BANKING REGULATION AND WORLD TRADE LAW

Banking Regulation and World Trade Law concerns the legal aspects of the interaction between banking regulation and international trade in financial services. The author studies the internal banking market of the European Union, the liberalisation of financial services trade in the World Trade Organization, the accords of the Basel Committee on Banking Supervision and the European Central Bank.

The book focuses on the balancing between banking regulation and international trade law. It discusses discrimination and proportionality in national banking regulation, the allocation of prudential regulation and supervision between home and host country, and international financial law-making. The author questions decentralised/nation-based banking regulation and supervision as a foundation for a sustainable liberalisation of international trade in financial services.

The book considers various reforms of the international financial architecture, such as the incorporation of the Basel processes and accords into the WTO system, and the setting up of new international institutions by building on the Basel Committees or the IMF structures. The role of central banking in designing the international financial architecture is also explored: the book reviews the ECB's competence over foreign exchange policy and its function as lender of last resort, and treats price stability, banking soundness and representation as critical concepts. The analysis also reveals that the concept of 'prudential', despite its extensive use in banking regulation, has not been defined with adequate precision.

In seeking to delineate the interface between international economic law and banking regulation, Dr Panourgias builds on the rich European scholarship on institutional financial issues and the US interdisciplinary approach to world trade law. He also entertains the notion of international financial law as a distinct field.

The book will be of particular interest to those concerned with financial law and international banking.

Banking Regulation and World Trade Law

GATS, EU and 'Prudential' Institution Building

Lazaros E Panourgias

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Στους γονείς μου

To my parents

Foreword

Lazaros Panourgias' book on Banking Regulation and World Trade Law is an invaluable contribution to our understanding of the internationalisation of banking, and the liberalisation of world trade in financial services. The interplay between regulation in the various jurisdictions and the developing law relating to international trade in financial services is a fascinating subject for study.

The international financial system is a complex and evolving edifice. To ensure its stability and its positive welfare effects we need to comprehend the issues at stake and balance them efficiently. This book identifies the legal issues and proposes a scholarly roadmap for balancing banking regulation and trade.

Policy makers will benefit from the book's discussion of international financial structures. Dr Panourgias engages in a detailed review of WTO jurisprudence and an analysis of international financial institution building. He explains the relevance of the Basel committees for financial services liberalisation in the WTO, and their potential role as international financial supervisors. The author demonstrates the achievements of the EC internal banking market and leads his readers to draw lessons for international financial architecture. His discussion of the European Central Bank and bank supervision offers a fresh perspective on the relationship between price stability and banking soundness.

This is a book that comes at a most opportune time. As banking becomes more globalised, international financial architecture needs to be strengthened. It is a time for all of us who take an active part in international financial services to talk more with each other. This book will facilitate such discussion, as it brings together international economic law and banking law scholarship, central banking research and international economic policy issues. Moreover, Dr Panourgias uses his diverse – and impressive for his age – experience to produce an elegant mix of US and European discourse.

I am delighted to commend this book and I look forward to the debate on the issues it raises.

Rt Hon Lord Brittan of Spennithorne QC, DL

Preface

This book is a study on *balancing* international trade and banking regulation, and as such forms part of a quest for a governance system for international banking. The book discusses the financial services systems of the World Trade Organization and the European Union, the Basel committees and accords and the European Central Bank. Its themes include: dealing with barriers to financial services trade; regulating international banks; determining the competence of home and host bank supervisor; addressing financial stability; determining the relationship of monetary policy and bank supervision; and designing a new international financial architecture.

The book's themes have recently been the subject of a number of developments in financial regulation, and debates among financial-services stakeholders. For example, the World Trade Organization is currently carrying on negotiations about trade in financial services. The new Basel Capital Accord (Basel II) aims to make regulatory capital requirements more risk-sensitive and market-driven. The European Union has adopted legislation to deal with consolidated supervision of financial conglomerates and of cross-border banking, investment and insurance groups, and is moving towards more centralised supervision structures. The regulators are seeking to exercise their financial supervision competence in a way that is consistent with the business organisation of international financial institutions. Various countries have established a single financial regulator, while there is talk of the supervisory role of central banks. The BCCI dispute involved complex issues of cross-border bank supervision and depositors rights.

This book provides an interface for the sensibilities involved. International economic law approaches these matters in terms of discrimination and proportionality of national banking regulation, while banking regulation is concerned with allocating prudential regulation and supervision between the home and the host country, and international financial lawmaking. In integrating the concerns of these two fields, I have relied on the rich European legal scholarship regarding institutional issues of banking regulation and the US interdisciplinary approach to international economic law, drawing especially on international relations, economics, law and economics and new institutional economics.

The book should be of value in various areas of financial services work. Financial law scholars will hopefully respond to the book's international focus and engage the internationalists. Financial services policy-makers should consider the international legal structures which are of relevance for the proposed banking rules. International economic lawyers can help with international banking if they have a good understanding of how

international banking works and how it may be impacted by their analysis. I have accordingly attempted to offer more precise definitions of key concepts. This conceptual approach should allow for more clarity in the sometimes obscure regulation of banking matters and unveil the risks of using broad concepts, such as the 'prudential', in legal texts. My discussion of the interdependence of price stability and banking soundness may contribute to a more informed treatment of the relationship of monetary policy and bank supervision. Knowledge of international banking norms and processes may be useful in the fine-tuning of regulatory requirements which is mandated by the increasingly discretionary approach to banking supervision. It should also improve legal advising and business planning in the financial services industry, as it enhances our understanding of the international financial environment and its long-term evolution.

The book also proposes a constitutional matrix for international financial architecture. The existence of international financial regulation cannot be taken for granted. There are national and regional laws, the content of which is affected by policy discussions and standard-setting at the international level (eg the Basel standards), as well as by the activity of international financial institutions. I have tried to locate international legal norms that derive from international processes and have an effect on national legal orders and financial institutions. This search is limited to the area of banking. The World Trade Organization and the General Agreement on Trade in Services regulate the trade aspects of financial services at the international level. The promulgations of the Basel committees produce international 'soft' law, which covers many of the prudential aspects of banking regulation, particularly regulatory capital. The interaction between the General Agreement on Trade in Services and the Basel process stands as a possible source of 'hard' international banking law addressing both trade and prudential aspects. The trade-off between international trade and banking regulation is at the centre of the book's analysis, and principles for operating such a trade-off may be another element of international banking law. We must also look at the EU edifice, as it has provided a comprehensive system of regional banking law. It is possible that this exercise will produce a template for building a system of international banking law.

The main themes of this book reflect my personal intellectual journey. It centers on the balancing of values. Exploring criteria for the conduct of trade-offs has been constant and sometimes intense. The function of money has come to add an interesting dimension. I have sought to make sense of money and finance problems, legal and other. The desire for a thorough understanding has made necessary the study of these problems in light of increased internationalisation.

Many people – and quite a few institutions – have been responsible for what good has come out of this journey. Mads Andenas, Director of the British Institute of International and Comparative Law, fired in me the

desire to write a legal book and shared much of his knowledge. I am most grateful to Professor Eva Lomnicka, my co-supervisor at King's College London, and Professors Joseph Norton, of Queen Mary College London and Ulf Bernitz, of the University of Stockholm. I am also very appreciative of Professors Charles Goodhart, of the London School of Economics (formerly member of the Monetary Policy Committee of the Bank of England), Jean-Victor Louis, of the European University Institute (formerly General Counsel of the Central Bank of Belgium), René Smits, of the University of Amsterdam (formerly General Counsel of the Central Bank of Netherlands) and Joanne Scott, of Cambridge University, for their comments on various parts of this work. Duncan Fairgrieve at Sciences Po and Eva Hüpkes, of the Swiss Federal Banking Commission, have also offered me their constructive comments and friendly advice. Since my time at Fletcher, I have found Joel Trachtman's work inspiring, particularly his thinking on the issue of balancing, and his comments on this work were invaluable. Philip Wellons gave good advice during my work at the Harvard Law School Program on International Financial Systems and kindly reviewed parts of this work. Arthur Dimopoulos at Georgetown and Taxiarchis Kokkores at the Center of Planning and Economic Research in Athens have provided invaluable guidance.

My colleagues at Herbert Smith have, over the last few years, offered me a congenial environment with constant stimulus and quality work. I am also thankful to the European Bank for Reconstruction and Development for an educative and supportive relationship.

The British Institute of International and Comparative Law provided a stimulating research environment. I would also like to thank the staff at the Williams Library at Georgetown, the Ginn Library at the Fletcher School, the ILS and Langdell Libraries at Harvard, the Dewey Library at MIT, the law libraries at NYU and Basel University, as well as the British Library of Political and Economic Sciences and the IALS and Maughan Libraries at the University of London.

A debt of gratitude is owed to the Greek State Scholarships Foundation (IKY) for the generous scholarship that supported my research and my postgraduate studies.

I am thankful to Richard Hart, Mel Hamill and the staff at Hart Publishing for turning this manuscript into an elegant book.

A number of friends have encouraged and enriched the writing of this work. Kostas Papadopoulos and Nikitas Hatzimihail have provided constant encouragement, and George Stephanakis eased my transition from the States to London. Thomas Varvitsiotis, Karim Makdisi, Yannick Mireur, Dimitris Keridis and Carlo Pozzi have provided priceless perspectives. Dimitris Pelekis, Stavros Papastavrou, Paris Anestis, Kostas Zaimis, Dora Papadopoulou and Michael Papadakis have all been around.

My most grateful thanks go to my family. They are unique. Their

approach to life has been a great source of inspiration and quality. My brothers Dimitris and George have taught me a lot. Long walks at Via Indipidenza and protracted coffee breaks at Piazza Delle Muse have been educative as well as invigorating. This book is dedicated to my parents Evangelos and Kiki Panourgias to whom I owe everything.

Lazaros E Panourgias
London 2005

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Following a decision by the city of Basel to standardize the English and German spelling (1999) reference is made to 'Basel' Committee, Standards, Documents etc. (as opposed to Basle). The term 'Basel' is used also for pre-1999 documents.

Most of the Basel recommendations, guidelines and standards are reproduced in the Compendium of the Basel Committee documents (Compendium). *Compendium of documents produced by the Basel Committee on Banking Supervision* (Basel Committee on Banking Supervision, May 2001), <http://www.bis.org>

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I

Introduction

LET IT BE important what welfare means, who decides for it and how it should be best pursued. Developments in the area of financial services give us an opportunity to test institutional arrangements against this objective and decipher the role of the law. Increasing share in economic growth, deregulation in the form of less regulation, more tolerance of the blurring of financial activities (banking, securities, insurance) and constant innovation characterize the financial services industry. These are important issues for the nations' internal web of welfare crystallization. Liberalization of international trade comes to add an extra layer in the welfare determination process. It does so by treating certain compromises on national regulatory autonomy as welfare enhancing, delegating relevant power to international norm-making and defining mechanisms for further welfare delineation.

This extra institutional layer of welfare determination as it applies to the regulation of banking is of concern for the analysis here. Banking is understood as commercial banking, mainly, the activity of institutions under which they take repayable funds, eg deposits, from the public and grant loans for their own account. This book examines the institutions for weighing trade and banking regulation objectives. The following questions will be addressed: How has international norm-making dealt with trade liberalization? What is the effect on banking regulation? What are the tools for resolving conflicts between international trade and banking regulation? How is jurisdiction over such conflicts allocated at both a vertical and horizontal level? What is left for the national regulator and what is determined at the international level? Is the legislative or the adjudicative process in charge? How is efficiency and legitimacy of this conflict resolution process best ensured? What does 'international banking regulation' have to say?

The starting point of this book is the General Agreement on Trade in Services (GATS)[1] and its Annex on Financial Services. As part of the World Trade Organization (WTO) framework,[2] the GATS establishes multilateral

[1] General Agreement on Trade in Services and Annexes, WTO Agreement, below note 2, Annex 1B, and 33 ILM 1167 [hereinafter GATS].
[2] Agreement Establishing the World Trade Organization, Final Act Embodying the results of the Uruguay Round of Multilateral Trade Negotiations, Marrakesh, April 15, 1994, 33 ILM 1144 (1994) [hereinafter WTO Agreement].[3] GATS art. II.

arrangements for liberalization of trade in financial services. It applies principles of free and fair trade to domestic financial regulation. WTO Member countries have agreed to certain market opening commitments (market access) and are expected to treat financial institutions and financial services of any other Member not less favourably than like financial institutions and financial services of any other country (most-favoured-nation principle)[3] or of their jurisdiction (national treatment principle).[4] Although market access and national treatment apply only to measures so agreed, considerable domestic regulation has been committed and further commitments are envisaged through a 'built-in' structure toward more liberalization.[5] In addition, non-discriminatory domestic regulation may be subject to trade disciplines.

The effect of these legally binding, international trade norms on banking regulation has two facets. Firstly, they impinge upon domestic banking regulation and its objectives. Of primary concern are the protection of depositors and the stability of the banking system, which, as shown below, are the main considerations in the public regulation of banking. To the extent that domestic banking regulation is found inconsistent with free trade, a compromise on these objectives is imminent. Secondly, they allow international activity of banks to intensify and therefore add a new issue for banking regulation, domestic and international. Banks operating in multiple national legal orders can bring macroeconomic benefits to the host jurisdictions. However, they also constitute additional sources of financial stability risk by linking national banking systems and making them vulnerable to deficiencies of one another's regulatory regime. In addition, they can prove complex for a decentralized system of regulation.

The GATS addresses the interplay of trade and banking regulation through its so-called prudential carve-out. It says that domestic measures for prudential concerns, that is mainly concerns about depositor protection and systemic stability, can be exempted as long as they do not constitute means for avoiding the GATS commitments or obligations. This is both over- and under-inclusive. It is over-inclusive because the lax means-ends balancing test[6] and the indeterminacy of the 'prudential' concept allow almost all banking regulation to sustain easily the GATS review. It can prove to be under-inclusive because of the ambiguity of the 'prudential'

[4] GATS art. XVII.

[5] See GATS Preamble and Part IV, Progressive Liberalization, art. XIX. Progressive liberalization is envisaged on the basis of cooperation without excluding unilateral concessions.

[6] I use the term 'balancing test' in a broad sense, meaning a test that reviews the conflict of values, trade and regulatory here. It does not mean weighing the conflicting values and choosing a desirable level of each. It will be used interchangeably with the term 'trade-off test' or 'trade-off device'. See Joel P. Trachtman, below note 7, for various trade-off devices of which a 'balancing test' is a special category consisting of certain trade-off elements. I should mention here that my preoccupation with the legal aspects of the 'balancing' concept has been greatly inspired by Professor Trachtman's work. All errors remain mine.

concept and the uncertainty regarding application of its means-ends trade-off test. Arguably, there is a failure to address the inadequacy of decentralized regulation in light of the trade-led interdependence of the banking systems. It is indeed interesting that the indeterminate concept of 'prudential' operates at the foundation of the GATS system. Interestingly, the 'prudential' concept has similar constitutional dimensions in the EU construct. All this when the literature does not, and perhaps cannot, offer a sufficiently narrow definition of the concept.

International banking regulation has not addressed the conflict of trade and banking regulation. It deals only with prudential aspects of banking activity and this only through legally non-binding norms. International banking standards have their own problems in respect of implementation and effectiveness, and it is only to a limited extent they can inform the balancing of trade and banking regulation. In addition, issues of legitimacy arise in transforming these standards in criteria for the application of legally binding trade disciplines to national regulation.

Therefore, it is all down to the capacity of the GATS dispute settlement process to deliver. Besides the complexity of dealing with the concept of 'prudential', additional efficiency and legitimacy concerns are triggered. Taking into account the rigidity of the WTO legislative machinery, an intensive trade-off test, eg a full-comparative cost-benefit evaluation, should take place if the system is to balance effectively trade and banking regulation.[7] Strong legitimacy objections may apply in this case. First, application of a cost-benefit test may not find support in the GATS text. This has to be judged against the Appellate Body's holding of textual interpretation as a condition for a legitimate ruling. Second, a cost-benefit test may impinge excessively upon the authority of domestic or international institutions, to which a legitimate interpretation needs to show *some* deference. Finally, the conduct of a comparative cost-benefit test itself entails substantial legitimacy concerns, as it involves a very intense weighing of various interests which is a function regarded as being reserved primarily for the political process.[8]

The fragmentation in the development of trade norms and bank standards at the multilateral level, and the reliance on a multilateral adjudication process should be contrasted with the integrated framework of the EU edifice. The development of the EC internal banking market is premised upon extensive harmonization of banking norms. In addition, the EU legislative machinery is efficient and can respond effectively to adjudicative rulings. Continuous monitoring of the national banking systems and

[7] See Joel P. Trachtman, 'Trade and . . . Problems, Cost-Benefit Analysis and Subsidiarity', 9 *European Journal of International Law* 32 (1998), also available at <http://www.jeanmonnetprogram.org/papers/00/001101.rtf> (Harvard Jean Monnet Working Paper No. 1/97, 1997); references here are to the version in the *European Journal of International Law*.

[8] *Ibid* at 84.

debate on the issues at the EU level helps EU banking regulation to keep up with market and theory developments. The EU's coordinated macroeconomic environment and its single monetary authority, the European Central Bank (ECB), supply further institutional support to the integration process. Thus, the EU arrangements replace domestic banking regulation, and balancing of trade and banking regulation becomes less necessary.

My work is about this *balancing* of world trade and banking regulation, and institution building toward more and sustainable reduction of jurisdictional constraints on banking activity. I examine the GATS liberalization model and its dealing with the conflict of international trade and banking regulation. Deficiencies from both an efficiency and accountability point of view are explored. The state of the existing prudential arrangements at the international level, mainly of the Basel process and promulgations, is set out. A study of the EU construct shows the weaknesses of the GATS system and offers lessons for institution building at the international level.

The analysis focuses on banking due to its special concerns for public regulation. The importance of banks for the conduct of monetary policy, the financing of the economy, the conduct of payments, credit allocation and power allocation, and negative externalities to the rest of the economy justify special regulation. It is market imperfections with respect to depositor protection and systemic stability, and subsequent negative externalities that call for regulation in the form of public intervention, public regulation and supervision. Thus, the point is that compromises on banking regulation called for by international trade liberalization have to be viewed against these special features and their welfare effect. This focus on banking is further explained in Section 2.

There is no attempt to elaborate on the integration dynamics and assess the state of international cooperation. Neither is it my purpose to undertake an economic analysis of integration and its institutions. International relations theory and economics are better disciplines for this kind of analysis. I offer only to examine the legal aspects of the integration process and in this way inform the rest of the debate. My assumption is that a clear understanding of the function of the micro issues, as the legal issues are, can help the institutional discussion avoid arbitrariness. Black letter law analysis is at the core of the methodological approach of this work[9] while use of analytical tools from other disciplines is limited.[10] Nonetheless, the

[9] I share Posner's criticism that law is not an autonomous discipline. However, Posner himself, while urging for an interdisciplinary legal analysis, has stressed the importance of doctrinal analysis. '[T]he growth of interdisciplinary legal analysis has been a good thing, which ought to (and will) continue. Disinterested legal-doctrinal analysis of the traditional kind remains the indispensable core of legal thought, and there is no surfeit of such analysis today'. Richard A. Posner, 'The Decline of Law as an Autonomous Discipline: 1962–1987', 100 *Harvard Law Review* 761, 777 (1987).

[10] Hopefully, my approach is also in line with Richard Musgrave's and James Buchanan's perception of the interaction of economics with other disciplines as it was expressed at late stages

analysis relies extensively upon the findings of international relations theory and economics, and it modestly attempts to draw on law and economics and new institutional economics.

Section 1 presents the conceptual issues regarding the term 'prudential'. Despite the constitutional function of the concept in both the GATS and the EU's legal constructs, a sufficiently narrow delineation of its qualities is not yet available. The literature should share part of the blame. There is some inconsistency as to the measures covered by the term 'prudential' and a clearer distinction between conduct of business rules and prudential regulation is yet to be made. However, there are inherent limits in what the literature can offer. It is shown here that this is because the rationale *per se* of the whole banking regulation is mainly about prudential concerns and related market imperfections.

Chapter II examines the EC internal banking market and the GATS liberalization of financial services trade. There is emphasis on the EU's extensive harmonization of banking norms as a condition for the creation of the internal banking market. This is contrasted to the GATS's reliance on the prudential carve-out. The operation of the prudential carve-out and the application of the GATS disciplines to hypothetical banking rules are examined. I discuss the GATS trade-off devices and the importance of the concepts of 'likeness' and 'necessity'. Both concepts involve application of complex trade-offs. I take the view that regulatory considerations can be read in the 'likeness' concept, as there is no textual constraint and the WTO jurisprudence has in various instances so suggested. Under both the 'likeness' and the 'necessity' concepts, the adjudicative body can apply intense balancing tests, such as proportionality or cost-benefit tests. Although what I will call *stricto sensu* balancing, that is balancing involving a quasi quantifiable weighing of trade and banking regulation and a choice as to the desirable level of each, has not yet been applied in the WTO jurisprudence, a nuanced form of balancing is developing.

A closer comparison of the GATS and the EU follows. Emphasis is put on the differences of the respective legislative and adjudication mechanisms and on issues of procedural and substantial legitimacy. Implications for regional integration are also examined.

of their work at a conference of the Center for Economic Studies at the University of Munich (at the time, Musgrave was 87 years old and Buchanan was 78 years). Musgrave said that he was 'bothered by the imperialism of economists, who use their tools on problems that are outside economics' and he referred to economics and law as an example. 'Economics, of all the social sciences, is the only one that has a powerful mechanism of analysis, and so we can go and overwhelm the others that have no comparable engine of analysis. In that sense, I would question interaction'. Buchanan followed up on this, saying that he agreed 'with what Richard Musgrave says in criticism of some of the modern economists who really try to argue that somehow economics gives you the total picture'. Discussion: 'The Nature of the Fiscal State: The Roots of My Thinking' by Richard A Musgrave, in *Public Finance and Public Choice, Two Contrasting Visions of the State* 51, 54–55 (James M Buchanan & Richard A Musgrave, 1999).

In Chapter III, possible reforms of the GATS system are set out. First, developing the prudential carve-out through the legislative process is considered. Second, I examine whether incorporation of the Basel standards in the GATS construct can make the 'prudential' concept more clear and also inform the balancing of trade and banking regulation. Then, weaknesses of the reform alternatives are presented. The inherently broad scope of the 'prudential' concept and political considerations impede further elaboration on the concept. Inadequacy of the Basel standards themselves and their development outside the GATS system are of concern in relation to the second reform alternative. Thus, we are led to the proposal for more intensive institution building at the multilateral level and the idea of an international prudential supervisor. The focus is on the choice of the norm-making process, informal vis-à-vis formal, while ideas regarding the possible forum for an international prudential supervisor are also proposed. Before that, the building of institutional links between the WTO and the international financial organizations is examined as a medium-term institutional arrangement.

Chapter IV analyzes the EU system of banking supervision. The objective is to show the limits of a decentralized framework as the foundation for a sustainable liberalization of trade in financial services. Even in the case of the EU, with the 'integrated' operation of legislative mechanisms for the reduction of trade barriers and development of prudential standards, the existence of advanced cooperation arrangements and the certainty of a coordinated macroeconomic environment, further centralization of prudential regulation and supervision appears necessary for a full and safe internal banking market. In the absence of such centralized mechanisms, prudential concerns allow trade-restrictive host country rules to be retained to the extent that harmonization of prudential regulation has not covered them. Besides the problems for the internal market, the home country control model may not be adequate for financial stability if the EC internal banking market is to be realized. Regulatory arbitrage, implementation divergence and issues of supervisors' liability show the shortcomings. Supervision cooperation may not deal effectively with the need for real-time information sharing and action in case of liquidity problems at pan-European banks.

Chapter IV engages in concept clarification and argues that the EC Treaty[11] allows centralization of prudential supervision (mainly macroprudential supervision) at the ECB level even without activation of the so-called 'enabling clause'.[12] The Treaty does not delineate the reach of the ECB's monetary policy competence and the language on supervision com-

[11] The term 'EC Treaty' is used here to refer to the EEC Treaty (Treaty Establishing the European Economic Community [EEC Treaty], 1957, 298 UNTS 3) as amended. See Chapter II, note 51, for these reference issues.

[12] 'The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and receiving the assent of the European Parliament, confer upon the ECB

petences is rather 'soft': monetary policy is not defined, and only its primary, macroeconomic objective of price stability is mandated. My thesis is that 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. Foreign exchange policy is an example of how applied monetary policy and the 'softness' of the Treaty language have allowed an expansion of the ECB's competence in areas incident to its monetary policy power. An analysis of Lender of Last Resort (LOLR) functions in the EU follows in order to demonstrate further the impact of applied monetary policy on the ECB's competences.

Price stability and representation are identified as fundamental variables in the operation of a centralized supervision mechanism in the context of a coordinated macroeconomic environment. Price stability pursued by a single monetary policy institution, like the ECB, is critical for assumption of supervision powers by the same institution due to the interdependence of monetary management and bank supervision. Representation ensures that centralization takes place for the benefit of people's welfare and that legitimacy flaws do not undermine the sustainability of the system. The ultimate objective is that these variables further inform international institution building.

Certain recent developments are centred on prudential institution building at both the regional and multilateral levels. The Basel Committee on Banking Supervision (Basel Committee) recently adopted a new Basel Capital Accord (Basel II) (June 2004) in order to improve banking regulation and supervision of the internationally active banks. Basel II prescribes more sophisticated rules of regulatory capital, provides for reliance on banks' internal risk-management systems and discretionary supervisory review, and envisages more extensive market discipline. The Basel Committee has also acknowledged implementation problems – due to both the soft law nature of its standards and the enhanced supervisory discretion envisaged in Basel II – and has thus established the Accord Implementation Group.

The content of Basel II and its capital requirements are not covered in detail here. This is in line with the book's focus on the constitutional matrix of world trade in financial services. The Basel process is of importance for our analysis in relation to its legal nature as a soft law making process that evolves in isolation of the production of trade law norms (as opposed to

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 art. 25(2) of the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute). EC Treaty art. 8 (ex art. 4a), art. 311 (ex art. 239). Treaty on European Union – Protocol (No. 18) (ex No. 3) on the Statute of the European System of Central Banks and of the European Central Bank, 1992 OJ (C 191) 68, also available at <http://www.ecb.int> [hereinafter ESCB Statute].

the more integrated process of EU banking regulation and trade integration). Of interest is the fact that, regardless of their exact content, the Basel standards are agreed by a network of regulators and their application is left to the discretion of the national regulators.This book points out the legal nature of the Basel norms and the implications for their effective application and for the accountability of the Basel process. More importantly, it examines their potential legally binding effect as well as the issue of their ultimate arbiter in light of the GATS trade disciplines and the exemptions for prudential reasons, as the Basel standards can be employed in order to determine whether certain measures are prudential. In my view, these are the aspects of the Basel process that have relevance for the constitutional discussion of financial services trade liberalization. The exact content of Basel II or of any future amendments should be of concern mainly for the economics or finance specialists. The reading of their expression in the national legal texts will be important for the purposes of compliance by the relevant financial institutions, mainly the banks.

As concerns the balancing of trade and financial stability, the relevance of Basel II is one of degree. As Basel II provides for enhanced supervisory review and discretion, for example in respect of supervising a bank's internal risk models, Basel II, compared to other Basel accords, will be a less useful benchmark in determining whether certain national measures are protectionist or justifiable for prudential purposes. Overlaps in the responsibilities of the home and host supervisor in validating or supervising a banking group's internal risk models and divergence of their respective supervisory practices raise additional trade barriers, as banking groups are likely to manage risk centrally and use a common approach to risk management for the whole group.

Developments in the EU reflect the importance of centralized banking regulation and supervision. The European Commission has established new banking committees at the EU level in order to improve regulation and supervision of cross-border banking in the EU. The new financial services committees follow the adoption of the Lamfalussy regulatory model in EC securities regulation under which a legislative role is given to EU committees, namely the new European Securities Committee, and supervisory cooperation and implementation are facilitated by a new committee of EU supervisors, the Committee of European Securities Supervisors. This model has been extended to banking (and insurance and investment funds). A new European Banking Committee with advisory and regulatory capacity has been set up, replacing the Banking Advisory Committee. There is also a new Committee of European Banking Supervisors which will provide advice to the Commission on technical implementing measures and will assist with supervisory cooperation and implementation. The aim of these new banking committees is to allow EC banking regulation to respond more efficiently to theory and market developments as well as to improve

implementation and supervision. This will contribute to further reduction of regulatory barriers and enhance the stability of the EU banking system.

My analysis tries not to lose sight of the importance of 'image' for banking. The Parthenon-like architecture of major banks perfectly reflects how crucial 'image' is. Upon translation of this at the 'conceptual' level, the claim for efficient regulation of banking becomes very pressing. The underlying feeling is that there is still a long way to go before banking regulation catches up with globalization of banking.

1 THE CONCEPT OF 'PRUDENTIAL'

The concept of 'prudential' has a very critical function in both the GATS and the EU systems of financial services trade liberalization, without however being defined in the relevant legal texts. I argue here that this is a serious shortcoming because of the inherently broad character of the 'prudential' concept. A review of the literature demonstrates that the terms of prudential regulation and supervision are very broad as well as that their use is not always consistent. This section suggests working definitions of the terms 'prudential' and 'macro-prudential' supervision. Yet, the objective is to stress that, due to its inherent indeterminacy, the 'prudential' concept is not very useful as a term of art in a legal text.

1.1 The concept of 'prudential' in the GATS and the EU

In the GATS, 'prudential' is the criterion for allocation of jurisdiction with respect to financial stability and depositor protection. The regulatory autonomy of the Members in these areas depends upon the 'prudential' concept, as measures with a rational link to *'prudential' reasons* are exempted from trade disciplines. In the EU, there has been essential harmonization, which allows the application of the principle of home Member State 'prudential supervision'. The term 'prudential supervision' also determines functions for which the European Central Bank (ECB) may have a coordinating role or which it potentially may itself undertake. Thus, the concept of 'prudential' operates at the core of the GATS and EU trade liberalization structures, determining the level at which regulation is to be undertaken.

Despite this 'constitutional' function of the concept of 'prudential', neither the GATS agreement nor Community law defines it. The GATS Annex on Financial Services prescribes a non-exhaustive list of reasons, that are prudential: [13]

[13] GATS, Annex on Financial Services art. 2(a).

> [M]easures for *prudential reasons, including* for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement. (emphasis added)

It should be noted that the North American Free Trade Agreement (NAFTA)[14] also includes a prudential carve-out without defining what 'prudential' is. Like the GATS Annex, NAFTA provides only a non-exhaustive list of considerations that are regarded as prudential:[15]

> Nothing in this Part shall be construed to prevent a Party from adopting or maintaining *reasonable* measures *for prudential* reasons, *such as*:
> (a) the protection of investors, depositors, financial market participants, policy-holders, policy claimants, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service provider;
> (b) the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers; and
> (c) ensuring the integrity and stability of a Party's financial system. (emphasis added)

Community banking law also lacks a definition of 'prudential'. The Treaty provides only general guidance on the role of the European System of Central Banks (ESCB) in advising and coordinating prudential policies[16] and its potential prudential tasks.[17] Notably, the term used in the Greek text of the EC Treaty is 'προληπτική εποπτεία', which literally translated means 'preventive' supervision. Neither does secondary Community law employ a clear and systematic distinction between prudential and non-prudential measures.[18] The Directives do no more than treat solvency and management rules as the core of prudential norms. The Banking Consolidation Directive[19] refers to 'essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of pruden-

[14] North American Free Trade Agreement, U.S.–Can.–Mex., 32 ILM 289 (1993) [hereinafter NAFTA].
[15] NAFTA art. 1410(1).
[16] EC Treaty art. 105(5), ESCB Statute arts. 3(3), 25(1).
[17] EC Treaty art. 105(6), ESCB Statute art. 25(2).
[18] For a critical analysis of the indeterminacy of the 'prudential' epithet in the context of Community law, see Mads Andenas and Christos Hadjiemmanuil, 'Banking Supervision, The Internal Market and European Monetary Union', *European Economic and Monetary Union: The Institutional Framework* 403 (Mads Andenas et al. (eds), 1997).
[19] EP and Council Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions 2000 OJ (L 126) 1, as amended by EP and Council Directive 2000/28/EC, 2000 OJ (L 275) 37 [hereinafter Banking Consolidation Directive] (the Commission proposal for a Directive establishing a new financial services committees' structure calls the 2000/12 Directive the 'Codified Banking Directive'). For purposes of clarity, the Second Banking Directive (2BD), as subsequently amended, has now been codified and

tial supervision systems' which makes possible 'the application of the principle of home Member State prudential supervision'.[20] Nevertheless, it does not delineate the exact scope of prudential supervision. It only provides that home country control is established with respect to supervising the 'financial soundness' of a credit institution, and in particular its solvency.[21] It is interesting that while some scholars argue that the general good exception to home country competence is not available to harmonized prudential measures, the Investment Services Directive links general good to the *stability and sound operation of the financial system and the protection of investors*, that is to prudential considerations.[22] Thus, uncertainty remains as to the reach of prudential regulation and as to what prudential measures are still within the jurisdiction of the host country.

1.2 The concept of 'prudential' in the literature

A review of the banking regulation literature reveals that the terms 'prudential regulation' and 'prudential supervision' are very broad. At best, we find a non-exhaustive list of rules and procedures that constitute prudential regulation and supervision. Professor Cranston provides us with a useful description of *prudential regulation* distinguishing between 'preventive' and 'protective' regulation:[23]

> Preventive regulation involves those techniques, which are designed to forestall crises *by reducing the risks facing banks*. These *include* vetting the controllers and monitoring the management of banks, capital, solvency, and liquidity standards, and large exposure limits. Protective techniques, on the other hand, provide support to banks *once a crisis threatens*. Lender-of-last-resort facilities are

combined (along with the 73/183 Directive, the First Banking Directive, the Own Funds Directive, the Solvency Ratio Directive, the Large Exposures Directive and the Consolidated Supervision Directive) in the Banking Consolidation Directive. References here will be to the Banking Consolidation Directive with the respective provisions in the Second Banking Directive indicated in parentheses.

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[20] Banking Consolidation Directive Preamble 7th whereas clause (ex 2BD Preamble 4th whereas clause).

[21] Banking Consolidation Directive Preamble 22nd whereas clause (ex 2BD Preamble 10th whereas clause).

[22] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, 1993 OJ (L 141) 27 [Investment Services Directive], Preamble 41st whereas clause. The EU Commission recently adopted a new Investment Services Directive, which does not rely on a general good exception, as it further harmonizes rules on conduct of business, best execution and dealing with clients' orders. The new Investment Services Directive, known as the Markets in Financial Instruments Directive (MiFID, also known as ISD2), was published in the EU's *Official Journal* on 30 April 2004 and must be implemented within 24 months of its publication in the *Official Journal*. EP and Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, 2004 OJ (L 145) 1.

[23] Ross Cranston, *Principles of Banking Law* 84 (1997).

> of immediate benefit, but ultimately rescue operations may be necessary, as well as payments under deposit insurance schemes. (emphasis added)

1.2.1 Prudential regulation vis-à-vis (a) systemic stability, (b) conduct of business

Regulation relating to systemic stability considerations is not always treated as part of prudential regulation. Professor Goodhart and his colleagues distinguish between *prudential* and *systemic* regulation:[24]

> *Prudential* and *systemic* regulation need to be distinguished, although both adopt a similar approach. Systemic regulation is about the safety and soundness of financial institutions for purely systemic reasons (ie because the social costs of the failure of an institution exceed the private costs). On the other hand, prudential regulation is about the safety and soundness of financial institutions vis-à-vis consumer protection, in that the consumer loses when an institution fails, even if there are no systemic consequences.

On the other hand, it is systemic stability that is often considered to be at the core of prudential regulation and supervision. Professor Norton in his early work employs a broad definition of prudential regulation and supervision: 'practices and measures undertaken by banking authorities *with respect to* trying to maintain the *"safety and soundness"* of the banking institutions under their administrative supervision' (emphasis added).[25] 'Safety and soundness' is further described as

> an *all embracing byword* of the bank regulators (often, but not always derived from express legislative, administrative or judicial authority) used to reflect the acceptable level of the liquidity and stability for the banking system as a whole, or an acceptable level of financial condition for a particular class of banking institution so that this class of institution is not in foreseeable danger of uncontrollable insolvency . . . or an acceptable financial and managerial condition of a particular banking institution (emphasis added).[26]

Interestingly, he later qualifies his definition by confining the reference to prudential regulation and supervision to arrangements for '*overall (but not*

[24] Charles Goodhart et al., *Financial Regulation: Why, how and where now?* 5 (1998). The Chairman of the Australian Prudential Regulation Authority, Jeffrey Carmichael, also employs a distinction between prudential and systemic regulation. Jeffrey Carmichael, 'Options for Financial Regulatory Structure', Paper prepared for the conference on 'The Future of Financial Regulation in Taiwan', Taipei, July 6, 2001.

[25] Joseph J Norton, 'Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?', 49 *Ohio State Law Journal* 1299, 1304 n. 4 (1989).

[26] *Ibid.*; Joseph J Norton, *Devising International Bank Supervisory Standards* xxvi–xxvii (1995).

necessarily individual) "safety and soundness"' (emphasis added). It is not clear whether this qualification relates to the focus of later work on preventive regulations.[27]

An ECB paper treats both individual and systemic stability as the subject matter of prudential supervision and analysis, distinguishing between *micro-prudential supervision* and *macro-prudential analysis*: '[*M*]*icro-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'. '[*M*]*acro-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'.[28]

Actually, it is difficult to see how a clear distinction between individual and systemic financial stability considerations can be maintained, both conceptually and in practice. This regards both the distinction between prudential and systemic regulation and the one between micro- and macro-prudential.[29] It would be natural for macro-prudential supervision to spill over micro-prudential concerns and also for macro-prudential tasks, eg information gathering and analysis of banks' reports or fine-tuning of individual capital requirements, to overlap with micro-prudential tasks.

Another problem is that these approaches assume a clear line between prudential and conduct of business rules. This is reflected in the above mentioned ECB paper, which describes supervision of 'investor protection activities' as focusing mainly 'on the issuance and enforcement of rules on the conduct of business and the disclosure of information' and distinguishes it from micro-prudential supervision and macro-prudential analysis.[30] Instead it could be argued that drawing a line between conduct of business and prudential rules cannot be clear-cut. Conduct of business does impinge upon the financial health of individual institutions and of the overall banking system. Clive Briault, then Financial Services Authority (UK) Director of Prudential Standards Division, points out the blurring of prudential and conduct of business regulation, 'both conceptually and in practice':[31]

[27] *Ibid.*
[28] European Central Bank, 'The Role of Central Banks in Prudential Supervision' (March 2001), <http://www.ecb.int/pub/pdf/prudentialsupcbrole_en.pdf> [hereinafter ECB, 'The Role of Central Banks in Prudential Supervision'].
[29] For an interesting analysis of the micro- and macro-prudential aspects of financial stability, see Andrew Crockett, 'Marrying the micro- and macro-prudential dimensions of financial stability', Remarks before the Eleventh International Conference of Banking Supervisors, held in Basel (September 20–21, 2000), available in 76 BIS Rev. 1 (2000), <http://www.bis.org/review/r000922b.pdf>.
[30] See also Charles Goodhart et al., above note 24, at 6: 'Overall, conduct of business regulation is designed not to ensure the safety and soundness of institutions but to establish rules and guidelines about appropriate behaviour and business practices in dealing with customers'.
[31] Clive Briault, *The Rationale for a Single National Financial Services Regulator*, FSA Occasional Papers No. 2, May 1999, 24–25.

> Both have a close and legitimate interest in the senior management of any financial institution subject to both of these types of regulation, in particular because of the crucial roles of senior management in setting the 'compliance culture' of a firm, in ensuring that management responsibilities are properly allocated and cover comprehensively the business of the firm, and in ensuring that other internal systems and controls are in place. The detail of some of these systems and controls may indeed be specific to either prudential or conduct of business considerations, but many of them will be more general.

1.2.2 Further deficiencies

In most instances, *prudential regulation* and *supervision* are defined only for the purposes of the specific scholarly work and even then in broad terms. 'Prudential supervision is understood as the application of specific legislative provisions to enterprises active in the financial sector with the objective of ensuring the protection of customers (depositors, investors, those insured) and the stability of the financial system as a whole. The "toolkit" of the provisions *usually covers* . . .' (emphasis added).[32] Another work distinguishes four stages in bank supervision – licensing, supervision *stricto sensu*, sanctioning and crisis management – and attributes the epithet 'prudential' only to *stricto sensu* supervision.[33] This limitation of the term is difficult to reconcile with the same work's preceding determination of licensing as important for financial stability as well as with the undisputed fundamental importance of crisis management (eg LOLR) for depositor protection and financial stability.

The use of the term *prudential regulation* and *supervision* is not more precise in analyses undertaken in international financial organizations and other Community institutions. A working paper of the International Monetary Fund (IMF) that addresses the interplay of financial services trade liberalization and prudential regulation relies on the following footnote: '*Typical* prudential measures *include* . . .' (emphasis added).[34] Another IMF paper only acknowledges the problem of the absence of a definition in GATS.[35] A working paper of the European Parliament *distinguishes* prudential regulation and supervision from 'financial safety nets' (ie deposit insurance schemes, lender of last resort, and, 'closure policy'), and underscores the dynamic character of prudential regulation and supervision: 'The

[32] Johannes Priesemann, 'Policy Options for Prudential Supervision in Stage Three of Monetary Union', *Banking, International Capital Flows and Growth in Europe* 81 (Paul JJ Welfens & Holger C Wolf eds., 1997).
[33] Rosa Maria Lastra, *Central Banking and Banking Regulation* 108, 110 (1996).
[34] Natalia Tamirisa et al., 'Trade Policy in Financial Services' 5 n. 6 (IMF Working Paper WP/00/31, February 2000), <http://www.imf.org/external/pubs/ft/wp/2000/wp0031.pdf>.
[35] Piritta Sorsa, 'The GATS Agreement on Financial Services – A Modest Start to Multilateral Liberalization' 10 (IMF Working Paper WP/97/55, 1997), <http://www.imf.org/external/pubs/ft/wp/wp9755.pdf>.

scope and *content* of *prudential measures and procedures are undergoing a significant global evolution* which reflect, among other things, the updating of techniques to identify, measure and manage financial risk and the increasing need to harmonise supervisory approaches at an international level' (emphasis added).[36] A distinction between prudential supervision and central banks' LOLR role is found in the 1983 Basel Concordat on supervision of banks' foreign establishments. It is stated there that 'the report deals *exclusively* with the responsibilities of banking supervisory authorities for monitoring the *prudential conduct and soundness* of the business of banks' foreign establishments. It *does not address itself to lender-of-last-resort* aspects of the role of central banks' (emphasis added).[37] Finally, it is worth noting that a working paper of the Committee on Financial Markets of the Organization for the Economic Cooperation and Development (OECD) uses the GATS definition as its working definition![38]

1.3 The problem

The work in the literature on determining the meaning of the terms is helpful but not adequate. There is some inconsistency in that protective *ex post* measures and practices are not always classified as prudential regulation and supervision. Systemic issues, while mainly considered to be at the core of prudential regulation, have also been treated as a concern for a separate regulation category. Moreover, the distinction between conduct of business rules and prudential regulation is unclear. In any case, the literature allows a wide range of rules to be qualified as prudential measures.

Exacerbating the complexity of the inherently broad scope of prudential regulation and supervision, the legal texts of the EU and GATS add to the ambiguity. The EC's Treaty language is general in its description of the ESCB's role in prudential regulation and supervision. Article 105(5)[39] provides that 'the ESCB shall contribute to the smooth conduct of *policies* pursued by the competent authorities *relating to the prudential supervision* of

[36] Università Commerciale 'Luigi Bocconi', 'Paolo Baffi' Centre for Monetary and Financial Economics, Newfin – Financial Innovation Research Centre, 'The Functioning and Supervision of International Financial Institutions' 82 (Directorate-General for Research, European Parliament, Working Paper ECON-118 EN, February 2000), <http://www.europarl.eu.int/workingpapers/econ/pdf/118_en.pdf>.

