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Harmonising and Regulating Financial Markets

Mads Andenas

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1. Harmonising and regulating financial markets[1]

Mads Andenas[2]

INTRODUCTION

This chapter discusses problems of harmonisation and regulation of the European Internal Financial Market. The argument is that the current division of powers between the EU and Member States is not achieving sufficient harmonisation to develop an internal market. The obstacles to the Internal Financial Market presented by national regulatory and supervisory regimes remain too high, and the EU minimum standards and mutual recognition regime have failed to lower these barriers sufficiently. There is a need for broader based regulatory and supervisory institutions, undertaking at a European level what cannot effectively be done at a national level, including providing a system for preventing and dealing with systemic crises and risks of such crises. The European Central Bank may develop a response to the latter, but the establishment of an EU financial market regulator is the better solution. The chapter also addresses some of the agency problems of the decision making process, and the crisis driven nature of regulatory reform.

1. PROBLEMS OF HARMONISATION AND REGULATION

The subject of this chapter is problems of European financial market harmonisation and regulation. The creation of a European Financial Market has encountered problems of two kinds. The first is that market integration has not been very effective. The markets are divided by national borders as many

[1] An earlier version of this chapter was delivered as the Annual Guido Carli Lecture at the University of LUISS Guido Carli, Rome, in 2006.

[2] MA, DPhil(Oxon.); PhD(Cambridge); Professor, University of Oslo, Norway. Former Director, British Institute of International and Comparative Law, London and Centre of European Law, King's College, University of London. Senior Research Fellow, IALS, University of London, UK. Research was undertaken with support from the Norwegian Finance Market Fund.

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financial services and most financial institutions are still limited to one country. The second is that the market integration that has taken place, and other features of modern financial markets working in the same direction, renders national regulators less effective. In one perspective, financial markets are becoming markets without a state. Whereas national authorities' effectiveness in regulation is questioned, in another perspective national regulations still impede market access and make cross-border establishment and provision of services too expensive for it to take off in many parts of the market.

Effectiveness in regulation has many aspects, one of which is to handle financial crises. Another aspect is that regulation is crisis driven, and has always been so. While national regulators today cannot be expected to handle a major financial crisis, the formal powers nonetheless firmly remain at the national level. While the European level may be able to develop the tools to handle such crises, EU institutions are not given the required powers to do so. This may suit both the Member State and the EU level well. Neither can in a real sense be held responsible for a breakdown, should it ever occur. So any more fundamental reform is postponed until the next crisis. Not that the solution with stronger Euro-regulators is a given consequence or outcome of a major financial crisis in Europe. But stronger Euro-regulators, or even a single European financial market regulator, seem the more effective solution for reasons just discussed, and which we will develop further in this chapter. It may seem surprising that it is not considered, or considered as a realistic alternative, in advance of the crisis, with the large welfare costs a crisis would bring with it.

In this chapter, we will first look at the foundations for financial market regulation, its harmonisation in Europe and the institutional dimension. We will discuss the framework of the EU and the different policy options it leaves. The chapter builds on the author's previous work on the problems of handling banking crises in Europe with central banking at a European level and financial market supervision at a national level,[3] complicated further by EU state aid rules,[4] his analysis of the problems of lack of enforcement of

[3] See M Andenas and L E Panourgias, 'Applied Montary Policy and Bank Supervision by the ECB' in J J Norton and M Andenas (eds), *International Monetary and Financial Law Upon Entering the New Millennium. A Tribute to Sir Joseph and Ruth Gold* (BIICL, London, 2002) 119; M Andenas and C Hadjiemmanuil, 'Banking Supervision, The Internal Market and European Monetary Union' in M Andenas (ed.), *European Economic and Monetary Union: the institutional framework* (Kluwer Law International, London, Doordrecht 1997) 373, and also Lazaros E. Panourgias and Mads Andenas, 'The euro, EMU and UK law', in Jean-Victor Louis (ed.), *The euro in the National Context* (BIICL, London 2002).

[4] See M Andenas, 'Who is Going to Supervise Europe's Financial Markets', in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator*, with a Foreword by Charles Goodhart (Kluwer Law International, London, The Hague, New York, 2003), xv–xxvi.

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financial market regulation,[5] and his work on general services issues in the EU and the WTO.[6]

2. WHY DO WE REGULATE?

We now turn to the different aims of financial market regulation. The stability of the financial system, consumer protection and deterrence of fraud are acknowledged as the three core aims. They are accorded different weight in different sectors of the financial market. Legislators, regulators and academics disagree not only about the weight but also the content of these three aims.[7] Systemic stability is however becoming the more important aim of financial market regulation but remains the most uncertain: we cannot agree on what can lead to systemic breakdown (or what can be done to deter or limit the risks).[8]

Why did 2008 seem a good time to revisit the different aims of financial market regulation? The first is the problems with Lamfalussy process for harmonising the EU Internal Financial Market. It has not delivered the integration which was expected. The second is the lack of a lender of last resort function in Europe which can tackle the issues that national authorities no longer can. The third is the evidence of the many problems in cooperation between national regulators. One simply cannot assume that it would stand the test that a major financial crisis would be.[9]

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[5] See for instance the article by M Andenas and D Fairgrieve, 'Misfeasance in Public Office, Governmental Liability and European Influences' (2002) 51 *ICLQ* 757–80. They argue in favour of an extended liability for lack of effective banking supervision, and that banking regulators should be liable where there is a sufficient breach of the duty to supervise and enforce banking regulation.

[6] See for instance M Andenas and K Alexander (eds), *WTO and Trade in Services* (Nijhoff, Brill, Leiden 2008) and M Andenas and W H Roth (eds), *The Right to Provide Services in EC Law* (Oxford University Press, Oxford, 2002).

[7] There is often a conflict between the statutory aims and objectives and the aims formulated by the regulators: see M Andenas and D Fairgrieve, 'Misfeasance in Public Office, Governmental Liability and European Influences' (2002) 51 *ICLQ* 757–80. In the UK, the Financial Services Authority (FSA) emphasises systemic stability as the primary aim of banking supervision. The FSA is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000, and the Act lists these aims: market confidence, public awareness, consumer protection and reduction of financial crime.

[8] Recent studies continue to challenge the basis for modern banking regulation. See for instance, J R Barth, G Caprio and R Levine, *Rethinking Bank Regulation. Till Angels Govern* (Cambridge University Press, New York, 2006).

[9] See the discussion in CAE Goodhart and D Schoenmaker, 'Burden sharing in a banking crisis in Europe', Special Paper No 164, LSE Financial Markets Group (FMG)

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A financial crisis would most likely open the window for reform. Financial marked regulation can only be understood on the background of the reactive nature of regulation. It develops in response to the crisis or the scandal. In Europe another kind of window was the proposal of the Delors Report which led to the creation of the European Central Bank (ECB) and introduction of the euro. There was strong support for an independent European central bank, for many also the only way of getting an independent monetary policy in their country.[10] The Delors Report proposed to move banking supervision to the ECB, but this proposal was in the end rejected. Since then we have had an expansion of national regulatory institutions, which may work against any European solution. A further window came after the introduction of the Euro and when French and German domestic needs made a European regulator attractive to those two countries. This too, closed rapidly.

What is the scholarly challenge in this? First we have the nature of applied research: analysing and bringing order into a practically important field. Research on financial market regulation often has policy implications and can appear to be mostly about rationalising and justifying policy choices. The level of scholarly ambition in the legal and economic contributions is usually rather low. There is a need to go beyond this. More ambitious contributions are required. And in particular at a point in time, such as today, where scholarship may influence policy choices which are in the process of being made. One can begin with the flawed tools at our disposal in this field, and with the different meanings of concepts that we use as if they had one meaning and were universally applicable. The prudential is a good example of a core concept which is flawed in the way it is used in scholarship and in policy. 'Prudential supervision' is a term used in the EU. Here 'prudential' denotes matters that are subject to home country control, and it also is used as a delimitation of ECB competence, which we will discuss below. The prudential is also used in international regulatory cooperation in the BIS, and here it has a similar but not identical meaning to that it has in the EU. In the WTO the 'prudential carve-out' appears, and here 'prudential'

Special Paper Series (London, March 2006) on who should bear the burden of any proposed recapitalisation should failures occur in large cross-border banks, and also S Osterloo and D Schoenmaker, 'Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities', LSE FMG Special Papers 156 (London, April, 2004).

