Applied Monetary Policy and Bank Supervision by the ECB

Mads Andenas
Lazaros E Panourgias

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INTERNATIONAL MONETARY AND FINANCIAL LAW UPON ENTERING THE NEW MILLENNIUM

A Tribute to Sir Joseph and Ruth Gold

Editors

Joseph J. Norton
Mads Andenas

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Applied Monetary Policy and Bank Supervision by the ECB

MADS ANDENAS* and LAZAROS E PANOURGIAS**

The European Monetary Union introduces a geographical separation of monetary policy and bank supervision. The European Central Bank defines and implements the single monetary policy as one of its basic tasks. National authorities remain responsible for bank supervision. Only a complementary supervision role is explicitly centralised.

There are similarities between this model and the functional separation introduced in several state jurisdictions. A bank regulator or single financial regulator has been established to exercise first line bank supervision while the national central banks retain a macro-prudential responsibility. However, neither functional nor geographical separation will much limit the prudential supervision power of the central bank. Monetary policy power does include supervision powers. An analysis of the core concept will clarify this. One starting point is the concepts of the EC Treaty.

To define the exact content of the Treaty competences is important for different reasons, not the least for the different functions to be efficiently undertaken and the institutions to be held accountable. This is all the more important because of the political intensity in the situations in which the relevant competences are exercised. This can often marginalise the legal texts: 'We did not have the Maastricht treaty lying open on the table. It was all done informally' one of the decision-makers is quoted to have said in the context of the foreign exchange intervention in favour of the Euro in 2000.1

* MA, DPhil (Oxon); PhD (Cantab). Director, British Institute of International and Comparative Law, Charles Clore House, 17 Russell Square, London, WC1B 5JP. Senior Teaching Fellow, Institute of European and Comparative Law, and Fellow, Harris Manchester College, Oxford University.

** LLB (Athens Law School); LLM (Georgetown University); MA (The Fletcher School of Law and Diplomacy); PhD (London); Greek State's Scholarships Foundation Scholar in Banking Law; Member of the Athens (Greece) and New York Bar. Legal Adviser, EBRD, and Research Fellow, British Institute of International and Comparative Law, Charles Clore House, 17 Russell Square, London WC1B 5JP.

1 Alan Beattle and Stephen Fidler, Careful planning behind banks' euro surprise, FIN TIMES, 25 Sept 2000, at 3.
I. THE PROBLEM

The introduction of the single European currency and the single monetary policy trigger the development of an integrated European banking system. Common low interest rates, denominations in a single currency, and further deregulation will contribute to pan-European banking activities, increased interbank links, more competition and further integration of the capital markets. The ‘peoples’\(^2\) of Europe will enjoy efficiency gains due to portfolio diversification opportunities,\(^3\) enhanced market liquidity and stable prices. Increased banking activity at the European level, however, poses regulatory challenges since systemic and depositors’ risks will no longer be confined at the national level.\(^4\)

So far, minimum standards and cooperation frameworks constitute the prudential institutional foundation of the liberalisation of the European financial markets. Prudential supervision by the home country authorities, supported by essential harmonisation of minimum standards and mutual recognition, provides the basis for both the reduction of national barriers to financial services and the supervision of cross-border banking activity.

We argue that this home country control model is not the most efficient solution for both the realisation of the internal banking market and for the

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\(^3\) A single yield curve in Euroland for private paper in euro is expected, with EURIBOR forward contracts on the shorter end and fixed leg of interest rate swaps on the longer end… a single curve enables investors to diversify their portfolios according to the issuers’ individual credit rating’. Michel Aglietta, *A Lender of Last Resort for Europe*, in *WHICH LENDER OF LAST RESORT FOR EUROPE* 36 (CAE Goodhart ed, 2000).

\(^4\) With financial integration and monetary unification in Europe, a whole range of market segments are going to blossom. They are expected to broaden the means of liquidity and risk management, making European market finance competitive with US. It can be argued that deeper and more complete markets make risk dissemination more effective and liquidity needs satisfied at lower costs. But in the meantime they hugely enlarge the number of participants who use the market for hedging and expectations arbitrage, incentives which are dependent on the speculative value rather than on the fundamental value assuming that the latter exists [citing G Gennette and H Leland, 1990, *Market Liquidity, Hedging and Crashes*, American Economic Review, December for original source]. A wider set of heterogeneous participants will increase the weight of non-fundamental behaviour when the market is under stress (chartists, trend followers, contrarians and the like). Interactions between conflicting viewpoints about immediate future price changes are what make a market suddenly more volatile and indeterminate as to the new convention which will emerge. Therefore European financial markets will be increasingly prone to multiple equilibriums of the US type. The host, of disturbances, which have arisen in various financial and derivative markets worldwide in the 1990’s, can propagate more intensely the more developed and integrated the markets are. Episodes of large increases in volatility and severe liquidity problems are likely to be with us in the years to come.’ Ibid, at 44.
safety and soundness of a 'Europeanised' banking system. Host country rules even though non-discriminatory have proved to be barriers to intra-community financial services trade. Admittedly, these host country rules are allowed to stay or even grow, as the home country control system is not a fundamental Community law principle that cannot be departed from and the 'general good' exception can provide further justifications. Besides the internal market concerns, the home country control model may not be adequate for financial stability in light of a further Europeanised banking market. Supervision cooperation will not deal effectively with the need for real-time information sharing and analysis, and it does not address Lender of Last Resort issues for illiquid pan-European credit institutions.

The necessary centralised prudential mechanism at the Community level is lacking at the moment. The European System of Central Banks (ESCB), and more precisely the ECB, is responsible for the single

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5 We use the term 'Europeanised' and 'Europeanisation' to denote the continuing process toward a pan-European banking system.

6 It could be argued that this is the case only with respect to micro-prudential functions, since the ESCB's responsibility for the payment systems, as well as its advisory and coordination role in supervision and its limited LOLR role constitute elements of macro-prudential supervision competence. See also European Central Bank, The Role of Central Banks in Prudential Supervision (Ma 2001), http://www.ecb.int/pub/pdf/prudential/prud2001.pdf. [hereinafter ECB, Role of Central Banks in Prudential Supervision] for the distinction between micro- and macro-prudential supervision: 'Macro-prudential supervision ... includes all on and off-site surveillance of the safety and soundness of individual institutions, aiming—in particular—at the protection of depositors and other retail creditors; ... macro-prudential analysis ... encompasses all activities aimed at monitoring the exposure to systemic risk and at identifying potential threats to stability arising from macroeconomic or financial market developments, and from market infrastructures'.

7 The ESCB is composed of the ECB and 15 national central banks. EC Treaty Art 107(1) (ex Art 106(1)), Art 111 of the Statute of the ESCB, annexed to the Maastricht Treaty on European Union (ESCB Statute). The ESCB lacks legal personality and it is merely 'the common roof for the joint existence of the ECB and the national central banks in a System with common principles and common rules', Chiara Zilioi and Martin Selmays, The European Central Bank, its System and its Law (first part). 2 Euredia 187, 203 (1999); Committee of Governors of the Central Banks of the Member States of the European Economic Community, Introductory Report on the Draft Statute of the European System of Central Banks and of the European Central Bank 3, 9-10 (27 Nov 1990) [hereinafter Draft ESCB Statute Introductory Report]. See also Zilioi and Selmays, at 194, for a comprehensive review of the two-level organisational structure of the ESCB as one of 'decisional centralism' (and not federalism) where the ECB has exclusive competence (that is, the subsidiarity principle will not apply) for the tasks entrusted to the ESCB and the national central banks are mere 'operating arms', 'functionally disconnected', with respect to these tasks.

8 It is the ECB (EC Treaty Arts 8 (ex Art 4a), 123 (ex Art 109)) vested with legal personality (ESCB Statute Art 9(1), EC Treaty Art 107(2) (ex Art 106)), that governs the ESCB through its decision-making bodies (EC Treaty Art 107(3) (ex Art 106), ESCB Statute Arts 8, 9(3)), the Governing Council and the Executive Board (EC Treaty Art 112 (ex Art 109a), ESCB Statute Arts 10, 11), and the General Council (EC Treaty Art 123(3), ESCB Statute Art 43). See Chiara Zilioi and Martin Selmays, The External Relations of the Euro Area: Legal
monetary policy\textsuperscript{9} and the smooth functioning of the banking system,\textsuperscript{10} but it does not have explicit supervision powers. It is only responsible for the payment systems, is entrusted with advisory and coordination role regarding supervision and it is uncertain whether it enjoys Lender of Last Resort (LOLR) status even under conditions of 'constructive ambiguity'.\textsuperscript{11}

This paper argues that the existing institutional framework may be adequate to deal with prudential concerns arising from the Europeanisation of the European markets. The adoption of minimum standards through harmonisation, the home country control principle combined with cooperation arrangements, along with the role of the European Central Bank (ECB), as guardian of the system, constitute effective prudential safeguards against a still nation-based European banking system. The success of the current system in the context of a further Europeanisation of the financial markets, depends, however, on the development of a centralised prudential mechanism at the Community level.

Under the EC Treaty,\textsuperscript{12} this centralisation is possible at the ECB level, even without activation of the so-called 'enabling clause'.\textsuperscript{13} The Treaty does not attempt to delineate the reach of the ECB's monetary policy competence and the language concerning supervision competences is rather 'soft': Monetary policy is not defined,\textsuperscript{14} and only its primary, macroeconomic,

\textit{Aspects,} 36 COMM. MKT. L. REV. 273, 284 (1999), for an accurate interpretation of Art 107(2) (ex Art 106(2)) of the EC Treaty to refer to the international legal personality of the ECB. On the character of the ECB as an independent specialized organisation of Community law see Chiara Zillioli and Martin Selmay, \textit{The European Central Bank: An Independent Specialized Organization of Community Law}, 37 COMM. MKT. L REV 591, 621 (2000). The Executive Board has the responsibility for the daily management of monetary policy in accordance with the guidelines and decisions of the Governing Council. Implementation can, and has been, be further delegated to the national central banks in their capacity as integral parts of the ESCB.

\textsuperscript{9} The basic tasks to be carried out through the ESCB shall be: to define and implement the monetary policy of the Community. ... EC Treaty Art 105(2), ESCB Statute Art 3(1).

\textsuperscript{10} EC Treaty Art 105(5), ESCB Statute Art 3(3).


\textsuperscript{13} 'The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.' EC Treaty Art 105(6). See also ESCB Statute Art 23(2).

\textsuperscript{14} Actually, clear delimitation of powers falling under monetary policy cannot be found anywhere.
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objective for price stability is mandated. So, the Treaty can be interpreted to provide for the dynamic form of the monetary policy, 'the applied monetary policy', which would include the microeconomic objective of banking stability. In addition, the Treaty language is vague and does not itself preclude expansion of ECB's supervision powers as microeconomic dimension of its monetary policy power: 'the ECB shall 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' (emphasis added) (EC Treaty Art 105(5) EC, ESCB Statute Art 3(3)). Foreign exchange policy is presented as an example of how applied monetary policy and the 'softness' of the Treaty language have allowed an expansion of ECB's competence in areas incident to its monetary policy power. We apply this further to LOLR functions.

II. BANK SUPERVISION: THE DECENTRALISATION MODEL

A. DECENTRALISATION

Essential harmonisation, mutual recognition, the home country control principle and consolidated supervision\(^\text{15}\) are the foundations for a safe and sound integrated banking system in the European Union.\(^\text{16}\) Credit institutions\(^\text{17}\) authorized in a Member country can provide services across the

\(^{15}\) For an analysis of the integration model of the EU financial system with a focus on the trade aspects, and an interesting comparison with the GATS and NAFTA liberalisation models see Joel P Trachtman, Trade In Financial Services Under GATS, NAFTA, And The EC: A Regulatory Jurisdiction Analysis, 34 COLUM. J TRANSNAT'L L 37 (1995).

\(^{16}\) This structure of banking integration and supervision has been developed through secondary legislation, which is founded upon the Community principles of freedom of establishment, the freedom to provide services and the free movement of capital. EC Treaty Art 43 (ex Art 52)–60 (ex Art 73g).

borders subject only to home country supervision.\textsuperscript{18, 19} Host Member States can (and should) rely on minimum regulation adopted by the home authorities after harmonisation,\textsuperscript{20} and can (and should) rely on home authorities’ supervision and cooperate\textsuperscript{21} with them by exchanging information and providing enforcement assistance.

\textsuperscript{18} 2000/12 Directive Preamble 14th whereas clause, Art 18, Annex I (ex 2BD Art 18(1), 2BD Annex ‘List of Activities Subject to Mutual Recognition’).

\textsuperscript{19} 2000/12 Directive Preamble 7th, 14th, 17th, 21st, 22nd whereas clauses, Art 26 (ex 2BD Preamble 4th, 10th whereas clauses, Arts 6, 13, 18–21). The host country retains its power for supervision of liquidity and monetary policy (at least for countries which remain outside the Eurosystem) as well as for gathering of statistical information. 2000/12 Directive Preamble 22nd whereas clause, Arts 27, 22 (ex 2BD Preamble 10th whereas clause, 2BD Arts 14(2), 21).

\textsuperscript{20} Pouli R Nielsen, Services and Establishment in European Community Banking Law 201 (1994).


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There is no provision, however, for a centralized supervisory institution at the Community level. The national central banks, or other entities in cases of separation of monetary and supervision powers, remain responsible for bank supervision. This applies also to the Eurosystem where only monetary policy is to be conducted by the ECB while bank supervision is still a national competence. When national central banks of Eurosystem countries are in charge of bank supervision they carry their relevant responsibilities as autonomous entities organised under national law and not as sub-divisions of the ESCB system, which is the case in the context of monetary policy.

B. Cooperation

Cooperation, bilateral or through various Community committees,\(^{22}\) is the main instrument for dealing with financial stability risks from Europeanisation of the banking systems. The national authorities, the ‘competent authorities’,\(^{23}\) are expected to cooperate in the execution of their supervision tasks, and exchange all information regarding the management and ownership of credit institutions, their authorisation and their liquidity and solvency.\(^{24}\) Bilateral cooperation has taken mostly the form of Memoranda of Understanding which provide for detailed provisions on information sharing and supervision coordination.\(^{25}\) Cooperation on a Community-wide basis takes place in the context of the Banking

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\(^{22}\) For the stand-alone, bilateral and multilateral mode of supervision in the EMU context see Tommaso Padoa-Schioppa, above n 11, at para 18. For the importance of the multilateral mode of cooperation see Interview: Tommaso Padoa-Schioppa, 4 n 1 THE FIN REGULATOR 51, 51 (1999).

\(^{23}\) ‘Competent authorities shall mean the national authorities which are empowered by law or regulation to supervise credit institutions.’ 2000/12 Directive Art 1(4) (ex 2BD Art 1(3), Consolidated Supervision Directive Art 1). The Capital Adequacy Directive requires that the competent authorities be ‘public authorities or bodies officially recognised by national law or by public authorities as part of the supervisory system in operation in the Member State concerned’. Art 9(2). See also Art 22(2) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, 1993 OJ (L141) 27 [hereinafter Investment Services Directive].

\(^{24}\) See above n 21.

\(^{25}\) For the extensive use of MOUs after the enactment of the Second Banking Directive see Tommaso Padoa–Schioppa, above n 11, at para 18. For the potential inconsistency of bilateral MOUs with the objective of a EU-wide ‘level playing field’ based on common supervision rules see René Smits, *The Community and International Contexts*, in JEAN-VICTOR LOUIS ET AL., WORKING GROUP, ECU INSTITUTE, BANKING SUPERVISION IN THE EUROPEAN COMMUNITY: INSTITUTIONAL ASPECTS 33, 39 (Report under the Chairmanship of Jean-Victor Louis, 1995). See also KAREL LANNOO, CHALLENGES TO THE STRUCTURE OF FINANCIAL SUPERVISION IN THE EU (Centre for European Policy Studies, Working Party Report No 30, July 2000), for lack of information on MOUs that it can be justified by moral hazard and liability considerations but also entails transparency concerns.
Supervisory Committee,26 the Banking Advisory Committee,27 and the Groupe de Contact (or Contact Group).28 However, these fora have only an advisory and coordinating role, and no formal rule-making or supervisory power.29

26 Originally created as the Banking Supervisory Sub-Committee of the Committee of Governors of the Central Banks of the European Community and operated as the ‘Banking Supervisory Sub-Committee’ in the context of the European Monetary Institute, the Banking Supervision Committee (BSC) is part of the structure of the ECB since 1998. The ECB, the national central banks and other supervisory authorities of the Member States (when separate from the central banks) participate in its advisory role regarding prudential regulation issues (the Commission and the Groupe de Contact can also participate as observers). The BSC contributes to the ESCB’s prudential rule-making and supervision functions and facilitates consultations among the EU banking supervisors on issues ‘outside’ the supervisory jurisdiction of the ECB. See René Smits, Banking Supervision in the Monetary Union, 1 n. 2 J. INT’L BANKING REG. 122, 126 (1999), for a discussion of the advisory role of the Banking Supervision Committee. See also Michel Aglietta, above n 3, at 53 (arguing against the ability of the Banking Supervision Committee to deal with liquidity crises).