[37] Basel Committee on Banking Supervision, 'Principles for the Supervision of Banks' Foreign Establishments' (May 1983), <http://www.bis.org> [hereinafter 1983 Basel Concordat].

[38] OECD, Committee on Financial Markets, 'Cross-Border Trade in Financial Services: Economics and Regulation', 75 *Financial Market Trends* 23, 39 (March 2000), <http://www.oecd.org/pdf/M000015000/M00015501.pdf> [hereinafter OECD, Committee on Financial Markets].

[39] See also article 3(3) of the ESCB Statute.

credit institutions' (emphasis added). Further, it is set out that the ESCB's co-ordinating role shall also relate to 'the stability of the financial system'. Article 105(6)[40] envisages that the Council may entrust the ECB with 'tasks *concerning policies relating to* the *prudential supervision* of credit institutions and other financial institutions with the exception of insurance undertakings' (emphasis added). Furthermore, article 25(1) of the ESCB Statute gives the ECB an advisory role with regard to 'the scope and implementation of Community legislation *relating to the prudential supervision* of credit institutions and *to the stability of the financial system*' (emphasis added).

The GATS adds to the complexity by saying that measures for prudential reasons which are enumerated in a non-exhaustive way, rather than prudential regulation and supervision, can be exempted from the GATS obligations. Thus, the literature's flexible descriptions of prudential regulation and supervision become even less helpful. Now, there must be a determination of the concept of 'prudential'.

The literature does not offer much more insight than this. Using 'safety and soundness',[41] financial stability and depositor protection as elements of a banking regulation field has the potential of encompassing all individual banking rules under this field. The reason for this is that the rationale *per se* of the whole banking regulation is mainly about prudential concerns and related market imperfections (this has its own problems, as demonstrated by the US debate on the concept of 'safety and soundness' and the wide discretion its scope allows when used as a criterion for regulatory intervention).[42] Public regulation of banks is justified primarily by the inability of depositors to assess the financial condition of the banks and structure their relationship accordingly as well as by the inability of the market to deal with systemic crises and their implications for the rest of the economy.[43] It is for this reason that my analysis does not attempt to further develop the concept of 'prudential'. I do want to stress, however, that while the concept is useful in field specification for scholarly purposes, it becomes problematic if it is used as a term of art in a legal text.

[40] See also article 25(2) of the ESCB Statute.
[41] Actually, the terms 'safety' and 'soundness' express a single concept concerned with financial health and their cumulative use only adds to emphasis. Jonathan R Macey et al., *Banking Law and Regulation* 275 (2001).
[42] See Timothy Haosen Wan, 'Comparative Approaches to Regulatory "Safety and Soundness" ', *International Banking Regulation and Supervision: Change and Transformation in the 1990s* 261, 282 (Joseph J Norton et al. eds., 1994).
[43] Admittedly, it is not the case that all individual banking rules serve the public interest rationale of banking regulation. Individual banking rules may serve the preferences of interest groups which do not necessarily coincide with prudential considerations. Then, the GATS will have to review the incentives of domestic regulation in order to apply the appropriate trade-off device, that is in order to apply the means-ends test only to measures for prudential reasons.

Perhaps the EU's reaction to Australia's proposal for clarification of the GATS prudential carve-out epitomizes the difficulties. It is reported that 'the European Communities felt that *defining prudential regulation* was possibly *too ambitious* since it was difficult to agree on something that would be useful to all' (emphasis added).[44]

1.3.1 Working Definitions: 'Prudential' – 'Macro-prudential supervision'

1.3.1.1 'Prudential' The term 'prudential' as used in this work includes arrangements addressing both the financial condition of *individual* banks and the stability of the relevant banking *system* and extends to both *ex ante* and *ex post* arrangements. My understanding of the concept covers licensing rules, capital adequacy requirements, payment systems regulation, deposit guarantee schemes, and LOLR arrangements as well as arrangements relating to supervisory cooperation. I talk about arrangements to encompass both regulation and supervision. It is often difficult to distinguish between prudential 'regulation' and 'supervision' and in any case the term 'prudential' extends to rules and practices emanating from a norm-making process as well as from operational tasks. The dynamic and evolutionary character of the concept is acknowledged.

1.3.1.2 'Macro-prudential supervision' This work uses the term 'macro-prudential 'supervision' to mean arrangements for monitoring and dealing with the systemic stability aspects of the operations of financial institutions as well as of economic and financial systems development.[45] Such arrangements include information gathering from financial institutions and assessment of risks for systemic stability, analysis of macroeconomic conditions and financial markets, fine-tuning of individual capital requirements, regulation of payment systems and management of liquidity crises and banks' insolvencies. My understanding of the term takes into account that there are inherent limitations in distinguishing micro- from macro-prudential supervision and that the respective functions may spill over into one another.

[44] Committee on Trade in Financial Services, WTO, Report of the Meeting Held on 25 May 2000, S/FIN/M/26, June 29, 2000. See also Committee on Trade in Financial Services, WTO, Report of the Meeting Held on 13 July 2000, S/FIN/M/27, August 23, 2000.
[45] See ECB, 'The Role of Central Banks in Prudential Supervision', above note 28.

2 RELEVANT POLICY RATIONALES

This volume focuses on banking. Banking is understood as commercial banking, mainly the activity of institutions under which they take repayable funds, eg deposits, from the public and grant loans for their own account.[46] It is this type of intermediation that presents special problems for the protection of depositors and the stability of the banking system.

This Section sets out the rationale for regulating banking, which then provides justifications for special exceptions in the trade regime.

2.1 Banking regulation – rationale

The banking system has special features which justify special regulation. The importance of banks for the conduct of monetary policy, the financing of the economy, the conduct of payments and credit allocation, as well as concerns regarding depositor protection, undue concentration of power and negative externalities to the rest of the economy, justify special rules for the regulation of banking:[47]

A Protection of depositors: Depositors lack the information and sophistication needed in assessing the financial condition of the account holding bank.[48] Economies of scale can also be achieved by assigning monitoring and assessment to regulation instead of every individual depositor spending separate resources for this.

B Monetary policy: The commercial banks supply the mechanism for transmission of monetary policy decisions to the rest of the economy.[49]

[46] For the nature of commercial banking and issues of definition, see Ross Cranston, above note 23, at 4. See also E Gerald Corrigan, 'Are Banks Special?' (Federal Reserve Bank of Minneapolis, 1982 Annual Report Essay), <http://minneapolisfed.org/pubs/ar/ar1982a.html> (doing away with the 'asset' side of the definition and identifying as the critical element of banking the issuance of 'transactions accounts', that is incurring 'liabilities which are payable on demand at par and are readily transferable by the owner to third parties'; 'term structure' risk is inherent in this function). See also E Gerald Corrigan, 'Are Banks Special?' A revisitation, The Region (Federal Reserve Bank of Minneapolis, Special Issue 2000), <http://minneapolisfed.org/pubs/region/00–03/corrigan.html>. I use the term 'bank' interchangeably with the term 'credit institution' in this book, particularly because 'credit institution' is the term used for commercial banking in the EU financial Directives.

[47] See Howell E Jackson, *The Regulation of Financial Holding Companies* (John M Olin Center for Law, Economics, and Business, Harvard Law School, Discussion Paper No 221, 1997), <http://www.law.harvard.edu/programs/olin_center/>, subsequently published in 3 P-Z *The New Palgrave Dictionary of Economics and the Law* 232–237 (Peter Newman ed., 1998); David Llewellyn, *The Economic Rationale for Financial Regulation* (FSA Occasional Papers No 1, May 1999), <http://www.fsa.gov.uk/pubs/policy/p14.pdf>.

[48] See David Llewellyn, above note 47, at 18, 21 (pointing out different regulation considerations for depositors in comparison to consumers of non-financial companies).

[49] See E Gerald Corrigan, above note 46, for the importance of banks as a 'transmission belt' for monetary policy.

It is important that interest rate changes or open market operations find their proper translation in the banks' balance sheets.

C *Economy financing*: The banks play a significant role in the financing of the economy by intermediating between depositors' savings and borrowers' financing needs.[50]

D *Payments*: It is through the banking system that payments are effected.

E *Credit allocation*: Rules on credit allocation are often necessary for the financing of economic agents who would not otherwise be able to obtain credit due to lack of financial means that can serve as collateral or due to lack of credit history.

F *Undue concentration of power*: Anti-competitive practices and concentration of power in a few banks are of considerable concern for the governments, as they can lead to excess profits, distortionary credit policies and undue influence on the political system.[51]

G *Negative externalities*: Bank failures can have a disproportionately negative effect on the rest of the economy through disturbing the monetary policy, impairing the financial operation of other industries and affecting the psychology of the economic agents. In commercial banking, the intermediation itself is a source of failures. The maturity mismatch between short-term liabilities and long-term assets in the banks' balance sheets exposes banks to liquidity problems. It is subsequent systemic risk and subsequent failures of other banks that compound the negative effect on the economy. This negative effect (social cost) that exceeds the cost of the bank failure itself (private cost) is not internalized by the bank and will have to be addressed by regulation.[52]

H *National control*: National ownership of banks is sometimes favoured so that their role in the national economy is controlled.

I *Fraud and money-laundering*: Fraud and money-laundering constitute significant risks to the reputation and financial health of individual banks and of the banking system. In addition, criminal activity may secure more substantial gains through use of the banking system for conducting its frauds and money laundering.[53]

Banking regulation should take the form of government intervention, government regulation and supervision, on the following grounds. First, the contribution of the banking system to the monetary policy, the conduct of

[50] In a world with zero transaction costs, intermediation would not be necessary. Investors would have information about profitable investments and they would invest directly in return for 'deposit-like' securities. Daniel R Fischel et al., 'The Regulation of Banks and Bank Holding Companies', 73 *Virginia Law Review* 301, 306 (2002).

[51] For competition considerations of banking regulation, see Howell E Jackson, above note 47, at 4.

[52] David Llewellyn, above note 47, at 13.

[53] Ross Cranston, above note 23, at 73.

payments, and the financing of the economy have the character of a public good,[54] which should be 'provided'[55] by the state. Second, the information asymmetry between banks and depositors and between banks and potential buyers of banks' assets[56] can lead to costs to the depositors or to the overall economy for which the market remedies are not adequate.[57] For example, depositors are not in a position to judge the financial condition of a bank and this, in case of doubts about the bank's financial health, can lead to panic withdrawals, which, in combination with the maturity mismatch of short-term liabilities and long-term assets, will result in liquidity problems and threaten bank failure. Banks will be forced to liquidate, if at all possible, their assets at fire-sale prices. A bank's attempt to prevent this by raising deposit interest rates is not likely to succeed as a raise in lending interest rates must also follow, with uncertain effect on the overall financial condition of the bank and the market's perception about the bank's failure probability.[58] In turn, serious problems or failure of a bank may trigger 'systemic risk', that is substantial systemic costs due to successive losses in many banks of the same system.[59] This can result in a loss of confidence, which may lead to panic runs on other banks and subsequent liquidity problems.[60] The same liquidity problems may arise due to interbank linkages through the payment system, interbank deposits or interbank loans. In that case, the interbank market might be unable to provide the liquidity needed. This will be due to competition or profitability concerns, coordination problems, or lack of information, which would have allowed distinguishing an illiquid from an insolvent credit institution.

[54] 'Public goods' are characterized by two elements: (a) non-exclusivity, that is there is no benefit to be gained by excluding someone from its consumption, and (b) non-rivalry, that is consumption by some has no effect on consumption by others. The state is called to provide the public goods because otherwise free-riding concerns lead to their insufficient 'provision' by the market. For the public goods theory, see Richard Musgrave, *The Theory of Public Finance* (1959).
[55] 'Provision', instead of 'production', is the term Musgrave uses to denote the 'political process by which such goods are made available, and *not* their public production'. Richard A. Musgrave, 'The Nature of the Fiscal State: The Roots of My Thinking', *Public Finance and Public Choice, Two Contrasting Visions of the State* 29, 37 (James M Buchanan & Richard A Musgrave, 1999).
[56] The banks' assets are often in the form of non-tradable long-term loans whose value cannot be established by the market.
[57] Manuel Guitián, 'Banking Soundness: The Other Dimension of Monetary Policy', *Banking Soundness and Monetary Policy, Issues and Experiences in the Global Economy* 41, 53 (Charles Enoch & John H Green eds., 1997).
[58] David Llewellyn, above note 47, at 14.
[59] See George G Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation', 16 n. 1 *Cato Journal* (1996), <http://www.cato.org/pubs/journal/cj16n1–2.html>, for a general definition of 'systemic risk' or 'contagion risk' as 'the probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system'. See n. 5 for various definitions of systemic risk. Yet, it should be noted that Kaufman does not share the prevailing perception of systemic risk as being a 'market phenomenon' and treats it more as a regulatory failure.
[60] For bank runs and panics, see Jonathan R Macey et al., above note 41, at 57 (2001).

Thus, public regulation of banking should be mainly about market imperfections relating to depositor protection and systemic stability and implications for the rest of the economy. This approach to government and market involvement in banking regulation is also confirmed by the debate on the new Basel capital adequacy arrangements. The new Basel Capital Accord (Basel II) of the Basel Committee on Banking Supervision reserves a discretionary role for the supervisor while envisaging extensive reliance on market discipline and on use of internal control mechanisms by 'sophisticated' banks.[61]

2.2 The conflict between banking regulation and trade liberalization

It is because of the operation of depositor protection and systemic stability at the foundation of banking regulation that financial services trade liberalization and its deregulation effects become of a special concern. Trade liberalization puts under scrutiny the reach of domestic banking regulation.[62] Discriminatory, and not consistent with its rationale, banking regulation is called to abolition. Even if it is consistent with its rationale, a trade-off against trade benefits is in place. A further compromise on domestic control might be inevitable if free trade is to materialize. But then, this means a compromise on depositor protection and systemic stability.

For an efficient weighing of banking regulation against trade objectives, proper balancing devices must be in place.[63] It should be ensured that trade advances while the stability of the national banking systems is not put at additional risk. It is argued here that the existing institutional framework for liberalizing international trade in financial services, ie the GATS, has not addressed satisfactorily the *banking regulation and trade* issue.

Actually, this volume submits that the limitations in the GATS trade-off mechanisms, legislative or judicial, are formidable. This is exactly due to the fundamental importance of depositor protection and systemic stability. These considerations permeate the entirety of banking regulation and it is difficult to draw criteria for compromising them. Perhaps there can be an explicit prescription of measures which are not directly relevant to depositor protection and systemic stability, and different, more trade intensive balancing devices can apply to such measures. Certainly, this is not what the GATS has opted for. The GATS has provided an exemption for measures which have a rational connection to 'prudential' reasons, that is reasons relating to depositor protection and systemic stability.[64] This is both over- and under-inclusive. It is over-inclusive because the lax balancing test

[61] For the new Basel Capital Accord, see p. 7.
[62] From now on the term is used to denote public regulation of banking.
[63] See note 6 above for the use of the term 'balancing' device to mean any test employed for addressing the conflict of trade and regulatory values.
[64] GATS, Annex on Financial Services art. 2(a).

and the indeterminacy of the 'prudential' concept allow almost all individual banking rules to be easily sustained. It can prove to be under-inclusive because of the ambiguity of the 'prudential' concept and the uncertainty regarding application of its balancing test. Further analysis of the issues reveals that a more sensible solution would be prudential institution building at the international level.[65]

It is worth noting that prudential considerations are found in the rationale of all individual banking rules, only if we accept that banking regulation is shaped by the general public interest in an efficient market economy. This is the case under the 'public interest' theory of economic regulation,[66] but it may be different under the 'capture' or 'supply and demand' theories ('interest group' theories).[67] The latter hold that regulation is the outcome of the competing demands of interest groups. Thus, it is possible that individual banking rules also accommodate the preferences of interest groups, which may not necessarily coincide with prudential considerations. It might have to be that the GATS dispute settlement process also decides on the incentives of domestic norm-making and theories of regulation, if it is to make sense of the 'prudential' concept and apply the appropriate tradeoff device.

The objective of the analysis in the following chapters is to show these limitations and ambiguities, and the subsequent problems in employing concepts as the 'prudential' concept in legal texts. This leads to considering further safety and soundness oriented institution building at the international level as a precondition for a meaningful internationalization of financial services. An attempt is made to inform this institution building by examining the interplay of *trade and banking regulation* in the context of the more advanced, regional integration model of the European Union.

[65] See Chapters II and III.

[66] For the various theories of economic regulation and a critique, see Richard A Posner, 'Theories of Economic Regulation', 5 n. 2 *Bell Journal of Economic and Management Science* 335 (1974).

[67] See *ibid*. For what Posner calls the 'economic theory of regulation', see George J Stigler, 'The Theory of Economic Regulation', 2 n. 1 *Bell Journal of Economic and Management Science* 3 (1971). In contrast to the 'capture' theory of political scientists, George Stigler includes interest groups other than the regulated firms among the agents who shape regulation.

II

Trade Liberalization and Banking Regulation: GATS and the EU

LIBERALIZATION OF CROSS-BORDER banking, and in particular of foreign direct investment in banking, in the context of the General Agreement on Trade in Services (GATS)[1] raises interesting issues for the stability of the international banking system and its institutional foundations. The GATS, legally separate from the General Agreement on Tariffs and Trade (GATT)[2] but within the framework of the World Trade Organization (WTO),[3] applies the GATT principles on trade in services. The

[1] General Agreement on Trade in Services and Annexes, WTO Agreement, below note 3, Annex 1B, and 33 ILM 1167 [hereinafter GATS]. The GATS is part of the 'WTO Agreements' which are annexed to the WTO Agreement and incorporated in the Uruguay Round Final Act (Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, April 15, 1994, 33 ILM 1125 (1994) [hereinafter Uruguay Round Final Act]). For an overview of the GATS, see John H. Jackson et al., *Legal Problems of International Economic Relations, cases, materials and text* 885 (4th edn 2002); *Trade in Services Division, WTO Secretariat, An Introduction to the GATS* (October 1999), <http://www.wto.org/english/tratop_e/serv_e/gsintr_e.doc> [hereinafter *Introduction to the GATS*].

[2] General Agreement on Tariffs and Trade 1994, WTO Agreement, below note 3, Annex 1A, Multilateral Agreement on Trade in Goods [hereinafter GATT]. The GATT and the GATS are not 'mutually exclusive' and they can both apply to a particular measure:

> [Measures which] involve a service relating to a particular good or a service supplied in conjunction with a particular good . . . [may] be scrutinized under both the GATT 1994 and the GATS . . . However, the specific aspects of that measure examined under each agreement could be different. Under the GATT 1994, the focus is on how the measure affects the goods involved. Under the GATS, the focus is on how the measure affects the supply of the service or the service suppliers involved. Whether a certain measure affecting the supply of a service related to a particular good is scrutinized under the GATT 1994 or the GATS, or both, is a matter that can only be determined on a case-by-case basis. This was also our conclusion in the Appellate Body Report in *Canada – Periodicals* [WTO Appellate Body Report: Canada – Certain Measures Concerning Periodicals, AB–1997–2, WT/DS31/AB/R (97–2653) 19 (July 30, 1997)].

WTO Appellate Body Report: European Communities – Regime for the Importation, Sale and Distribution of Bananas, AB-1997–3, WT/DS27/AB/R (97–3593) para. 221 (September 9, 1997) [hereinafter Bananas AB Report]. Reports of the WTO panels and Appellate Body are available at http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm.

[3] Agreement Establishing the World Trade Organization, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Marrakesh, April 15, 1994, 33 ILM 1144 (1994) [hereinafter WTO Agreement].

GATS has prescribed trade obligations in respect of the financial services sector and envisages more free trade through its built-in mechanism for progressive liberalization,[4] but it does not provide for institutional arrangements toward the stability of the envisaged more 'globalized' financial system. Instead, it relies on its exemption from trade obligations for 'prudential' concerns and leaves the rest to the international cooperation, which evolves in the context of international organizations like the International Monetary Fund (IMF),[5] the International Bank for Reconstruction and Development (World Bank),[6] the Organization for Economic Cooperation and Development (OECD)[7] and the Bank for International Settlements (BIS),[8] or in fora like the Basel Committee on Banking Supervision (Basel Committee),[9] the International Organization of Securities Commissions (IOSCO),[10] the International Association of Insurance Supervisors (IAIS),[11, 12] and the various G-initiatives, ie G-7, G-10, G-20 (the successor of G-22).[13]

[4] See GATS Preamble and Part IV, Progressive Liberalization, Art XIX. Progressive liberalization is contemplated through cooperation without excluding unilateral concessions. See OECD Secretariat, *The General Agreement on Trade in Services (GATS): An Analysis* 13 (OCDE/GD(94)123, 1994) [hereinafter OECD, *GATS Analysis*].
[5] See http://www.imf.org.
[6] See http://www.worldbank.org.
[7] See http://www.oecd.org.
[8] See http://www.bis.org.
[9] The Basel Committee was founded by the Governors of the Central Banks of the Group of Ten countries in 1974 and meets usually under the auspices of the Bank for International Settlements (BIS) in Basel. Its members are central banks and bank supervisory authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States (note that the members currently number thirteen). It contributes to bank supervision cooperation and enhancement of supervision standards, without though being a supranational supervisory authority. For background information and an up-to-date review of the Basel Committee's work, see 'History of the Basel Committee and its Membership' (March 2001), 1 Compendium of documents produced by the Basel Committee on Banking Supervision (Basel Committee on Banking Supervision, May 2001), <http://www.bis.org>.
[10] See http://www.iosco.org/iosco.html; AA Sommer, Jr, '*IOSCO:* Its Mission and Achievement', 17 *Journal of International Law & Business* 15 (1996).
[11] See http://www.iaisweb.org.
[12] Cooperation of these fora has intensified with the establishment of the Joint Forum on Financial Conglomerates (successor to the Tripartite Group), which is concerned with the increased presence of international financial conglomerates. Joint Forum on Financial Conglomerates (September 1998), 3 Compendium of documents produced by the Basel Committee on Banking Supervision Ch. 2 (Basel Committee on Banking Supervision, May 2001), <http://www.bis.org>. The Financial Stability Forum also coordinates the work of the Bank for International Settlements, the IMF, the World Bank, the OECD, the Basel Committee, the IOSCO, the IAIS and national authorities in addressing international financial stability issues and avoiding overlaps in the development of standards. See <http://www.bis.org>. See also Basel/IOSCO Joint Statement for the Lyon Summit (May 1996) in 3 Compendium of documents produced by the Basel Committee on Banking Supervision Ch. 2 (Basel Committee on Banking Supervision, May 2001), <http://www.bis.org>, for the joint initiative of the Basel Committee and IOSCO in the supervision of 'diversified financial groups'.
[13] For a comprehensive review of the international financial architecture, as composed of international financial institutions and other fora, see Mario Giovanoli, 'A New Architecture for

This chapter studies the GATS liberalization system from both a trade and financial stability point of view and reviews it against the more advanced EU integration model. My working conjecture is that institution building at both national *and international* levels should precede ('sequencing'[14]) a meaningful process of further liberalization of the banking sector, for trade liberalization to be effective and for the international banking system to operate in a sound and safe environment. In the absence of effective prudential structures *at the international level*, the national regulators could cancel effects of their trade obligations by resorting to the GATS exemption for prudential concerns ('prudential carve-out').[15] The inadequacy of the international banking standards and cooperation arrangements – let alone the absence of an international supervisor – can potentially be used in justifying domestic trade-restrictive rules as measures for prudential concerns. Besides, irrespective of the level of integration that is achieved, of concern is that enhanced liberalization may accentuate the systemic risk[16] of the banking system.[17] Strengthening prudential regulation and supervision *at the national level* is definitely fundamental for the safety and soundness of the respective national banking systems. However, prudential institution building *at the international level* may also be necessary for sustainable financial integration.

The analysis focuses on liberalization with respect to cross-border banking activity through commercial presence. It is submitted that this mode of cross-border banking entails more risks for the safety and soundness of the banking systems, as it enhances the interdependence of banking jurisdictions and subsequent systemic risk.

Section 1 offers some background on the international legal treatment of foreign direct investment (FDI), in contrast to the multilateral bindings instituted by the GATS with respect to FDI in banking. The liberalization model of the European Union (EU) and its institutional underpinnings with respect to banking regulation are described in Section 2. The GATS liberalization model and its 'prudential carve-out' are also set out. Section 3 first addresses the uncertainty that may arise from the 'prudential carve-out'. It then discusses how the GATS adjudication system would deal with the

the Global Financial Market: Legal Aspects of International Financial Standard Setting', *International Monetary Law* 3, para. 1.45 (Mario Giovanoli, ed., 2000).

[14] For the importance of 'sequencing' as a principle in the development of a 'new global public financial law', see Joseph J Norton, *Financial Sector Law Reform in Emerging Economies* 25–32 (2000). Professor Norton proposes that the new framework should be guided by the following 'thematic strands': 'coherence', 'sequencing', 'evaluation', 'interconnection', 'accounting standards as quasi-legal rules', 'transparency', 'governance and the Rule of Law', 'ongoing fight against corruption and global financial criminality' and 'a viable legal *infra*-structure'.

[15] GATS, Annex on Financial Services art. 2(a).

[16] For the phenomenon of 'systemic risk' in banking, see Chapter I, Section 2.

[17] For the increased probability of systemic failures due to more international banking, see Charles Goodhart et al., *Financial Regulation: Why, how and where now?* 173 (1998).

conflict of trade and regulatory values through the interpretation of the concepts of 'likeness' and 'necessity'. The implications for trade liberalization and the stability of the integrated banking systems are presented. Finally, Section 4 compares the institutional mechanisms for trade liberalization and banking stability in the EU and the GATS and attempts to show deficiencies of the GATS in building a global and sound banking system. Implications for other regional integration initiatives are also discussed.

1 LIBERALIZATION OF CROSS-BORDER BANKING

1.1 Foreign direct investment (FDI) and international cooperation

Foreign direct investment (FDI),[18] one of the most important economic activities,[19] has grown[20] significantly since World War II.[21] Despite its importance for the world's welfare, there has been a failure to create an effective multilateral mechanism[22] that would provide remedies for legal problems of FDI and integrate efficiency objectives and national interests.[23] Conflicting economic interests, sensitivity about the issue of national sovereignty, cultural reservations and disagreement about the FDI's overall impact on national economies have impeded progress towards consensus

[18] '[I]nvestment in enterprises located in one country but effectively controlled by residents of another country'. IMF, 38 Balance of Payments Statistics 10 (1987). The IMF provides a definition of control:

> Control of a company in country Y by residents in country X is inferred if (1) 50 percent or more of the voting stock is owned by residents of country X, or (2) 25 percent or more of the voting stock is concentrated in the hands of a single holder or organized group of holders in X, or (3) residents of X are known in fact to have a controlling interest in the companies' policies.

The United States *Statistical Abstract*, however, holds that a 10 percent or more ownership interest satisfies the control requirement. According to a WTO annual report, '[f]oreign direct investment occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) *with the intent to manage that asset*. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments' (emphasis added). WTO, *Annual Report* (1996).

[19] Stephen Thompsen, *Recent Trends in Foreign Direct Investment*, <http://www.oecd.org>.

[20] See WTO, *Annual Report* (1996), above note 18, at 50, for the rationale of foreign direct investment activity.

[21] See Streng and Salacuse*, International Business Planning: Law and Taxation*, Chapter 19, 19–5 (1996), for international business activities of the US prior to World War II and factors leading to expansion of foreign direct investment after the War.

[22] For the absence of compelling grounds towards multilateral regulation of investment in general and the importance of unilateral liberalization, see Pierre Sauvé & Christopher Wilkie, 'Investment Liberalization' *GATS, GATS 2000: New Directions in Services Trade Liberalization* 331 (Pierre Sauvé & Robert M Stern eds., 2000).

[23] See WTO, *Annual Report* (1996), above note 18, at 55, for the debate addressing the perceived benefits and costs of foreign direct investment.

on establishing a multilateral framework. Instead, FDI has been effectively regulated only at a bilateral – through 'FNCs' (Treaties of Friendship, Commerce and Navigation)[24] and 'BITs' (Bilateral Investment Treaties)[25] – and regional[26] level.

It is interesting that such important international economic activity grew 'without generally accepted principles of international law'.[27] FDI was primarily regulated at a national level and international norms were confined in state responsibility for injuries to aliens.[28] In the meantime, national jurisdictions relaxed their stringent entry and operation requirements[29] and important progress was made at a bilateral level. BITs focusing exclusively on international investment replaced FNC agreements and established significant protection schemes against investors' risks, which were not covered before by the customary international law of FDI. BITs have also facilitated the creation of multilateral frameworks, triggering multilateral cooperation and lending significant concepts and standards to multilateral agreements.[30]

International regulation, however, has not yet produced a multilateral agreement,[31] which would prescribe comprehensive and binding rules on foreign direct investment. Conflicting interests and institutional deficiencies have confined regulation of FDI to multilateral agreements, which are either non-binding, or binding but narrow in scope and without substantive norms. The recent, very ambitious OECD initiative for a multilateral

[24] See Robert Renbert Wilson, *United States Commercial Treaties and International Law* (1960).
[25] See Streng and Salacuse, above note 21, at 19–34.
[26] See eg Part V, Chapter 11 of the North American Free Trade Agreement. North American Free Trade Agreement, US–Can.–Mex., 32 ILM 289 (1993). The Energy Charter Treaty should also be noted, as it covers (Part III and articles 26–27) foreign direct investment in the energy sector. Energy Charter Treaty, 34 ILM 381 (1995). See http://www.encharter.org/index.jsp.
[27] See Jeswald W Salacuse, *The Emerging International Law of Direct Foreign Investment* 16 (1992): 'The International Court of Justice recognized this fact in 1970 in the well known case *of Barcelona Traction Company* (*Belgium v Spain*), when it stated:

> Considering the important developments of the last half-century, the growth of foreign investments and the expansion of the international activities of corporations, in particular of golding companies, which are often multinational, and considering the way in which the economic interests of states have proliferated, it may at first sight appear surprising that the evolution of law has not gone further and that no generally accepted rules in the matter have crystallized on at the international plan.

[citing *Barcelona Traction Company* (Belgium v Spain), 1970 ICJ 3, 46–7)]'.
[28] See AA Fatouros, Towards an International Agreement on Foreign Direct Investment, *Towards Multilateral Investment Rules, OECD Documents* 47 (1996), for the evolution of the international legal framework on FDI.
[29] See WTO, *Annual Report* (1996), above note 18, at 61.
[30] *Ibid.* at 62, for the importance of BITs.
[31] See Jeswald W Salacuse, 'Towards a New Treaty Framework for the Direct Foreign Investment', 50 *Journal of Air Law & Commerce* 969, 1005 (1985), for a discussion of the multilateral approach.

agreement on investment (MAI)[32] had also to be abandoned.[33] Currently, the WTO-Doha Ministerial Declaration (2001) has called for the establishment of a multilateral framework regulating 'long-term cross-border' investment.[34] Negotiations, however, have not started, as the Cancun 5th WTO Ministerial Conference (2003) ended without a consensus, in particular because of disagreement on the 'Singapore' issues, of which one is the 'trade and investment' issue.[35]

Instead, we experience a process that has unintentionally promoted certain FDI worldwide. This has happened in the WTO context. The GATS has provided a multilateral binding framework for FDI in the financial sector,[36] when at the same time negotiators of the Agreement on Trade-Related Investment Measures (TRIMS),[37] another WTO agreement, avoided negotiating FDI rules. This is quite interesting. The most important multilateral regulatory effort towards world economic integration results in FDI liberalization in the financial sector, and in particular in the banking sector, a very dynamic sector,[38] but also regulation-intensive and subject to systemic risks, without its focus being on FDI.

[32] For an overview of the MAI and its objectives, see Rainer Geiger, 'Towards a Multilateral Agreement on Investment', 31 *Cornell International Law Journal* 467 (1998). For the MAI from a US perspective, see Wesley Scholz, 'International Regulation of Foreign Direct Investment', 31 *Cornell International Law Journal* 485 (1998).

[33] For the shortcomings of the MAI negotiations with a focus on the absence of a 'global public policy network', see Katia Tieleman, 'The Failure of the Multilateral Agreement on Investment (MAI) and the Absence of a Global Public Policy Network' (Case Study for the UN Vision Project on Global Public Policy Networks), <http://www.globalpublicpolicy.net/Tieleman%20GPP%202000.pdf>. Unfortunately, the proposal for the much needed multilateral mechanism seems to remain a 'fanciful proposal'. Professor Salacuse was proposing in 1985 a General Agreement on Direct International Investment while he was aware of the risk of the proposal perceived as fanciful. International regulation still fails to respond, as it probably still ignores the premises of that proposal: 'accommodate the interests of both groups and that proceeds on the basis of genuine mutuality . . .' See Jeswald W Salacuse, above note 31, at 1010.

[34] WTO, Ministerial Declaration, WT/MIN(01)/DEC/1 (01–5859) (November 20, 2001).

[35] The issues of 'trade and investment', 'trade and competition policy', 'transparency in government procurement' and 'trade facilitation' are sometimes called 'Singapore' issues, as it was the Singapore 1st Ministerial Conference (1996) that mandated work on them.

[36] Of course, the GATS commitments do not amount to a comprehensive multilateral framework for foreign direct investment. Still, the GATS has produced substantive, legally binding norms, and stands as a vehicle for multilateral liberalization of foreign direct investment. See also Pierre Sauvé & Christopher Wilkie, above note 22.

[37] The TRIMS Agreement attempts to bring investment measures under the GATT discipline. See WTO, *Annual Report* (1996), above note 18, at 72, for the main features of the TRIMS Agreement.

[38] See Mary E Footer, 'GATT and the Multilateral Regulation of Banking Services', 27 *International Lawyer* 343, 344 (1993).

1.2 FDI in banking

The GATS has produced substantive and legally binding norms for the regulation of FDI in the banking sector. As commercial presence constitutes one of the modes of trade in financial services, foreign direct investment in the financial sector is subject to the trade disciplines of the GATS. The GATS achieved liberalization in FDI without focusing on FDIs. At the same time, negotiators of TRIMS 'objected to multilateral investment negotiations and refused discussion of investment under GATT auspices'.[39] Interestingly, the GATS has instituted FDI liberalization in the banking sector, a sector of *sui generis* interest to the national regulator[40] due to its importance for monetary policy, economy financing and the conduct of payments[41] as well as due to systemic risk from banking activity. This took place in the context of trade negotiations, while at the negotiations covering financial services some countries, mainly emerging market economies, were represented by trade experts.[42]

The GATS liberalization of FDI in banking is of interest here for its effect on the stability of the international banking system. Liberalization results in deeper interdependence of the national banking systems and so potentially exacerbates the effect of negative externalities originating in jurisdictions with deficient financial supervision systems. The GATS addresses this concern through the prudential carve-out and it is interesting to examine how this prudential mechanism will operate. Does the prudential carve-out adequately address financial stability? Does it allow for realization of the

[39] See Daniel M Price & P Bryan Christy, III, 'Agreement on Trade Related Investment Measures (TRIMS): Limitations and Prospects for the Future', *The World Trade Organization: The Multilateral Trade Framework for the 21st Century and US Implementing Legislation* 439, 439 (Terence P Stewart, ed., 1996).

[40] 'A sound, internationally competitive banking system is critical to the Nation's economic vitality and the financial well-being of our citizens.' Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (1991).

[41] See Chapter I, Section 2.1, for the rationale of banking regulation.

[42] See Sydney J Key & Hal S Scott, *International Trade in Banking Services: A Conceptual Framework* 41 (Group of Thirty, Occasional Papers 35, 1991). See Sydney J Key, *Financial services in the Uruguay Round and the WTO* 13 (Group of Thirty, Occasional Papers 54, 1997): '[w]hile the GATS framework agreement and the structure of the schedules of commitments were negotiated by trade officials, the Annex on Financial Services, the Understanding on Commitments in Financial Services, and the contents of the schedules of commitments for financial services were negotiated primarily by *finance officials*'. *But* '[b]ecause of the time and expense of travel to Geneva, a number of countries, especially *emerging market economies*, relied on officials at their Geneva missions, necessarily *trade not financial experts*, for at least some of the bilateral negotiating sessions dealing with financial services. In some cases, these negotiators, in implicit retaliation for positions of the United States and other industrial countries on issues involving goods, may have taken a harder line than would have been taken by financial officials' (emphasis added). *Ibid.* at 29.

GATS free and fair trade objective? Or will it have an 'unintentional'[43] negative effect on both?

In addressing these questions, the analysis dwells upon the GATS mechanisms for balancing banking regulation and trade and the relevant concepts of 'likeness' and 'necessity'.

The GATS model is viewed in contrast to the EU model, where the Second Banking Directive,[44] as now incorporated in the Banking Consolidation Directive,[45] provides for liberalization of financial services trade. The Banking Consolidation Directive is part of a broader institutional machinery, which not only removes barriers to an internal banking market but also deals with re-regulation for prudential reasons, and this in the context of a recently integrated monetary environment. Examining the GATS against such a liberalization model, that is a model of differing degree of integration, institutional depth and macro-economic underpinnings, aspires to inform 'prudential' engineering in the GATS and in other international contexts.

1.2.1.1 General policy questions As the financial sector is critical for a nation's economy and its importance for international welfare is growing, it is worth giving some thought to how regional and world liberalization of financial services trade affects national powers. Do they remain adequate to pursue legitimate, namely non-protectionist, national economic policies? What are the issues of democratic legitimacy in international regulation, in particular whether compromises on the input side of a democratic political system can be justified by benefits on the output side?[46]

[43] For a criticism of this notion by 'progressives' as being part of the 'perversity' theory used by 'reactionaries' against Keynsian interventionism, see AO Hirschman, *The Rhetoric of the Reaction* 11 (1991).

[44] Second Council Directive 89/646 of 15 December 1989 on the coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780, 1989 OJ (L 386) 1, as amended by Council Directives 92/30/EEC, 1992 OJ (L 110) 52 and 95/26/EC, 1995 OJ (L 168) 7 [hereinafter 2BD].

[45] For the sake of clarity the Second Banking Directive, as subsequently amended, has now been codified and combined (along with the 73/183 Directive, the First Banking Directive, the Own Funds Directive, the Solvency Ratio Directive, the Large Exposures Directive and the Consolidated Supervision Directive) in a single Directive: EP and Council Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, 2000 OJ (L 126) 1, as amended by EP and Council Directive 2000/28/EC, 2000 OJ (L 275) 37 [hereinafter Banking Consolidation Directive] (the Commission proposal for a Directive establishing a new financial services committees' structure calls the 2000/12 Directive the 'Codified Banking Directive'). References here will be to the Banking Consolidation Directive with the respective provisions in the Second Banking Directive indicated in parentheses.

[46] See Von Fritz W Sharpf, *Economic Integration, Democracy and the Welfare State* (MPIfG Working Paper 96/2, July 1996), <http://www.mpi-fg-koeln.mpg.de/pu/workpap/wp96–2/wp96–2.html>, for a discussion of the trade-off between the input and the output side of the democratic process. Sharpf distinguishes between the input side, which refers to the accountability of the decision making bodies to the governed, and the output side, which refers to the efficiency outcome of their decisions.

Arguably, considerable efficiency-enhancing effects result from the free flow of finance to its best uses[47] and it is admitted that regulatory barriers can hardly restrict the globalization of finance. However, interdependence of the national financial systems leads to links for the transmission of deficiencies among each other. Can a nation-based regulation and supervision framework deal with this interdependence?

These are some of the broader questions to bear in mind as we review liberalization of trade in financial services.

2 TRADE LIBERALIZATION AND BANKING REGULATION

2.1 Regional liberalization – European Union (EU)

2.1.1 EC internal banking market

The European Union builds liberalization of trade in financial services on its unique constitutional structure[48] and its powerful administrative, legislative and adjudicative institutions. The liberalization process has been gradual, starting with the constitutional principles enshrined in the Treaty of Rome, continuing with the jurisprudence of the European Court of Justice (ECJ)[49] and the commitments of the Second Banking Directive, and strengthening with the European monetary union.[50]

The Treaty of Rome laid the foundations for the European internal banking market by prescribing the freedom of establishment, the freedom to provide services and the free movement of capital.[51] There was still a long

[47] 'At root, financial instruments – whether bank deposits, loans, stocks, bonds, or complicated derivative contracts-are ultimately claims on real resources, goods, or services. Efforts to restrict flows of financial instruments therefore hinder exchanges of goods and services, thus impeding the transfer of resources to their best uses'. Richard J Herring & Robert E Litan, *Financial Regulation in the Global Economy* vii (1995).

[48] For a critical perspective on the 'uniqueness' of the European legal construct, see Joseph H H Weiler & Joel P Trachtman, 'European Constitutionalism and its Discontents', 17 *Journal of International Law & Business* 354 (1996–1997).

[49] The European Court of Justice (ECJ) is the adjudication body of the European Union, with an important role in the development of the EU legal and political system. *The Court of Justice of the European Communities* (N Brown & T Kennedy eds., 4th edn 1994). For a comprehensive study of the contribution of the ECJ to the EU integration process see Renaud Dehousse, *The European Court of Justice* (1998).

[50] For the development of the regulatory framework of the EC internal banking market, see Eva Lomnicka, 'The Single European Passport in Financial Services', *Developments in European Company Law*, Volume 1/1996 181 (Barry A K Rider & Mads Andenas eds., 1996).

[51] Treaty Establishing the European Economic Community [EEC Treaty], 1957, 298 UNTS 3, arts. 52–73g (currently arts. 43–60). The term EC Treaty is used for reference to the EEC Treaty as amended. References to EMU provisions are also to the EC Treaty, as these

way to go before impediments such as non-discriminatory barriers would be dealt with[52] and the Capital Liberalization Directive[53] allowed for implementation of the free movement of capital.[54] The First Banking Directive[55] provided for elimination of trade barriers and also for supervision cooperation. Liberalization was yet weak, as the First Banking Directive granted only limited freedoms for branches and only envisaged further harmonization, mutual recognition and home country control.[56] The European Commission's 1985 White Paper[57] and the Single European

provisions were inserted by the Maastricht Treaty on European Union into the EEC Treaty. For a full analysis of related terminology issues, including the use of the term EC instead of the term EU, see René Smits, *The European Central Bank, Institutional Aspects* 8, 31 (1997). It should be noted that the terms EC and EU are used interchangeably here.

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[52] The EC Treaty freedoms were founded upon a discrimination principle. It was through the ECJ jurisprudence that the needed trade discipline on non-discriminatory measures developed. See Joel P Trachtman, 'Trade in Financial Services under GATS, NAFTA, and the EC: A Regulatory Jurisdiction Analysis', 34 *Columbia Journal of Transnational Law* L. 37, 60 (1995) [hereinafter Trachtman, 'Trade in Financial Services'].

[53] Council Directive 88/361 of 24 June 1988 for the implementation of Article 67 of the Treaty, 1988 OJ (L178) 5 [hereinafter Capital Liberalization Directive].

[54] Removal of restrictions on capital movements was necessary for the realization of the internal financial services market. Despite the direct effect of freedom of establishment and freedom to provide services, barriers to trade in services were possible to the extent that there were capital movement restrictions 'compatible with Community law'. As ex article 67(1) of the EC Treaty had no direct effect, abolition of restrictions on capital movement was possible only through directives enacted on the basis of ex article 69. Case 222/95, *Société civile immobilière Parodi v Banque H Albert de Bary et Cie*, 1997 ECR I–03899, paras. 10, 11. Capital liberalization, however, had been delayed because past policies of using direct instruments for monetary and credit policy were dependent on capital restrictions. See Mads Andenas, 'The interplay of the Commission and the Court of Justice in giving effect to the right to provide financial services', *Lawmaking in the European Union* 332, 333 (Paul Craig & Carol Harlow eds., 1998).