[10] The growing realisation of the benefits of an independent monetary policy still met with strong opposition. Some of those responsible for monetary policy in national institutions such as ministries of finance and central banks saw the ECB as the opportunity for gaining central bank independence, which may not have been possible at a national level. They had to accept that this implied that monetary policy moved up to the EU level, a move some of them otherwise might have resisted. See the discussion in Lazaros E. Panourgias and Mads Andenas, 'The euro, EMU and UK law', in Jean-Victor Louis (ed.), *The euro in the National Context* (BIICL, London, 2002).

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indicates that something is subject to host country jurisdiction. You find it in different national jurisdictions, again with different meanings, and in US law it is the basis for federal jurisdiction in banking legislation.

The list of tools that are flawed due to the vagueness of concepts continues. The lender of last resort function of central banks is central in the handling of bank crises. Various authors will use the concept as if it only had one and a most precise meaning. The only problem is that they will ascribe different meanings to it. There are historical reasons for the particular degree of vagueness in financial market supervision and central banking. Vagueness may deter distortions and reduce perverse incentives, and hold market actors from placing reliance on state intervention. Vagueness can serve a purpose.

The discussion of the flawed tools could also take account of the rapid growth of financial marked regulation, and the arrested development of many of the concepts used. Regulation has expanded considerably. The meaning of prudential regulation, of conduct of business and consumer or investor protection, and of home country control therefore changes. Home country control, even if the different meanings of the prudential are taken into account, is used in different ways, for instance in the EU and BIS. One has to enquire whether the historical reasons for particular vagueness in financial market supervision and central banking hold up. With the changing nature of the field and its regulation there is every reason to take the enquiry further and to ask whether the concepts underpinning regulation remain adequate.

There is also limited scholarship on the national traditions and approaches. Let us pick two examples. The first is the 1994 IMF study on the effectiveness of banking supervision and handling of banking crises. It gave the highest score to the UK as there had been no regulatory interventions in the relevant period. In another study from 2006 the highest score went to regulators that most actively used administrative measures/interventions.[11] The 2006 study stated that there are methodological problems, which the 1994 IMF study did not.

The tools do not become less flawed with the impact of different national traditions and differences between financial markets. To start with the methods of banking supervision and the UK. The BCCI and Baring inquiries from the 1990s show the difference from other European and from the US regulatory tradition. Then there is the difference between regulation in banking, insurance and investment services. One also has to note the rapid change. There is for instance not much in terms of traditions for investment services regulation. And with the rapid change which now is taking place, national traditions may be less relevant in this sector.

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[11] J R Barth, G Caprio and R Levine, *Rethinking Bank Regulation. Till Angels Govern* (Cambridge University Press, New York, 2006).

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The core concepts are not wholly belonging to the sphere of law or that of economics. Inter-disciplinarity can be a reason for vagueness with the need to rely on concepts partially based in another discipline. The outcome could be that they are based in no discipline. One ends up with sociological ideal-types built on different models. They are lacking the rigour needed for empirical or legal/normative research. This goes back to the need for going beyond the current state of scholarship, and that more ambitious contributions are required, at a point in time when scholarship may influence policy choices.

3. SEPARATING MONEY AND BANKING SUPERVISION

Monetary policy and supervision of financial institutions or markets were until recently an unchallenged competence of the national state; some would regard it as being at the very core of the modern state. All the European Community could offer was a low level of coordination of economic and monetary policy and a severely restricted free movement of financial services with a limited harmonisation of supervisory rules. European economic and monetary union introduced a geographical separation between money and supervision of financial institutions and markets. In the euro area, with a single currency, it is still the many different national authorities that are regulating or supervising banks and other financial institutions. The European Central Bank defines and implements a single monetary policy as one of its basic tasks. But within a harmonised legislative framework in the directives, national authorities (in many countries they are more than one) remain responsible for banking supervision. The European Central Bank's complementary supervision role in relation to banks and payment systems adds to the complication.[12]

One of the major obstacles to the development of an Internal Financial Market was the economic policies pursued by Member States. The old quantitative regime regulated the supply of credit. It did this through the fixing of interest rates, loan terms and quotas for credit, both on the total lending by different financial institutions and on what sectors of the economy they could lend to. It restricted the access to the bond market. There were numerous other regulatory techniques applied. This kind of credit policy as well as monetary policy was a matter for Member States. And it could not be effective unless capital flows between Member States were kept to a minimum. Money and banking

[12] See the discussion in M Andenas and C Hadjiemmanuil, 'Banking Supervision, The Internal Market and European Monetary Union' in M Andenas (ed.), *European Economic and Monetary Union: the institutional framework* (Kluwer Law International, London, Doordrecht, 1997) 373.

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supervision had to be united in the Member States. This has changed, partly as a consequence of the new economic and monetary policies that have taken over. There are a number of issues that need to be resolved when money and supervision are separated. There is first the question of the lender of last resort and the wider handling of banking crises. The central bank acts as the banks' lender of last resort, providing liquidity when the market does not do so. This will often extend to a more extensive responsibility for the handling of banking crises, and crises of other financial institutions or markets. This leads to the issues of regulation and supervision of institutions and markets generally. Are there problems in separating the handling of crises and the preventative regulation and supervision? Does this lead to any distortions or perverse incentives on the side of regulators or regulated? There are also the questions of efficiency and of transparency and democratic control. It is not clear that the present uncertain and complex situation scores highly on either of these boards.

What is then the optimal institutional outcome? What should remain at a national level, and how would the tasks at a European level best be organised? One major problem here is that financial market regulation has rarely come about as a consequence of rational deliberation. Historically regulatory reform has taken the form of panic stricken short term responses to the crisis that has just passed.

One also has the situation that authorities in this field are generally not too concerned with acquiring the formal responsibility. We have already discussed certain aspects of how, increasingly formalised though detailed rulemaking, the regulatory competences nevertheless remain broad and widely discretionary. Sanctions and enforcement remain uncertain. Certain central bank or regulatory functions, such as the lender of last resort, are traditionally left open-ended in order not to affect market behaviour. It is assumed that clear rules could lead to distortions and perverse incentives. A situation where responsibility is not clearly allocated can have its further advantages for a regulator. Financial market crises will continue to occur, and not having the formal responsibility (the European Central Bank) or not having the tools (national regulators) for handling them may disperse the institutional repercussions of flawed supervision.

The relationship between financial market regulation and economic policy is a complex one. Major changes in the established policies and the abolition of capital controls have been necessary for the development of the Internal Financial Market. The euro will bring it further and will also entail further challenges. Let us go back to the Commission's 1985 White Paper *Completing the Internal Market.*[13] The White Paper set out the legislative programme for the creation of a single market by the end of 1992. Free movement of capital and financial

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[13] COM(85)310 final.

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services stood out as an area where little had been achieved and as to which the Commission proposed many ambitious measures. One reason for the slow progress of the internal market in financial services was that it depended on capital liberalisation, that is, on the abolition of restrictions and administrative controls on cross-border financial transactions. Capital liberalisation would, in fact, inevitably have two consequences. First, deregulation of financial markets, and, second, the abolition or easing of rules with respect to the participation in domestic financial markets of foreign institutions.