27 The ‘Advisory Committee of the Competent Authorities of the Member States of the European Economic Community’ (Banking Advisory Committee) (First Banking Directive Art 11) was established by the First Banking Directive to ‘assist the Commission in the preparation of new proposals to the Council concerning further co-ordination in the sphere of credit institutions’ (Art 11(2)). The Banking Advisory Committee is not part of the ECB (although the ECB may participate in its meetings as observer). Its members are representatives of the Commission, supervisory authorities and Ministries of Finance. It advises the Commission on issues of prudential regulation and it assists in the implementation and technical adaptation of the EU Banking Directives. The Banking Advisory Committee itself may effect changes in technical provisions through the so-called ‘comitology’ procedure. It also examines issues arising from the application of host country rules in the ‘general good’ interest as well as bank supervision issues in relation to third countries. It should be noted that the Committee cannot deal with ‘concrete problems relating to individual credit institutions’ (emphasis added). 2000/12 Directive Art 57(3) (ex First Banking Directive Art 11(3)). Its agenda can still cover individual institutions to the extent that crises in individual institutions have an impact on the financial stability of the Eurosystem. For a comprehensive analysis of the structure and tasks of the Banking Advisory Committee see DIRECTORATE GENERAL/INTERNAL MARKET, THE EUROPEAN COMMISSION, INSTITUTIONAL ARRANGEMENTS FOR THE REGULATION AND SUPERVISION OF THE FINANCIAL SECTOR (Jan 2000), <http://www.europa.eu.int/com/mkt/sector/finances /general/index.htm> [hereinafter INSTITUTIONAL ARRANGEMENTS REPORT].

28 The Contact Group was established in 1972 as a policy forum for the discussion of supervisory issues. It is interesting that the Contact Group reviews individual cases (in confidence and without the presence of a Commission observer). Although solely an informal forum, it has often provided the basis for effective cooperation in supervision, and it is more within its structure that exchange of ideas and information about individual institutions takes place. See ibid, at 14. 2000/12 Directive Preamble 66th whereas clause (ex First Banking Directive 15th whereas clause).

29 We say formal because we argue below for a potential Basel-type informal rule-making power. Also, it should not be ignored that the Banking Advisory Committee does enjoy some rule-making power regarding ‘technical’ amendments of the banking directives in the context of the ‘comitology’ procedure.

30 It should be noted, however, that national supervisory authorities and the Commission are required to report to the Banking Advisory Committee actions on certain issues of bank supervision, in particular actions relating to third, non-EU, country jurisdictions. 2000/12 Directive Art 4, 22(9)–(10), 23(1), 24(2), 49, 52(9).
C. European Central Bank

Although the Maastricht Treaty did not adopt the proposals for prescribing prudential supervision as one of the basic tasks of the ESCB,31 it still entrusted the ESCB with significant supervision responsibilities. The ESCB has an advisory and coordinating role regarding prudential supervision, which can be expanded through acts of the Council. The Eurosystem32 is concerned with banking soundness and financial stability by contributing to the supervision policies of the ‘competent’ authorities of the Member States.33 Also, upon request or upon its own initiative the ECB may offer its advice on the ‘scope’ and ‘implementation’ of Community legislation that regards prudential supervision of banks and the financial stability.34 This advisory role extends to national legislation on issues in its field of competence. Macro-prudential concerns including matters pertaining to payment systems are within the ECB’s competence and thus the ECB’s advisory role

31 See Draft Statute of the European System of Central Banks and of the European Central Bank, No. 1669/1670 (Dec 8, 1990), AGENCIE EUROPE DOCUMENTS [hereinafter Draft ESCB Statute], Art 3 of the Draft ESCB Statute provided that one of the ESCB’s main tasks should be ‘to participate as necessary in the formulation, coordination and execution of policies relating to prudential supervision and the stability of the financial system’. See also Art 25 of the Draft ESCB Statute for the originally proposed extensive advisory and regulatory role of the ECB: ‘The ECB shall be entitled to offer advice and to be consulted on the interpretation and implementation of Community legislation relating to the prudential supervision of credit and other financial institutions and financial markets.’ Art 25(1). ‘The ECB may formulate, interpret and implement policies relating to the prudential supervision of credit and other financial institutions for which it is designated as competent supervisory authority.’ Art 25(2). On the legislative history of the ESCB provisions see René Smits, THE EUROPEAN CENTRAL BANK, INSTITUTIONAL ASPECTS 334 (1997).

32 See EUROPEAN CENTRAL BANK, ‘The Eurosystem and the European System of Central Banks’, ECB Monthly Bull, Jan 1999, at 7, <http://www.ecb.int/pub/pdf/mb199901en.pdf>, for the term Eurosystem as ‘denoting the composition in which the ESCB performs its basic tasks’ without referring to a legal person. It is merely used to reflect the integrated framework for the conduct of monetary policy comprising only the NCBs of the EMU countries. We should note that we do not cover prudential supervision issues in respect of countries with a derogation, that is countries that have not met the criteria for entry into the EMU or that have opted to stay out). For related issues see René Smits, above n 31, at 352, 359; René Smits, above n 25, at 45.

33 The ESCB shall 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.’ EC Treaty Art 105(3), ESCB Statute Art 3(3). We agree with the wide interpretation of the ESCB’s task under Art 3(3), that does not confine it to an advisory role and extends it to a coordinating role. See René Smits, above n 31, at 339. See also René Smits, above n 25, at 45.

34 The ECB may offer advice and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system.’ ESCB Statute Art 25. The ECB may also offer advice to other Community institutions, besides the Council or the Commission, as well to other national authorities, besides the ‘competent authorities’. Thus, the ECB can also provide opinions to the European Court of Justice (ECJ) or the Banking Advisory Committee. EC Treaty Art 105(4), ESCB Statute Art 4(2).
should extend to, the directly linked, micro-prudential issues of national legislation.\textsuperscript{35}

A direct supervisory task is also established for the purpose of maintaining the soundness of the payment systems.\textsuperscript{36} Finally, the ECB can undertake further direct supervisory tasks if the Council unanimously so decides upon the Commission's proposal, consultation with the ECB, and the assent of the European parliament ('enabling clause').\textsuperscript{37}

D. Reform

The European single market awaiting the intensification of its integration with the advent of the euro on 1 January 2002\textsuperscript{38} does not seem to have adequate institutional levers to deal with financial stability. It is argued that the current decentralized supervisory framework is inadequate,\textsuperscript{39, 40} and

\textsuperscript{35} EC Treaty Art 105(4), ESCB Statute Art 4. An example of exercise of relevant powers by the ECB is the opinion that the ECB submitted upon the request of the Austrian Federal Ministry of Finance regarding a draft Federal law for a new financial market supervisory authority. For its competence the ECB relied on article 105(4) of the EC Treaty, Art 3(1) of the ESCB Statute and Art 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions, as the draft Austrian law concerned "a national central bank, payment and settlement systems as well as rules applicable to financial institutions which could materially influence the stability of financial institutions and markets" (emphasis added). Opinion of the European Central Bank of 25 May 2001 at the request of the Austrian Ministry of Finance on a draft Article of the Federal law establishing and organising the financial market supervisory authority and amending the laws relating to banking, securities supervision, investment funds, equities funds, savings banks, building societies, mortgage banks, mortgage bonds, the IAPL, the stock exchange (1989), insurance supervision, motor vehicle third party liability insurance (1994), pension funds, capital markets, the Commercial Code, companies limited by shares, limited liability companies and the National Bank (1984) ([Fiscarkaufsichtsgesetz— FMAG]), CON(2001)10, also available at <https://www.ecb.int> [hereinafter ECB Opinion—Austria Reform].

\textsuperscript{36} The Treaty empowers the ECB to promote the smooth operation of the payment systems, and regulate for their efficient and sound operation. EC Treaty Art 105(2), ESCB Statute Arts 3(1), 22. See below in the text for the ECB's oversight and regulatory responsibilities over the payments system.

\textsuperscript{37} The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. EC Treaty Art 105(6), ESCB Statute Art 23(2).

\textsuperscript{38} On 1 Jan 2002 the Euro became the legal means of payment (along with the currencies of the participating Member States during the transitional period) in the Euro countries. It was already, since 1 Jan 1999, the official book money for the participating countries.

\textsuperscript{39} See Franco Brunl, The System of European Central Banks and Prudential Regulation, available at http://www.escanet.org/conferences/1bruni.htm, for an interesting analysis of the rationale of EU's opting for decentralisation of prudential regulation and supervision. Brunl considers the decentralisation model to be in 'dangerous' contrast with the more ambitious EMU objectives and he attributes it to the lack of strong political institutions in the EU.

\textsuperscript{40} The European Shadow Financial Regulatory Committee believes that the existing framework is inadequate to handle potential risks: 'Within a European context, monetary union is
that centralisation of supervision should take place. Although the existing supervision framework is considered effective, there is concern about its adequacy when Europeanisation of the banking systems proceeds further. There is a proposal for further institutionalisation of supervision coordination with more clear allocation of responsibilities,\(^41\) which should eventually be underpinned by a centralised body.\(^42\)

Our response is that the Treaty establishes adequate prudential safeguards for a sound and stable integrated banking system and that no major prompting a quantum leap in interpenetration of financial institutions and markets. These developments generate a new potential for European-wide instability while also reducing the capacity of individual member states to handle crises. Against this background, it is necessary to reassess the adequacy of home country control and existing provisions for the lender-of-last-resort.\(^3\) European Shadow Financial Regulatory Committee, EMU, The ECB and Financial Supervision, Statement No 2 (19 Oct 1998), <http://www.aei.org/shdw/shdw.htm> [hereinafter ESFRIC ON EMU]. See also Rosa Maria Lastra, Banking Regulation in the 1990s, 14 n 2 J. Int’l Banking L 43 (1999).

\(^41\) The ESFRIC proposes a more institutionalised coordination of supervisory authorities by the European Central Bank as a first step:

At present supervisory coordination is based on bilateral memoranda of understanding. However, closer market integration under EMU demands intensified cooperation between supervisors and central banks both at national and European levels. It is important that such cooperation be underpinned by a clear EU-wide agreement on a code of conduct covering supervisory responsibilities and standards in order to avoid misunderstandings, institutional rivalry, and excessive forbearance by national supervisors. The overriding objective would be to ensure that all banks, financial conglomerates and other financial institutions are adequately supervised by a lead regulator. The ECB could in this context act as a clearing house for cooperation agreements between national supervisors at EU and international levels. The coordinating mechanism should in particular make provision for the allocation of responsibilities in times of crisis. Such coordination at the European level would represent a contribution to global financial stability.

It then supports the establishment of a European-wide structure, part of the ECB or not, that will contribute to common ‘supervisory and transparency standards’, monitor financial market developments, and inform about systemic instability:

As the euro-capital market deepens and pan-European financial groups become dominant, the cooperative mechanisms will have to be supplemented by a European-wide structure. This reflects the fact that any supervisory shortcomings in a particular jurisdiction would be quickly felt in other member states. The new structure could take the form of a European Observatory of Systemic Risk which might or might not be a part of the ECB. The aim would be to ensure common supervisory and transparency standards, to monitor market developments across Europe and alert national and European authorities to exposures with a potential systemic impact. This does not imply that the new entity is given decision-making power, but it must be in position to obtain information from national authorities.

ESFRIC ON EMU, above n 40.

\(^42\) For example, the operation of a sub-committee in the context of the Banking Supervisory Committee is supported as a satisfactory institutional response. Rosa Maria Lastra, The European Central Bank as Lender of Last Resort (European Financial Forum, 1999). The creation of a European Financial Supervisory Agency and a European Liquidity Consortium is also proposed. Lorenzo Bini-Smaghi and Daniel Gros, Open Issues in European Central Banking 172 (2000).
reform, Treaty amendment or establishment of a new institution, is needed. At the current state of the internal market, establishment of a new institution will have only limited financial stability benefits, which are easily outweighed from transaction costs of institutional designing and of administration of the new institution. Benefits from possible enhanced certainty will be limited as the financial institutions retain their local (national) character by being incorporated and having their head office in a specific Member State with limited cross-border activity. In this context, close monitoring by the national authorities on a consolidated basis constitutes effective supervision. This is further supported by the fact that the European financial market in general comprises of developed financial systems with powerful regulatory structures and with a few, if any, fragile financial institutions. Of course, the integration benefits are very significant to the extent that centralisation of supervision will allow Europeanisation of the banking systems to intensify. In that case, the Treaty will allow the needed centralized supervision mechanism to develop at the ECB level. The 'enabling clause', the interdependence of price stability and banking soundness, the commonality of monetary and supervision tools, and the ambiguity of the Treaty language allow the ECB to undertake supervision functions. We first discuss why the internal market objective calls for centralisation of supervision in the EMU and why such centralisation is needed for the stability of a completed internal market. We then examine how the Treaty allows this to take place at the ECB level.

We do not deal here with the merits of the interesting proposition for a centralized mechanism served by the European Supervisory Committee. Such a development could also be helpful. The European Supervisory Committee already coordinates European banking regulators and its composition from influential European regulators can lead to a 'Basle-type' rule-making power.

1. Internal market

Centralisation of the European supervisory framework is the institutional arrangement that will contribute to further integration of the currently fragmented European banking systems and will deal effectively with subse-

43 We use here the term 'Basle-type' to denote the nature of the rule-making in the context of the Basle Committee. Despite it lacks the status of an international organisation (not established by treaty, its members are not states, its rules have no formal legal power), the Basle Committee issues regulations that are effectively legally binding due to the influential role of its member banking regulators.


45 Antonio Vicuna, ECB's General Counsel, also expresses his personal view for a revision
sequent Euro-wide systemic stability concerns. As mentioned above, the dominance of domestic financial institutions in the context of developed national financial systems does not entail Euro-wide systemic stability risks that would call for centralisation of supervisory responsibilities. Such a 'systemic stability'-led centralisation would be required in the context of Europeanised financial systems. At this stage, it is the efficiency gains of Europeanised financial markets that would call for centralisation.

Despite the establishment of the single banking licence and the substantial reduction of regulatory barriers, the European banking market remains largely fragmented. Banking business is primarily local and has not yet realized the benefits of an integrated European market. Deficiencies of

of the current supervisory framework towards centralisation if the internal market is to be realised. Antonio Sáinz de Vicuna, The ECB and Its Role in Banking Supervision, 34 n 1 INTL. LAW 117, 122 (2000).

46 Portfolio diversification opportunities, enhanced market liquidity, reduced costs and stable prices.


48 The Report on Financial Stability of the Economic and Financial Committee ('Henk-Brouwer Report') uses four criteria (cross-border establishment, mergers and acquisitions, geographical distribution of earnings and interbank claims) to assess the degree of Europeanisation and concludes that European banking activity remains primarily local. It is also reported that international interbank claims from banks located in and outside the EU, are becoming a serious source of contagion risk.

The market share of foreign branches and subsidiaries established by credit institutions domiciled in other EU countries is currently relatively small, with the exception of Belgium, Ireland and Luxembourg. . . . Cross border mergers and acquisitions—another measure of penetration in foreign markets—have thus far not taken place in the EU on a large scale . . . although there exist some regional differences. . . .

[Most of the income of the largest EU banks is generated in the home country (home country 67%, EU/EU 15%, non-Europe/EU 18%—source: Annual reports of individual credit institutions that are part of the European top 50 of The Banker, based on total assets end 1999)] [while] [more than half of this foreign income of EU banks is earned in countries outside the EU. . . .] [In the fourth quarter of 1998 international claims from banks located in the EU, on banks located outside the EU, cover 7% of the balance sheet total of the EU banking system. International claims from banks located in the EU, on banks located in the EU, cover 12% of the balance sheet total of the EU banking system—source: BIS Databank (block M), International Banking Statistics.

WORKING GROUP OF THE ECONOMIC AND FINANCIAL COMMITTEE, REPORT ON FINANCIAL STABILITY 9–10 (May 2000), <http://www.europa.eu.int/comm/economy_finance/document/ecopap/ ecp143en.htm> ('Henk-Brouwer Report') [hereinafter EFC, REPORT ON FINANCIAL STABILITY]. See also KAREL LAMNOO, FINANCIAL SUPERVISION IN EMU 59 (Centre for European Policy Studies, Brussels 1999), also available at http://www.upmfgrenoble.fr/curep/lntra/strfi/lanoo.pdf; 'According to recent data, only 4.25% of the loans and 6.2% of the liabilities of financial institutions to non-banks were cross-border in 1996 in the five largest EU countries . . . .' (citing WILLIAM R. WHITE, THE COMING TRANSFORMATION OF CONTINENTAL EUROPEAN BANKING (BIS working papers No 54, June 1998)). 'This home bias is confirmed in an analysis of balance sheets (1997) of European banks with global ambitions, such as ING, ABN-AMRO and Deutsche Bank. In each case, 50% or more of the income and profits are generated in the local market, while the European share is still limited.'
the decentralised supervisory framework seem to impede further integration of the financial markets.\textsuperscript{49}

The Second Banking Directive does not provide for a European banking licence and banks still have to comply with host country regulation in areas not covered by Community legislation. Host country measures that address legitimate regulatory considerations can be maintained, even when they restrict Community trade. Thus, the host country can still apply its own conduct of business rules on the condition that they are in the ‘general good’ interest.\textsuperscript{50} Prudential regulation also remains available for the host country to the extent not harmonised and justified by ‘general good’ considerations.\textsuperscript{51} The indeterminacy of the term ‘prudential’ and the ultimate assessment by the ECJ of what constitutes sufficient harmonisation barring host country regulation, suggest that prudential rules still fall within the jurisdiction of the host regulator. The home country control principle itself does not mark clearly the limits of host country jurisdiction\textsuperscript{52} as it does not constitute a fundamental Community law principle.\textsuperscript{53} All this results in duplication of regulatory costs and it impedes significant cross-border banking activity.

