

Towards a New Architecture for European Banking Supervision

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1. A BRIEF INTRODUCTION ON THE ALLOCATION OF FINANCIAL SUPERVISION IN THE TREATY

How to properly allocate supervision on multi-jurisdictional financial conglomerates has been vividly debated, at least in Europe, for a long time.¹ It might be worth recalling that the initial proposals of the Treaty of Maastricht advocated the allocation of supervisory functions to the European Central Bank (ECB):² a forward looking proposal which however clearly departed from the home country control and mutual recognition principles³ governing the European banking integration (and already embedded in the Second Banking Directive) and was eventually dropped for political reasons. Article 105 of the EC Treaty confirms indeed that supervisory functions rest on national authorities (some of which are central banks⁴ and therefore components of the European System of Central Banks (ESCB)) and entrusts the ESCB simply with a complementary role: that of contributing to the good conduct of prudential supervision by national authorities and to financial stability. In turn, under Article 25 of the ECB Statute, the ECB may render (solely) 'opinions' on the scope and implementation of EC legislation on prudential supervision and financial stability. True, Article 105 (6) sets out a 'last resort clause' whereby, if the interaction between the Eurosystem and national supervisory authorities turned out not to work effectively, the Council could entrust the ECB with specific functions in bank supervision.⁵ However, the implementation of this provision is generally (and rightly) considered as being very complex. On the one hand, albeit not imposing a Treaty amendment, the deferral of supervisory functions to the ESCB would require a unanimous resolution of the Council upon proposal of the Commission and with the agreement of the European

Parliament. On the other hand, Article 105(6) expressly excludes insurance supervision, whereby making it impossible, without a Treaty amendment, to set up at the ECB an efficient centralized European supervision of financial conglomerates.

2. MICRO AND MACRO INEFFICIENCIES OF A NATION-BASED SUPERVISORY ARCHITECTURE FOR MULTI-JURISDICTIONAL BANKS AND FINANCIAL CONGLOMERATES

Since the entry into force of the Treaty of Maastricht, the asymmetry between international financial conglomerates and national supervision increased dramatically. Following the cross-border expansion and consolidation of the European banking industry in recent years, a small number (compared to the total number of about 8,800 banks in the EU) of multi-jurisdictional banks or financial conglomerates account for a disproportionate share of total assets (in 2003 the top 50 EU banks accounted for more than 60% of total assets of all EU banks). These large players are, to be honest, inefficiently supervised. Inefficiencies are both micro- and macro-prudential.

Micro-prudential inefficiencies from the regulator side stem from a well recognized conflict of interest among national supervisors. As it has been recently said 'in addition to contributing to the stability of their financial system, supervisory authorities have an implicit – and sometimes explicit – task, that of defending and promoting their national industry within an integrated international financial market. To some extent, this puts supervisory authorities in competition among themselves, which affects their regulatory and oversight tasks.'⁶ This conflict of interest fosters a strong regulatory and supervisory competition in laxity, since there is a negative correlation between regulation (and strict

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1 Vella, 'Banca centrale europea, banche centrali nazionali e vigilanza bancaria: verso un nuovo assetto dei controlli nell'area dell'Euro?', *Banca, borsa e tit. cred.*, 1 (2002): 150 (with additional references).

2 Smits, *The European Central Bank. Institutional Aspects*, London, 1997, p. 336; Louis, *Banking Supervision in the European Community*, Brussels, 1995, especially at p. 58. For the rationale of such proposals compare Padoa Schioppa, *L'Europa verso l'Unione Monetaria*, Torino, 1992, p. 256.

3 Nicolin, *Il mutuo riconoscimento tra mercato interno e sussidiarietà*, (Padova: Cedam, 2005), 173.

4 A majority, though, within the Eurosystem: see D. Schoenmaker, 'Central Banks and Financial Authorities in Europe: What Prospects?', in *Handbook of Central Banking and Financial Authorities in Europe*, ed. Masciandaro (Cheltenham: Edward Elgar, 2005), at 426 (mentioning the allocation of prudential supervision at the central bank in the Netherlands, France, Italy and Germany and Austria) and at 424, Table 16.6.

5 Padoa Schioppa, 'EMU and Banking Supervision', in *Which Lender of Last Resort for Europe?*, ed. By Goodhart (London, 2000), 18.