Capital restrictions were a necessary precondition for the effectiveness of the direct instruments of monetary and credit control. Credit control imposed limitations on the growth of clearing banks' assets (in some cases also their liabilities). It usually extended to other financial institutions' assets and to markets such as those in corporate bonds. With the help of such instruments, monetary objectives could be achieved at a lower interest rate than would otherwise be possible. Capital restrictions made it possible to pursue relatively autonomous monetary and credit policies. Such policies depended on the possibility of maintaining an interest rate different from that of neighbouring countries. Capital restrictions were instruments to limit capital inflows and outflows. Their importance would depend on the trends in other financial markets. Restrictions on capital outflows – so that savers and investors could not go abroad – allowed, in the short term, the preservation of low interest rates. The restrictions impeded downward pressures on the currency's exchange rate. In the long term, they protected domestic savings and domestic capital markets. Particularly strict restrictions on pension funds and life-assurance companies, affecting their ability to diversify their investments by investing abroad, could have both such short-term and long-term effects.

Restrictions on capital inflows – for instance, so that lenders could not go to banks or securities markets abroad to raise capital – preserved, in the short term, price stability and avoided upward pressure on the exchange rate. In the long term, restrictions on foreign investors contributed to the protection of the domestic control of key industries, which in several countries was considered to be an important matter of national sovereignty. The national interest in domestic control of business enterprises was thought to be particularly strong in the area of financial institutions, such as banks, pension funds and insurance companies. Strong partnerships would be established between the authorities in charge of banking supervision and the quantitative restrictions, providing an effective shield against foreign establishment or direct competition. Similar intensity partnerships were established in the other financial industry sectors.

Capital controls have been applied by all countries, in different ways and to different degrees. There is a tidal quality to capital controls, which rise and subside with some regularity. In the late 1980s and early 1990s they had subsided to a lower ebb than ever before in modern history. Economic policy in the 1980s

Not for distribution

became increasingly based on a doctrine of greater market orientation. Indirect instruments, seeking to influence credit expansion through price mechanisms, gradually replaced the direct instruments of monetary control. This is what is usually described as liberalisation in domestic economic policy and in domestic financial markets. The final conversion to liberalisation came after the experiences of the late 1970s and early 1980s. Sceptics had had to accept that the existing controls were characterised by a low degree of effectiveness and high costs. There were costs of an administrative nature. More importantly there was a macroeconomic cost in that distortions in asset prices and interest rates could lead to a sub-optimal allocation of capital resources. Financial markets became less effective. There were also problems following from shielding financial markets from foreign competition. Temporary advantages could be outweighed by the cost of postponing the economic policy and private sector adaptation to changes in international economic circumstances.

The direct instruments of monetary and credit control had created a close relationship between the major players. They were the financial institutions, in particular large clearing banks, and the monetary authorities, ministries of finance and central banks. Banking supervision became subordinated to this relationship, and played a limited role. Prudential rules – for instance, liquidity requirements – were turned into instruments of monetary policy, with a view to influencing interest rates. Competition polices were not developed, or at least not enforced with any rigour. In many countries the banking supervisory authorities managed to keep their sector out of the remit of the general competition authorities. All the parties to those close relationships had a strong interest in retaining them. Eventually, the gradual deregulation in domestic credit and monetary policy, with the abolition of direct controls, spurred a strengthening of prudential requirements and supervision and of competition policies. Some degree of internationalisation of financial markets and institutions took place under the capital controls in spite of the restrictions of national monetary and credit policies. This clearly undermined the effectiveness of these quantitative policies. There was no immediate link between, on the one hand, domestic deregulation and, on the other hand, the opening-up of domestic markets for financial institutions from other Member States or the development of an internal financial market in other ways. The financial services industry continued to enjoy a close relationship to the authorities. In some countries, the state would even directly own the major clearing banks. For most Member States, retaining domestic control over the financial services industry was considered to be of vital importance; financial institutions and markets should remain in the hands of their own nationals. The prospect of clearing banks, pension-fund managers or life-assurance companies being bought up by nationals of other countries appeared distant. Any other direct access to markets for foreign institutions was seriously curtailed. Gradually, however, deregulation in domestic monetary and

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credit policy did lead to the implementation of free movement of capital from 1990, on the basis of the Capital Liberalisation Directive,[14] which was adopted in 1988. This was the first time that all Member States agreed that the escape clause in Article 67 of the Treaty (abolishing capital-movement restrictions 'necessary to ensure the proper functioning of the common market') implied a full liberalisation.

With the lifting of capital controls, an internal financial market was now possible – and even necessary for ensuring that financial business would not drift to the Member State that would offer the least intensive regulatory environment and the best financial and tax incentives. The economic policies of Member States no longer depended on domestic markets. Most of the other obstacles just mentioned were still in place. The attempt to resolve them, guaranteeing unrestricted market access, was made in a series of financial market directives, the most important of which has been the Second Banking Directive of 1989.[15] Abolishing capital controls was an easy step in terms of execution when the economic polices allowed it. It was mainly a question of abolishing some rather simple regulation. Making free movement work was much more complicated.

Before the 1992 deadline of the Commission's 1985 White Paper, the major directives in this area of financial services and financial institutions were either adopted or going through the late stages of the legislative process, with a common position having been reached, guaranteeing their adoption.[16] The 1992 deadline was extremely tight in an area where so little had been achieved, placing considerable pressure on both the Member States and the Commission. This

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[14] Council Directive 88/361/EEC of 24.6.88 for the implementation of Article 67 of the Treaty.

[15] Second Council Directive 89/646/EEC of 15.12.89 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC.

[16] In addition to the Second Banking Directive, one must refer here to the following instruments: First Council Directive 77/780/EEC of 12.12.77 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (the 'First Banking Directive'); Council Directive 89/299/EEC of 17.4.89 on the own funds of credit institutions (the 'Own Funds Directive'); Council Directive 89/647/EEC of 18.12.89 on a solvency ratio for credit institutions (the 'Solvency Ratio Directive'); Council Directive 92/30/EEC of 6.4.92 on the supervision of credit institutions on a consolidated basis (the 'Second Consolidated Supervision Directive'); Council Directive 92/121/EEC of 21.12.92 on the monitoring and control of large exposures of credit institutions (the 'Large Exposures Directive'); Council Directive 93/6/EEC of 15.3.93 on the capital adequacy of investment firms and credit institutions (the 'Capital Adequacy Directive'); and Directive 94/19/EC of the European Parliament and of the Council of 30.5.94 on deposit-guarantee schemes (the 'Deposit-Guarantee Directive').

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was bound to have some impact on the form of the solutions that were found, and certain issues could not be explicitly resolved in the directives.

Making free movement work required more than abolishing capital controls and the supervision of financial institutions and the regulation of financial services. A large number of further issues have had to be addressed. The cost of cross-border payments has become a concern. The euro contributes to making the right to free movement of capital more effective; it could even be seen as the ultimate harmonisation measure! The introduction of the euro harmonises the currency or capital itself and takes care of mutual recognition in a way one could not in practical terms have done if the different national currencies were to be maintained.

We now turn to capital, services and establishment in the EC Treaty. The original provisions of the free movement of capital in the Treaty of Rome (Article 67–73) were more conditional than those concerning the other Treaty freedoms, such as those on the right to provide services and the right of establishment which have provided the basis for review of national financial market regulation. The obligation to abolish progressively restrictions on capital applied only to the extent necessary to ensure the proper functioning of the common market. One consequence of this was that the European Court held that the Treaty freedom was not directly effective. With the revisions of the Maastricht Treaty the free movement of capital was formulated in a broader and less conditional way than any other Treaty freedom. But even before those amendments entered into force, the European Court, held in *Sanz de Lera* [1995] ECR I-4821, that the Treaty freedom was directly effective. The Court argued that the Treaty provisions had to be read in the context of secondary Community legislation giving effect to the freedom, in particular the Directive abolishing the Member States' right to restrict capital movements.