A supervisory institution with prudential rule-making power at the Community level will allow banks to expand across the borders in Europe by harmonising further supervisory rules and procedures. It will save them unnecessary duplicatory efforts to conform to different rules and supervisory processes. In addition, the common supervisory framework developed

\textsuperscript{49} See though Karel Lanno, above n 48, for other industry considerations and national biases that prevent further integration: ‘Different currencies have kept the local markets protected from foreign competition. Furthermore, a strong home bias can be noticed. Public debt is largely issued on the local market and is domestically held. Institutional investors are strongly biased towards the local market and are not internationally diversified.’ For other obstacles to the development of the internal banking market see Georgios S Zavvos, \textit{EC Financial Markets: Regulation for Stability and Openness}, in \textsc{Further Perspectives in Financial Integration in Europe} 27 (Eddy Wymeersch ed, 1994).

\textsuperscript{50} For the negative effect from the operation of the ‘general good’ doctrine on the integration of the EU financial market see Michel Tson, \textit{Unravelling the General Good Exception, The Case of Financial Services}, in \textsc{Services and Free Movement in EU Law} (Mads Andenas and Wulf-Henning Roth eds, 2003). See also Georgios S Zavvos, above n 49, at 28, for the uncertainty arising from the application of the ‘general good’ doctrine in spite of the specific criteria developed by the ECJ. It is rightly submitted that litigation is not an efficient way of sorting out issues of the financial services industry.

\textsuperscript{51} 2000/12 Directive Preamble 17th whereas clause, Arts 20(4), 22(5), 22(11) (ex 2BD Preamble 16th whereas clause, Arts 19(4), 21(5), 21(11) respectively).

\textsuperscript{52} For limitations of the home country control principle in the context of the Investment Services Directive see Eva Lonnicka, \textit{The Home Country Control Principle in The Financial Services Directives and the Case Law}, in \textsc{Services and Free Movement in EU Law} (Mads Andenas and Wulf-Henning Roth eds, 2003). See also id, for burdens on cross-border business due to the notification requirements.

and administered by a body at Community level will reduce the anti-
competitive effects of divergent regulatory systems. Banks from systems
with less stringent standards will no longer enjoy a competitive advantage.
Banks from systems with high reputation and stringent standards will not
have an easier access to capital and business markets. All banks will be
able to expand across Europe without fearing non-tariff barriers from
unfavourable regulation.

The negative effect on trade from regulatory fragmentation is acknowl-
edged by the Community institutions and policy action is contemplated. At
the moment, the Economic and Financial Committee and the Commission
work in parallel with the view of reporting on how supervision will need to
evolve in order to address banking industry developments as well as further
integration of the EU banking market. The issues in relation to the secu-
rities market have already been addressed by the Wise Men report. Further
and more efficient harmonisation is envisaged through the establishment of
a fast-track legislative process. The report proposes that general rules and
principles (framework principles) be decided in the normal EU legislative
process ('Level 1') and that technical issues be assigned to a new EU
Securities Committee ('Level 2').

This part presented the policy argument that further integration requires
centralisation of prudential supervision. It will be centralisation of supervi-
sion, and in particular of LOLR responsibilities, that will allow the sound
operation of an integrated European market. This is examined in the
following section.

54 We accept here that the case is still not clear for either ‘race for the top’ or ‘race for the
bottom’ in the context of a decentralised regulation system, and that it is also likely that
national banking regimes stay divergent with all the anti-competitive effects this might have.
In any case, further centralisation of EU banking regulation and supervision is supported in
the first place by trade and financial stability considerations. For analysis of the issues regard-
ing regulatory competition see Joel P Trachman, *International Regulatory Competition, Extern-
alization, and Jurisdiction*, 34 Harv Int'l L. J 47 (1993). See also Howell E Jackson,
*Centralization, Competition, and Privatization in Financial Regulation*, 2 Theoretical Inq L
649 (2001), for centralisation, regulatory competition, and privatisation of regulatory stan-
dards as alternative approaches to financial regulation.
55 Results of Council of Economics and Finance Ministers, Brussels, 7 May 2002—financial
services, taxation and postal services, <http://www.europa.eu.int/rapid/start/cg/guesten.
hk?p_section.gettxt=gr&doc=MEMO/02/9210RAPID&lg=EN&display=>; See
also Francesco Guerrera, *EU closer to shake-up in financial regulation*, Fin Times, 11 July
56 An EU Securities Regulators Committee with an advisory role is also proposed.
57 *Final Report of the Committee of Wise Men on the Regulation of European
finances/general/iamfalussy.pdf>.
2. Financial stability

Europeanisation of the financial markets of the Member States means stronger presence of financial institutions outside their home country, increased interbank lending across the borders (within the EU) and more intense involvement in the payment systems (due to integration of the EU capital market).

Increased cross-border activity, however, is expected to create problems for the current supervision system. Disparities in regulatory standards in combination with effective national LOLR systems encourage financial institutions to seek for more favourable to risk-taking jurisdictions.58 A Member State-based supervision system will lack the information and resources needed to assess the Euro-wide implications of illiquid (or suspected for their solvency)59 pan-European financial institutions. Although supervision by national authorities ensures accurate information and perception of local market problems, it cannot deal with Euro-wide systemic problems. Bilateral cooperation through MOUs combined with the generally described ECB coordinating role do not provide the real time information and coordination needed to detect and respond to systemic crises. Also, a decentralised system of supervision will fail to integrate adequately price stability concerns in decisions related to financial stability.60 An institution at the Community level with supervision responsibilities will be necessary to deal with potential Euro-wide systemic risk and assess the interaction between financial and monetary stability. Such a centralized supervisory body will also lead to a unified framework that will reduce regulatory arbitrage and related moral hazard problems.

A centralised supervision system will also avoid discrepancies in implementation of the Directives and their implications for depositors' protection and financial stability. In the BCCI litigation in England and France, conflicting interpretations of secondary Community law and the finding for

58 See Michel Aglietta, above n 3, at 63.
59 One of the basic principles of LOLR is to help illiquid but solvent banks. However, in the current context of developed interbank markets, banks in need of LOLR are often not merely illiquid but also subject to doubts about their solvency, which is why they cannot obtain the needed funds from other banks. In that case, the central bank remains the only source of liquidity without having the time to assess the solvency of the troubled bank. See CHARLES GOODHART, MYTHS ABOUT THE LENDER OF LAST RESORT 12 (Financial Markets Group Special Paper 120, Dec 1999), <http://cep.lse.ac.uk/fmg/publications>. The Federal Deposit Corporation Improvement Act (FDICIA) has been amended to address problems from extending LOLR to insolvent institutions. Rosa Maria Lastra, Lender of Last Resort: An International Perspective, 48 Int'l. & Comp LQ 340, 346 (1999).
60 However, it should be noted that Art 14(4) of the ESCB Statute empowers the ECB to prevent functions of the national central banks which interfere with the objectives and tasks of the ESCB. The ECB may also undertake open market and credit operations to offset any effects of liquidity operations of national central banks on price stability.
the responsible national supervisor have saved the bank supervisors’ liability costs while reducing protection for depositors. In interpreting the First Banking Directive, UK courts ruled for limited role of depositors’ protection, while French courts recognized an enhanced rationale for depositors’ protection. In both jurisdictions the result was wider application of the national law and no liability for the bank supervisor. Notably, the French courts found no liability for the French authorities by relating the damage to French depositors to the negligence of the Bank of England.61

As we argue, centralisation of supervision functions can take place in the context of the ESCB system and hence, it will not require a Treaty amendment or the creation of a new institution. The European Central Bank can assume supervision responsibilities that are compatible with its monetary policy mandate and do not conflict with democracy concerns.

III. MONETARY POLICY AND SUPERVISION

Centralisation of bank supervision in EU is possible under the Treaty, with no further legal process being necessary.62 The European Central Bank can undertake supervision functions on the basis of its monetary policy responsibility and its strict mandate for price stability. The interdependence of the objective of price stability with banking stability and the commonality of the tools employed for exercising monetary and supervision functions do allow extension of the ECB’s competences to supervision. As the Treaty does not define monetary policy or supervision and uses ambiguous terms when it comes to allocation of supervision competences there should be no legal impediment to such centralisation of the Euro-system supervision.

A. Price Stability

Price stability is the primary aim of the Community’s monetary policy and the determining concept for the ECB’s jurisdiction. The Treaty entrusts the ECB with defining and implementing the monetary policy of the Community.63 However, it does not provide a definition of monetary policy. It only prescribes price stability as the overriding objective of the ECB’s

61 For an extensive and critical analysis of the comparative and community law issues of the Three Rivers case see Mads Andenas, Liability for Supervisors and Depositors’ Rights—the BCQ and the Bank of England in the House of Lords, 3 EUEDRA 379 (2000). For the comparative law aspects see also Mads Andenas and Duncan Fairgrieve, To Supervise or to Compensate: A Comparative Study of State Liability for Negligent Banking Supervision, in JUDICIAL REVIEW IN INTERNATIONAL PERSPECTIVE 333 (Mads Andenas and Duncan Fairgrieve eds, 2000).

62 Activation of the enabling clause will not be necessary either.

63 EC Treaty 105(2), ESCB Statute 3(1).
monetary policy and it prescribes the monetary functions and operations. The Member States have agreed that price stability is the sine qua non condition for the macroeconomic success of the European Union. Economic theory and empirical documentation as informed by monetarists support that price stability has no long-term impact on growth and employment but only benefits for the economies. The theory based on the ‘expectations-augmented Phillips curve’ finds that there is no trade-off between low inflation, and employment and growth in the medium and long run. Instead, there is even a long-term positive impact of low inflation on employment and growth. Empirical evidence has showed that low level and variability of inflation due to monetary discipline by an independent central bank has no negative impact on ‘real macroeconomic performance’.

64 "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2.' EC Treaty Art 105(1), ESCB Statute Art 2. The Treaty and the statute do not provide a definition of the term price stability. It is agreed, however, that it refers to relatively stable price fluctuations. For a discussion of the price stability objective, its interpretation and checks by the European Court of Justice see RENÉ SMITS, above n 31, at 184, 186.

65 ESCB Statute Ch. IV, Arts 17–24.

66 It should be reminded that there had been an extensive debate, where France and other countries insisted on prescribing a more flexible policy objective for the ECB that would require a trade-off between inflation, growth and employment objectives. This is the case of the Fed, whereas the mandate is to pursue the optimum mix of inflation, growth and employment goals. See ROBERT ELGIE and HELEN THOMPSON, THE POLITICS OF CENTRAL BANKS 31, 32 (1998), for Fed's role in juxtaposition to Bundesbank's policy: "[W]hile the Bundesbank's overriding aim is to safeguard the currency, the Fed's responsibilities are more diverse. Section 2A of the 1977 amendment to the 1913 Federal Reserve Act states that the Fed "shall maintain long run growth of the monetary and credit aggregates commensurate with the country's long run potential to increase production, so as to promote the goals of maximum employment, stable prices, and moderate long-term interest rates" (emphasis added).

67 For the monetarist's position see TAXIARCHIS COCORES, MONETARY POLICY AND MONEY SUPPLY POLICY: THE IMPLICATIONS OF 'MONETARISM' (University of Birmingham, Series A, Economic Theory and Econometrics, Discussion Paper No 164, Dec 1973), reprinted in KΩΔ Τ. 1 ΣΠΟΥΔΑΙ 66, 75 n 36 (1979). Referring to LC Andersen (The State of the Monetarist Debate, FRB St Louis Review, Sept 1973), Cocores points out that empirical evidence is not conclusive and that the crucial factor is the relevant price expectations: '[N]o trade-off exists unless price expectations are formed in such a manner that in the long run expected price changes fully reflect actual price changes.'

68 The prevalent superiority of this economic theory is accepted here. However, there should continue to be consideration for Keynes's position that in the long run we are all dead and that even in the medium run our attitudes may change.

69 See ROBERT ELGIE and HELEN THOMPSON, above n 66, at. 17, 18.

70 Alberto Alesina and Lawrence H Summers, Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence, 25 n 2 JOURNAL OF MONEY, CREDIT AND BANKING 151, 159 (1993): "[T]he monetary discipline associated with central bank independence reduces the level and variability of inflation but does not have either large benefits or costs in terms of real macroeconomic performance."
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On this basis, a consensus has been developed about the political neutrality of the price stability objective, which allows its removal from the political debate and, its administration by an independent body, the ECB. The Treaty establishes the independence of the European Central Bank providing—among other safeguards—for protection from influence by the political authorities. Again, both economic theory and empirical evidence support that an independent central bank, uninfluenced by short-term political considerations which may distort monetary policy, the so-called time-inconsistency problem, is the most effective institutional.

71 Padoa Schioppa points that it is historical experience, which first dictates the 'vital link' between central bank independence and price stability, and that economic theory and empirical evidence have further supported this. Tommaso Padoa Schioppa, An institutional glossary of the Eurosystem, Article at the conference on 'The Constitution of the Eurosystem: the views of the EP and the ECB' (8 March 2000), <http://www.ecb.int> [hereinafter, Padoa Schioppa, An institutional glossary of the Eurosystem].

72 But see André Szász, Introductory Remarks on 50 years of the Bundesbank: Lessons for the ECB, in THE HISTORY OF THE BUNDESBANK, LESSONS FOR THE EUROPEAN CENTRAL BANK 1, 3 (Jacob de Haan ed., 2000) (mentioning acceptance of the independent status of the ECB by France as the 'price' France had to pay for formulation of monetary policy at the European level instead of monetary policy anchored to the Bundesbank's policy).

73 For such 'organic' (personal) and 'functional' (operational) safeguards see Rosa Maria Lasra, The Independence of the European System of Central Banks, 23 n 2 HARV INT'L L J 475, 482 (1992). The 'assured tenure' of the members of the Governing Council and the Executive Board, enshrined in Arts 11 and 14 of the ESCB Statute, is deemed to be an important such safeguard. See DRAFT ESCB STATUTE INTRODUCTORY REPORT, above n 7, at 5.

74 When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.' EC Treaty 108 (ex Art 7), ESCB Statute 7. For a comparison of Art 108 with the respective provision on the independence of the Commission's members, Art 213(3) (ex Art 157(2)), see Jean-Victor Louis, A Legal and Institutional Approach for Building a Monetary Union, 35 COMM. MKT L REV 33, 43 (1998).

75 The time-inconsistency problem consists in the inflation bias of the economy agents, who distrusting the monetary authority expect 'surprise inflation' and they incorporate this into their decision-making. This only leads to inflationary policies and no positive effect on growth and employment. A politically controlled monetary authority is expected to be less credible as political forces are likely to favor easing of monetary policy when there is a pressing need for short-term growth and employment gains, eg., during an elections period. In addition to the time-inconsistency problem deficiencies of monetary targeting have allegedly enhanced the rationale for independent monetary policy by central banks. CHARLES GOODHART, CENTRAL BANK INDEPENDENCE 5 (Financial Markets Group Special Paper 57, Nov 1993), <http://cep.lse.ac.uk/fmg/publications> [hereinafter GOODHART, CENTRAL BANK INDEPENDENCE].

76 For the independent central bank as the institutional vehicle (as opposed to designing the optimal monetary 'path') toward a credible monetary policy see Susanne Lohmann, The Dark Side Of European Monetary Union, in THE EUROPEAN CENTRAL BANK, HOW ACCOUNTABLE? HOW DECENTRALIZED? 15, 19 (Ellen E Meade ed, American Institute for Contemporary German Studies, The Johns Hopkins University, Economic Studies Program, Conference Report No 4, 1999).
mechanism toward low inflation and long term growth.\textsuperscript{77} Economic theory suggests that a rule-based monetary system\textsuperscript{78} run\textsuperscript{79} by an independent central bank can produce low inflation. Empirical evidence shows that there is positive correlation between central bank independence and low inflation,\textsuperscript{80} and in some cases positive growth.\textsuperscript{81}

It is the interdependence of banking stability with price stability that allows the ECB to extend its competences over supervision functions.

B. DEFAULT SUPERVISION OF CENTRAL BANKS

Functional or geographical separation of monetary and supervision powers does not mean no prudential supervision power for the central bank. The central bank always retains a significant, in the worst case residual, supervision responsibility. In the case of functional separation the relevant functions of the national central banks are a case in point. Even when there is a separate agency in charge of bank supervision, the central bank can undertake supervision tasks as these are indispensable to its monetary policy power. Macro-prudential supervision, that is supervision with the view of safeguarding systemic stability, is important for the attainment of the, most of the time, primary monetary objective of price stability. And as micro-prudential supervision, that is first line supervision for the protection of depositors, is intertwined with macro-prudential supervision\textsuperscript{82} it can also fall within the monetary policy function. The central banks’ monetary tools may contribute to the effective exercise of such supervision functions.

\textsuperscript{77} There can also be pure political considerations for assigning monetary policy to an independent central bank. Politicians might favor central bank independence so that they avoid the costs of anti-inflationary policies (while enjoying the benefits of stable prices) and dealing with conflicting preferences of the financial markets and, workers and manufacturers. Politicians will also be concerned about the complexities of monetary issues, especially in the current regime of deregulation, capital liberalisation and fluctuating exchange rates. \textsc{Robert Elgie and Helen Thompson}, above n 66, at 144, 21-2.

