INTERNATIONAL LAW ASSOCIATION

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COMMITTEE ON INTERNATIONAL MONETARY LAW

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Introduction

Since the Rio de Janeiro Conference of the ILA in 2008, the Committee (generally known by its acronym, MOCOMILA) has held two meetings: in Paris, France (20-21 March 2009) and Kuala Lumpur, Malaysia (26-27 September 2009). Both meetings focused on the credit crisis. The Paris meeting included speakers from the Commission Bancaire and the Banque de France, and featured a presentation by M. Jacques de Larosière, President of the High Level Expert Group on EU Financial Supervision, on "Market Regulation in the Wake of the Recent Turmoil." The Kuala Lumpur meeting began with an opening address by H.E. Tan Sri Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, on "Financial Stability Functions of Central Banks." The meeting also included an address on "The Credit Crunch From an Asian Perspective" by Professor Kishore Mahbubani of the National University of Singapore.

The Committee notes with sadness the passing of our friend and former Chairman, Professor Hugo J. Hahn. Professor Hahn was Chairman of MOCOMILA from 1973-1995, and its Honorary Chairman since 1995. He was a German Federal Civil Servant (1956-1958) and member of the German Delegation that negotiated the original Common Market Treaty, thereafter legal adviser to OECD, Paris (1958-1969). He was Emeritus Professor of Law, University of Würzburg, and wrote numerous books and articles on national and international monetary law, including the treatise *Währungsrecht* (Monetary Law), (1990).

The subjects of the foregoing meetings and other topics discussed by the Committee are reflected in the following sections of this report.

I. Update on Regulatory Issues in Respect of the Credit Crisis (by Dr K P Follak)

II. The International Financial Architecture and its Reform After the Global Crisis (by Prof M Giovanoli)

III. Developments in European Banking Law (by Prof C Gortsos, Mr B Krauskopf, Prof R Lastra, Prof J-V Louis, and Prof R Smits)

This report reflects the views of the individual members and not necessarily those of any institutions with which they are affiliated.

I. Update on Regulatory Issues in Respect of the Credit Crisis

A. Financial turmoil and global recession

In 2008, we saw a credit event in the finance industry – the realisation of subprime mortgage risks – evolve into a liquidity event and then into a solvency event.

There are two separate aspects of the crisis, with separate driving factors, which have to be clearly distinguished:

- a liquidity and credit event in the finance industry, accelerated by enormous leverage in the financial sector; and
- unwinding of global imbalances, triggered by the fallout of the financial crisis. However, these imbalances have not been caused by the crisis.

The downturn of the real economy is a separate problem and cannot be solved by regulating the finance industry. Nor can rescue and recovery actions for financial institutions in distress replace preventive prudential regulation. At the moment the focus is on cleaning up, whereas the regulatory stage has to be set carefully, avoiding hasty patchwork and over-reaction born out of day-to-day crisis management – although the regulators have to be established with powers of early intervention urgently in case of any legal loopholes. This is why, basically, we are still confronted with the same regulatory needs as last year and why progress can be only gradual. Just putting more capital into the system can strengthen banks' balance sheets in respect of future write-offs during the downturn of the real economy. But it will not solve the regulatory problems – the focus has to be on avoiding wrong and providing for the right incentives for financial institutions.

B. Driving factors and possible responses

1. Supervisory style; macro versus micro supervision

Supervisors worldwide are unanimous on the need for a systemic approach of banking regulation and supervision as a complement to assessing individual institutions. There may be a need in some jurisdictions to better define the boundaries between macro- and micro-supervision.

2. Structure of supervision and supervisory authorities

Cross-border supervision of banks is still based on the "Basel Concordat", issued in 1975 and amended in 1983. The so-called "Turner Review" by the FSA (March 2009) is getting to the point "…the world has…not…even a powerful treaty-based organisation with authority in the area of bank regulation and supervision…International agreements on bank regulation, and encouragement to increased but voluntary coordination on supervision are achieved via multiple non treaty-based fora, e.g. the Financial Stability Forum, the Basel Committee on Banking Supervision, the Senior Supervisors Group." The crisis has clearly brought to light the limits of such "soft law" regulation.

The collapse of the US investment bank Lehman Brothers has demonstrated the urgent need for a clear base in public international law with the authority to issue regulation on large cross-border institutions, comprising

- minimum harmonisation of regulation to achieve consistency and a level playing field; and
- co-operation of supervisors including mandatory intervention in specified cases.

The outcome might be a regulatory framework beyond mere principles, but less detailed than the related European Directives. The early intervention framework should include moratoriums in respect of cross-border transactions of non-compliant institutions. A difficult question is how to avoid moral hazard incentives caused by bail-out expectations. Excluding national discretion on bail-outs would not be realistic, although one might argue that, in general, such bail-outs could discriminate against compliant institutions. However, in the case of bail-outs of large cross-border institutions which are subject to the above-mentioned regulatory minimum harmonisation, supervisory co-operation and burden-sharing should be mandatory, as well as application of stringent conditions on the institutions concerned. The March 18, 2010 report and recommendations of the cross-border bank resolution group, issued by the Basel Committee on Banking Supervision demonstrates how difficult a task this will be.

Due to the political implications, progress will be slow.

Regional organisations – in particular the EU, and monetary unions – could achieve a clear legal basis more easily. But neither in the EU nor in the USA have final decisions been made.

Based on the High-Level Group Report on Financial Supervision in the EU, chaired by Jacques de Larosière, the European Commission has set out an action plan. The draft directives to give effect to the new framework have been published on 23rd September, 2009. They encompass:

- a European Systemic Risk Council (ESCR), hosted by, but separated from the ECB; and
- three new EU supervisory agencies: the European Banking Authority (EBA), the European Security and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). They would issue mandatory technical standards and guidelines, whereas day-to-day supervision would basically remain with the national authorities. However, in certain cases the EU Agencies would have power of direct intervention.

Implementation will be very delicate, because basically, binding powers over national supervisors require amendments to the EU Treaty.

A fundamental re-structuring of the U.S. supervisory system is also under discussion.

3. Liquidity

Liquidity, or rather unexpected shortage of liquidity in the financial system, had proved to be a key factor in driving the turmoil. Therefore, major efforts to strengthen global standards for liquidity risk management and supervision are crucial. They would require similar dimensions as Basel II, and priority for this project vis-à-vis to further perfection of Basel II might have to be taken into consideration. This will be part of a broader Basel Committee programme announced under the headline “Comprehensive response to the global banking crisis” in September 2009. The intention is “to introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.” Concrete proposals have been published in December 2009 under the headline “International Framework for Liquidity Risk Measurement, Standards and Monitoring”.

Related EU proposals are included in the early 2010 Consultation Paper “Possible Further Changes to the Capital Requirements Directive”.

4. Capital adequacy

Although capital adequacy was only a secondary, i.e., second round, issue of the crisis, it plays a fundamental role in building up confidence between financial institutions. Such confidence is essential in order to kick-start interbank lending and repair the liquidity of the financial system.

In the regulatory field, the first EU package – "CRD 2", a Directive proposed in October 2008 – has been finally issued in July 2009. It focuses on securitisation regulation, including a 5% tranche to be retained by originators in case of securitised credit risk, and enhanced disclosure. Further proposals, outlined in July 2009, have been published in a Consultation Paper "Possible Further Changes to the Capital Requirements Directive" in early 2010, including:

- liquidity standards;
- definition of capital;
- balance-sheet based leverage ratio;
- through-the-cycle expected loss provisioning;
- systemically important financial institutions;
- specific incremental capital requirements for residential mortgages denominated in a foreign currency, as well as LTV restrictions for preferential treatment of mortgages under the Standard Approach; and
- removal of national options and discretions in the CRD.

A CEBS working group on the definition of core capital elements has been set up in June 2009.

The first Basel Committee package – enhancements to the Basel II framework – has been published in July 2009, including the capital regime for trading book positions, as well as enhanced requirements for the use of models. It will also provide for the management and disclosure of non-contractual commitments, implicit support, as well as pipeline and warehousing risks with regard to securities positions. This package is part of the above-mentioned broader programme announced under the headline "Comprehensive response to the global banking crisis" in September 2009, with the aim to:

- introduce a countercyclical capital buffer;
- address systemic risks;
- raise the quality of the Tier 1 capital base (common shares and retained earnings); and
- introduce a general balance-sheet based leverage ratio.

Concrete proposals have been issued in December 2009 / January 2010 under the headline "Strengthening the Resilience of the Banking Sector", to be finalised by the end of 2010.

In summary, there has been a resurfacing of problems which had been addressed and criticised during the Basel II consultative process, but have not been finally resolved.

5. The non-regulated financial sector

The crisis has clearly demonstrated that the existence of an undisclosed and unregulated, thinly capitalised shadow banking system, involved in large-scale liquidity and maturity transformation, can directly affect the liquidity and, through second round effects, the solvency of the entire financial system.