The free movement of capital has been further strengthened by the unconditional and wide formulation in the Treaty. One issue which has been discussed in the legal literature is that of horizontal direct effect. In *Sanz de Lera* the action was against the state and the Court only had to address vertical direct effect. Horizontal direct effect, where a private party invokes the Treaty freedom against another private party, has not yet been addressed by the Court. Treaty provisions are normally capable of both horizontal and vertical direct effect. *Sanz de Lera* does not in any way indicate the contrary in relation to Article 56. Article 56 itself does not depend on implementing measures and is widely formulated. Argument to the contrary may be derived from Article 28 (ex Article 30) on the free movement of goods which is limited to actions against the state, and there are certain parallels between the provisions.

The Treaty freedoms provide a powerful tool for review of national regulation. Most of the field is now also based on EC directives, and harmonisation should reduce the restrictive nature of traditional financial market regulation.

Not for distribution

But there remain several issues in relation to the institutional solutions, in particular concerning the level of regulation at EU and national level, and beyond harmonisation which is based on national legislation and actual supervision. The most pressing is to what extent a European supervisor has to be established, and what should be the relationship with the supervisory functions that remain at the Member State level.

4. SYSTEMIC RISK AND INTERNAL MARKET ISSUES

We now return to the reasons we give for regulation. We have already discussed how the stability of the financial system, consumer protection and deterrence of fraud are acknowledged as the core aims. They are accorded different weight in different sectors of the financial market and there is disagreement also about the content of these three aims. Systemic stability is becoming the most important aim of financial market regulation[17] but remains the most uncertain: we cannot agree on what can lead to systemic breakdown (or what can be done to deter or limit the risks).[18] It has a whiff of the religious about it.

Systemic risk and systemic stability are like sin and redemption, and are based on revelation and tradition. The empirical support is weak, to say the least, for setting it top of the aims of financial market regulation. Pascal's Wager[19] offers a parallel from the religious world. Applied here it would go as follows: even if we cannot know if it exists, as long as we do not know with certainty that it does not, the consequences of being wrong are too terrible to neglect it. Vagueness and uncertainty as we know it from the regulatory sector apply in particular to the systemic issues. This is rarely openly acknowledged by the regulators, and also scholarship and academic teaching will rarely take this into account. So the important question is what consequences one can draw from this vagueness and uncertainty. If systemic risk is what justifies regulation, it must be taken seriously. It may have consequences for the solutions, including whether the national level remains effective.

The problem of coordinating financial market regulation is brought on by several developments. The first may be a convergence in supervisory aims and

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[17] In areas other than banking (insurance and investment services), investor protection and market organisation have traditionally been the primary aims but the systemic stability concerns are increasingly central.

[18] Recent studies continue to challenge the basis for modern banking regulation. See for instance, J R Barth, G Caprio and R Levine, *Rethinking Bank Regulation. Till Angels Govern* (Cambridge University Press, New York, 2006).

[19] Blaise Pascal, *Pensées* (1669). 'Pascal's Wager' is one of three arguments that Pascal presents for believing, or for at least taking steps to believe, in God.

Not for distribution

also in methods. Another is in the integration of markets on the product side, and a third in the integration on the ownership side. The Scandinavian model of a unified financial market regulator has been taken up in the United Kingdom with the establishment of the Financial Services Authority in 1997. Similar developments have taken place in France, Germany and Austria, and most recently in Italy.[20]

We will in this chapter rehearse the arguments for and against a unified financial market regulation. We will also address the issue of whether the European Central Bank and the removal of monetary policy discretion from the national to the European level in the euro area have any impact on the argument. The institutional consolidation of financial market regulation leaves other issues, for instance the material regulation, and also the relationship to European regulation and coordination which remains fragmented. We will also consider the alternative model of 'regulation by objective', as advocated by Giorgio Di Giorgio and others.[21] Among the several questions about this model in a domestic perspective is whether the recent financial crises or scandals demonstrate that different regulators can cooperate in resolving the problems.

Much of the discussion about financial markets and institutions would focus on one kind of institution or market. Traditionally regulation and supervision have developed in very different ways. Banking supervision has focused on banks and their solidity or their supporting role in the traditional credit policies described above. Life insurance and pension fund regulation has had its focus on securing the interests of the insured, and the contractual terms have been regulated often in great detail. Securities markets have been regulated with investor protection as the focus, and fraud legislation an integral part of the regulatory model. The regulators have been based in different ministries and they have championed 'their' industry against the others. Not only the content or character regulation but also the intensity of regulation have varied between these three main sectors.

Similar products are now offered by institutions that are primarily based in any of these three main sectors. Cross-ownership requires new consolidated supervision. And there is an increasing interdependency between financial

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[20] See for instance Part III in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe. Towards a Single Regulator?* (Kluwer Law International, London, The Hague, New York, 2003).

[21] G Di Giorgio and C Di Noia, 'Financial Market Regulation and Supervision: How Many Peaks for the Euro Area?' (2002–2003) 28 *Brooklyn Journal of International Law* 463. See also G Di Giorgio, C Di Noia and L Piatti, 'Financial Market Regulation: The Case of Italy and a Proposal for the Euro Area' in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe. Towards a Single Regulator?* (Kluwer Law International, London, The Hague, New York, 2003) 397.

Not for distribution

markets going beyond what can be explained by these features of the development. If sectoral supervision is to be maintained it must be heavily coordinated. In many countries new models of a universal regulator have been developed. In the Scandinavian countries this took place in the 1980s, in the UK in the late 1990s.

Banking supervision is increasingly influential as the emerging paradigm of financial market regulation. The basic regulation relates to capital adequacy and in matching the financial exposures. Risk is priced correctly and the systemic risks of a meltdown of a financial sector or the whole financial market are reduced.

Basically, banking supervision was created to provide solutions for domestic markets. That remains as a limitation even in its modern form. If anything this applies with even greater force to other sectors of financial market regulation. To some extent regulation and the actual supervisory functions undertaken have developed to restrict capital flows from other countries or to protect against competition from foreign institutions or markets. Globalisation creates a new role for financial market regulation which has had to become increasingly European and international.

The process of internationalisation of domestic financial market regulation has created problems to both national authorities and to institutions and markets that have an international dimension in their activities.

Other important surrounding areas of law with important impact in this field, such as contract law and company law, remain even more traditionally national. This leads to problems that are becoming increasingly more pressing. Banks and other financial institutions are authorised in one jurisdiction and it remains very difficult to move that authorisation to another Member State. That can in practice only be done by establishing a branch in the other country which will remain supervised primarily by the authorities of the first country of authorisation. Establishment though a branch is not covered by the authorisation by the home country supervisor. Moving to another jurisdiction is also still impossible as a matter of company law. One cannot move a company from one jurisdiction to another: it remains a foreign company in the new jurisdiction. There are of course techniques that alleviate this. Establishing a subsidiary in the new jurisdiction, and then transferring assets and activities. But a full recognition of a foreign company, so that it can reincorporate or register in the new jurisdiction (acquire a new nationality or citizenship so to speak) is still not possible in the national company laws of the world. The *Centros* decision[22] of the European Court of Justice has limited, as a matter of EU company law, the possibility to withhold the recognition of foreign companies or their branches. For the pur-

[22] Case C–212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I–1459.

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poses of financial market regulation, financial institutions had already achieved this. Authorities cannot discriminate on the grounds that the authorisation has been granted in another Member State. But the company law restrictions remained as for all other companies. The European Commission has drafted a proposal for a new directive on the ultimate free movement issue: how can a company register (or re-register) in a new jurisdiction. But this proposal still has a long way to go.

The separation of money and financial market supervision provides an opportunity to revisit the obstacles to the development of the Internal Financial Market. The old model under the quantitative regime did more than keep money and supervision together. It created regulatory systems which had as one of their primary aims to limit capital flows. The present level of harmonisation through the directives in the sector has not done away with this.

