises* (Working Paper, available at ssrn.com).

Amtenbrink, F., A. Geelhoed and S. Kingston, 2008, *Economic, Monetary and Social Policy*, in Paul J.G. Kapteyn *et al*. (eds.) THE LAW OF THE EUROPEAN UNION AND THE EUROPEAN COMMUNITY 881 (4th ed.).

Arnone, Marco and Alessandro Gambini, 2007, *Architectures of Supervisory Authorities and Banking Supervision*, in Masciandaro and Quintyn, 262.

Ayotte, Kenneth and David A. Skeel, *Bankruptcy or Bailouts*, 2009 (Working Paper, available at ssrn.com).

Bednarski Piotr, and Grzegorz Bielicki, 2006, *Home and Host Supervisors' Relations from a Host Supervisor's Perspective*, in Caprio, Evanoff and Kaufman, 211.

Benston, George I. and George G. Kaufmann, 1995, *Is the Banking and Payments System Fragile?* 9 JOURNAL OF FINANCIAL SERVICES RESEARCH 209.

Benston, George J., Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane and George G. Kaufman, 1986, PERSPECTIVES ON SAFE AND SOUND BANKING.

Bini Smaghi, Lorenzo and Daniel Gros, 2000, OPEN ISSUES IN EUROPEAN CENTRAL BANKING.

Bliss, Robert R., 2007, *Multiple Regulators and Insolvency Regimes*, in Mayes and Wood 132.

Boot, Arnoud W. A., 2007, *Supervisory Arrangements, LOLR and Crisis Management in a Single European Banking Market*, in Evanoff, Kaufman and LaBrosse 387.

Butler, Henry N. and Jonathan R. Macey, 1988, *The Myth of Competition in the Dual Banking System*, 73 CORNELL LAW REVIEW 677.

Calomiris, Charles W., 2003, *Blueprints for a New Global Financial Architecture*, in Leonardo Auernheimer (ed.), INTERNATIONAL FINANCIAL MARKETS 259.

Calzolari, Giacomo and Gyongyi Loranth, 2005, *Regulation of Multinational Banks, A Theoretical Perspective*, (ECB Working Paper, available at ecb.int).

Caprio, Gerard, Douglas D. Evanoff and George G. Kaufman (eds.), 2006, CROSS-BORDER BANKING: REGULATORY CHALLENGES.

Čihák, Martin and Jörg Decressin, 2007, *The Case for a European Banking Charter* (IMF Working Paper, available at ssrn.com).

Čihák, Martin and Tigran Poghosyan, Distress in European Banks Before and During the Financial Crisis, 2009 (Working Paper, available at ssrn.com)

Dale, Richard and Simon Wolfe, 1998, *The Structure of Financial Regulation*. 6 JOURNAL OF FINANCIAL REGULATIONS AND COMPLIANCE 326.

Demirgüç-Kunt, Aslı, Edward J. Kane and Luc Laeven (eds.), 2008, DEPOSIT INSURANCE AROUND THE WORLD.

Dermine, Jean, 2000, *Bank Mergers in Europe, The Public Policy Issues* 38 JOURNAL OF COMMON MARKET STUDIES 409.

Dewatripont, Mathias and Jean Tirole, 1994, THE PRUDENTIAL REGULATION OF BANKS.

Dewatripont, Mathias and Jean Charles Rochet, 2009, *The Treatment of Distressed Banks* (Discussion Paper, available at cepr.org).

Dowd, Kevin, 1989, THE STATE AND THE MONETARY SYSTEM.

Eichengreen, Barry, 1999, TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE 93 (1999).

Eichengreen, Barry, 2009, *Out of the Box Thoughts About the International Financial Architecture* (Working Paper, available at ssrn.com).

Eijffinger, Sylvester C.W., 2005, *The European Central Bank and Financial Supervision*, in Donato Masciandaro (ed.), HANDBOOK OF CENTRAL BANKING AND FINANCIAL AUTHORITIES IN EUROPE 455.

