Optional EU Banking Supervision?

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Whilst the EC has harmonized banking regulation, banking supervision remains decentralized. Member States must subject credit institutions to prudential, market and consumer protection supervision, but remain free to adopt institutional design that they deem best suited to their needs. In addition, room is left for Member State specific regulation, in particular regarding the liquidation and restructuring of banks. Harmonization is complete enough for banks supervised in one Member State to be able to offer banking services or establish a branch in another Member state without becoming subject to prudential supervision by that state. Under this home country control approach, a bank can essentially do business throughout Europe under the regulation of its home state. The host state is merely empowered to impose additional compliance with rules it has adopted in the interests of the general good.

Decentralized banking supervision has the advantage of empowering the agency closest to the main domain of activity of most banks. Conversely, decentralization implies close international collaboration for the supervision of those banks that have significant cross-border operations. Consequently, EC law requires Member States to enter into written coordination and cooperation agreements not only for banks with branches outside the home Member State, but also for those subsidiaries in other Member States (while the subsidiary is supervised by the Member State in which it is incorporated, the parent bank's home Member State is responsible for consolidated supervision at the group level).

Many bilateral Memoranda of Understanding establish regular exchanges of information and procedures for on-site inspections. In addition, EU banking supervisors have signed three multilateral Memoranda of Understanding on financial crisis management which also involve central banks and treasuries. Multilateral cooperation among supervisory authorities logically takes place with the European Committee of Banking Supervisors, whereas cooperation with central banks takes place within Member States or, for Euro-zone participants, within the European System of Central Banks. The efficiency of these non-legally binding cooperative arrangements, especially their robustness in times of crisis, has been questioned by commentators. In particular, it has been pointed out that they fail to properly address principal-agent conflicts of interest among supervisors, deal effectively with diversity in deposit insurance schemes and contribute effectively in financial distress situations. Indeed, the current financial crisis that emerged in August 2007 has shown that these concerns were justified.

To be sure, banking supervisors across the EU have played down, as long as possible, the financial difficulties faced by credit institutions operating in their jurisdictions. Naturally this can be understood as an effort to prevent a downward spiral in confidence that could lead to bank runs and payment system disruptions. Equally, this is also likely to reflect opportunistic behaviour. Hence, some home supervisor optimism can be seen as an attempt to protect local depositors – for example, by constraining transfer of liquidity of assets from branches or subsidiaries to the parent bank. Host supervisor optimism, on the other hand, may reflect an effort to avoid corrective actions by the home supervisor, for example, by constraining subsidiary or branch activity.

Cross-border financial distress situations provide more direct evidence of supervisory coordination and cooperation failures. In theory, financial distress operations should have been structured within the supervisory colleges set up in the application of EU law, which requires close cooperation among host and home authorities. Given each bank with cross-border activities having its dedicated supervisory college, with its home Member State supervisor as the chair, it was expected that financial distress would be swiftly dealt with. While the evidence remains scarce and partly anecdotic, the emerging view is that the involvement of multiple supervisors and the lack of clarity regarding financial burden sharing has resulted in imperfect outcomes. Thus, it comes as no surprise that the EU finance ministers have called for improvement in EU financial supervision. At the same time, a number of institutional reform proposals have emerged, including the establishment of a 'global regulatory body', or European supervisory colleges and the creation of a European System of Financial Regulators. While there is little enthusiasm for creating 'global' supervisory colleges, some commentators contend, without citing much evidence, that introducing European supervisory colleges might prove more effective than the supervisory colleges previously established by the Member States. Finally, a more centralized approach to European supervision has been advanced by representatives of financial firms and institutions. More specifically, they propose to go beyond the supervisory colleges and establish a European System of Financial Supervision, which would require substantial institutional changes similar to those undertaken in the creation of the European System of Central Banks. While such a proposal has the advantage of addressing

Hertig, Gerard and Joseph McCahery. 'Editorial'. *European Company Law* 6, no. 1 (2009): 4-5.

the main effectiveness issues relating to financial supervision, it will require a Treaty amendment and must be built from scratch, which makes the final framework difficult to predict.

In a forthcoming article, we propose an alternative that is both more effective than the supervisory colleges proposals and less interventionist than the European System of Financial Supervisors proposal as it relies on an established centralized institution and offers Member States a choice regarding supervision rather than imposing a mandate.[1] In essence, we suggest that Member States be given the option to subject their largest banks to supervision by the European Central Bank (ECB).[2] Under our choice-oriented proposal, it would be possible for Member States to opt in and out of ECB banking supervision. The approach is based upon an established EC regulatory technique, which has been implemented within as well as outside the financial services area. ECB banking supervision authority would be based upon Article 105 (6) of the Treaty, according to which specific tasks concerning policies relating to the prudential supervision of credit institutions may be conferred upon the ECB. While this choice-oriented proposal is not first best, we believe that it may be superior to the other proposal. First, it does not require a Treaty amendment, as it already provides that the ECB can be empowered with banking supervision tasks. Second, it allows different approaches by different Member States, both regarding the principle of ECB supervision and its timing. This avoids the deficiencies of a 'one size fits all' approach and allows shifts in supervision to occur gradually. Third, ECB supervision increases the likelihood that risks rather than names ('national champions') are the main driver of supervisory interventions. Finally, we believe that allowing Member States to reverse their decision to confer supervisory powers to the ECB ensures accountability.

1 Gerard Hertig, Ruben Lee & Joseph A. McCahery, *Empowering the European Central Bank to Supervise Banks: A Choice-Based Approach* (Working paper, 2008).

2 Our proposal builds upon Gerard Hertig & Joseph A. McCahery, 'Optional Rather Than Mandatory EU Company Law: Framework and Specific Proposals', *European Company and Financial Law Review* 4 (2006): 341 and Gerard Hertig & Ruben Lee, 'Four Predictions about the Future of Securities Regulation', *Journal of Corporate Law Studies* 3 (2003): 359.