Even a very high degree of harmonisation will still lead to the double burden of having to follow more than one set of national rules. The proposed mechanism to limit double regulation in the directives – home country control – is not sufficiently effective. Its extent is not clear enough, there are too many and too wide exceptions, and the reporting even when it applies has proven too burdensome.

The recent proposals from the European Commission are still based on the home country control principle.[23] The otherwise very timely proposals deal with the programme of developing and modernising the harmonised regulatory rules. The new model for the adoption of these rules comes from the proposals from the Lamfalussy Committee. The Lamfalussy proposals included the adoption of a new legislative procedure and the use of regulations instead of directives. This has a huge potential when it comes to making the regulatory procedures more rapid and the adopted rules more effective.

It does however not resolve the basic problem of double burden that remains if there are all these different national regulators that remain in charge of the actual supervision. The intensity and extent of regulation of financial institutions are such that this burden is higher than in other sectors.

The Lamfalussy proposals included as mentioned the adoption of a new legislative procedure and the use of regulations instead of directives. This is now adopted for both investment services and (from 2002) for banking. The regulatory procedures become quicker and the adopted rules more effective. But can national regulators deliver a sufficient level of efficiency? They may not only provide restrictions on the free movement which is necessary to get the internal market to function. It is questionable whether they provide the level of effective

[23] Financial Services: Implementing the framework for financial markets: Action Plan. Communication of the Commission, COM(1999)232, 11.05.99.

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regulation that is required for the market to function? The European Commission has continued its adherence to home country control. The remedy is seen to be in an elaborate structure of bodies to promote cooperation and coordination between the national regulators. There is no doubt that coordination is necessary and that much can be achieved this way. But it is very uncertain if it can achieve the sufficient level of efficiency. Where there are different national interests of sufficient strength, one would expect the agreement to be lasting less.

The aim of systemic stability is now at the core of modern financial market regulation. Financial stability cannot be achieved at a national level with the present level of market integration, even when it is supported by an extensive body of harmonised EU legalisation in directives and regulations. Here there will often be strong diverging national views, and the different fora for cooperation and coordination cannot mediate effectively between these interests.

The handling of financial crises is one area where the lack of a European institutional solution seems particularly critical. The existing lender of last resort (LOLR) arrangements are not adequate to deal with liquidity issues in the context of a European 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 needed to judge on the systemic effect of liquidity problems and decide quickly on the collateral issues. 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. Even if they are concerned with the implications for the European market, they may 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.[24] Finally, cooperation on the basis of Memoranda of Understanding (MOU) does not secure the necessary real-time information sharing and action, while availability of resources is questionable.

A centralised LOLR competence at the ECB level will deal more effectively with most of the inadequacies of the current decentralised 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

[24] 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.

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the anti-competitive effect of national central bank policies and decisions on eligible collateral, and of interventions in support of insolvent institutions.[25] 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.

Two major arguments may be added for the ECB's handling the LOLR situations. The first argument is that national authorities may act counter to the requirements of monetary policy. It may be preferred that the balancing of financial stability and monetary policy is undertaken by one institution. This runs counter to some of the arguments brought up by others on this point that seems to build on an ordo–liberal division of functions to secure the uncorrupted exercise of monetary policy powers. The second argument in favour is that national authorities would easily run counter to the rules on state aid. ECB could not be restricted under these rules. Time pressures and other factors in this kind of financial crisis will make it less realistic that a solution may be achieved at the national level

At this stage it may be useful to sum up some points relating to regulators' jurisdiction. Regulators should follow markets. This seems an obvious starting point when one deals with regulation aiming at increasing market efficiency or counteracting market failure. Regulators do not follow markets. They follow national jurisdictions and state organisation that less and less often coincide with markets. New economic policies and market conditions should have removed obstacles so regulators now could follow markets. The way they presently divide them up applies also within domestic markets and not only in relation to foreign markets and institutions. National jurisdictions divide markets up. National regulation tends to obstruct market integration. It also makes regulation less effective. Any form of cooperation between regulators will provide less than optimal efficiency, both in terms of costs to business (in the EU, one still has to submit to twelve different regulatory regimes) and in achieving the primary goals of financial market regulation (increased financial stability, effective competition, market surveillance and sanctions against transgressors). In the financial markets regulators have traditionally divided markets up, making borders between countries effective barriers protecting their 'own' financial institutions against competition and also making economic policies effective. Today the EU and also broader forms of international cooperation, WTO/GATS, limit the power of regulators to achieve this. Most will be critical of this at a wholesale level: good reasons

[25] 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.

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also to challenge in relation to consumer or investor protection. A discussion of national regulation as a barrier leads to the following question. How can so many obstacles remain that are that much against the interests of the financial services industry that wishes to establish itself or sell its products in other Member States? Partly the answer must be that there are other interests that are served by most of the regulatory regimes. There are client relationships where the regulators protect 'their industry' against foreign competition. The other is the inertia that is displayed by many of the main players. It is not so that the interests are carefully balanced and the best solutions automatically solved. The story of the Merger Regulation and the 'one stop shop' is indicative. Only when the EU regulation was a fact that could not be avoided did business involve itself, in spite of the obvious benefits of EU level regulation. Business did not move to make merger control an EU competence. Only when this had come about did business take steps to avoid having an EU and a national level dealing with the individual cases. Conversely, for the international financial institution the independence of the regulator can be of importance. There is a problem of independence in a national context. Regulators are too closely involved with the political process. National business interests forms too close relationships with the regulator (regulatory capture). These problems are still there at EU level but there is less scope for capture than in the more limited national political and business environment. There is a case for saying that financial market regulation and supervision cannot be effectively developed and exercised at a national level: it is too vulnerable to pressure and form too many and too close client relationships. National lobbying at EU level is also a problem, but not as great a problem as at the national level.

One important question is the extent to which financial market regulation acts as a barrier to the Internal Financial Market. This is the justification for harmonisation of national regulation at the EU level. It can also provide grounds for review of existing national legislation, which may be set aside and cause liability for breach of EU law. The Internal Financial Market is far from realised. Nationally based financial market regulation remains the primary barrier. This chapter sets out the stages of the development of the Internal Financial Market, and points to some of the present problems. For instance the problems with the Lamfalussy process and that much EU legislation and Member State practice is not giving effect to free movement.

We have to go back to the fundamental freedoms of the treaty, the free movement rights, and they require financial market regulation (in particular in prohibiting double regulation).[26] The concepts of home country control, EC passport,

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[26] The process of financial market harmonisation was set on its path by the judgment of the Court of Justice in Case 205/84 *Commission v Germany* (*Re-insurance*) [1986] ECR, 03755.

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minimum standards and mutual recognition are discussed.[27] Free movement is leaving little room for special exclusions for banking and other financial services: see for instance the European Court of Justice in the case of *Caixa Bank France*.[28]

When we are assessing the EU legislation on financial market regulation, Lamfalussy's challenge to the lack of effectiveness and to the over-complication of the European regulatory system provides an important background. The different reviews of the Financial Services Action Plan of 1999 add to this.[29] Lamfalussy's ultimatum was that the home country control system had to be made effective or be replaced by 'a European SEC'. Where do we now stand? The Internal Financial Market is about a market in services that functions without national borders and can realise economies of scale, increased competition, etc. Recently focus has been moving towards establishing a functioning regulatory regime with a European level of rules and a national level of transposition and supervision. The question is the weight which free movement is given in this. This chapter argues that the process of eating into home country control by developing conduct of business rules under host country control reduces the effectiveness of the regime.