Eijffinger, Sylvester C.W., 2009, *What Role for the ECB on Financial Market Supervision?* (Briefing Paper, available at feweb.uvt.nl).

Eisenbeis, Robert A. and George G. Kaufman, 2008, *Cross-Border Banking and Financial Stability in the EU*, 4 JOURNAL OF FINANCIAL STABILITY 168.

Evanoff, Douglas D., George G. Kaufman and John R. LaBrosse (eds.), 2007, INTERNATIONAL FINANCIAL STABILITY.

Fidrmuc, Jarko and Christa Hainz, *Financial Integration and Banking Regulation: Cross-Border Lending in Germany*, 2009 (Working Paper, available at ssrn.com).

Franck, Raphaël and Miriam Krausz, 2008, *Why Separate Monetary Policy from Banking Supervision?,* 36 JOURNAL OF COMPARATIVE ECONOMICS 388.

Freixas, Xavier, 2003 *Crisis Management in Europe*, in Kremers, Schoenmaker and Wierts 102.

Freixas, Xavier and Jean-Charles Rochet, 2008, MICROECONOMICS OF BANKING (2d ed.).

Freixas, Xavier and Bruno M. Parigi, 2008, *Lender of Last Resort and Bank Closure Policy* (Working Paper, available at ssrn.com).

Freytag, Andreas and Donato Masciandaro, 2008, *Financial Supervision Architecture and Central Bank Independence*, in Masciandaro and Quintyn 211.

Friedman, Milton 1959, A PROGRAM FOR MONETARY STABILITY.

di Girogio, Giorgio and Carmine Di Noia, 2007, *Financial Supervisors: Alternative Models*, in Masciandaro and Quintyn, 342.

Glasner, David, 1989, FREE BANKING AND MONETARY REFORM.

Glatzl, Stefan, 2009, GELDPOLITIK UND BANKENAUFSICHT IM KONFLIKT.

Goodhart, Charles A.E., 2000 *The Organizational Structure of Banking Supervision* (Financial Stability Institute Occasional Paper 1).

Goodhart, Charles A.E. and Dirk Schoenmaker, 1995, *Should the Functions of Monetary Policy and Banking Supervision be Separated?*, 47 OXFORD ECONOMIC PAPERS 539.

Goodhart, Charles A.E. and Dirk Schoenmaker, 2006, *Burden Sharing in a Banking Crisis in Europe*, 2 SWEDISH RIKSBANK ECONOMIC REVIEW 34.

Goodhart, Charles A.E. and Dirk Schoenmaker, 2009, *Fiscal Burden Sharing in Cross-Border Banking Crisis*, 5 INTERNATIONAL JOURNAL OF CENTRAL BANKING 141.

Goodhart, Charles A.E., Pojanart Sunirand and Dimitrios P. Tsomocos, *The Optimal Monetary Instrument for Prudential Purposes*, 2009 (forthcoming in JOURNAL OF FINANCIAL STABILITY).

Häde, Ulrich, 2007, *Article 105*, in Christian Calliess and Matthias Ruffert (eds.) KOMMENTAR DES VERTRAGES ÜBER DIE EUROPÄISCHE UNION UND VERTRAG ZUR GRÜNDUNG DER EUROPÄISCHEN GEMEINSCHAFT (3d ed.).

Hayek, Friedrich A., 1978, DENATIONALIZING MONEY (1978).

Hertig, Gerard and Ruben Lee, 2003, *Four Predictions about the Future of Securities Regulation*, 3 JOURNAL OF CORPORATE LAW STUDIES 359.

Hertig, Gerard and Joseph A. McCahery, 2006, *Optional rather than Mandatory EU Company Law: Framework and Specific Proposals*, 4 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 341.

Holthausen, Cornelia and Thomas Roende, 2004, *Cooperation on International Banking Supervision* (ECB Working Paper, available at ecb.int)

Howarth, David and Peter Loedel, 2003, THE EUROPEAN CENTRAL BANK.

Huizinga, Harry, 2008 *The EU Deposit Insurance Directive: Does One Size Fit All?,* in Demirgüç-Kunt, Kane and Laeven, 253.