[55] First Council Directive 77/780 of 12 December 1977 on the coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive, 1977 OJ (L 322) 30 [hereinafter First Banking Directive]. The First Banking Directive was preceded by Council Directive 73/183 of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions, 1973 OJ (L 194) 1. The 73/183 Directive was largely superseded by *Reyners* (Case 2/74 *Jean Reyners v Belgian State*, 1974 ECR 631, 2 CMLR 305 (1974)) and *Van Binsbergen* (Case 33/74, *Johannes Henricus Maria Van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid*, 1974 ECR 1299, 1 CMLR 298 (1975)), which held for the direct effect of the freedom of establishment and the freedom to provide services. It still has some limited value in respect of reference to the financial institutions subject to further harmonization and the harmonization objectives. See Julian Maitland-Walker, *EC Banking Directives* Ch 4, 4–1 (Lloyd's of London Press Limited 1994). The 73/183 Directive and the First Banking Directive with subsequent amendments have now been codified and combined in the Banking Consolidation Directive.

[56] See First Banking Directive Preamble. See also Case 222/95, *Société civile immobilière Parodi v Banque H. Albert de Bary et Cie*, 1997 ECR I–03899, para. 24: 'The first banking directive *was no more than a first step . . . towards the mutual recognition* by Member States of authorizations issued by each of them to credit institutions.'

[57] *Completing the Internal Market*: White Paper from the Commission to the European Council, COM(85)310 final [hereinafter White Paper].

Act[58] were significant in the move towards further liberalization. The freedom of services was treated as an essential element in the construction of the single market. Further harmonization and free movement of capital were envisaged to the benefit of financial services. The European Community would promote deregulation through 'essential harmonization',[59] 'mutual recognition'[60] and 'home-country control'.[61] Financial institutions would be subject to home country jurisdiction in respect of authorization and prudential supervision, after the establishment of minimum common rules throughout the Community and recognition of home country rules by the host country.

It was the ECJ decisions and the Second Banking Directive that provided the powerful legal instruments[62] towards a European banking market without trade barriers, discriminatory or not, on the basis of essential harmonization, mutual recognition and home country supervision. The Court has ruled that both discriminatory and non-discriminatory measures can be in contravention of the fundamental internal market freedoms. Building on the *Dassonville*[63] and *Cassis de Dijon*[64] cases on the free movement of goods,[65] the ECJ[66] has extended the trade discipline of the freedoms of

[58] Single European Act 1987 OJ (L 169) 1, 3 Common Mkt. Rep. (CCH) P 21,000.
[59] See Joel P Trachtman, 'Unilateralism, Bilateralism, Regionalism, Multilateralism and Functionalism: A Comparison with Reference to Securities Regulation', 4 *Transnational Law and Contemporary Problems* 69, 89 (1994) [hereinafter Trachtman, 'Unilateralism'], for 'essential harmonization' as a predicate to 'mutual recognition'. See also Manning Gilbert Warren III, Global Harmonization of Securities Laws: The Achievements of the European Communities', 31 *Harvard International Law Journal* 185, 232 n.33 (1990), for the terms 'harmonization' and 'mutual recognition', which are often used synonymously with the terms 'commonality' and 'reciprocity'.
[60] For the regulatory device of 'mutual recognition' and problems in its operation in the internal market, see Directorate General/Internal Market, The European Commission, Mutual recognition in the context of the follow-up to the Action Plan for the Single Market (June 16, 1999), <http://europa.eu.int/comm/ internal_market /en/update/general/mutualen.pdf>.
[61] '[T]he principle of home country control . . . means attributing the primary task of supervising the financial institution to the competent authorities of its Member State of origin . . . The authorities of the Member State which is the destination of the service, whilst not deprived of all power, would have a complementary role'. White Paper, above note 57, at paras. 102–103.
[62] Article 248 (ex art. 189) of the EC Treaty prescribes the legal character of the directive as binding in respect of its objective and open in respect of the form and methods employed by the national authorities: 'A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods'. For the choice of directives as the legal instrument toward liberalization of financial services in the EU, see Joseph J Norton, 'The European Community Banking Law Paradigm: A Paradox in Bank Regulation and Supervision – Reflections on the EC Second Banking Directive', *International Banking Regulation and Supervision: Change and Transformation in the 1990s* 49, 58–61 (Joseph J Norton et al eds., 1994).
[63] Case 8/74, *Procureur du Roi v Benoit and Gustave Dassonville*, 1974 ECR 837.
[64] Case 120/78, Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein, 1979 ECR 649.
[65] See also Cases 267–268/91, *Criminal Proceedings against Bernard Keck and Daniel Mithuard*, 1993 ECR I–6097.
[66] For the notion of discrimination and services trade liberalization in the ECJ jurisprudence,

establishment and of provision of services to non-discriminatory measures.[67] Such non-discriminatory measures are mostly measures which, although equally applicable to nationals and non-nationals, are in effect more detrimental to non-nationals (de facto discrimination). *Gebhard* has taken this further by holding that even non-discriminatory measures without any discriminatory effects may be found to be a trade barrier if they are 'liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty'.[68]

As shown below, secondary Community law implementing the

see Wulf-Henning Roth, 'The European Court of Justice's Case Law on Freedom to Provide Services: Is Keck Relevant?', *Services and Free Movement in EU Law* (Mads Andenas & Wulf-Henning Roth eds., 2003).

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[67] For the *freedom of establishment*, see Case 53/95, *INASTI v Kemmler*, 1996 ECR I–704; Case 55/94, *Reinhard Gebhard v Consiglio dell' Ordine degli Avvocati e Procuratori di Milano*, 1995 ECR I-4165; Case 19/92, *Kraus v Land Baden-Württemberg*, 1993 ECR I–1663; Case 292/86, *Claude Gullung v Conseil de l' Ordre des Avocats du barreau de Colmar et de Saverne*, 1988 ECR 111, 2 CMLR 57 (1988). For the *freedom to provide services*, see Case 384/93, *Alpine Investments BV v Minister van Financiën*, 1995 ECR I-1141, 2 CMLR 209 (1995); Case 275/92, *Her Majesty's Customs and Excise v Gerhart Schindler and Jörg Schindler*, 1994 ECR I-1039, 1 CMLR 4 (1995); Case 76/90, *Manfred Säger v Dennemeyer & Co Ltd* 1991 ECR I-4221, 3 CMLR 639 (1993). See also Case 415/93, *Union Royale Belge des Sociétés de Football Association and others v Jean-Marc Bosman and others*, 1995 ECR I–4921, for application of the *free movement of workers* to non-discriminatory measures.

[68] Advocate General Jacobs has provided an authoritative statement on this in *Säger*:

> I do not think that it can be right to state as a general rule that a measure lies wholly outside the scope of Article 59 simply because it does not in any way discriminate between domestic undertakings and those established in other Member States. Nor is such a view supported by the terms of Article 59: its expressed scope is much broader. If such a view were accepted, it would mean that restrictions on the freedom to provide services would have to be tolerated, even if they lacked any objective justification, on condition that they did not lead to discrimination against foreign undertakings. There might be a variety of restrictions in different Member States, none of them intrinsically justified, which collectively might wholly frustrate the aims of Article 59 and render impossible the attainment of a single market in services. The principle should, I think, be that if an undertaking complies with the legislation of the Member State in which it is established it may provide services to clients in another Member State, even though the provision of such services would not normally be lawful under the laws of the second Member State. Restrictions imposed by those laws can only be applied against the foreign undertaking if they are justified by some requirement that is compatible with the aims of the Community. The case for taking that approach is particularly strong when the service is provided by means of post or telecommunications without the provider of the service moving physically between Member States.

Opinion of Advocate General Jacobs delivered on 21 February 1991 in Case 76/90, *Manfred Säger v Dennemeyer & Co Ltd* 1991 ECR I-4221, para. 27. But see Anthony Arnull et al., *Wyatt and Dashwood's European Union Law* 478 (4th edn 2000), for the view that the ECJ's departure from the non-discrimination principle, as reflected in *Säger*, has been unfortunate, and this for two reasons: First, cases of indirect discrimination can be prohibited through application of the non-discrimination principle. Second, it is unclear what the justification is for subjecting genuinely non-discriminatory regulation to judicial scrutiny. It is also submitted that such a departure from the non-discrimination principle is reasonable to the extent that it is likely to occur only when non-discriminatory regulation restricts market access. See Wulf-Henning Roth, above note 66 (supporting that discrimination is the 'general principle' incorporated in article 49 (ex art. 59) and that the 'prohibition of restrictions' should apply only when market access is

internal banking market has limited the scope of the ECJ jurisprudence on the freedom of establishment and the freedom to provide services with respect to banking regulation. The financial services Directives have provided for extensive regulatory harmonization and subsequent application of the home country rules on the basis of mutual recognition with respect to cross-border provision of financial services and bank branching.

Nevertheless, the ECJ jurisprudence does matter for the internal banking market. First, it matters for cross-border banking activity through subsidiaries, as the financial services Directives do not deal with a Member State's restrictions on banking activity which is pursued in that Member State by subsidiaries of a bank established in another Member State. The recent *CaixaBank France* case applied the principle of freedom of establishment (article 43 of the EC Treaty) to cross-border banking through subsidiaries and held that a Member State's non-discriminatory measures may not be consistent with the freedom of establishment if they affect access to its banking market (but, according to the opinion, not when they only reduce the economic attractiveness of carrying on the relevant banking activity).[68a] In addition, the ECJ jurisprudence is still relevant for cross-border provision of financial services and bank branching. For example, host countryprudential regulation is still possible to the extent not harmonized. Such host country regulation may be found in contravention of the EU freedoms if, although non-discriminatory, restrictive of EU-wide banking. If so, it will be sustained only if it falls within the 'general good' exception.[69] If discriminatory, it can be exempted only for 'public policy' reasons.[70]

The Second Banking Directive (which has been incorporated in the Banking Consolidation Directive) established the single banking license[71] eliminating barriers,[72] like host country authorization and 'endowment capital' requirements,[73] to cross-border bank branching and provision of financial services. Without creating a European banking license, the

impeded). But then the issue becomes how we determine market access. Is entry into the market the only criterion, or should treatment within the market also be considered, and if so how?

[68a] Opinion of Advocate General Tizzano delivered on 25 March 2004 in Case 442/02, *CaixaBank France v Ministère de l'Economie, des Finances et de l'Industrie* [2004] ECR I-08961; Case 442/02, *CaixaBank France v Ministère de l'Economie, des Finances et de l'Industrie* [2004] ECR I-08961.

[69] See discussion below section 2.1.2.2, for the 'general good' exception.

[70] See below section 2.1.2.2, for the 'public policy' exception.

[71] For a comprehensive analysis, see Michael Gruson & Wolfgang Feuring, 'A European Community Banking Law: The Second Banking and Related Directives', *The Single Market and the Law of Banking* 25 (Ross Cranston edn 1995).

[72] See George S Zavvos, 'Banking Integration and 1992: Legal Issues and Policy Implications', 31 *Harvard International Law Journal* 463, 468 n.32 (1990), for obstacles to the freedom of establishment under the First Banking Directive.

[73] Banking Consolidation Directive art. 13 (ex 2BD arts. 6(1), 7, First Banking Directive art. 4).

Second Banking Directive has allowed 'credit institutions'[74] authorized in a Member State to open branches[75] (or provide cross-border financial services) in another Member State by simply complying with a notification requirement[76] while they are subject to home country prudential supervision.[77] A 'credit institution' can through its branch conduct activities, which are listed in the Annex to the Second Banking Directive and for which it is licensed in the Member State of the initial authorization.[78]

The 'mutual recognition' approach goes against anti-competitive effects of the Member States' regulatory regimes and provides the impetus for further harmonization. For example, a credit institution that is licensed in a Member State with a universal banking regime[79] can carry on most of the activities listed in the Annex[80] in another Member State that may not allow its credit institutions to conduct all such activities. This can have a negative effect on the competitiveness of the host country credit institutions, as they are not able to engage in activities permitted to their foreign competitors. The remedy is expected to be further harmonization through the host country allowing its credit institutions to carry on most, if not all, of the activities listed in the Annex.[81]

[74] The EU Directives use the term 'credit institution' for commercial banks and define it as an 'undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account'. Banking Consolidation Directive art. 1(1) (ex First Banking Directive art. 1, 2BD arts. 1(1), 2(2)). For the definition of 'credit institution' and the debate on its reconsideration, see Pieter Verheugd, 'Definition of "credit institution" and list of banking activities', *Banking and EC Law, Commentary* Ch 3 (Amsterdam Financial Series, Martijn van Empel & René Smits eds., August 1992). The terms 'credit institution' and 'bank' are used interchangeably in this book to denote commercial banking.

[75] Subsidiaries need to be authorized and supervised by the host competent authority.

[76] For problems with the notification requirement in respect of the provision of services before the adoption of the Commission's Interpretative Communication on the Second Banking Directive, see Marc Dassesse, 'A Courageous Initiative and an Important Precedent, The Commission's Interpretative Communication on the Second Banking Directive: The Single Market in Financial Services May at Long Last, Become a Reality', 1997 *Butterworths Journal of International Banking & Financial Law* 339.

[77] Banking Consolidation Directive Preamble 7th, 14th, 17th, 21st, 22nd whereas clauses, art. 26 (ex 2BD Preamble 4th, 10th whereas clauses, arts. 6, 13, 18–21).

[78] Banking Consolidation Directive Preamble 14th whereas clause, art. 18, Annex I (ex 2BD art. 18(1), 2BD Annex 'List of Activities Subject to Mutual Recognition'). With respect to activities not listed in the Annex, the Treaty freedoms of establishment and of provision of services throughout the Community apply.

[79] See George S Zavvos, above note 72, at 481, for three types of financial structure that can be found in the Community:

> (a) the traditional universal banking system found in Germany and the Netherlands, whereby banks are licensed to engage in a full range of financial activities, including securities; (b) the hybrid system, like that found in the United Kingdom after the Big Bang, France, and Greece; and (c) the Belgian model, whereby banks are subject to strict limitations against involvement in the securities business.

[80] Such activities will mostly fall within the Annex, as the Annex builds on the German model of 'universal' banking.

[81] See Michael Gruson & Wolfgang Feuring, above note 71, at 24.

Mechanisms are also in place to prevent a possible regulatory 'race for the bottom'. Arguably, essential harmonization combined with mutual recognition entails risks for the quality of banking regulation, as it may trigger a regulatory 'race for the bottom'.[82] Of concern is that, as banks are able to carry on EU wide business on the basis of home country prudential regulation and supervision, they may opt for the jurisdictions with less rigid and less costly regulation and supervision. In turn, Member States may relax their standards in order both to attract banks and to protect the competitiveness of banks already incorporated in those Member States. However, it is likely that 'race for the bottom' will not be the case. Requiring that a bank has its head office in its home Member State and that it actually operates there already discourages 'forum shopping'.[83] In addition, the home regulator's responsibility for depositors' insurance suggests

[82] See Joel P Trachtman, 'Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation', 12 *Northwestern Journal of International Law & Business* 241, 267 (1991) [hereinafter Trachtman, 'Recent Initiatives']. The 'race for the bottom' literature was born with the seminal article of William Cary which pointed out to the 'race for the bottom' risks from regulatory competition in US. This is argued to be the effect of the home country control rule for interstate activities of US corporations combined with the absence of any restrictions as to the place of incorporation. William Cary, 'Federalism and Corporate Law: Reflections upon Delaware', 83 *Yale Law Journal* 663 (1974).

[83] Banking Consolidation Directive art. 6(2) (ex First Banking Directive art. 3(2a)). Banking Consolidation Directive Preamble, 9th whereas clause (ex 2BD Preamble, 8th whereas clause – see also Post-BCCI Directive Preamble, 7th whereas clause):

> The principles of mutual recognition and home Member State supervision require that Member States' competent authorities should not grant or should withdraw authorisation where factors such as content of the activities programmes, the geographical distribution or the activities actually carried on indicate clearly that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within whose territory it carries on or intends to carry on the greater part of its activities. A credit institution which is a legal person must be authorised in the Member State in which it has its registered office. A credit institution which is not a legal person must have its head office in the Member State in which it has been authorised. In addition, Member States must require that a credit institution's head office always be situated in its home Member State and that it actually operates there.

This should be contrasted with the ECJ ruling in *Centros*, which covers companies not covered by the Second Banking Directive (or the Investment Services Directive). In *Centros*, freedom of establishment was confirmed in relation to the right of Danish nationals to register their limited liability company in the UK and carry on the company's business activities through a branch in Denmark although the sole reason for opting for UK registration was to avoid the stricter Danish capital requirements:

> [T]he fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.

Case 212/97, *Centros Ltd v Erhvervs- og Selskabssstyrelsen*, 1999 ECR I–1459, 2 CMLR 551 (1999), para. 27.

that retention of strict requirements is in the interest of the home regulator. This is because a lax prudential framework increases the risk for *ex post* reaction to financial crises and therefore the risk for possible costs on the deposit guarantee schemes[84] or for costs from lending of last resort operations. Besides, the ability of the host country to retain regulation in the interest of the general good stands as a barrier to a harmful regulatory 'race for the bottom'. Finally, as the literature favouring regulatory competition suggests,[85] banking systems with higher standards and reputation should contribute to their institutions' better access to capital and business markets and thus should be more attractive to banking business.[86] In any case, the 'race for the bottom' critique has to be viewed in the context of founding the liberalization mechanism of the Second Banking Directive upon the premise of substantial minimum regulation.

Finally, the Financial Services Action Plan – adopted by the European Commission in May 1999 and endorsed by the European Council in June 1999 (Cologne) and March 2000 (Lisbon) – sets out a plan toward a Single Market for financial services.[87] It prescribes measures for further harmonization and reduction of regulatory barriers, while it stresses the importance of 'state-of-the-art' prudential regulation and supervision. Of particular interest are the directives on financial collateral,[88] winding up and reorganization of credit institutions[89] and supervision of financial conglomerates[90] as well as the new Capital Adequacy Directive.[91] The Council has continuously

[84] See Eva Lomnicka, 'The Home Country Control Principle in the Financial Services Directives and the Case Law', *Services and Free Movement in EU Law* (Mads Andenas & Wulf-Henning Roth eds., 2003).
[85] See Ralph K Winter, 'Government and the Corporation' (1998); Daniel R Fischel, 'The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law', 76 *Northwestern University Law Review* 913 (1982).
[86] See also *Alpine Investments BV v Minister van Financiën*, 1995 ECR I–1141, 2 CMLR 209 (1995). For the attractiveness of efficiently regulated markets to financial institutions with a reference to the success of the 'strictly regulated' City, see Norbert Walter, *The Banking Supervision Issue in Europe* 2 (Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, May 11, 2001), <http://www.europarl.eu.int/comparl/econ/pdf/emu/speeches/20010528/20010528_walters.pdf>.
[87] Commission Communication of 11 May 1999 on Implementing the framework for financial markets: Action Plan, COM(1999) 232, also available at http://www.europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.
[88] EP and Council Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements, 2002 OJ (L 168) 43.
[89] EP and Council Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, 2001 OJ (L 125) 15.
[90] EP and Council Directive 2002/87/EC of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and EP and Council Directives 98/78/EC and 2000/12/EC, 2002 OJ (L 35) 1 [hereinafter Financial Conglomerates Directive].
[91] See below note 109.

reiterated its commitment for implementation of the Plan by 2005 (as set by the March 2000 Lisbon Council).[92]

2.1.2 Banking regulation

2.1.2.1 Harmonization The Second Banking Directive reduced regulatory barriers to EU financial services trade and lays the foundations for a single banking system on the basis of harmonization of prudential standards.[93] The Second Banking Directive itself and the Directives on prudential arrangements addressed risks that the presence of foreign banks, subject to home country control, can entail for the stability of the host country banking system[94] and for depositor protection. That is, the aim is that integration will not endanger financial stability, and that integration will not be undermined by the absence of prudential mechanisms.

The Second Banking Directive itself dealt with prudential aspects of an integrated banking system. It required a minimum initial capital of five million Euro[95, 96] and allowed Member States to deny authorization if they

[92] For the progress on the Financial Services Action Plan, see http://www.europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.

[93] 'The Directive should be seen in the wider context of interlinked Community measures that safeguard the financial stability of banks'. George S Zavvos, above note 72, at 476. Article 24(1) of the Second Banking Directive provided that Member States shall implement the Directive 'by the later of the two dates laid down for the adoption of measures to comply with the . . . [Own Funds Directive and the Solvency Ratio Directive] and at the latest by 1 January 1993'. See also Own Funds Directive 1st whereas clause, Solvency Ratio Directive Preamble 4th whereas clause. Capital Adequacy Directive Preamble 3rd whereas clause (see below in the text for these Directives).

[94] See below in the text, for the risks that the presence of foreign financial institutions may have for the stability of domestic financial systems. See also for the significance of the mode of presence: branches vis-à-vis subsidiaries.

[95] Banking Consolidation Directive art. 5(1). Article 4(1) of the 2BD read five million ECU (European Currency Unit). As of the start of Stage 3 references to ECU are read as references to Euro. At its meeting in Madrid in 1995, the European Council decided that the term ECU used by the Treaty is a 'generic term', that this decision is the 'agreed and definitive interpretation of the relevant Treaty provisions', and that the new, 'full', name shall be Euro as of the start of Stage 3. Council Regulation 1103/97 on certain provisions relating to the introduction of the Euro, 1997 OJ (L 162) 1 [hereinafter Council Regulation 1103/97], 2nd whereas clause; Extracts from the Presidency conclusions of the Madrid European Council relating to the name of the single Currency, *The Introduction of the Euro, Compilation of Community Legislation and Related Documents* 67 (Directorate General II/Economic and Financial Affairs, The European Commission, October 1997), <http://europa.eu.int/comm/economy_finance/publications/euro_papers/europapers07_en.htm>. Although there has been no litigation as to the legality of the name change, its consistency with Community law cannot but be doubted. There is no support for the EU Council's authority to hold what a 'definitive' interpretation of the Treaty is. See also Anthony Arnull et al., above note 68, at 526; René Smits, above note 51, at 490.

[96] I use the term Euro for the plural form of Euro. This is also consistent with the view of Wim Duisenberg, the ECB President, as expressed in response to a question by an FT correspondent at an ECB Press Conference, Frankfurt am Main, March 7, 2002, <http://www.ecb.int/key/02/sp020307.htm>. It should be noted that the term Euro for the plural has also been consistently used in legal texts, since the ECB at a meeting of the Monetary

were not satisfied with the suitability of major shareholders that hold investments in non-financial institutions.[97] It also imposed restrictions on bank investments in non-credit or non-financial institutions,[98] required 'sound administrative and accounting procedures and adequate internal control mechanisms',[99] and provided for supervision of liquidity and monetary policy (at least for countries which remain outside the Eurosystem)[100, 101] as well as for gathering of statistical information by the host country.[102]

The Own Funds Directive, the Solvency Ratio Directive, the Large Exposures Directive, the Capital Adequacy Directive, the Deposit-Guarantee Directive, the Post-BCCI Directive, the Directive on the Reorganization and Compulsory Winding Up of Credit Institutions and the Consolidated Supervision Directive complemented the prudential safeguards of the Second Banking Directive.[103] The Solvency Ratio

Committee in 1998 urged for the invariable use of 'Euro' and 'cent' for the plurals of 'Euro' and 'cent'. However, the use of 'Euro' for the plural has not been invariable in all countries and the Commission acknowledges flexibility by pointing to the recommendation of its translation service (section 12.12 of the English Style Guide): '*Guidelines on the use of the euro, issued via the Secretariat-General, state that the plurals of both 'euro' and 'cent' are to be written without 's' in English. Do this when amending or referring to legal texts that themselves observe this rule. Elsewhere, and especially in documents intended for the general public, use the natural plural with 's' for both terms*' (emphasis in original). Directorate General/Economic and Financial Affairs, 'The European Commission, A fistful of euro or a fistful of euros? That is the question...' (March 2002), <http://europa.eu.int/comm/economy_finance/euro/essentials/spelling_sign_informatics/00718_en.pdf>. Actually, Mr. Duisenberg himself said that he stands to be corrected. Professor Jean-Victor Louis has also confirmed (private correspondence) that nothing prohibits using the plural in accordance with national uses. He further pointed out that in Belgium the term frank was invariable, but the term franc was not.

[97] Banking Consolidation Directive arts. 7, 16 (ex 2BD arts. 5, 11).
[98] Banking Consolidation Directive art. 51 (ex 2BD art. 12).
[99] Banking Consolidation Directive art. 17 (ex 2BD art. 13(2)).
[100] For the term Eurosystem, see Chapter IV, Section 1.1, note 28.
[101] Banking Consolidation Directive Preamble 22nd whereas clause, art. 27 (ex 2BD Preamble 10th whereas clause, 2BD art. 14(2)). Poul R Nielsen, *Services and Establishment in European Community Banking Law* 201 (1994). Host country supervision of liquidity was prescribed due to the link of liquidity issues to the monetary policy of the host jurisdiction. Since monetary union this link vanished and so didthe rationale for liquidity supervision by the host country. See Antonio Saínz de Vicuña, 'The ECB and its Role in Banking Supervision', *A New International Financial Architecture: A Viable Approach* 17, 23 (John B Attanasio & Joseph J Norton eds., 2001). Even outside the Eurosystem and in respect of branches of banks from third countries, some supervisors, eg the UK, Netherlands, rely on the home supervisor for supervision of liquidity. These supervisors do so when the bank at issue employs global liquidity management and the home supervisory system is 'equivalent' to their own. Bank of England, 'Strengthening financial infrastructure', 15 *Financial Stability Rev*iew 80 (2003).
[102] Banking Consolidation Directive art. 22 (ex 2BD art. 21).
[103] As mentioned above (note 41), the Second Banking Directive, the Own Funds Directive, the Solvency Ratio Directive, the Large Exposures Directive and the Consolidated Supervision Directive have been codified and combined in a single Directive, the Banking Consolidation Directive. This codification took place for purposes of clarity. I refer here to the individual directives in order to show the logic of the EU liberalization model and how it has evolved.

Directive[104] established minimum requirements for 'own funds' in relation to assets and off-balance sheet items so that both prudential implications of credit risk[105] and competition distortions from divergent capital requirements are addressed.[106] The Own Funds Directive[107] provided a definition of 'own funds' for the purpose of implementation of Community prudential standards by the Member States. The Large Exposures Directive[108] dealt with solvency risk by placing limits on credit exposures to a single client or a group of 'connected' clients and requiring that banks have the capacity to identify and record large exposures. The Capital Adequacy Directive[109] set out capital requirements for banks and investment firms[110] as a cushion against market risk, position risk, counterparty/settlement risk and

[104] Council Directive 89/647 of 18 December 1989 on a solvency ratio for credit institutions, 1989 OJ (L386) 14, as amended by EP and Council Directives 98/32/EC, 1998 OJ (L204) 26 and 98/33/EC, 1998 OJ (L 204) 29 [hereinafter Solvency Ratio Directive]. The Solvency Ratio Directive with its amendments has been incorporated in the Banking Consolidation Directive.

[105] Banking Consolidation Directive Preamble 47th, 48th, 57th whereas clauses (ex Solvency Ratio Directive Preamble 3rd, 4th whereas clauses).

[106] Banking Consolidation Directive Preamble 50th whereas clause (ex Solvency Ratio Directive Preamble 7th whereas clause).

[107] Council Directive 89/299 of 17 April 1989 on the own funds of credit institutions, 1989 OJ (L 124) 16 [hereinafter Own Funds Directive]. The Own Funds Directive has been incorporated in the Banking Consolidation Directive.

[108] Council Directive 92/121 of 21 December 1992 on the monitoring and control of large exposures of credit institutions, 1992 OJ (L 29) 1 [hereinafter Large Exposures Directive]. The Large Exposures Directive has been incorporated in the Banking Consolidation Directive.

[109] Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, 1993 OJ (L141) 1, as amended by EP and Council Directives 98/31/EC, 1998 OJ (L 204) 13 and 98/33/EC, 1998 OJ (L 204) 29 [hereinafter Capital Adequacy Directive]. Following the adoption of the new Basel Capital Accord (Basel II) (see below, note 217), the EU Commission proposed changes to its capital adequacy requirements. These changes implement Basel II, which provides for the use by 'sophisticated' banks of internal credit ratings and portfolio models in combination with the existing 'standardized' approach for minimum capital requirements, a supervisory review and more extensive market discipline. The EU's legislative proposal is widely known as Capital Adequacy Directive 3 (CAD 3) or the Capital Requirements Directive, but in fact there is no self-standing amending Directive. Rather, the proposal comprises amendments to existing Directives, mainly the Banking Consolidation Directive and the Capital Adequacy Directive (the EU proposal uses the so called 're-casting technique', which enables substantive amendments to be made to existing legislation without a self-standing amending directive. The rationale is to reduce complexity and make EU legislation more accessible and comprehensible). For CAD 3, see http://www.europa.eu.int/comm/internal_market/regcapital/index_en.htm. For background to CAD 3, see Directorate General/Internal Market, *The European Commission, Review of Capital Requirements for Banks and Investment Firms* (Commission Services Third Consultation Paper – Explanatory Document, July 1, 2003).

[110] Credit institutions and investment firms may still, if the competent authorities so allow, calculate capital requirements in respect of their trading book business in accordance with the Solvency Ratio Directive, when their trading book business does not normally exceed 5% of their total business and is never more than 6%, and their total trading book position is normally less than 15 million Euro and always less than 20 million Euro. Capital Adequacy Directive art. 4(6).

foreign-exchange risk[111] and expanded consolidated supervision requirements to include groups which comprise only investment firms. The Deposit-Guarantee Directive provided for minimum deposit insurance, for which responsibility lies with the home country regulator.[112] Following the collapse of the Bank of Credit and Commerce International (BCCI),[113] the Post-BCCI Directive[114] sought to address supervision issues in respect of international banking groups. It provides for exchange of information between supervisors and prescribes an auditor's duty to report to the competent authorities facts which may have a serious impact on the banks' financial soundness. It also requires that banks have their head office in their home Member State and that they actually operate there, and that their links to other persons do not prevent the exercise of effective supervision. The Directive on the Reorganization and Compulsory Winding Up of Credit Institutions ensures certainty and equality in the treatment of creditors' claims in case of bankruptcy or reorganization of a credit institution with cross-border banking activity. Consistent with the home country control principle, credit institutions are subject to the insolvency proceedings of the home Member State and the home country law on insolvency applies.[115]

The Consolidated Supervision Directive[116] provided for 'consolidated

[111] Capital Adequacy Directive Preamble 12th whereas clause, Capital Adequacy Directive Annexes I–IV.

[112] Council Directive 94/19/EC of 30 May 1994 on deposit-guarantee schemes, 1994 OJ (L 135) 5 [hereinafter Deposit-Guarantee Directive]. See also Mads Andenas, 'Deposit Guarantee Schemes and Home Country Control', *The Single Market and the Law of Banking* 105 (Ross Cranston eds., 1995); Mads Andenas, 'Directive on Deposit Guarantee Schemes Challenged', 16 *Company Lawyer* 18 (1995). The Investor Compensation Directive prescribes minimum compensation for investors and requires credit institutions to be members of the home country investor-compensation scheme in respect of their investment business. EP and Council Directive 97/9 of 3 March 1997 on investor-compensation schemes, 1997 OJ (L 084) 22.

[113] For the failure of BCCI and supervisory responsibilities of the Bank of England, see Lord Justice Bingham, *Inquiry into the Supervision of the Bank of Credit and Commerce International* (1992); *Banking supervision and BCCI: the implications of the Bingham report: Second Report* (Great Britain, Parliament, House of Commons, Treasury and Civil Service Committee, 1993). For the BCCI affair, see also John Kerry & Hank Brown, *The BCCI affair: a report to the Committee on Foreign Relations, United States Senate* (1993).

[114] EP and Council Directive 95/26 of 29 June 1995 amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non-life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities (UCITS), with a view to reinforcing prudential supervision, 1995 OJ (L 168) 7 [hereinafter Post-BCCI Directive].

[115] EP and Council Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, 2001 OJ (L 125) 15 [hereinafter Directive on the Reorganization and Compulsory Winding Up of Credit Institutions].

[116] Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis, 1992 OJ (L 110) 52 [hereinafter Consolidated Supervision Directive]. The Consolidated Supervision Directive repealed Council Directive 83/350/EEC of 13 June 1983 on the supervision of credit institutions on a consolidated basis, 1983 OJ (L 193) 18. The Consolidated Supervision Directive has been incorporated in the Banking Consolidation Directive.

supervision'[117] of credit institutions.[118] The credit institution which has a credit institution or a financial institution[119] as a subsidiary (or which holds a participation, namely a holding, direct or indirect, of 20 per cent or more of the voting rights or capital, in such institutions), or the parent undertaking of which is a financial holding company,[120] is subject to consolidated capital requirements, which will include the relevant group entities (credit institutions or financial institutions) and the parent financial holding company.[121]

2.1.2.2 'General good' exception The 'general good' exception allows national regulation to be exempted from the EU trade disciplines. The 'general good' doctrine has been developed by[122] the ECJ with a view to optimizing[123] the sum of liberalization benefits and domestic regulatory

[117] For the principle of consolidated supervision, see Basel Committee on Banking Supervision, *Consolidated Supervision of Banks' International Activities* (March 1979), http://www.bis.org; *Basel Committee, Supervision of Cross-Border Banking*, below note 218, at Annex B; 1983 Basel Concordat, above note 37, at 4. For a comprehensive review of issues in consolidated supervision, see Ronald MacDonald, *Consolidated Supervision of Banks* (Centre for Central Banking Studies, Bank of England, Handbooks in Central Banking Series No 15, June 1998), <http://www.bankofengland.co.uk/ccbs/publication/ccbshb15.pdf>.
[118] The Capital Adequacy Directive has extended consolidated supervision requirements to groups which comprise only investment firms. The new Capital Adequacy Directive, which is still under consultation, will also provide for consolidated supervision in respect of both credit institutions and investment firms.
[119] 'Financial institution' is 'an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in points 2 to 12 of Annex I' of the Banking Consolidation Directive. Banking Consolidation Directive art. 1(5).
[120] 'Financial holding company' is 'a financial institution the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, one at least of such subsidiaries being a credit institution'. Banking Consolidation Directive art. 1(21) (ex Consolidated Supervision Directive art. 1).
[121] Banking Consolidation Directive arts. 52 and 54 (ex Consolidated Supervision Directive arts. 3 and 5). The competent authority for applying consolidated supervision will be determined in accordance with article 53 of the Banking Consolidation Directive (ex Consolidated Supervision Directive art. 4). The consolidated supervision requirement will include downwards relevant group entities which are incorporated outside the EU. Banking Consolidation Directive art. 1(1). Consolidated supervision upwards includes financial holding companies that have their head office in the EU (Banking Consolidation Directive art. 2(2)). The Financial Conglomerates Directive has amended the Banking Consolidation Directive to provide for consolidated supervision requirements also in respect of the ultimate group holding company when its head office is outside the EU and is not subject to equivalent supervision by a third country (Financial Conglomerates Directive art. 29(11), inserting a new art. 56a into the Banking Consolidation Directive).
[122] It should not be ignored that the Commission has also played an important role in the formulation of the general good concept. This is also reflected in the General Good Interpretative Communication (see below note 129). For the Commission's use of infringement proceedings and non-binding instruments (eg Communications) and its effect on the application of the Treaty freedoms, see Mads Andenas, above note 54.
[123] However, it could be argued that optimization of trade and regulatory objectives needs the operation of a full, comparative, cost-benefit analysis. The ECJ jurisprudence seems to limit its balancing to a proportionality trade-off, which requires that the host country measure be

values.[124] It is Community case law through a proportionality analysis[125] that continues[126] to delineate the legitimate reach of domestic regulatory considerations in restriction of the internal market freedoms. The following criteria have been developed by the ECJ for the application of the general good exception:

> 1. [The host rule] must have not been subject to prior Community harmonization, 2. it must not be discriminatory,[127] 3. it must be justified by a compelling reason to protect the general good (eg consumer protection, fraud prevention, cohesion of the tax system), 4. it must not duplicate rules applicable in the home Member State, 5. it must, from an objective point of view, be *necessary* and *proportionate* to the objective pursued (emphasis added).[128]

The Second Banking Directive confirmed the ability of the host regulator to maintain banking rules in the interest of the 'general good'. It provided in its Preamble[129] that 'the Member States must ensure that there are no obstacles to carrying on activities receiving mutual recognition in the same

necessary and proportionate for the attainment of the regulatory objective. For a critical analysis of various trade-off devices and an evaluation of their operation on the basis of a. maximization of net gains of trade and regulation, b. administrability (standards v rules), c. distributive concerns, d. moral concerns (commensurability) and e. theoretical concerns (avoidance of interpersonal comparison of utility), see Joel P Trachtman, 'Trade and . . . Problems, Cost-Benefit Analysis and Subsidiarity', 9 *European Journal of International Law* 32 (1998), also available at <http://www.jeanmonnetprogram.org/papers/00/001101.rtf> (Harvard Jean Monnet Working Paper No 1/97, 1997) [hereinafter Trachtman, 'Trade and . . . Problems']. References here are to the version in the *European Journal of International Law*.

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[124] For the operation of the general good doctrine as a counterweight to ECJ's judicial activism toward including non-discriminatory measures in prohibited restrictions on free movement, see Michel Tison, 'Unravelling the General Good Exception, The case of Financial Services', *Services and Free Movement in EU Law* (Mads Andenas & Wulf-Henning Roth eds., 2003) (manuscript at 4, on file with author).

[125] For the development of the principle of proportionality by EC case law and the relevance of the 'Verhältnismässigkeitsgrundsatz' principle of the German Basic Law (arts. 2, 12), see John A. Usher, *General Principles of EC Law* 40 (1998). For the principle of proportionality in EU law, see Nicholas Emiliou, *The Principle of Proportionality in European Law, A Comparative Study* (1996).

[126] The Second Banking Directive employed the 'general good' concept without, however, determining further its scope.

[127] For the issue of discrimination and the applicable exceptions, see below Section 4.2.1.

[128] Banking – Commission clarifies freedom to provide services and the concept of 'general good', <http://www.europa.eu.int>.

[129] Banking Consolidation Directive Preamble 17th whereas clause (ex 2BD Preamble 16th whereas clause). For the legal significance of the Directives' Preamble, see Commission Interpretative Communication, 'Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive', SEC(97) 1193 final at 17, also available at http://europa.eu.int/comm/dg15/en/finances/banks/ [hereinafter General Good Interpretative Communication]: 'Since the recitals to a directive have legal value as an aid to interpretation, they shed light for the reader on the intentions of the Community legislature' (citing Case 76/72 *Michel* [1973] ECR 457).

manner as in the home Member State, *as long as the latter do not conflict with legal provisions protecting the general good in the host Member State*' (emphasis added).[130]

Thus, host country prudential arrangements can be maintained if they meet the criteria of the general good principle.[131] The host regulator can apply prudential measures, which are equally applicable to national and non-national banks, to the extent[132] that minimum common prudential standards and home country supervision on a consolidated basis are not adequate to address risks for financial stability and depositor protection.[133]

There is the view that prudential measures have been subject to essential (and sufficient) harmonization, in which case there should be no room for the application of the general good exception by the home authorities.[134] The argument goes that the home Member State is competent for prudential regulation and supervision in general and not only with respect to specific prudential measures that have been harmonized.[135]

This argument ignores the fact that prudential regulation and supervision are not defined in the Directives while the 'prudential' concept is very broad. The Banking Consolidation Directive refers to 'essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems' which makes possible 'the application of the principle of home Member State prudential supervision'.[136] However, it does

[130] See also Banking Consolidation Directive arts. 20(4), 22(5), 22(11) (ex 2BD arts. 19(4), 21(5), 21(11) respectively); Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, 1993 OJ (L 141) 27 [Investment Services Directive], Preamble 33rd whereas clause, Investment Services Directive arts. 19(6), 13, 17(4), 18(2).

[131] See Michel Tison, above note 124 (manuscript at 21), for prudential concerns as a valid 'general good' motive under EC case law. However, for the reasons developed below in the text, I do not agree that this is limited to institutions and activities not covered by the Directives, which establish minimum prudential standards.

[132] For the necessity and proportionality tests of the general good exception, see General Good Interpretative Communication, above note 129, at 22–25.

[133] It remains open what regulatory considerations can be considered under the 'general good' exception. The ECJ has held that depositor protection is a legitimate consideration in the public interest. Case 3/95, *Reisebüro Broede v Gerd Sandker*, 1996 ECR I–6511, 1 CMLR 224 (1997). See also *Alpine Investments BV v Minister van Financiën*, 1995 ECR I–1141, 2 CMLR 209 (1995), for the good reputation of the national financial system as a general good objective.

[134] Harmonization has to be 'sufficient' in order to be a barrier to additional, in the general good interest, measures by the host country. For a discussion of 'sufficient' (vis-à-vis 'partial') harmonization and its codification effect with regard to the general good doctrine, see Michel Tison, above note 124 (manuscript at 15). However, as Tison rightly argues, the decision of what constitutes 'sufficient' harmonization rests with the ECJ. Thus, the ECJ in the *German Insurance* case found that additional host country supervision beyond the harmonized measures was necessary, in particular to the extent that harmonization of solvency rules had not covered 'technical reserves'. Case 205/84, *Commission v Germany*, 1986 ECR 3755, 2 CMLR 69 (1987).

[135] Michel Tison, above note 124 (manuscript at 28).

[136] Banking Consolidation Directive Preamble 7th whereas clause (ex 2BD Preamble 4th whereas clause).

not delineate the exact scope of prudential supervision – let alone providing for mutual recognition of prudential regulation in general. It only establishes home country control with respect to supervising the 'financial soundness' of a credit institution, and in particular its solvency.[137] The literature has so far defined 'prudential' regulation and supervision only in broad terms. At best, there is a non-exhaustive enumeration of measures of which prudential regulation and supervision are composed, while on the whole the 'prudential' concept is merely linked to the safety and soundness of the banking system.[138] Neither does secondary Community law employ a clear and systematic distinction between prudential and non-prudential measures.[139] The Directives do no more than treat solvency and management rules as the core of prudential norms. The Investment Services Directive goes even further to link general good to the *stability and sound operation of the financial system and the protection of investors,*[140] which is to say that the general good exception is not only applicable to prudential regulation but it relates primarily to the rationale of prudential measures.

This leads me to suggest that a more accurate finding would be that the home country control principle applies only with respect to the harmonized prudential rules eg own funds, solvency ratios, capital requirements.[141] Thus, the Member States can still adopt non-discriminatory restrictions with respect to prudential rules that have not been harmonized or with respect to rules that address prudential concerns not sufficiently dealt with by the harmonized prudential standards.[142] Under the former, lending of last resort arrangements can be founded upon the interest of the general

[137] Banking Consolidation Directive Preamble 22nd whereas clause (ex 2BD, Preamble 10th whereas clause).

[138] See Chapter I, Section 1, for a review of the banking literature and its deficiency in defining with adequate precision prudential regulation and supervision.

[139] For a critical analysis of the indeterminacy of the 'prudential' epithet in the context of Community law, see Mads Andenas & Christos Hadjiemmanuil, 'Banking Supervision, The Internal Market and European Monetary Union', *European Economic and Monetary Union: The Institutional Framework* 403 (Mads Andenas et al. eds., 1997).

[140] Investment Services Directive, 41st whereas clause. The EU Commission has adopted a new Investment Services Directive, which does not rely on a general good exception, as it further harmonizes rules on conduct of business, best execution and dealing with clients' orders. The new Investment Services Directive, known as the Markets in Financial Instruments Directive (MiFID, also known as ISD2), was published in the EU's *Official Journal* on 30 April 2004 and must be implemented within 24 months from its publication in the *Official Journal*. EP and Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, 2004 OJ (L 145) 1.

[141] General Good Interpretative Communication, above note 129, at 21.

[142] This is also in line with the Commission's interpretation of the type of host country banking measures that can be justified by 'general good' considerations: '[A] national measure aimed at protecting recipients of banking services may, *if it does not come within the scope of a harmonized area,* be relied upon for reasons relating to the general good . . .' (emphasis added). General Good Interpretative Communication, above note 129, at 19.

good, whereas under the latter conduct of business rules linked to prudential considerations can fall within the general good exception.[143]

Directly discriminatory[144] measures may be sustained only under the 'public policy' exception of article 46 (ex article 56) of the EC Treaty.[145] Application of article 46 to banking regulation will be difficult, as the Court of Justice has excluded economic considerations from the ambit of 'public policy' under article 46.[146]

2.1.2.3 Home country control principle – Derogation Further derogation from the home country control principle is possible. The home country control principle does not constitute a constitutional Community law principle, and therefore, the regulatory jurisdiction of the host country may always be brought back. This has been stated by the ECJ in its decision on the Directive on Deposit Guarantee Schemes. The ECJ rejected the German Government's argument that the 'supplementary guarantee' provision was against the home country control principle.