\textsuperscript{78} \textsc{Robert J Barro and David B Gordon}, \textit{Rules, discretion and reputation in a model of monetary policy}, 12 J MONETARY ECONOMICS 101 (1983).

\textsuperscript{79} See \textsc{Robert Elgie and Helen Thompson}, above n 66, at 18, for the influence of work on political business cycles.


\textsuperscript{82} See ECB, \textit{ROLE OF CENTRAL BANKS IN PRUDENTIAL SUPERVISION, above n 6, for the distinction between micro- and macro-prudential supervision.}
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The same applies also in case of geographical separation. This is the case of the Eurosystem where monetary policy constitutes a Community competence while supervision remains within the jurisdiction of the national authorities. The ESCB can extend its limited supervision responsibility for both macro- and micro-prudential purposes on the basis of its monetary competence and its monetary tools.

We demonstrate below how both macro- and micro-supervision functions of a central bank can develop on the basis of the interdependence of the price stability and banking soundness, and through the conduct of monetary operations. We do not say that the central bank should undertake both macro- and micro-supervision functions. Our purpose is only to show that in such expansion of the central bank powers legal or factual obstacles may not be that serious. And that only macro-prudential supervision should be clearly allocated to the central bank without transfusing into the micro-prudential jurisdiction of the bank regulator. This should happen for both efficiency and accountability reasons.

C. Price Stability and Supervision

Bank supervision cannot but be considered as a function of monetary policy. Both the interdependence of the banking soundness (bank supervision) and the price stability (monetary policy) as well as the commonality of tools and objectives for their attainment, lend support to a concept of ‘applied monetary policy’ that encompasses core monetary policy (policy in pursuit of price stability) and all powers incident to it e.g. bank supervision, foreign exchange policy.

The interdependence of banking soundness and price stability is demonstrated by the importance of a sound banking system for the effectiveness of monetary policy actions and by the effect of monetary policy on banking soundness. First, an inefficient and unstable banking system can distort monetary policy decisions through incorrect translation of the respective signals in the balance sheets of the banks. Subsequently, the economy may not respond appropriately to monetary policy moves. Distortions in allocation of credit are also likely. Secondly, an ailing banking system will likely need extra liquidity support, which can endanger price stability. Thirdly, monetary policy decisions may affect the sound operation of banks. For example, an increase in interest rates dictated by inflationary pressures in the economy can negatively affect earnings or liquidity of banks. Depositors will demand higher returns and borrowers will have increased difficulty in repaying their loans.83

83 Manuel Gutián presents an interesting analysis of the interdependence of banking soundness and price stability. Actually, he treats banking soundness as part of the central bank's
This interdependence shows that the possible conflicts between monetary policy and banking supervision objectives are by no means resolved by assigning monetary and supervision functions to separate bodies. Effective monetary policy has to take into account the conditions of the banking system as banking soundness is a variable of price stability. For example, in the case of an interest rate decision under conditions of inflationary pressures and weak banking systems there is no conflict between monetary and supervision functions but only an ‘intertemporal’ trade-off which the monetary authority has to conduct in any case, having supervision powers or not. The monetary authority will have to consider how an increase in the interest rates will address inflation concerns without endan-

monetary management and this solely on the basis of the interdependence of banking soundness and price stability:

In common with other policy areas, monetary policy management has a macroeconomic, as well as a microeconomic dimension. Attention must be paid to both if monetary policy objectives are to be not only attained but also maintained. The ample literature on monetary policy and central banking has largely focused on the macroeconomic objective of stability in the value of the national currency, which is increasingly seen as equivalent to domestic price level stability. Systemic bank soundness is now seen as a component of monetary management, as a complement to macroeconomic policy in general, and as a policy objective in its own right for the pursuit of economic balance and stability. To put it cryptically, sound money and sound banking go hand in hand.

Manuel Gutián, Banking Soundness: The Other Dimension of Monetary Policy, in Banking Soundness and Monetary Policy, Issues and Experiences in the Global Economy 47, 44, 58 (Charles Enoch and John H. Green, eds, 1997). The same interdependence is argued between banking soundness and exchange rate stability. Ibid, at 48.


85 See also Rent Smits, above n 31, at 325, for institutional arrangements within a central bank eg ‘Chinese walls’, which in any case could isolate possible conflicting considerations of monetary policy and supervision.

86 In light of this interdependence of banking soundness and price stability, we find that the following statement by Padoa Schioppa, Member of the ECB Executive Board, is an oxymoron: ‘My remarks should also not be interpreted as implying that financial stability considerations should normally influence monetary policy-making. The ECB is focused on maintaining price stability and neither the Treaty allows it nor is it inclined by its own convictions to change its focus.’ Tommaso Padoa-Schioppa, Securities and banking: bridges and walls, Lecture at the London School of Economics, London (21 Jan 2002), <http://www.ecb.int/key/02/sp020221.pdf>.

87 Conflicts between the aims of price stability and bank soundness may be more apparent than real in that they entail basically an intertemporal trade-off; this is the choice of price stability today, for example, strict pursuit of this goal without regard to its consequences for the banking sector, versus price stability tomorrow, or the specific concern for the macroeconomic consequences of a systemic banking failure. The former approach risks tomorrow’s stable price level in favor of today’s; the latter, in contrast, risks today’s for tomorrow’s.

Manuel Gutián, above n 83, at 72.
1. Distorted separation of monetary and supervision powers

But even in case of theoretical objections to extending monetary management to banking soundness, arguments in favor of separating monetary and supervision powers are valid only in theory in relation to the benefits to supervision policies, as such separation can only be 'distorted': monetary and supervision powers cannot be separated in practice. The Bundesbank model demonstrates this 'distorted separation' of central banking and bank supervision. The Bundesbank is formally deprived of any supervisory responsibility. Still, it is the Bundesbank that effectively exercises supervisory power through close cooperation with the supervisory authority, the Federal Banking Supervisory Office.

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88 For arguments against separation, see Charles AE Goodhart and Dick Schoenmaker, above n 64, at 345. See also ibid, at 360, Appendix 1A, for the allocation of monetary and supervision powers in various jurisdictions. See Johannes Priesemann, Policy Options for Prudential Supervision in Stage Three of Monetary Union, in Banking, International Capital Flows and Growth in Europe 81, 83–4 (Paul J J Welfens and Holger C Wolf, eds, 1997), for a summary of arguments in favor (supervision is 'natural extension' of central banking, economies of scope, efficient use of information, supervisory information needed for LOR, supervision of participants important for payment system oversight) and against (conflict of interest, failure's impact on credibility of central bank, concentration of power, independent character of central bank) combination of monetary and supervision powers. See also Rosa Maria Lastra, above n 80, at 148–56. See also ECB, Role of Central Banks in Prudential Supervision, above n 6, for arguments in favor of prudential supervision by the central bank: (1) information-related synergies between supervision and core central banking functions; (2) focus on systemic risk; and (3) independence and technical expertise', and arguments in favor of supervision by a separate, single agency: (1) the potential for conflicts of interest between supervision and monetary policy, and moral hazard; (2) the tendency towards conglomeration and the blurring of the distinctions between financial products and intermediaries; and (3) the need to avoid an excessive concentration of power in the central bank. The European Central Bank supports that the case for supervision by the central banks becomes stronger in the Euro area due to the unique combination of the Eurosystem's monetary responsibilities with the supervisory competences of the national central banks (NCBs) as autonomous national entities, and the ability for their 'reinforced cooperation' at a Euro-wide level. Only the NCBs can coordinate effectively their supervision functions at a Euro-wide level to deal with Euro area problems as the NCBs besides being national entities are also organs of the Eurosystem, arms of the ECB with regard to monetary policy competences. We do agree with the argumentation in favor of prudential supervision by the central banks, and even more so in the context of the Eurosystem, but we also argue that a more clear attribution of supervision powers to the Eurosystem, possible under the EC Treaty, should take place for efficiency and accountability reasons.

89 Even in case of less important supervision tasks like the collection of supervision information it is Bundesbank officials that will perform these tasks for the Bank Supervisory Office. Alessandro Prati and Garry J. Schinasi, Financial Stability in European and Economic Monetary Union, in Which Lender of Last Resort for Europe 71, 100 n 32 (CAE. Goodhart, ed, 2000).

Section 7 of the German Banking Act requires that 'the Deutsches Bundesbank and the Federal Banking Supervisory Office shall communicate to each other any observations and
Our argument goes beyond the proposition that banking soundness is part of the monetary management, which taken along with arguments for combining monetary and supervision functions and 'distorted separation' in practice means delegation of supervision responsibilities to the central bank. We support that the tools and considerations for banking soundness overlap with those for price stability, and that bank supervision is incident to monetary policy. In any case monetary policy transposes over bank supervision, mainly macro-prudential supervision. A more clear assignment of certain supervision competences to the central bank is proposed for both efficiency and accountability purposes.

2. Commonality of tools

The central bank can and exercises de facto supervision while performing its monetary tasks. Open market and credit operations result in an intense interaction of the central bank with the bank counterparties which allows

findings which may be of significance for the performance of their respective functions. The Bundesbank specifies in one of its publications that 'the Supervisory Office, which has no branches of its own, takes advantage of the Bundesbank's familiarity with local conditions and its relevant expertise. There is a mutual exchange of information, which may be significant for the discharge of the duties each institution has to perform. (emphasis added)


Much is made of the independence of the Bundesbank and its separation from banking supervision, which is conducted by the Aufsichtsamt in Berlin. But the facts do not fit the perfection. Although the Aufsichtsamt authorizes and regulates banks, its decisions are made after consultation with the Bundesbank and prudential policies are jointly agreed. Even more important, certain inspections of the authorized banks are conducted by Bundesbank employees working at Landeszentralbanken. The Bundesbank is therefore directly and immediately-and I emphasize both words-in possession of all information it needs to discharge its responsibilities for the stability of the currency.


One example that is frequently used by those that believe that central banks in foreign countries are not involved in supervision is the Bundesbank. The facts are quite the contrary: the Bundesbank has more supervisory staff than the German Federal Banking Supervisory Office, reviews the auditors' reports before the Banking Supervisory Office receives them, and has veto power over certain liquidity and capital regulations of that office.

Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, United States Senate (2 Mar 1994).

90 Without going that far, Padua-Schioppa confirms the strong involvement of the central banks with the banking system even when a separate regulator is in charge of supervision: 'In all systems, however, whether or not it has the task of supervising the banks, the central bank is deeply involved with the banking system precisely because the banks are primary creators of money, providers of payment services, managers of the stock of savings and counterparties of central bank operations.' Tommaso Padua-Schioppa, above n 11, at para 4.
the central bank both to evaluate effectively the financial standing of the banks and conduct first line supervision eg make recommendations, issue warnings, effect changes through its influence. In this context, the central bank can also develop a macro-prudential role by intervening in case of serious liquidity problems. It can do this through open market operations, mainly in the case of general liquidity problems, or credit operations with banks under serious liquidity distress. Responsibility for gathering statistical information is another monetary tool that a central bank could use for supervision purposes. Statistical information provides significant insight in the banks' operations and it can be used for timely supervisory action. Minimum reserves can also be used to deal with financial stability problems, both systemic and individual. Their temporary reduction will help the credit institution to overcome liquidity problems or deal with liquidity strains of a tight monetary policy.

D. ECB AND PRUDENTIAL SUPERVISION

1. Commonality of tools

The ECB's monetary policy competence can also encompass similar prudential supervision tasks. Its power to conduct open market operations and credit operations with individual credit institutions on the basis of adequate collaterals91 means that the ECB can also act as LOLR in case of both systemic and individual liquidity crises. The ECB can also exercise micro-prudential supervision while collecting statistical information.92 It can evaluate the financial condition of credit institutions and recommend or effect changes. It can also promote the internal market by harmonising the relevant rules and practices,93 which means reduction of duplicatory costs and more equal competitive conditions.

2. Legal basis

Art. 105(6)
The Treaty provides explicitly for expansion of the ECB's supervision competence. The Council can activate the enabling clause and entrust the ECB with responsibility for prudential supervision.94 Additional responsibility could also include prudential rule-making with positive effect on further integration. Although Article 105(6) of the Treaty refers only to prudential supervision policies,95 the Treaty does not seem to employ a systematic distinction between regulation and supervision. That viewed in

91 ESCB Statute Art 17, 18. 92 ESCB Statute Art 5.
93 ESCB Statute Art 5(3). 94 EC Treaty Art 105(6), ESCB Statute Art 25(2).
95 'The Council may . . . confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions . . .' (emphasis added). EC Treaty Art 105(6) EC. See also Art 25(2) ESCB.
the more general context of blurred boundaries between prudential regulation and supervision.\(^{96}\) Tasks concerning prudential supervision policies can be interpreted to cover regulatory power. Such an interpretation can be further supported by the 'softness' of the expression of article 105(6) (Article 25(2) ESCB Statute): 'tasks concerning', 'policies', 'relating', 'to the prudential\(^{97}\) supervision' (emphasis added). Prudential rule-making will allow further harmonisation of prudential and conduct of business rules and hence reduce duplicatory regulatory costs and level the playing field.

It is argued that the 'unanimity' requirement for the Council's action is another indication of the current regime's inadequacy. Although we agree that this makes activation of the enabling clause unlikely at present, it is important that the possibility exists for the Council to act and that centralisation of prudential supervision tasks at the ECB level will be possible without recourse to the political hurdles and transaction costs of a Treaty amendment. Unanimity should not be difficult to achieve when the policy considerations are strongly in favour of further centralisation.

In activation of the enabling clause there should be no subsidiarity\(^{98}\) concerns. The subsidiarity principle should not apply here, since the

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\(^{96}\) Brian Quinn sees the distinction between regulation and supervision but he also recognizes that this 'distinction can become grey at the edges' (emphasis added). Brian Quinn, Rules \& Discretion: the case of banking supervision in the light of the debate on monetary policy, in The Emerging Framework of Financial Regulation 119, 127 (CAE Goodhart, ed., 1998).

\(^{97}\) In contrast to its significance for the effectiveness of banking rules and its wide use, the concept of prudential regulation and supervision still awaits its clarification. The General Agreement on Trade in Services (GATS) goes as far as to address systemic stability concerns only through a 'prudential' concerns exception to GATS market-opening commitments. See Lazaros E. Panourgias, Institutional Anarchy and the Stability of the International Banking System, 10 n 1–2 EUN BUS L REV 47 (1999), for GATS implications for financial stability due to the ambiguity of the prudential exception effect. For a critical analysis of the indeterminacy of the 'prudential' term in the context of Community law see Mads Andenas and Christos Hadjiemmanuil, below n 103, at 403. Our perception of the concept encompasses all rules that pertain to the safety and soundness of the financial system. It will definitely include licensing, vetting of managers and shareholders, solvency and liquidity requirements. It will also include lender of last resort and payment system rules. But cf Johannes Priesemann, above n 88, at 82, 83. Priesemann considers the lender of last resort function as part of monetary management, and distinguishes payment systems from prudential supervision.


Just as it is gravely wrong to take from individuals what they can accomplish by their own initiative and industry and give it to the community, so also it is an injustice and at the same time a grave evil and disturbance of right order to assign to a greater and higher association what lesser and subordinate organizations can do. For every social activity ought of its very nature to furnish help to the members of the body social, and never destroy and absorb them (emphasis added).
Community enjoys exclusive competence in allocation of prudential supervision tasks. In still, the enabling clause can be interpreted that it operates at the constitutional level, where subsidiarity always applies as a guiding principle of the Community design. In this case, subsidiarity concerns will be alleviated due to the deficiencies of the current system. Inadequacy of decentralised supervision to lead to integration of the financial systems and deal with the risks of the single financial market could enhance the justifications for transferring supervisory responsibilities at the community level.

99 'In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity. . . .', EC Treaty Art 5 (ex Art 3b). See also Stephen Weatherill, below n 110, at 27, for the weakness of the subsidiarity principle even when applicable: 'Whatever is its political impact, Article 3b is not the legal rule which will, at last, provide a brake on expanding Community competence.'

100 There is no legal basis for the operation of subsidiarity at the constitutional level of the Community.

101 It should be noted that the very criteria of the subsidiarity principle, that is the proportionality requirements, also apply to the measures adopted by the Community. In our case the Council has exclusive competence to activate the enabling clause and entrust the ECB with further prudential tasks, but the entrusted prudential tasks must be necessary for the achievement of the internal market and financial stability objectives sought. For the operation of the proportionality principle in determining the Community competences (as the very criterion of the subsidiarity principle) and in determining the legitimacy of Community actions see John A. Usher, General Principles of EC Law 37 (1998).

102 Cf Franco Bruni, above n 39 (arguing for the need to adopt a 'deeper prudential policy of subsidiarity' in the context of the EMU):

Monetary unification requires a deeper prudential principle of subsidiarity for various reasons. First of all, the risk of contagion is higher when a crisis develops in a banking area where a single currency is used. When the currency becomes the same, international payments and deposit connections increase, and it is more probable that a systemic crisis or a panic will be able to cross national borders. Consider also the problem of moral hazard of financial intermediaries. With monetary unification, for each intermediary it is easier to conceal its own specific risk and the risk associated with its home country, under the veil of the single, large international money market: in the latter there is more asymmetry of information and moral hazard is therefore a more serious issue. As we know, moral hazard also depends on the amount of explicit or implicit insurance supplied to the intermediaries by the authorities. With monetary unification national authorities are prevented from bailing out their banks using domestically produced seigniorage. This would cause a lower implicit insurance. But a stronger force would create implicit insurance of national authorities with the ECB, asking for centrally financed bail-outs, 'shifting the cost of insolvent financial intermediaries to the rest of the Community' [citing A. Giovannini, Central Banking in a Monetary Union, 29 Carnegie-Rochester Conference, first draft, mimeo (April 1992)] and interfering with the common design of monetary policy. Implicit reinsurance would also cause a net increase in moral hazard after currency unification.