Regulating and supervising the Internal Financial Market is not only a question of giving effect to the Internal Market or developing a normative regulatory framework. It is also a question of the effectiveness of the present supervisory system. Can the national supervisory authorities undertake their tasks with a sufficient level of effectiveness? This is a typical Internal Market problem (the one in the preceding discussion of national regulation as a barrier is another): is the task better undertaken at an EU level?[30] The handling of banking crises is

[27] The European Court of Justice has made clear that these concepts are ways of giving effect to free movement but remain concepts of secondary legislation (directives) and do not have any 'constitutional' character: see Case 233/94 *Germany v European Parliament and Council* (*Deposit guarantee directive*) [1997] ECR I–2405.

[28] In Case 442/02 *Caixa Bank France* [2004] ECR I–89615 the Court held that the prohibition of paying interest on current accounts was a breach of the right to establishment of the French subsidiaries of Spanish banks. It constituted an 'obstacle to the pursuit of their activities via a subsidiary in France, affecting their access to the market'. Such a prohibition restricts, in particular, the activities of subsidiaries of foreign banks in raising capital from the public. The judgment applies in the banking sector the very broad freedom of establishment approach adopted by the Court in *Gebhard*. See Case C–55/94 *Gebhard* [1995] ECR I-4165.

[29] See the critical analysis in J Dalhuisen, *Dalhuisen on International Commercial, Financial and Trade Law* (2nd edn, Hart Publishing, Oxford, 2004) 1102–10.

[30] See S Osterloo and D Schoenmaker, 'Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities', LSE FMG Special Papers 156 (London, April 2004). The need for European arrangements ultimately depends on the intensity of cross-border spill-over effects or externalities within the EU, and the authors attempted to measure these cross-border externalities. They found that cross-border penetration

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one pressing issue which has been discussed. The formal responsibility remains at the national level. The necessary coordination at European level is expected to be undertaken through committee meetings between regulators.[31]

Tommaso Padoa-Schioppa, who ended his distinguished central banking career as member of the Executive Board of the European Central Bank (ECB), developed in a series of lectures an analysis which could be read in this manner: that if the present coordination of national responsibilities is insufficient, only an actual crisis demonstrating this would lead to new arrangements. Only the failure in handling a crisis will provide sufficient momentum to consider a European solution, and, if so, the failure will prove the point about the crisis-driven nature of the regulation of financial market.

Monetary and competition policy is already based at a European level. The European powers are starting to have an effect in relation to financial markets. The EU Commission has gradually stepped up its review of competition and merger cases in the financial services sector (as a matter of competition policy), and a recent initiative proposes to take discretionary control with mergers in the financial sector away from Member State supervisory and political authorities (as an Internal Market/free movement measure).

The European Central Bank has a limited express mandate in relation to banking and other financial services. On the one hand there is monetary policy, the traditional central banking responsibilities for payments and payments systems, and financial stability. This is firmly within the mandate of the ECB. On the other hand there is regulation and supervision at a macro and intermediate level, which there is no clear provision for at the EU level. However, the way is short between monetary policy and regulation at the macro level. There is no clear demarcation of the responsibilities of the ECB in relation to banking supervision. There is a growing feeling of regulatory competition between the European Commission and the ECB (and it is as ever there between the national and the EU level).

We will argue that an expansion of the ECB's supervision powers may be based on the ECB's monetary competence and the Treaty provisions for prudential

within the EU is currently limited: only seven banks out of the sample of 30 large EU banking groups are considered to be 'European' banks that have the potential to pose significant cross-border externalities. However, aggregate data show a gradual, though statistically significant, increase of cross-border penetration in the EU. Their conclusion is that policy-makers may in the near future face the challenge of designing European structures for financial supervision and stability.

[31] The unresolved issues are many. See the discussion of one of them in CAE Goodhart and D Schoenmaker, 'Burden sharing in a banking crisis in Europe', Special Paper No 164, LSE FMG Special Paper Series (London, March 2006): who should bear the burden of any proposed recapitalisation should failures occur in large cross-border banks.

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supervision. 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 link between monetary policy and prudential supervision. The Community law doctrine of implied powers applies here. The implied powers doctrine provides that when the Community only has competence which is conferred upon it, this may either follow directly from an express Treaty provisions or it may be implied from them. The implied powers doctrine also applies to the ECB, which is 'in the constellation of the EC legal order'[32] and 'fully subject to the principles of primary Community law and to the jurisdiction of the ECJ'.[33]

Article 105(5) of the Treaty (Article 3(3) ESCB Statute) states that the ECB has a responsibility to contribute to the smooth conduct of national policies relating to prudential supervision and financial stability. 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. 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 is expressly stated that open market and credit operations are to be undertaken for the attainment of the objectives and tasks of the ESCB (European System of Central Banks with the ECB at the summit).

The concept of 'macro-prudential supervision', explained as 'supervision with a view of safeguarding systemic stability', may prove useful here. The concept was introduced in a study I co-authored with Lazaros E. Panourgias in 2002.[34] We argued for a solution where micro-prudential supervision should remain with the bank regulator (national central banks, NCBs, or NCBs as part of the ESCB) and the ECB should intervene only when there is a compelling financial stability or internal market consideration. Prudential supervision in the UK provides an interesting example. First line prudential supervision (micro-) has been transferred to the Financial Services Authority (FSA)[35] while the Bank of England (BoE)

[32] Jean-Victor Louis, *Banking Supervision in the European Community: Institutional Aspects*, Report under the Chairmanship of Jean-Victor Louis (1995), at 73.

[33] Chiara Zilioli and Martin Selmayr, *The European Central Bank, its System and its Law (first part)*, 2 *Euredia* 187, 203 (1999), at 623.

[34] See Mads Andenas and Lazaros E. Panourgias, 'Applied Monetary Policy and Bank Supervision by the ECB' in J J Norton and M Andenas (eds), *International Monetary Law and Financial Law in the New Millenium* (British Institute of International and Comparative Law, London, 2002) 119–70 at 130 in a section under the heading 'Default Supervision of Central Banks'.

[35] 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

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remains the primary macro-prudential supervisor. Although the UK model has its own ambiguities, it does provide for a macro-prudential role of the central bank (BoE) on a clearer basis than in most other countries. The BoE has the responsibility for overseeing the payment systems,[36] and it does have a lender of last resort role for both individual and systemic liquidity crises, [37] which it can exercise in the context of its standing cooperation with the Treasury and the FSA, as provided for in the relevant Memorandum of Understanding.[38] The BoE also has the infrastructure to perform its macro-prudential supervision function. In 2010, the UK government outlined plans for reform of the UK regulatory framework, including the creation of an independent Financial Policy Committee at the Bank of England and a new prudential regulator as a susidiary of the Bank.[39]

Community law does not provide for any clear allocation of lender of last resort (LOLR) competences. We argue that this is redressed by attributing LOLR competence to the European Central Bank on the basis that this is applied

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services industry. For a report on the current supervisory framework in the UK see Lazaros E. Panourgias and Mads Andenas, 'The euro, EMU and UK law' in Jean-Victor Louis (ed.), *The euro in the National Context* (BIICL, London, 2002).

[36] The oversight responsibility of the BoE is provided in the Memorandum of Understanding agreed with the FSA and the Treasury: '[t]he Bank will be responsible for the overall stability of the financial system as a whole which will involve: … ii. financial system infrastructure, in particular payments systems at home and abroad. As the bankers' bank, the Bank will stand at the heart of the system. It will fall to the Bank to advise the Chancellor, and answer for its advice, on any major problem inherent in the payments systems. The Bank will also be closely involved in developing and improving the infrastructure, and strengthening the system to help reduce systemic risk'. See Bank of England, *The Bank of England's Oversight of Payment Systems*, at 169 (Dec. 2000); David Clementi, Deputy Governor of the Bank of England, 'UK Financial Services following the Launch of the Euro', Speech at the Economist Conferences (23 Apr. 1999), www.bankofengland.co.uk/speeches/subject.htm. Its oversight responsibility covers the CHAPS Euro (Clearing House Automated Payment System for Euro), a Real-Time-Gross-Settlement-System (RTGS) payments system for payments in Euro: *Bank of England, The Bank of England and Payment and Settlement Systems*, www.bankofengland.co.uk/markets/payments/index.htm.