> The Court finds, first, that it has not been proved that the Community legislature laid down the principle of home State supervision in the sphere of banking law with the intention of systematically subordinating all other rules in that sphere to that principle. Second, since it is not a principle laid down by the Treaty, the Community legislature could depart from it, provided that it did not infringe the legitimate expectations of the persons concerned.[147]

This has also been the opinion of the Advocate General Léger, who stated that the home Member State control principle constitutes only 'the *guiding*

[143] Of course, the case for host country conduct of business rules is more clear to the extent that conduct of business rules relate more to investor protection and the integrity of the financial system rather than to prudential concerns. In that case, conduct of business rules are not deemed as having been subject to 'sufficient' harmonization, and hence, they are still within the competence of the host country. Michel Tison, above note 124 (manuscript at 33), for host country competence over conduct of business rules.
[144] Case 352/85, *Bond van Adverteerders and others v The Netherlands State*, 1988 ECR 2085, 3, para. 33. See also Paul Craig & Gráinne de Búrca, *EU Law, text, cases and materials* 748 (2nd edn 1998). For indirectly discriminatory measures, see below Section 4.2.1 and note 358.
[145] 'The provisions of this Chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health'. See also art. 55 (ex art. 66), for the 'public policy' exception from the freedom to provide services.
[146] *Bond van Adverteerders*, above note 144, at para. 34; Case 288/89, *Stichting Collectieve Antennevoorziening Gouda and Others v Commissariaat voor de Media*, 1991 ECR I–4007, para. 11; Case 484/93, *Svensson & Gustavsson*, 1995 ECR I–3955, para. 15. The General Good Interpretative Communication considers as the main impediment for application of article 46 (ex article 56) into banking the ECJ's finding (Case 30/77, *R v Bouchereau*, 1977 ECR 1999) that there must be a 'genuine and sufficiently serious threat affecting one of the fundamental interests of society'. General Good Interpretative Communication, above note 129, at 21.
[147] Case 233/94, *Federal Republic of Germany v European Parliament and Council of the European Union*, 1997 ECR I–2405, 2464, para. 64.

principle which has prevailed in the harmonization of the financial services sector' and that 'it has not been shown that, in the various texts harmonizing banking law, the Community authorities have adopted that principle with the intention of applying it systematically to measures which fall within this sector in the future' (emphasis added).[148]

2.1.2.4 EU institutions The regulatory and supervisory machinery of the EC internal banking market is further enhanced through the EU institutions. The Banking Advisory Committee, as recently replaced by the European Banking Committee, and the Banking Supervision Committee contribute to effective supervision by performing an advisory and coordinating role.[149] The European Central Bank (ECB) also stands as the ultimate guarantor of financial stability. While it is the national central banks (or other national agencies in cases of separation of monetary policy and bank supervision) – not as ECB agents but as autonomous entities organized under national law – that are primarily responsible for banking supervision, the ECB has a coordinating role and a responsibility for the smooth conduct of national policies toward financial stability.[150] Moreover, the ECB has an advisory role with regard to the scope and implementation of EU legislation with respect to prudential supervision of credit institutions and to the stability of the financial system,[151] is vested with the power to supervise and regulate payment systems,[152] and can assume further supervisory tasks upon the decision of the Council of Ministers.[153] Finally, new institutions are envisaged by the follow-ups to the Financial Services Action Plan and its calls for strengthening prudential regulation and supervision. Extending to banking (and insurance and investment funds) the Lamfalussy regulatory model,

[148] *Ibid* at 2434, paras. 126, 127. For the limitations of the home country control principle under the Investment Services Directive with a focus on the negative effect on integration, see Eva Lomnicka, above note 84. For an analysis of the *Federal Republic of Germany v European Parliament and Council of the European Union*, see Mads Andenas, above note 112.

[149] See Chapter IV, Section 1.2, for these committees and their role in EU banking supervision. The Banking Advisory Committee also exercises regulatory powers in acting as a 'comitology' committee that assists the Commission in adopting technical amendments to the banking directives. See Chapter IV, Section 1.4.1, for the new financial services committees' structure, including the European Banking Committee and the Committee of European Banking Supervisors.

[150] EC Treaty art. 105(5). See also article 3(3) of the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute). EC Treaty arts. 8 (ex art. 4a), art. 311 (ex art. 239). Treaty on European Union – Protocol (No. 18) (ex No. 3) on the Statute of the European System of Central Banks and of the European Central Bank, 1992 OJ (C 191) 68, also available at <http://www.ecb.int> [hereinafter ESCB Statute].

[151] ESCB Statute art. 25(1).

[152] EC Treaty art. 105(2), ESCB Statute arts. 3(1), 22.

[153] EC Treaty art. 105(6), ESCB Statute art. 25(2). I argue below in Chapter IV that the ECB's responsibility for single monetary policy allows expansion of the ECB's supervision competence without a Council decision. The dynamic concept of monetary policy ('applied monetary policy') allows the ECB to exercise macro-prudential supervision as a micro-economic function of monetary management.

which is already applied to the EU securities sector, the European Commission has established two new banking committees at the EU level in order to improve regulation and supervision of cross-border banking in the EU. A new European Banking Committee replaces the Banking Advisory Committee and a new Committee of European Banking Supervisors, comprised of national supervisory authorities, is established in order to advise the Commission on technical implementing measures and assist with supervisory cooperation and implementation.[154]

2.2 Multilateral liberalization – General Agreement on Trade in Services (GATS)

The GATS lays the foundations for free trade in financial services at the multilateral level,[155] as it applies the GATT principles on measures[156] by WTO Members which affect[157] trade in services, including banking and other financial services.[158]

[154] See Chapter IV, Section 1.4.1, for these regulatory and supervisory structures. For the Lamfalussy model as applied to EC securities regulation and background to it, see Chapter III, Section 2.3.2.1 and accompanying notes.

[155] See Trachtman, 'Trade in Financial Services', above note 52, at 51, for background information on the GATS.

[156] 'This Agreement applies to measures by Members affecting trade in services'. GATS art. I(1). Such measures include measures by central, regional or local governments and authorities as well as by non-governmental bodies in the exercise of powers delegated by their governments. Services supplied in the exercise of governmental authority (eg central banking), and not on a commercial basis or in competition with one or more service suppliers, are not covered. GATS art. I(3), GATS, Annex on Financial Services art. 1. Article 45 (ex article 55) of the EC Treaty provides for a similar limitation, as it excludes 'activities . . . connected, even occasionally, with the exercise of official authority' from the application of the freedom of establishment and provision of services. For the concept of 'activities connected with the exercise of official authority' as developed by the ECJ jurisprudence, see Anthony Arnull et al., above note 68, at 483.

[157] The Appellate Body has given the term 'affecting' a wide scope, confirming prior Panels' findings that the term 'affecting' is wider than terms like 'regulating' or 'governing', and on this basis it has endorsed the Panel's finding (WT/DS27/R/ECU, WT/DS27/R/MEX and WT/DS27/R/USA) that 'no measures are excluded *a priori* from the scope of the GATS as defined by its provisions'. Bananas AB Report, above note 2, at para. 220. See also WTO Appellate Body Report: Canada – Certain Measures Affecting the Automotive Industry, AB–2000–2, WT/DS139/AB/R, WT/DS142/AB/R (00–2170) paras. 164–67 (May 31, 2000), for what can constitute a 'sufficient basis' in finding that a measure affects trade in services. For a critical point on the AB's interpretation of 'affecting' being quite broad, see Piet Eeckhout, 'Constitutional Concepts for Free Trade in Services', *The EU and the WTO: Legal and Constitutional Issues* 211, 231 (Gráinne de Búrca & Joanne Scott eds., 2001).

[158] Article 5 of the Annex on Financial Services defines 'financial service' as 'any service of a financial nature' and provides a non-exhaustive list, which follows the model of the relevant United Nations classification. United Nations Central Product Classification – Central Product Classification (CPC) Version 1.0, United Nations Statistical Papers, Series M, No. 77, 1998, Subclass 61281. See also WTO Appellate Body Report: Canada – Certain Measures Affecting the Automotive Industry, AB–2000–2, WT/DS139/AB/R, WT/DS142/AB/R (00–2170) para. 157 (May 31, 2000), for a ruling of the Appellate Body that accepts 'wholesale trade services of motor vehicles' as a case of 'trade in services' by reference to its listing in the United Nations Central Product Classification.

As far as financial stability is concerned, GATS is of special interest because it provides for free trade through the commercial presence[159] of a foreign bank in the territory of another WTO Member. Of primary concern are the transmission of regulatory deficiencies through the presence of banks in multiple jurisdictions and the inadequacies of decentralized (nation-based) banking regulation and supervision to deal with internationally active banks.

2.2.1 Liberalization of trade in financial services

The GATS was signed in Marrakesh in 1994 and entered into force in January 1995, and its structure resembles that of the GATT with general principles and obligations for all Members, annexes covering specific sectors and schedules listing the Members' specific access commitments. However, the GATS allows the Members to derogate from its trade disciplines. The Most-Favoured-Nation (MFN) principle is applicable to all measures covered by the GATS without a condition for listing these measures as measures subject to the MFN principle, but exemptions can be maintained in accordance with the Annex on Article II Exemptions.[160] The other two main GATT principles, the market access and the national treatment principles, can be limited, since their application is conditional upon the listing of a specific service sector in a Member's schedule of commitments.[161] Government measures covering a specific sector are subject to market access and national treatment obligations only if the specific sector

[159] Other modes of cross-border banking raise concern more in relation to consumer protection and affect banking stability mainly through disturbances in the macro-economic environment. Besides, commercial presence appears to be the main mode of financial services trade.

[160] GATS art. II(2). In principle, MFN exemptions are valid only for a period of 10 years and subject to review within 5 years from the entry into force of the GATS (the GATS entered into force in January 1995). Members could gain such exemptions before the entry into force of the GATS. New exemptions are also possible through the Article IX(3) waiver, and, for new Members, at the time of accession. See GATS, Annex on Article II Exemptions. For financial services, new exemptions were also possible for a period of 60 days beginning four months after the entry into force of the WTO agreement. See Second Annex on Financial Services arts. I and III, and *Introduction to the GATS*, above note 1, at 11.

[161] 'With respect to *market access* . . . each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for *under the terms, limitations and conditions agreed and specified in its Schedule*' (emphasis added). GATS art. XVI. '*In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein*, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment *no less favourable* than that it accords *to its own like* services and service suppliers' (emphasis added). GATS art. XVII. For the features of the Schedules of Specific Commitments, which are annexed to the GATS and so constitute an 'integral part' of the GATS, see GATS art. XX.

has been scheduled, and even then only if certain reservations have not been maintained.[162]

At the time, the Members' commitments were not significant[163] and, as regards financial services, the Second Annex on Financial Services (Annex on Financial Services) and the Decision on Financial Services provided for new negotiations[164] in accordance with the objective of progressive liberalization.[165] The new negotiations led to the Interim Agreement of 28 July 1995, which, although it provided for improved commitments,[166] was characterized by extensive exemptions and reservations by the Members.[167] Negotiations started again in April 1997 (and concluded in December 1997) and led to extensive market access commitments[168]

[162] Members may also opt to list their commitments by reference to the Understanding on Commitments on Financial Services (Understanding on Financial Services). The Understanding on Financial Services was developed and adopted by developed countries (only OECD countries have opted for the Understanding so far) as a means of more extensive liberalization. Its preamble prohibits any conflict with the GATS and requires application of the Understanding commitments on an MFN basis. Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Understanding on Commitments in Financial Services. See also Trachtman, 'Trade in Financial Services', above note 52, at 70, 78; OECD, *GATS Analysis*, above note 4, at 23.

[163] There was also a failure to achieve agreement on unconditional MFN treatment. The developing countries were concerned about the comparative advantage of the industrialized countries while the United States refused to open its financial markets and allow less committed countries to 'free ride'. See Richard B Self, 'General Agreement on Trade in Services', *The World Trade Organization: The Multilateral Trade Framework for the 21st Century and US Implementing Legislation* 523, 523–24 (Terence P Stewart ed., 1996), for the concerns of the developing countries. See *ibid.* at 527, for reasons for MFN exemptions and the leading role of the US. See also *ibid.* at 547, for the MFN debate. See also Trachtman, 'Trade in Financial Services', above note 52, at 54–5.

[164] For a brief description of the negotiations developments, see WTO, *The Results of the Financial Services Negotiations under the General Agreement on Trade in Services (GATS)*, <http://www.wto.org/english/tratop_e/serv_e/finance_e/finance_fiback_e.htm> [hereinafter Results]. See also Pierre Sauvé & James Gillespie, 'Financial Services and the GATS 2000 Round', *Brookings-Wharton Papers on Financial Services*: 2000 423 (Robert E Litan & Anthony M Santomero eds., 2000).

[165] The GATS Preamble sets out as one of the primary objectives 'the early achievement of progressively higher levels of liberalization of trade in services through successive rounds of multilateral negotiations aimed at promoting the interests of all participants on a mutually advantageous basis and at securing an overall balance of rights and obligations, while giving due respect to national policy objectives'. See also GATS Part IV, Progressive Liberalization. This reminds us of the 'progressive liberalization' mandate of the ex articles 52 (freedom of establishment) and 59 (freedom to provide services) of the EC Treaty.

[166] The improved commitments were annexed to the Second Protocol to the GATS.

[167] The agreement owes its very name ('Interim') to its unsatisfying outcome.

[168] The US proposal was announced on July 14 and guaranteed market access to 'all foreign institutions and to new or expanded financial services' and not only to existing operations of foreign institutions. Frances Williams, 'US lifts financial services hopes', *Financial Times*, July 15, 1997, at 5. The EU guaranteed non-discriminatory market access to foreign companies and eliminated 12 existing restrictions and reduced others. Gwen Robinson, 'Tokyo in offer on financial services', *Financial Times*, July 13, 1997, at 4. Japan would allow foreign institutions to take advantage of the deregulation of its financial system. *Ibid.* See Gilliam Tett, 'Reform plans gather pace', *Financial Times*, July 15, 1997, at 3, for the Japanese 'Big Bang'. Canada agreed to non-discriminatory market access to foreign institutions. Frances Williams, 'Leading traders force financial services pace', *Financial Times*, July 16, 1997.

and limitation of MFN exemptions (with US, India and Thailand withdrawing their broad, reciprocity-based MFN exemptions).[169] The new, significantly improved commitments are annexed to the Fifth Protocol to the GATS and as of November 2004 only three (out of the seventy countries that participated in the 1997 financial services negotiations) have not yet ratified their commitments.[170] In line with the GATS objective for progressive liberalization through successive negotiation rounds,[171] new negotiations started in February 2000.[172] The Declaration of the Doha 4th WTO Ministerial Conference reaffirmed the Guidelines and Procedures for the Negotiations (adopted March 28, 2001) and called for requests for improved specific commitments by June 2002 and submission of initial offers by March 2003.[173] It was contemplated that the negotiations would be concluded by January 2005.

Under the GATS, the national regulator faces the challenge of curtailed authority in respect of the entry and operation of foreign financial institutions in its jurisdiction.[174] Through its trade disciplines, the GATS brings foreign direct investment[175] in banking under the GATT liberalizing

[169] The US submitted only a limited MFN exemption in the insurance sector. *See Results*, above note 164.

[170] For countries that ratified the Protocol before March 1, 1999 the Protocol entered into force on March 1, 1999, while for those that ratified it after March 1, 1999 it entered into force upon acceptance (replacing previous Schedules of Commitments and MFN Exemption Lists). Brazil, Jamaica and the Philippines had not yet ratified their commitments.

[171] GATS art. XIX.

[172] They were scheduled to start in January 2000, but they were delayed due to the failure of the Seattle Ministerial Conference. 'WTO members draw up 'roadmap' for services negotiations', *Agence France-Presse*, May 26, 2000, available in Westlaw WL 2802105).

[173] Twenty five countries had tabled their initial offers by May 2003. These offers are conditional upon the other WTO Members' offers in the requested sectors and the Members retain their right to withdraw any parts or the whole of their offers at any time during the negotiations.

[174] See Non-attributable summary of the main improvements in the new financial services commitments, <http://www.wto.org/wto/english/tratop_e/servfi_e/finsum.htm>, for a summary of the main trade commitments at the time.

[175]

> '[T]he NAFTA (Article 1139–Definitions) and the ECT (Article 1(6)–Definitions) both define investment using an asset-based approach which covers a wide range of direct and portfolio investments, including ownership and other interests in an enterprise, as well as interests that entitle an owner to share in the income or profits of an enterprise, real estate and all forms of tangible and intangible property. This includes physical assets, intellectual property rights, goodwill, securities, long-term loans linked to an investment, joint ventures, concession agreements, licensing agreements and similar rights arising under contracts. The lack of such an explicitly broad definition in the GATS *suggests that the term 'commercial presence' covers at least foreign direct investment*, but whether the other asset categories described above are covered seems, at the very least unclear'. (emphasis added)

Pierre Sauvé, 'Qs and As on Trade, Investment and the WTO', 31 *Journal of World Trade* 10 (1997).

framework. Article I(2)(c) defines trade in services to include[176] the supply of a service 'by a service supplier of one Member, through the *commercial presence* in the territory of any other Member' (emphasis added). Article XXVIII(d) of the GATS defines 'commercial presence' as any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service.[177]

Thus, host country regulation and supervision of foreign banks is potentially subject to the trade discipline of the GATS principles. The MFN principle requires that banks and banking (and investment and insurance) services of any other Member must not be treated less favourably than 'like' banks and banking (and investment and insurance) services of *any other* country.[178] The market access obligations reduce barriers to entry of foreign banks, namely limitations on the number of foreign banks,[179] the total value of service transactions or assets, the total number of service operations or the total quantity of service output, the total number of employees, the type of legal entity or joint venture through which a foreign bank operates, and foreign equity participation.[180] The national treatment principle prohibits measures that discriminate against 'like' banks and banking (and investment and insurance) services of *other Members* and distort the conditions of competition in favour of domestic banks.[181] Article

[176] Article I(2) of the GATS defines trade in services as:

a) the supply of a service from the territory of one Member into the territory of any other Member;
b) the supply of a service in the territory of one Member to the service consumer of any other Member;
c) the supply of a service by a service supplier of one Member, through commercial presence in the territory of any other Member;
d) the supply of a service by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.

See also *Introduction to the GATS*, above note 1, for the meaning and operation of each mode of trade in services.

[177] See also Understanding on Financial Services sec. D(2).

[178] GATS art. II.

[179] The term 'foreign banks' is used here to mean banks of any other WTO Member. See GATS art. XXVIII(j)–(n) for the definition of 'juridical' or 'natural' person of another Member.

[180] GATS art. XVI. Section B of the Understanding on Financial Services provides for the alternative approach to market access. It envisages freedom of establishment and provision of services, reduction of monopoly rights (as well as endeavours for their elimination), MFN and national treatment in the purchase or acquisition of financial services by public entities, and 'endeavours' to eliminate or reduce non-discriminatory regulation with adverse trade effects.

[181] GATS art. XVII. See also Understanding on Financial Services sec. C. Article XVII(3) prescribes as 'less favourable' treatment the one which, being either 'formally identical' or 'formally different', 'modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member'. The GATS does not provide further guidance as to what constitutes distortion of the conditions of competition. The similar provision in the North American Free Trade Agreement (NAFTA) determines 'equal competitive opportunities' by reference to advantages accorded to

VI asks for 'reasonable, objective and impartial' administration of measures affecting trade in services and aims to prevent the use of qualification requirements and procedures, technical standards and licensing requirements as a barrier to entry of foreign banks.[182] Although the market access and national treatment principles apply only to measures that are listed in a Member's schedules, a significant number of domestic measures are already listed and negotiations for further listings are under way.

2.2.2 *Banking regulation*

2.2.2.1 Integration of banking systems and financial stability The opening of financial markets, and in particular the increased presence of foreign banks in the domestic markets, entails risks as well as welfare benefits. Free trade may bring about not only considerable macroeconomic and consumer benefits,[183] but also risks for financial stability.[184]

Foreign bank entry is likely to lead to a more competitive environment with benefits for the consumer due to cost savings and new financial services and products, and to enhance the efficiency of the financial system through 'better resource allocation across sectors, countries and time'.[185] Moreover, national regulators have an additional incentive to develop prudent macroeconomic policies to ensure the stability of the domestic system and deal with competition pressures.[186]

domestic vis-à-vis foreign financial institutions. It further provides that 'differences in market share, profitability or size' may be used as evidence, but not as the basis, for finding distortion of competitive conditions. NAFTA art. 1405(6)–(7).

[182] GATS art. VI.

[183] For the overall positive effect of foreign bank entry in the case of transitional economies, see Luca Papi & Debora Revoltella, 'Foreign Direct Investment in the Banking Sector: A Transitional Economy Perspective', *The Internationalization of Financial Services, Issues and Lessons for Developing Countries* 437 (Stijn Claessens & Marion Jansen eds., 2000).

[184] For a comprehensive synopsis of the effects of foreign bank entry, see Natalia Tamirisa et al., *Trade Policy in Financial Services* (IMF Working Paper WP/00/31, February 2000), <http://www.imf.org/external/pubs/ft/wp/2000/wp0031.pdf>. See also Università Commerciale 'Luigi Bocconi', 'Paolo Baffi' Centre for Monetary and Financial Economics, Newfin – Financial Innovation Research Centre, The Functioning and Supervision of International Financial Institutions 96 (Directorate-General For Research, European Parliament, Working Paper ECON–118 EN, February 2000), <http://www.europarl.eu.int/workingpapers/econ/pdf/118_en.pdf>, which emphasizes the positive efficiency and stability effect of foreign bank entry. The stability risk from a decrease in the 'franchise value' of a domestic bank and assumption of more risky activities as a consequence of enhanced competition is also discussed. However, this is a stability risk that relates more to domestic prudential institution building, where the focus of my analysis is the 'interstate systemic risk', ie the systemic risk which arises from internationalized banking and the interconnectedness of the domestic banking systems.

[185] See Masamichi Kono et al., *Opening Markets in Financial Services and the Role of the GATS* (1997).

[186] *Ibid.*

However, besides these likely benefits of financial services liberalization, there are also risks for the domestic banking systems. No doubt, the increased presence of healthy foreign banks may bring regulatory benefits. It can lead to improvement of prudential standards and accelerate institution building in the area of prudential regulation and supervision. Yet, trade discipline may extend to domestic measures that serve legitimate, non-protectionist, objectives. Trade scrutiny may cover measures that facilitate the use of domestic banks for national industrial and monetary policies, deal with the integrity and the stability of the domestic banking system, and protect the sound operation of the payment systems.[187]

Of concern here is the stability of the domestic banking systems as elements of a more global banking environment. Increased interconnectedness of the domestic banking systems adds to the sources of systemic risk (I will call this 'interstate systemic risk'). Large banks, becoming more global, augment systemic risk concerns, as through these banks deficiencies of one domestic regulatory system may potentially be transmitted to another domestic regulatory system.

A decentralized system, as the current one is, consisting of national structures and international cooperation may not be adequate for the regulation and supervision of a bank that is active in various jurisdictions. The existing domestic regulatory structures, even if strengthened, may not deal effectively with problems in the payment and settlement systems[188] and interbank complications in a more global banking system. Current international 'prudential' structures, relying mainly on the Basel arrangements, have not been very successful in the past, and, arguably, they would not be more helpful with more intense integration.

Assuming that increased entry of foreign banks does not constitute a detrimental intrusion on the national sovereign power to pursue industrial and monetary policy objectives,[189] and that instead financial services liberalization leads to less distortionary macroeconomic policies[190] and increases welfare benefits, it remains to address the problem of adequate prudential regulation and supervision of a global banking system.

[187] See Trachtman, 'Trade in Financial Services', above note 52, at 48–49.
[188] See 'Global risks in banking', *Financial Times*, July 15, 1997.
[189] See Trachtman, 'Trade in Financial Services', above note 52, at 48–49. See also Sydney J Key & Hal S Scott, above note 42, at 15: '[International banking activity] would not render domestic monetary policy ineffective *even though it might change the responsiveness of interest rates to a given change in the monetary base or modify the relationship between a change in interest rates and a change in nominal gross national product*' (emphasis added).
[190] See Masamichi Kono et al., above note 185.

2.2.2.2 Prudential carve-out The GATS addresses prudential implications from its liberalization dynamics through the prudential carve-out. Article 2(a) of the Annex on Financial Services provides that:

> Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

Thus, the host country regulator may take measures in contravention of the GATS provisions, if such measures are justified by prudential considerations and are not a means of avoiding GATS commitments or obligations.[191]

We will examine the value of the prudential carve-out exemption in addressing conflicts between trade and banking regulation. It is shown here that as long as the 'prudential' concept remains elusive, effective application of this exemption involves a constant and complex trade-off between trade and regulatory values. Particular consideration is given to the operation of trade-offs by the GATS adjudicative body.

We assess the prudential carve-out in terms of its capacity to deliver certainty regarding the optimum sum of trade and regulatory values. Preserving trade-restrictive rules on the basis of their prudential function may not be a satisfactory outcome. Thus, we look for international structures, that could replace the prudential function of trade-restrictive domestic regulation and provide a remedy with respect to the inadequacies of domestic supervision.

Section 3 examines the possible effects of different legal forms of foreign bank activity on the stability of the domestic banking systems and on depositors' interests, and the effectiveness of potential remedies, prudential or not, under the GATS regime.[192] A search for additional 'prudential' mechanisms at the international level follows.

[191] The NAFTA agreement includes a similar prudential carve-out without defining the term 'prudential'. NAFTA art. 1410(1). See Chapter I, Section 1.1.

[192] This chapter limits its analysis to the most important forms of commercial presence of banks in foreign markets, that is, branches and subsidiaries, and does not cover agencies and representative offices. This follows the analytical pattern used by Professor Hal Scott in one of his articles discussing international banking supervision post-BCCI. Hal S Scott, 'Supervision of International Banking Post-BCCI', (1992) 8 *Georgia State University Law Review* 487, 488.

3 GATS: TRADE AND FINANCIAL STABILITY

3.1 Branch

The entry of foreign banks mainly in the form of *branches* raises concerns for the stability of the host banking system and the protection of depositors. Since the branch is not a separate legal entity but merely an office of the parent bank, the solvency and liquidity of branches of foreign banks is largely dependent on the financial structure and the operations of the foreign parent bank. Thus, any deficiency of the home regulatory regime, which, for example, allows excessive risk-taking activity by the parent bank, may adversely affect the sound operation of the branch. In turn, a failure of the branch may have a negative impact on the operations of credit institutions in the host country, harm depositors, and, depending on the size of the branch, lead to realization of systemic risk.[193] Deficiencies of the host jurisdiction may also be transmitted to the home banking system through the branch.

3.1.1 'Prudential'

Under the GATS regime, seeking valid measures towards the stability of domestic banking systems and depositor protection, we need to make a distinction between measures for prudential reasons and other measures, as different GATS disciplines will apply in each case.[194] The Annex on Financial Services allows[195] measures for prudential reasons to be exempted from the GATS disciplines as long as they do not constitute means for avoiding the GATS commitments or obligations.[196] Measures for non-prudential reasons are exempted on the basis of limited public

[193] Professor Hal Scott submits that in the case of branches systemic risk relates mostly to problems in the payment systems and less, if at all, to complications due to interbank deposits. *Ibid.* at 497.

[194] It is worth noting the inconsistency of our statement, which is, however, the product of the fuzziness of the term 'prudential' and the reliance of the GATS upon it. In our search for institutions supporting financial stability, we distinguish between measures for prudential and non-prudential reasons when measures related to the financial stability cannot but have a prudential function!

[195] GATS art. XXIX. For the legal character of the annexes, see Joel P Trachtman, 'Accounting Standards and Trade Disciplines: Irreconcilable Differences?' (1997) 31 *Journal of World Trade* 63, 80, reprinted in revised form in *Transatlantic Regulatory Cooperation: Legal Problems and Political Prospects* 223 (George A Bermann et al. eds., 2001) [hereinafter Trachtman, 'Accounting Standards']; references here are to the version in the *Journal of World Trade*. 'The annexes are an integral part of the GATS itself, and in circumstances of conflict the provisions of the Annex that deal more specifically with financial services would be expected to control the more general provisions of GATS'.

[196] Annex on Financial Services art. 2(a).

policy grounds in accordance with articles XIV and XIV *bis* of the GATS while, when they fall under the category of licensing and qualification requirements and technical standards, they are subject to the intense trade discipline of article VI(4)–(5) of the GATS:

> the Member shall not apply licensing and qualification requirements and technical standards that a) nullify or impair 'scheduled' . . . commitments, b) are not 'based on objective and transparent criteria, such as competence and the ability to supply the service', are *'more burdensome than necessary to ensure the quality of the service'*, and 'in the case of licensing procedures . . . in themselves a restriction on the supply of the service', and c) 'could not reasonably have been expected of that Member at the time the specific commitments in those sectors were made' (emphasis added).

But, how do we make the distinction between measures for prudential reasons and those for non-prudential reasons when prudential considerations are what banking regulation is mainly about? The GATS provides that measures for prudential reasons *include* measures 'for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system'. This is not of any help. Using systemic stability and depositor protection as elements of a regulation field has the potential of encompassing all individual banking rules under this field. The reason for this is that the rationale *per se* of the whole banking regulation is mainly about prudential considerations and related market imperfections. Public regulation of banks is primarily justified by the inability of the depositors to assess the financial condition of the banks and structure their relationship accordingly, as well as by the inability of the market to deal with systemic crises and their implications for the rest of the economy.[197] Moreover, any domestic measure with a trade-restrictive effect is potentially relevant for systemic stability to the extent that supranational mechanisms are not adequate for the regulation and supervision of global banking activity.

An alternative interpretation should be sought.[198] Otherwise, if we interpret measures for prudential reasons to include any measure that can have a prudential function, the door for reinforcement of protectionism is left wide open. A solution could be to identify measures for prudential reasons with 'prudential' regulation. But then, what is 'prudential' prudential regulation'? Professor Cranston provides us with a useful description of 'prudential' distinguishing between 'preventive' and 'protective' prudential regulation:[199]

[197] See Chapter 1, Section 2.
[198] See Chapter I, Section 1, for an overview of the 'prudential' concept in the banking regulation literature and problems with its use in legal texts.
[199] Ross Cranston, *Principles of Banking Law* 84 (1997).

> Preventive regulation involves those techniques, which are *designed to forestall crises by reducing the risks facing banks*. These *include* vetting the controllers and monitoring the management of banks, capital, solvency, and liquidity standards, and large exposure limits. Protective techniques, on the other hand, provide support to banks once a crisis threatens. Lender-of-last-resort facilities are of immediate benefit, but ultimately rescue operations may be necessary, as well as payments under deposit insurance schemes. (emphasis added)

Even under this interpretation, however, a wide range of rules can qualify as rules for prudential reasons. The rest of the banking regulation literature is no more helpful.[200] The concept of 'prudential' regulation and supervision has not been defined with adequate precision. There is some inconsistency in that protective *ex post* measures and practices are not always classified as prudential regulation and supervision. Also, systemic issues are treated either as a separate category or being at the core of prudential regulation. Moreover, the distinction between conduct of business rules and prudential regulation is not as clear as we like to think.

For the purposes of the analysis here, I will employ Professor Cranston's description as representing the prevailing perception of what prudential regulation means. I also assume that measures with a 'prudential' function only as their side effect or only in respect of hindering inadequately regulated global banking activity will be treated as measures for non-prudential reasons and will not therefore be covered by the GATS prudential carve-out.

My discussion uses the distinction between measures for prudential reasons and other measures including licensing and qualification requirements and technical standards. In order to illustrate better the issues in the possible trade-offs between trade and banking considerations, I examine hypothetical measures that the national regulator could employ toward the stability of the national banking system.

3.1.2 Measures for prudential reasons

Requirements for 'endowment capital' are an example of measures for prudential reasons. 'Endowment capital' requirements for branches constitute licensing measures which deal with capital and solvency considerations in relation to the dependence of branches on the foreign parent bank and so they would indisputably qualify as rules for prudential reasons.

[200] See Chapter I, Section 1.

Let us assume that a Member State[201] of the European Union requires banks authorized in non-EU, WTO Member countries[202] to supply their branches with a minimum endowment capital. We also assume that this requirement is not listed as an MFN exemption under the GATS Annex on Article II Exemptions or inscribed as an exemption in the EU Schedule of Specific Commitments under the GATS.[203]

This 'endowment capital' requirement violates the MFN and the national treatment principles unless an exemption applies.[204] The MFN and national treatment principles require respectively that like service suppliers[205] of a WTO Member are not treated by the host country less

[201] It should be noted that the term Member State is used for countries that are members of the European Union, while the term Member is used for countries that are members of the WTO.

[202] This is possible under the First Banking Directive (arts. 4, 9), which still applies to branching by non-EU banks in the EU (ex 2BD 19th whereas clause). Extra capital requirements are no longer applicable to branches of EU banks. Banking Consolidation Directive art. 13 (ex 2BD arts. 6(1) (7).

[203] This is the case with all EU countries except Greece. Greece has listed such limitation in the EU Schedule of Specific Commitments:

> For the establishment and operations of branches a minimum amount of foreign exchange must be imported, converted into drachmas and kept in Greece as long as a foreign bank continues to operate in Greece: Up to four (4) branches this minimum is currently equal to half of the minimum amount of share capital required for a credit institution to be incorporated in Greece; For the operation of additional branches the minimum amount of capital must be equal to the minimum share capital.

European Communities and their Member States, *Schedule of Specific Commitments, Supplement 4, GATS/SC/31/Suppl. 4* (February 26, 1998) [hereinafter *EU Schedule of Specific Commitments*]. It is worth noting that Greece has listed this measure as a limitation on market access. I think that this is rather a limitation on national treatment. Branching by foreign banks is not restricted but it has to meet conditions, which are different from the ones required for domestic banks.

[204] A WTO Member may challenge the legality of the 'endowment capital' requirement under the GATS through recourse to the WTO dispute settlement process. The Dispute Settlement Understanding (see below note 220) will apply. GATS arts. XXII, XXIII.

[205] The GATS language recognizes the importance of the production process for the service itself by allowing the host regulator to extend its jurisdiction to the service supplier on the condition that this takes place on a non-discriminatory basis. Thus, articles II and XVII require that each Member accord to services *and service suppliers* of any other Member treatment no less favourable than that it accords to its own or any other country's like services *and service suppliers*. For the discriminatory measure to be sustained, the test should not be that, both services and service suppliers must be unlike. Nicolaidis and Trachtman rightly argue that this would lead to the 'absurd' result of finding the measure illegal when the service suppliers are unlike but the service is like. Instead, the correct test, and that most likely to be followed by the WTO dispute settlement process (DSP), is whether the discriminatory measure relates to *either* the unlike service *or* the unlike service supplier. The unlike treatment of a like service will be in compliance with the GATS to the extent it derives from the justifiable unlike treatment of unlike service suppliers. Kalypso Nicolaïdis & Joel P Trachtman, below note 245, at 254. In most of the cases, however, resort to this argumentation will not be necessary. The intertwining of the service with its production process means that differences between the service suppliers will entail differences between otherwise like services. Often, services will not be like when provided by unlike service suppliers, and this will justify unlike treatment of the, *prima facie* like, service *per se*. We should also note that in the case

favourably than like service suppliers of any other country nor treated less favourably than like service suppliers of the host country.[206] The 'endowment capital' requirement is a direct discrimination against non-EU, WTO Member banks, as it is imposed only on them and not on EU or domestic banks, and as such it violates both the MFN and the national treatment principles. As we have assumed that this requirement is not listed as exempted from the Member's MFN or national treatment commitments, it can be valid only if it falls within a GATS exemption.

Such an exemption from the MFN principle is found in the provisions on economic integration.[207] The European Union meets the requirements of article V of the GATS for regional liberalization agreements and this allows banks authorized in one of the EU Member States to receive more favourable treatment vis-à-vis banks authorized in WTO countries that are not members of the EU.

Departure from the national treatment principle could be grounded in article 2(a) of the Annex on Financial Services.[208] For the exemption to be granted discriminatory capital requirements 'shall not be used as a means of avoiding the Member's commitments or obligations under the

of credit institutions regulation will mostly relate to the service supplier than to the service itself, namely to prudential regulation and supervision, rather than to regulation of conduct of business and of the service product. In any case, this type of domestic regulation is of most relevance for the main theme of our analysis, ie the trade-off between trade and prudential objectives. *Bananas III* held that likeness of services means likeness of the respective service suppliers. This cannot be correct. It is very broad to determine likeness of the service suppliers only by reference to the provided services. In addition, regulation may cover only the service supplier. See Section 3.1.3 below in the text.

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[206] GATS arts. II, XVII. Understanding on Financial Services sec. C. The GATS applies here, as the measure in question affects trade in services, and in particular trade in financial services through the commercial presence of a bank. Financial services are widely defined in article 5 of the Annex on Financial Services and should include any financial service for which the WTO Member banks have obtained authorization. The 'endowment capital' requirement affects directly financial services trade by non-EU, WTO Member banks. For the steps in determining the compliance of a measure with the GATS obligations see WTO Appellate Body Report: Canada – Certain Measures Affecting the Automotive Industry, AB–2000–2, WT/DS139/AB/R, WT/DS142/AB/R (00–2170) para. 170 (May 31, 2000).

[207] GATS art. V. For a discussion of the issues raised under article V and the need for reform, see Sherry M Stephenson, 'GATS and Regional Integration', in *GATS 2000: New Directions in Services Trade Liberalization* 509 (Pierre Sauvé & Robert M Stern eds., 2000). Other exceptions to the MFN principle can be found in the following provisions: article II(3) on preferential treatment for adjacent countries, article XIII on government procurement (but see Understanding on Financial Services sec. B.2), articles XIV–XIV*bis* on general and security exceptions, and articles 2(a) and 3 of the Annex on Financial Services on 'prudential concerns' exceptions and 'recognition' of another country's standards respectively.

[208] Unlike in the context of the discussion below of measures for non-prudential reasons, I do not examine here the 'likeness' of the services suppliers and the different trade-off tests involved, as the measures for prudential reasons fall under the prudential carve-out and its lenient (less trade-intensive) simple means–ends test.

Agreement',[209] that is the Member will have to meet a *simple means–ends rationality* test.[210] This means that the measure should rationally serve a legitimate end and should not constitute an intentional attempt to avoid GATS commitments or obligations.[211]

The loose discipline of the means–ends rationality test is likely to allow an exemption for prudential measures irrespective of their effectiveness. The means–ends rationality test does not ask for the measure to be necessary for the attainment of the regulatory consideration at issue. There is only a requirement for the measure to have a rational link to legitimate prudential concerns. The legitimate prudential concern here is the financial stability implications from the dependence of the branch on the foreign parent bank.[212] Endowment capital addresses these concerns, for example, by helping the branch to meet its obligations from participation in a payment or settlement system, or by providing capital cushion to domestic depositors in case of failure. In the latter case, this extra capital cushion is effective only if the host country can also ring-fence the assets of the foreign bank's branch in case of bankruptcy of the parent bank. In the US, for example, ring fencing is prescribed in the event of bankruptcy of a foreign bank's US branch under both federal and state (eg New York, California) law. US bank insolvency laws have adopted the 'separate entity' principle and subject to the US liquidator *all the property and assets* of a foreign chartered bank in the US (not just the property and assets of its branch).[213] However, ring fencing might not always be possible, especially if comity considerations are taken into account.[214] Nevertheless, the remaining possibility for prudential effect of the extra capital requirements would allow them to meet the lax means–ends rationality test.

[209] Annex on Financial Services art. 2(a). Instead, article 1410(1) of the NAFTA talks about 'reasonable' prudential measures. This could be interpreted as requiring a similar test to the GATS means–ends rationality test. It does allow, however, flexibility for reading a more trade-intensive test. It should be noted that the words 'reasonable' and 'reasonableness' in English administrative law are interpreted as referring only to the rationality of the measure in question. This differs from the Community law principle of proportionality and has caused reservations for incorporation of the proportionality principle in English law. John A Usher, above note 125, at 155.

[210] See Trachtman, 'Accounting Standards', above note 195, at 87. See also Trachtman, 'Trade and . . . Problems', above note 123, at 35, for the 'simple means-ends rationality' test.

[211] See Trachtman, 'Accounting Standards', above note 195, at 87.

[212] This covers deficiencies of the home regulatory system which may impact on the parent bank.

[213] J Virgil Mattingly et al., United States Country Report, *International Bank Insolvencies: A Central Bank Perspective* 259 (Mario Giovanoli & Gregor Heinrich eds., 1999).

[214] In his examination of 'quasi-capital' requirements for branches, Professor Hal Scott questions the effectiveness of such ring fencing due to home country interests, argues that ring fencing is a fair solution (only for insured depositors) only if the host country also provides for insurance of the deposits in the foreign bank branch, and considers host country deposit insurance in combination with host country bankruptcy jurisdiction as the most sensible remedy. He goes on to suggest that only an international agreement could effectively provide for such a solution. Hal S Scott, above note 192, at 500–7. For the related issue of the 'location'

3.1.2.1 The Basel standards A GATS scrutiny of the 'endowment capital' requirement might be different[215] if both the home and the host country have adopted the Basel Accord and the Basel Concordat.[216] The capital standards and supervision arrangements for international banking operations prescribed therein may be deemed adequate to deal with the prudential aspects of foreign branch activity. In that case, additional capital requirements would constitute unjustified discrimination.

The Basel Accord establishes minimum capital standards for banks with international activities. These standards are endorsed by the Basel Committee and implemented through national legislation.[217] The Basel

of capital and the need for international solutions for multinational bank insolvencies, see 'The Insolvency Liquidation of a Multinational Bank' (December, 1992), 3 *Compendium of documents produced by the Basel Committee on Banking Supervision*, ch 3 7 (Basel Committee on Banking Supervision, May 2001), <http://www.bis.org>. It should be noted that the EU system has addressed the issues by establishing the home country control principle. The home Member State is responsible for the insolvency proceedings and the home country law on insolvency applies. See Directive on the Reorganization and Compulsory Winding Up of Credit Institutions, above note 115. For a 'universal' solution with respect to cross-border bank insolvency and the importance of effective consolidated supervision toward such solution, see Eva HG Hüpkes, *The Legal Aspects of Bank Insolvency: A Comparative analysis of Western Europe, the United States, and Canada* 168–70. (2000). But see Lynn M LoPucki, 'Cooperation in International Bankruptcy: A Post-Universalist Approach', (1999) 84 *Cornell Law Review* 696 (arguing against 'universalism' and proposing a system of 'cooperative territoriality' for dealing with international bankruptcy in general).

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[215] The analysis below will also apply to MFN considerations. The host country may recognize the supervision regime of the home country that has adopted the Basel arrangements and discriminate in favour of this home country to the extent the Basel standards address prudential concerns. This is also in conformity with the conditions for recognition of article 3 of the Annex on Financial Services. When recognition is based on an agreement, article 3 requires that access to this agreement is possible for all Member States. The Basel Accords are not open for accession to all countries, but all countries can equally implement them.

[216] It should be noted that the Basel documents are titled Accord or Concordat to denote the non-binding character of the agreements. For the terms employed by the Basel Committee to denote the non-binding nature of its documents, see Raj Bhala, 'Banking Law Symposium: Applying Equilibrium Theory and the Ficas Model: A Case Study of Capital Adequacy and Currency Trading', 41 *St Louis Law Journal* 125, 173 (1996).