An EU Draft Directive on so-called "Alternative Investment Funds" would apply the principles of home-country control and the European Passport to a widely defined range of funds other than UCIT

funds, such as hedge funds and private equity funds. It would include licensing, minimum capital, disclosure and regulatory reporting requirements.

Proposed U.S. drafts are aiming at extending financial group consolidation, based on a wide definition of control, and, separately, at hedge funds.

However, the core topic still requires an in-depth analysis of aims, scope, and scale of supervision and regulation.

6. The role of the rating agencies

The Basel II regime has created (wrong) incentives to rely on ratings, as well as statutes in a couple of jurisdictions forcing investment institutions to restrict investments to agency-rated AAA instruments. In the U.S., the Credit Agency Reform Act of 2006 has been in force since 27th June 2007, and has been enhanced by an amendment to the Exchange Act in February 2009. The EU has issued a related Directive in September 2009. The Basel Committee's first package seeks to ensure that banks perform their own due diligence and do not simply rely on rating agency credit ratings. Failure to meet these criteria would result in related capital deductions.

7. The use of risk models

The UK FSA distinguishes four categories of problems:

- short observation periods;
- statistically non-normal distribution;
- systemic versus idiosyncratic risk; and
- non-independence of future events (uncertainty).

As a minimum solution, the Basel Committee has proposed Principles for Sound Stress Testing Practices and Supervision which should be generally applied in risk management practices.

8. GAAP valuation and disclosure

Strictly marking to market is certainly an appropriate requirement for trading books. For performing assets on the banking book, valuation at par value might be more appropriate as long as the intention is to hold them to maturity – be they securitised or not. The EU has already amended IAS 39 and IFRS 7 by a Directive which allows for re-classifications of assets which are no longer held for selling. Such assets can be reported as loans and receivables at cost or amortised costs. A similar US proposal has been implemented by the US FASB in April 2009.

The IASB and the U.S. FASB intend to achieve an agreement on a future common standard. The FASB is still in favour of fair value as a regular basis, including credit exposures and liabilities. The IASB intends to measure financial instruments at amortised costs, if they have characteristics of a basic loan and are managed on a yield basis. The latest Basel Committee High Level Guiding Principles issued at the end of August 2009 are closer to the IASB, allowing for re-classifications according to an institution's business model. This view is shared by the US regulatory agencies.

9. Further topics

Regarding harmonisation of the legal framework for cross-border liquidation and bankruptcy of financial institutions, in particular in respect of complex group structures, the Basel Committee has recently published a consultative document "Report and Recommendations of the Cross-border Bank Resolution Group". This is an extremely broad field, although not exactly in the regulatory area – as the Governor of the Bank of England, Mervyn King, has put it: global banking institutions are global in life but national in death.

10. Credit crisis and Islamic banking

Banks applying the principles of Islamic banking have so far performed relatively well. They cannot escape the deterioration of the global economy and falling asset prices. However, they were not much affected by the first round core crisis of the financial industry, because they are much less exposed to the systemic drivers of the liquidity squeeze:

- They have minimal direct exposure to the credit fallout of toxic securities – for obvious reasons. Regularly, these instruments are interest (riba) based and structured on interest cash flows and hence not shariah-compliant.

- Due to the closer link of Islamic finance instruments (murabaha and ijara-based sukuk) to the real economy, there is less leverage in the system. In general, Islamic banks have a strong commitment to asset-based transactions, which insulates them from specific internal risks of the financial system.

- The liquidity base of shariah-compliant trust account deposits is less volatile than the wholesale, in particular inter-bank, capital markets.

- Derivatives are only shariah-compliant for hedging purposes, i.e. risk mitigation instead of building up of open risk positions. Hence, proprietary trading can normally not endanger the capital base of Islamic banks.

- The concept of risk sharing (rather than selling off origination risks) supports an interest in the proper management of credit risk.

- Islamic bonds (sukuk) are strictly based on cash flows of the real economy (in particular ijara).

- Sharia compliance is based on the principles of gharar (contractual certainty) and maysir (i.e. profit or loss shall not be left to chance).

Nevertheless, the crisis has also revealed a few weaknesses which deserve some attention:

- Short-term liquidity management in the money market can be a problem, in particular funding through the overnight interbank market. The basis of shariah-compliant repo transactions (in particular sukuk) needs more critical mass. Perhaps governments and central banks of Islamic monetary unions could support the money market for Islamic banking by issuing suitable instruments.

- A further problem arises for Islamic banks seeking access to liquidity provided by non-Islamic central banks. On one hand, the repo-eligibility criteria of "traditional" central banks are based on interest-related instruments and would require some amendments. On the other hand, as mentioned above, the market of shariah-compliant tradeable instruments needs more critical mass.

- Whether or not the "profit equalisation reserves" of Islamic banks need more support in the direction of deposit guarantees, is uncertain. There is an implicit guarantee by Islamic regulators (which is explicit in certain states).

In view of the current supervisory regime, the Islamic regulators have done their homework by applying the international standards, supported by the Islamic Financial Services Board (IFSB).

II. The International Financial Architecture and its Reform After the Global Crisis

The global economic and financial crisis of 2008 and 2009 – the worst the world experienced since the 1930s – prompted a complete overhaul of the international financial architecture. Once again it appeared that financial regulation and supervision - whether domestic or international - essentially develops as a child of crises. On the occasion of the recent crisis, the G-20, an informal grouping of states, which had been dormant for some ten years, took the lead and established a consolidated international financial architecture. In so doing, the G-20 built on the efforts of the preceding 35 years, which had seen the emergence of an impressive corpus of international financial standards elaborated

by a variety of standard-setting bodies, such as the Basel Committee on Banking Supervision created as early as 1974. The following summary attempts to give an overview of this thorough reform, as regards (1) the principles underlying the reform, (2) its institutional aspects, (3) the expansion of membership and legitimacy of the bodies involved, (4) the scope and legal character of the international financial standards, and highlights (5) some critical issues in connection with the reform.

A. The principles underlying the reform

On the basis of the statements delivered on the occasion of the G-20 summits of Washington (November 2008), London (April 2009), and Pittsburgh (September 2009), the essential principles inspiring the reformed international financial architecture, and consequently the contents of the international financial standards, may be summarized as follows:

- All systemically important financial intermediaries, markets and products irrespective of type must be subject to appropriate regulation and supervision in all jurisdictions.

- Furthermore, financial supervision should not only be exercised institution by institution ("micro-prudential" supervision), but it should also encompass the good functioning of the whole financial system ("macro-prudential" or systemic supervision).

In order to implement these principles, a detailed work plan setting forth some fifty specific measures (some for immediate action, others for later action) was published after the Washington summit, followed by regular progress reports on their implementation, which are available on the G-20's website www.g20.org. Further information on the immense work accomplished since then may also be found at www.financialstabilityboard.org.

B. Institutional aspects

Since 1974, a variety of standard-setting bodies had emerged in connection with the international financial architecture, some created "top down" by the governors of the G-10 central banks (such as the Basel Committee, the CPSS [= Committee on Payment and Settlement Systems]) or by the G-7 (the FATF [= Financial Action Task Force]), others established "bottom up" in the form of associations of regulatory bodies (such as IOSCO [= International Organization of Securities Commissions] and IAIS [= International Association of Insurance Supervisors]) or even as private sector organizations (the IFAC [= International Federation of Accountants]). Only in 1999, in the wake of the Asian and Tequila crises, the G-7 set up under the name Financial Stability Forum (FSF) a relatively weak structure with a view to co-ordinating the activity of the relevant standard-setting bodies and also including the international financial institutions involved in this process (IMF, World Bank, BIS, and OECD).

Following the 2008/2009 global financial crisis, the G-20 felt that the institutional underpinning of the standard-setting process and of the implementation of international financial standards needed to be reinforced and streamlined. Thus, it was decided to reestablish the FSF as the *Financial Stability Board* (*FSB)*, with a wider scope and an enhanced structure (including a Charter spelling out basic rules of functioning), in order to oversee and coordinate the standard-setting process in the field of international financial regulation and prudential supervision and to oversee the implementation of these standards by the national jurisdictions. The relevant standard-setting bodies, although keeping their independence, are invited to cooperate with the FSB, which henceforth reports to the G-20.

It should be noted that the *IMF* and the *World Bank*, in addition to their traditional tasks which benefit from increased resources following the G-20 summits, continue to be involved in the standard-setting process in certain areas (transparency in monetary and financial policies, fiscal transparency and data dissemination standards for the IMF; insolvency and creditors rights for the WB) and contribute to the overall assessment of the implementation of international financial standards through ROSCSs and FSAPs. However, the IMF is not at the center of the international financial architecture (unlike its position within the former Bretton Woods system), which is essentially based on a "horizontal" intergovernmental cooperation and networking.

In specific areas, two other entities combine the functions of standard-setting, assessing the implementation of standards, and reporting directly to the G-20 in their respective fields of competence:

- the *Financial Action Task Force* (*FATF*), with respect to money laundering and countering terrorist finance; and

- the *Global Forum on Transparency and Exchange of information* (*GFTEI)*, created within the ambit of the OECD, with respect to international assistance in tax matters.