He also interestingly calls the existing harmonisation process a 'textbook application of the principle of subsidiarity'.

103 See also Mads Andenas and Christos Hadjimannouil, Banking Supervision, The Internal Market and European Monetary Union, in European Economic and Monetary Union: The Institutional Framework 373 (Mads Andenas et al, eds, 1997), for the unanimity condition as a device toward eliminating subsidiarity concerns.
Monetary policy and 'Implied powers' doctrine—Article 105(5)

Expansion of the ECB’s supervision powers can find a legal basis in the ECB’s monetary competence and the Treaty provisions on prudential supervision. The Community law doctrine of ‘implied powers’ may also apply.

Monetary policy is strictly defined only in relation to its primary objective and its tools, and the interdependence of banking soundness and price stability establishes the ‘inseparable link’ between monetary policy and prudential supervision. This invokes application of the Community law doctrine of ‘implied powers’. The ‘implied powers’ doctrine provides that the Community has not only competence which is express consequence of specific Treaty provisions but also competence that is implied from them. The ‘implied power’ doctrine also applies to the ECB, which is ‘in the constellation of the EC legal order’ and ‘fully subject to the principles of primary Community law and to the jurisdiction of the ECP’. Thus, the ECB can exercise only powers, which are conferred upon it by the Treaty, being explicitly entrusted by or implied from. Supervision powers may be exercised by the ECB not only to the extent that they are specifically prescribed in the Treaty but also to the degree that they intertwine with the ECB’s monetary policy competence.

Also, Article 105(5) of the Treaty (Article 3(3) ESCB Statute) prescribes explicitly the ECB’s responsibility to contribute to the smooth conduct of national policies relating to prudential supervision and financial stability, and this should be interpreted to cover the supervision functions described above. The ambiguity of the terms used and the importance of prudential supervision for monetary policy suggest against reading any restrictions on possible ECB supervision functions. Finally, it is interesting that Article 18(1) of the ESCB Statute does not confine open market and credit operations to monetary policy. Although it is placed under Chapter IV on monetary functions and operations of the ESCB, it prescribes open market and credit operations for the attainment of the ESCB’s objectives and tasks.

We do not ignore that the Maastricht Treaty expressly provides that further prudential tasks by the ECB are possible only upon the activation of the enabling clause by the Council. Yet, it is unclear what the prudential

104 EC Treaty Arts 5 (ex Art 3b), 7(1) (ex Art 4).
105 ‘It follows from Article 3b [currently Art 5] of the Treaty, which states that the Community is to act within the limits of the powers conferred upon it by the Treaty and of the objectives assigned to it therein, that it has only those powers which have been conferred upon it. . . . The Community acts ordinarily on the basis of specific powers which, as the Court has held, are not necessarily the express consequence of specific provisions of the Treaty but may also be implied from them.’ Opinion 2/94, Opinion of the Court of 28 Mar 26 delivered pursuant to Art 228 of the EC Treaty, 1996 ECR 1-1759, 1787.
106 Jean-Victor Louis, above n 74, at 73.
107 Chiara Zillioli and Martin Selmayr, above n 8, at 623.
108 EC Treaty Art 8 (ex Art 4a).
tasks are that only the Council can further confer. It is unclear where we
draw the line between prudential tasks already allocated to the ECB and
prudential tasks conferred only by the Council. It is in that regard that the
'implied powers' doctrine may operate to strengthen the legality of addi-
tional prudential supervision tasks irrespective of the enabling clause.

Inconsistent interpretations of relevant Treaty provisions demonstrate
the problems with determining the reach of competences on the basis of
ambiguous Treaty language. The role of the ECB under Article 105(5) of
the Treaty (Article 3(3) ESCB Statute) to contribute to the smooth conduct
of national policies relating to prudential supervision and financial stability
is interpreted as to exclude any direct supervisory function of the ECB and
to allow only a limited coordinating role. Instead, Article 105(2) of the EC
Treaty (ESCB Statute Art. 3(1)) is interpreted to confer upon the ECB over-
sight competence for the payment systems despite its wording not
drafted that different from that of Article 105(5): 'The basic tasks to be
carried out through the ESCB shall be to promote the smooth operation
of payment systems'. The wording of Article 105(2) suggests that the
ECB's power of overseeing the payment systems is a concurrent com-
petence, shared with the national central banks as autonomous national enti-
ties. Interestingly, views in the ECB leave room for considering the ECB's
oversight competence as exclusive.

110 EC Treaty Art 105 (2), ESCB Statute Art 3 (1), but cf. Maria Chiara Malagutti, The
oversight responsibilities on central banking practice, as developed after reports of the Bank
of International Settlements (the Lamfalussy Report in particular), rather than on a 'clear
and indisputable interpretation' of Art 105 EC Treaty). She also argues that the ECB will likely
share responsibilities with the national central banks only in case its power derives from
general central bank practice and not solely from the Treaty. This argument does not take into
account that the Treaty, even when the sole source of power, can still, as in this case, provide
for concurrent competences which means that the ECB will share power with the national
central banks.

111 Even according to the broad view of 'exclusive competence', language is sufficient to
conclude for shared competence in areas covered by the Single European Act and the
Maastricht Treaty. AG Toch, A Legal Analysis of Subsidiarity, in Legal Issues of the
Maastricht Treaty 37, 41 (David O’Keeffe and Patrick M. Twomey, eds, 1994). Of course,
recourse to language is not even necessary in the context of the narrow view of exclusive
competence. According to the narrow view, Community competence remains shared until it
has been exercised. Josep Steinmetz, Subsidiarity under the Maastricht Treaty, in Legal Issues of
the Maastricht Treaty 49, 54 (David O’Keeffe and Patrick M Twomey, eds, 1994). See
Stephen Weatherill, Beyond Preemption? Shared Competence and Constitutional Change in
the European Community, in Legal Issues of the Maastricht Treaty 13, 16 (David O’
Keeffe and Patrick M Twomey, eds, 1994), for criticism on the preemption doctrine and the
need for shared competence. See also Nicolas Bernard, The Future of European Economic Law
in the Light of the Principle of Subsidiarity, COMM MKT L REV 633, 655–64 (1996), for exclusive
competences 'a priori' and by preemption.

112 An ECB paper submits that decentralisation (ESCB competence allocated in line with the
subsidiarity principle), applies to the implementation of common payment system oversight
policy while the subsidiarity principle (shared competence exercised on the basis of subsidiar-
ity) applies to areas not falling within the common oversight policy: 'In line with the provi-
Irrespective of the character, shared or exclusive, of the ECB's oversight power over the payment systems, it is important that its competence is founded upon language, which is used to exclude other prudential functions from the ECB's competence.

sions of the Treaty and Statute, the Governing Council ... determines the objectives and core principles of a common Eurosystem oversight policy in those cases where the functioning of payment systems may affect: the implementation of monetary policy; systemic stability; the establishment of a level-playing field between market participants; cross-border payments within the EU and within other countries. ... In line with the principle of subsidiarity, in areas not specifically covered by the common oversight policy, policies defined at the NCB level apply within the framework of the objectives and the core principles defined at the Eurosystem level, in relation to which the Governing Council can always take an initiative where necessary.' European Central Bank, Role of the Eurosystem in the Field of Payment Systems Oversight 2, 3 (June 2000), <http://www.ecb.int/pub/pdf/paysysover.pdf>. This position is reaffirmed by Padova-Schiopfa in a reference to this ECB paper. However, Padova-Schiopfa proceeds to state that payment system oversight has 'clearly been entrusted to the Eurosystem' (emphasis added), and hence, decentralisation, and not subsidiarity, is the 'modality' that governs the exercise of these powers. Tommaso Padova-Schiopfa, Domestic payments in Euroland: commercial and central bank money, Speech at the European Commission Round-Table 'Establishing a Single Payment Area: State of Play and Next Steps', Brussels (9 Nov 2000), <http://www.ecb.int>. This is interesting. Views in the ECB leave room for the exclusive character of the ECB's payment systems oversight power and the legal basis for this is a provision that is not drafted any different from the provision for prudential supervision (Art 105(5), ESCB Statute Art 3(3)), when Art 105(5) is interpreted to establish only a limited coordinating role. An explanation for this could be that there is no clear distinction between regulation of payment systems (for which an exclusive competence of the ECB is provided) and their oversight. It might also be relevant that both regulation and oversight have traditionally relied on non-statutory rules, on 'moral persuasion'. But how different is it in the case of regulation and supervision of individual credit institutions? With regard to bank regulation and supervision we argue that similar ECB tasks should be read in the Treaty. As for the payment systems oversight, our position is that the Treaty gives the ECB only a shared competence. The language used by the Statute clearly suggests a concurrent competence and the subsidiarity principle should apply. We accept an exclusive competence only to the extent that the oversight act also aims toward the realisation of the internal market. See AG Toth, above n 110, at 41, for the exclusive character of the Community competence in the areas of health, safety, environment and consumer protection when connected with the internal market. In this case, however, the internal market dimension of this ECB competence needs to be closely associated with the smooth operation of the payment systems because otherwise it will be in conflict with the Community's competence for the single market. See René Smits, above n 31, at 303. See also Chiara Zilloli and Martin Selmayr, above n 8, at 634–6, for a comprehensive reference to this 'horizontal' conflict and its difference from 'vertical conflicts of competence' between the Communities or the ECB and, the Member States. Here, we face the 'soft' nature of the relevant provisions since it will be difficult to delineate the boundaries between pure internal market measures and payment systems measures with internal market implications. See A. G. Toth, above n 110, at 42. Finally, we should underscore that, since the Treaty lacks a determination of the areas which are within the exclusive competence of the Community, the relevant Treaty provisions will retain a 'soft' character until the ECJ provides for more guidance. See also Paul Craig and Gráinne de Búrca, EU Law, Text, Cases and Materials 124 (2d edn 1998). The problem will be more accentuated in the context of the monetary union. First, because most of the provisions are formulated in a vague manner, eg, 'to promote the smooth operation of payment systems', '[t]he ESCB shall 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' (emphasis added). Second, because of the powerful effect of monetary policy, which is exclusively entrusted to the Eurosystem. The
Monetary Policy and Bank Supervision

Again, this exercise in concepts clarification purports to show only that there might not be significant legal or institutional obstacles in ECB’s expansion of supervision competence. And this is necessary for the system to be efficient and accountable. A recognition of the ECB’s supervision responsibility will make it accountable for any supervision malfunction. A clarification of the real supervision competence of the ECB should lead in building the necessary capability and ensuring efficient supervision of the integrated EU banking system. This is important to happen mainly with regard to macro-prudential supervision functions. Micro-prudential supervision, although intertwined with macro-prudential supervision, should remain in the hands of the bank regulator while strong cooperation with the central bank is further institutionalized.

3. Efficiency and Accountability

Efficiency and accountability is strengthened when there is clear delineation of a central bank’s supervision responsibilities. There is more efficient planning, duplicatory costs of the regulatees are avoided and market certainty is enhanced. Also, when a central bank is not formally responsible there can be a negative impact on the sum of monetary and supervision benefits. There is a risk that the central bank will handle conflicts of monetary and supervision policies at the expense of supervision objectives. It is likely that the central bank will give priority to its monetary function, although independent, its reputation depends on (and its accountability relates to) the effectiveness of its monetary policy. On the contrary, formal responsibility for supervision will lead to a more efficient trade-off between monetary and supervision policies. The central bank will then be forced to seek optimisation of monetary and supervision benefits since its reputation will depend on both, and it will be accountable for both. The central bank will also be accountable for the conduct of its supervision powers.

competence to exercise monetary policy being interdependent with the competence to regulate and supervise individual financial institutions and systems (payment systems) could encompass the latter on the basis of the ‘implied powers’ doctrine. It could also support their exclusive character due to their strong interdependence (their exclusive character could also be derived from the close link of the payment systems and the financial stability with the realisation of the internal market—this will come into play, however, only after the existence of a power at all has been established either explicitly by the Treaty or implicitly through the effect of the monetary policy).


113 For example, see Charles A E Goodhart and Dirk Schoenmaker, above n 84, at 356 (stating the importance that the closing of a bank (macro-prudential function) can have for the macro-prudential regulator).
This will apply in case of the potential centralisation of supervisory competences at the EU level. The sum of monetary and supervision benefits will be higher if the European Central Bank has formal responsibility for its part of supervision functions. Formal responsibility will create reputation constraints (added to accountability constraints), which in turn will lead to an efficient trade-off of monetary and supervision objectives. And, the ECB will be accountable for any conduct of supervision powers.

The negative effect on supervision considerations from the absence of formal supervision responsibility of the central bank can be demonstrated by examining a supervisory function with monetary implications. The LOLR that is based on the use of taxpayer’s money is such a supervisory function. According to Goodhart’s argument that ‘he who pays the piper, calls the tune’, LOLR should be performed by the institution that provides the money in crises. If it is mostly taxpayer’s money used in liquidity crises, since bank’s reserves will be most of the time inadequate, then an agency, and in fact a ‘quasi-autonomous body’, should be entrusted with LOLR responsibilities. Here, we are faced with an LOLR category that is not within the power of the central bank. This LOLR category constitutes a supervisory responsibility with monetary implications that is outside the formal power of the central bank. In this case, the issue of distorted separation comes into play. The central bank, as the only source of immediate funding, will exercise actual supervision and affect the LOLR decision without formal responsibility. This will be at the expense of the supervision function, since monetary policy remains its responsibility and its priority. The use of taxpayer’s money affects (debatable) the monetary base and the central bank will influence the LOLR decision accordingly.

More efficient supervision in the EU enhances financial stability, which in turn solidifies the continuing integration. It allows the integrated market to function smoothly and prevents stability problems to reintroduce fragmentation. But before helping the functioning of a fully internal market, more efficient supervision contributes to the process towards integration. For example, financial stability-driven objections of the national regulator

114 In case of monetary functions with supervision implications, as an interest rate increase, the issue of formal responsibility does not matter. Irrespective of its supervision responsibility, the Central Bank will not be hindered to give priority to monetary policy. This is consistent with our argument that banking soundness is a variable of monetary management.

115 See Charles AE Goodhart and Dirk Schoenmaker, above n 84, at 357.

116 Ibid. ‘While the Government may, therefore, feel impelled to take ultimate responsibility, it too is likely to delegate authority to quasi-autonomous body (a Quango), if only to escape the onus and mud flung about when failures do occur. If so, particularly if the Central Bank wishes to maintain its independence of action in other fields, there is a much stronger case for a separation of function, with a division between the Central Bank and the agency, or agencies, charged with regulation, supervision, authorisation, closure and insurance.’

117 Ibid.

118 Ibid.
to cross-border mergers and acquisitions\(^{119}\) diminish in the context of a supervision framework based not only on essential harmonisation and home country consolidated supervision but also on the supervision competence of a Community institution. Also, centralised supervision contributes to reduction of regulatory differences. A case in point is further harmonisation of rules on statistics and other reporting.\(^{120}\)

Representativeness
There are concerns about the effective representation of all affected interests in the context of centralised bank supervision. Representation claims here are related first to the ‘distance’\(^{121}\) aspect of the democratic deficit discourse, that is the shift of the decision making process away from the citizen. The criticism for democratic deficit intensifies when the ECB is proposed as the responsible body for the centralized supervision. The independence of the ECB from the political process augments\(^{122}\) the democratic deficit problem relating to all its aspects: ‘executive dominance issue’, ‘by-passing of democracy argument’, ‘transparency and complexity issue’, ‘substantive imbalance issue’, ‘weakening of judicial control issue’.\(^{123}\)

It is beyond the purpose of this paper to examine the value of these representation concerns and the adequacy of accountability mechanisms. We present, however, the relevance of the link between monetary policy and bank supervision, of the technical character of supervision, and of the democratic character of alternative arrangements.

An assessment of the value of democratic control over a centralized supervision system must take into account the rationale for independent monetary policy and the link between prudential supervision and monetary policy. The democratic character of alternative arrangements should also be examined. As described in Part III.1, economic theory has established that there is no trade-off in the long run between price stability and employment or growth, and hence, that monetary policy involves no balancing of diverse

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119 It is reported that prudential supervision and regulation are used as protectionist barriers against merger and acquisitions. See Norbert Walter, Chief Economist, Deutsche Bank Group, The Banking Supervision Issue in Europe, Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament 1 (11 May 2001), <http://www.europarl.eu.int/comparl/econ/pdf/emu/speeches/20010528/20010528_walters.pdf>

120 For the relevant competence of the ECB under Art 5 of the ESCB Statute vis-á-vis the Community’s competence see Chiara Zilioli and Martin Selmayr, above n 8, at 635.

121 For a summary of democratic deficit features following Weiler’s work see Paul Craig, The Nature of the Community: Integration, Democracy and Legitimacy, in The Evolution of EU Law 23, 24 (Paul Craig and Gráinne de Búrca, eds, 1999).

122 The ECB’s independence will extend to prudential supervision as its independent status covers all the tasks and duties entrusted to the ECB by the EC Treaty and the ESCB Statute. EC Treaty Art 108 (ex Art 107), ESCB Statute Art 7.