[217] See P. Cooke, *Bank Capital Adequacy*, Hal S. Scott & Philip A. Wellons, *International Finance, Transational Policy, and Regulation* 233 (3rd edn, 1996). The Basel Accord was adopted by the Basel Committee in 1988, establishing minimum common capital adequacy standards. For the Basel Accord as amended (until 1998), see International Convergence of capital measurements and capital standards (July 1988, updated to April 1998), 1 Compendium of documents produced by the Basel Committee on Banking Supervision, Ch. 1 (Basel Committee on Banking Supervision, May 2001), <http://www.bis.org> [hereinafter Basel Accord]. The Basel Committee recently adopted (June 2004) a new Basel Capital Accord ('Basel II'). Basel II provides for the use by 'sophisticated' banks of internal credit ratings and portfolio models in combination with the existing 'standardized' approach for minimum capital requirements, a supervisory review and more extensive market discipline. See Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (June 2004), http://www.bis.org/publ/bcbs107.htm. For background to Basel II, see Basel Committee on Banking Supervision, *A New Capital Adequacy Framework* (Consultative paper, June 1999), <http://www.bis.org/publ/bcbs50.pdf>; Basel Committee on Banking Supervision, *The New Basel Capital Accord, Third Consultative Paper* (April 29, 2003), <http://www.bis.org/

Concordat[218] – and its subsequent amendments and supplements, including the Core Principles for Effective Banking Supervision (Basel Core Principles),[219] – deals with supervision of international banking operations by providing for allocation of supervisory responsibilities, supervision cooperation and the principle of 'consolidated supervision'. Like the Basel

bcbs/bcbscp3.htm>; Basel Committee on Banking Supervision, *The New Basel Capital Accord* (Consultative Document, April 2003), <http://www.bis.org/bcbs/cp3part1.pdf>.

[218] The initiative of the Basel Committee to address regulation and supervision of internationally active banks started with the Basel Concordat in 1975, following the failure of the German Bankhaus Herstatt bank and the US Franklin National Bank. The Concordat was subsequently amended in response, most of the time, to failures of internationally active banks. The Basel Concordat in 1983, following the failure of Banco Ambrosiano, established principles for the supervision of banks' foreign establishments; in particular, it introduced the principle of 'consolidated supervision' and called for contact and cooperation among the supervisory authorities. After the closure of the Bank of Credit and Commerce International (BCCI) and the problems with the Banca Nazionale del Lavoro, the Basel Minimum Standards were issued in 1992 to provide for more structured consolidated supervision and intense cooperation by reformulating the 1983 principles as minimum standards (that was in line with the EU model of mutual recognition on the basis of essential harmonization). In 1996 a Document on the Supervision of Cross-Border Banking was published. This document was the result of a working group established to examine issues regarding the implementation of the 1992 Basel Minimum Standards, and mainly the information access problem and the problem of effective home and host supervision of all international banking operations. The findings consist of 29 recommendations, which are applicable to all international banking operations (although the original focus was offshore banking operations). For the 1975 Concordat, see International Monetary Fund, *International Capital Markets: Recent Developments and Short-term Prospects* 29 (IMF Occasional Paper No 7, August 1981). See also Basel Committee on Banking Supervision, *Principles for the Supervision of Banks' Foreign Establishments* (May 1983), <http://www.bis.org> [hereinafter *1983 Basel Concordat*]; Basel Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments* (July 1992), <http://www.bis.org> [hereinafter *Basel Minimum Standards*]; Basel Committee on Banking Supervision, *The Supervision of Cross-Border Banking* (October 1996), <http://www.bis.org> [hereinafter *Basel Committee, Supervision of Cross-Border Banking*]. Most of the Basel recommendations, guidelines and standards are reproduced in the Compendium of the Basel Committee documents (Compendium): *Compendium of documents produced by the Basel Committee on Banking Supervision* (Basel Committee on Banking Supervision, May 2001), <http://www.bis.org> [hereinafter *Basel, Compendium*]. I will use the term Basel Concordats to denote the Basel Concordat, including its amendments and the Basel Core Principles (see note 219 below).

[219] The Basel Core Principles are part (the other is the Compendium) of the response of the Basel Committee to calls by the G–7 countries (Communiqué of the 1996 Lyon Summit) for strengthening prudential supervision in the emerging markets. It provides for minimum requirements and principles for effective supervision of internationally active banks. Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (September 1997), <http://www.bis.org> [hereinafter *Basel Core Principles*]. It should be noted that many non-G–10 supervisory authorities contributed to the development of the core principles. The Basel Committee has issued principles for cross-border banking supervision in relation to Basel II. These principles do not change the current arrangements but they address specific issues from the adoption of Basel II eg issue of multiple approvals for the approaches envisaged by Basel II. Their objective is to enhance cooperation between supervisors towards effective and efficient supervision. Basel Committee on Banking Supervision, *High-level principles for the cross-border implementation of the New Accord* (August 2003), < http://www.bis.org/publ/bcbs100.htm>.

Accord, the Basel Concordats are endorsed by the Basel Committee and are binding only to the extent national legislatures adopt them.

The Basel accords can be taken into account in the assessment of the factual issues by the panel.[220] Their promulgations may provide a criterion for the adequacy of national prudential rules or justify certain trade restrictive measures. Being relevant only for the factual assessment their consideration will only be of persuasive value.[221] Yet, it should be considered whether any rights and obligations in international law have been developed between the two parties simply by adopting of the Basel accords.[222] In that case, the Basel accords may also have a binding effect on the parties' rights and obligations under WTO law. This is consistent with article 31(3)(c) of the Vienna Convention, which asks that 'any relevant rules of international law applicable in the relations between the parties' shall be considered in settling disputes between the parties.[223]

Thus, if, for example, the home country has adopted the Basel Accord, its banks are deemed to carry adequate capital for sound international banking operations. Any additional capital requirements by the host country could be challenged as intentional trade restrictions, ie as 'a means of avoiding the Member's commitments or obligations under the Agreement'.[224]

Further, adoption of the Basel Concordats by both the home and the host country makes 'endowment capital' requirements less sustainable under the GATS disciplines. It becomes more difficult for the host country to justify extra capital requirements on the basis of, for example, problems in supervision of international banking activity. Additional measures by the host (or the home) country will need to be consistent with the conditions specified in the Concordats. That is, extra capital requirements will hardly be justified if the home authority exercises effective 'consolidated supervision' over the whole banking group including the branch, the consent of the home regulator is obtained before the establishment of the branch and there is efficient information sharing between the concerned authorities.[225]

In the end, however, domestic prudential measures are likely to meet the low threshold of the means-ends rationality test. This is likely to remain the

[220] Understanding on Rules and Procedures Governing the Settlement of Disputes, WTO Agreement, above note 3, Annex 2, and 33 ILM 1226 [hereinafter Dispute Settlement Understanding] art. 11.

[221] Joost Pauwelyn, The Role of Public International Law in the WTO: How Far Can We Go?' (2001) 95 *American Journal of International Law* 535, 572.

[222] However, the 'soft law' character of the Basel arrangement should also be taken into account.

[223] David Palmeter & Petros C Mavroidis, 'The WTO Legal System: Sources Of Law' (1988) 92 *American Journal of International Law* 398, 411 (interpreting article 31(3)(c) to mean the parties to the dispute and not all WTO members). See below note 321, for articles 31 and 32 of the Vienna Convention as part of WTO law.

[224] Annex on Financial Services art. 2(a).

[225] See Basel Minimum Standards, above note 218, for the supervision requirements for cross-border bank establishments.

case as long as the 'soft law'[226] of the Basel arrangements continues to be the prudential foundation of internationalized banking. Domestic prudential measures can find their justification in filling the gaps and inadequacies of the Basel arrangements,[227] as only a rational link to these regulatory considerations is required. For example, the host country can justify the extra capital requirements by the absence in the Basel accords of Lender of Last Resort (LOLR)[228] arrangements for international banking operations. In that case, the home country authority in charge of LOLR is likely not to extend liquidity support to an illiquid, but solvent, branch[229] and the host country may not want to use its resources for this. Extra capital requirements together with sealing the branch's assets from the home country bankruptcy jurisdiction will be an efficient way for the host country to protect its banking system and the depositors.[230]

It would have been different, if a more trade-intensive test, for example, a 'least trade-restrictive alternative reasonably available' test,[231] was

[226] For the 'soft law' nature of the Basel standards and related problems for the effectiveness of international prudential regulation and supervision, see Chapter III, Section 2.3.3.1.

[227] See Chapter III, Section 2.1.1.2, for a discussion of the weaknesses of the Basel standards.

[228] LOLR is defined as the '*discretionary* provision of liquidity to a financial institution (or the market as a whole) by the central bank in reaction to an adverse shock which causes an abnormal increase in demand for liquidity which cannot be met from an alternative source'. Xavier Freixas et al 'Lender of Last Resort: a review of the literature', 7 *Financial Stability Review* 151, 152 (1999). The LOLR concept is built upon the work of Henry Thornton and Walter Bagehot, and its mechanism aims at preventing liquidity problems from impairing the solvency of individual banks and the stability of the banking system, without, however, distorting the conditions for competition. Henry Thornton, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* (1802); Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873). The legitimization of the LOLR function can be traced in the so-called 'crisis letters' between the Bank of England and the Government. The first of these letters by the Prime Minister and the Chancellor of the Exchequer, during the 1847 liquidity crisis, delineates the principles for the exercise of LOLR. It endorsed the Bank's right to '*freely*' 'enlarge the amount of their discounts and advances on *approved security*; but that in order to retain this operation within reasonable limits, a *high rate of interest* should be charged' (emphasis added). Quoted in RG Hawtrey, *The Art of Central Banking* 124 (1932). See *ibid.* at 116, for the evolution of the LOLR role of the Bank of England.

[229] The home country might decide to act as LOLR if impairment of the branch's solvency threatens to affect the solvency of the parent bank or that of other home banks due to their dealings with the branch or due to depositors' panic (although depositors' panic is unlikely to be realized in this case).

[230] Professor Scott presents as a more efficient solution limitations on access by foreign branches to payment and settlement systems. Hal S Scott, above note 192, at 498. However, as shown below in Section 3.1.3, certain limitations may not sustain the GATS disciplines, because extra capital requirements, for example, are likely to be regarded as less trade-restrictive alternatives. This brings up again the importance of the ring-fence mechanism. If the ring fence mechanism is proved ineffective the extra capital requirements will not qualify as an adequate regulatory alternative and the payment and settlement system restrictions will be sustained. In any case, such restrictions do not cover protection of depositors of the failed foreign bank branch. For problems with the ring fence mechanism ('separate entity' principle), see above note 214.

[231] For the least trade-restrictive alternative test, see Trachtman, 'Trade and . . . Problems', above note 123, at 35.

applicable.[232] In that case, the international standards for capital requirements and supervision cooperation would be a least trade-restrictive alternative reasonably available, as they would equally address the relevant financial stability concerns of the host regulator and thus the host country extra capital requirements would, being a more trade-restrictive alternative, be in contravention of the GATS principles. Similarly, if the applicable test involved a more intense balancing of trade and regulatory values, the international prudential standards, would to a considerable extent, address relevant financial stability concerns and thus any regulatory costs from elimination of the extra capital requirements would not be disproportionate to (proportionality test), or more than (cost-benefit test), the trade benefits.[233]

3.1.2.2 Applicable trade-off test This book does not attempt to determine what type of trade-off tests the GATS dispute settlement process (DSP) should read into various GATS provisions or the content of these trade-off tests. It rather seeks to reveal the legal uncertainty as to the applicable trade-off tests, ie as to the content of these tests for reviewing the conflict of trade and banking regulation, the difficulty of applying them to a complex set of trade and regulatory values and the implications for both free trade and financial stability.[234] This uncertainty goes along with efficiency and legitimacy concerns[235] due to the handling of the trade-off by the adjudication process.

Such concerns will become more serious once the balancing of trade and banking regulation intensifies. Although what I will call *stricto sensu*

> *Necessity or least trade restrictive alternative tests*. This type of test goes a significant step beyond simple means-ends rationality testing. It inquires whether there is a less trade restrictive means to accomplish the same end. The definition of the end is often outcome-determinative. In some cases, necessity testing is qualified by requiring that the means be the least trade restrictive alternative that is *reasonably available*. In addition, necessity testing is sometimes combined with limitations on the categories of ends permitted.

See also *ibid.* at 69, for the various forms the test may take.

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[232] See below in Section 3.1.3, for reading the prudential carve-out so that a least trade-restrictive test applies.

[233] It should be noted that regulatory benefits from extra capital requirements are already marginal as they are premised on the questionable ability of the host country to employ ring fencing of the assets of the foreign bank branch. See above note 214.

[234] The term 'trade-off test' is used interchangeably with the term 'balancing test'. Both terms are used in a broad sense to mean the review of the conflict of values. They do not mean a specific test, under which the conflicting values have to be weighed against each other and the desirable level of each has to be decided. See Trachtman, 'Trade and . . . Problems', above note 123, for various trade-off devices, of which the 'balancing test' is a special category consisting of certain trade-off elements.

[235] Legitimacy objections here relate primarily to the empowering *per se* of the adjudicative process for the balancing of values and interests, and not to procedural deficiencies of the DSP process. For issues of legitimacy and judicial power with a focus on the WTO, see Robert Howse, 'The legitimacy of the World Trade Organization', *The Legitimacy of International Organizations* 355, 374 (Jean-Marc Coicaud & Veijo Heiskanen eds., 2001).

balancing of trade and banking regulation, ie a trade-off test involving a quasi-quantifiable weighing of the conflicting values and a decision on the desirable level of each, has not yet been operated by the DSP[236] and considerable deference to the chosen (by the national authority) level of banking regulation could be expected, a more nuanced form of balancing has been developing.[237] For the WTO system to move forward more balancing is expected, in which case efficiency and legitimacy problems will grow.

More, in particular *stricto sensu*, balancing of trade and banking regulation by the adjudication process would have significant efficiency and legitimacy implications. For example, a cost-benefit trade-off raises efficiency and legitimacy issues, as it involves a very intense weighing of various interests (including a choice as to the desirable level of the weighed domestic regulatory policy), that is a function regarded as primarily reserved for the political process. In the words of Professor Trachtman:[238]

> [I]t is clear that courts or dispute resolution tribunals may not be the best place to engage in comparative cost–benefit analysis. Rather, the redistributive question always raised by potential Pareto efficiency is seen as the natural province of legislatures. Finally, legislatures overcome the problems of interpersonal comparison of utility insofar as they are places where preferences are revealed and collated directly.

Similar considerations can be discerned in the less intensive test of proportionality (compared to the cost-benefit test) and in the discussions for its influence on English law. As Lord Irvine of Lairg has commented:

> The fundamental objection to proportionality is that it invites review of the merits of public decisions on the basis of a standard which is considerably lower than that of Wednesbury reasonableness and would involve the court in a process of policy evaluation which goes far beyond its allotted constitutional role. Proportionality requires the court to address questions involving compromises between competing interests which in a democratic society must be resolved by the legislature. In the administrative context, they are plainly questions whose decision is entrusted by Parliament to the decision-maker. [239]

[236] Such *stricto sensu* balancing could arguably be more likely to occur in respect of the determination of 'likeness' and consideration of an open-ended list of legitimate domestic regulatory purposes.

[237] See Section 3.1.3 below. See also Section 3.1.3 below for the potential application of a *stricto sensu* balancing in the review of discrimination and the application of the 'aim and effects' test.

[238] Trachtman, 'Trade and . . . Problems', above note 123, at 84.

[239] Lord Irvine of Lairg QC, 'Judges and Decision-Makers: The Theory and Practice of Wednesbury Review', *Public Law* 59, 74 (1996). However, this approach to the principle of proportionality in the context of English law is not expected to be sustainable. As Lord Bingham has put it:

More efficiency and legitimacy are likely by assigning intensive weighing of competing interests at the legislative level. The political process is closer and more visible to the interests at issue and this contributes not only to more accountable outcomes but also to better evaluation of the conflicts at issue. In addition, interested agents may organize their affairs more efficiently, as more balancing at the legislative level produces more precise rules (or simply 'rules' in the *rules v standards* rhetoric) and hence more predictability.[240]

Admittedly, while the WTO legislative machinery remains rigid, intensive balancing mechanisms, after being more precisely prescribed by the legislature,[241] should be operated by the DSP.[242] It will be a way for the system to move forward. For example, a full-comparative cost–benefit test

> [I]n relation to the established European doctrines of proportionality and legitimate expectation, the English courts have, in domestic matters, behaved like a nervous patient, willing to taste the medicine but hesitant to swallow it. In the longer term, however, the trend must surely be towards ever closer assimilation between the rules which prevail in public law disputes in matters with a Community element and those which prevail in purely domestic matters.

Lord Bingham, 'A New Common Law for Europe', *The Coming Together of the Common Law and the Civil Law* 27, 34 (Basil S Markesinis ed., 2000). Lord Bingham's claims of 'compelling extra-curial support for this argument' makes reference to Mads Andenas' view on this:

> It is not likely that judges will favour operating with one legal method, or one kind of review, or one set of remedies, and then a completely different one depending on rather arbitrary and unclear jurisdictional criteria: in one case *Wednesbury* unreasonableness, in the other proportionality and legitimate expectations, and the outcome depending on whether the administrative action is based on a Community law measure or not.

Mads Andenas, 'Introduction', *English Public Law and the Common Law of Europe* 1, 3 (Mads Andenas ed., 1998). For the recent treatment by the House of Lords of the relationship between the *Wednesbury* unreasonableness and the proportionality doctrines, as well as of the proportionality doctrine under common law, see *R Alconbury Developments Ltd v Secretary of State for the Environment and the Regions*, [2001] 2 WLR 1389; *R (Daly) v Secretary of State for the Home Department* [2001] 2 WLR 1622. See also PP Craig, *Administrative Law* 585 (4th edn., 1999), for some thoughts on the future of *Wednesbury* unreasonableness in English law cases in light of the influence of the EC and Human Rights Act proportionality tests. See also *ibid.* at 603, for the limits of judicial review. For a critical review of the English courts' 'conflating' the two concepts in their application of Community law, see Gráinne de Búrca, 'Proportionality and Subsidiarity as General Principles of Law', *General Principles of European Community Law* 95, 99 (Ulf Bernitz & Joakim Nergelius eds., 2000).
However, this discussion is about convergence of Community law and national legal systems with respect to the application of the Community law principle of proportionality, as the principle has developed through ECJ jurisprudence as informed by national law. These views do not lend much support to the application of the proportionality principle in the WTO context. The language of the WTO Agreements provides little guidance as to the exact scope of the trade-off tests available to the DSP, the absence of harmonization allows more room for the trade-off tests regardless of their content and the DSP lacks the institutional environment of the ECJ. This shows that operation of a proportionality test in the WTO context entails substantial legitimacy costs.

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[240] For the *rules v standards* issue, see Chapter III, note 5.
[241] See Chapter III, Section 1.1.
[242] See Trachtman, 'Trade and . . . Problems', above note 123.

would sufficiently take into account the trade and regulatory considerations at issue. However, related efficiency and legitimacy risks suggest that additional legislative capacity should be built[243] which will undertake most of the balancing.

This work presents the case for prudential institution building at the international level. Deficiencies of the decentralized, nation-based, regulatory and supervision system as a basis for a sustainable liberalization of financial services trade are explored. Such deficiencies can be discerned in the BCCI crisis, and further evidence can be found in the problems with the interplay of trade and financial stability in the EC internal banking market. Even if WTO balancing favours domestic regulation at the expense of trade, financial stability risks from trade-led interdependence of banking systems will not be adequately addressed. Thus, I search here for international prudential structures which could deal with such risks and also promote trade by making less relevant the banking regulation side of the balancing.

3.1.3 Measures for non-prudential reasons

Measures for non-prudential reasons may also be important from a financial stability point of view. Again, this statement is contradictory, as measures which are relevant with respect to financial stability cannot but have a prudential function in which case they should benefit from the prudential carve-out. Such contradiction, however, is inevitable as long as the 'prudential' concept remains elusive and the GATS builds its system upon it. I should repeat my working assumption that measures of which the 'prudential' function is only a side effect or is attested only in respect of hindering inadequately regulated global banking activity, will be treated as measures for non-prudential reasons and will therefore not be covered by the GATS prudential carve-out.

The hypothesis here examines restrictions on branches of foreign banks, such as the denial of participation of foreign branches in the host payment systems.[244] I assume that the principal regulatory objective is the efficiency of the payment systems and that the prohibition only secondarily relates to prudential concerns.[245] The principal regulatory consideration is assumed

[243] The costs from enhancing the legislative capacity will be lower if the process relies on the Basel process. In that case, the Basel consensus will inform the debate and negotiations will be more efficient. See Chapter III, Section 2.3.
[244] For an example of requirements for branches of foreign banks, see Hal S Scott, above note 192, at 498.
[245] This is in line with the expectation that the DSP will interpret the prudential carve-out by analogy to its approach to article XX(g) of the GATT. The article XX(g) exemption for measures for 'the conservation of exhaustible natural resources' has been interpreted to cover regulation 'primarily aimed' at such conservation. See Kalypso Nicolaïdis & Joel P. Trachtman, 'From Policed Regulation to Managed Recognition in GATS', *GATS 2000: New Directions in*

to be the cost effect the foreign branch may have on the domestic interbank market and on the payment and settlement systems.[246] Therefore, the more deferential test of the prudential carve-out will not be available and review of the prohibition under the GATS should start with applying the national treatment principle.[247]

These prohibitions are likely to be found inconsistent with the national treatment principle. Foreign branches are *prima facie* 'like' the domestic banks and hence the prohibition constitutes a formally discriminatory measure. For finding violation of the national treatment principle, 'less favourable treatment' of the foreign branches as a consequence of the prohibition must also be established.[248] The test is whether competitive conditions are potentially distorted[249] in '*each individual case*' of a foreign branch.[250] Denial of participation in the payment systems is expected to disadvantage foreign branches and will therefore violate the national treatment principle.

3.1.3.1 'Likeness' and 'regulatory considerations' The host country can argue that review of 'likeness' should consider the special regulatory considerations relating to foreign branches. That is, foreign branches and branches of domestic banks are not *like* service suppliers due to the

Services Trade Liberalization 241, 255 (Pierre Sauvé & Robert M Stern eds., 2000). Here our contradiction becomes worrisome. Access to payment systems by foreign branches has considerable prudential implications. Where do we draw the line between the cost-efficiency rationale of such a measure and its prudential function? How do we decide on its classification as a prudential measure or not for GATS purposes? For the potential risks to the US banking system had Herstatt been a CHIPS participant through a New York branch, see Hal S Scott, above note 192, at 498–99.

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> The payment and settlement system of a host country is subject to two risks from foreign branches. First, a foreign branch might default on a settlement position through failure to cover uncollateralized overdrafts on its clearing account with a central bank, incurred in connection with a use of a central bank payment system, such as FedWire in the United States. Such a failure might result in a loss for the central bank. Second, the failure of a foreign branch to meet its uncollateralized settlement obligations in a net settlement system, such as CHIPS in the United States, could expose other bank participants to losses.

Sydney J Key & Hal S Scott, above note 42, at 24.

247 GATS art. XVII. Section C of the Understanding provides for national treatment specifically with respect to access to payment and clearing systems.

248 GATT Panel Report: United States – Section 337 of the Tariff Act of 1930, BISD 36S/345 (November 7, 1989) [hereinafter US – Section 337 Panel Report]; WTO Appellate Body Report: Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef, WT/DS161/AB/R, WT/DS169/AB/R (00–5347) paras. 135–7 (December 11, 2001) [hereinafter Korea-Beef AB Report].

249 GATS art. XVII(3).

250 US – Section 337 Panel Report, above note 248, at para. 5.14; WTO Panel Report: United States – Standards for Reformulated and Conventional Gasoline, WT/DS2/R (96–0326) para. 6.14 (January 29, 1996) [hereinafter United States – Standards for Reformulated and Conventional Gasoline Panel Report].

dependence of the foreign branch on its parent bank and the home regulatory and supervisory regime, and subsequent financial stability risks for the host banking system. The host country can claim that difference in treatment should be judged against the degree of 'unlikeness' of the service suppliers due to regulatory considerations.

This invokes the GATT and WTO jurisprudence on the concept of 'likeness', and in particular that on the *aim and effects* test. It is helpful to recall here the relevant case law as this largely derives from the application of the GATT to trade in products.

The GATT and WTO review of the concept of 'likeness' has focused on the competitive relationship of the products and has avoided acknowledging the significance of domestic regulatory policies. Relying on the Report of the Working Party on Border Tax Adjustments,[251] the criteria for determining 'likeness' have mainly been: '(i) the properties, nature and quality of the products; (ii) the end-uses of the products; (iii) consumers' tastes and habits – more comprehensively termed consumers' perceptions and behaviour – in respect of the products; and (iv) the tariff classification of the products.'[252] These criteria relate to what has been termed 'competitive likeness' and do not take into account domestic regulatory policies.[253]

Regulatory policies were later taken into account in the review of 'likeness' through the introduction of the 'aim and effects' test. Following the application of the GATT disciplines to origin-neutral domestic measures, the 'aim and effects' test was incorporated in the review of 'likeness' in order to sustain domestic measures, which, despite their discriminatory trade effects, had a *bona fide* purpose. The 'aim and effects' test was applied by the Panel in *Malt Beverages*[254] calling for consideration of the purpose of the disputed measure and of its trade effects in determining 'likeness'.[255] The test allowed a member to maintain its trade-restrictive origin-neutral measure to the extent its distinctions between products were based on different regulatory concerns in respect of those products.

The 'aim and effects' test was subsequently rejected, because a) it lacked textual support and b) it deprived article XX of the GATT of its *effet utile*. It was held that support for considering regulatory aspects – not the

[251] GATT Working Party Report, Border Tax Adjustments, December 2 1970, GATT BISD (18th Supp.) 97 (1972).
[252] Asbestos AB Report, below note 262, at para. 101.
[253] Professor Hudec criticized GATT/WTO jurisprudence for relying on the Working Party's report, as the report discussed the terms 'like or similar' and 'similar' rather than 'like product' and did not provide 'official' recommendations but it rather offered an indicative list of criteria, which were based on suggestions by some Members of the Working Party. Robert E Hudec, '"Like Product": The Differences in Meaning in GATT Articles I and III', *Regulatory Barriers and the Principle of Non-Discrimination in World Trade Law* 101 (Thomas Cottier & Petros C Mavroidis eds., 2000).
[254] GATT Panel Report: United States – Measures Affecting Alcoholic and Malt Beverages, DS23/R – 39S/206 (adopted June 19, 1992) [hereinafter Malt Beverages Panel Report].
[255] See also United States – Taxes on Automobiles, DS31/R (October 11, 1994, unadopted).

measure's regulatory purpose, but the measure's 'protective application'[256] – could only be found in article III:2, second sentence of the GATT (national treatment – internal taxes, 'directly competitive or substitutable' products), which, by reference to article III:1, explicitly provides that there is violation only if the relevant measures are applied so as to afford protection. There is no similar language in article III:2, first sentence (national treatment – internal taxes, 'like' products)[257] or, as *Bananas III* held, in article III:4 (national treatment – internal regulation, 'like' products).[258] Similarly, *Bananas III*[259] held that there is no basis in the GATS text for the application of an 'aim and effects' test. In addition, it was noted that there would be no room for application of article XX of the GATT and for its conditions for exempting certain regulatory objectives if regulatory objectives were considered in determining violation of, for example, article III:2, first sentence.[260]

Yet, an 'aim and effects' test has been accepted in a more covert manner. This has occurred through the so-called 'seat of the pants'/'smell' approach to the application of the test, which has nicely been elaborated by Professor Hudec.[261] A more recent demonstration of this approach is the *Asbestos* case, in which the Appellate Body reintroduced the 'aim and effects' test by[262] considering the regulatory purpose in its review of the product's physical properties[263] and of the consumers' behaviour,[264]

[256] WTO Appellate Body Report: Japan – Taxes on Alcoholic Beverages, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (96–3951) (October 4, 1996) [hereinafter Japan Alcoholic Beverages AB Report]. The Appellate Body referred to the measure's 'protective application' rather than to its 'regulatory purpose': 'Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure.' Japan Alcoholic Beverages AB Report, at sec. H, para. 2(c). This does not seem to differ from the 'aim and effects' test, which should not be more than an 'objective analysis of the purpose'. Robert E. Hudec, below note 261, at 631, 632.

[257] Japan Alcoholic Beverages AB Report, above note 256.

[258] Bananas AB Report, above note 2, at para. 215.

[259] Ibid. at para. 241.

[260] WTO Panel Report: Japan – Taxes on Alcoholic Beverages, WT/DS8/R, WT/DS10/R, WT/DS11/R (96–2651) para. 6.17 (July 11, 1996) [hereinafter Japan Alcoholic Beverages Panel Report]. The Panel referred to the Appellate Body which in United States – Standards for Reformulated and Conventional Gasoline noted that '[o]ne of the corollaries of the 'general rule of interpretation' in the Vienna Convention is that interpretation must give meaning and effect to all the terms of a treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility'. United States – Standards for Reformulated and Conventional Gasoline AB Report, below note 321, at sec. IV.

[261] See Robert E Hudec, 'GATT/WTO Constraints on National Regulation: Requiem for an "Aim and Effects" Test', 32 *International Lawyer* 619, 641 (1998).

[262] In *Asbestos* the Appellate Body introduced elements of the 'aim and effects' test also in its review of 'less favourable treatment'. However, it did not rule on the issue, as this issue had not been appealed. WTO Appellate Body Report: European Communities – Measures Affecting Asbestos and Asbestos-Containing Products, WT/DS135/AB/R (01–1157) para. 100 (March 12, 2001) [hereinafter Asbestos AB Report].

[263] *Ibid.* at para. 116.

[264] *Ibid.* at para. 122.

which are accepted as valid criteria for determining the 'likeness' of products.[265, 266]

Taking into account the scholarly comments on the 'seat of the pants'/'smell' approach to the 'aim and effects' test and the arguments for its reappearance,[267] our analysis assumes that an 'aim and effects' test can be read in the GATS text and proposes[268] a proportionality test as the standard of review.[269] There is nothing in the 'likeness' wording *per se* which can limit the review of the interplay of trade and regulatory considerations. The Appellate Body has colourfully acknowledged the indeterminacy of the 'likeness' term by likening it to an 'accordion'[270] and by pointing outthat the 'dictionary definition of "like" does not indicate from whose perspective "likeness" should be judged.'[271] The 'aim and effects' test itself to the

[265] Porges and Trachtman indicate that this seems to have come as a response to Professor Hudec's criticism of *Bananas III* and of the Appellate Body's 'literalist approach' and 'empty formalism'. Interestingly, Porges and Trachtman were told that the Appellate Body members had read Hudec's work. Amelia Porges & Joel P Trachtman, 'Robert Hudec and Domestic Regulation: The Resurrection of Aim and Effects', 37 n. 4 *Journal of World Trade* 783, 787, 788 (2003).

[266] In *Asbestos* it was also held that considering regulatory policies under article III:4 does not deprive article XX of its *effet utile*. It was stated that a less frequent recourse to article XX does not make article XX redundant and that this would be the case only if the exemptions in article XX for domestic regulatory policies were made unavailable. Asbestos AB Report, above note 262, at para. 115.

[267] Robert E Hudec, above note 261. Professor Eeckhout, affirming the need for consideration of regulatory objectives, contemplates that the 'aim and effects' test will 'come in again through some backdoor.' Piet Eeckhout, above note 157, at 235. Perhaps *Asbestos* has already confirmed this by introducing 'aim and effects' through the 'less favourable treatment' element and through incorporation of regulatory objectives in the analysis of the product's physical properties and of the consumer's tastes and habits. Asbestos AB Report, above note 262, at paras. 100 and 116, 122 respectively.

[268] The Appellate Body in *Pisco* held that only the rational relationship of the domestic policy objective with the measure should be examined, and rejected that a 'necessity' requirement can be read in article III:2, second sentence. WTO Appellate Body Report: Chile – Taxes On Alcoholic Beverages, AB–1999–6, WT/DS/87/AB/R, WT/DS/110/AB/R (99–5414) para. 72 (December 13, 1999). This is somewhat inconsistent with the Appellate Body's 'refusal' to read an 'aim and effects' based exception at all in the concept of 'likeness' other than in the case of article III:2, second sentence. In any case, I would say that my interpretation of 'likeness' entails a trade-intensive test, which is consistent with AB's reluctance to apply an 'aim and effects' test.

[269] We observe now the transformation of the national treatment in a more intensive trade-off test. For a comprehensive examination of the 'metamorphosis' of the national treatment principle in other balancing tests, covering the US, GATT and EU national treatment mechanisms, see Trachtman, 'Trade and . . . Problems', above note 123, at 60, 65:

> But national treatment is inherently unstable, and with time and pressure seems to metamorphose into more rigorous tests, including simple means-ends rationality testing, proportionality testing, necessity testing and balancing or cost benefit . . .
>
> . . .
>
> . . . [This may happen] *in considering the degree of distortion of competition* and *in determining the 'likeness'* of products. (emphasis added)

For Community law cases addressing the 'possible overlap between the principles of proportionality and non-discrimination', see John A Usher, above note 125, at 43–4.

[270] Japan Alcoholic Beverages AB Report, above note 256.

[271] Asbestos AB Report, above note 262, at para. 92.

degree accepted in the GATT and WTO jurisprudence is 'not a finished legal standard' either.[272] The proportionality test proposed here will take the form of validating the measure that is least inconsistent with the GATS while requiring that the detriment to the regulatory objective at issue is not disproportionate to the trade benefit.[273] Being trade intensive, this proportionality test should be consistent with the reluctance of the Appellate Body to read an 'aim and effects' test in its review of discrimination.

Applying the 'aim and effects' test to a facially discriminatory, origin specific, measure, like the hypothetical measure here, might be criticized. It might be argued that the WTO jurisprudence has applied the 'aim and effects' test only to facially non-discriminatory measures. I see no obstacle in extending the 'aim and effects' test to facially discriminatory measures. First, the concept of 'likeness' itself renders flawed a distinction between facially discriminatory and facially non-discriminatory measures. 'Likeness' has first to be established before finding whether a measure is discriminatory. And, it is in reviewing 'likeness', among others,[274] where the 'aim and effects' test can come into play. Here a difference from the EU concepts can be discerned. In Community law, it makes sense to talk about *prima facie* discriminatory measures, as discrimination is established in respect of the nationality rather than the 'likeness' of the subjects concerned. Secondly, there is no justification for distinguishing between facially discriminatory and facially non-discriminatory measures and for drawing different legal outcomes accordingly. The only qualitative difference between such measures is difference in the style of drafting and this does not justify different legal treatment. In our hypothesis, the measure could have read that all banks must have a legal incorporation in the host banking system in order to participate in the host payment systems.[275]

[272] Robert E Hudec, above note 261, at 627.

[273] For the proportionality test, see Trachtman, 'Trade and . . . Problems', above note 123, at 74. The proposed proportionality test comprises strict policing of the domestic regulatory policies and accepts the possibility of compromises on the choices of the domestic regulator. It should be acceptable in the context of determining discrimination. Here the burden of proof lies primarily with the complaining party while there is no limit on the defensible regulatory policies. With respect to the burden of proof, arguably, it is unclear under WTO jurisprudence when the burden of proof is deemed to be satisfied and when it shifts to the defending party. See Sydney M Cone III, 'The Asbestos Case and Dispute Settlement in the World Trade Organisation: The Uneasy Relationship Between Panels and the Appellate Body', 23 n. 1 *Michigan Journal of International Law* 103, 133 (2001). For the burden of proof vis-à-vis the 'burden of going forward with the evidence', see Donald H. Regan, 'Regulatory Purpose and 'Like Products' in Article III:4 of the GATT (With Additional Remarks on Article III:2)', 36 n. 3 *Journal of World Trade* 443, 449 n. 23 (2002).

[274] See above notes 262, 267.

[275] Professor Wulf-Henning Roth articulates similar argumentation with respect to overt discrimination in the EU and argues that overt and covert (indirect) discrimination should be treated alike and be justified on the same 'general good' grounds. Wulf-Henning Roth, above note 66 (manuscript at 12).

3.1.3.2 Likeness of service suppliers and regulatory considerations In the GATS, further grounds can be found for incorporating regulatory considerations in the review of 'likeness' because of their importance for the qualities of the service supplier and the service itself. *Bananas III* held that there is no textual support for considering regulatory purposes in determining the 'likeness' of services and that 'likeness' of services means 'likeness' of the respective service suppliers.[276] This cannot be correct.[277] As shown above, there could hardly be any limitations on reading regulatory considerations in the concept of 'likeness'. And it is difficult to find textual support for interpreting 'likeness' of services to mean 'likeness' of the service suppliers.

Bananas III seems to have ignored the intertwining of the service supplier with the service, as well as the importance of regulation for the qualities of both. Quite often the qualities of the service will be shaped by the features of the service supplier. The size, complexity and goodwill of the service supplier will impact on the quality of the service. For example, the underwriting of an initial public offering by an established international investment bank should ensure wide subscription and efficient pricing. Further, the regulatory framework of the service supplier will be critical. Legal advising by a law firm that is subject to the rules of an advanced legal system should be more comprehensive and adherent to rules of professional responsibility. These observations show that likeness of the service cannot be judged without first examining the special features of the service suppliers. They also demonstrate the importance of regulatory considerations in determining the likeness of service suppliers and of services.

The intertwining of the service supplier with the service and the importance of the applicable regulation become more apparent in the case of regulation-intensive service suppliers such as banks. Banks are subject to special regulation because of their special functions in an economy and because of market failures to deal with negative externalities from these functions.[278] Banking regulation influences the financial structure of banks, eg minimum capital, composition of assets, and prescribes rules for the conduct of their business (conduct of business rules). Further, prudential supervision ensures that banking business does not pose any threat to depositors and to financial stability. A bank which is subject to effective

[276] WTO Panel Report: European Communities – Regime for the Importation, Sale and Distribution of Bananas, WT/DS27/R (97–2077), at para. 7.322 (May 22, 1997). The Appellate Body did not rule on the relationship between the 'likeness' of services and the 'likeness' of service suppliers, probably because this issue was outside the scope of the appeal. See Werner Zdouc, 'WTO Dispute Settlement Practice Relating to the GATS', 4 *Journal of International Economic Law* 295, 332 (1999).

[277] For criticism of the *Bananas III* ruling on the likeness of service suppliers, see Gaëtan Verhoosel, *National Treatment and WTO Dispute Settlement, Adjudicating the Boundaries of Regulatory Autonomy* 60–4 (2002).

[278] See Section 2 of Chapter I, for the rationale of banking regulation.

regulation and supervision is more likely to remain financially strong and solvent and thus, for example, its overseas branch is more likely to have adequate resources to deal with liquidity risks as well as not to create any risks for the stability of the host financial system. The overseas branch's deposit taking business will be more secure, in particular if the applicable depositor protection scheme and the lender of last resort arrangements of the home country are effective. Depositors will benefit from conduct of business rules which prescribe in detail and efficiently fair treatment of the bank's clients.

Therefore, we would not expect the *Bananas III* rulings on the 'aim and effects' test and on the 'likeness' issue to be sustainable, in particular with respect to financial services. Banking regulation significantly influences the characteristics of the banks and thus the likeness of their overseas branches vis-à-vis banks of the host jurisdiction. The host regulator may have legitimate reasons for treating foreign branches and domestic banks as unlike institutions and so regulating them differently. On the basis of the differences between foreign branches and domestic banks the host regulator may also establish a legitimate regulatory distinction between their respective banking services. Furthermore, it should be reminded that in the case of branches, through which trade in financial services is of interest for my analysis, host regulation may cover the foreign branch as such, eg authorization, capital adequacy requirements, and not its services.

3.1.3.3 Our hypothetical example The reliance of foreign branches for capital on the parent bank, which is subject to the home regulatory regime, could support a finding that foreign branches are not 'like' domestic banks in respect of the attainment of host country regulatory objectives. For example, if the lending of last resort arrangements of the home country are not effective, liquidity problems of the foreign branch might not be dealt with sufficiently and might lead to non-fulfilment of the branch's obligations from participation in a host payment system.[279] Although not directly relevant here,[280] it is interesting to note that the dependency on the parent bank and the home regulatory system renders foreign branches and domestic banks unlike from the perspective of the depositors.[281] For example, in

[279] Even if it were held that foreign branches and domestic banks are 'like' without considering regulatory concerns, an 'aim and effects' test could be read in the requirement that 'like' foreign service suppliers are not treated 'less favourably' than domestic service suppliers. See Asbestos AB Report, above note 262, for this interpretation in the context of GATT III:4.

[280] It would have been relevant if the disputed measure concerned domestic law requiring to take out foreign branches membership with the host deposit insurance scheme. This requirement would have been discriminatory in that it would entail duplicatory obligations for foreign branches and could have been justified on the basis of the 'unlikeness' of the foreign branches. In addition, such domestic measure would have been a measure for prudential reasons and thus would have been able to benefit from the prudential carve-out.

[281] See Asbestos AB Report, above note 262, at para. 122, for the importance of regulatory considerations in determining consumers' tastes and habits as one of the market-based criteria of 'likeness'.

the case of branches of foreign banks which are not members of the host deposit insurance scheme,[282] their depositors have to rely on home country deposit insurance. In this regard, the depositors' choice between foreign branches and domestic banks is affected. Therefore, the foreign branches can be found 'unlike' vis-à-vis the domestic ones whereby difference in treatment does not establish discrimination, *de jure* or *de facto*.[283]

The prohibitions under review may be sustained under the application of the proposed proportionality test. These prohibitions address the different regulation of foreign branches and its possible cost effect if foreign branches were to participate in the host payment systems. To the extent measures such as, for example, extra capital requirements (which is less trade-restrictive and so is a less GATS-inconsistent measure)[284] would not effectively address this cost effect, it could be argued that the regulatory costs from elimination of direct prohibitions would be disproportionate to possible trade benefits. Thus, the direct prohibitions could be maintained.

However, a complete review of the host regulation at issue should again take into account the Basel standards. Direct prohibitions will be even more difficult to justify if both the home and the host country of the foreign branches have adopted the Basel accords, in particular the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten countries (the Lamfalussy Report)[285] and the Core Principles for Systematically Important Payment Systems (the Core Principles).[286] Like the other Basel accords, the Lamfalussy Report and the Core Principles are not binding and are subject to implementation through national legislation. The Lamfalussy Report provides for standards and

[282] It will not be so when the host country's scheduled commitments include a requirement for membership of the foreign branches with the host deposit insurance scheme. This, however, only solves the problem by maintaining trade barriers.

[283] Pure *de facto* discrimination, that is discrimination relating solely to trade effects, has not yet been treated as a violation of the national treatment principle in the WTO. Only origin-neutral measures, whose regulatory distinction is actually an effective substitute for origin-specific distinction, constitute prohibited *de facto* discrimination. US – Section 337 Panel Report, above note 248; Bananas AB Report, above note 2.

[284] For the 'least GATT-inconsistent' vis-à-vis the 'least trade restrictive' test, see below note 303.

[285] Committee on Interbank Netting Schemes, *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten countries* (CPSS Publications No 4 November 1990), <http://www.bis.org/publ/cpss04.htm#pgtop> [hereinafter Lamfalussy Report].

[286] Committee on Payment and Settlement Systems, *Core Principles for Systematically Important Payment Systems* (CPSS Publications No 43, January 2001), <http://www.bis.org/publ/cpss43.htm> [hereinafter Payment Systems, Core Principles]. The Committee on Payment and Settlement Systems (CPSS) is a forum of the G–10 central banks that meets under the auspices of the Bank for International Settlements (BIS) and deals with issues in payment and settlement systems. The Task Force for the Core Principles, however, included representatives of 11 more central banks as well as IMF and World Bank representatives. See <http://www.bis.org/cpss/index.htm>.

access criteria to large-value payment systems, with its focus on credit and liquidity risk, and related systemic risk. It also establishes principles for central bank cooperation in overseeing cross-border and multi-currency netting and settlement schemes. The Core Principles build on the Lamfalussy Report and extend to all types of settlement systems.[287] Incorporation of these standards into the host payment and settlement systems will be less trade-restrictive than direct prohibitions and even more so in the event of adoption by both the home country and the host country of the other Basel accords. The standards of the Core Principles and the Lamfalussy Report will be sufficient for designing efficient and safe payment systems. And the Basel minimum capital standards along with the Basel supervision arrangements will be adequate to address efficiency considerations from the activity of foreign branches.[288] This in combination with extra capital requirements for foreign branches participating in the host payment and settlement systems will be a less trade-restrictive measure, as it ensures more market access for the foreign branch, and the regulatory costs from the abolition of direct prohibitions will be, if not marginal, at least not disproportionate to the trade benefits.[289] In that case, the DSP should find that direct prohibitions do not comply with the national treatment principle.