[37] See section 2 of the Bank of England, 'Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority', www.bankofengland.co.uk/financialstability/mou.htm.

[38] 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.

[39] Such vague powers as we discuss here may not provide sufficiently clear responsibility for the BoE. Some may say the BoE is run more as a monetary policy seminar than as an institution concerned with systemic stability.

Not for distribution

monetary policy. There is an inseparable link of LOLR with monetary policy and the commonality of the tools used for both tasks. On the other hand, 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 supervision in general, and this could limit its involvement for LOLR purposes. It seems clear that if financial stability or internal market considerations requires centralization of micro-prudential supervision, and the case for a Community bank regulator or a Community single regulator may be made, then Treaty amendment would be necessary. Our argument is that this is not necessary in relation to the LOLR issues, and we support the general argument that LOLR can constitute applied monetary policy on the system of the Treaty.

There are two exceptions to what may seem to be an exclusive LOLR competence of the national central banks. First, in case of a 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.[40] 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, this is applied monetary policy with an implied power of the ECB to intervene due to the strong link[41] of systemic liquidity problems with monetary policy. The monetary policy tools, open market operations and credit operations, already available to the ECB,[42] will enable its intervention.[43] The second exception is that in case of a liquidity crisis generated in the payments system the ECB will share the LOLR competence with national central banks, as the Treaty provides for the ECB's competence to oversee the payment systems: '[t]he basic tasks to be carried out through the ESCB shall be…to promote the smooth operation of payment systems'.[44] The ECB can provide liquidity through intra-day credit on the basis of adequate collateral[45] and open market operations.[46]

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[40] EC Treaty Art. 105(5) EC; ESCB Statute Art. 3(3).

[41] See also Johannes Priesemann, 'Policy Options for Prudential Supervision in Stage Three of Monetary Union' in Paul J J Welfens and Holger C Wolf (eds), *Banking, International Capital Flows and Growth in Europe* (Springer, Berlin, New York 1997) 81, at 82–83. Priesemann goes further to support the inseparability of LOLR from monetary policy *both* in case of system and individual institutions crises.

[42] ESCB Statute Arts 17, 18.

[43] Of course, the monetary policy tools exclusively entrusted to the ECB will allow it an LOLR role even without any legal basis. Identifying the LOLR function and establishing a legal basis may serve both efficiency and accountability purposes.

[44] Art. 105(2) of the EC Treaty; ESCB Statute Art. 3(1).

[45] Art. 18(1) ESCB Statute.

[46] There is every reason to expect that the ECB will accept non-eligible collateral in case of liquidity crisis. The Governing Council will be able to change the characteristics

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The situation becomes more blurred in the case of liquidity problems of individual financial institutions. Are national central banks solely competent for prudential supervision, including as LOLR for individual liquidity crises? There is the view that this form of a decentralised LOLR complemented by other liquidity mechanisms is an effective arrangement. Our argument in this chapter is that the current LOLR framework is inadequate. The existing LOLR arrangements, modelled on a market approach, 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 needed to assess the systemic effect of liquidity problems and to make quick decisions on the eligible collateral. In case of liquidity problems of individual financial institutions, the national central banks are expected to act and undertake the LOLR costs only when the liquidity crisis poses systemic risks for their constituent banking system. Even if they are concerned with the implications for the European market, they may lack both the necessary resources and the ability to assess the severity of the liquidity problems. Their ability to act can be further limited due to the ECB's power to prohibit or restrict the LOLR role of the NCBs, and other EU law, in particular state aid rules. Real-time cooperation and information sharing is not guaranteed, neither is the availability of resources. The ECB in turn will not have the necessary information to assess the systemic impact of the liquidity crisis.

Minor reforms and improvements on a system where the competences remain at the national level cannot take the place of a centralised and European LOLR. First, some argue that market operations can deal effectively with liquidity problems and prevent bank runs spreading through contagion. The LTCM rescue orchestrated by the Fed in the 1990s is presented as an example of 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.[47]

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of eligible collateral since Art. 18(1) ESCB Statute only requires that the collateral is 'adequate' without determining the characteristics of 'adequate' collateral. This contrasts with the Bundesbank arrangements where the 'eligibility' characteristics are determined, and a legislative act is required in order to accept non-eligible collateral.

[47] The LTCM rescue through coordinated private action took place in a very competitive environment. However, in that case the intervention by the Federal Reserve and its chairman Alan Greenspan 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.* 151, 162 (November 1999), where a reference is made to related problems in the rescue of Johnson Matthey Bankers Ltd.

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Even if feasible, they will often be time-consuming, expensive and subject to free-rider problems.

A centralisation of the LOLR competence for both systemic and individual liquidity crises can be effected without any major reform. A European level institutional solution is available in the ECB. The legal basis for such centralisation would be in the applied monetary policy concept. An activation of the enabling clause of Article 105(6) of the Treaty (Article 25(2) of the ESCB Statute) is one way of allocating LOLR power to the ECB. It is not required if one relies on the applied monetary policy concept. This provides the basis for the ECB's LOLR competence without recourse to the enabling clause. The interdependence of banking soundness and LOLR with stable money growth establishes the link of LOLR with monetary policy.[48] The ECB's responsibility for the smooth conduct of national prudential policies further enhances the legality of the ECB's LOLR role.[49] 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 situation and when necessary inject liquidity against adequate collateral.[50] There is still a need for effective access to information. Such reforms can proceed alone, or in the context of a further centralisation of macro-prudential functions which moves up to the EU level.

5. SO WHO IS GOING TO REGULATE FINANCIAL MARKETS?

The European system of financial market regulation is continuing to evolve towards a functional multiple peak model.[51] The scholarly argument at the moment seems to have turned against a more comprehensive institutional solution at the European level.[52]

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[48] It is in this context that we agree with Paddoa Schioppa on the (lack of) adequacy of the existing system operating under 'constructive ambiguity'.

[49] EC Treaty Art. 105(5); ESCB Statute Art. 3(3).

[50] ESCB Statute Arts 17, 18. The ECB's Governing Council has a high degree of flexibility in determining what adequate collateral is.

[51] Since the publication of G Di Giorgio and C Di Noia, 'Financial Market Regulation and Supervision: How Many Peaks for the Euro Area?' (2002–2003) 28 *Brooklyn Journal of International Law* 463 this development has continued. These authors propose the establishment of a European System of Financial Regulators (similar to the ESCB) comprising a European Central Authority, a European Financial Supervision Authority and European Authority for Market Transparency.

[52] E Wymeersch, 'The future of financial regulation and supervision in Europe' (2005) 42 *Common Market Law Review* 987 and Rosa Maria Lastra, 'The Governance

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There is still a case to be made for the EU solution, and we will now rehearse some of the arguments that the discussion has brought up, concluding and complementing those in the preceding sections of the chapter.[53] The main support is in the following two points: (1) the obstacles to the Internal Financial Market presented by national regulatory and supervisory regimes, and the failure of the minimum standards and mutual recognition regime to lower these barriers; (2) the need for broader based regulatory and supervisory institutions, undertaking at a European level what cannot effectively be done at a national level, including providing a system for preventing and dealing with systemic crises and risks of such crises.