6 Bini Smaghi, *A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market*, paper presented at the CFM-IMF Conference in Frankfurt am Main, 26 Sep. 2008, p. 2.

supervision) and profitability. 'We know by now that those sectors of the **financial markets** that are less regulated are also more prone to be risk taker and thus more profitable at least in certain periods. There is a clear incentive for market participants to have less regulation.' Due to the international **dimension** of finance and the rapid mobility of products and factors of production in this sector, 'in such a context there is an incentive to reduce the level of regulation (and strict supervision) compared to other countries in order to attract the financial industry from neighbours. Given the high value added that financial industry generates and the negative correlation between regulation and profitability, the incentive to compete on regulatory standard is much stronger than in other sectors, especially for countries which have put the financial sector at the centre of their economic policy priorities'. History repeats itself: indeed, this was also the way the American dual banking system has been operating since 1864.⁷ In addition to that, an ECB study of 2004⁸ finds that, since the costs and benefits of closing a multi-jurisdictional bank usually differ across countries (either due to different activity or size of activity in the two countries, to different systemic importance of the bank in the two countries or to the pressure exerted by the institutional environment), supervisors' preferences for closure do not coincide and the host country supervisor may have incentives to misreport its private (soft) information to the home country supervisory authority in order to obtain a preferable outcome. The same could probably be said also the other way round in respect of the evaluation of the information made by the home country supervisor. This indicates that joint welfare depends negatively on the supervisors' divergence of interest and that, when supervisors' preferences are not aligned, a first best decision can never be reached. This is an important finding in respect of the benefits which can be rationally expected by bilateral or multi-lateral Memoranda of Understandings for international banking supervision (instead of a **centralized** authority).

Micro-prudential inefficiencies from the side of international banks are, in turn, well known. The industry is confronted with a multitude of **supervisory** authorities (Professor Wymeersch recently counted up to fifty-four financial **supervisors** in Europe)⁹ and different, albeit partially harmonized, requirements. Explicit or implicit national discretions left open by the directives, gold-plating and diverging national interpretation make it very difficult and sometimes impossible for an international bank to adopt a cost-efficient single compliance **strategy** within the EU.

A frequent example is internal model validation: sometimes

multi-jurisdictional banks are induced to use locally the **standard** model instead of the advanced model used by the parent **company** and by the group elsewhere due to the reluctance of local supervisors to accept the methodologies **approved** by other supervisors. An even worse example is reporting. Each national supervisor has imposed its own specific requirement for prudential reporting regardless of the rules at the consolidated level.¹⁰

Macro-prudential inefficiencies are also highly topical, especially in the 'black days' of the current financial crisis. As large European banks have grown in prominence and wholesale markets have become closely integrated, problems at the level of individual large banks are more likely to have systemic effects.¹¹ 'Consequently – it has been rightly said¹² – it is difficult to draw a line, in practice, between the responsibility for systemic stability, including the function of lender of last resort and that of prudential supervision of large banks. Indeed, in today's increasingly market based financial system, disturbances are likely to affect core market mechanisms'. This has important implications. Lacking a clear allocation of responsibility among supervisors, there are huge risks of informational asymmetries and opportunistic behaviours. First, as it has been correctly noted, 'recent experience has shown that conflict of interest hampers the necessary transmission of information on critical institutions from the supervisory authority to the central bank, even within the same country, in the hope that weak institutions would be bailed out by liquidity injections rather than by addressing the solvency problem. This makes contagion from individual **institutions** to the rest of the market more difficult to avoid'.¹³ This is to say that, in the current situation, where central banking and banking supervision are split at national level, strict and timely informational cooperation sometimes failed; and it was so despite the very fact that 'for the execution of central bank functions, timely access to micro-prudential information on individual banks is relevant. In the financial turbulence, information on the liquidity **arrangements** of counterparties, their sources of funding and of their financial position has proven to be essential to obtain a clearer picture of the liquidity pressures influencing banks'. Second, in case of crisis authorities have an incentive to push the burden of adjustment towards other foreign institutions (activating e.g., host MS central banks as lenders of last resort or foreign deposit insurance schemes for subsidiaries) or to advocate the use of inflation tax to help out weak banks so to spread out the costs to all taxpayers of the Union rather than to only those of the country of origin, who however reaped all the fruits in good times.

7 White, *The Regulation and Reform of the American Banking System, 1900-1929*, (Princeton University Press, 1983), passim.

8 Holthausen, Ronde, *Cooperation in International Banking Supervision*, ECB Working Paper Series, No. 316, Mar. 2004, passim.