123 See Paul Craig, above n 121.
interests. In addition, it is submitted that price stability is more effectively pursued by an independent central bank without any influence by short-term political interests, which might favor inflationary policies. The interdependence of banking soundness with price stability can justify the 'protection' of macro-prudential policies by the independent character of the ECB. The 'political neutrality' of price stability can legitimize the removal of functions incident to it from the democratic process. The technical character of the prudential functions provides additional justifications for this.

Finally, the alleged democratic deficit of centralisation should be judged against the alternative arrangements, existing or potential, at both national and international level. As Paul Craig states: 'When we consider the alleged democratic deficiencies of the EU we must, however, do so against a realistic background. This must include an appreciation of the realities of decision-making at national level. It must also mean equally realistic appreciation of the alternative to the EU's existence' (emphasis added). Thus, at the national level, the democratic character of the national supervision systems is not unquestionable. Taking into account the technical character of the supervision issues and the lack of expertise by the national parliaments it is unclear how parliamentary control has added to the political scrutiny of bank supervision. Also, supervision has not been subject to political control in all cases. This is demonstrated by the arrangements in

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124 It is beyond the purpose of the thesis to examine the merits of this economic theory. It is submitted here that the operation of accountability mechanisms ensures a residual political role. Also, in the case of prudential supervision, alternatives do not seem to be closer to democratic process.

125 See also Group Recommendations, in Jean-Victor Louis et al., Working Group, ECU Institute, Banking Supervision in the European Community: Institutional Aspects 49, 61 (Report under the Chairmanship of Jean-Victor Louis, 1995) (considering supervision as an administrative issue that does not call for a particular governmental control).


National regulators and supervisors should be more independent from political influences in order to strengthen the integrity of the . . . ['Structured Early Intervention and Restructuring'] and liquidation processes. . . .

. . . .

Although the public accountability of financial regulators is clearly important, the authorities must be independent of ad hoc political pressures. This is central to the credibility of the intervention process. The political independence of the regulatory authority should therefore be strengthened according to the same principles as those underlying the foundation of the European Central Bank.

127 Of course, there is also the flaw of discussing the democratic legitimacy of the European Union, which is not a state, by use of modern democracy discourse, which centers on the state and its ethnocentric 'demos'. In the words of Professor Weiler '[this is] a description of oranges with a botanical vocabulary developed for apples'. Joseph H.H. Weiler, above n 2, at 7.

128 Paul Craig, above n 121, at 27.
the Bank of England. The Bank of England was independent in the conduct of supervision while it lacked independence with regard to monetary policy.\textsuperscript{129} Moreover, national central banks in the EU are independent with respect to their monetary policy functions. It is reasonable to expect that political control over their function as supervisors, although not prohibited, will be found unacceptable to the extent it intrudes on their monetary policy tasks. This can be quite frequent on the basis again of the interdependence of price stability and bank soundness and the communality of the tools employed. In any case effective accountability of the national supervisors to national constituencies does not lead to accountability of supervision with respect to European Union interests. Accountability to national Parliaments cannot provide legitimacy to decisions that have an impact on the European banking system. Moreover, even in a 'fully accountable' decentralized supervision system the ECB enjoys the 'uncontrolled' power to prevent the national central banks from performing actions that interfere with the objectives and tasks of the ECB.\textsuperscript{130}

Viewing the democratic deficit issue against existing international arrangements, we observe that centralised macro-prudential rule-making will involve balancing of the same type of policies that the Basel Committee evaluates in formulating its standards. The scholars finding democratic deficit in a centralised EU supervision system should extend their scrutiny to the standards of the non-accountable Basel Committee,\textsuperscript{131} that is standards that the Community has already followed\textsuperscript{132} in building its prudential regulation and supervision without effective political control. As a

\textsuperscript{129} For an extensive analysis of the discretionary character of supervision by the Bank of England and accountability implications see CHRISTOS HADJIMANUEL, BANKING REGULATION AND THE BANK OF ENGLAND (1996).

\textsuperscript{130} ECB Statute Art 14(4).

\textsuperscript{131} The Basel Committee as a group of central bank governors is not subject to any review or transparency requirements. Nevertheless, its regulations are legally binding in effect due to the influential role of its members.

\textsuperscript{132} For example, see Michel Aglietta, above n 3, at 52: 'In Europe the Commission has issued directives which endeavoured to be compatible with Basel regulations. The Ecofin Council has adopted the common norms and the European Parliament has enshrined them' (emphasis added). See also Peter Nobel, A Swiss Perspective on the EMU and the advent of the euro, 1 J. INT'L. BANKING REG 43, 46 (1999); 'Basel Committee (European Directives are also an offshoot of the Committee's recommendations) ...' (emphasis added). Mario Giovanoli, A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting, in INTERNATIONAL MONETARY LAW 3, 40, para 1.55 (Mario Giovanoli ed., 2000): 'The capital requirements rules may be found in the relevant European Union directives directly inspired by the Basel Capital Accord ...' (emphasis added). Of course, the EU institutional structure adds a different dynamic to the Basel standards. Professor Norton illustrates this more dynamic incorporation of the Basel standards in the EU structure: '[T]he EC process serves not only as a receptor and transmitter of Basel prudential standards, it is also showing the capacity proactively to determine the specifics of these emerging standards and their practical implementation ...' JOSEPH J NORTON, DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS 102, 103 (1995).
Commission paper states, 'the Basel Committee's] recommendations are usually translated into EU banking legislation, taking into account the specific nature of the EU banking sector' (emphasis added). A review of the accountability of the current system should also take into account the influential role of the Banking Advisory Committee in the development of the EU supervision system. The Banking Advisory Committee is de facto the body that effects technical amendments to the banking directives in the context of the 'comitology' procedure. It should be noted that among the issues subject to technical amendments are: a. 'expansion' of the banking activities listed in the Annex and b. 'alteration' of the amount of initial capital . . . to take account of developments in the economic and monetary field' (emphasis added).

In the absence of a centralised supervisor, the alternative will be sought in bilateral or international agreements based solely on the will and initiative of the executive or other sub-governmental entities. Also, demo-

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133 See INSTITUTIONAL ARRANGEMENTS REPORT, above n 27, at 4. See also ibid, at 5: 'In the area of solvency, the requirements which the BAC and the Commission have prepared and which have been laid down in EU directives, provide the groundwork for the minimum capital norms which banks are obliged to observe (this norm reflects recommendations within the G 10 Basel Committee on capital adequacy)' (emphasis added).

134 'The European Commission has never proposed measures which were not in accordance with the majority view of the BAC.' Also '[t]he BAC is entrusted with the task of establishing ratios for the solvency, liquidity and profitability of credit institutions'. Ibid, at 5.

135 'Although legally and technically, the BAC is separate from the committee instituted under the Second Banking Directive to make such technical amendments, the composition of this Committee coincides with that of the BAC. In practice, if an amendment of a banking directive is called for under a comitology procedure, the BAC changes its chairmanship in its meetings to permit the Commission to assume the chair and assist the Commission in carrying out technical adaptations to the Banking Directives'. INSTITUTIONAL ARRANGEMENTS REPORT, above n 27, at 7.

136 Technical provisions of the banking directives are subject to amendment through the simple 'comitology' procedure. Ibid, at 6. For issues of democratic legitimacy in relation to 'informationalism' and its main arena in the EU context, comitology see Joseph HH Weiler, above n 2, at 15, 21.

137 2000/12 Directive Art 60 (ex 2BD Art 22).

138 Cross-border activities produce externalities, which can be managed only through interstate cooperation. Therefore, if the EU institutions were not in place, the substitute would be international agreements by the executive with limited control by national parliaments. See Paul Craig, above n 121, at 26-7.

139 For the role of sub-state entities as agents of 'transgovernmental' law see Anne-Marie Slaughter, International Law in a World of Liberal States, 6 EUR J INT'L L 503 (1995); Anne-Marie Slaughter, The Real New World Order, 76 FOREIGN AFF 183 (1997). Professor Slaughter has aptly denied the claims of liberal internationalists for prevalence of international rules and institutions and the claims of new medievalists for the end of the nation-state, and she suggests that the nation-state is not disappearing but instead is disaggregating into its 'functionally distinct parts'. She uses the term transgovernmentalism to denote the operation of these sub-state entities and the networks they form across the borders. This has been the case with respect to prudential supervision at the international level. Cooperation is effected through networks of the respective national authorities, and prudential standards have been produced by the Basel Committee, which consists of representatives from central banks and supervision...
cratic deficit arguments should take into account the potential evolution of the EMU supervision system if no clear delineation of supervision competences toward centralisation takes place. In that case the most likely scenario is that the 'applied monetary policy' concept will allow the ECB to undertake substantial prudential regulation and supervision powers in a non-transparent and unregulated manner. Ultimately, it will have to be recognized that enhanced efficiency from a centralised system will prove more effective in promoting legitimacy: leading to democratic surplus (enhanced systemic stability) in the output side of the financial system it will outweigh the democratic deficit (lack of accountability) in the input side.140

4. Macro-prudential supervision v Micro-prudential supervision

It is mainly macro-prudential supervision that concerns our analysis. Micro-prudential supervision should remain with the bank regulator and the ECB should intervene only when there is a compelling financial stability or internal market consideration (eg reporting rules). Prudential supervision in the UK provides here an interesting example. First line prudential supervision (micro) has been transferred to the Financial Services Authority (FSA)141 while the Bank of England (BoE) remains the primary macro-prudential supervisor.142 Although the UK model has its own ambiguities, it does provide for the macro-prudential role of the BoE on a more clear basis. The BoE has the responsibility for overseeing the payment systems143 authorities. It should be noted that Slaughter sees enhanced accountability in international cooperation and norm-making through sub-state agencies.

140 As we show above, centralisation of supervision contributes to financial and monetary stability. Enhanced financial and monetary stability reflects surplus in the output side of the democratic process (Sharpe distinguishes between the input and the output side of the democratic process; while the input side refers to the accountability of the decision-making bodies to the governed, the output side refers to the efficiency effect of their decisions). VON FRITZ W SHARPE, ECONOMIC INTEGRATION, DEMOCRACY AND THE WELFARE STATE (MPIF Working Paper 96/2, July 1996), <http://www.mpi-fg-koeln.mpg.de/wp96-2/wp96-2.html>.

141 The Bank of England Act 1998 transferred banking supervision to the Financial Services Authority (FSA). The 1998 Act did not provide for detailed rules but instead envisaged the enactment of a new act. The Financial Services and Markets Act (FSMA) was adopted in June 2000 providing for the legislative framework of the FSA as a single financial regulator with regulation and supervision responsibility for the entire financial services industry. For a report on the current supervisory framework in the UK see Lazaros E Panourgias and Mads Andersen, The euro, EMU and UK law, in THE EURO IN THE NATIONAL CONTEXT (Jean-Victor Louis, ed, 2002).

142 The Bank of England has retained a broad responsibility for financial stability that is defined very much in the same way as the Bank defined its responsibility for banking supervision before it was taken away from the Bank. To some extent other central banks have used much the same terminology. The Bank of England can under one interpretation be said to retain the level of responsibility for the banking and broader financial sector it had before the First Banking Directive forced a continental European model of banking supervision (with licensing and actual formal continuous supervision) on it.

143 The oversight responsibility of the BoE is provided in the Memorandum of Understanding agreed with the FSA and the Treasury (see below n 144); 'The Bank will be
and it does have a lender of last resort role for both individual and systemic liquidity crises that can exercise in the context of its standing cooperation with the Treasury and the FSA, as this is prescribed in the relevant Memorandum of Understanding. The BoE also has the infrastructure to perform its macro-prudential supervision function. If financial stability or internal market considerations suggest centralisation of micro-prudential supervision then the case for a Community bank regulator or a Community single regulator may be made, in which case a Treaty amendment would be necessary.

We examine below the Treaty arrangements for foreign exchange policy to show how the ‘implied powers’ doctrine has provided the basis for extension of the ECB’s monetary competence into powers implied from it. Finally, we apply the ‘implied powers’ doctrine to the LOLR function. Again, we acknowledge the risk of a wide interpretation of the monetary policy concept. Our purpose is more to signal the potential evolution of the EU supervision system in line with the Europeanisation of the banking system, and stress the efficiency and accountability considerations of a clear delineation of the institutional setting.

5. ECB and Foreign Exchange Policy

The foreign exchange policy competence is an example of the effect that ‘applied monetary policy’ can have toward expansion of ECB’s powers. The


143 The Memorandum provides also for information gathering and sharing arrangements between the Bank of England and the Financial Services Authority as well as for cross-representation in their decision-making bodies. Apart from continuous contacts and a programme of secondments, the Memorandum provides that the Deputy Governor of the Bank of England, in charge of financial stability, will be a member of the FSA Board, and the Chairman of the FSA will represent the FSA in the Court of the Bank of England.

146 A Community single regulator is already proposed as the institutional framework that will promote further integration, deal with subsequent financial stability risks and level the playing field. See Norbert Walter, above n 119.
ECB is not explicitly entrusted with a power over 'informal' foreign exchange policy and its relevant actions could be justified only on the basis of its monetary policy competence and its aim for price stability. The analysis here employs the term 'informal' to denote foreign exchange policy, which does not take the form of more structured articulation or commitment vis-à-vis third parties as in the case of the Treaty prescribed 'formal' or 'less formal' foreign exchange agreements.

The Treaty does not establish a clear allocation of competences in the area of foreign exchange policy. In case of formal (like the Bretton-Woods agreement), or less formal agreements, the Treaty confers upon the (Ecofin) Council the competence to negotiate and conclude such agreements. In the absence

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147 For the complexity of the relevant Treaty provision, Art 111 (ex Art 109), see RENÉ SMETS, above n 31, at 375. The uncertainty as to the responsible authorities is reflected in the phrase 'no one is in charge', and it has been blamed for the fall of the Euro vis-à-vis the dollar. See BEN PATTERSON ET AL, EXCHANGE RATES AND MONETARY POLICY 8, 35 (Directorate-General For Research, European Parliament, Working Paper ECON-120 EN, Aug 2000), <http://www.europarl.eu.int/workingpapers/econ/pdf/120_en.pdf>.

148 By way of derogation from Article 300, the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, in accordance with the procedure in paragraph 3 for determining the arrangements, conclude formal agreements on an exchange-rate system for the ECU in relation to non-Community currencies. EC Treaty Art 111(1) (ex Art 109). For the meaning of formal agreements see RENÉ SMETS, above n 31, at 386.

149 By way of derogation from Article 300, where agreements concerning monetary or foreign exchange regime matters need to be negotiated by the Community with one or more states or international organisations, the Council, acting by a qualified majority on a recommendation from the Commission and after consulting the ECB, shall decide the arrangements for the negotiation and for the conclusion of such agreements. These arrangements shall ensure that the Community expresses a single position. The Commission shall be fully associated with the negotiations. EC Treaty Art 111(3) (ex Art 109). We agree with Zillioli and Selmayr that Art 111(3) is not a provision that covers the process for entering into agreements under Art 111(1) but that it deals itself with allocation of external competences. Chiara Zillioli and Martin Selmayr, above n 8, at 295, 296. See also ibid, at 299, for the scope of 'agreements concerning monetary or foreign exchange regime matters'.

150 Less formal arrangements will be agreements like the Plaza accord, which, in contrast to the Bretton-Woods agreement, do not establish an exchange rate system but merely policy guidelines for foreign exchange rates. But see RENÉ SMETS, above n 31, at 380, nn 57–8 (treat the Plaza and Louvre accord as arrangements that would fall under Art 111(2) (ex Art 109) of the EC Treaty).

151 Declaration No 3 on Part Three, Titles III and VI [currently Title VII], of the Treaty establishing the European Community. It should be noted that Member States with a derogation as well as Denmark and UK do not have the right to vote. EC Treaty Art 122(3),(5) (ex Art 109K). Protocol No 11 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland Arts 5, 7.

152 In case of formal agreements it is the Council alone that has the competence to act (exclusive competence). Instead, it has a concurrent competence in case of less formal agreements. It is shared with the residual (very limited) competence of the Member States, and the competence of the ECB as derived from the inseparable link of external to internal aspects of monetary and foreign exchange policy.
of formal or less formal\textsuperscript{153} agreements, the Council can provide for general exchange-rate policy orientations,\textsuperscript{154} which would cover 'informal' foreign exchange policy. A related competence of the Council could also be founded upon the internal competence of the Council to target economic policies to a certain foreign exchange rate. 'Informal' foreign exchange policy would always fall within the residual competence of the Council to formulate foreign exchange policy. There is nothing in the Treaty to suggest that foreign exchange policy has left the political authority. There has been only a vertical transfer from the Member States to the Community. No transfer at the horizontal level, that is transfer from the Council to the ECB, is established. The negotiations on the relevant issues confirm this. There was no acceptance of the proposals for a direct role of the ECB in the formulation of the Community's foreign exchange policy.\textsuperscript{155}

Therefore, the Council has an exclusive competence to define the 'informal' foreign exchange policy through binding orientations\textsuperscript{156} or ad hoc

\textsuperscript{153} But see René Smits, above n 31, at 380–1 (interpreting Art 111(2), as opposed to Art 111(3), to cover less formal, 'Plaza-like', agreements).

\textsuperscript{154} In the absence of an exchange-rate system in relation to one or more non-Community currencies as referred to in paragraph 1, the Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange-rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability.' EC Treaty Art 111(2), (ex Art 109).