This shows that non-prudential regulation may be found to be in violation of the national treatment principle, and hence, may not be available against systemic risk. Here, it needs to be acknowledged that my interpretation that measures with 'prudential' functions only as their side-effect or only in respect of global banking activity are not measures for prudential concerns in the meaning of article 2(a) of the Annex might be challenged as arbitrary. The response to this is that if article 2(a) is interpreted so as to include any measure with a prudential function, this could cancel most of the trade commitments. Most individual banking rules will be treated as having a prudential function. In addition, the absence of prudential institutions at the international level can accord all trade barriers a potentially prudential function and make them proof under the lenient means–ends rationality test of article 2(a). Although the importance of the

[287] The Lamfalussy Report covers netting for interbank payments or currency obligations.

[288] This again resembles the effect that the degree of harmonization has on the legitimacy of host country rules in the EU system. The more sufficient the harmonization is found to be the less justifiable host country rules beyond the home country control become. However, the difference remains that harmonization in the EU takes place through its legislative process, there has been agreement (and continuous discussion) as to the degree of harmonization needed for the internal market, and the harmonization effect in relation to host country jurisdiction has been given more certain measurements by the ECJ.

[289] For a comprehensive regulation and design of the clearing and payment systems as an efficient remedy which is non-discriminatory against foreign banks, see also Natalia Tamirisa et al. above note 184, at 10 (citing Peter Nicholl, 'New Zealand's Experience with Foreign Ownership in its Financial System', a paper presented at the World Bank Workshop on Internationalization of Financial Services, Singapore (August 8, 1997)).

prudential carve-out in getting the WTO members to agree to open their financial market, such interpretation of the prudential carve-out would not be concordant with a system which aims to a meaningful liberalization of financial services trade.

In the event a challenge to my interpretation of 'prudential' is successful and article 2(a) is found to be applicable to all measures with a prudential function, a solution against such broad scope of article 2(a) and its potential negative effects on financial services trade would be to interpret it so as to incorporate a least WTO inconsistent alternative (reasonably available) test. Such test will make it more difficult for prudential regulation to meet the requirements of the prudential carve-out, because the prudential measure at issue will have to be the least WTO inconsistent alternative that is reasonably available, and not merely not a means to avoid GATS commitments. Arguably, it would be difficult to justify the application of a least WTO inconsistent alternative (reasonably available) test under a text that calls for a mere rationality test. Application of a least WTO inconsistent alternative test may be possible if objective factors are sufficient to establish that the prudential measure at issue is used as a means of avoiding commitments or obligations under the GATS. Then, the mere existence of a least trade-restrictive measure could render the disputed prudential measure a means for avoiding GATS commitments or obligations, irrespective of the intention of the domestic regulator.[290] Again we are faced with the problem of defining the content of trade-off devices and of examining their application in the WTO context, and with all the efficiency and legitimacy concerns which may arise therefrom.

All this further confirms that both the elaboration of the 'prudential' concept and the synthesis of trade and regulatory values are now in the sphere of the adjudicative proceedings of the GATS, and of course within the legislative jurisdiction of the WTO. The GATS evaluation will cover the issue of the adequacy of the current international prudential mechanisms as effective substitutes for trade-restrictive domestic prudential measures. This does not prepare for a promising integration of the financial systems. It rather stands to disturb the constitutional balance of the international economic system by rendering the GATS the *de facto* ultimate arbiter of international financial regulation.

[290] Arguing for the application of a least trade-restrictive test to prudential measures is likely to be more convincing in the NAFTA context. Article 1410(1) leaves more room, as it requires that the prudential measures are 'reasonable'.

3.1.4 Licensing and qualification requirements and technical standards

The host country may prescribe stringent requirements for the approval of entry and operation of branches of foreign banks.[291] The hypothetical entry measure here is assumed to have objectives other than prudential, eg security concerns, and hence the prudential carve-out will not be available. Relevant US regulations serve as our hypothetical entry measure.

First, we examine whether US entry requirements comply with the national treatment principle. The entry rules will violate the national treatment principle if they treat foreign branches *less favourably* than *like* domestic branches. Discriminatory US entry rules can be found in the requirement that foreign banks be licensed by both the Office of the Comptroller of the Currency for federal banking (or by the state banking authority for state banking),[292] and the Federal Reserve Board (FRB),[293] while US banks do not need the FRB's approval. These discriminatory entry rules are likely to result in less favourable treatment for foreign banks.

Again, an argument can be made that, before finding a violation of the national treatment principle, regulatory considerations should be taken into account in determining 'likeness'.[294] It is submitted that:

> Allowing entry by a foreign branch is inherently different from permitting a domestic bank to open a branch. Branching by a domestic bank is predicated on initial approval for the establishment of the bank itself, and establishment of a branch is merely incremental. Moreover, domestic banks are subject to domestic (host-country) regulation for safety and soundness, whereas a foreign bank establishing a branch is not. The host country therefore needs to assure itself on this point in permitting entry for a foreign branch.[295]

Therefore, regulatory considerations may render branching by a foreign bank different than branching from a domestic bank. Difference in the regulatory treatment by the host authority does not constitute discrimination to the extent it addresses unlikeness of foreign branches with respect to the attainment of the regulatory objectives at issue. According to the discussion above of 'likeness' and of the 'aim and effects' test, the discriminatory char-

[291] Sydney J Key & Hal S Scott, above note 42, at 12. '[T]he United Kingdom . . . relies on procedures for screening of banks seeking to establish branches in its territory and regular monitoring of branch activities.'
[292] 12 USC § 3102(a)(1) (Supp. IV 1992).
[293] 12 USC § 3105(d)(1) (Supp. IV 1992). The requirement for approval by the FRB was prescribed in the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) as implemented by the Federal Reserve Board's Regulation K Foreign Bank Supervision Enhancement Act of 1991, Pub. L. No. 102–242, 105 Stat. 2286 (1991) (codified in scattered sections of 12 USC 3101–); Regulation K of the Board of Governors of the Federal Reserve System 12 CFR pt. 211 (1993). For issues in the regulation of foreign banks in US, see Jonathan R Macey et al., *Banking Law and Regulation* 799 (2001).
[294] See above Section 3.1.3.
[295] Sydney J Key & Hal S Scott above note 42, at 21.

acter of the different regulatory treatment should be judged through applying a proportionality test.[296]

Under the proportionality test, the US entry requirements will be upheld only if regulatory costs from the adoption of alternative measures are disproportionate to the trade benefits. Assuming that the US entry requirements significantly impede access by foreign banks to the US banking market and that security concerns could be alleviated through the adoption of alternative measures, eg single licensing of foreign banks by the FRB providing for supplemental, rather than full-fledged name-checking of the bank's employees, directors and principal shareholders, regulatory costs from elimination of double licensing will not be disproportionate to the trade benefits. This conclusion will be further corroborated if both the home and host countries have adopted the Basel accords, in which case effective supervision on a consolidated basis should contribute to security checks. The relevant interplay of trade and banking regulation and the significance of the Basel arrangements are elaborated in the analysis of article VI below, which imposes similar trade disciplines to non-discriminatory entry requirements.

Article VI of the GATS expressly covers non-discriminatory measures that fall under the category of licensing and qualification requirements and technical standards. Thus, entry requirements are subject to trade discipline, even when they do not discriminate against services or service suppliers of any other Member.[297] Pursuant to Article VI, 'the Member shall not apply licensing and qualification requirements and technical standards' that a) 'nullify or impair . . . specific commitments', b) are not 'based on objective and transparent criteria, such as competence and the ability to supply the service', are '*more burdensome than necessary to ensure the quality of the service*', and 'in the case of licensing procedures . . . in themselves a restriction on the supply of the service', and c) 'could not reasonably have been expected of that Member at the time the specific commitments in those sectors were made' (emphasis added).[298] This trade discipline aims to reduce unnecessary duplicatory compliance and subsequent restrictions on market assess.[299]

[296] For reading a proportionality test in the review of discrimination, see above Section 3.1.3.

[297] It is interesting that licensing and qualification requirements, together with technical standards, are subject to a trade-intensive review even when they are non-discriminatory. As we show below article VI of the GATS provides for the trade-intensive *least trade-restrictive alternative* test. This can be explained due to the significance of measures under article VI for giving substance to the market access commitments. It is also in line with the distinction in the EU context between, for example, authorization requirements and conduct of business rules. While the former fall entirely within the home country competence, the latter can still be retained by the host country (albeit only if non-discriminatory and if in the 'general good' interest).

[298] GATS art. VI(4)–(5).

The following conditions can be read in article VI(4)–(5) for the sustainability of an entry rule, which otherwise is based on 'objective and transparent criteria' and is not in itself 'a restriction on the supply of the service': a) no nullification or impairment, b) no less trade-restrictive measures reasonably available, and c) reasonable expectation with regard to the measure.

The first condition will not be satisfied if the stringent entry requirements significantly limit effective access to the US banking market.[300] Substantial restrictions on effective access will likely be established, because the US entry requirements entail 'high transaction costs', require a 'voluminous amount of information about the foreign regulatory system' and make banks likely to 'withdraw applications after incessant questioning and requests for documentary material'.[301]

3.1.4.1 'Necessary' The second condition is that the measure in question is not 'more burdensome than *necessary* to ensure the quality of the service' (emphasis added). This condition could be interpreted to require a balancing of the conflicting trade and banking regulation values. The term 'necessary' is already employed in article XX of the GATT and the relevant jurisprudence should inform its operation under article VI of the GATS. The DSP has interpreted the term *necessary* to involve balancing of trade and regulatory considerations.[302] This has not been a *stricto sensu* balancing, ie a trade-off test involving a quasi-quantifiable weighing of the conflicting values and a decision on the desirable level of each, but a more nuanced form of balancing.

[299] Likewise, in the European Union, the ECJ jurisprudence has led to a departure from non-discrimination as the basis for freedom of establishment and freedom to provide services. Even non-discriminatory measures can be found in violation of internal market freedoms and can be maintained only if they are justified by 'general good' considerations. Professor Roth recognizes that such measures can also be considered as a matter of discrimination but he expresses reservations for this approach. Wulf-Henning Roth, above note 66 (manuscript at 13).

[300] On the relationship of the first condition with the second and third conditions, see Trachtman, 'Accounting Standards', above note 195, at 84: 'The structure of this provision makes it possible to argue that the "nullification or impairment" prong of this test should be deemed to be satisfied, by virtue of the fact that a measure satisfies the second and the third prongs. However, a strong counterargument would recall that in GATT, nullification or impairment is only presumed where there is a violation of the agreement itself.' For the non-violation nullification or impairment conditions under the GATT, see WTO Panel Report: Japan – Measures Affecting Consumer Photographic Film and Paper, WT/DS44/R (98–0886) (March 31, 1998).

[301] See Hal S Scott & Philip A Wellons, *International Finance, Transactions Policy, and Regulation* 172 (3rd edn, 1996) (citing Raj K Bhala, 'Tragedy, Irony, and Protectionism After BCCI: A Three-Act Play Starring Maharajah Bank', 48 *SMU Law Review* 11 (1994)). Bhala considers as the major obstacle the whole process for approval by the FRB. Raj K Bhala, above note 301, at 24.

[302] Professor Howse does not see much room in the WTO jurisprudence for reading the application of balancing tests. In his view, the Appellate Body, following its *Reformulated Gasoline* decision, has interpreted article XX(g) to require only 'a rational connection between the measure in question and the policy objective at issue', and the *chapeau* of article XX to require

In *Asbestos*, the Appellate Body reiterated the reading of a 'least GATT inconsistent reasonably available test'[303] in the concept of 'necessity'. Following the Panel's ruling in *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes*[304] and its own ruling in *Korea-Beef*[305] (in reliance upon *United States – Section 337 of the Tariff Act of 1930*),[306] the Appellate Body held that a measure is *necessary* only if there is 'no alternative measure consistent with the General Agreement, or less inconsistent with it', which the Member could '*reasonably be expected to employ to achieve*' its regulatory objective.[307]

It is not clear what qualities can be read in the '*least WTO inconsistent reasonably available*' test. In its review of 'necessity' under article XX(b), *Asbestos* confirmed the *Korea-Beef* interpretation of 'reasonably available' under article XX(d):[308] 'one aspect of the "*weighing* and *balancing* process . . . comprehended in the determination of whether a WTO-consistent alternative measure" is reasonably available is the extent to which the alternative measure "contributes to the realization of the end pursued"' (emphasis added). It reiterated that '"[t]he *more vital or important [the]*

'evenhandedness in administration and enforcement of the measures and *not the measures themselves*.' Otherwise, he continues, application of balancing tests would constitute an unacceptable departure from the DSP's well-founded (relating to legitimacy considerations) formalism. Robert Howse, 'Comment', in *GATS 2000: New Directions in Services Trade Liberalization* 307, 312 (Pierre Sauvé & Robert M Stern eds., 2000). Arguably, article XX(g) calls only for a rational relationship between the measure and the policy objective: measures '*relating to* the conservation of exhaustible natural resources' (emphasis added). This does not exclude, however, balancing tests from the GATS altogether. Even if the argument for consistency in the Appellate Body's reluctance to use balancing tests and the justified legitimacy reasons for this are accepted, the wording of the GATT as well as that of the GATS do not rule out more intense policing of domestic regulation. Requirements for the 'necessity' of the domestic measure allow a legitimate application of balancing tests, and the Appellate Body has done so. The concept of 'like' regulatees may entail the employment of balancing tests so that the appropriate level of difference in the treatment of different regulatees is determined. See above Section 3.1.3, for the incorporation of more intensive balancing tests in the national treatment test. For interpretation of the GATT jurisprudence on the *chapeau* of article XX of the GATT to include a balancing test, see also Kalypso Nicolaïdis & Joel P Trachtman, above note 245, at 256 (arguing in favour of the same approach with respect to article XIV of the GATS due to identical wording); Robert E Hudec, above note 261, at 637–38, 645 (1998).

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[303] For a criticism of the 'least GATT inconsistent' test and of the fact that in theory it does not necessarily embody a 'least trade restrictive' test, see Jan Neumann & Elizabeth Türk, 'Necessity Revisited: Proportionality in World Trade Organization Law After Korea-Beef, EC-Asbestos and EC-Sardines', 37 n. 1 *Journal of World Trade* 199, 207, 214 (2003).

[304] GATT Panel Report: Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes, DS10/R BISD 37S/200 para. 75 (November 7, 1990).

[305] Korea-Beef AB Report, above note 248, at para. 159.

[306] US – Section 337 Panel Report, above note 248, at para. 5.26.

[307] Asbestos AB Report, above note 262, at paras. 170, 171. See also WTO Appellate Body Report: United States – Measures Affecting the Cross-border Supply of Gambling and Betting Services, WT/DS285/AB/R (05-1426) paras. 304–327 (April 7, 2005) [hereinafter US-Gambling and Betting AB Report]

[308] *Ibid*. at para. 172 (citing Korea-Beef AB Report, paras. 166, 163 and 162). See also US – Gambling and Betting AB Report, above note 307, at paras. 304–327.

common interests or values" pursued, *the easier it would be to accept as "necessary" measures designed to achieve those ends*'[309] (emphasis added) and looked for a less trade restrictive alternative measure. *Korea-Beef* held that determining in the context of article XX(d)

> 'whether a measure, which is not "indispensable", may nevertheless be "necessary" . . . involves in every case a process of *weighing and balancing* a series of factors which prominently include *the contribution made* by the compliance measure to the enforcement of the law or regulation at issue, *the importance of the common interests or values* protected by that law and regulation, and the *accompanying impact of the law or regulation on imports or exports*'.[310] (emphasis added)

In the view of some scholars, the Appellate Body has not held that a balancing of trade and regulatory values may take place.[311] They say that the Appellate Body has explicitly stated that the level of protection chosen by the domestic regulator is undisputed.[312] Thus, the argument goes, there is only a requirement for a less WTO inconsistent alternative measure, which, however, should be equally effective in respect of the chosen regulatory end.

We could accept this view as correct only to the extent that what perceives as balancing is *stricto sensu* balancing. It is difficult to argue that the Appellate Body has read 'necessity' as comprising *stricto sensu* balancing, ie a quasi-quantifiable weighing of the trade and regulatory values and a choice as to the desirable levels of each. Yet, it would be equally difficult to deny that a more nuanced form of balancing is being suggested by the Appellate Body. *Korea-Beef* held that, when the measure is not 'indispensable', 'necessity' should be assessed through the *weighing* and *balancing* of the importance of the pursued regulatory values, the effectiveness of the measure for the realization of these values and the effects on trade. This should mean that, when the challenged measure is not indispensable, the search for alternative measures would take into account, *weigh and balance* both trade and regulatory implications. Such balancing still respects the chosen level of regulatory protection. It only says that as long as none of the measures under review is indispensable, the least WTO inconsistent measure will be determined after balancing all relevant factors and may not necessarily be the one

[309] *Ibid.* at para. 162.
[310] Korea-Beef AB Report, above note 248, at para. 164
[311] Axel Desmedt, 'Proportionality in WTO Law', 4 n. 3 *Journal of International Economic Law* 441, 469, 476 (2001); Jan Neumann & Elizabeth Türk, above note 303, at 212. See *ibid.*, for a comprehensive study of the WTO jurisprudence on 'necessity' and the possibility for a balancing of trade and regulation. See also *ibid.* at 227, for an analysis of the chapeau of article XX and the possibility of a balancing test inthe light of the equivalent wording in article 30 (ex article 36) of the EC Treaty. It is argued that the Appellate Body has not read in the chapeau a *stricto sensu* proportionality test. See also Axel Desmedt, above, at 473–75.
[312] See Asbestos AB Report, above note 262, at para. 168.

contributing most to the chosen level of regulatory protection. The latter proposition should be consistent with the Appellate Body's ruling in *Korea-Beef* that 'a measure with a relatively slight impact upon imported products might more easily be considered as "necessary" than a measure with intense or broader restrictive effects'.[313] Further, it should be noted that the Appellate Body in *Shrimp/Turtle* is considered to have applied a balancing test ('locating and marking out a "line of equilibrium"')[314] in its interpretation of the introductory clause (the so-called chapeau) of article XX.[315]

For the purposes of the analysis here, let us assume the application of a *stricto sensu* balancing test, as such test better portrays the complexities of a balancing test. It is assumed that a proportionality, rather than a cost-benefit analysis, test will be a more plausible approach, and it will take the following form. Entry requirements will be inconsistent with the GATS only if an alternative measure is less trade-restrictive (*less WTO inconsistent test*), and the regulatory costs in case of opting for the less trade-restrictive alternative are not disproportionate to the trade benefits (*reasonably available test*).[316] Such test should be more consistent with the interpretation of the term 'necessary' by the Appellate Body. In *Korea-Beef*, the Appellate Body interpreted 'necessary' in the context of article XX(d) to refer to a 'range of degrees of necessity'. It held that

[313] Korea-Beef AB Report, above note 248, at para. 163.

[314] 'The task of interpreting and applying the chapeau is, hence, essentially the delicate one of locating and marking out a line of equilibrium between the right of a Member to invoke an exception under Article XX and the rights of the other Members under varying substantive provisions (eg Article XI) of the GATT 1994 . . . The location of the line of equilibrium, as expressed in the chapeau, is not fixed and unchanging; the line moves as the kind and the shape of the measures at stake vary and as the facts making up specific cases differ.' WTO Appellate Body Report: United States – Import Prohibition of Certain Shrimp and Shrimp Products, AB–1998–4, WT/DS58/AB/R (98–3899), at para. 159 (October 12, 1998).

[315] Kalypso Nicolaïdis & Joel P Trachtman, above note 245, at 256. But see Jan Neumann & Elizabeth Türk, above note 303, at 227 (arguing that the Appellate Body has not read in the chapeau a *stricto sensu* proportionality test). See also Axel Desmedt, above note 311, at 473–75.

[316] Cost-benefit analysis is assumed by another hypothetical trade-off in the context of the GATS art. VI(4)–(5). Raj K Bhala, above note 301, at 55. This hypothetical trade-off deals with the US requirement for foreign banks to accept deposits only through a subsidiary. The following observations are interesting. First, the hypothetical trade-off does not address the regulatory costs from deficiencies of the home *preventive* prudential regulation, which in the case of a branch can be critical due to its dependence on the parent bank. Regardless of the intensity of the host regulation of the branch, the branch remains dependent on the parent bank and its effective regulation and supervision. Second, it considers prudential concerns as the regulatory value at stake. If so, the prudential carve-out should apply, which involves only a simple means–ends test! This only makes more apparent the pitfalls of the trade-off between trade and banking regulation. At least, there is some comfort from the requirement that the members of the dispute settlement panels must have expertise with regard to the specific financial service under dispute. Annex on Financial Services art. 4. For the idea for a separate dispute settlement body exclusively for financial services, see Kathleen M O'Day, 'GATT and Its Effect on Banking Services', *4 Current Legal Issues Affecting Central Banks* 131, 133 (Robert C Effros ed., 1997).

> [a]t one end of this continuum lies 'necessary' understood as *'indispensable'*; at the other end, is 'necessary' taken to mean as *'making a contribution to'*. We consider that a 'necessary' measure is, in this continuum, located significantly closer to the pole of *'indispensable'* than to the opposite pole of simply *'making a contribution to'*.[317]

A cost-benefit analysis test would preserve a measure if the regulatory costs from elimination of that measure were more than the trade benefits and this would be possible when the measure was only 'making a contribution' to the regulatory objective. Instead, under a proportionality test, the measure at issue would be preserved only if the regulatory costs from the alternative measure were disproportionate to the trade benefits and this is more likely to happen when the measure is closer to being '*indispensable*'.

On the other hand, an argument can be made in favour of a cost-benefit analysis test on the basis of the *dubio mitius* principle, as cost-benefit analysis may entail more deference to domestic regulation than a proportionality test. In *Hormones*,[318] the Appellate Body endorsed the *dubio mitius* principle, which, in case of ambiguity of the text, favours the interpretation with the less compromise on national sovereignty.[319] A cost-benefit analysis test will validate a domestic measure when regulatory costs from an alternative measure exceed trade benefits, while a proportionality test asks only that regulatory costs not be disproportionate to trade benefits. However, although deference to national sovereignty is a valid claim, it should be reminded that the WTO agreement is an international treaty and as such it involves cession of sovereign power.[320] The Appellate Body has confirmed the limits on national regulation by requiring that it be close to being 'indispensable'. In any case, the applicable trade-off test would be expected to vary depending on the measure and the specific factual and legal context.[321]

[317] Korea-Beef AB Report, above note 248, at para. 162. See also *ibid*. at para. 164.

[318] WTO Appellate Body Report: EC Measures concerning Meat and Meat Products (Hormones), AB–1997–4, WT/DS26/AB/R, WT/DS48/AB/ (98–0099), at para. 165 (January 16, 1998) [hereinafter Hormones AB Report].

[319] See *ibid*. at para. 165 and n. 154 (citing *I Oppenheim's International Law* 1278 (R Jennings & A Watts eds, 9th edn, 1992).

[320] See also Japan Alcoholic Beverages AB Report, above note 256, at sec. F.

[321] 'A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose'. Vienna Convention on the Law of Treaties, opened for signature May 23. 1969, 1155 UNTS 331, 8 ILM 679 (1969), art. 31(1). In *Japan Alcoholic Beverages* and in *United States – Standards for Reformulated and Conventional Gasoline*, the Appellate Body recognized articles 31 and 32 of the Vienna Convention as 'a rule of customary or general international law', whose application is mandated by article 3(2) of the Dispute Settlement Understanding. Japan Alcoholic Beverages AB Report, above note 256, at sec. D; WTO Appellate Body Report: United States – Standards for Reformulated and Conventional Gasoline, WT/DS2/AB/R (96–1597), sec. III(B) (April 29, 1996) [hereinafter United States – Standards for Reformulated and Conventional Gasoline AB Report]. It should be noted that the *dubio mitius* principle has not found its expression in the Vienna Convention.

Thus, review of the entry rules will employ a proportionality test and will again take into account the Basel arrangements. In case of adoption of the Basel accords by both the home and the host country, the regulatory objectives of the entry requirements should be judged in light of the incompleteness of the Basel arrangements. As the regulatory objectives in question are assumed to be other than prudential,[322] eg security issues, it is incompleteness of Basel as to these other objectives which will be significant. For example, single licensing involving supplementary name-checks, instead of full-fledged checks, applicable to all employees, directors, and principal shareholders (*less WTO inconsistent*) could be a proportionate (*'reasonably available'*) security compromise (*regulatory costs*) toward avoiding burdensome delays (*trade benefits*),[323] if effective home supervision on a consolidated basis ensures scrutiny of the foreign banks' employees, directors and principal shareholders (*Basel arrangements*). If so, single licensing involving supplementary name-checks will be a less WTO consistent measure reasonably available. My conclusion may have been different under a more nuanced form of balancing. Single licensing may have not been held as reasonably available if regulatory costs, even though not disproportionate, were significant, as security is an important value.

Here, the relevance of the Basel standards may also be derived from paragraph 5(b) of article VI of the GATS. Pursuant to article VI, paragraph 5(b) '[in] determining whether a Member is in conformity with the obligation under paragraph 5(a), account shall be taken of international standards of relevant international organizations applied by that Member.' Relevant organizations are 'international bodies whose membership is open to the relevant bodies of at least all Members of the WTO'.[324] The rationale of the requirement for open membership should be to secure the legitimacy of the standards and also that benefits from these standards are available to all WTO Members. The Basel accords are open for accession only to Basel members, but any country is free to proceed with equivalent implementation. If both the home and the host country – which are parties to the dispute at issue – have adopted the Basel accords they should be assumed to have waived possible reservations which would have been

[322] A further limitation on the regulatory objectives that can be sought is read in the requirement for the regulation to be necessary for '*the quality of the service*'. See Kalypso Nicolaïdis & Joel P Trachtman, above note 245, at 260. In my view, although there is value in the proposition for a correction of this wording, the broad scope of the term 'quality' of the service should prevent significant limitations on regulatory objectives. For a proposal to reform article VI, which should also confirm the broad scope of the '*the quality of the service*' condition, see Geza Feketecuty, 'Regulatory Reform and Trade Liberalization in Services', in *GATS 2000: New Directions in Services Trade Liberalization* 225, 237 (Pierre Sauvé & Robert M Stern eds, 2000).

[323] For the burdensome name-checks required by US banking regulation and the delays involved, see Raj K Bhala, above note 301, at 30–32.

[324] GATS art. VI footnote 3.

voiced but for the lack of access. In addition, adoption ensures that the countries at issue enjoy the benefits from the Basel accords.

In my example, consolidated supervision, a principle promulgated in the Basel accords,[325] may be taken into account in assessing the regulatory value of stringent entry rules. Arguably, limited access to the Basel Committee may reduce the value of consolidated supervision as an accepted regulatory instrument toward the integrity of a credit institution's management. However, this should not be the case with respect to the parties to the dispute if they have both adopted the Basel accords.

I do not agree that paragraph 5(b) should be read so as to exclude consideration of the Basel accords in determining conformity of a Member's measure with the GATS. Even if it is accepted that the Basel accords do not qualify as standards of 'relevant' international organizations, only a difference in the degree of deference to the standards of 'relevant' and to those of not 'relevant' international organizations should be read in section 5(b), and not an *a contrario* exclusion of the Basel accords. There is no apparent reason why they should not be considered at least in the objective assessment of the factual issues by the Panel.[326] It is unclear whether paragraph 5(b) itself requires anything more than this, when it states that the relevant standards *shall be taken into account*. Arguably, paragraph 5(b) does not establish presumption of compliance of the disputed measures with the GATS in the event these measures are consistent with the standards of 'relevant' international organizations.

Finally, two further points can be made in support of incorporating the Basel accords in the review of the disputed measure by the DSP. First, regard should be had as to whether any rights and obligations in international law have been developed between the two parties merely through their adoption of the Basel accords.[327] In that case, consideration of the Basel arrangements by the DSP may also be mandated in consistency with article 31(3)(c) of the Vienna Convention, which states that 'any relevant rules of international law applicable in the relations between the parties' shall be considered in settling disputes between the parties.[328] Second, it is possible that on a certain issue the Basel process may provide for open access to negotiation and agreement of its accords,[329] in which case the promulgations of these

[325] See above notes 117, 218.

[326] Dispute Settlement Understanding art. 11. For non-WTO rules as facts, see Joost Pauwelyn, above note 221, at 572.

[327] However, the 'soft law' character of the Basel arrangement should also be taken into account.

[328] David Palmeter & Petros C Mavroidis, above note 223, at 411 (interpreting article 31(3)(c) to mean the parties to the dispute and not all WTO Members). See above note 321, for articles 31 and 32 of the Vienna Convention as part of WTO law.

[329] For example, many non-G–10 countries took part in the development of the Core Principles for Effective Banking Supervision and the Core Principles for Systematically Important Payment Systems. See above notes 219 and 286, respectively.

accords will more easily qualify as international standards of 'relevant' international organizations in accordance with paragraph 5(b).

In our example, considering the Basel accords is not necessary since an attack on the stringent entry requirements will not satisfy the third condition. The interested Member will not be able to prove that it was not reasonably expecting the *already existing* US entry regulation. Therefore, *existing* technical standards, licensing and qualification requirements will sustain GATS disciplines, even if they amount to barriers to market access.[330]

Future requirements will be sustained only if they meet the least WTO inconsistent test,[331] which brings up the uncertainty about the trade-off involved and subsequent prudential implications.[332]

The possibility for applying the prudential carve-out is always there. As long as 'prudential' is not defined with precision, prudential considerations will be found in most of the entry-related measures and application of the means-ends test of article 2(a) will secure more prudential output. But this only after an encounter with the mystery of the term 'prudential' – let alone the still possible incorporation of a least WTO inconsistent test in article 2(a).

It should be mentioned that in the GATS certain prudential issues are dealt with predictability through the scheduling of the necessary measures. For example, the US has listed in its schedule the requirement[333] that a foreign bank 'in order to accept or maintain domestic retail deposits of less than $100,000 . . . must[334] establish an insured banking subsidiary'.[335] This ensures that retail depositors enjoy the full protection of the domestic regulation and are significantly[336] protected from deficiencies of the foreign banking system.[337] Even then, however, there is considerable systemic risk

[330] Such trade concerns are to some extent addressed by Section B(10) of the Understanding on Financial Services, which calls for unilateral *efforts* to remove non-discriminatory barriers.

[331] Article XIV of the GATS can provide a final basis for exception if the entry requirements: a) 'are not applied in a manner which would constitute a means of *arbitrary or unjustifiable discrimination* between countries where like conditions prevail, or a *disguised restriction* on trade in services' and b) are '*necessary* to secure *compliance with laws or regulations which are not inconsistent* with the provisions of [the GATS] . . .' (emphasis added).

[332] Article VI(4) of the GATS envisages further work by the Council for Trade in Services on such measures, but this does not eliminate our concerns. It is, however, a more satisfactory alternative to the extent we accept that a trade-off at the political level is more efficient and more legitimate.

[333] FBSEA, 12 USC § 3104(c) (Supp. IV 1992).

[334] This requirement does not apply to branches of foreign banks which were already engaged in insured deposit-taking on December 19, 1991.

[335] United States, Schedule of Specific Commitments, Supplement 3, GATS/SC/90/Suppl.3 (February 26, 1998) [hereinafter US Schedule of Specific Commitments]. Australia has also listed the requirement that a foreign bank must establish a subsidiary in order to accept 'retail' deposits, that is deposits of less than $A250,000. Australia, Schedule of Specific Commitments, Supplement 4, GATS/SC/6/Suppl.4 (February 26, 1998) [hereinafter Australia Schedule of Specific Commitments].

[336] See below Section 3.2, for the prudential concerns in case of foreign bank operations through a subsidiary.

[337] But see Hal S Scott, above note 192, at 507 (arguing that such requirements have both prudential and trade costs).

from other, permitted, foreign branching as well as from foreign bank activity through subsidiaries.[338]

3.2 Subsidiary

A *subsidiary* is normally fully subject to the host country laws and regulations, since it is a separate legal entity incorporated in the host country jurisdiction. Thus, departure from the national treatment principle will be difficult to justify on the basis of regulatory considerations, prudential or otherwise. Depositors enjoy the full protection of the host deposit insurance schemes and of the host insolvency regime.[339] Insolvency of the parent bank does not entail insolvency of the subsidiary bank,[340] and hence, 'interstate systemic risk' will be limited. Also, the host country is likely to use its LOLR to prevent the failure of a subsidiary bank. Therefore, measures for prudential reasons might not sustain even the lax means–ends test of the prudential carve-out. It will be harder for non-prudential measures, as the more trade-intensive 'least WTO inconsistent' test will apply.

Still, the activity of a foreign subsidiary raises some special concerns, which may justify its discriminatory treatment by the host regulator. First, the 'source of strength' doctrine and the parent–subsidiary relationship cause home country regulatory deficiencies to be of concern. [341] To the extent that the subsidiary looks to the parent bank for capital support or that affiliate (parent bank–subsidiary) transactions are not always at arm's length, regulation of the parent bank becomes of interest for the host country regulator. Similar concerns arise if problems in the parent bank put the financial health of the subsidiary at risk. The host country might not be able to ring-fence the subsidiary's assets, especially if the subsidiary's activity is to a large extent 'outsourced' to the home country.[342] Second, there

[338] We assume that the listed limitations will not be affected by further liberalization, as they can be regarded an affordable compromise on free trade. Of course it should always be borne in mind that the listed measures remain open to further trade-off by the WTO legislative process.
[339] But see below in the text, for problems with ring fencing the subsidiary's assets.
[340] It is important, however, that the host regulator is able to ring-fence the subsidiary's assets if the financial health of the subsidiary is put at risk. See below for problems with ring fencing.
[341]

> Under . . . [the source of strength] doctrine the host country looks to the foreign parent to supply capital to the subsidiary if the subsidiary becomes weak. The basic idea is that the strength of the parent determines whether it will be able to save its subsidiary from difficulty by injecting additional capital. In addition, the host country may be concerned that a weak foreign parent may try to loot a local subsidiary through nonmarket affiliate transactions, for example, purchasing its assets at below market prices.

Hal S Scott, above note 192, at 488–89.
[342] Basel Committee on Banking Supervision, *Supervisory Guidance on Dealing with Weak Banks* 39, 40 (March 2002), <http://www.bis.org/publ/bcbs88.pdf>

may be problems in the supervision of the subsidiary when the home country authority in charge of consolidated supervision for the parent bank is not the same as the home country authority in charge of consolidated supervision for the banking group that owns or controls the parent bank. In addition, supervision problems arise when the subsidiary has a 'sister' bank operating under the same ownership in another jurisdiction without, however, one bank being a subsidiary of the other ('parallel-owned' banks).[343]

Therefore, trade-restrictive measures in respect of subsidiaries of foreign banks may also be exempted from the GATS commitments or obligations in order to attain the relevant regulatory objectives.

Adherence by the competent authorities (of the home and the host country) to the Basel arrangements reduces the weight of regulatory implications from the parent–subsidiary relationship. In the Basel context, it is submitted that 'the parent bank should recognize a "moral commitment" to support faltering corporate children even though limited liability absolves the parent bank of the legal obligation to provide additional resources.'[344, 345] This should mitigate some of the risks, such as those relating to non-market transactions of the parent bank with the subsidiary, and enhance the likelihood for support by the parent bank in case of liquidity problems at the subsidiary. As far as supervision problems are concerned, the Basel standards contemplate that consolidated supervision is applied. In particular, they ask for special regulatory vigilance when multiple home country authorities are in charge of consolidated supervision for the subsidiary's operations[346] or when 'parallel-owned' banks operate.[347]

Thus, albeit the host country applies its own regulation and supervision to subsidiaries and is therefore in control of the related financial stability and depositor protection issues, risks remain from the operation of subsidiaries of foreign banks and additional measures, beyond those applicable to domestic parent banks and their domestic subsidiaries, may be warranted. Again, review of these measures under the GATS is expected to involve complexities of balancing trade and banking regulation and of evaluating international financial standards similar to those described above for branches.

[343] Basel Committee, *Supervision of Cross-Border Banking*, above note 218, at para. 41.
[344] See Richard J Herring & Robert E. Litan, above note 47, at 99.
[345] The reverse side of the source of strength doctrine should not be ignored. That is, the parent bank's responsibility for the subsidiary exposes the parent bank to deficient foreign systems to the extent it avails of further liberalization. Nothing in the GATS, however, prevents the home country from regulating the parent bank–subsidiary relationship as it wishes. The home country may even restrict further expansion of its banks' international activities. This should be contrasted with the situation in the EU, where similar restrictions can constitute violation of article 43 (ex article 52) of the EC Treaty. For the issue of 'reverse discrimination' in the EU, see Paul Craig & Gráinne de Búrca, above note 144, at 749.
[346] *Basel Minimum Standards*, above note 218, at 24.
[347] *Basel Committee, Supervision of Cross-Border Banking*, above note 218, at para. 41.

3.3 Non-financial entity

The host country will be less constrained in regulating and supervising a branch or a subsidiary of a foreign entity when the parent is not a financial institution and hence, not subject to home country prudential regulation. Possible negative effects from the unregulated activity of the parent entity and information problems[348] will allow the host country to discriminate against bank establishments of non-financial companies without violating GATS commitments or obligations. For example, distortionary credit interventions by the parent entity or lack of liquidity support through LOLR will substantiate prudential concerns. Respective home country measures will fall within the prudential carve-out and will likely not be held 'as a means of avoiding the Member's commitments or obligations under the [GATS]'.[349] The Basel principles themselves call for 'caution' and strict application of the Basel minimum standards in the case of establishments by non-bank entities.[350]

4 TRADE AND FINANCIAL STABILITY – REVIEW OF THE EU AND GATS INSTITUTIONAL FOUNDATION: LESSONS FOR THE GATS

An examination of the trade and financial stability output in the EU and the GATS and of the respective institutional foundations could contribute to our understanding of the GATS financial liberalization framework. While it is acknowledged that important differences remain in the overall structure and the constitutional mandates of the two constructs, a juxtaposition of the EU and GATS financial services liberalization systems can inform possible GATS reforms. There may also be some lessons for other regional liberalization systems

The GATS envisages liberalization of banking at the multilateral level while it ignores the need for institution building with respect to prudential implications from globalization of banking. It addresses prudential concerns from its deregulation effect only through its prudential carve-out, which covers all national measures for prudential reasons.

Unlike the GATS, the EU conditions the integration of the Member States' banking systems on essential harmonization of prudential rules and the development of prudential institutions. Minimum capital requirements and other prudential rules, mutual recognition of national regulation and

[348] As non-financial companies are subject to less intensive regulation than banks, less information is available about their financial condition. See Duncan E Alford, 'Basle Committee Minimum Standards: International Regulatory Response to the Failure of BCCI', 26 *George Washington Journal of International Law & Economics* 241, 270 (1992).

[349] GATS, Annex on Financial Services art. 2(a).

[350] *Basel Committee, Supervision of Cross-Border Banking*, above note 218, at paras. 42–43. See also *ibid*. for regulatory issues with respect to under-regulated financial centres.

allocation of supervisory responsibilities on the basis of the home country control principle are established through implementation of the EU Directives by the Member States. Shortcomings in the allocation of regulation and supervision competence, and related risk for regulatory arbitrage are addressed through provisions against 'forum shopping'.[351] In addition, while coordination of supervision already takes place in the context of the Eurosystem,[352] there is an intense debate as to the need for a centralized EU supervision body – let alone the existing possibility for expansion of the ECB's supervision competence without a Treaty reform.[353] And all these safeguards in the context of the European Economic and Monetary Union (EMU), which alleviates concerns for adverse effects of financial services liberalization on domestic macroeconomic policies and in turn on the domestic banking system, and vice versa.

4.1 Trade and financial stability output

A closer review of the EU and GATS liberalization and prudential mechanisms is informative as to the overall trade and regulatory output and as to necessary GATS reforms.

4.1.1 EU

In the EU, the Second Banking Directive, now the Banking Consolidation Directive,[354] provides for a single banking licence on the basis of mutual recognition and home country supervision that allows for broad access to national markets, as only limited host regulation remains intact.[355] Recognition of home country regulation is further mandated through the application by the ECJ of the proportionality test on national barriers to the internal market freedoms,[356] which in turn produces more market access. Prudential implications from these trade benefits are addressed through

[351] See above note 83.
[352] See Chapter IV, Section 1.1, note 28, for the term Eurosystem as 'denoting the composition in which the ESCB performs its basic tasks' without referring to a legal person.
[353] See Chapter IV, for arguments supporting the assumption of a supervisory role by the ECB on the basis of its monetary policy competence and the ambiguity of the Treaty language.
[354] See above note 45.
[355] I talk about broad, as opposed to complete, access because decentralization of prudential supervision and other national regulation, like non-harmonized prudential regulation and conduct of business rules, remain an obstacle to the internal market. Further impediments may arise to the extent the home country control principle is not considered a fundamental Community law principle and derogation from it is not excluded. See Chapter IV, for barriers to the EC internal banking market.
[356] Responsibility for the application of the proportionality test, as defined by the ECJ, to the actual facts lies with the national courts. However, the ECJ has effectively undertaken the full application of the proportionality test. Michel Tison, above note 124 (manuscript at 18).

harmonization of regulation and through home country supervision on a consolidated basis. That is, the legislative mechanism stands ready to codify, complement or reverse the adjudicative rulings on integration. Adding the ECB's extended competence for prudential regulation and supervision,[357] we can achieve full harmonization of prudential rules, and also a full internal market.

4.1.2 GATS

It can be argued that the GATS does not provide for broad market access, and that therefore its prudential carve-out is adequate to deal with prudential matters. But this ignores its dynamic character, and definitely defies the very purpose of the GATS. It says only that enough liberalization has taken place, and no more liberalization at the multilateral level is needed. Neither of these propositions can be valid. The GATS does not provide a single banking licence, but it does provide for considerable trade disciplines, which are expected to expand through further negotiations. More market access on the basis of mutual recognition and home country supervision can also ensue through the built-in trade-off devices. As shown above, recognition of the home country standards and application of home country supervision may be mandated by the DSP as least trade-restrictive alternatives. Although this will not lead to a single banking licence, it may considerably reduce the domestic entry, and other, requirements. Reduction of trade-restrictive domestic measures will be more likely in the case of adoption of the Basel accords by the home and the host regulator, that is in the case of adoption of internationally agreed minimum capital standards and of modes of supervision coordination. The Basel arrangements may be considered by the DSP as necessary in order for the home country's banks to benefit from the host country's trade commitments. In addition, the Basel arrangements may be held adequate to deal with prudential implications from foreign banks' entry, and additional, trade-restrictive, host country regulation may not be sustained. Thus, a mechanism for essential harmonization toward the Basel minimum arrangements is also available in the GATS, albeit through its adjudicative mechanism (vis-à-vis the mainly legislative production of essential harmonization in the EU). Yet it should be acknowledged that a full harmonization of prudential rules and a full global banking market are arguably not likely within the GATS structure, and nor within its mandate.

[357] I argue in Chapter IV that the ECB can exercise such extended competence under the current Treaty framework.

4.2 Trade and financial stability – Review of the EU and GATS institutional foundation

It appears that the overall trade and regulatory output in the GATS might eventually not be that different from such output in the EU. However, the fundamental difference is again the legal foundation and other institutional underpinnings that determine the final output.

4.2.1 Micro-aspects

A comparison of the micro-mechanisms in the EU and the GATS is revealing, in particular with respect to how the existing GATS machinery is expected to operate and its limits in delivering the optimum mix of trade and banking output.