9 Wymeersch, *The structure of financial supervision*, available at ssrn 946695.

10 EFR – European Financial Services Round Table, *Monitoring Progress in EU Prudential Supervision*, Brussels, Sep. 2007, especially at pp. 14, 31 and 32.

11 Compare Alexander, Eatwell, Persaud, Reoch, *Financial Supervision and Crisis Management in the EU*, a study commissioned by the EP Policy Department, Brussels, Dec. 2007 (IP/A/ECON/IC/2007-069), passim, **complaining** that there has been a failure up to now to incorporate systemic risk into the design of regulatory institutions.

12 Wellink, *Banking supervision in Europe: Developments and challenges*, speech held at the 36th Economics Conference 2008, Austrian National Bank, Vienna, 28 Apr. 2008, p. 3.

13 Bini Smaghi, *A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market*, p. 2.

3. THE FIRST BEST SOLUTION: A EUROPEAN CENTRAL SUPERVISORY AUTHORITY FOR MULTI-JURISDICTIONAL BANKS STRICTLY CONNECTED BOTH TO THE ECB AND THE ESCB AND TO THE EXISTING NETWORK OF NATIONAL SUPERVISORS

For the reasons briefly mentioned above, I believe (and the idea is certainly neither new nor original)¹⁴ that the current situation would suggest the swift adoption of a strong European initiative and that in principle this should lead to the prompt establishment of a centralized European supervisory authority for multi-jurisdictional banks strictly connected both to the ECB and the ESCB, on the one hand, and to the existing network of national supervisors, on the other hand. This would indeed reduce if not eliminate the scope for regulatory arbitrage (and the inherent conflicts of interest), would re-align power and risk in financial supervision and crisis management at the European level – bail out costs fall indeed on several Member States and, in the Euro area, although national central banks decide autonomously on whether or not to provide emergency liquidity assistance, this has repercussions on the common currency – and would fill in the gap between truly pan-European industry and pan-European supervision. The time has come, to my mind, for a more far reaching European supervisory architecture and the unique opportunity offered by the current crisis should not be missed. As Professor Draghi recently reminded ‘history has repeatedly shown that needed reforms are ignored until a crisis forces action and that the will to reform quickly dissipates after the crisis has passed. This crisis is no different and this is an opportunity to strengthen the structure of the financial services industry’.¹⁵ The crisis clearly showed that large financial conglomerates raise significant cross-border externalities that can undermine financial stability. To properly address such externalities supervisory and crisis management decisions need to be taken at the European level. This is not to say, however, that banking supervision should be entirely transferred to the centre. Quite on the contrary. Drawing from the Bank of Italy supervisory architecture (which decentralizes oversight of small and local banks and centralizes that of national banks) and following past advice, for example, of Padoa Schioppa and Schoenmaker¹⁶ the European Financial Supervisor – a new European institution resulting from a bottom up consortial integration of national supervisors in a European System of Financial Supervisors along the lines of the ESCB – should exert authority only over the handful (forty to fifty?) of multi-jurisdictional banks and financial conglomerates which pose financial stability concerns. Small and medium sized banks and financial conglomerates which operate mainly within national borders

should remain under the oversight of national supervisors. As is the case for the ECB, also the European Financial Supervisor should act through a mix of centralized and decentralized activities. Core supervisory decisions (herein included the adoption of a uniform rule book and reporting format for multi-jurisdictional banks) should be taken by the central institution; desk analysis and on site inspections of cross-border banks and conglomerates should be delegated at the national level, either to the sole home country supervisor or (and this is preferable in my opinion because supervision is effective if performed not at too great a distance from the bank) to both the home country supervisor as regards headquarters supervision and the host countries’ supervisors as regards subsidiaries and branches. As mentioned before, this European System of Financial Supervisors would have the advantage of aligning power and risk, at least as regards liquidity injections made by the ECB and the ESCB as lender of last resort in case of crisis. On the contrary, it would not solve, as such, the thorny issue of who should bear the fiscal cost of a bail out so long as there will be no meaningful European budget which could be drawn upon for such cases.¹⁷ True, to agree upon a fixed rule to share the costs among Member States as well as a Treaty amendment is a very complex game. However, the experience of these days seems to make such an exercise a matter of urgency.