Neither the various entities involved (with the notable exceptions of the IMF and the World Bank) nor the multiple arrangements regarding their functioning and cooperation are embodied in formal international instruments equivalent to treaties. As a consequence, these bodies are "soft institutions", many of them do not even have legal personality (for instance the Basel Committee, the FSB, and probably the FATF and the GFTEI) and their secretariats are provided or supported by other institutions such as the BIS and the OECD. The G-20 itself has no permanent infrastructure; the continuity of action is merely ensured by a "troika" of past, current and designated chairs. Such institutional existentialism does not foster transparency and makes any legal assessment of these bodies difficult.

C. The expansion of membership and legitimacy of the bodies involved

One of the main criticisms which had been expressed in the past with regard to the international financial architecture was the restricted membership of many (often G-10 based) bodies involved, thus depriving them from sufficient representation and legitimacy to establish truly international financial standards.

This situation has considerably changed, since the (much wider) G-20 established itself as the leading force governing the international financial architecture. In addition, the membership of the former FSF (now re-established as the FSB) was extended, as well as that of the Basel Committee and of other groups, such as the CPSS and the IASB. As a consequence, it appears that for all practical purposes, the G-10, which historically played an important role in setting up several standard-setting bodies (Basel Committee, CPSS) ceased to be relevant in this context. Indeed, the oversight body for the Basel Committee now is the Group of Central Bank Governors and heads of Supervision comprised of the same member jurisdictions as the Committee, and the Global Economy Meeting (at the BIS) where 30 central banks are represented fulfils the same function for the CPSS.

Notwithstanding these significant improvements following the extension of the circle of participants, the issue of fair representation of all countries involved and of legitimacy of the various bodies concerned with the international financial architecture cannot be considered as being resolved, at least from the legal viewpoint. In many of these bodies (including the G-20, the FSB, and the Basel Committee), membership is by invitation only. The G-20 has taken the initiative of reforming the international financial architecture and taken the lead without having received any mandate from the other countries, which were not invited to participate in the process. The mere geopolitical and financial weight of the G-20 and the obvious merits of its initiative are not as such a substitute for a clear mandate from all countries concerned and a structure providing in principle the equality of access to the decision-making and standard-setting bodies. In this respect a system of constituencies like the one which exists within the IMF, despite its shortcomings, would ensure a much higher degree of legitimacy, but would of course necessitate a more formal legal underpinning of the process.

D. The scope and legal character of the international financial standards

According to the hitherto prevailing view, international financial standards have in principle the nature of "soft law". As they are not based on an international treaty, their implementation by national authorities is "voluntary", at least in theory. Indeed, the various international standard-setting bodies have no legislative power and their recommendations do not have any legal force on their own: in order to become legally binding rules, they need to be incorporated into domestic legislation, regulation, and administrative practice by the relevant national legislators of each jurisdiction.

In the course of the reform process initiated by the G-20, a significant shift appears to have occurred with regard to the scope and character of international financial standards. According to the statements published after the three G-20 summits of 2008/2009, these standards are increasingly viewed as minimum standards, the implementation of which, if not formally enforceable, must be "encouraged" by "a tool box of effective counter-measures against non-cooperative jurisdictions (NCJs)". This approach, which started some time ago in the ambit of the FATF with regard to anti money laundering (AML) and countering financing of terrorism (CFT), now also extends to transparency and exchange of information in tax matters under the aegis of the GFTEI, and progressively creeps into the area of prudential standards monitored by the FSB. While black lists have already been produced and specific countermeasures defined with regard to AML/CFT and transparency in tax matters, the appropriate bodies in all three areas (monitored by the FATF, the GFTEI and the FSB) have now been invited by the G-20 to conduct and strengthen objective peer reviews and to report progress in addressing NCJs.[1]

E. Some critical issues in connection with the reform

Obviously, this evolution cannot be ignored by international lawyers. The question thus arises to what extent international financial standards can still be deemed to be "soft law" and, if not, what legal consequences should be drawn from this change. This, of course, raises a number of quite delicate issues in international law, some of which are listed below:

- As long as international financial standards are deemed to be mere recommendations, the legitimacy of the standard-setting body was not of primary importance. To the extent that such standards become quasi-mandatory, the question of a more formal endorsement by a body with the recognised power to do so, arises.

- In this context, the decision-making process would need to be spelled out and made more transparent. How is consensus reached and what are the possibilities for a country to dissent and make reservations? What are the procedural guarantees in this regard, particularly for those jurisdictions which do not directly participate in the decision-making process?

- If countermeasures are recommended by a specific body against NCJs and applied by certain states, what legal remedies are available to the NCJs concerned? How (and by whom) can it be determined to what extent potential countermeasures are consistent with the general principles of international and administrative law (valid legal basis, non-discrimination, subsidiarity, proportionality…) or with the special principles of WTO law?

- To what extent the invitation to take countermeasures against NCJs could encourage some jurisdictions to take unilateral measures with extra-territorial effect which, in the longer run, might have undesirable side effects on international financial and legal relations?

These issues and some others no doubt deserve further investigation by international lawyers. It is thus proposed that MOCOMILA should continue to study this matter.

III. Developments in European Banking Law

A. Introduction: the recent (2007-2009) international financial crisis as a catalyst for the re-adjustment of European banking law

The recent (2007-2009) international financial crisis has triggered a revolution in financial regulatory and supervisory thinking. Once relegated to the obscure universe of the specialist, financial regulation and supervision have now come to the forefront of economic and policy debate. The crisis has shown that markets cannot always be trusted to deliver what is good for society, since the pursuit of the private interest has proven at times to be greatly misaligned with the pursuit of the common good. Lord Turner has claimed that some trading activities are socially useless, while much anger has been vented towards the compensation policies of bankers. Others have directed their criticism at activities

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[1] See FSB Framework for Strengthening Adherence to International Standards, available at http://www.financialstabilityboard.org/publications/r_100109a.pdf

that appear to feed instability in times of crises, such as short-selling practices or an implicit bias towards default in credit default swaps (CDS) protection.[2]

In recent decades, financial markets and institutions have become global, while regulation, supervision, resolution, and insolvency remain still largely nationally based, constrained by the domain of domestic jurisdictions, despite the efforts that have been undertaken at both international and regional (especially in the European Union) level since the mid-1970s for closer regulatory harmonization and supervisory cooperation. Financial stability is a goal that not only transcends institutional mandates, but like a 'tsunami', does not respect geographic boundaries. The solution to European and international markets lies in finding mechanisms to advance in European and international regulatory, supervisory and resolution mechanisms.

At the European level, the crisis has shown the weaknesses of two of the three pillars that sustain monetary union. The economic pillar is weak, as shown by the Greek debt crisis and its ripple effects upon some of the less fiscally disciplined countries in the euro-zone, and the supervisory pillar is also weak, since supervision and crisis management remain for the most part anchored at the national level.[3] On December 2nd, the ECOFIN Council adopted in first reading proposals advanced by the European Commission on September 23, 2009 to 'upgrade' the EU bodies of national supervisors that monitor individual credit institutions and insurance companies as well as securities markets into a European System of Financial Supervisors (ESFS) and to establish a European Systemic Risk Board (ESRB), as explained below, under Section B.

According to the House of Lords Report on the Future or EU Supervision and Regulation:[4] *"macro-prudential supervision is the analysis of trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy. The focus of macro-prudential supervision is the safety of the financial and economic system as a whole, the prevention of systemic risk. Micro-prudential supervision is the day-to-day supervision of individual financial institutions. The focus of micro-prudential supervision is the safety and soundness of individual institutions as well as consumer protection. The same or a separate supervisor can carry out these two functions. If different supervisors carry out these functions they must work together to provide mechanisms to counteract macro-prudential risks at a micro-prudential level".*

The need to balance competition and financial regulation on the one hand and the challenges to some of the rules that govern the single market in financial services on the other hand, have tested the resolve of politicians and policy-makers in the EU over the last three years. It should also be noted that supervision and crisis management are parts of a seamless process. A healthy institution can quickly turn into an unsound one, which inevitably will lead – if conditions further deteriorate – to crisis management. Early intervention by the supervisor, resolution of a crisis in a financial institution and, ultimately, reorganization and winding up of an insolvent one could be partly overlapping stages, going well beyond supervision proper, but clearly a process into which national supervisors have a key role in designing. The European Commission published on 20 October 2009 a Communication, "An EU Framework for Cross-Border Crisis Management in the Banking Sector",[5] which makes the link from supervision to crisis management explicit.

The cross-border resolution of financial crises presents complex and difficult challenges. Yet, as Einstein famously remarked: *"we can't solve problems by using the same kind of thinking we used when we created them"*. We must find ways to resolve the problems posed by large cross-border systemically important financial institutions. Capitalism, it has been rightly said, relies on the lure of wealth (privatization of gains) and the discipline imposed by the fear of bankruptcy (privatization of

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[2] See R. Lastra, contributions to [UK] *Parliamentary Brief* of December 2009 and March 2010.