Kaufman, Henry, 1994, *Structural Changes in the Financial Markets: Economic and Policy Significance*, 79 FEDERAL RESERVE BANK OF KANSAS CITY ECONOMIC REVIEW 5.

Kempen, Bernhard, 2003, *Article 105*, in Rudolf Streinz (ed.), VERTRAG ÜBER DIE EUROPÄISCHE UNION UND VERTRAG ZUR GRÜNDUNG DER EUROPÄISCHEN GEMEINSCHAFT.

Kick, Thomas and Michael Koetter, *Slippery Slopes of Stress: Ordered Failure Events in German Banking,* 3 JOURNAL OF FINANCIAL STABILITY 132 (2007).

Kremers, Jeroen J.M., Dirk Schoenmaker and Peter J. Wierts (eds.), 2003, FINANCIAL SUPERVISION IN EUROPE.

Krimminger, Michael , 2007, *Banking in a Changing World: Issues and Questions in the Resolution of Cross-Border Banks*, in Evanoff, Kaufman and LaBrosse 257).

Koch, Manfred, 2006, *Article 105*, in Carl Otto Lenz and Klaus-Dieter Borchart, KOMMENTAR ZU DEM VERTRAG ÜBER DIE EU UND ZU DEM VERTRAG ZUR GRÜNDUNG DER EG (4th ed.).

Lannoo, Karel, 2008, *Concrete Steps Towards More Integrated Financial Oversight* (available at ceps.eu).

Lastra, Rosa Maria, 2007, *Cross-Border Resolution of Banking Crises*, in Evanoff, Kaufman and LaBrosse, 311.

Litan, Robert E., 1985, WHAT SHOULD BANKS DO?.

Louis, Jean-Victor *et al*., 1995, *General Report*, in Working Group, BANKING SUPERVISION IN THE EUROPEAN COMMUNITY.

Masciandaro, Donato, 2007, *Divide et Impera: Financial Supervision Unification and Central Bank Frangmentation Effect*, 23 EUROPEAN JOURNAL OF POLITICAL ECONOMY 285.

Masciandaro, Donato, 2009, *Politicians and Financial Supervision Unification Outside the Central Bank: Why Do They Do It?*, 5 Journal OF FINANCIAL STABILITY 124.

Masciandaro, Donato, Maria J. Nieto and Marc Quintyn, *Will they Sing the Same Tune? Measuring Convergence in the new European System of Financial Supervisors* 2009 (IMF Working Paper, available at ssrn.com).

Masciandaro, Donato and Marc Quintyn (eds.), 2007, DESIGNING FINANCIAL SUPERVISION INSTITUTIONS.

Masciandaro, Donato and Marc Quintyn, 2009a, *After the Big Bang and Before the Next One? Reforming the Financial Supervision Architecture and the Role of Central Banks* (Working Paper, available at ssrn.com).

Measuring Financial Regulation Architectures and the Role of Central Banks: The Financial Supervision Herfindhal Hirschman Index, 2009b (Working Paper, available at ssrn.com).

Masciandaro, Donato, Marc Quintyn and Michael W. Taylor, 2008, *Inside and Outside the Central Bank: Independence and Accountability in Financial Supervision*, 24 EUROPEAN JOURNAL OF POLITICAL ECONOMY 833.

Mayes, David G. and Geoffrey E. Wood (eds), 2007, THE STRUCTURE OF FINANCIAL REGULATION.

Mayes, David G., María J. Nieto and Larry Wall, 2008 *Multiple Safety Net and Agency Problems in the EU: Is Prompt Corrective Action Partly the Solution?* 4 JOURNAL OF FINANCIAL STABILITY 232.

Mortimer-Schutts, Ivan, 2005 *EU Regulatory and Supervisory Convergence: The Case for a Dual-System with Choice* (Working Paper, available at aei-brookings.org).

Nenovsky, Nikolay and Kalina Dimitrova, 2008, *Deposit Overinsurance in EU Accession Countries*, in Demirgüç-Kunt, Kane and Laeven, 281.