The choice between regulatory models may not be obvious. There is need for a further sorting out of the arguments which seem partially to be based on national paradigms and usually also based on outdated models of regulation and not taking account of the present state of development of the financial markets. The most radical solution would be an integrated consolidated single regulator for Europe's financial markets and intermediaries. We conclude that the arguments against a consolidated regulator have less weight at a European level. There is a European trend towards a universal regulator. The last decade has seen an emerging European model of a domestic universal financial market regulator in a rather tight European framework responding quickly to international developments. The recent developments include the establishment of the British Financial Services Authority and the German reforms. Their consequences for Europe are still not clear. Here we return to the question whether home country control does achieve the primary internal market aims. The answer remains that very limited financial integration has been achieved. This does, on the other hand, not exclude the increased interdependence and

Structure for Financial Supervision and Regulation in Europe' (2003) 10 *Columbia Journal of European Law* 49–68; see also her articles on 'Cross-Border Bank Insolvency: Legal Implications in the Case of Banks Operating in Different Jurisdictions in Latin America' (2003) 6 *Journal of International Economic Law* 79–110, and 'Regulating European Securities Markets: Beyond the Lamfalussy Report' in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe. Towards a Single Regulator?* (Kluwer Law International, London, The Hague, New York, 2003) 211. See the arguments the other way in S Osterloo and D Schoenmaker, 'Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities', LSE FMG Special Papers 156 (London, April 2004) and CAE Goodhart and D Schoenmaker, 'Burden sharing in a banking crisis in Europe', Special Paper No 164, LSE FMG Special Paper Series (London, March 2006).

[53] And developing the argument in M Andenas, 'Who is Going to Supervise Europe's Financial Markets' in M Andenas and Y Avgerinos (eds), *Financial Markets in Europe. Towards a Single Regulator?* (Kluwer Law International, London, The Hague, New York, 2003) xv.

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systemic risk. The introduction of the euro has not in itself changed this situation. But it shows, even more clearly than before, the costs and inefficiencies of existing market divisions. It also leads to increased integration, which in turn increases systemic risk. Cooperation between national authorities is not enough to handle crises. Although certain steps have been made in the field of capital adequacy, arrangements for regulation and monitoring are inadequate in today's markets. Consolidation of financial services calls for consolidation of supervision at EU level. It is not easy today to distinguish between market risk and the risk of financial institutions. A single supervisor could better function as coordinator of national regulatory authorities and lender of last resort. A single regulator with lender of last resort responsibilities could also respond better to a financial crisis, which would need immediate and resolute action. Negotiations and compromise between national regulators may not provide the optimal process. A constant challenge of other EU policies, e.g. on state aid, will remain.

On the other hand, we have the ECB's role: is it the most realistic prospect that it will gradually be filling the void? Its present role is limited but is increasing. It may provide the only realistic alternative for a European macro-prudential regulator and LOLR. We concluded that the argument against central bank involvement in financial market regulation, if rigorously tested, is less than convincing. There is a need for analysis and further sorting out of the issues to provide the basis for rational policy discourse. The ECB must be discussed as a model in relation to the sectoral regulators or the European super regulator. In itself the ECB may provide an organisational model for the development of a European super regulator.

The decision making process concerning financial market regulation and its reform is flawed, also at the EU level. There are several agency issues which distort the decision making process and which will effectively block the integrated consolidated single regulator. That financial market regulation traditionally is crisis driven means that it develops in response to financial crises or scandals and not as the outcome of a process of rational deliberation. There may be a window of opportunity following a financial crisis where the present system is seen to fail. The present coordination of national responsibilities is insufficient, and the risks involved with the current system are considerable. Waiting for such a window to open is not a satisfactory situation, but it seems that only an actual crisis demonstrating this can lead to new arrangements. Furthermore, authorities in this field are generally not too concerned with extending their formal responsibility but a crisis may force them to.

We now come to the discussion of some models for transfers of power to the European level. One is the euro and the ECB. The trade-off for ministries of finance and central banks was monetary policy and institutional independence which they were strongly ideologically committed to and could not achieve

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otherwise.[54] Trying to identify trade-offs that can create windows of opportunity for moving financial market supervision to a European level, one finds there are several candidates. The needs of the Internal Financial Market, spurred on by the introduction of the euro, should be the most realistic platform. The trade-off should be straightforward: more efficient home financial markets with benefits for investors, savers and society at large, and opportunities for expansion across borders for the financial institutions. Another form of trade-off lies in how a European solution may seem a radical solution. Historically regulatory reform has taken the form of panic stricken short term responses to the crisis that has just passed, and here the European solution may also offer a clean break with discredited national institutions.[55]

There is also a global financial policy challenge. The major issue here is that there is no viable political structure to support an international regulator, universal or sectoral. International financial liberalisation results in a major increase in risk in both the national and international real economies. An effective policy towards financial markets must be international in character. Already the financial instabilities in the 1990s, such as the Asian crisis, as well as collapses of financial institutions such as BCCI and Barings Bank, called for more efficient regulation for an effective lender of last resort. Demand for international financial regulation cannot be coped with by traditional forms of international cooperation between regulators. We need a tighter organisation; an IMF for financial market supervision, not only one that deals with such questions as a sideline to currency issues. The IMF, OECD and World Bank have been concerned with financial systems in the developing countries. There are further legitimacy concerns with the present international standard setting. They cannot be remedied by civil society participation through consultation.

We can conclude with the identification of a set of issues that require further research. There is a clear role for scholarship, institutional economics, legal and interdisciplinary scholarship. The law and the legal and economic concepts remain unclear, and their interrelationship is treated in a way that usually is confusing. We return to Pascal and the need to avoid taking the smallest risk when the risk is eternal damnation and our parallel is systemic risk and regulatory

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[54] Compare the situation in the United Kingdom where today still the Bank of England and the Treasury strongly oppose joining the euro. The window has closed: the Bank of England has been granted independence. See Lazaros E. Panourgias and Mads Andenas, 'The euro, EMU and UK law' in Jean-Victor Louis (ed.), *The Euro in the National Context* (BIICL, London, 2002).

[55] In the scenario where a crisis just has taken place. There may be diminishing returns from games of musical chairs with consolidations and break ups and further reorganisation of regulators and central banks at the national level. Cynically speaking, the European level offers a fresh start.

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models. Systemic risk and regulatory models, whether we base them on revelation or tradition, require rigorous analysis. Also the Internal Market process and what makes it effective require further analysis. We do not know enough about the mechanics of free movement deregulation or its costs and benefits, or for that matter about depositor or investor protection and its effects.

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2. Applied uniformity of a uniform commercial law: ensuring functional harmonisation of uniform texts through a global jurisconsultorium of the CISG*

Camilla Baasch Andersen**

DEFINING UNIFORMITY

This book, and the conference which inspired it, focuses on the theory and practice of harmonisation. The concluding chapter grapples with the concept of the taxonomy of harmonised law. One of the key questions here is the determination of what we mean by 'harmonisation' and the closely related term 'unification' of law.

Defining the concept of 'uniformity' in the context of commercial law is a complex task, as it is a term which has been used with a certain element of obscurity.[1] Any attempt to clarify it involves terminological deliberations and a comparative analysis of the preambles to uniform laws and their aims.[2] The present chapter argues that:

1. Uniformity in law is different from a dictionary definition, as no laws are

* 1980 Convention on Contracts for the International Sale of Goods [CISG].

** Cand.Jur. (Copenhagen), PhD (Aarhus School of Business). Fellow, Institute of International Commercial Law, Pace University Law School, New York, USA and Senior Lecturer in Law, University of Leicester, UK.

[1] See Michael Bridge's humorous remarks in 'Uniformity and Diversity in the Law of International Sale' in 15 *Pace International Law Review* (Spring 2003) 55–89: '[u] niform law represents a part of that phenomenon that we call globalisation, a word that means so many different things to so many different people and ought on that account to be used sparingly, perhaps with a modest financial forfeit that upon sufficient accumulation will be paid over to charitable purposes. Those of us participating in one or more of the incremental efforts to bring about uniform law are, fortunately, sufficiently obscure to be spared the attentions of anti-globalisation protestors'.

[2] For such an analysis see C Baasch Andersen, 'Defining Uniformity in Law' in (XII) *Uniform Law Review*, 2007–1, 5–57.

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