[3] See R. Lastra and J-V. Louis, 'European Monetary Union', chapter in a book edited by T. Tridimas on EU Law, to be published by Oxford University Press (2011).

[4] See http://www.publications.parliament.uk/pa/ld200809/ldselect/ldeucom/106/106i.pdf.

[5] COM (2009) 561/4

losses). It is imperative to reinstate a credible fear of bankruptcy for systemically important financial institutions to reconnect the incentives of bankers with the interests of society.

The financial regulatory and supervisory reform proposals currently under consideration can be divided into five groups (the fourth and fifth groups being mostly national):[6]

(a) The first group looks at the substance of regulation, at the what to regulate, with new rules (or proposed rules) for capital, liquidity and other indicators of banking and financial soundness. There are new national rules, new EU rules (e.g., the controversial proposed Directive on Alternative Investment Fund Managers) and new international soft law rules (e.g., Basel Committee rules on bank capital requirements). Certainly, the financial crisis has acted as a catalyst for the re-adjustment of European financial law.

(b) The second group of proposals looks at the structure of supervision and regulation, at the how and the who, and the intensity of supervision. The scope of institutions that should be regulated and protected, in particular the problems of non-banks' systemically important financial institutions and how to best regulate systemic risk, remain contentious issues.

(c) The third group of proposals concerns the behaviour of the banking industry and bank managers, whether through better risk management, or through corporate governance or simply the responsibility that comes with the banking job and the need to internalize the costs of protection. In this respect one can include the proposals to establish a European Rescue and Resolution Fund largely financed by the banking industry.

(d) The fourth group focuses on the fiscal side. The problem of 'extracting rents' (rather than merely profit taking) in a banking and financial market which has been largely subsidized by governments' rescue packages, monetary and fiscal policies, raises a great deal of controversy. Acute moral hazard problems persist. Governments have targeted the compensation problems so far mostly via taxation (e.g., the 50% one-off bonus tax on bonus pools of a number of financial institutions in the UK, or the 90% taxation of bank bonuses in Greece).

(e) Finally, the fifth group of proposals contains the 'structural reforms' which aim to tackle the problems of the banking industry and the balance sheet structure of commercial banks and other financial institutions, to separate 'utility banking' from 'casino banking'. Amongst the structural reforms, we can include:

- the so-called Volcker rule (which proposes that banking organizations in the US will no longer be allowed to own, invest or sponsor hedge funds, private equity funds or conduct proprietary trading operations for their own profit unrelated to serving their customers),

- the proposals to "mutualise" the financial industry (as advocated by Laurence J. Kotlikoff),[7] and

- a return to a Glass-Steagall style separation between commercial banking and investment banking (which was the principle prevailing after the 1929 financial crisis mainly in the USA and in Japan).

A common denominator of these proposals is the need to circumscribe the scope of institutions (to some sort of narrow bank) that receive governmental protection (via lender of last resort, deposit insurance and other policies).

Global problems – and the crisis was indeed a global problem – require global solutions. We need to devise better frameworks for the regulation, supervision and resolution of cross-border banks and other

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6 See R. Lastra, contribution to *Parliamentary Brief*, March 2010 (above note 1) and R. Lastra and G. Wood, 'The Causes *of* the Financial Crisis 2007-2009' forthcoming in the Special Issue of the *Journal of International Economic Law* on 'The Quest for International Law in Financial Regulation'.

7 See L.J. Klithoff, *'Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking'*, John Wiley and Sons, 2010.

financial institutions; we need better co-ordination of policies internationally, greater harmonisation of national policies (not only on capital and liquidity requirements, but also on compensation structures and other issues that can otherwise trigger regulatory arbitrage), and we need to aim to build an international institutional framework that can adequately response to the needs of global financial institutions and markets. National, European (essential for the proper functioning of the single market in financial services) and international responses must be aligned. Perhaps Europe can lead the reform process that could eventually culminate in adequate international responses.

B. The re-adjustment of the European financial supervisory framework: implementation of the Larosière Report

1. The three European Supervisory Authorities

1.1 Introductory remarks

It is not easy at the moment of preparing the present section on the reform of the European supervisory arrangements to predict what the final regime adopted by the European Union (EU) legislator will exactly look like. Indeed, the ordinary legislative procedure established under article 294 of the Treaty on the Functioning of the EU (TFEU) provides for a complex collaboration between the European Parliament and the Council of ministers (in this case, of Economic and Financial Affairs, the so-called Ecofin Council) of the EU. This procedure is still in progress. It is the reason why there are no references to articles of the regulations, concerning the future set up of the European supervisory arrangements.

The basis of the reform is the so-called "Larosière Report", a *Report by a high-level group on financial supervision in the EU*,[8] chaired by Jacques de Larosière, a former general manager of the IMF and governor of the Banque de France, presented to the European Commission, on 25 February 2009. The orientation of the report was accepted by the Commission and endorsed by the European Council (i.e., the heads of State and Government of the member states) in June 2009 after a lively debate at the Ecofin Council. The Commission was asked to present proposals after the summer, which it did on 23 September 2009.

These texts included proposals for regulations establishing respectively a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA) and a European Securities and Markets Authority (ESMA), as well as a European Systemic Risk Board (ESRB) and a decision entrusting the ECB with specific tasks concerning the ESRB (see below, under Section B2). Later on, the Commission proposed in October 2009 a directive amending a number of directives in respect of the EBA, the EIOPA and the ESMA. Except for the decision, all these texts require the agreement of both the Council and the European Parliament.

The Council worked extremely rapidly, under the chairmanship of the Swedish Presidency. It reached compromise positions before the end of the year. In parallel, the newly elected European Parliament appointed rapporteurs who presented at the end of February 2010 their reports to the Committee on Economic and Monetary Affairs. The hope was for the EP to be able of adopting its position in first reading before the summer recess for starting the conciliation process with the Council, involved by the legislative procedure, in September in order to get the texts approved in second reading for the end of the year. An ambitious programme, considering the number of amendments the European Parliament wants to introduce in the texts and the lack of active support (to say the least) of the Commission for the compromise position adopted at Council's level.

1.2 The philosophy of the System

[8] The reader will find an analysis of the Larosière report made by Christos Gortsos, 'The proposals of the Larosière group and the future of financial supervision in the European Union', in the book published by MOCOMILA: M. Giovanoli and D. Devos (eds.), *International Monetary and Financial Law*, chapter 6, OUP, 2010. Chapter 7 by Jean-Victor Louis of the same book bears on 'The implementation of the Larosière report: a progress report.'

Jacques de Larosière himself has qualified the solutions proposed by its group as "pragmatic".[9] A centralised solution was discarded because, in his view, for adopting such a concept, rules applicable to financial institutions should have been unified and a harmonised supervision of private institutions according to the most demanding standards should have been achieved. In the absence of a *"genuine single market in financial services"*, it was judged necessary in the *"interests of savers and taxpayers (...) to operate an essentially national system of supervision"*. Main responsibilities in the views of the group, the Commission and the Council, should remain essentially national. Hence the accent on a System which will work on the basis of a single rulebook and include a surveillance of systemic risks in charge of an ESRB, analysed further on in this report (under Section B2).

1.3 The configuration of the System

The European System of Financial Supervisors (ESFS) will be a network of authorities, in two modes: it is a complex of European Authorities and each Authority includes the national authorities competent in their respective field. The Larosière report, the Commission and the Council reject the formula of a single all-inclusive European Supervisory Authority. There will be three European authorities: the EBA, the EIOPA and the ESMA.

For the Larosière report, one could in a second stage think on the establishment of a twin-peaks model, a suggestion that could be considered under the examination of the functioning of the new regime in a three years time as provided by the regulations. The choice for three Authorities[10] derives from the existence of the three so-called "level 3 Lamfalussy committees", which have been given newly adopted rules in January 2009.[11] Like the present committees, the Authorities will have legal personality. A Joint Committee will ensure a co-ordination among the three Authorities and have special responsibilities, in particular in the area of supervision of financial conglomerates and other cross-sectoral issues.

1.4 The composition of the Authorities

Each Authority will comprise a Board of Supervisors, a Management Board, a Chairman of the Board and an Executive Director. A Board of appeal will be common to the three sectors.

The Board of Supervisors is the plenary and principal decision-making organ. The Managing Board is in charge of ensuring that the mission of the Authority is carried out. The Chairman is a full-time official, representing the Authority and the Executive director is also a full time official in charge of the management and the preparation of the work of the Managing Board.

1.5 The tasks and powers of the Authorities

The EBA will be taken as an example, with the same general reservation that there are no common views between the two branches of the Legislative on the final content of these competences. A general description is given in article 6 of the proposal. The most important tasks consist in

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[9] See Belgian Financial Forum Conference, '*The new European financial supervision framework applied to cross-border banks and the possible specific implications for small countries'*, Brussels, 22 January 2010, p. 3.