Nier, Erlend Walter, 2009 *Financial Stability and the Role of Central Banks: Lessons from the Crisis* (IMF Working Paper, available at ssrn.com).

Nieto, María J. and Larry D. Wall, 2006, *Preconditions for a Successful Implementation of Supervisors' Prompt Corrective Action: Is There a Case for a Banking Standard in the EU?*, 7 JOURNAL OF BANKING REGULATION 191.

Nieto, María J. and Garry J. Schinasi, 2007, *EU Framework for Safeguarding Financial Stability: Toward an Analytical Benchmark for Assessing its Effectiveness* (IMF Working Paper, available at ssrn.com).

Olson, Mancur, 1965, THE LOGIC OF COLLECTIVE ACTION

Padoa-Schioppa, Tommaso, 2003, *Financial Supervision: Inside or Outside Central Banks?*, in Kremers, Schoenmaker and Wierts 160.

Padoa-Schioppa, Tommaso, 2004, REGULATING FINANCE (2004).

Posen, Adam and Nicolas Véron, 2009, *A Solution for Europe's Banking Problem* (Policy Brief, available at bruegel.org).

Schinasi, Garry J, and Pedro Gustavo Teixeira, 2006, *The Lender of Last Resort in the European Single Financial Market*, in Caprio, Evanoff and Kaunfman.

Schoenmaker, Dirk and Sander Oosterloo, 2005, *Financial Supervision in an Integrated Europe: Measuring Cross-Border Externalities*, 8 INTERNATIONAL FINANCE 1.

Schoenmaker, Dirk and Sander Oosterloo, 2007, *Cross-border Issues in European Financial Supervision*, in Mayes and Wood, 264.

Schoenmaker, Dirk and Christiaan van Laecke, 2007, *Current State of Cross-Border Banking*, in Evanoff, Kaufman and LaBrosse 39.

Scott, Kenneth, 1977, *The Dual Banking System: A Model of Competition in Regulation*, 30 STANFORD LAW REVIEW 1.

Smits, René, 2003, *Article 105*, in Hans von der Groeben and Jürgen Schwarze (eds.), KOMMENTAR ZUM VERTRAG ÜBER DIE EUROPÄISCHE UNION UND ZUR GRÜNDUNG DER EUROPÄISCHEN GEMEINSCHAFT (6th ed.).

Spencer, Peter D., 2000, THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS.

Speyer, Bernhard and Norbert Walter, 2007, *Towards a New Structure for EU Financial Supervision* (available at dbresearch.com).

Tobin, James, 1985, *Financial Innovation and Deregulation in Perspective*, 3 BANK OF JAPAN MONETARY AND ECONOMIC STUDIES 19.

Véron, Nicolas, 2007, *Is Europe Ready for a Major Banking Crisis* (available at bruegel.org).

Véron, Nicolas, 2008, *Supervisory Colleges: Way Forward or Red Herring?* (available at bruegel.org).

Zilioli, Chiara and Martin Selmayr, 2001, THE LAW OF THE EUROPEAN CENTRAL BANK.

european corporate governance institute

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

european corporate governance institute

ECGI Working Paper Series in Finance

Editorial Board

Editor	Paolo Fulghieri, Professor of Finance, University of North Carolina, ECGI & CEPR
Consulting Editors	Franklin Allen, Nippon Life Professor of Finance, Professor of Economics, The Wharton School of the University of Pennsylvania & ECGI
	Patrick Bolton, Columbia University, ECGI & CEPR
	Marco Pagano, Professor of Economics, Università di Salerno, ECGI & CEPR
	Luigi Zingales, Robert C. McCormack Professor of Entrepreneurship and Finance, University of Chicago, ECGI & CEPR
	Julian Franks, Corporation of London Professor of Finance, London Business School, ECGI & CEPR
	Xavier Vives, Professor of Economics and Finance, IESE & CEPR
Editorial Assistants :	Paolo Casini, ECARES, Université Libre de Bruxelles
	Lidia Tsyganok, ECARES, Université Libre De Bruxelles

www.ecgi.org\wp

european corporate governance institute

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html