4. THE EUROPEAN WORK IN PROGRESS TOWARDS A SECOND BEST SOLUTION: FROM SIMPLE COOPERATION TO STRICT COORDINATION AMONG NATIONAL SUPERVISORS (COLLEGES OF SUPERVISORS AND 3L3)

Nevertheless, despite the recognized failures of the existing European supervisory architecture based on mere cooperation and although many agree that in an integrated European financial market ‘market players as well as consumers would probably benefit from having one integrated pan-European supervisory authority both from a practical and an economic perspective’,¹⁸ there is still ‘a long way to Tipperary’. Realistically, in the short term it seems that we should continue to build on the existing, albeit upgraded, institutional structure. Europe seems to have chosen, once again, a progressive institutional evolution at multiple stages, very much along the lines of the historical development of the ESCB where the Committee of the central governors was first set at stage 1, then turned into the European Monetary Institute at stage 2 and finally transformed and upgraded into the ECB and ESCB at stage 3. It could be said, thus, that as regards pan-European banking supervision, the current European proposals are aimed at improving the supervisory architecture from stage 1

14 The model is advocated by the industry itself: see EPR – European Financial Services Round Table, *On the Supervisory Model and the Future of Financial Supervision in the EU*, Brussels, 2005, p. 42.

15 Draghi, *How to Restore Financial Stability*, Bundesbank Lecture 2008, 16 Sep. 2008, p. 14.

16 Schoenmaker, *Central Banks and Financial Authorities in Europe: What Prospects?* at p. 445.

17 Schoenmaker, *Central Banks and Financial Authorities in Europe: What Prospects?* at p. 447.

18 Moss, *The International Network of Financial Authorities*, in *Handbook of Central Banking and Financial Authorities in Europe*, ed. by Masciandaro, at p. 396; see also Eijffinger, ‘The European Central Bank and Financial Supervision’, in *Handbook of Central Banking and Financial Authorities in Europe*, ed. Masciandaro, at pp. 476 and 481.

to stage 2. In other words, moving ahead from mere cooperation to enhanced coordination without much more. The Commission, also urged by the recommendations of the EP,¹⁹ currently envisages a four pillar approach, to be eventually complemented by new rules of liquidity risk and on the harmonization of Deposit Guarantee Schemes. The reform of existing supervisory arrangements should be based in particular on:

- (a) establishing under EU law colleges of supervisors for each and all cross-border banks under the revised CRD, providing also the lead consolidating supervisor with binding powers on selected supervisory issues, if necessary;
- (b) enhancing the coordinating role and the functioning of Lamfalussy Level 3 (3L3) Committees through an appropriate amendment to their founding directives;
- (c) implementing the Memorandum of Understanding (MoU) on cooperation between the financial supervisory authorities, central banks and finance ministries of the EU on cross-border financial stability as amended on 1 June 2008;
- (d) setting out harmonized rules on cross-border asset transferability within multi-jurisdictional groups both in going concern and emergency situations.

I will briefly touch on each of them, describing their rationale, where we stand now and what these reforms should deliver and, in particular, some of their legal implications. At the conclusion, according to the mandate implied in the title of this paper, I will discuss in some detail the legal constraint of any pan-European arrangement among supervisors transferring decision making from a single Member State (as is the case in a nation-based supervisory architecture) to a different body, outside such Member State.

5. THE CRD AMENDMENT AND THE DECISION MAKING CONFERRED UPON THE CONSOLIDATING SUPERVISOR

The current CRD amendment proposal (COM(2008) 602/3 'amending Directives 2006/48/EC and 2006/49/EC as regards, inter alia, supervisory arrangements and crisis management') is aimed at improving information rights of host supervisors of systemically relevant branches, reinforcing supervisory cooperation and clarifying supervisors' tasks and responsibilities, requiring supervisors to have regard to financial stability concerns in all interested Member States and clarifying the legal framework for transmitting information to ministries of finance and central banks. The reforms are 'Level I' measures under the Lamfalussy approach and will therefore be grounded on the same Treaty legal basis as the existing CRD. The proposal provides therefore