The EU liberalization framework, developing through the ECJ jurisprudence, has moved beyond discrimination to link integration to elimination of trade-restrictive regulation. Discrimination seems to remain relevant only with respect to the type of regulatory considerations which can justify exemption of trade-restrictive regulation. Thus, directly discriminatory measures can be exempted only for the very limited reasons of public policy, public security and public health prescribed in the EC Treaty (article 56). In contrast, indirectly, that is *prima facie* non-discriminatory measures whose regulatory distinction is an effective substitute for a nationality-based distinction,[358] and *de facto* discriminatory measures, that is measures discriminatory only as to their trade effect, can be preserved on the basis of a wider range of general good reasons, which the ECJ develops and whose proportionality to their trade affects reviews. Measures without any discriminatory effect but nevertheless hindering EU-wide trade have also been added to the latter category. Further, it is claimed that there is no

[358] The ECJ is not clear as to whether such indirectly discriminatory measures may be justified only under the expressly provided Treaty derogations (article 30 (ex article 36) for freedom of goods, article 46 (ex article 56) for freedom of establishment and article 55 (ex article 66) (referring to article 46 for freedom of services) or also under the broader 'general good' exception. In *Decker* and *Kohll*, Advocate General Tesauro stated that the former will apply if the Court follows *Svensson*, while the latter will apply if the approach in *Bachman* is followed. Joined opinion of Advocate General Tesauro delivered on 16 September 1997, in Case 120/95, *Nicolas Decker v Caisse de maladie des employés privés* and Case 158/96, *Raymond Kohll v Union des caisses de maladie*, 1998 ECR I–01831, para. 50 (citing Case C-484/93 *Svensson* 1995 ECR I–3955, Case C–204/90 *Bachmann* 1992 ECR I–249). Advocate General Fennely has also stated that the 'general good' exception applies to indirectly discriminatory measures. Opinion of Advocate General Fennelly delivered on 4 December 1997 in Case 350/96, *Clean Car Autoservice GesmbH v Landeshauptmann von Wien*, 1998 ECR I–02521, para. 28. See also Wulf-Henning Roth, above note 66 (manuscript at 11) (citing Case 106/91, *Claus Ramrath v Ministre de la Justice, et l'Institut des reviseurs d'entreprises*, 1992 ECR I–03351, paras. 27–9). But see Paul Craig & Gráinne de Búrca, above note 144, at 748 (maintaining that only 'a genuinely equally applicable rule which constitutes neither hidden nor covert discrimination' may be justified under the 'general good' exception).

reason for distinguishing between discriminatory and indirectly discriminatory measures,[359] while the ECJ has indicated abandonment of the discrimination element altogether[360] and shown signs of inconsistency with respect to the applicable exceptions and their content, more in the direction of making exception on general good grounds available to all measures.[361]

GATS' trade disciplines still evolve around the 'discrimination' concept. They cover discriminatory measures, namely measures that treat foreign service suppliers and services less favourably than 'like' domestic ones. The GATS also prohibits *prima facie* non-discriminatory measures which, nevertheless, are *de facto* discriminatory. These measures refer to, in WTO parlance, origin-neutral regulation whose regulatory distinction is an effective substitute for origin-specific distinction. Exceptions for both[362] *de jure* and *de facto* discriminatory measures on the basis of limited public policy reasons are provided in articles XIV and XIV *bis*. Purely *de facto* discrimination, that is discrimination solely as to trade effects (*de facto* discrimination according to the EU), is also being addressed, but not as a matter of inconsistency with the GATS general principles. Article VI of the GATS disciplines qualification requirements and procedures, technical standards and licensing requirements and subjects the underlying regulatory objectives to a proportionality test.

However, this is not the complete story of how the DSP has dealt or is contemplated to deal with trade-restrictive domestic regulation. Deference to *de facto* discriminatory domestic regulation can be similar to deference in respect of indirectly discriminatory regulation in the EU. Review of 'likeness' in the GATT and WTO jurisprudence has considered regulatory considerations ('aim and effects' test), and hence, allowed for deference to legitimate domestic regulatory objectives beyond the limited public policy considerations of article XX of the GATT. Although the 'aim and effects' test has been rejected in the context of the GATS, such approach is not expected to be sustainable. This is demonstrated in the incorporation of regulatory considerations in the review of the market-based criteria for likeness, consistently accepted as valid criteria, eg consumer tastes and habits, and in the determination of 'less favourable' treatment. There is nothing in the slippery notion of 'likeness' that prevents the increasingly textual inter-

[359] Wulf-Henning Roth, above note 66 (manuscript at 12).

[360] The view of Advocate General Jacobs in *Leclerc-Siplec* is illustrative: '[F]rom the point of view of the Treaty's concern to establish a single market, discrimination is not a helpful criterion.' Opinion of Advocate General Jacobs delivered on 24 November 1994 in Case 412/93, *Société d'Importation Edouard Leclerc-Siplec v TF1 Publicité SA and M6 Publicité SA*, 1995 ECR I–0179, para. 40.

[361] For an excellent presentation of the issues, see Siofra O'Leary, 'The Free Movement of Persons and Services', *The Evolution of EU Law* 377, 400 (Paul Craig & Gráinne de Búrca eds., 1999).

[362] In the case of goods, the Standards Code applies to *prima facie* non-discriminatory ('origin-neutral') measures a more deferential test than the one applied by article XX to *prima facie* discriminatory measures. See article 2.2 of the Standards Code. This resembles the more receptive 'general good' exception and its application to *de facto* discriminatory measures.

pretation-sensitive Appellate Body from examining the relevance of regulatory objectives for discrimination. In this vein, there is no impediment to the application of a, similar to the EU, proportionality-like balancing of regulatory objectives and trade effects. Also, the conditioning of discrimination on the *likeness* of the regulatees suggests that review of *de jure* discriminatory measures may also involve the same consideration of regulatory objectives, and this goes well with the similar tendency in the EU for equal treatment of direct and indirect discrimination. Finally, review of 'likeness' can also lead to application of trade disciplines to *purely de facto* discrimination. Thus, non-discriminatory domestic regulation can be found discriminatory if foreign regulatees are 'unlike' because of their regulation *per se* by another jurisdiction. Equal regulatory treatment of domestic and foreign service suppliers puts foreign service suppliers at a disadvantage when foreign service suppliers are already subject to similar home country rules.

Application of the 'aim and effects' test in the GATS may find strong resistance but it should still be upheld. Admittedly, there is more room in the GATS for an argument along the line that the exception of article XX of the GATT might become redundant if the 'aim and effects' test were to be accepted. This is because the counterargument that article XX provides only for very limited public policy justifications is not equally applicable in the GATS. In the GATS (article XIV the equivalent to the GATT article XX) provides for a broader set of public policy exceptions.[363] More important the prudential carve-out allows a wide range of banking regulation to be exempted. However, article XIV remains limited in its coverage of regulatory considerations. Also, the prudential carve-out is available only for prudential reasons. Although an exemption for 'prudential reasons' seems to be very broad, it is unclear what rules it will cover. Not all banking regulation should be judged as being for prudential reasons and in that case some deference should also be considered, albeit through the more trade-intensive balancing of the 'aim and effects' test.

4.2.2 Macro-aspects

The GATS seems to be unconstrained in evolving towards an EU-like balancing of trade and domestic regulation betweenand this should be assessed in light of the differences between the WTO and EU edifices. There are fundamental differences in the macro-foundations of the two systems. First, the state of the substantive constitutional process differs. In the EU, there is a well-defined *legislative* process for the operation of mutual recognition and home country control principle on the basis of essential harmonization, while the ECJ is *accountable,* and *always subject to immediate*

[363] Unlike article XX, however, article XIV does not provide for an exemption in relation to 'the conservation of exhaustible natural resources'.

legislative reversal. And this takes place in the context of the ECB supervision 'umbrella' and of the EMU macroeconomic environment.

The GATS lacks the EU's macro-legal mechanism. Its limited legislative machinery is not efficient. Authoritative interpretation of the agreements requires a majority of three-fourths of the GATS Members and amendments are subject to a more complex process and stronger majority voting.[364] Instead, the GATS has to rely mainly on its DSP for building the necessary balancing devices. This creates uncertainty[365] for both free trade of financial services[366] and financial stability. It also entails legitimacy risks due to the potential power of the adjudication process. Adherence to the text of the GATS and a policy of deference to domestic policies do add to legitimacy but most likely only by making it harder to achieve a satisfactory mix of trade and domestic regulation.

Second, the democratic legitimacy of the two systems is of different degree. It can be said that the EU's approach to the interplay of trade and regulation epitomizes economic and political developments throughout EU's history.[367] Its distancing from the discrimination element signifies the increasing consensus for the welfare-enhancing effect of the full internal market. It also reflects its enhanced confidence in its regulatory machinery, which has grown stronger through harmonization of regulation and development of EU-wide institutions. However, its increasing awareness of regulatory objectives is also served by the evolving 'general good' principle and the tendency to extend it to all trade-restrictive measures, whether nondiscriminatory or not. It is along these lines that a claim can be made for the existence of a non-ethnos-based *demos*. This non-ethnos-based *demos* indeed consists of European people without organic-type relations but with only shared values and interests who can add democratic legitimacy to the EU construct and can contribute to its sustainability.[368]

The GATS promises a similar approach to balancing of trade and banking regulation. However, its political process has not provided a clear direction as to the desirable mix of trade and regulation objectives. The reason for this is disagreement on the content of the relevant welfare issues and the means for their pursuit. The result is a political compromise, which can be

[364] WTO Agreement arts. IX and X. See Marco CEJ Bronckers, 'Better Rules for a New Millennium: A Warning Against Undemocratic Developments in the WTO', 2 n. 4 *Journal of International Economic Law* 547 (1999).

[365] As a trade advocate has pointedly stated, 'the prudential carve-out . . . can mean anything'. Pierre Sauvé & James Gillespie, above note 164, at 459.

[366] Uncertainty about the degree of protection afforded to banks pursuing the expansion of their international banking activities impedes the efficient structuring of such activities, and hence, the trade benefits of banking liberalization. Litigation is not an efficient alternative for dealing with the time-sensitive plans of financial institutions.

[367] For economic and political developments underlying the evolution of the EU construct, see Judge David Edward, 'Introduction', *Services and Free Movement in EU Law* (Mads Andenas & Wulf-Henning Roth eds., 2003) (manuscript at ix, on file with author).

[368] See Chapter III, Section 2.1.1.2, note 38, for Joseph Weiler's work on the demos thesis.

seen in the ambiguities of the text. The GATS political process lacks the substantial legitimacy, which a *demos* could furnish. Such *demos* does not yet exist in the EU either, and it would be unrealistic to contemplate its development at the WTO level.[369]

4.3 Trade and Financial stability – regional integration

The review of the EU and GATS constructs offers lessons for liberalization initiatives at the regional level. First, it has shown that institution building at both the national and regional level should precede meaningful liberalization of financial services at the regional level.[370] The strengthening of national financial regulation and institutions allows national financial systems to benefit from increased financial integration at the regional level and reduces the risk of negative externalities originating from domestic financial instability. Harmonization of financial regulation at the regional level makes mutual recognition of home country regulation and supervision possible and thus reduces trade barriers.

Furthermore, the EC internal banking market reveals that centralized structures matter for reduction of trade-restrictive national regulation and also for managing systemic risk from increased interdependence of the national financial systems. Of course, there should be recognition of the limitations in building EU-like adjudicative, legislative and executive structures or in developing an EU-like constitutional framework and constructs such as the 'direct effect', and of subsequent constraints on harmonizing and regionalizing regulation and supervision.[371, 372] The EC internal banking model will also be of particular relevance to the regional initiatives that aim at a monetary union.[373]

Regional initiatives, such as the Free Trade Area of the Americas (FTAA),[374] NAFTA, Mercosur,[375] the Andean Community,[376] the Central America Economic Integration,[377] the Common Market for Eastern and

[369] See Chapter III, Section 2.1.1.2 and note 39, for the search for a WTO demos.
[370] For the importance of a law-based and 'bottom-up' approach to regional liberalization, see Joseph J Norton, above note 14, at 34–35.
[371] It might be different with regional initiatives that have demonstrated the commitment to develop supranational entities including a single monetary system.
[372] But see Benn Steil, *Regional Financial Market Integration: Learning from the European Experience* (Tokyo Club Papers vol. 12, 1999) (arguing that supranational bodies are not necessary for financial integration).
[373] Namely the Andean Community, COMESA, CARICOM, and ECOWAS.
[374] See <http://www.ftaa-alca.org> for the 'matrix' of the FTAA-related integration structures. Joseph J Norton, 'Doing business under the FTAA: Reflections of a US Business Lawyer', *NAFTA: Law and Business Review of the Americas*, Summer 2000, at 421, 430–33.
[375] Treaty Establishing a Common Market, March 26, 1991, 30 ILM 1041.
[376] See <http://www.comunidadandina.org/ingles/who/who.htm>.
[377] See <http://www.sicanet.org.sv>.

Southern Africa (COMESA),[378] the Caribbean Community (CARICOM),[379] the Economic Community Of West African States (ECOWAS),[380] and the Southern African Development Community,[381] should work on reform of national financial regulation and institutions, while they could also move toward regulatory harmonization similar to the EU[382] and centralized structures. They can be informed by the deficiencies of the GATS system and from the EU model.

The current state of these integration projects is not a consideration for our recommendation, as we would expected that in one form or another they will build on the general GATS principles of MFN, national treatment and market access and thus their long-term evolution, through either the adjudication or the legislative process, will be towards more integration of the national financial systems. In that case, a GATS-type prudential carve-out will not deal effectively with the trade and banking regulation issue.

NAFTA, for example, contains a measure similar to the GATS prudential carve-out, which may give rise to similar trade and financial stability issues. Article 1410(1) of NAFTA requires that national prudential measures should be reasonable. Article 1410(1) could be interpreted to require a means–ends rationality test similar to the GATS,[383] but it also leaves room for reading a more trade-intensive test.[384] Thus, abalancing of trade and banking regulation similar to the GATS may be conducted at the NAFTA adjudication level. A more coordinated process of financial regulation and supervision at the NAFTA level will be a more efficient mechanism for integrating trade and financial stability. Financial regulation and supervision at the NAFTA level can be informed by the Basel process and the EC internal banking market, and at the same time be part of the strengthening of the international financial architecture. Although at the moment the political will has committed itself only to limited liberalization, further financial integration is expected to be the natural evolution of the NAFTA project.

In turn, shortcomings of the GATS system may also be remedied through regional integration. Financial regulation and supervision at the regional level can be a significant step toward further regulatory harmonization that

[378] See <http://www.comesa.int>.

[379] See <www.caricom.org>.

[380] See <http://www.sec.ecowas.int/>.

[381] See <http://www.sadc.org>; Clement Ng'ongo'la, 'Regional Integration and Trade Liberalization in the Southern African Development Community', 3 n. 3 *Journal of International Economic Law* 485 (2000).

[382] For some first steps in Mercosur towards harmonizing financial regulation, see Joseph J. Norton, 'Are Latin America and East Asia an Ocean Apart? The Connecting Currents of Asian Financial Crises', *NAFTA: Law and Business Review of the Americas*, Autumn 1998, at 93, 121.

[383] The words 'reasonable' and 'reasonableness' in English administrative law are interpreted as referring only to the rationality of the measure in question. See above note 209.

[384] See Trachtman, 'Trade in Financial Services', above note 52, at 90.

will be beneficial for financial services liberalization at the international level. Not only are systemic risk due to deficiencies of the national financial systems and regional contagion reduced but also supervision of cross-border financial activity is facilitated through better monitoring of regional financial business. Regional bank supervisory groups,[385] like the Caribbean Banking Supervisors Group or the Executives' Meeting of East Asian and Pacific Central Banks (EMEAP),[386] may contribute to regional financial stability.

5 CONCLUSIONS

Regulation of Foreign Direct Investment is an example of an ineffective response by international law to a rapidly changing global economic environment. This is more apparent in the banking sector. The GATS achieved liberalization of FDI in the banking sector, while GATT negotiators were avoiding negotiations on FDI rules in the context of the TRIMS agreement. *Ironically*, the GATS provides for a multilateral and binding FDI agreement, while its focus is trade in services. And this liberalization of FDI takes place in the banking sector, a sector of paramount importance for the national economy and with enormous regulatory ramifications from its liberalization.

The GATS envisages liberalization of banking at the multilateral level through application of its trade disciplines. Authorization requirements as well as other banking regulation, prudential or not, remain primarily decentralized, operating at the level of the host jurisdiction. And of course there are still restrictions to the extent national regulation has maintained exemptions from trade disciplines.

For a meaningful liberalization of international banking, less national regulation should be allowed. It is expected that the GATS mandate for further, progressive, liberalization will reduce currently exempted national regulation. In addition, national measures, discriminatory or not, that stand as trade barriers should sustain less the GATS disciplines, especially when the Basel arrangements have been incorporated in the national systems.

However, the current system and its evolutions do not promise much in terms of either less national regulation or financial stability. Reduction of trade-restrictive national regulation depends on the review of the conflict of trade and regulation in the dispute settlement process. The WTO jurisprudence on the concepts of 'likeness' and 'necessity' does not ensure legal

[385] For the various regional bank supervisory groups that cooperate with the Financial Stability Institute in Basel, see <http://www.bis.org/about/fsi06.pdf>.

[386] See >http://www.emeap.org:8084/>. It should be noted that the Executives' Meeting of East Asian and Pacific Central Banks (EMEAP) and other regional supervisory groups are not part of any institutionalized trade liberalization process at the respective regional levels.

certainty and predictability in determining the desirable mix of trade and banking values. Most likely, less national regulation will not be possible as long as the concept of 'prudential' is the ultimate criterion for the GATS legality of trade-restrictive measures. The broad and dynamic character of the 'prudential' concept may provide legitimacy to a wide array of bank rules. But the 'prudential' concept will not be more helpful with prudential regulation either. First, uncertainty remains as to how the GATS adjudication process will review the conflict of trade and regulatory values. Secondly, even if the trade-off test of the prudential carve-out, being lax from a trade perspective, is assumed to be favourable to national prudential rules, national rules alone will not effectively deal with risk from international banking. And, as shown below, further development of the 'prudential concept' and of the 'trade-off' mechanism does not seem to offer an adequate solution.

All this uncertainty, the inefficiency of the GATS legislative mechanism and efficiency and accountability concerns due to the DSP being the ultimate arbiter of the trade and banking regulation output call for a search for prudential arrangements at the international level. Prudential institution building at the international level could provide strong guarantees for a stable international financial system in which case the regulatory value of remaining national barriers would diminish. This would contribute to more efficient and predictable balancing, easier withdrawal of regulatory barriers and more sustainable free trade. In Chapter III, which follows, the case is presented for prudential institution building at the international level. It is shown that reform of the existing processes will not be adequate and that further institution building at the international level is needed.

III

The Case for Prudential Supervision at the International Level and Related Reforms

THE GATS[1] FRAMEWORK for liberalization of financial services trade has not adequately addressed the interplay of trade and banking regulation. Unlike the EC internal banking market, the GATS has proceeded with liberalization without being concerned with harmonization of banking regulation and with prudential supervision issues. Instead, it relies on its prudential carve-out[2] and the ultimate determination of its content by the dispute settlement process (DSP). Chapter II has shown that this has considerable efficiency and legitimacy implications, and that reform should be sought.

This chapter examines various reform alternatives and finds that intensive prudential institution building at the international level will be a more complete solution. Further development of the 'prudential carve-out' and the applicable trade-off tests[3] through the legislative process is one of the reform alternatives examined. The analysis takes into account the inherent broad scope of the term 'prudential' in banking regulation, the failure of banking literature to describe the term with precision and political objections to its further formulation in the GATS context. We also explore whether legislative guidance as to the applicable trade-off test is indeed helpful. Another possible reform consists of incorporation of the Basel standards[4] in the GATS system in order to make more sense of the term 'prudential' and supply criteria for determining the need for national regulation. Shortcomings of the Basel arrangements themselves as the basis for regulation and supervision of internationally active banks are

[1] General Agreement on Trade in Services and Annexes, Agreement Establishing the World Trade Organization, Marrakesh, April 15, 1994, 33 ILM 1144 (1994), Annex 1B [hereinafter GATS]

[2] GATS, Annex on Financial Services art. 2(a). For the prudential carve-out, see Chapter II, Section 2.2.2.2.

[3] For the various trade-off tests which can be read in the GATS, see Chapter II, Section 3.1.

[4] See Chapter II, Sections 3.1.2 – 3.1.4, for the relevant Basel standards.

considered. Moreover, it is questioned how the GATS can update its reliance on the Basel standards, when their development occurs in a separate norm-making process. We show that under these reform proposals the ultimate judge of the desired trade and financial stability output remains the adjudication process. Medium-term institutional arrangements are also examined. They consist of institutionalized cooperation between the WTO and the international financial standard-setting organizations. They are expected to contribute to an effective integration of trade and financial regulation considerations. We argue for intensive prudential institution building at the international level as an alternative towards further and sound international banking. This prudential institution building is expected to be informed by the analysis of the EU supervision model, as set out in Chapter IV.

1 GATS REFORM

1.1 Definition of the prudential carve-out – Development of the trade-off devices

The GATS can enhance certainty by developing its prudential carve-out and its trade-off devices through its legislative mechanism. A more precise definition of the 'prudential' concept and determination of the content of the GATS trade-off devices will help foreign banks to assess the degree of the market access committed and national regulators to assess the reach of their jurisdiction over prudential matters. Recognition of domestic regulation will be more structured, as it will become more certain which trade-off devices apply to which domestic measures and how they apply.[5]

Although development of the 'prudential' concept and of the trade-off devices is already possible at the adjudicative level, further reform at the legislative level will be preferable for reasons of efficiency and democratic

[5] Basically, I assume that more 'rules' will be more helpful than simple reliance on 'standards', that is reliance on the existing 'prudential carve-out'. This suggests a greater role for the legislative process. It is beyond the scope of this analysis to examine in depth the *rules v standards* issue in the context of the GATS. For a discussion of the *rules v standards* debate and the related 'incomplete contracts' theory in the context of the WTO, see Joel P Trachtman, 'The Domain of WTO Dispute Resolution', 40 *Harvard International Law Journal* 333 (1999); Joel P Trachtman, 'International Trade as a Vector in Domestic Regulatory Reform: Discrimination, Cost-benefit Analysis, and Negotiations', 24 *Fordham International Law Journal* 726 (2000). For an introduction to the *rules v standards* and the 'incomplete contracts' literature, see respectively Louis Kaplow, 'Rules versus Standards: An Economic Analysis', 42 *Duke Law Journal* 557 (1992) and Gillian K Hadfield, 'Weighing the Value of Vagueness: An Economic Perspective on Precision in the Law', 82 *California Law Review* 541 (1994).

legitimacy.[6] With respect to the prudential carve-out, it is difficult for the DSP to define further the 'prudential' concept in such a way that there will be predictability as to what rules fall under the prudential carve-out. In the Introduction (Chapter I, Section 1) we saw that 'prudential' is the underlying rationale of the whole banking regulation and that the literature has not developed criteria that can effectively narrow the scope of 'prudential'.

There should also be legislative guidance as to the more appropriate trade-off test and the weight of domestic regulation in different contexts. For example, it is unclear whether and when the GATS allows the application of a full-comparative cost-benefit device. A full-comparative cost-benefit test would be an effective instrument in evaluating discrimination against the degree of 'unlikeness' (and thus possibly preserving national regulation) or in assessing the trade effect of non-discriminatory measures (and thus possibly further reducing trade barriers). However, its application by the DSP without the explicit consent of the political process may be hindered by legitimacy objections. It could be challenged as unfounded in the GATS text, which a legitimate interpretation should have as its starting point, or as impinging excessively upon the authority of domestic or international institutions, to which a legitimate interpretation needs to show *some* deference.[7]

1.2 Incorporation of the Basel standards

The GATS could provide for a more certain outcome of the trade and regulation synthesis through incorporating the Basel capital and supervision standards in its system. Such incorporation could be effected, for example, through amendments to the Annex on Financial Services and could require that adoption of the Basel standards by the home country be a precondition for the application to host country regulation of the disciplines of market access, national treatment and MFN. No matter how burdensome, entry requirements and full host country supervision will be sustained if,

[6] See above note 5 and accompanying text. For the accountability of the adjudication vis-à-vis the legislation process in the context of the current state of international regulation, see Kalypso Nicolaïdis & Joel P Trachtman, 'From Policed Regulation to Managed Recognition in GATS', *GATS 2000: New Directions in Services Trade Liberalization* 241, 273 (Pierre Sauvé & Robert M Stern eds., 2000).

[7] Professor Howse, following the work of Helfer and Slaughter, talks about three main elements of legitimacy in the adjudication of competing values: 'fair procedures', 'coherence and integrity' in interpretation and 'institutional sensitivity'. He then argues that in the WTO context 'coherence and integrity' is enhanced, inter alia, through the Appellate Body's choice to put emphasis on the WTO text, as well as through the application by the Appellate Body of the interpretation rules of articles 31 and 32 of the Vienna Convention. 'Institutional sensitivity' is served by deference to national and international institutions and includes a subsidiarity aspect. Robert Howse, 'The Legitimacy of the World Trade Organization', *The Legitimacy of International Organizations* 355, 376 (Jean-Marc Coicaud & Veijo Heiskanen eds., 2001).

for example, the home country does not impose on its banks the Basel capital to assets ratios or it does not cooperate with the host country in accordance with the Basel Concordats.

In this way, certainty with respect to trade liberalization and bank stability can be enhanced, as the framework for the balancing of the respective values at issue becomes more structured. There will be legislative[8] recognition of the Basel standards as the condition for application of the GATS trade disciplines. Trade-restrictive host country regulation will be sustained to the extent home regulation does not apply the Basel standards or the Basel standards do not cover certain prudential matters.

1.2.1 Incorporation of Basel standards and harmonization

Moreover, incorporation of the Basel standards into the GATS system will supply a mechanism for realizing the harmonization function of the Basel process. The GATS Members are expected to adopt the Basel standards so that financial institutions incorporated in their jurisdiction can take advantage of trade commitments and avoid discriminatory treatment. This should be more efficient than the current alternatives for effecting harmonization of banking regulation at the international level and ensuring sustainable globalization of banking.

The IMF conditionality[9] and the World Bank financing conditions, in coordination with the Basel fora, are such alternative mechanisms toward harmonization. The IMF and the World Bank condition stabilization and development projects on banking regulation and supervision reform,[10] and

[8] Incorporation of the Basel standards is already possible at the adjudicative level. See Chapter II, Section 3.1.4. It could be argued that, in the case of technical standards, licensing and qualification requirements, consideration of the Basel standards is also mandated by article VI(5)(b) of the GATS. See Chapter II, Section 3.1.4. But, again I submit that a *rules v standards* perspective suggests that the legislative process is a more efficient venue.

[9] Articles of Agreement of the International Monetary Fund, December 27, 1945, 60 Stat. 1401, 2 UNTS 39, also available at <http://www.imf.org/external/pubs/ft/aa/index.htm>, art. V, sec. 3. Conditionality is defined as '*those features of a member's program of economic reform whose successful implementation is expressly established by the Fund as a condition for the availability of Fund financial assistance*.' Ross Leckow, 'Conditionality in the International Monetary Fund', Paper delivered at the IMF Seminar on Current Developments in Monetary and Financial Law, Washington, DC, May 7–17, 2002 (May 7, 2002) <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/leckow.pdf>. For the IMF conditionality, see Joseph Gold, *Conditionality* (IMF Pamphlet Series No 31, 1979).

[10] Ross Leckow, above note 9, at 8. See eg Korea Letter of Intent, December 3, 1997, <http://www.imf.org/external/np/loi/120397.HTM> (last visited July 8, 2002). For extension of IMF conditionality beyond traditional macroeconomic policies in the context of the Asian stabilization programs, see also Committee on Financial Markets, OECD, 'Cross-Border Trade in Financial Services: Economics and Regulation', 75 *Financial Market Trends* 23, 47 (March 2000), <http://www.oecd.org/pdf/M000015000/M00015501.pdf>; *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* (Report of an Independent Task Force, Sponsored by the Council on Foreign Relations, October 1999), <http://www.cfr.org/public/pubs/IFATaskForce.html> (last visited July 8, 2000). For the evolution of the 'conditionality' concept, see Andre Newburg, 'The Changing Roles of the Bretton Woods Institutions, Evolving Concepts of Conditionality', *International Monetary Law* 81 (Mario Giovanoli ed., 2000).

do so in line with the Basel arrangements. The IMF has also extended its surveillance process under article IV of the Articles of the Agreement to cover banking systems. In addition, both the IMF and the World Bank carry out coordinated monitoring and assessment of domestic financial systems in the context of the newly established Financial Sector Assessment Program.[11] The Financial Sector Assessment Program mainly covers assessment of compliance with the Code of Good Practices on Transparency in Monetary and Financial Policies of the IMF (July 1999) and with the Basel Core Principles for Effective Banking Supervision and is undertaken upon the request of the member countries.[12] In assessing compliance with the Basel Core Principles, the guidelines and criteria of the *Core Principles Methodology* of the Basel Committee on Banking Supervision (Basel Committee)[13] are followed.[14]

The Financial Stability Forum (FSF) contributes further to harmonization of banking standards. Established in 1999 by the G-7 countries to promote cooperation in prudential regulation and supervision,[15] the FSF can utilize its extensive network of supervisory authorities, national and international, in effecting adoption of international banking standards.[16]

[11] See <http://www.imf.org/external/np/fsap/fsap.asp>; Manuel Conthe & Stefan Ingves, *Financial Sector Assessment Program, A Commentary*, <http://www.imf.org/external/np/vc/2001/030901.htm>. For an IMF assessment of the Financial Sector Assessment Program (FSAP) and its future, see *IMF Reviews Experience with the Financial Sector Assessment Program and Reaches Conclusions on Issues Going Forward* (IMF, Public Information Notice (PIN) No. 03/46, April 4, 2003), <http://www.imf.org/external/np/sec/pn/2003/pn0346.htm>.

[12] The IMF staff prepares reports to the Fund's Executive Board on the basis of FSAP assessments (Financial System Stability Assessment (FSSA)), which are published together with article IV staff reports upon the Member's consent. The FSSA's summary assessments of observance of international standards and codes are published as financial modules of the IMF's Reports on the Observance of Standards and Codes (ROSCs). ROSCs summarize countries' compliance with internationally recognized standards and codes, and they are prepared and published with the consent of the Member. ROSCs may also be undertaken independently of the FSAP assessments and cover issues beyond the financial sector. See François Gianviti, 'Legal Aspects of the Financial Sector Assessment Program (FSAP)', Paper delivered at the IMF Seminar on Current Developments in Monetary and Financial Law, Washington, DC, May 7–17 2002 (May 9, 2002), <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/gianv2.pdf> (last visited July 1, 2002). For ROSCs, see IMF, *Reports on the Observance of Standards and Codes* (ROSCs), <http://www.imf.org/external/np/rosc/rosc.asp> (last visited July 20, 2002).

[13] For the Basel Committee, see Chapter II, note 9.

[14] The IMF and the World Bank took part in the formulation of the *Core Principles Methodology*, whose aim is to reduce divergence in implementation of Basel standards. See Basel Committee on Banking Supervision, *Core Principles Methodology* (October 1999), <http://www.bis.org/publ/bcbs61.htm>. The Core Principles Liaison Group (a forum of the Basel Committee, the World Bank, the IMF and the Financial Stability Institute) is working on improvement of the *Core Principles Methodology*. See Financial Stability Forum, *Ongoing and Recent Work Relevant to Sound Financial Systems* 17 (August 29, 2001), <http://www.fsforum.org/Reports/OngoingSFSAug2001.pdf>.

[15] See <http://www.fsforum.org>.

[16] For a comprehensive review of the Financial Stability Forum and its role in the new international financial architecture, see George Walker, *A New International Architecture and the Financial Stability Forum* (Studies in International Financial and Economic Law, No. 24, 1999).

These mechanisms are helpful, although inadequate both for harmonization and for the GATS balancing of trade and banking regulation. Although they are very effective mechanisms for banking reform and for wider adoption of the Basel standards, they take place in a fragmented mode and at a unilateral level, and are often non-compulsory. In addition, they do not have any binding effect with respect to determining what constitutes prudential reasons and what balancing tools are available to the DSP. The DSP remains equally alone with its balancing of trade and regulation and with its evaluation of the 'soft law' Basel promulgations. Nevertheless, the IMF-, World Bank- and FSF-led implementation of standards does provide a very significant harmonization mechanism that could complement that potentially effected by the GATS. More importantly, it can address the issue of implementation divergence, which is set out below as one of the disadvantages of the proposal examined here.

2 PRUDENTIAL INSTITUTION BUILDING AT THE INTERNATIONAL LEVEL

2.1 Decentralization model

2.1.1 Review of GATS reform proposals

2.1.1.1 'Prudential' – Trade-off devices A more precise definition of the 'prudential' concept and determination of the content of the GATS trade-off devices are not expected to be an adequate solution. First, although a definition of the 'prudential' concept solely for the purposes of the GATS operation will suffice, the state of the concept in the banking literature sets the potential complexities and inherent limits.[17]

Second, it is unclear to what degree the trade-off devices can be further defined and how consensus can be achieved at the multilateral level. The 'cautious' response of the WTO Members to Australia's proposal for clarification of the prudential carve-out is quite illustrative. Although many Member States shared Australia's concerns, Malaysia's position exemplifies the difficulties for consensus toward further clarification: 'The *prudential carve-out* was the *result* of a *fine balance* struck when the GATS was concluded and *trying to define prudential regulation* could *upset that balance*' (emphasis added).[18] The US and EU response was no more encouraging:

[17] See Chapter I, Section 1.
[18] Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 13 April* 2000, S/FIN/M/25 (May 8, 2000).

> [T]he European Communities felt that *defining prudential regulation* was possibly *too ambitious* since it was difficult to agree on something that would be useful to all . . . [T]he US was inclined to be *cautious* in considering the need for any further definition of that provision at that time. Thus far they had not found compelling evidence that excessive prudential regulation was undermining commitments' (emphasis added).[19]

Unfortunately, the debate has not been advanced much further, as the Members have reiterated their opposition to further work on the prudential carve-out and have expressed strong reservations even with regard to Japan's proposal for gathering relevant information from international financial organizations.[20]

Third, significant efficiency and legitimacy risks remain even if the legislative process determines the applicable trade-off devices and gives them more specific content. The operation of balancing tests, like the proportionality test or the cost-benefit test, by the DSP will consist of intense synthesis of competing interests, which is more suitably undertaken at the legislative level. The proximity of the political process to the preferences at stake ensures more efficient outcomes. There is also more predictability as the weighing of values at the legislative level produces more precise rules (or simply 'rules' in the *rules v standards* rhetoric) and activity in conformity with the law can be more easily planned. As far as legitimacy is concerned, redistribution ramifications call for the evaluation of the competing preferences to be politically more visible.

2.1.1.2 Basel standards Incorporation of the Basel accords is also an incomplete remedy for the GATS shortcomings regarding the trade and banking regulation issue. It does not give a full answer to the desirable balance between trade and regulation sum, and hence, the DSP retain wide discretion in its balancing. Uncertainty remains as to the degree to which domestic measures in excess of the Basel standards are in conformity with the GATS disciplines. The DSP is left with the decision on the adequacy of the Basel arrangements and the degree of liberalization they can support. Prescribing the Basel arrangements as minimum standards for the operation of the GATS disciplines has additional problems. The weaknesses of the Basel standards themselves as well as issues of democratic legitimacy should be taken into account.[21]

[19] Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 25 May 2000*, S/FIN/M/26 (June 29, 2000). See also Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 13 July 2000*, S/FIN/M/27 (August 23, 2000).

[20] See below Section 2.2. and note 60.

[21] Professor Cranston nicely presents problems with the current international prudential standards referring to their 'soft law' character, their limited nature and scope, and problems with their application in practice. Ross Cranston, *Principles of Banking Law* 116 (1997).

The BCCI (Bank of Credit and Commercial International) case has shown that despite minimum capital standards and consolidated supervision considerable risks exist for depositors and financial stability.[22] The post-BCCI, more intense, Basel standards also present problems. First, there is room for implementation divergence, as the Basel standards are only 'soft' law,[23] that is non-binding international norms, which are more likely to take effect through discretionary national legislation.[24, 25] Second, the effectiveness of the Basel standards ultimately depends on the resources available to the national regulators to exercise the envisaged supervisory duties.[26] Third, they do not deal with allocation of lender of last resort responsibilities. Fourth, the Basel Committee has still to address regulatory arbitrage.[27] Finally, it should be taken into account that no matter how

[22] See below Section 2.3.1; Richard Dale, 'Regulatory Consequences of the BCCI Collapse: US, UK, EC, Basle Committee – Current Issues in International Bank Supervision', *International Banking Regulation and Supervision: Change and Transformation in the 1990s* 377 (Norton, Joseph J Norton et al. eds., 1994). The Basel Committee has attempted to address gaps in consolidated supervision in its revised standards for cross-border banking in 1992 and in 1996. See *Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments* (July 1992) and *The Supervision of Cross-Border Banking* (October 1996) which revised the *Principles for the Supervision of Banks' Foreign Establishments* (May 1993) all available at <http://www.bis.org>. Although this has definitely strengthened consolidated supervision, it remains to be seen how effectively it will deal with BCCI-type problems. See also Richard Dale, above, at 394, for concerns related to reliance of the Basel 1992 regime on the countries' 'willingness' to 'exercise their powers of exclusion', and for problems in assessing the relevant supervision systems in each case. As for assessment of national supervision systems, the new IMF–World Bank Financial Sector Assessment Program (FSAP) should help national supervisory authorities to assess more effectively each other's systems.

[23] For the 'soft' law character of the Basel standards, see below Section 2.3.3.1.

[24] International financial standards set by the Basel committees are recognized as 'soft' law, which constitutes policy recommendations and takes effect through incorporation in the national legal systems. For the nature of international financial standards as international 'soft' law that consists of 'legally non-binding rules', see Mario Giovanoli, 'A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting', in *International Monetary Law* 3, para. 1.45 (Mario Giovanoli ed., 2000).

[25] 'For instance, penalties for violation of banking laws or regulations based on the standards will rest with the individual country regulators.' Duncan E Alford, 'Basle Committee Minimum Standards: International Regulatory Response To The Failure of BCCI', 26 *George Washington Journal of International Law and Economics* 241, 272 (1992). For implementation by national authorities as the only feasible alternative, see Michele Fratianni & John Pattison, 'International Financial Architecture and International Financial Standards', 579 *Annals of the American Academy of Political & Social Science* 183, 193 (2002). Fratianni and Pattison argue that such decentralized implementation is at the same time the 'Achilles' heel' of the international standards, and while they doubt the effectiveness of a contractual incentive-based implementation scheme they propose a leading role for the US and the UK regulators. However, they do not seem to propose anything beyond the, already existing, *de facto* influence of the US and UK systems.

[26] 'For example, if the new standards had been in place in 1991, the BCCI fraud would have been more difficult to conceal because a single regulator (Luxemburg) would have been in charge. With its limited regulatory resources, however, Luxemburg most likely would not have been able to detect the fraud'.. Duncan E Alford, above note 25.

[27]

> While the Accord has the virtue of being relatively easy to administer and enforce, it also clearly gives banks an incentive to find ways to avoid the regulatory capital standard for

rigorously 'consolidated supervision' is prescribed, its effectiveness in practice depends on the relationship of the supervisors. This remains so while cooperation of the supervisors is still characterized by some mutual distrust.

Basel II

These weaknesses are not absent[28] from the new Basel Capital Accord (Basel II).[29] In fact, under Basel II, implementation divergence is more likely due to its more complex promulgations and the wide role envisaged for the supervisory review, in respect, for example, of supervision of the banks' internal risk management systems. The Basel Committee has acknowledged this and established the Accord Implementation Group to help bank supervisors with information sharing and implementation. It has also issued high-level principles for cross-border banking supervision in relation to Basel II, the objective of which is to enhance cooperation and coordination between supervisors towards effective and efficient supervision.[30] The high-level principles do not change the current Basel arrangements for supervision cooperation but they address specific issues from the adoption of Basel II, eg application of new standards at each level of a banking group and the need for multiple approvals – by both the home (for the purposes of consolidated supervision) and host supervisors (for the purposes of individual or sub-consolidated supervision) – for the Basel II approaches for capital measurement. This should also deal with potential trade barriers due to overlaps in the responsibilities of the home and host supervisor in validating or supervising a banking group's internal risk models and to divergence of their respective supervisory practices, particularly because banking groups are likely to manage risk centrally and use a common approach to risk management for the whole group.

> loans that their internal models say need less capital than is required by the Basel Accord. Conversely, banks should want to keep loans which their models say require more capital than does the Basel standard. And, guess what, banks have been doing just that. This so-called 'regulatory arbitrage' may not be all bad, but it surely causes some serious problems as well. For one thing, it makes reported capital ratios – a key measure of bank soundness used by supervisors and investors – less meaningful for government supervisors and private analysts.

Meyer discusses issues and trends in bank regulatory policy and financial modernization in the United States, <http://www.bis.org/review/index.htm>. For further discussion of regulatory arbitrage, and securitization and credit derivatives as its main techniques, see Laurence H Meyer, 'Increasing Global Financial Integrity: The Roles of Market Discipline, Regulation, and Supervision', 18 n. 3 *Cato Journal* 345 (1999).

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[28] Perhaps regulatory arbitrage will be of less concern under Basel II, one of the objectives of which is to address regulatory arbitrage.

[29] See Chapter I, Introduction and Chapter II, note 217, for the new Basel Capital Accord.

[30] Basel Committee on Banking Supervision, *High-level principles for the cross-border implementation of the New Accord* (August 2003), <http://www.bis.org/publ/bcbs100.htm>.

Furthermore, the US approach to Basel II may undermine the value of the Basel standards in conducting the balancing of trade and banking regulation under the GATS. The US plans for only partial implementation[31] of Basel II in relation to its largest and more complex internationally active banks[32] may make the Basel capital standards a less reliable reference tool for assessing the adequacy of national banking regulation and possible protectionist effects. The Basel capital standards will no longer constitute a common, widely agreed, capital adequacy framework and it may be more complex and difficult to discern protectionist motives in possible departures of national regulators from these standards.

Legitimacy issues

As far as 'democratic legitimacy' is concerned, incorporation of the Basel standards in the GATS is also problematic. By prescribing the Basel standards as the determining elements for the application of the trade obligations, the GATS formally becomes the *de facto* standard-setter for international banking regulation. This is inconsistent with the GATS mandate, which is limited to the establishment of a 'multilateral framework of principles and rules'[33] for free and fair trade in services and does not provide a basis for regulating credit institutions. Even if jurisdiction concerns could be set aside on the assumption that the GATS mandate covers banking matters directly linked to trade, 'democratic legitimacy' would still be an issue. This is because automatic incorporation of the Basel standards entails the democracy-related problem of legalization at the multilateral level of international norms, which have been developed by an international forum without the safeguards and the transparency of treaty making.[34]

The EU harmonization process relies extensively on the informally produced Basel standards but in a significantly different way than this would happen in the GATS.[35] The institutional machinery of the EU construct and its accountability mechanisms ensure more political control over the process of incorporating Basel standards. The Community legislative bodies have competence over the realization of the internal banking market and can, in a relatively efficient manner, undertake necessary initiatives

[31] This further illustrates problems of implementation divergence.
[32] The US proposal for partial implementation of Basel II is set out in the interagency Advance Notice of Proposed Rulemaking (ANPR). See <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030711/>.
[33] GATS Preamble.
[34] See below Section 2.3.3.1, for democratic legitimacy issues regarding international norm-making by networks of governmental entities. I also argue there that these legitimacy concerns become less significant when they are weighed against trade and regulatory benefits from the 'informal' process.
[35] See Chapter IV, Section 2.4.3.2, for the modelling of EC prudential measures on the Basel standards.

when market or theory developments, reflected or not in new Basel standards, call for reform of banking regulation and supervision. It is hard to see how the GATS legislative machinery can be mobilized to give effect to similar reforms and Basel standards updates. The WTO mechanism for both the authoritative interpretations of the agreements and the adoption of new rules is extremely cumbersome.[36] The flexibility of the EU legislative system is also important for accountability purposes, as the various interests can change legislative outcomes more easily than in the GATS when a majority consensus is developed. In addition, the EU in the first place plays an influential role in the formulation of the Basel standards[37] and although the relevant EU rules are modelled on them they are enacted through its comprehensive and efficient legislative process. The GATS is not likely to be efficient in updating its reference to the Basel standards, if representation of all interested constituencies has to be ensured.