[10] The lack of a merger of the three Authorities, officially explained by the specificities of the industries concerned, was criticised by some who observed that the true motive for this configuration was the political opportunity of maintaining three different seats, respectively in London, Frankfurt and Paris. The unification of the Authorities was thought to possibly create a very difficult supplementary problem.

[11] CESR was the first one to be created as a result of the Lamfalussy report by Decision 2001/527/EC, OJ L191, 13.7 2001, pp. 33-34; CEBS and CEIOPS were established later on by Decisions 2004/5/EC and 2004/6/EC, OJ L3, 7.1.2004, pp. 28-31. These decisions were repealed and replaced by Commission Decisions 2009/77/EC (CESR), 2009/78/EC (CEBS) and 2009/79/EC (CEIOPS), OJ L25, 29.1.2009, pp. 18-32. A number of elements of the reform of these Committees have found their way in the regulations on the new Authorities, that have also drawn lessons from their working.

contributing to the establishment of high quality common regulatory and supervisory standards, and to a consistent application of Union's legislation. The Authority should develop a common supervisory culture, facilitate the delegation of tasks and responsibilities between competent (national) authorities, conduct peer review analysis of these authorities and monitor and assess developments in the area of its competence. It should also cooperate closely with the ESRB. There has to be a reciprocal flux of information between the Authority and the Board. The Authority will be as appropriate represented in the colleges of supervisors for cross border financial institutions, which already exist or are being established. It has also the task of oversight of the rating agencies.

The powers proposed by the Commission for the authorities have been at the centre of the discussions within the Council. The UK wanted to limit drastically the possibility for the Authority to address binding decisions directly to financial institutions as it wished to preserve the fiscal autonomy of the member states. A week after the publication of the Larosière report, the Chancellor of the Exchequer, Alistair Darling, made clear that *"supervisory authority needs to be aligned with fiscal responsibility and this will be a very significant factor in limiting the extent to which national supervisors can devolve responsibility for the supervision to a centralised body"*.

This concern was present in the Larosière Report and was formally expressed in the conclusions of the European Council in June 2009 in order to get the UK's consent to the whole project. It is at the origin of the introduction in the Commission's proposal of the possibility of appeal to the Ecofin Council, a mechanism of safeguard of the fiscal autonomy of the member states, that was strengthened by the Ecofin Council to a point which significantly reduces the powers of the Authority. Furthermore, the Council has resolved to considerably reduce the possibility for the Authority to address directly decisions to the financial institutions.

The powers of the EBA will consist in:

- the development of technical standards suggested to the Commission for their adoption under the form of binding acts, under a procedure that the European Parliament wants to adapt to the new provision (article 290 TFEU) on delegation of powers to the Commission. These standards should be adopted in the field covered by the regulatory directives and in the cases mentioned in the proposed directive already mentioned;

- the issuance of (non compulsory) guidelines and recommendations;

- the adoption of decisions addressed to the competent authorities as a contribution to the consistent application of Union's law and in case of emergency or for the settlement of disputes among authorities; and

- decisions directly addressed to financial institutions requiring the necessary action to comply with their obligations under EU law including the cessation of any practice. These decisions should be in conformity with a formal opinion addressed to the state concerned by the Commission in the procedure of infringements to EU law.

1.6 Legal remedies

The regulations will provide for the establishment of a Board of Appeal as well as the possibility to appeal to the Court of Justice of the EU. The Board of Appeal, whose composition is provided in order to guarantee its independence and impartiality, could, under the proposal, if it didn't confirm the decision of the Authority, either substitute itself to the Authority and take a new decision or limit itself to act as judiciary appeal organ and remit the case to the Authority. The Council has suppressed the former possibility.

Actions for annulment are possible before the Court of Justice against decisions taken by the Board of Appeal or directly by the Authority.

1.7 Accountability

The same kind of political accountability is provided for the Authority in the form of appearance before the European Parliament and reporting that is provided for the ECB. Nevertheless no role for the

European Parliament was provided by the proposals in the process of appointment of the Chairman and the Executive Director of the Authority. It is probable that the European Parliament will get the right to organise hearings before the appointment of the leading figures of the Authority.

2. The European Systemic Risk Board

2.1 Introductory remarks

As already mentioned above (under Section B1), the Larosière Report suggested for the first time that an institution at EU level should be entrusted with the task of macro-prudential supervision. It recommended that the ECB/ESCB should be charged with this responsibility in the European Union.[12] On 23 September 2009, the European Commission presented legislative proposals to implement the recommendations made in the Larosière Report with the aim of strengthening financial supervision in Europe. These proposals included, inter alia, the creation of a European Systemic Risk Board (ESRB) for macro-prudential oversight. It was put forward that the ECB and the EU national central banks (constituting the ESCB) should have a leading role in this owing to their expertise and existing responsibilities in the area of financial stability.

The Ecofin Council reached a broad consensus regarding the main features of the ESRB at its meeting on 20 October 2009.[13] Subject to approval by the European Parliament,[14] the political objective is that the ESRB should take up its duties at the beginning of 2011, together with the three abovementioned European Supervisory Authorities.

The ESRB will be responsible for the macro-prudential oversight of the whole financial system within the EU in order to contribute not only to the prevention or mitigation of systemic risks to EU financial stability but also to the smooth functioning of the internal market. Consequently, the regulation of the European Parliament and of the Council on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board is based on the provision regarding the functioning of the EU internal market (Art. 114 of the Treaty on the Functioning of the European Union (TFEU)) and is to be adopted by the European Parliament and the Council by a qualified majority[15] pursuant to Art. 16 of the Treaty on European Union.

2.2 The composition of the Board

The ESRB will be governed by a General Board and will have a Steering Committee, a Secretariat and an Advisory Technical Committee. The members of the ESRB must perform their duties impartially and solely in the interests of the EU as a whole.

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12 Report by “The High-Level Group on Financial Supervision in the EU”, pp. 39-40, para. 153.

13 This report is based on the legal texts proposed by the EU Commission as amended by the Council of the European Union (Interinstitutional File: 2009/0141(CNS), 5551/10 dated 21 January 2010 and Interinstitutional File: 2009/0140(COD), 5554/10 dated 21 January 2010). These documents are available at: n/10/st05/st05551. en10.pdf, and register.consilium.europa.eu/pdf/en/10/st05/ st05554.en10.pdf.

14 A draft report by the committee responsible (ECON) is available at: www.europarl.europa.eu/ oeil/FindByProcnum.do?lang=2&procnum=COD/2009/0140. The proposed amendments deviate from the Larosière Group’s recommendations, the EU Commission’s proposals and the ECOFIN consensus in suggesting that the number of central bank representatives in the ESRB should be reduced and replaced by persons with backgrounds in academic fields, the private sector, or trade unions, or as providers or consumers of financial services.

15 The requirements for a qualified majority pursuant to art. 16 of the Treaty on European Union are laid down in the Protocol (No. 36) of the Lisbon Treaty on Transitional Provisions. In principle, pursuant to art. 3 of this Protocol, a qualified majority is achieved if two thirds of the members are in favour of adopting the legal act.

The General Board will consist of the President of the ECB, the Governors of the ESCB central banks, a member of the European Commission and the chairpersons of the three new European Supervisory Authorities. Furthermore, a representative of the national supervisory authority of each EU member state and the President of the EU's Economic and Financial Committee will be members without voting rights. The Chair, presumably the ECB President, will be elected only from those members of the General Board who are also members of the General Council of the ECB.

A Steering Committee will assist the General Board and will consist of the Chair, the Vice-Chair of the ESRB, five other members of the General Board who are also members of the General Council of the ECB, a member of the EU Commission, the President of the EU's Economic and Financial Committee and the chairpersons of the three new European Supervisory Authorities. This composition will not reflect the composition of the General Board, on which members from EU central banks will have a clear majority.

The members of the Advisory Technical Committee, which will provide advice and assistance on technical issues, will be representatives of the institutions and bodies involved in the General Board.

The ECB will ensure the Secretariat, which will provide analytical, statistical, logistical and administrative support to the ESRB. This task could have been based on Art. 127 (5) of the TFEU, whereby the Eurosystem already has its own competence in the field of financial stability.[16] As the ESRB will be established on the basis of Art. 114 of the TFEU, it will be a European body mandated with tasks concerning the stability of the financial system. It would consequently have been conceivable to base the role of the Secretariat only on Art. 127 (5) of the TFEU. On this basis, the Governing Council of the ECB could have decided independently on the provision of the secretariat function for the new EU body. Nevertheless, for the purpose of establishing the Secretariat, the EU Commission has proposed a second Council Regulation on the basis of Art. 127 (6) of the TFEU entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board.[17] This regulation must be adopted unanimously by the Council.

The Governing Council of the ECB has already declared its willingness for the ECB to provide the ESRB's Secretariat.[18] The ECB's own financial stability tasks according to Art. 127 (5) of the TFEU will remain legally unaffected, while its primary objective of maintaining price stability will remain unchanged. The ESRB's members from the Governing Council of the ECB will have to distinguish between their ESRB responsibilities and their ESCB tasks, namely their financial stability functions, which they will execute independently pursuant to Art. 130 of the TFEU.