a sound Community legal basis for the establishment of colleges of supervisors (Article 131a) of the proposal). It sets out that 'colleges of supervisors shall provide a framework for the consolidating supervisor and the other competent authorities concerned to carry out the following tasks: a) exchange information; b) agree on voluntary entrustment of tasks and delegation of responsibilities; c) determine supervisory examination programmes based on a risk assessment of the group; d) increase the efficiency of supervision by removing unnecessary duplication of supervisory requirements; e) consistently apply the prudential requirements under the Directive across all entities within a banking group; apply Article 129(1)(c) taking into account the work of other forum that may be established in the area'. There will be a college for each multi-jurisdictional group (this means, today, 123 colleges) and therefore the composition of the colleges is 'at variable geometry', and rightly so. This increases however the coordination problem of all these colleges²⁰ and would not deliver a truly level playing field for cross-border supervision unless a uniform implementation of the supervisory functions by the colleges is achieved. A difficult task essentially delegated to the Committee of European Banking Supervisors (CEBS), which 'shall elaborate guidelines for the operational functioning of colleges' extending also on highly sensitive topics such as the size foreign branches and subsidiaries should have to give a right to participate at the college to the host supervisor and the possible differentiation between core and extended colleges. Each college shall be chaired by the consolidating supervisor, it being the supervisor of the Member State where the parent company has its headquarters. Colleges shall be set up also where a credit institution has systemically relevant branches in other Member States (Article 42(4): the college will be composed here by the home country supervisors and by the supervisors of MS where such branches operate). In principle, colleges shall work unanimously: under Article 129(3) the consolidating supervisor and the other competent supervisory authorities 'shall do everything within their power to reach a joint decision on the adequacy of the consolidated level for own funds as well as on uniform formats, frequencies and dates of reporting'. The 3L3 CEBS can be consulted in case of disagreement by the consolidating supervisor either on its own initiative or upon request of any other competent authorities concerned and shall provide its non-binding advice (the college shall consider such advice and the consolidating supervisor departing from such advice shall be obliged to explain why). If, despite the advice of CEBS, a unanimous agreement cannot be reached within the college, the new CRD proposal entrusts now the consolidating lead supervisor with the power 'to make its own decision on the application of Articles 74(2), 123, 124 and 136(2)' (and namely

¹⁹ See in particular *Van den Burg and Daianu Report*, 18 Sep. 2008, INI/2008/2148.

²⁰ A problem already discussed by the industry, complaining that 'practices concerning formation and activities of banking supervisory colleges are extremely divergent'; see EFR, *Monitoring Progress in EU Prudential Supervision*, at p. 42.

on reporting for the calculation of minimum capital requirements and on own funds requirements in excess of the minimum) and provides that such a decision 'shall be recognized as determinative and applied by the competent authorities in the Member State concerned'. This new provision extends thus the binding powers of the consolidating supervisor well beyond the one already existing under Article 129(2) concerning solely internal risk model validation for the whole group (under Articles 84(1), 87(9) and 105). Although this innovation is far from making the lead supervisor a single entry point for any aspects of cross-border consolidated supervision (many supervisory functions will continue to be entrusted with host supervisors as long as there is no home country safety net in place for the whole group), this is a remarkable enhancement of the decision making power of the consolidating supervisor and, interestingly enough, was brought about by the Commission as a response to the consultation process where many respondents voiced dissatisfaction with the overly timid approach followed on this issue by the original Commission's proposal. The first draft relied indeed on unanimity and on a mediation procedure 'for consultation' only of the 3L3 CEBS. It should be noted that the reform introduces a delegation of decision making and not only a delegation of operational tasks and has therefore important implications in terms of home country/host country responsibilities which shall be considered at the conclusion, once the overview of the four pillars EU action plan is completed.

6. 3L3 REFORM, MAJORITY PRINCIPLE AND 'COMPLY OR EXPLAIN'

To enhance the role and the functioning of Lamfalussy Level 3 (3L3) Committees, the Commission, following the Council conclusions on the EU supervisory framework and financial stability arrangements of 14 May 2008 and the Council roadmap agreed on 4 December 2007, brought about on 23 May 2008 a public consultation paper on amendments to the founding Level 2 Directives (2001/527/EC, 2004/5/EC and 2005/6/EC). The proposal is aimed at improving the mediation responsibilities and the consultative role of the Committees (a feature covered also by the CRD amendment, as mentioned above); at providing an explicit mandate to the Committees to promote information exchange and delegation of tasks and responsibilities among national supervisors,²¹ to streamline reporting requirements and to set common operational guidelines for colleges of supervisors (monitoring at the same time the coherence of the practices of different colleges and fostering the adoption of best practices); at promoting the development of a common supervisory culture also through the adoption of standardized approaches (toolkits) and promoting cross-sectoral cooperation; at strengthening their role for financial stability. To this end, the 3L3 shall be required 'to frequently assess key developments, risks and vulnerabilities in

the EU financial system, alert other authorities at EU level about potential or imminent problems and where necessary propose policy actions'. From an institutional perspective, also here the most striking feature is represented by the new decision making process: the proposal advocates a shift from decision by consensus (which has hampered to date the contribution of the Committees to effective and speedy supervisory convergence) to a qualified majority vote system. The group decisions are not binding, though, since adoption of the common position is still based on a 'comply or explain' procedure, whereby a national supervisor can still deviate from the common position provided it substantiates the reasons for such a deviation.