\textsuperscript{155} Art 4(3) of the Draft ESCB Statute read: 'The ECB shall be consulted with a view to reaching consensus, consistent with the objective of price stability, prior to any decision relating to the exchange rate regime of the Community, including, in particular, the adoption, abandonment or change in central rates or exchange rate policies vis-à-vis third currencies.' The square brackets denote issues for which the Committee of Governors had not reached a decision. Here, they indicate the alternative wording of Art 4(3) as suggested by the Bundesbank. The Bundesbank's proposal for a role of the ECB in the formulation of exchange rate policy vis-à-vis third currencies was not accepted by the majority of the central bank Governors, and was not incorporated in the final Treaty provisions. See Charles Goodhart, A European Central Bank, in THE CENTRAL BANK AND THE FINANCIAL SYSTEM 303, 323 (Charles AE Goodhart, 1993).

\textsuperscript{156} The prevailing view is that the 'general orientations' cannot be binding on the ECB, and that if there is any legal effect at all this cannot be based on Art 111(2) but only on general principles of Community law. The lack of a requirement for a consensus on price stability, the possibility for the Council to decide without unanimity and the absence of any obligation for publicity of the orientations are used to support the non-binding effect of Art 111(2). The argument goes that absence of these safeguards, in contrast to their provision in Arts 111(1),(3), means that orientations are not binding and that the ECB is free to follow its own course of action. This must be wrong. Absence of these safeguards is only related to the less severe and definitely short-term effect on price stability from ad hoc foreign exchange interventions. We agree that the ECB can deviate from the general orientations of the Council to the extent that the price stability objective is impaired. But, we still hold that the general orientations should be binding, and that the Council will enjoy the exclusive competence to define the 'informal' foreign exchange policy. This is supported by Art 105(2) of the EC Treaty that subjects ECB's competence to conduct foreign exchange operations to the arrangements of article 111. See also below n 161 and accompanying text, for arguments against founding a competence of the ECB upon Art 105(2). Zillioli and Selmayr themselves accept that the
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decisions. That is, in the absence of formal or less formal agreements, the
decision for the desired for the European economy exchange-rate level
between the Euro and third currencies, and mainly the major currencies,
dollar and yen, rests with the Council alone. It is envisaged that its policy-
decisions will be primarily implemented through the ECB, as among the
ECB’s basic tasks 157 is to conduct foreign exchange operations. The ECB
will be free 158 not to abide by the orientations to the extent that its price
stability mandate requires so. 159

However, it was the ECB that intervened in the markets twice in 2000—
first in cooperation with the US Treasury and the central banks of the G-7
Countries and then alone—with the aim of preventing a further decline of
the Euro against the dollar. There was a limited consultation with the
Ecofin Council, but it seems it was the ECB alone that in coordination with
the other central banks decided to intervene in the financial markets in
support of the Euro. It is doubtful 160 that the Council convened prior to
intervention to adopt an exchange-rate policy orientation or decision for
the Euro against the dollar. There was no indication that the Council’s role
in the whole effort was significant at all.

This recent intervention almost solely on the initiative of the ECB
provides an indication of the powerful effect of ‘applied monetary policy’
towards expansion of ECB’s power. Only in the context of the ‘applied
monetary policy’, the ECB can be deemed competent to exercise ‘informal’
foreign exchange policy on the basis and to the extent of the importance of
the foreign exchange rate for price stability. 161 This extension of ECB’s

Council’s general orientations can have a binding effect on the ECB to the extent they reflect
Community economic policy goals and do not interfere with the price stability objective.
Chiara Zillioli and Martin Selmayr, above n 8, at 308 n 136.

157 EC Treaty Art 105 (2) EC, ESCB Statute Art 3 (1).
158 The Emminger clause allowed the Bundesbank freedom from interventions required by
formal exchange rate arrangements concluded by the German government when such inter-
ventions would impair its monetary policy.
159 ‘the definition and conduct of a single monetary policy and exchange-rate policy the
primary objective of both of which shall be to maintain price stability . . .’ (emphasis added).
EC Treaty Art 4(2) (ex Art 3a); ‘the Council . . . may formulate general orientations for
exchange-rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability’ (emphasis added).
EC Treaty Art 111(2) (ex Art 109).
160 ‘There is a small reservation as there is no requirement for the general orientations under
Art 111(2) to be published and such publication is within the discretion of the Council.
161 It is argued that Art 103(2) of the EC Treaty provides the legal basis for the ECB’s com-
petence over foreign exchange policy. However, Art 103(2) only empowers the ECB to conduct
foreign exchange operations and this only in conformity with the division of responsibilities
specified in Art 111. There is nothing to suggest that there was more than a horizontal change
in the competence to conduct foreign exchange policy. Foreign exchange policy has only been
transferred from the Member States to the Community. This is clear from the negotiations
history where the Bundesbank-led original proposition, as reflected in the draft Statute, for the
ECB’s role in foreign exchange policy failed. See above n 155 and accompanying text.
competence to 'informal' foreign exchange policy can find its legal basis in the Community doctrine of 'implied powers', and to the extent it requires external acts in the respective doctrine of 'parallelism'. The 'implied powers' doctrine applies to the ECB and it entails powers that they are implied from the ones, which are expressly prescribed. Thus, ECB's competence for foreign exchange policy can be founded upon its competence for the single monetary policy to the extent that price stability establishes interdependence of the two competences. In case 'informal' foreign exchange policy involves external acts, as for example in case of an intervention coordinated by the G-7 central banks and finance ministers, the Community law doctrine of parallelism comes into play. The doctrine of parallelism, as developed by the ECJ, also applies to the ECB and provides for external competences of the Community and the Member States when such competences are 'inseparably linked' to their internal competences. Thus, the inseparable link between foreign exchange policy and monetary policy to the extent they both serve price stability may establish ECB's competence for foreign exchange policy. Zillioli and Selmayr also identify this inseparable link between foreign exchange policy and monetary policy, and the subsequent foreign exchange policy competence of the ECB on the basis of the doctrine of parallelism.

This shows that the doctrines of 'implied powers' and of 'parallelism' make it very difficult to prevent the ECB from undertaking tasks, which although not conferred by the Treaty, are incident to its monetary policy power. In the case of foreign exchange policy, the monetary policy objec-

162 Case 22/70 Commission v Council, 1971 ECR 263, CMLR 335 (1971), Opinion 1/94, Opinion pursuant to Art 228 (6) of the EC Treaty, 1994 ECR 5267. The doctrine of parallelism provides for external competences of the Community that are 'inseparably linked' with its internal competences.

163 See above in the text for the application of Community law on the ECB.


165 Case 22/70 Commission v Council, 1971 ECR 263, CMLR 335 (1971), Opinion 1/94, Opinion pursuant to Art 228 (6) of the EC Treaty, 1994 ECR 5267. The doctrine of parallelism is already incorporated in the EC Treaty. In the case of international agreements concluded by the Council, articles 300(2)-(3) (ex Art 228) determine the voting process in the Council and the participation by the European Parliament in accordance with the respective internal processes in the same field.

166 Zillioli and Selmayr support the application of the doctrine of parallelism not only to vertical conflicts of competence but also to horizontal ones as the rationale of the doctrine is that there should be 'identity between the bearer of internal and external competences'. Chiara Zillioli and Martin Selmayr, above n 8, at 292.

167 Opinion 1/94, Opinion pursuant to Art 228 (6) of the EC Treaty, 1994 11/12 ECR 5267.

168 Chiara Zillioli and Martin Selmayr above n 8, at 292. It should be noted that Zillioli and Selmayr in their analysis of the external aspects of monetary policy treat foreign exchange policy as an issue of external aspects of monetary policy. We do agree with this to the extent that they both aim at price stability. This also proves our point about the reach of applied monetary policy. However, foreign exchange policy is more than external monetary policy, and it is also itself a case of internal Community competence.
tives, the overriding being the price stability, can serve not only as a restraint to foreign exchange policy measures but also as a legal basis for such measures. It must be emphasized that in the last ECB intervention, the ECB did not even attempt to justify the intervention on price stability considerations.\textsuperscript{169, 170} Only to add to uncertainty, the Governor of the ECB, Wim Duisenberg, responded to past pressure for an ECB foreign exchange market intervention in support of the Euro by saying that the ECB will and can do so only if its price stability mandate so requires.

It will be interesting to see how the EU framework will evolve: unhindered and unaccountable operation of the, entrenched in the European economic constitution, `applied monetary policy' towards expansion of ECBs competence; Treaty reform toward more clear delineation of competences; overruling of the system by the ECJ.\textsuperscript{171} In particular the last possibility could be enormously interesting as well as alarming: Challenging by individuals or the Commission of ECB's exchange-rate acts, eg interest rate changes or direct market operations, due to lack of competence. Individuals with a very high amount of US dollar-denominated assets could seek review of the legality of exchange-rate interventions in support of the Euro \textit{vis-à-vis} the dollar, when such intervention has been decided solely by the ECB. There will be two significant difficulties for success of relevant actions. First, `individual concern', as the requirement for the individuals standing,\textsuperscript{172} in case of exchange-rate related losses could be established only.\textsuperscript{173}

\textsuperscript{169} Duisenberg subscribes to the view that ECB's power to intervene in this case is derived from Art 103(2) EC: `We didn't ask for [finance ministers'] permission because we don't need permission. While ministers had a role in the overall orientation of exchange rate policy, the management of the foreign exchange markets was a matter for the ECB.'\textsuperscript{4} Alan Beatle and Stephen Fidler, above n 1. It shows that apart from the `softness' of the Treaty language and the powerful effect of the `applied monetary policy' concept, legal barriers, even at the Treaty level, cannot, beyond a certain level, restrict the monetary and political authorities in the management of `critical' situations.

\textsuperscript{170} Again, we should remind ourselves of this statement: `We did not have the Maastricht treaty lying open on the table. It was all done informally' one said.\textsuperscript{5} Alan Beatle and Stephen Fidler, above n 1. It shows that apart from the `softness' of the Treaty language and the powerful effect of the `applied monetary policy' concept, legal barriers, even at the Treaty level, cannot, beyond a certain level, restrict the monetary and political authorities in the management of `critical' situations.

\textsuperscript{171} The Treaty and the ESCB Statute provide for review of the ECB acts by the ECJ. EC Treaty Arts 230 (ex Art 173), 232 (ex Art 175), 233 (ex Art 176), 234 (ex Art 177), 235 (ex Art 178); ESCB Statute Art 35. See also EC Treaty Art 237(d) (ex Art 180), 241 (ex Art 184), 288 (ex Art 215); ESCB Statute Arts 14(1), 36(2). For judicial review of the ECB see Paul Craig, \textit{EMU, the European Central Bank and Judicial Review}, in \textit{LEGAL FRAMEWORK OF THE SINGLE EUROPEAN CURRENCY} 95 (Paul Beaumont and Neil Walker eds, 1999).

\textsuperscript{172} EC Treaty Art 230 (ex Art 173).

\textsuperscript{173} Otherwise the restrictive \textit{Planmann} approach applies. Forstanding to be established \textit{Planmann} requires that the individuals are affected `by reason of certain attributes which are peculiar to them or by reason of circumstances in which they are differentiated from all other persons'. Case 25/62 \textit{Planmann & Co. v Commission}, 1963 ECR 95, CMLR 29 (1964). This requirement could be hardly met by individuals whose high US dollar-denominated asset holdings are affected.
by reliance on the 'degree of factual injury' approach, and this approach remains to be followed by the ECJ. Secondly, finding illegality for the ECB's act will involve a delicate delineation of the lines between price stability-led intervention and intervention for other exchange-rate objectives, in which case the ECJ is expected to accord a high degree of deference to the macroeconomic judgment of the ECB. Still, it is interesting to see how a future challenge will be dealt with, and what its possible effect on the Community macroeconomic structure will be.

IV. LENDER OF LAST RESORT

Community banking law does not provide for clear allocation of LOLR competences. The problem is that there isn't a Community competence for LOLR in case of liquidity problems at individual financial institutions. Also, in case of a systemic liquidity crisis the necessary mechanism seem to be absent. We argue that this is redressed by attributing LOLR competence to the European Central Bank on the basis of the 'applied monetary policy', that is on the basis of the inseparable link of LOLR with monetary policy and the commonality of the tools used for both tasks.

As stated above, we interpret prudential regulation and supervision to encompass the LOLR function as an ex post measure that aims toward systemic stability. Therefore, the Treaty provisions on prudential regulation and supervision will apply in case of LOLR tasks. Prima facie, the national central banks, as autonomous national entities, appear to have exclusive competence to exercise LOLR functions. The ECB is entrusted only with an advisory and coordinating role regarding prudential regulation and super-

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174 Case 358/89 Extramet Industrie SA v Council, 1991 ECR I-2501, 2 CMLR 619 (1993). Individuals whose a high percentage of their portfolio comprises of a high amount of US dollar-denominated assets could show a serious injury from an ECB's intervention in support of the Euro. For the 'degree of factual injury' approach see Paul Craig, supra n 171, at 107.

175 The 'degree of factual injury' approach has been applied in the context of anti-dumping regulation. Although the Codorniu (Case 309/89 Codorniu SA v Council, 1994 ECR 1-1833, 2 CMLR 561 (1995)) case builds on this approach, it still requires application of the prohibitive Prümme test. For a comprehensive analysis of the related issues and the ECJ jurisprudence see Paul Craig and Gráinne De Bóroa, supra n 111, at 468.

176 See Paul Craig, supra n 171, at 111.

177 We use LOLR to include liquidity support for both the financial system and individual financial institutions. Goodhart rightly argues that it is practically almost impossible to distinguish between LOLR and open market operation in case of liquidity injections to the market as a whole and hence, that LOLR should not be used in this case. However, when, even rarely—Goodhart mentions Fed's decision after the 1987 crash to provide liquidity to the market through OMO and easy access to the discount window—liquidity injections to the market are clearly due to financial stability concerns, it will be useful to know how to classify the relevant action and examine its legality. See Charles Goodhart, supra n 59, at 11.

178 See above n 97 for the indeterminacy of the epithet 'prudential' and the interpretation employed by our paper.
vision in general, and this should be the nature of its involvement for LOLR purposes.

However, there are two exceptions to this exclusive competence of the national central banks. First, in case of systemic, pan-European, liquidity crisis the ECB has the power to intervene on the basis of its responsibility for the smooth conduct of national prudential policies pertaining to financial stability.\textsuperscript{179} Its competence to intervene will also be supported by the interdependence of the systemic aspects of the liquidity risks with the effectiveness of the monetary policy. Again, the ‘applied monetary policy’ concept comes into play and provides a basis for the implied power of the ECB to intervene due to the strong link\textsuperscript{180} of systemic liquidity problems to monetary policy. In this case, the monetary policy tools, open market operations and credit operations, already available to the ECB\textsuperscript{181} will enable its intervention.\textsuperscript{182}

Secondly, in case of a liquidity crisis generated in the payments system the ECB will share the LOLR competence with national central banks,\textsuperscript{183} as the Treaty provides for ECB’s competence\textsuperscript{184} to oversee the payment systems: ‘The basic tasks to be carried out through the ESCB shall be . . . to promote the smooth operation of payment systems.’\textsuperscript{185} The ECB can provide liquidity through intra-day credit on the basis of adequate collateral\textsuperscript{186} and open market operations.\textsuperscript{187}

\textsuperscript{179} EC Treaty Art 105(5), ESCB Statute Art 3(3)
\textsuperscript{180} See also Johannes Priesemann, above n 88, at 82–3. Priesemann goes further to support the inseparability of LOLR from monetary policy both in case of system and individual institutions crises.
\textsuperscript{181} ESCB Statute Arts 17, 18.
\textsuperscript{182} Of course, the monetary policy tools exclusively entrusted to the ECB will allow it an LOLR role even without any legal basis and without most of the time being possible to trace the LOLR implications. Still, this does not allow us not to identify it as an LOLR function and seek for a legal basis. This will be significant for both efficiency and accountability purposes.
\textsuperscript{183} See Rosa Maria Lastra, above n 42 (considering Bank of England’s obligation to contribute substantial collateral in order to take part in TARGET, as a supporting factor of the ECB’s LOLR responsibility for the payment system): ‘[I]n the case of an explicit payment system gridlock, the ECB has competence to act as lender of last resort, according to Article 105.2 of the EC Treaty. This point is actually supported by the fact that the Bank of England has had to put up substantial collateral with the ECB to take part in TARGET, whereas this is not the case for the NCBs of the in-Member States participating in TARGET in their capacity as agents of the ECB.’
\textsuperscript{184} See above in the text (interpreting Art 105(2) to establish a shared competence for payment systems oversight).
\textsuperscript{185} Art 105(2) of the EC Treaty, ESCB Statute Art 3(1).
\textsuperscript{186} ESCB Statute Art 18 (1).
\textsuperscript{187} Prati and Schinasí rightly point out that the ECB will likely accept non-eligible collateral in case of liquidity crisis. Alessandro Prati and Garry J Schinasí, above 89, at 108. The Governing Council will be able to change the characteristics of eligible collateral since Art 18(1) of the ESCB Statute only requires that the collateral is ‘adequate’ without determining the characteristics of ‘adequate’ collateral. This contrasts to the Bundesbank arrangements where the ‘eligibility’ characteristics are determined, and a legislative act is required in order to accept non-eligible collateral. Ibid, at 102 n 34.
The situation becomes more blurred in the case of liquidity problems at individual financial institutions. It is argued that before the enabling clause is activated, the national central banks are solely competent for prudential supervision, and this would include LOLR for individual liquidity crises. There is the view that this decentralised LOLR complemented by other liquidity mechanisms is an effective arrangement. We argue instead, that the current LOLR framework is inadequate, and that institution-building toward further centralisation should take place. Again, the legal basis for such centralisation will be found in the 'applied monetary policy' concept.