2.3 The tasks and powers of the Board

The ESRB's key role will be to issue warnings and recommendations for action in response to identified risks. They can be addressed to the EU as a whole, to one or more EU member states, to one or more of the new European Supervisory Authorities (as mentioned above, under Section B1) or to one or more national supervisory authorities. The ESRB shall decide on a case-by-case basis, after having consulted the Council, whether a warning or a recommendation should be made public. The addressees must communicate the action undertaken in response to the recommendations or provide adequate justification in the event of inaction ("act or explain").

In order to fulfil its tasks, the ESRB will collect and analyse relevant information and identify systemic risks to financial stability. To this end, the ESRB may request macro-prudential information, primarily

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16 According to this article, the ECB and the Eurosystem contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

17 Under article 127 (6) of the TFEU, specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings could be conferred on the ECB.

18 See No. 3 of the ECB opinion on the EU Commission's proposals concerning the ESRB (CON/2009/88). This document is available at: www.ecb.int/ecb/legal/pdf/c_27020091111en 00010008.pdf.

from the new European Supervisory Authorities. Furthermore, the ESRB will coordinate with international institutions and *fora*, in particular the International Monetary Fund and the Financial Stability Board.

C. Regulatory developments in European banking law

1. Introductory remarks

Since August 2008, significant regulatory developments took place in European banking law. As already mentioned in Section A, these are mainly a response to the recent international financial crisis, in order to address specific shortcomings and gaps of the regulatory framework that have contributed to the crisis.[19] These developments refer to the regulatory framework for the prudential regulation of credit institutions (see below, under Section C2), and to the regulatory framework for deposit guarantee schemes (under Section C3).

During this period, another important regulatory development took also place, not related to the financial crisis, concerning the amendment of the existing regulatory framework for cross-border payments in the European Union (under Section C4). In addition, in September 2009, Directive 2009/110/EC was issued on the taking up, pursuit and prudential supervision of the business of electronic money institutions repealing Directive 2000/46/EC,[20] with the objective of removing barriers to market entry and facilitating the taking up and pursuit of the business of electronic money issuance and ensuring a level playing field for all payment services providers. One of the major changes of the new Directive was the amendment of the definition of credit institution in Directive 2006/48/EC in order to ensure that electronic money institutions are not anymore considered to be credit institutions. However, credit institutions should continue to be allowed to issue electronic money and to carry on such activity at European level, subject to the principle of mutual recognition and to the comprehensive prudential regulatory framework applying to them in accordance with the provisions of European banking law, as in force.

2. Prudential regulation of credit institutions

The objective of the new regulatory framework for the prudential regulation of credit institutions, already adopted or under consultation, is the establishment of comprehensive and risk-sensitive rules, and the fostering of enhanced risk management by credit institutions (and investment firms). The review of Directives 2006/48/EC and 2006/49/EC, which are the basic legal acts constituting the legal sources of the framework in force, is taking place gradually through three sets of revisions:

- the first set has already been adopted by Directive 2009/111/EC (see below, under Section 2.1);
- the second set is included in a proposal for a Directive under consultation (under Section 2.2); and
- the third set, still at an early stage of consultation, reflects fully the expected amendments to the so-called "Basel II framework" by the Basel Committee on Banking Supervision (under Section 2.3).[21]

Moreover, in order to contribute to the further convergence of banking regulatory practices across the EU, the Committee of European Banking Supervisors (CEBS) has, during 2009, adopted or launched consultations on a series of standards and guidelines with respect to various aspects of banking

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[19] For a definition and overview of the sources of European banking law before these current developments, <u>see</u>, among others, Christos Vl. Gortsos, 'European financial integration: Economic aspects, the existing legal framework and the way ahead', article to be published in the collective work (editor Miroslav Jovanovich): *Handbook of Economic Integration*, Edward Elgar, Hehlthahn (2010, forthcoming) – already published in the Working Paper Series of the Wharton Financial Institutions Center at the following address: http://fic.wharton.upenn.edu/fic/papers/09/09.htm (#9-35), section B.

[20] OJ L 267, 10.10.2009, pp. 7-17.

[21] Several of these rules will also apply to investment firms.

regulation, such as risk management, liquidity risk and liquidity buffers, remuneration policies, colleges of supervisors and exchange of information between supervisory authorities, capital buffers, passport notification, operational risk, own funds and hybrid capital instruments, stress testing, large exposures and concentration risk.[22]

2.1 Directive 2009/111/EC

In November 2009, Directive 2009/111/EC of the European Parliament and the Council was published in the Official Journal of EU, by which Directives 2006/48/EC and 2006/49/EC were amended.[23] The major amendments introduced by Directive 2009/111/EC, whose provisions shall apply by 31 December 2010, are the following:

(a) The Directive introduces the term of 'significant branches'. For a branch of a credit institution established in a host member state to be considered as significant, the competent authorities of the host member state must, if specific requirements are fulfilled, make a request to the consolidating supervisor or to the competent authorities of the home member state of the credit institution. This provision has been introduced in order to reinforce the information rights of host supervisors, taking into account that information deficits between home and the host competent authorities have proved detrimental, during the recent crisis, to the financial stability in host member states (and might prove again).

(b) Specific criteria have been set for hybrid capital instruments to be eligible for inclusion in credit institutions' original own funds. The alignment of the criteria has been considered necessary taking into account that hybrid capital instruments play an important role in the ongoing capital management of credit institutions and allow them to achieve a diversified capital structure and to access a wide range of financial investors.

According to the new Directive, original own funds referred to in Article 57(a) of Directive 2006/48/EC should include all instruments that are regarded under national law as equity capital, rank *pari passu* with ordinary shares during liquidation and fully absorb losses on a going-concern basis *pari passu* with ordinary shares.

(c) The regulatory framework on the monitoring and control of credit institutions' large exposures has been enhanced. Since a loss arising from an exposure to a credit institution can be as severe as a loss from any other exposure, such exposures should be treated and reported in the same manner as any other exposures. However, an alternative quantitative limit has been introduced to alleviate the disproportionate impact of such an approach on smaller institutions.

(d) Colleges of Supervisors have been established for the purpose of strengthening the coordination of the competent authorities with the aim to strengthen the efficiency of the prudential supervision and regulation of a banking group on a consolidated basis and to mitigate systemic risk. Their establishment should be an instrument for stronger cooperation by means of which competent authorities reach agreement on key supervisory tasks.

2.2 Proposal for a Directive for a further review of Directives 2006/48/EC and 2006/49/EC

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[22] On the work of CEBS, see the following internet address: http://c-ebs.org/Publications.aspx.

[23] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, OJ L 302, 17.11.2009, pp. 97-119.

In July 2009, the European Commission submitted a proposal for a Directive[24] in order to address, mainly, the risks linked to re-securitisation, the trading book and remuneration policies. The main changes proposed are as follows:

(a) Enhancement of capital requirements relating to re-securitization, in order to ensure that credit institutions take proper account of the risks of investing in such complex financial products. According to the Commission, re-securitisations have played a significant role in the development of the recent financial crisis.

(b) Enhancement of disclosure requirements for securitisation exposures, in order to ensure market confidence and encourage the smooth operation of interbank markets, which was seriously negatively affected during the recent financial crisis.

(c) Strengthening of capital requirements for the trading book (i.e., for exposure to market risks), in order to ensure that the assessment of risks connected with it fully reflect the potential losses from adverse market movements under stressed conditions.

(d) Establishment of the obligation for credit institutions to apply sound remuneration policies that do not encourage or reward excessive risk-taking. The competent authorities will be given the power to sanction credit institutions with remuneration policies that do not comply with the new requirements. However, the amount and form of remuneration and the ultimate responsibility for the design and application of their remuneration policy remain to to the discretion of credit institutions. The proposed high-level principles concern remuneration for staff whose professional activities have a material impact on the risk profile of credit institutions.

According to the proposal, member states shall apply these rules by 31 December 2010.

2.3 Additional amendments to Directives 2006/48/EC and 2006/49/EC

In February 2010, the European Commission submitted for consultation a staff working document on additional amendments to Directives 2006/48/EC and 2006/49/EC,[25] relating to the following areas:

(a) The establishment of two regulatory standards for liquidity risk in order to promote both short-term and longer-term resilience of the liquidity risk profile of credit institutions.

(b) The re-definition of regulatory capital in order to strengthen, harmonise and simplify the existing framework (core tier 1 capital, non-core tier 1 capital, tier 2 capital and tier 3 capital).

(c) The introduction of a leverage ratio to supplement the risk-based minimum capital requirement ratio across the economic cycle.

(d) The amendment of the treatment of the counterparty credit risk and, specifically, the enhancement of the capital requirements for counterparty credit exposures arising from credit institutions' derivatives, repo and securities financing activities, providing, by this way, additional incentives to move over-the-counter (OTC) derivative contracts to central counterparties in order to reduce exposure to systemic risk.