7. EMERGENCY SITUATIONS AND THE NEW MOU OF 1 JUNE 2008

To address emergency situations and in particular cross-border crises which may potentially jeopardize the stability of the financial system in any of the home or host Member States, the CRD revision sets out under Article 130 an alert and exchange of information procedure among the concerned supervisors and no more. Most of the EU coordination action is based, thus, on the non legally binding provisions of MoU, and now in particular on the 'soft law' provisions of the Memorandum/a of Understanding (MoU) on cooperation between the financial supervisory authorities, central banks and finance ministries of the EU on cross-border financial stability as amended on 1 June 2008. The MoU fosters the establishment of Domestic Standing Groups and Cross-Border Stability Groups for national and international banking groups respectively whose activity should be guided by Voluntary Specific Cooperation Agreements. It sets out in Article 2 important common principles for cross-border financial crisis management, including the principle whereby 'if public resources are involved, direct budgetary net costs are 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'. As regards the appointment of the lead supervisor, the MoU sets out in Article 4.4. that, 'as a rule the National Coordinator of the home country assumes the task of Cross-Border Coordinator in the management of a cross-border financial crisis' but at the same time that 'it may delegate tasks to authorities in a host country'. The party assuming the role of coordinator may vary according to the nature and the stage of the crisis, and namely in a liquidity crisis with a potential for systemic implications the Central Bank of the home country will coordinate actions, whereas in a solvency crisis with a potential for systemic implications which may imply the use of public funds, the Finance Ministry in the home country will coordinate the process of deciding on whether, to what extent and how public funds will be used. In this connection, Member States

21 On the legal implication of delegation of tasks among supervisors, see Wymeersch, *Delegation as an instrument of financial supervision*, working paper, 12 Dec. 2006.

should agree in advance' on burden sharing based on equitable and balanced criteria' (Article 4.4). According to Article 10.1., however, 'as the provisions of this Memorandum are not legally binding on the Parties, they may not give rise to any legal claim on behalf of any Party or third parties in the course of their practical implementation'; in legal terms this means that these provisions are not legal norms but social norms. A code of good manners for supervisors, so to say, at least so long as detailed and specific burden sharing agreements between Member States are not agreed upon and made internationally binding by the Member States concerned. It is hard to believe that in difficult times good manners may suffice to counterbalance possible incentives to cheat. Even more so when cheating may help in shifting the fiscal costs of banking bail out to other communities.

8. COMMISSION'S WORKS IN PROGRESS ON ASSET TRANSFERABILITY

Finally, in order to overcome the dual supervision of both home and host Member State with respect to banking groups (a dual supervision which increases significantly compliance costs and triggers a 'liquidity trap' for cross-border groups), the Commission is currently working on new harmonized rules for asset transfer within cross-border groups, aimed at levelling the prudential situation of subsidiaries and branches. In particular the Commission should present a feasibility study to the Ecofin in November 2008 and, based on this, it should launch a proposal in 2009/2010 which, ideally, in my view should be centred on the extension of Article 69 of the CRD to cross-border banking groups. Also in this domain, what is emerging is – in addition to long lasting company law and insolvency law national discrepancies in respect to the concept of group interest and of the treatment of cross-border groups in insolvency – a need for an equitable burden sharing among home and host countries. It is clear, indeed, that internal arrangements whereby the parent company is legally entitled and at the same time obliged to transfer assets to the subsidiaries facing an emergency situation are viable insofar as the bail out costs are equitably split among all Member States where the group operates.

9. LEGAL CONSTRAINTS IN THE ALLOCATION OF SUPERVISORY BINDING POWERS TO A LEADING SUPERVISOR: SOVEREIGNTY, DELEGATION OF DECISION MAKING AND CORRELATION BETWEEN SUPERVISORY POWER AND RISK