We submit that the existing LOLR arrangements, modeled on the market-approach,\textsuperscript{188} are not adequate to deal with liquidity issues in the context of a Europeanised banking system. This is the case for both systemic and individual liquidity crises. In case of a systemic problem, the ECB lacks the supervisory information\textsuperscript{189} needed to judge on the systemic effect of liquidity problems and decide quickly on the eligible collateral.\textsuperscript{190} In case of liquidity problems at individual financial institutions, the national central banks along with the national supervisory authorities will act and undertake the LOLR costs only when the liquidity crisis poses systemic risks for their own banking system.\textsuperscript{191} Even if they are concerned about the implications for the European market, they might lack both the necessary resources and the ability to assess the severity of the liquidity problems. Neither is it clear whether authorisation by the ECB is also required in which case the ECB will not have the necessary information to assess the systemic impact of the liquidity crisis.\textsuperscript{192} Finally, cooperation on the basis of MOUs does not secure the necessary real-time information sharing and action,\textsuperscript{193} while availability of resources is questionable.

\textsuperscript{188} Ibid, at 102. On the 'market-operations' versus the 'banking-policy' approach see ibid, at 91-3.
\textsuperscript{189} See Michel Aglietta, above n 3, at 52 (referring to problems with the current system of information-exchange).
\textsuperscript{190} Alessandro Prati and Garry J. Schinasi, above n 89, at 108.
\textsuperscript{191} For deficiencies of the operation of the home country control principle regarding LOLR functions see Dirk Schoenmaker, above n 44, at 432.
\textsuperscript{192} The ECB may prohibit or restrict LOLR functions by the national central banks. ESCB Statute Art 14(4). Neither is it clear whether authorisation by the ECB is also required. Padoa Schioppa suggests that the national central bank would ask the Governing Council for a 'decision or a consultation' if the amount involved is 'very big' and hence relevant for monetary policy purposes. \textit{Interview with Tommaso Padoa-Schioppa, The Region} (Federal Reserve Bank of Minneapolis, Dec 2001), <http://minneapolisfed.org/pubs/region/01-12/padoa-schioppa.html>.
\textsuperscript{193} On the inadequacy of bilateral arrangements, like MOUs, in the context of a pan-European financial system where prompt reaction to crises is essential, see Alessandro Prati and Garry J Schinasi, above n 89, at 113. The Economic and Financial Committee report on crisis management also acknowledges the problems. Although there are no legal problems in information sharing there is no obligation under Community law for exchange of information in liquidity crises. Yet, the recommendation of the report finds sufficient that further arrangements are established through MOUs. \textit{ECONOMIC AND FINANCIAL COMMITTEE, REPORT ON
The proposed alternatives cannot make up for LOLR centralisation. First, it is argued that market operations can deal effectively with liquidity problems and prevent bank runs spreading through contagion. The LTTCM rescue orchestrated by the Fed is presented as an example of a successful management of a major threatening liquidity crisis through the joint action of private banks. The ECB will face no regulatory impediment in coordinating market forces in a similar fashion to prevent a financial institution from becoming insolvent. However, this argument ignores that market operations are not guaranteed to be effective in a highly competitive environment. Even if feasible, they will often be 'time-consuming, somewhat expensive and subject to free-rider problems'. The LTTCM negotiations background should also be reminded. In the discussions for a liquidity response, Greenspan made immediately clear that none of the financial institutions representatives could leave the table before putting down four million US dollars.

Secondly, Ministries of Finance are claimed to be another effective LOLR candidate as they can use taxpayer's money to inject liquidity to illiquid but solvent or even to insolvent financial institutions. Member States still enjoy such power, and the Commission can monitor such interventions to ensure that they comply with state aid rules so that they do not have any anti-


194 See Tommaso Padoa-Schioppa, above n 11, at para 23 (considering 'market-based' intervention a preferable mechanism since not only can it deal effectively with liquidity problems but it also reduces moral hazard risk).


196 The Banking Supervision Committee can be an alternative coordinating institution. Tommaso Padoa-Schioppa, above n 11, at para 23.

197 Indeed, where the cartel is particularly strong, as in Germany, it is possible for the member banks to finance the small number of rescues necessary in such circumstances without reference to either the Central Bank or the government. In such circumstances the supervisory and regulatory agency may be independent of both the government and the Central Bank. Whether such a system could survive in a much more competitive banking milieu is debatable (emphasis added).

Charles AE Goodhart and Dirk Schoenmaker, above n 84, at 355. See also Alessandro Prati and Garry J Schinasi, above n 89, at 106. Of course, the LTTCM rescue was effected through coordinated private action and in a very competitive environment. However, in that case Greenspan's forceful intervention was a critical factor. For weaknesses of coordinated private sector lending in the context of a competitive environment see Xavier Freixas et al, Lender of Last Resort: a review of the literature, FIN STABILITY REV, Nov 1999, at 151, 162, where a reference is made to related problems in the rescue of Johnson Matthey Bankers Ltd.

198 CHARLES GOODHART, above n 59, at 13. See also Dirk Schoenmaker, above n 44, at 434, for problems with 'life-boat' operations organized at a national level to deal with the emergence of pan-European banks.

199 EC Treaty Art 87 (ex Art 92), Art 87 and the 'private investor test' (that is, the operation in question must be justifiable under the investment rationale of a private investor) will also
competitive effect. However, apart from the immediate\(^{200}\) distortionary effect on taxpayer's burden-sharing, there will be problems of coordination, information and cost-allocation when the liquidity crisis involves a financial institution with a strong multi-jurisdictional presence.\(^{201}\)

We should note here that Germany is normally quoted as an example of successful liquidity management without the existence of a Lender of Last Resort. Supporters of this argument ignore that in Germany there is a specialized agency, the Liquidity Consortium Bank (LCB),\(^{202}\) which performs LOLR tasks and is 'closely associated' with the Bundesbank.\(^{203}\)

apply to liquidity assistance by the central bank to individual institutions. For the application of EC competition law to banks see Case 172/80 Züchher v Bayerische Vereinsbank, 1981 ECR 2021. See also Rosa Maria Lastra, above n 59, at 350. See René Smits, above n 31, at 270, for the involvement of State funds in liquidity assistance by central banks which trigger application of the Community State aid rules. Liquidity assistance to ailing credit institutions that is found to be a state aid will be exempted from EC state aid rules, if it is based on systemic risk concerns, that is, concerns for 'a serious disturbance in the economy of a Member State'. EC Treaty Art 87(3)(b) (ex Art 92(3)(b)). For the application of EC state aid rules to credit institutions and their interplay with prudential concerns in the context of the Credit Lyonnais case see Commission Decision 95/547/EC, of 26 July 1995 giving conditional approval to the aid granted by France to the bank of Credit Lyonnais, 1995 OJ (L 308) 92; Commission Decision 98/490/EC, of 20 May 1998 concerning aid granted by France to the Credit Lyonnais group, 1998 OJ (L 221) 28, at 62, 64, 67, 73. For the application of the EC State Aid rules to state guarantees for German Landesbanken with regard to their international activities (as opposed to their public functions in furtherance of the local (regional) banking system) see Christian Koenig and Ernst Röder, State Guarantees for the German Landesbanken and the EC State Aid Regime, 9 n 11–12 EUR. BUS L REV 381 (1998). See also Karel Lannooy, above n 25, for the anti-competition implications of a proposed system for decentralisation of the state aid rules on banking.


\(^{201}\) For additional problems see Alessandro Prati and Garry J Schinasi, above n 89, at 105–6.


\(^{203}\) And, if the liquid resources of the LCB [Liquidity Consortium Bank] are insufficient, short-term emergency liquidity assistance provided directly by the Bundesbank to the LCB but only if the LCB guarantees the troubled institution.

... The Bundesbank holds 30 percent of the LCB's capital. ... The four-member credit committee of the LCB (one Bundesbank member plus one member for each association of credit institutions) decides on the granting of liquidity support. ... The LCB's partners are obliged, if necessary, to make supplementary payments of up to 5 times their equity stakes, but this option has thus far not been used in the midst of a crisis. If the liquid sources of the LCB are insufficient, the LCB can use a special rediscount facility at the Bundesbank, which allows it to discount promissory notes that troubled banks have issued and on which the LCB has provided the 'second good signature' required by law. (emphasis added)

Alessandro Prati and Garry J Schinasi, above n 89, at 100–1. See also ibid, for unanimity required in LCB's decisions for liquidity assistance, and for information-exchange arrangements with the Bundesbank.
Moreover, the LCB operates in an environment with broad public ownership of banks and weak capital markets. This limits substantially the possibility of a major and abrupt liquidity crisis and hence, reduces the importance of a LOLR agency.

A centralised LOLR competence at the ECB level will deal more effectively with most of the inadequacies of the current decentralised LOLR framework. The ECB will be able to intervene effectively and timely when the emerging pan-European financial institutions face liquidity problems. It will avoid coordination problems—present in a decentralised system involving discussions between the interested central banks and consultations at the ECB level—and it will be able to decide quickly. It will have the capital resources required and will ensure a proper allocation of the LOLR costs across the Community. It will also reduce the anti-competitive effect of NCB’s policies and decisions on eligible collateral, and of interventions in support of insolvent institutions. Still, the precondition for a successful LOLR role by the ECB will be the establishment of information-sharing arrangements. Such information-sharing arrangements are needed to provide the real-time information necessary for an accurate assessment of the systemic effect of liquidity problems, a decision on the adequate collateral, and a real-time intervention.

Ibid, at 105.
Ibid. Also the argument about the almost non-existent liquidity interventions in Germany is not well grounded since there is not sufficient public evidence. Prati and Schinasì are wisely cautious when referring to the Bundesbank’s involvement in liquidity crises: ‘The Bundesbank is widely regarded as a central bank that has been involved in crisis management to the least possible extent. It is generally believed that no Bundesbank funds have been directly used to support troubled institutions in the postwar period’ (emphasis added). Ibid, at 99.

Goodhart also supports that the current decentralized LOLR arrangements will not be adequate when European financial systems become more integrated. However, he points out that a LOLR role by the ECB will be restricted by the ‘dysfunction’ between a centralized monetary policy and decentralized fiscal policies which will deprive the ECB’s LOLR role from the support of the state’s taxing power. He draws a parallel between this limitation on the ECB’s LOLR role and the deficiencies of a potential international LOLR by the IMF, as the IMF also lacks the support of a single government with taxing power. Charles Goodhart, above n 59, at 24.

For example, it is mentioned that it is unlikely that LOLR by the ECB will cover liquidity implications of non-EU activities of EU banks. Jan H Dalhuisen, Dalhuisen on International Commercial, Financial and Trade Law 735 n 11 (2000).

Timely decisions are essential for liquidity interventions. Alessandro Prati and Garry J Schinasì, above n 89, at 96: ‘From the point of view of this study, an important aspect of the 1987 episode is that, although the volatile environment was making credit assessments extremely difficult, the commercial banks and the Federal Reserve had to decide—probably in less than one hour—whether to allow traders and brokerage houses to default by not meeting intraday margin calls’ (emphasis added).

Although NCB’s LOLR functions are subject to State-aid rules, it is difficult to evaluate their ‘arbitrariness’ and subsequent negative externalities due to information problems.

It should be mentioned that the ECB can already affect these policies as under Art 14(4) it may restrict national policies that interfere with the ECB’s objectives and tasks.
This centralisation of the LOLR competence for both systemic and individual liquidity crises can be effected without any major reform. First, activation of the enabling clause of Article 105(6) of the Treaty (Article 2.5 (2) of the ESCB Statute) will allow allocation of LOLR power to the ECB.

Secondly, the ECB's responsibility for the smooth conduct of national policies regarding prudential supervision and financial stability may extend to liquidity problems at individual financial institutions.\textsuperscript{211} Again, the 'applied monetary policy' concept enhances the justification for the ECB's LOLR role. The interdependence of banking soundness and LOLR with stable money growth\textsuperscript{212} establishes the 'inseparable link'\textsuperscript{213} of LOLR with monetary policy which allows a compliant with the Treaty extension of the ECB's competence to LOLR responsibilities.\textsuperscript{214} The ECB's responsibility for the smooth conduct of national prudential policies enhances further the legality of the ECB's LOLR role.\textsuperscript{215} The ECB's monetary tools make this LOLR role practicable. Open market and credit operations with individual banks allow the ECB both to evaluate their financial condition, and when necessary inject liquidity against adequate collateral.\textsuperscript{216} Still, effective information-transmitting mechanisms should be built. This can proceed alone or in the context of the proposed overall centralisation of macro-prudential functions.

There should not be significant concerns regarding the accountability of the ECB's LOLR role. Benefits of an effective LOLR function for the taxpayers\textsuperscript{217} will outweigh democracy costs from lack of effective representation of various interests in its exercise. Arguably a parliamentary role is not desirable even when the Treasuries provide liquidity to the system.

\textsuperscript{211} EC Treaty Art 105(6), ESCB Statute Art 3(3).

\textsuperscript{212} Arguments for conflict were used against entrusting the ECB with LOLR. For the drafting background and Bundesbanks' concerns for inflation and moral hazard implications from entrusting the ECB with LOLR see Charles Goodhart, above n 155, at 326. We explained above how we see no conflict between banking soundness decisions and monetary policy but only an 'inter-temporal' trade-off. In any case such trade-off exists mainly in the case of LOLR for systemic liquidity problems. It is in this case that there is a change in the money base. In case of individual liquidity problems, injections of liquidity have an effect only on the synthesis of a banks' balance sheet. Interestingly, it is the former LOLR role for which the ECB's competence is not doubted.

\textsuperscript{213} Borrowing the concept from the ECJ's doctrine of parallelism. See above n 162 and accompanying text.

\textsuperscript{214} It is in this context, that we agree with Patd"{o}a Schioppa on the adequacy of the existing system as operating under 'constructive ambiguity'.

\textsuperscript{215} EC Treaty Art 105(5), ESCB Statute Art 3(3).

\textsuperscript{216} ESCB Statute Arts 17, 18. See above n 187 and accompanying text, for the flexibility of the ECB's Governing Council in determining what adequate collateral is.

\textsuperscript{217} These benefits will be due not only to enhanced financial stability from an effective LOLR but also due to avoidance of costs associated with LOLR by a supervisory body subject to political control. It is submitted that in the latter case costs to taxpayers are higher and capture by the banking industry more likely. See Charles AE Goodhart and Dick Schoenmaker, above n 84, at 344.
since it could only cause delays in a time-sensitive operation.\textsuperscript{218} Also, the
democracy costs are limited if the proposed centralised function is viewed
against the accountability of the existing arrangements. With the exception
of ex post accountability requirements, NCBs are not subject to any political
scrutiny in their exercise of the LOLR. In Germany, for example, the
identity of the rescued financial institutions is never publicised.\textsuperscript{219} Also,
unpublicised cooperation arrangements between the ECB and the NCBs for
the performance of LOLR tasks seem to exist already, and it is regarded
sufficient that the ones immediately concerned know who has the competence
to act. Finally, a centralized LOLR provides more guarantees that the
interests of the European peoples are considered rather than local interests.
These limited democracy costs can be further reduced: Accountability can
be provided ex post through reports to the parliament. And, judicial review
always stands available to provide an ultimate check on the arbitrary use of
the LOLR power.

X. CONCLUSION

The EC Treaty reinforces the model of functional separation of monetary
policy and bank supervision at a geographical level. The ECB is now the
single monetary authority and the national authorities have responsibility
for prudential supervision of banks. This arrangement is not expected to
facilitate further integration. Neither is it expected to be adequate for the
stability of an integrated banking system. However, the system stands ready
to adapt. The ECB competence for monetary policy could encompass func-
tions, which would be instrumental to monetary management, and this
would include prudential supervision functions. In our view it is clear that
the operation of monetary policy, or applied-monetary policy, is an exten-
sion of monetary management over banking soundness as the micro-aspect
of price stability. It will resemble exercise of respective functions in national
jurisdictions with functional separation of monetary and supervision
powers where the central bank has retained its basic responsibility for
macro-prudential supervision. The conduct of foreign exchange policy by
the Community has provided an example of how the applied monetary

\textsuperscript{218} Alessandro Prati and Garry J Schinasi, above n 89, at 106.

\textsuperscript{219} 'The identities of the intervened institutions are publicly revealed neither at the time of
the crisis nor after the fact.' ibid, at 106. See also for similar, albeit limited to the time of inter-
vention, secrecy surrounding LOLR by the Bank of England. Eddie George, Governor of the
Bank of England, said: '[W]e usually try to keep the fact that we are providing systemic
support secret at the time.' Eddie AJ George, The Pursuit of Financial Stability, 34 n 1 BANK
OF ENGLAND Q BULL 60, 65 (1994).
policy widens the competence of the ECB. Expansion of the macro-prudential functions of the ECB is supported as an efficient regulatory arrangement for both internal market and financial stability purposes. It should now be clearly defined and constructed so that the system can develop into a more efficient and accountable one.