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24 Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, available at the following internet address: http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_adopted_1307.pdf.

25 European Commission (2010): *New Public Consultation regarding further possible changes to the Capital Requirements Directive (CRD)*, February, available at the following internet address: http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf.

(e) The introduction of counter-cyclical regulatory measures (through-the-cycle provisioning and creation of counter-cyclical buffer).

(f) The introduction of tougher prudential requirements for the systemically important financial institutions, in order to reduce their exposure to moral hazard and, hence, the frequency and severity of financial crises.

(g) The establishment of a "single rulebook" at least in specific areas. According to the Commission, a single rulebook "*does not mean uniform rules regardless of specific national circumstances (...). But at the same time, it makes sure that same things are treated the same way, i.e., that a product, specific as it may be to a national market, is treated the same by whoever offers that product and independent of in which Member State that bank is authorized*".[26]

The relevant legislative proposal is envisaged to be published in the second half of 2010 and will be accompanied by an impact assessment, as it is recognized that "*the cumulative effect of potential provisions ... might be substantial and could have implications for the amounts of funds that institutions have available to lend to businesses*".

3. Deposit guarantee schemes

In order to restore confidence in the European banking system and to enhance its stability during the recent international financial crisis, it was considered necessary to take measures in order to enhance the protection of deposits in credit institutions established in the EU and to further promote the convergence of national deposit guarantee schemes. In this context, in March 2009 Directive 2009/14/EC of the European Parliament and of the Council was issued,[27] amending Directive 94/19/EC on deposit guarantee schemes.

The main amendments introduced by Directive 2009/14/EC, whose provisions should be (and have been) implemented by member states by 30 June 2009, are the following:

(a) The minimum coverage level provided by deposit guarantee schemes (if it has been determined that the deposits of a credit institution are unavailable), has been increased (from euro 20,000 before) to euro 50,000 for the aggregate deposits of each depositor, and, by 31 December 2010, to euro 100,000.

(b) The payout period has been reduced to twenty (20) working days (from three (3) months before). This period can be extended for another ten (10) working days only under exceptional circumstances, in special cases, and upon approval by the competent authorities.

(c) When the payout is triggered by a determination of the competent authorities that the deposits of a credit institution are unavailable (and not by a ruling of a judicial authority), this determination must be made at the latest within five (5) working days (from twenty-one (21) days before), after first becoming satisfied that a credit institution has failed to repay deposits which are due and payable.

(d) Information requirements to actual and intending depositors have been enhanced.

According to article 12 of Directive 94/19/EC, as amended by Directive 2009/14/EC, the Commission ought to submit to the European Parliament and to the Council by 31 December 2009 a report assessing the impact of the level of the coverage increase to euro 100,000, and the need to fix this amount as the harmonized level of coverage in the Community, as well as regarding the harmonization of the mechanisms financing the deposit-guarantee schemes and the possible establishment of a European deposit guarantee scheme, along with any suitable proposals. Until May 2010, this report was not publicly available.

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[26] *Ibid*, para. 172.

[27] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, OJ L 68, 13.3.2009, pp. 3-7.

4. Cross-border payments in the European Union

Regulation (EC) 2560/2001 of the European Parliament and of the Council of 19 December 2001 on cross-border payments in euro established the principle of "equality of charges" between cross-border payments in euro and the corresponding payments within a member state, which applied to cross-border payments in euro (and in Swedish kronor) up to euro 50,000, or equivalent. A report of the European Commission of 2008 on the application of this Regulation confirmed that it has effectively led to the reduction of charges for cross-border payment transactions in euro to the level of national charges and it has encouraged the European payments industry to make the necessary efforts to build a pan-European infrastructure for payments, leading to the creation of the Single European Payments Area (SEPA).

However, the same report identified the need for a number of amendments to the Regulation. Accordingly, the European Parliament and the Council adopted in September 2009 Regulation 924/2009,[28] which applies, mainly, as of 1 November 2009. Its main provisions concern the following:

(a) Each national payment corresponding to a cross-border payment must be identified using the following exhaustive criteria: the channel used to initiate, execute and terminate the payment, the degree of automation, any payment guarantee, customer status and relationship with the payment service provider, or the payment instrument used.

(b) Standardisation as regards, in particular, the use of the International Bank Account Number (IBAN) and the Bank Identifier Code (BIC) is further promoted.

(c) As of 1 January 2010, settlement-based national reporting obligations on payment service providers for balance of payments statistics related to payment transactions of their customers up to euro 50,000 have been removed.

(d) The reachability for direct debit transactions has also been established: by 1st November 2010 a payment service provider of a payer reachable for a national direct debit transaction denominated in euro on the payment account of that payer shall be reachable, in accordance with the direct debit scheme, for direct debit transactions denominated in euro initiated by a payee through a payment service provider located in any member state.

D. Stabilisation measures for financial institutions in the EU Member States

The recent international financial crisis induced many governments to bail out banks and other financial institutions. In the EU, giving financial support to undertakings is, if not explicitly admitted by Article 107 TFEU,[29] considered to constitute state aid which is prohibited. Thus, EU governments needed approval of their financing transactions and guarantees from the Directorate General Competition (DG Comp), the EU executive's Directorate General responsible for enforcing competition law.[30]

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[28] Regulation (EC) 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payments in the Community and repealing Regulation (EC) No 2560/2001, OJ L 266, 9.10.2009, pp. 11-18.

[29] The first paragraph of article 107 of the Treaty on the Functioning of the European Union (TFEU) reads as follows: *"Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market"*. Article 87 (1) of the EC Treaty contained the same prohibition.

[30] On this topic see also, Bernd Krauskopf, Legislative Measures to support Financial Market Stability: The German Example and its European Context, chapter in Mario Giovanoli and Diego Devos (eds.), *International Monetary and Financial Law in the light of the Global Crisis*, Oxford University Press, 2010.

Draft government measures in the area of competence of the ECB need to be submitted to it for its advice. This follows from article 105 (4) EC Treaty, now article 127 (4) TFEU[31] and from the implementing Council decision.[32] This decision requires prior consultation of the ECB on *"rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets"*, as well as, *inter alia*, on rules regarding national central banks and payment and settlement systems.[33]

In their respective roles both the European Commission and the ECB were to pronounce themselves on a great number of national measures in respect of the crisis.[34]

It fell upon the executive of the EU to ensure the necessary coordination and compliance with market rules since these measures, as explained elsewhere,[35] were taken independently and not often in a co-ordinated fashion. The ECB and DG Comp referred to one another's policy lines. The ECB often insisted on market conformity of guarantees and other measures.[36] DG Comp referred to ECB recommendations on the pricing of State guarantees and on the pricing of recapitalisations.

The Commission gave guidance to the process of saving the finance industry by adopting successive Communications: a *Bank Guarantee Communication* of 13 October 2008,[37] in the midst of a crisis, followed by a *Recapitalization Communication*[38] of 5 December 2008, a *Toxic Assets Communication*[39]

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31 The text of this paragraph reads as follows: *"The European Central Bank shall be consulted:*

- *on any proposed Union act in its fields of competence,*
- *by national authorities regarding any draft legislative provision in its field of competence, but within the limits and under the conditions set out by the Council in accordance with the procedure laid down in Article 129(4). The European Central Bank may submit opinions to the appropriate Union institutions, bodies, offices or agencies or to national authorities on matters in its fields of competence."*

32 Council Decision of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (98/415/EC), OJ L 189, 3.7 1998, p. 42 f.

33 Note that the prior consultation requirement applies to each Member State irrespective of whether its currency is the euro or not, with the exception of the United Kingdom whose "Opt-out" Protocol declares the relevant provision not applicable in respect of draft legislation concerning Europe's major financial centre. See Protocol No. 15 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, paragraph 4 (OJ C 83,30.3 2010); formerly Protocol No. 25, paragraph 5 (OJ C 321E, 29.12.2006).

34 Of course, the Commission also needed to authorise measures in respect of undertakings outside of the financial sector. The combined involvement of the ECB and the Commission was restricted to financial firms.

35 See René Smits, European supervisors in the credit crisis: issues of competence and competition, chapter in Mario Giovanoli and Diego Devos (eds.), *International Monetary and Financial Law in the light of the Global Crisis,* Oxford University Press, 2010.

36 The ECB's opinions can be found on its internet adress (only ECB opinions relating to draft Community legislation are published in the Official Journal); see at: www.ecb.europa.eu/ecb/legal/opinions/html/index.en.html.

37 Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270/8, 25 October 2008.

38 Communication from the Commission – The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15.1.2009, p. 2 ff.

39 Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ C 72, 26.3.2009, p. 1 ff.

of 25 February 2009 and a *Restructuring Aid Communication*[40] of 22 July 2009. This latter guideline foreshadowed the strict requirements imposed on banks whose viability would not have been assured without state aid, to divest. Commerzbank, Royal Bank of Scotland and ING[41] are among the banks that will have to slim down considerably, shedding up to 40% of their balance sheet, to ensure that the state aid does not lead to a permanent disturbance of the markets.[42]

These measures are not unlike remedies offered in the context of merger control, where a company which takes over another company divests itself of certain business so as to allay fears for effective competition post-merger. Through their actions, these two authorities combined their influence in order to steer the European economy through the crisis with the internal market and the single monetary policy intact.