In conclusion, against the backdrop of all these measures – which seem to epitomize the victory of pragmatism – we should ask ourselves to what extent legal restraints could hamper the proper

functioning of this evolutionary 'stage 2' supervisory architecture. The starting point of our discussion rests on the general principle whereby, in an international setting, 'supervisory functions are indeed directly linked to the exercise of national sovereignty and therefore cannot be exercised on a cross-border basis, except on ground of an agreement between the states concerned'.²² Moreover, as a general rule, public authorities should exercise their powers themselves, with the correlated risks and responsibilities. Delegating authority would in principle affect constitutional or other public law principles 'as it would allow public bodies to discharge themselves of their legal duties by designating somebody else to do so'.²³ This means that there cannot be any delegation of decision making from one supervisor to another, unless there is a clear legal basis to do so. Delegation of operational tasks and, much to a lesser extent, delegation of decision making are not new in the EC securities and banking laws, though.²⁴ In turn, much of the existing and incoming patterns of cooperation and coordination among European supervisors, herein included the home country consolidating supervisor, are grounded on the Treaty's freedom of establishment and its ancillary principles of mutual recognition and home country control. They do have thus an appropriate European legal basis. And this is true also for the consolidating supervisor decision making when decisions by consent within the colleges cannot be reached.

To be true, the institution of colleges of supervisors for systemically relevant branches, as foreseen under the CRD revision, gives back to the host supervisor at least a portion of the sovereignty which the straightforward application of the home country control principle had previously taken away from the host country supervisors. I do not see, thus, how the consolidating supervisor role could be challenged here, where in fact the institution of the colleges limits – and does not enhance – the prerogatives granted by EC law to the home country supervisor. The opposite could be true, by contrast, for colleges supervising a cross-border group under Articles 129 and 130 (a). Here, through the colleges, the consolidating supervisor adds to its say. However, the CRD 'coverage' – coupled with the clear need for an efficient and well functioning supervisory architecture for the integrated European financial market under the principles of subsidiarity and proportionality – does provide a sufficient EC legal basis for such a reform, as it was already recognized in the past with the original Article 129(2) on internal model validation. Moreover, this reform extends to some decisions of primary supervision a principle already embedded in EC law, albeit solely for supplemental supervision, under Articles 10 and 11 of the Conglomerates Directive 2002/87/EC.²⁵ The same legal basis would also support, to my mind, even a possible future step forward if and when

22 Wymeersch, *Delegation as an instrument of financial supervision*, p. 3.

23 Wymeersch, *Delegation as an instrument of financial supervision*, p. 17.

24 In EU banking law compare Art. 12(9) of Second Banking Directive 2000/12/EC on delegation of solvency monitoring to the parent company supervisor and the above mentioned Art. 129(2) CRD.

home country control could be applied to the banking group as such, making the parent company supervisor responsible for the overall oversight also of foreign subsidiaries. A reform advocated also by the industry²⁶ which would allow bridging of the gap between legal and factual structures, letting substance prevail over form. And rightly so: when financial groups are integrated the practical distinction between branches and subsidiaries, despite their legal forms, blurs as far as the exercise of a unified and centralized management is concerned. Responsibility should therefore follow. In so doing, the reform would therefore allow the European architecture to overcome an unjustified persistent supervisory fragmentation and, at the same time, better correlate power and responsibility. On the other hand, such a reform could rely on the principle of 'group economic unit' already recognized in other fields of EC law and gaining momentum also in the European Court of Justice (ECJ) case law on banks.²⁷

The topical issue with the consolidating supervisor – to the extent that such supervisor is expressly entrusted by EC law with specific decision making functions – in my view is not, therefore, on its legal basis but rather on the balance between power and responsibilities. A good example are Deposit Guarantee Schemes. Subsidiaries are covered by host country schemes and foreign branches can 'top up' if the host country scheme provides better coverage. Another good example is lending of last resort by 'host' central banks to provide liquidity to subsidiaries established in their Member States but governed by a parent company established elsewhere. State direct intervention to provide guarantees or to inject capital into subsidiaries – as witnessed by very recent G7 and Eurosystem decisions – goes a step further in the same way. It is apparent that the burden of failure or bail out costs are not necessarily aligned with the allocation of supervisory functions and that in principle lender of last resort and applicable deposit guarantee schemes should be those of the Member State of the consolidating supervisor.²⁸ Instead of spelling out this way the 'constructive ambiguity' existing on last resort lending (at least in the Eurozone), EC institutions address this issue by fostering the adoption of the MoU which – as mentioned above – should inter alia provide an equitable burden sharing among home and host countries, correlated to the joint exercise of crisis management. Nonetheless, this crucial exercise of international fair cooperation is explicitly made non-binding. It builds, therefore, and quite surprisingly so, on social norms and not on proper legal undertakings. It is moreover hard to believe that the parties of the MoU would really be able to anticipate and detail

precisely in their understandings the burden of costs which each of them should accept in proportion to the activities carried on by the supervised banking group in each Member State. Recent events tend to suggest that ex ante and ex post loss calculations of a systemic crisis differ greatly. Any international agreement aiming at allocating and transferring such risks would therefore likely prove very incomplete and could hardly be renegotiated at the occurrence of an emergency situation or thereafter, when data become more reliable. I do not see, moreover, how the parties could incorporate in their assessment the benefits which each of them accrued to very different extents from the banking group activity, when still profitable, in order to proportionate effectively costs and benefits. If the parent company skimmed the cream of the group profits, why should host Member States take up part of the burden? Game theory, as mentioned above, suggests moreover that joint welfare depends negatively on the supervisors' divergence of interest and that, when supervisors' preferences are not aligned, a first best decision can never be reached. This is a fundamental bias negatively affecting international banking supervision made through bilateral or multi-lateral Memoranda of Understandings.

Finally, it is difficult to anticipate the final allocation of (civil) liability in such a complex decision-making process. To be true, when the colleges resolve a matter by consent, it seems quite obvious that all members should be considered liable for the common decision. It may be questioned, however, if this responsibility should be joint or several: in the latter case, it might prove awkward to allocate to each supervisor its part of the whole burden. But what if a national supervisor where foreign branches or subsidiaries operate was not even invited to participate in the college and a subsequent crisis had significant spill over effects adversely affecting depositors or clients established in its Member State? Would it be possible to build up a case of negligence by omission against it? In turn, when the consolidating supervisor makes a decision on its own within the college, it would seem that it should be held liable for such a solo decision. Indeed, whereas simple delegation of operational tasks does not modify the accountability and responsibility of the delegating authority,²⁹ the exercise of the delegation of decision making should shift the responsibility. The question here is however twofold: first, if and to what extent there will be a level playing field among colleges in this respect. It should be recalled that the standard of care required of the consolidating supervisor taking the decision on its own shall be that of its home country and the liability action

25 Since the consolidating supervisor is the home country supervisor (i.e., that of the MS where the head offices of the bank are located), it might be questioned whether such reliance on the home country control principle to identify the consolidating supervisor is still justified where the largest balance sheet total of the bank or the group be made in a Member State other than the home country.

26 EFR, *Towards a Lead Supervisor for Cross Border Financial Institutions in the EU*, Brussels, Jun. 2004, at p. 12.

27 ECJ 5 Oct. 2004, in Case C-442/02 Caixa, where a French subsidiary of a foreign group was found eligible to avail itself of Art. 43 of the Treaty.

28 Compare also EFR, *On the Lead Supervisor Model*, at p. 8.

29 A principle clearly embedded in EC financial and securities law: see e.g., Art. 12(1) of the Market Abuse Directive, Art. 64(3) MiFID; particularly illustrative is Art. 48(2) MiFID according to which 'any delegations of tasks may not involve either the exercise of public authority or the use of discretionary powers of judgement, in any case the final responsibility for supervising compliance with the Directive and with its implementing measures still lie with the competent authority'.

shall be brought in such a Member State under its **procedural** rules, also including those on the standing to sue. It is apparent that there is a risk here of additional fragmentation. Second, it is not obvious whether or not the other supervisory authorities in the college will be exempted from liability. It might be worth **recalling**, in this respect, that – despite the fact that the CRD amendment does not expressly address the issue – Articles 13(5) and 13(6) of the Prospectus Directive set out that ‘the competent authority of the home Member State may transfer the approval of a prospectus to the competent authority of another Member State subject to the agreement of that authority’ and that ‘this directive shall not affect the competent authority’s liability, which shall continue to be governed solely by national law’. This ambiguous provision does not say that liability is not affected by delegation but in turn does not exclude either that a liability for delegation might exist. It might well be that this depends on the voluntary nature of the delegation under the Prospectus Directive as opposed to the compulsory nature of that implied by the college under the CRD: but some uncertainty may persist. Even more so because the CRD revision requires the ‘other competent authorities to express their views and reservations’: what if they didn’t?

In conclusion, to my mind, the current stage 2 action plan for an upgraded European supervisory architecture based on multi-lateral coordination and lead supervisor last resort decision making may well be a masterpiece of pragmatism and political realism; it rests however more on good resolutions and overly **optimistic** expectations of natural convergence of interests and fair behaviour among Member States than on clear and solid legal foundations. In my view, European policy is still lagging behind events.³⁰ And sadly so.

³⁰ Compare also M. Pagano, *The subprime lending crisis: lessons for policy and regulation*, in *Finance Monitor*, 2/2008, p. 37.