E. Measures taken in the context of the Greek debt crisis and the European financial stabilisation mechanism

The crisis resulting from bond market reluctance to continue to invest in Greek government debt was quick to develop and not easy to be countered by the EU and its Member States. The Eurogroup (the meeting of Ministers of Finance of the Member States whose currency is the euro), the European Council (the meeting of the Heads of State or Government of all 27 Member States and the President of the European Commission),[43] and the meeting of the Heads of State or Government of the euro area plus the President of the European Commission,[44] announced:

- first a combined euro area Member States/IMF package[45] of initially € 30 billion[46] and then € 120 billion[47] for Greece,[48] and

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40 Communication from the Commission – The return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ C 195, 19.8.2009, p. 9 ff.

41 ING and the Dutch State have lodged appeals before the EU's General Court against the Commission's imposed requirements. See *ING Groep v Commission* (Case T-33/10), OJ C 80/38, 27 March 2010 and *Netherlands v Commission* (Case T-29/10**),** OJ C 80/40, 27 March 2010.

42 The authorisations and other decisions taken by DG Comp can be found at: ec.europa.eu/competition/state_aid/register/. The Commission provided overviews of national measures adopted as a response to the financial/economic crisis. For the latest, see MEMO/10/179 of 12 May 2010 at: europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/179&format=HTML&aged=0&language=EN&guiLanguage=en.

43 Since the entry into force of the Lisbon Treaty, chaired by a permanent president, currently Herman Van Rompuy.

44 Similarly presided over by the European Council president Herman Van Rompuy as it turned out: the TFEU does not provide for a meeting of the Eurogroup at Heads of State and Government level or for a European Council meeting with the States which have adopted the euro, only. In practice, the European Council President has taken the lead. See *the Invitation by President Herman Van Rompuy to the Summit of Heads of State or Government of the Euro area*, at: consilium.europa.eu/uedocs/cms_data/docs/pressdata/fr/ec/114165.pdf.

45 See the statement by the Heads of State and Government of the euro area of 25 March 2010, at: consilium.europa.eu/uedocs/cms_data/docs/pressdata/ en/ec/113563.pdf.

46 The Statement on the support to Greece by Euro area Members States of 11 April 2010, at: consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113686.pdf.

47 Activated on the basis of findings of the Eurogroup, the meeting of Ministers of Finance of the euro area; see: consilium.europa.eu/uedocs/cmsUpload/100502-%20Eurogroup_statement.pdf.

- then a 'European financial stabilisation mechanism'[49] adopted by the Ecofin Council on 9 May 2010,[50] with the intention to calm down the markets.

The mechanism consists of three elements:

(a) First, an extension of an existing EU balance of payments finance facility for Member States whose currency is not the euro,[51] to euro area Member States based on Article 122 (2) TFEU[52] for a total of € 60 billion. Releases of instalments of any loans under the € 60 billion EU programme are to be decided upon by the Commission on the basis of compliance with the adjustment programme a Member State is to submit and with the economic policy conditions adopted by the Council by qualified majority voting.

(b) Second, an intergovernmental agreement of euro area member states[53] providing for loans to individual euro area Member States, through a Special Purpose Vehicle (SPV) of the other euro area Member States of up to € 440 billion.[54] The text of the legal instrument underpinning the European stabilisation mechanism is supposed to ensure that the SPV will borrow on the financial markets backed by guarantees of the euro area Member States limited to their respective NCB's capital share in the ECB. Loans of the SPV can only be granted unanimously by the euro area Member States.

(c) Third, IMF participation at least equal to half of the former amounts.

The fact that activation of the mechanism will be in the context of a joint euro area Member States/IMF support (not public) is understood to ensure strict conditionality. The legal texts seek to avoid difficulties with regard to the no bail-out clause (article 125 TFEU).[55]

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48 Decision of the European Central Bank of 10 May 2010 concerning the management of pooled bilateral loans for the benefit of the Hellenic Republic and amending Decision ECB/2007/7 (ECB/2010/4), OJ L 119, 13.5.2010, p. 25 ff.

49 See the statement of the Heads of State and government of the euro area of 7 May 2010 at: consilium.europa.eu/App/newsroom/loadbook.aspx?BID=76&LANG=1 &cmsid=347.

50 Press Release 9596/10 (Presse 108), 9/10 May 2010, at: consilium.europa.eu/App/NewsRoom/loadDocument.aspx?id=350&lang=EN&directory=en/ecofin/&fileName=114324.pdf. See also a Decision of the Representatives of the Governments of the Euro Area Member States Meeting within the Council of the European Union and a Decision of the Representatives of the Governments of the 27 EU Member States at: consilium.europa.eu/showFocus.aspx?id=1&focusId=478&lang=en.

51 Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments, OJ L 53, 23.2.2002, p. 1 ff., lastly amended by Council Regulation (EC) No 431/2009 of 18 May 2009 amending Regulation (EC) No 332/2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments, OJ L 128, 27.5.2009, p. 1 ff.

52 This provision reads as follows: *"Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken."*

53 To date, this agreement has not been made public.

54 Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, OJ L 118, 12.5.2010, p. 1 ff.

55 The first paragraph of which reads as follows: *"The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other*

A legal challenge is brought before the German Constitutional Court questioning the conformity with the German *Grundgesetz* of the law authorizing a guarantee of the Federal Republic of Germany *vis-à-vis* the *Kreditanstalt für Wiederaufbau* (KfW), a German publicly held credit institution, participating for Germany in the financial package for Greece[56] organised by the euro area Member States and the IMF, announced earlier and to be made effective before 19 May 2010.

The ECB announced a State-specific widening of the eligibility criteria for collateral, allowing banks to continue to borrow from the Eurosystem on the basis of Greek government bonds,[57] irrespective of whether credit rating agencies downgrade this debt below investment grade status.[58]

The ECB also announced similar to unconventional methods of intervention used by other central banks buying government securities in secondary markets which had become illiquid, while absorbing excess liquidity by neutralising operations.[59] Further actions of the ECB were taken in conjunction with other central banks.[60] The ECB has assured that the maintenance of price stability which is the Eurosystem's primary objective[61] remains unaffected.

These developments underscore the need for stronger and more effective economic policy coordination[62], extending beyond budget deficit procedures. Proposals to strengthen the economic union element of EMU have been submitted by the Commission.

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bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."

[56] For the German Constitutional Court's decision not to grant an interim injunction against the German participation, see: *BVerfG*, 2 BvR 987/10 of 7 May 2010, at: www.bverfg.de/entscheidungen/rs20100507_2bvr098710.html.

[57] Pursuant to Article 18.1 second indent of the Statute of the ESCB and of the ECB, the ECB and the National Central Banks (NCBs) are competent to *"conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral"*. The adequacy of collateral is for the ECB to decide.

[58] See the ECB press release of 3 May 2010 ("ECB announces change in eligibility of debt instruments issued or guaranteed by the Greek government") at: www.ecb.int/press/pr/date/2010/html/pr100503.en.html.

[59] See its press release of 10 May 2010 (*ECB decides on measures to address severe tensions in financial markets*), at: www.ecb.europa.eu/press/pr/date/2010/html/ pr100510.en.html. See, also, the Decision of the European Central Bank of 14 May 2010 establishing a securities markets programme (ECB/2010/5), OJ L 124, 20.05.10, p. 8 ff.

[60] Notably, the reactivation of dollar swaps enabling the ECB to provide European banks with liquidity in the US currency. See the ECB's press releases of 10 May 2010 (*Reactivation of US dollar liquidity providing operations; ECB announces details regarding the reactivation of the US dollar liquidity-providing operations*) at: www.ecb.europa.eu/press/pr/date/2010/html/pr100510_1.en.html and at: www.ecb.europa.eu/press/pr/date/2010/html/pr100510_2.en.html.

[61] See its press release of 10 May 2010 (*ECB decides on measures to address severe tensions in financial markets*), at: www.ecb.europa.eu/press/pr/date/2010/html/ pr100510.en.html.

[62] This is acknowledged by the European Council which requested its President to study ways to strengthen economic policy coordination in its statement of 25 March 2010 (see footnote 20 above) which concludes with the following paragraphs: *"For the future, surveillance of economic and budgetary risks and the instruments for their prevention, including the Excessive Deficit Procedure, must be strengthened. Moreover, we need a robust framework for crisis resolution respecting the principle of member states' own budgetary responsibility. We ask the President of the European Council to establish, in cooperation with the Commission, a task force with representatives of Member States, the rotating presidency and the ECB, to present to the Council, before the end of this year, the measures needed to reach this aim, exploring all options to reinforce the legal framework."*