It should finally be noted that for both the GATS and the EU there will have to be some discounting of the legitimacy of their autonomously produced rules by virtue of their reliance on formal international law-making processes. In the EU, this is reflected in the discussion about the absence of a *demos*, that is European people with organic-type relations, or simply shared values and interests, who will give social legitimacy to the EU construct and hold it accountable.[38] In the case of the WTO, there is a similar absence of a *demos*, which would provide social legitimacy to the WTO system.[39] Nevertheless, this does not say that the treaty-making process promises less democracy than norm-making by networks of national authorities.

The examined reform alternatives in the context of the GATS system do not seem to promise an efficient and accountable optimization of the sum of trade and banking regulation values. The ambiguity of the 'prudential' concept, the wide and dynamic scope of the trade-off devices and the status of the international prudential norms leave the DSP as the ultimate arbiter of the optimum sum of trade and banking regulation values. This

[36] Marco CEJ Bronckers, 'Better Rules for a New Millennium: A Warning Against Undemocratic Developments in the WTO', 2 n. 4 *Journal of International Economic Law* 547 (1999).

[37] Joseph J Norton, *Devising International Bank Supervisory Standards* 102, 103 (1995). Nine EU countries – Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain (since February 2001), Sweden and the United Kingdom – are members of the Basel Committee. The ECB also has the status of observer.

[38] Joseph HH Weiler, *The State 'über alles', Demos, Telos and the German Maastricht Decision* (Harvard Jean Monnet Working Paper No. 6/95, 1995), <http://www.jeanmonnetprogram.org/papers/95/9506ind.html>; Joseph HH Weiler et al., 'European Democracy and its Critique, Five Uneasy Pieces' (EUI Working Paper No. 95/11, 1995).

[39] Professor Howse points to this problem of legitimacy in the WTO and reviews the various approaches to building the substantive legitimacy of the WTO: concern for the world welfare, the 'Washington consensus', Ernst-Ulrich Petersmann's argument for property and contractual rights, 'conflict management' and 'political liberalism'. Robert Howse, above note 7. See also *ibid.* at 361, for secretive consultations and the 'package deal' approach as further impediments to legitimacy.

has efficiency and accountability costs that may be intolerable. And from the financial stability perspective, even if the GATS adjudication process delivers the optimum regulatory output, the risk remains that the current international prudential norms together with the national prudential infrastructures, no matter how stringent, will not be sufficient to deal with globalized banking, no matter how restricted.

In the search for a more effective balancing of trade and regulatory values, ideas for prudential arrangements at the international level are presented in Section 2.3. The relevance of the recent BCCI litigation is discussed. However, first, medium-term institutional arrangements that could improve the GATS balancing system are discussed.

2.2 Medium-term institutional arrangements

Building institutional linkages between the WTO and the international financial standard-setting organizations will facilitate the interface of trade and financial issues. More intensive cooperation of the WTO with the Basel fora will contribute to services negotiations through better understanding of international financial regulation and of the implications of financial services liberalization for financial stability. It will help the WTO balancing system better to assess the prudential rationale of individual banking measures and determine possible protectionist effects. Such interaction can already take place in the context of the WTO adjudication process. Yet it could become more helpful by prescribing its exact content and also by providing for cooperation at the legislative level.

The Panels can be informed about the work of the Basel fora by making use of their judicial right under article 13 of the Dispute Settlement Understanding (DSU) to seek any information or technical advice that they consider 'appropriate'.[40] On the basis of articles 11–13 of the DSU, the Appellate Body in *Shrimp/Turtle* has also confirmed the Panels' right to accept unrequested information or advice from non-parties,[41] and thus *amicus curiae* briefs by the Basel fora may also be admitted to the Panels.[42] Further, article 11 of the DSU may be interpreted to establish an

[40] Understanding on Rules and Procedures Governing the Settlement of Disputes, in WTO Agreement, below note 46, Annex 2, and 33 ILM 1226 [hereinafter Dispute Settlement Understanding].

[41] WTO Appellate Body Report: United States – Import Prohibition of Certain Shrimp and Shrimp Products, AB–1998–4, WT/DS58/AB/R (98–3899) paras. 99–110 (October 12, 1998). See also WTO Appellate Body Report: United States – Import Prohibition of Certain Shrimp and Shrimp Products, Recourse to Article 21.5 of the DSU by Malaysia, AB–2001–4, WT/DS58/AB/RW (01–5166) paras. 75–78 (October 22, 2001); WTO Panel Report: United States – Import Prohibition of Certain Shrimp and Shrimp Products, Recourse to Article 21.5 by Malaysia, WT/DS58/RW (01–2854) paras. 3.5–3.15, 4.87–4.88 and 5.14–5.16 (June 15, 2001).

[42] For the Panel's right to accept *amicus curiae* briefs and the Appellate Body's right to request *amicus curiae* briefs on the basis of article 16(1) of the Working Procedures for Appellate

obligation of the panels to seek such information and advice to the extent it is necessary for the objective assessment of the facts. An agreement for cooperation could further specify matters on which the Panels would be required to consult the Basel fora and could determine the nature of the Basel findings, eg dispositive or not. Such an agreement should take into account legitimacy considerations relating to the limited membership of the Basel committees and the 'soft law' character of its promulgations. The need to preserve the independence of the panels should also be considered.

As for institutional cooperation at the legislative level, the policy on global economic coherence provides a framework. In this context, the Bretton Woods institutions have been developing an interface system for their respective subject matters: monetary, development and trade issues.[43] The cooperation of the WTO with the IMF[44] and the World Bank has found its expression in the Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking (Declaration on Greater Economic Coherence)[45] and in the WTO agreements.[46] The relationship with the IMF and the World Bank is prescribed in more details in the respective Cooperation Agreements, which provide for observership, exchange of documents and information, as well as for joint research and technical cooperation projects.[47] Cooperation with other international organizations concerned with monetary, financial and other WTO-related matters is also mandated in the WTO agreements[48] and the Declaration on Greater Economic Coherence.[49]

Review, and a critical discussion of the disagreement of the WTO Members with the Appellate Body's handling of the latter, see Petros C Mavroidis, 'Amicus Curiae Briefs before the WTO: Much Ado About Nothing', *Festschrift für Claus-Dieter Ehlermann* (Armin von Bogdandy et al., eds. 2002), also available at <http://www.jeanmonnetprogram.org/papers/01/010201.html> (Jean Monnet Working Paper No. 2/01, 2001).

[43] See Dukgeun Ahn, 'Linkages between International Financial and Trade Institutions; IMF, World Bank and WTO', 34 n. 4 *Journal of World Trade* 1 (2000).
[44] For the IMF/WTO Relationship, see Deborah E. Siegel, 'Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements', 96 *American Journal of International Law* 561 (2002).
[45] Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking, 33 ILM 1249 (1994) [hereinafter Declaration on Greater Economic Coherence].
[46] Agreement Establishing the World Trade Organization, Final Act Embodying the Results of the Uruguay Round Of Multilateral Trade Negotiations, Marrakesh, April 15, 1994, 33 ILM 1144 (1994) [hereinafter WTO Agreement], art. III(5); General Agreement on Tariffs and Trade 1994, WTO Agreement, above note 46, Annex 1A, Multilateral Agreement on Trade in Goods [hereinafter GATT], art. XV; GATS arts. XI(2) and XII(2)(b). For relevant provisions of the Fund and the World Bank Agreements, see Dukgeun Ahn, above note 43, at 7–8; Deborah E Siegel, above note 44, at 567–72.
[47] General Council, WTO, *WTO Agreements with the Fund and the Bank*, WT/L/195 (November 18, 1996), Annexes I, II.
[48] WTO agreement art. V, GATS art. XXVI.
[49] Declaration on Greater Economic Coherence para. 5.

Thus, the WTO process can be informed about the international financial standards through its existing relationship with the IMF and the World Bank, as well as through establishment of similar links to the Basel fora. First, the WTO bodies, including the Panel, can make use of the IMF and the World Bank financial reform work and of their assessment of national banking systems in the context of the Financial Sector Assistance Program. The WTO bodies seek for information regarding certain banking measures and thus make better assessments of their prudential nature.[50]

Second, the Basel fora can be invited to participate in the various WTO bodies and committees. For example, the Financial Stability Forum can be granted observer status in the General Council and the Ministerial Conference as well as in the Committee on Trade in Financial Services (CTFS) and the Working Party on Domestic Regulation. A formal agreement may be necessary as under the current WTO legal framework the following two problems may arise in relation to granting observer status to Basel fora. First, it is not clear whether only traditional international organizations, that is organizations which have states as members and a treaty as their legal basis,[51] qualify as international intergovernmental organizations eligible for observer status under Rule 11 of the Rules of Procedure for Sessions of the Ministerial Conference and Meetings of the General Council.[52] The discussion on granting the International Association of Insurance Supervisors (IAIS)[53] observer status in the CTFS shows that international financial regulatory organizations like the Basel committees are also eligible for observer status. Although no decision was taken, there was disagreement only about the CTFS' right to grant observer status[54] pending a decision by the General

[50] Following the presentation by international financial standard-setting bodies to the Committee on Trade in Financial Services (see below in the text and note 60), the IMF proposed a presentation of its own work on international financial standards, and a briefing session was scheduled for July 22, 2002. It was suggested that it would cover the FSAP, the use of the FSAP findings by the IMF and the World Bank, 'operational linkages' with other initiatives for the international financial architecture and the importance of the FSAP for trade and financial liberalization issues. Again, this was agreed on the condition that the presentation would not extend to country-specific information. See Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 27 November 2001*, S/FIN/M/33 paras. 19–25 (December 13, 2001); Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 4 June 2002*, S/FIN/M/35 paras. 35–38 (July 8, 2002).

[51] See below Section 2.3.3.1, for traditional international organizations vis-à-vis networks of national regulators like the Basel Committee, IOSCO and IAIS.

[52] WTO, Rules of Procedure for Sessions of the Ministerial Conference and Meetings of the General Council, WT/L/161 (July 25, 1996) [hereinafter Rules of Procedure].

[53] See <http://www.iaisweb.org>.

[54] See Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 9 October 2000*, S/FIN/M/28 (November 20, 2000). See also *ibid.* at para. 31, for confirmation by the Secreteriat representative of the right of the CTFS to grant observership by reference to the Rules of Procedure.

Council,[55] while the nature of the IAIS as a non-traditional international organization does not appear to have been an issue. Second, the limited membership of the Basel committees and lack of access to their processes may be an obstacle. Annex 3 on Observer Status for International Intergovernmental Organizations in the WTO (paragraph 4)[56] requires that, among other factors, the number of WTO Members in the organization[57] requesting observer status and reciprocity with respect to access to proceedings, documents and other aspects of observership should be considered in granting observer status.

In addition, Basel fora may be invited to attend specific meetings.[58] They could also be asked to provide information on their work and the state of international banking regulation and supervision. Such information can be utilized in financial services negotiations and in particular in the assessment of the necessity of trade-restrictive domestic prudential measures for the stability of both the domestic and the international banking system. It could also indicate individual (national) banking rules whose trade-restrictive effect can be avoided only through more international banking rules and structures.

So far there has been opposition to a relationship with Basel fora that would go beyond collection of information. Such has been the reaction to Japan's proposal for more interactions with organizations like the Basel committees, the International Organization of Securities Commissions (IOSCO)[59] and the IAIS. After a long debate, the Members agreed only to an informal presentation for 'information and educational' purposes, which took place in October 2001 on the condition that there would be no implication for determining the prudential character of country-specific banking regulation or for relevant CTFS work. The Members had demanded that the presentation would be an informal 'one-off event', that it would constitute no attempt to interpret the prudential carve-out, that there would be no reference to national banking measures and that no formal link would be developed between the committee and these organizations.[60]

[55] See General Council, WTO, Annual Report 2000, WT/GC/44 (February 12 2001), Item 34(b); General Council, WTO, Minutes of Meeting held on 3 and 8 May 2000, WT/GC/M/55 (June 16 2000), paras. 291–292; General Council, WTO, Minutes of Meeting held on 17 and 19 July 2000, WT/GC/M/57 (September 14 2000), paras. 215–26; General Council, WTO, Minutes of Meeting held on 7, 8, 11 and 15 December 2000, WT/GC/M/61 (February 7 2001), paras. 155–75.

[56] Rules of Procedure, Annex 3, Observer Status for International Intergovernmental Organizations in the WTO.

[57] See also Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 25 May 2000*, S/FIN/M/26 (June 29, 2000) (reporting large membership of the IAIS as an element in favour of granting IAIS observer status).

[58] Rules of Procedure, Annex 3, Observer Status for International Intergovernmental Organizations in the WTO para. 5.

[59] See <http://www.iosco.org/iosco.html>.

[60] See Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 13 July 2000*, S/FIN/M/27 paras. 24–44 (August 23, 2000); Committee on Trade in Financial

Bringing closer the work of the WTO and of international organizations that are responsible for financial stability should improve the balancing of trade and banking regulation. It could also make more apparent the limits of a decentralized, nation-based, prudential model and identify areas in which more international regulation would be necessary. Ideas for prudential arrangements at the international level are presented in the following section.

2.3 Prudential institution building at the international level – Long-term institutional arrangements

2.3.1 Decentralization model and prudential implications – Three Rivers

The recent litigation in England and France on the liability of the respective central bank authorities regarding supervision of the BCCI[61] demonstrates the prudential limitations of a banking integration model without centralized supervision mechanisms. Deficiencies in supervising cross-border banking can put depositor protection and financial stability at risk while national authorities can get away with no legal blame. Interestingly, this litigation took place under the First Banking Directive, which did not introduce strong integration commitments, as it only envisaged further harmonization, mutual recognition and home country control,[62] while the GATS integration model is likely to resemble this. It also took place in the context of national adjudication processes with considerable 'interaction' between one another,[63] and this is not imaginable for the multilateral system of the GATS.

Services, WTO, *Report of the Meeting Held on 9 October 2000*, S/FIN/M/28 paras. 12–28 (November 20, 2000); Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 29 November 2000*, S/FIN/M/29 paras. 15–25 (March 14, 2001); Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 2 April 2001*, S/FIN/M/30 paras. 18–35 (May 8, 2001); Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 9 May 2001*, S/FIN/M/31 paras. 16–53 (June 1, 2001). The presentation took place on October 10, 2001 and the only information available is Japan's commendation of the event. Committee on Trade in Financial Services, WTO, *Report of the Meeting Held on 11 October 2001*, S/FIN/M/32 para. 43 (November 9, 2001).

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[61] For some background to the BCCI affair, see the references in note 113 of Chapter II, Section 2.1.2.

[62] It is argued that the First Banking Directive did not provide either for strong regulatory safeguards which would be anywhere near equivalent to the Second Banking Directive, and which would have clearly established the duties of the respective national supervisors. This is valid only if we adopt the opinion of Lord Hope of Craighead. Lord Hope argued that the First Banking Directive established only a cooperation duty of the national supervisors and did not prescribe any specific supervision duties. This was one of the arguments used to relieve the Bank of England of its liability. But, as Mads Andenas submits (supporting the opinion of Lord Justice Auld), this argument cannot be sustained under Community banking law. The First Banking Directive did establish specific supervision duties. See Mads Andenas below note 64.

[63] The adjudication proceedings at issue, that is the English and French systems, might be expected to have more 'interaction' between one another than other systems do, from both a Community and a comparative law perspective. From a Community law perspective they are

In the *Three Rivers* case, the Bank of England has been absolved of legal liability under Community law for its supervision of the BCCI.[64] The House of Lords refused to recognize enforceable rights for depositors on the basis of the First Banking Directive after an unsatisfactory interpretation of tort liability of the supervisors and of direct effect. The House of Lords also failed to refer the issue to the European Court of Justice under article 234 of the EC Treaty.[65] The effect of the first outcome of the *Three Rivers* case is compounded if it is considered that the French courts held that the Bank of England's negligence broke the causation between the damage to French depositors and the non-feasance of the French authorities.[66]

Adding to concerns for the effectiveness of the current supervisory system, the House of Lords failed to take sufficiently into account supervision developments in other jurisdictions. It referred only to the case of Denmark, and this only to state inaccurately that there was no formal banking supervision before the First Banking Directive.[67]

The First Banking Directive is one of the first regulatory expressions of the initiative to liberalize the European banking system. To address systemic risk implications as well as to promote equal conditions of competition it also provided for minimum prudential standards. Among these were the protection of depositors and the duties of banking supervisors. *Three Rivers* raises questions about the adequacy of the decentralized framework based on minimum harmonized prudential standards.

The *Three Rivers* case has shown the degree of potential divergence in the incorporation of the Directives' minimum standards in the Member States. The treatment of the issue by English and French courts in the BCCI case demonstrates the problems. English courts have ensured wider application for English law by limiting the role of depositors' protection, while French courts based a wider application of the French law on a broader recognition of the depositors' protection objective. In both jurisdictions the cases turned

bound to examine issues and concepts on which the ECJ has ruled, and they are expected to refer issues of Community law to the ECJ. From a comparative law perspective, interaction is expected due to scholarship and culture ties.

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64 *Three Rivers District Council and Others v Governor and Company of the Bank of England* [2000] 2 WLR 1220, also available at <http://www.publications.parliament.uk/pa/ld199900/ldjudgmt/jd000518/rivers-1.htm>. 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 BCCI and the Bank of England in the House of Lords', 3 *Euredia* 379 (2000).

65 For the duty to refer, see *ibid.* at 408, 409 (citing the opinion of Advocate General Jacobs in the *Stockholm Lindöpark* case (Opinion of Advocate General Jacobs delivered on 26 September 2000 in Case 150/99, *Svenka Staten* (*Swedish State) v Stockholm Lindöpark Aktiebolag* and *Stockholm Lindöpark Aktiebolag v Svenka Staten* (*Swedish State)*, 2001 ECR I–493)).

66 Mads Andenas, above note 64, at 388.

67 *Ibid.* at 389. It should be noted that a formal banking supervision system has existed in Denmark since the 19th century.

on an interpretation of the First Banking Directive, and they both extended the reach of their national jurisdictions in relation to Community law but this required conflicting interpretations of the Directive.

Besides the issue of the accountability of the banking supervisors and the effectiveness of banking supervision in the UK, the *Three Rivers* case suggests a review of the effectiveness of a decentralized supervision framework. It provides support to efficiency arguments in favour of further centralization of the EU banking supervision system. The case concerns exactly what the First Banking Directive was supposed to prevent: that regulators can claim non-responsibility because of the involvement of other Member States' regulators. Now the House of Lords has held that the depositors are entitled to a full trial on the English law issues and the liability of the Bank for the tort of misfeasance in public office.[68] Time will tell whether this will provide any remedy.

The BCCI litigation is of value for the GATS integration model, because further international integration in the context of the GATS is more likely to resemble the First Banking Directive model: that is, compared to the current EU model, it is likely to have less internalized[69] essential harmonization and more host country control.

2.3.2 What type of prudential institution building at the international level?

Prudential institution building at the international level can contribute to optimizing the sum of trade and regulation benefits. International financial standards and more structured international supervision will reduce prudential risks from international banking. This will reduce the weight of domestic prudential regulation, and hence, make it more difficult for domestic rules, discriminatory or not, to sustain the GATS disciplines.

Some thoughts for two types of prudential institution building at the international level are presented here: *harmonization of standards* and *centralization of supervision mechanisms*. Although for both types only some views are expressed here, the focus is more on the centralization of super-

[68] *Three Rivers District Council v Governor and Company of the Bank of England* [2001] UKHL 16, also available at <http://www.parliament.the-stationery-office.co.uk/pa/ld200001/ldjudgmt/jd01…/three-1.htm>. For the English law issues, see Mads Andenas & Duncan Fairgrieve, 'To Supervise or to Compensate? A Comparative Study of State Liability for Negligent Banking Supervision', *Judicial Review in International Perspective* 333 (Mads Andenas & Duncan Fairgrieve eds., 2000); Charles Proctor, 'BCCI: Suing the Supervisor', 6 n. 1 *The Financial Regulator* 35 (June 2001); Kanaga Dharmananda & Pierre Dzakpasu, 'Central Bank Liability to Depositors: Three Rivers may not Open Floodgates', *Journal of International Banking Law* 41 (2002).

[69] Internalized harmonization, as opposed to harmonization through development of international standards by a separate international norm-making process (namely-Basel), is the harmonization process in the EU, as it takes place within its construct through its legislative mechanisms.

vision mechanisms as the most feasible alternative. The various fora that could provide centralized supervision mechanisms are examined. Seeking the features of such centralization, I undertake a more extensive analysis of the EU supervision model in the next chapter (Chapter IV).

2.3.2.1 Harmonization of banking regulation at the international level
The first type of harmonization at the international level may consist of harmonization of banking regulation and supervision *in close relation* to the reduction of barriers to financial services trade. It could be a treaty-based harmonization model, similar but more advanced than the incorporation of the Basel standards in the GATS as proposed above and resembling the processes towards the EC internal banking market.[70]

It sounds an appealing alternative, but I would not claim intellectual strength to pursue it in depth in the context of this work. Nevertheless, the following remarks should be of value. First, a treaty-based harmonization may develop within the GATS financial services framework or alternatively require the abolition of the financial services from the GATS ambit and their inclusion in a new institutional framework. The new framework will work out the desirable mix of trade and regulation and accordingly develop trade disciplines and financial standards. Second, the main impediment is likely to be the absence of political consensus for such institutional endeavour. There will be complex sovereignty issues, for which there is no indication that domestic political debates are ripe to deal with. Moreover, it is doubtful that the resources for such institution building could be made available. Third, the role of Basel organizations and networks, or those similar to Basel, is likely to remain significant in translating market and theory developments into international policy and norm making.

This first type of prudential institution building is comparable to incorporating the Basel standards in the GATS. Although the adopted standards will be subject to the more intense scrutiny of international treaty making, the proposed framework will essentially follow the Basel norms. The updating of the international treaty making process will also be problematic. A legislative mechanism based on intergovernmental cooperation is not expected to be efficient in responding to developments in banking, that is to constant and rapid market and theory developments, even if this response is effected by reliance on the work of the Basel committees.

A proposal by Professor Giovanoli, General Counsel of the Bank for International Settlements, offers some ideas that could remedy the problem of updating the international treaty making process.[71] The proposal is that an international treaty framework be built for the 'official' recog-

[70] Professor Giovanoli makes a similar proposal, which however does not deal with the issue of integrating trade and banking regulation considerations under a single institutional structure. Mario Giovanoli, above note 24.
[71] *Ibid.*

nition[72] of general international financial standards, while the more technical issues are kept separate from these general standards. Although it is unclear whether what is proposed is that regulation of the more technical issues be entirely outside the treaty framework or be delegated to committees within this treaty framework, the proposal could allow for the necessary flexibility and efficiency in amending the more technical rules. It could also bring the work of all these committees into the accountability and discussion mechanisms of the treaty framework, when their promulgations impinge upon the core of the general standards and upon their political nature.

This distinction between politically important general principles and technical issues reminds us of the EU 'comitology' regime and norm making under this regime. In the EU, due to efficiency considerations, legislative power covering specific matters in a particular area has been delegated to the Commission. In implementing rules laid down by the Council, the Commission may legislate on technical issues through a committee structure in which Member States are represented.[73] This process is known as 'comitology'.[74]

The Lamfalussy model of law making which is used in EC securities regulation and as of recently in EC banking and insurance regulation comprises an endorsement of the comitology process.[75] The Lamfalussy model consists of a fast-track legislative process where the formulation of general rules and principles (framework principles) stays with the EU co-decision process (Level 1), while that of technical implementing measures is assigned

[72] The mere use of the words 'official recognition' of international financial standards defies one of the objectives of the proposal, which is to 'avoid a "top down" process'. It actually shows the inevitable influence of the various experts' committees under any institutional alternative.

[73] EC Treaty art. 202 (ex art. 145). Through a Decision adopted in 1999 and amending a prior Decision (adopted in 1987), the Council has laid down the principles and rules to be followed in legislating under the 'comitology' regime. Council Decision 99/468 of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, 1999 OJ (L 184) 23.

[74] For the 'comitology' regime, see Paul Craig & Gráinne de Búrca, *EU Law, text, cases and materials* 150–53 (2nd edn, 1998); *Delegated Legislation and the Role of Committees in the EC* (Mads Andenas & Alexander Türk eds., 2000); Wolf Sauter & Ellen Vos, 'Harmonization under Community Law: The Comitology Issue', in *Lawmaking in the European Union* 169 (Paul Craig & Carol Harlow eds. 1998).

[75] The Lamfalussy model was recommended by the Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Alexandre Lamfalussy, in its final report issued in 15 February 2001. It was endorsed by the Council in March 2001 (Stockholm) and agreed by the EU Parliament in February 2002. See below notes 76 and 77, for the EU legal instruments which provided for the establishment of the necessary Committees and their competences. For the background to the Lamfalussy model, see the final report of the Committee of Wise Men, where the Lamfalussy model was recommended. *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (February 15, 2001), <http://www.europa.eu.int/comm/internal_market/en/finances/general/lamfalussy.htm>.

to the Commission. The Commission, assisted by new European Securities Committee, acting in a regulatory capacity, adopts implementing measures in accordance with the comitology procedure (Level 2).[76, 77] Extension of the Lamfalussy model to banking (as well as insurance and investment funds) has recently taken place.[78]

2.3.2.2 International supervision structures Prudential institution building may also consist of international supervision structures. Thus, an international prudential supervisor or an international lender of last resort can be *imagined* to underpin the internationalization of banking. An international prudential supervisor could have responsibility for the supervision of internationally active banks that are also important from a systemic stability point of view. Although, provided that there are adequate resources, an international institution should ideally perform both micro- and macro-prudential supervision,[79] it is essential that it act as a macro-prudential supervisor[80] with its focus on systemic risk.[81] Its responsibility for macro-

[76] The regulatory capacity of the European Securities Committee under Level 2 is prescribed in the Market Abuse Directive. EP and Council Directive 2003/6 of 28 January 2003 on insider dealing and market manipulation (market abuse), 2003 OJ (L 96) 16. The European Securities Committee (ESC) was established through a Commission Decision, which provided for the ESC's advisory capacity in relation to rules and principles adopted by the Commission under Level 1. Commission Decision 2001/528 of 6 June 2001 establishing the European Securities Committee, 2001 OJ (L 191) 45.

[77] The Lamfalussy model provides for two additional levels. Level 3 deals with implementation providing for enhanced cooperation through the Committee of European Securities Regulators (CESR), and Level 4 envisages strengthening enforcement of Community law by the Commission in cooperation with the Member States, the national regulators and market forces. CESR, composed of representatives of the Member State supervisory authorities, has an advisory role and assists with the preparation of the technical implementing measures as well as with implementation. Commission Decision 2001/527 of 6 June 2001 establishing the Committee of European Securities Regulators, 2001 OJ (L 191) 43. For a comprehensive review of the Lamfalussy model, see Niamh Moloney, *EC Securities Regulation* 29–32, 864–71 (2002). See also Eilís Ferran, *Building an EU Securities Market* 58-127 (2004), for the EU securities law-making process with an emphasis on its impact on issuers' access to the primary and secondary markets.

[78] See Chapter IV, Section 1.4.1.

[79] For the distinction between micro- and macro-prudential supervision, see European Central Bank, *The Role of Central Banks in Prudential Supervision* (March 2001), <http://www.ecb.int/pub/pdf/prudentialsupcbrole_en.pdf> [hereinafter *ECB, The Role of Central Banks in Prudential Supervision*]: '[*M*]*icro-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.'

[80] For our understanding of 'macro-prudential supervision', see Chapter 1, Section 1.3.

[81] In the event only a macro-prudential supervisor emerges, the relationship with the national micro-prudential supervisors should be worked out. A solid basis for their cooperation will be important, as macro-prudential functions rely for their quality on micro-prudential supervision. It should also be taken into account that it would be natural for macro-prudential supervision to spill over micro-prudential considerations and also for macro-prudential tasks, eg

prudential supervision should include lending of last resort functions. Such lending of last resort could also be independently undertaken by an international institution, particularly if it is not feasible to develop a macro-prudential supervisor. I should clarify that my examination of an international lender of last resort refers to LOLR (Lender of Last Resort) operations with respect to liquidity problems of solvent internationally active and system-important banks, and not to LOLR in support of governments facing serious macroeconomic disturbances.

It is beyond the scope of this volume to give an answer as to the form and forum for an international macro-prudential supervisor. I explore, however, principles and macroeconomic considerations, which could inform such institution building. This examination takes place in Chapter IV below in the context of the EU structure. The following section sets out some ideas regarding the choice of the international forum by comparing 'formal' and 'informal' norm making and reviewing existing international institutions.

2.3.3 Forum for prudential institution building

2.3.3.1 Informal vis-à-vis formal norm making and forum for prudential structures Networks of national regulators,[82] like the Basel Committee or the International Organization of Securities Commissions (IOSCO),[83] could provide a forum for an international prudential supervisor. They could extend their making of financial standards to supervision of international and systemically important banks, including LOLR functions. First, I shall compare norm making by these networks to other, more formal norm making regarding international activities, and then I shall examine how this applies to an international supervisor.

Networks of national regulators share some common features, which distinguish them from international organizations[84] and determine the

information gathering and analysis of banks' reports, to overlap with micro-prudential ones. The interplay of the relevant functions and the content of the relevant arrangements are beyond the scope of the analysis here.

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[82] David Zaring calls these networks, eg the Basel Committee, IOSCO, and IAIS, international financial regulatory organizations (IFROS) and distinguishes them from traditional international organizations. David Zaring, 'International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations', 33 *Texas International Law Journal* 281 (1998).

[83] The Basel Committee is a less institutionalized forum consisting of the cooperation between national supervision authorities and central banks for whose meetings the BIS provides a permanent secretariat. IOSCO is more formalized as it has taken the form of a private company incorporated under Canadian law.

[84] IFROs are composed of administrative agencies ('sub-state actors'), are 'informally constituted', have a 'flexible internal organization' and 'decentralized bureaucracies', are often 'secretive' and 'informal', and their agreements are legally non-binding. David Zaring, above note 82, at 287.

quality of their norm making. Their members are not states but sub-state entities, they do not have a treaty as their legal basis and lack legal personality in international law. In this vein, their agreements do not take the form of a treaty and produce only legally non-binding standards in an arguably non-accountable way.

Notwithstanding the non-binding legal character of their promulgations, the financial norms thus produced are regarded as constituting international 'soft law'. In the Basel standards, for example, we can discern all the features of 'soft law', as described by Sir Joseph Gold, the former General Counsel of the IMF, with an emphasis on the development of soft law in the context of the IMF processes:[85]

> '[*J*]*us cogens* is at one extreme and soft law at the other. Among as many definitions of soft law can be found as there are writers about it. An element common to most definitions is that soft law is not binding on states in the traditional sense of binding force of firm law . . . soft law expresses a preference and not an obligation that states should act, or should refrain from acting, in a specified manner.
>
> . . .
>
> The failure of states to behave in accordance with an expressed preference that has the character of soft law is not regarded as the violation of conventional or customary international law . . . Nevertheless, soft law is entered into with the expectation shared by all parties that they will observe it.
>
> Another missing element is a preordained penalty for failures to observe soft law.
>
> . . .
>
> . . . Some authors have concluded that soft law must be interpreted to constitute no more than moral or political pronouncements . . . Experience does not justify this reaction.

Likewise the Basel standards are not agreed as legally binding rules via the normal treaty making process. Nevertheless, the Basel standards are agreed with the expectation that they will be adopted in the national legal orders. This expectation covers not only the participating national regulators but also the regulators with a stake in cross-border banking business and financial stability.

Undoubtedly, this 'informal' process has facilitated international banking regulation.[86] Basel has already shown that its small membership, consisting of a few authorities that also share common expertise and concerns regarding the international financial system, has allowed a strong consensus culture to develop and, subsequently, has ensured efficiency in reaching agreements. Its flexible structure is more efficient as well as more respon-

[85] Joseph Gold, *Interpretation: The IMF and International Law* 301–3 (1996).
[86] For an analysis of the pros and cons of international 'soft' law with regard to international financial standard setting, see Mario Giovanoli, above note 24, at para. 1.58.

sive to banking developments than the complex and time-consuming processes of treaty making. The non-binding legal nature of the agreements has not been a problem, as the prestige of the Basel Committee and of its members' economies has resulted so far in wide adoption at the national level.[87] An analogy can be drawn here to the medieval merchant law, which relied for its enforcement on its reputation effect.[88]

The main weaknesses of Basel-like agreements relate to implementation divergence and democratic legitimacy. Divergence and unpredictability in the implementation of the financial standards, inherent in international 'soft law', reduce legal certainty and undermine the effectiveness of the standards.[89] Democratic legitimacy is weak due to the absence of the safeguards of international treaty making. It is missing the strong legitimacy effect of the sovereigns' consent, as developed through the constitutional process of synthesizing the interests of the various national constituencies and of the subsequent crystallizing of the state will. In addition, participation and a prevalent role are reserved only for the most important financial jurisdictions, and non-transparent processes[90] are the main mode of operation.[91]

Evaluation of the regulatory activity of the government networks has to consider the current *'transgovernmentalism'* discourse, which is concerned with the operation of government entities' networks. Anne-Marie Slaughter, dismissing calls of liberal internationalism for international rules and institutions as the remedy for states' problems, and claims of medievalism about the diminishing role of the state, talks about *transgovernmentalism* as the 'most widespread and effective mode of international

[87] For the binding effect of the members' reputation, see Heath Price Tarbert, 'Comment: Are International Capital Adequacy Rules Adequate? The Basle Accord and Beyond', 148 *University of Pennsylvania Law Review* 1771, 1788 (2000). See also David Zaring, above note 82, at 287, for the importance of the links of the IFROs to 'international, regional, and national financial regulators.'

[88] '[T]he system works by making the reputation system of enforcement work better.' Paul R. Milgrom, Douglass C North & Barry R Weingast, 'The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs', 2 *Economics and Politics* 1, 19 (1990), quoted in Joel P Trachtman, 'The Theory of the Firm and the Theory of the International Economic Organization: Toward Comparative Institutional Analysis', 17 *Northwestern Journal of International Law & Business* 470, 528 (1996–1997).

[89] For the issues as to implementation of international 'soft' law financial standards, see Mario Giovanoli, above note 24, at para. 1.64. See also Ross Cranston, above note 21; Duncan E Alford, above note 25.

[90] See David Zaring, above note 82, at 288, quoting Huib J Muller (former chairman of the Basel Committee): 'We don't like publicity. We prefer, I might say, our hidden secret world of the supervisory continent' (citing Huib J Muller, Address to the 5th International Conference of Bank Supervisors (May 16, 1998)).

[91] International treaty making is not free of similar weaknesses. As Professor Howse submits, consent in the WTO has often been the outcome of a threat of unilateral action, mainly from the US. The deal on agriculture during the Uruguay round was the result of negotiations between the US and the EU. Secrecy and 'package deals' are not missing from the negotiation process. Robert Howse, above note 7, at 360.

governance'.[92] 'Transgovernmentalism' is presented as a more efficient and accountable alternative of international cooperation and norm making. Slaughter argues that networks of national regulators are more accountable than a 'supranational bureaucracy', as their members, as national regulators, remain anchored to the national order and their norm making activity concerns mainly enforcement of national rules. In addition, they promote democratization through their support to national regulators who operate in non-democratic regimes. They are also more efficient as they avoid the rigidities of international institutions and are not confronted with reaction by forces opposing internationalization. Possible accountability problems, it is claimed, will be cured, as the national legislative process becomes more aware of the role of the networks and, hence, intensifies its control over their activity.

Arguably, international norm making through cooperation of sub-state actors is an efficient alternative to internationalization, and accountability costs from their activity could be justified by the increased efficiency output.[93] However, it is difficult to accept the accountability benefits of this process, especially in the field of banking regulation and supervision. National banking authorities are already absent from the political debate due to the technical, complex and time-sensitive character of their subject matter. They become even less visible for the domestic political process by producing norms at the international level through their cooperation with other national authorities. It is exactly this reduced visibility which allows them to appear as a more efficient alternative. This also shows the oxymoron of the argument that transgovernmentalism, favoured for its efficiency, will also be accountable once the awareness of and the control by, the legislature intensify. Further, it is not true that their norm making activity is primarily related to enforcement of national regulation. The Basel Committee has been extensively engaged in the development of prudential standards and principles of supervision. It is actually a pioneer in banking supervision, very recently setting the tone for internal risk management, effective supervision and market discipline as the model for banking supervision. Finally, its composition from banking authorities of the G–10 countries cannot be ignored when accountability is the issue.

Applying this to the proposal for an international prudential supervisor, it appears that building the new structure on a more solid legal footing is a more convincing alternative. Most of the arguments favouring development of financial standards through 'soft law' would not apply to a new

[92] Anne-Marie Slaughter, 'The Real New World Order', 76 *Foreign Affairs* 183 (1997).
[93] See Von Fritz W Sharpf, *Economic Integration, Democracy and the Welfare State* (MPIfG Working Paper 96/2, July 1996), <http://www.mpi-fg-koeln.mpg.de/pu/workpap/wp96–2/wp96–2.html>, for the trade-off between the input and the output side of the democratic process. The input side refers to the accountability of the decision-making, while the output side refers to the efficiency outcome of the decisions.

international institution with a supervision mandate. Consensus will not be any more difficult to develop once the benefits of more free and sound banking are demonstrated. Rigidities of international treaty making will not be an issue, as the relevant cumbersome processes will be involved mainly at the stage of creation of the new international institution. An international prudential supervisor should be expected to function efficiently without the need for frequent amendments of its charter. This should be possible by prescribing a clear supervision mandate with adequate discretionary powers and controlled through strong accountability mechanisms. Such accountability mechanisms could be a strong role for the political system and judicial review of the supervisor's acts. The role of the political system can be performed either by the political arms of the IMF, the World Bank or the GATS, or by a political counterpart of the international supervisor within the same institution. In any case, accountability would be stronger than if the IMF, for example, were to act as a LOLR without clearly defined criteria on the basis of its monetary stability mandate.[94]

Moreover, the arguments of implementation and democratic legitimacy against informal rule making seem to be accentuated in the case of an international prudential supervisor. It is difficult to see how an international supervisor supported by a network of government authorities could itself exercise bank supervision effectively. It is true that the IMF and World Bank mechanisms of conditionality and surveillance as well as the coordination efforts of the Financial Stability Forum can significantly help with inadequate or divergent implementation of financial standards. But how could they provide, for example, for authorization or sanctioning of certain multinational and systemically important, banks by the international supervisor? Possibly, the respective national authorities could prescribe rules under which internationally active and systemically important banks that are established in their jurisdiction would be subject to an international supervisor with respect to supervision of their international activities. But again, this is unlikely to avoid divergence in implementation or ensure effectiveness in its application. For example, it is likely that not all of the relevant regulators would agree as to the scope of subjecting the respective banking group entities to an international supervisor. Finally, the accountability concerns will be formidable. It will be problematic to subject domestic financial institutions to the authority of an international institution whose function is underpinned by a 'gentlemen's agreement' developed in a regulators' network. In any case, it will not address the issue of the true responsibility and liability of the international supervisory institution, which, as the *Three Rivers* case has shown, is fundamental not only for accountability purposes but also for the protection of depositors and for financial stability.

[94] See below note 95.

2.3.3.2 International Organizations – Other The prudential supervisor could be a totally new international institution or could be built within the structure of one or more of the existing institutions. In the latter case, the IMF and the Bank for International Settlements (BIS) appear as sensible choices.

The IMF's mandate for monetary and macroeconomic stability[95] could encompass prudential institution building for international banking. This actually means that the IMF could operate as international supervisor on the basis of its current mandate without the need for extra political consensus. Lending of last resort could also be undertaken on the same grounds due to its preventing systemic risk.

On the other hand, the BIS has a comparative advantage, because being the bank for central banks it is at the heart of the central banking system.[96] The BIS enjoys a strong institutional relationship with most of the existing networks of central banks and supervision authorities by providing them with a permanent secretariat. In addition, most of the international standards have come to be associated with its broader institutional machinery.

[95] Article I(i) of the IMF Articles provides that among the purposes of the IMF is 'to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems'. Further, article IV, section (3)(a) provides that: 'The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article'. Articles of Agreement of the International Monetary Fund, December 27, 1945, 60 Stat. 1401, 2 UNTS 39, also available at <http://www.imf.org/external/pubs/ft/aa/index.htm>. The question is where we should draw the line between international monetary issues and issues of financial stability. Sir Joseph Gold stated that it is difficult to determine what is meant by the IMF's responsibility for oversight of the international monetary system due to difficulties with the concept of the international monetary system. Joseph Gold, above note 85, at xxix n. 3. The IMF has already endorsed the position that the objective of banking soundness falls within its mandate. Thus, bank regulation and supervision are now subject to the Fund's conditionality and surveillance process, while conditionality has to be consistent with the Fund's mandate. The reference by François Gianviti, the current IMF General Counsel, to the title of the 1999 Managing Director's report to the Interim Committee is also interesting. He notes that while the final title read 'Progress on Strengthening the Architecture of the *International Monetary System*' the original title was 'Progress in Strengthening the Architecture of the *International Financial System*'. He further submits that, although the former is more consistent with the Fund's objectives, the latter reflected more accurately the subject matter of the report. François Gianviti, 'The Reform of the International Monetary Fund (Conditionality and Surveillance)', in *International Financial Architecture: A Viable Approach* 71, 72 (John B Attanasio & Joseph J Norton eds., 2001). Still, this does not say much as to whether the Fund's jurisdiction may include specific bank supervision powers. In his discussion of the IMF's financial jurisdiction, Sir Joseph Gold addresses nicely the complexity of 'casuality'. He makes an interesting reference to Francis Bacon and his 'dictum' that 'the causes of causes are infinite and their impulsion one of another'. Joseph Gold, above note 85, at 500. In Chapter IV (Section 2.3), I argue that monetary stability is interdependent with banking soundness and that monetary stability competence does include bank supervision functions. It remains to explore how this translates in the context of the Fund's responsibility for international monetary cooperation and oversight of the international monetary system.

[96] See <http://www.bis.org>; Bank for International Settlements, *BIS History*, <http://www.bis.org/about/history.htm> (last visited April 23, 2002).

This could provide a solid and subject-related regulatory culture and consensus for an efficient building of the international prudential supervisor. The international prudential supervisor could be developed by transforming one of the Basel networks into a new international organization or into a similar structure within the BIS. For example, the Financial Stability Forum (FSF) could be this new international organization or could evolve into an arm of the BIS. It is already concerned with international financial stability and contributes to international cooperation in prudential norm making and implementation. It operates a Task Force to strengthen implementation of standards, and provides a forum for regulatory and supervisory authorities, national and international, international financial institutions and committees of central bank experts, like the Committee on the Global Financial System (CGFS)[97] and the Committee on Payment and Settlement Systems (CPSS).[98] Its functions can be expanded to cover authorization and monitoring of international and systemically important banks as well as LOLR operations. The existing connection of the FSF to all the relevant international financial institutions and regulators' networks will add to the regulatory culture of the new structure and contribute to efficient structuring of its supervision activity, the effective coordination of the interested parties and the credibility of its role.

Lending of last resort could be operated autonomously. The IMF could extend its activities only to international LOLR, leaving prudential supervision to a new institution. The Federal Reserve System with its capacity to shape world monetary conditions and its importance for the capital markets could assume a leading role in respect of international financial stability.[99] And again, the BIS could undertake LOLR functions. The autonomous operation of a LOLR could proceed without the international supervisor being in place. In that case, a moral hazard problem should be acknowledged due to the possible effect on the rigorousness of national supervision.

[97] Like the Basel Committee and the CPSS, the CGFS, successor of the Eurocurrency Standing Committee, is a forum of the G–10 countries and has its secretariat at the BIS. It is concerned with the functioning and evolution of the financial markets and systems, and the implications for the central banks' monetary and financial stability policies and their impact on financial markets <http://www.bis.org/cgfs/index.htm>.

[98] For the CPSS, see Chapter II, Section 3.1.3, note 286.

[99] For the advantages in entrusting the Federal Reserve Board, instead of the IMF, with international LOLR responsibilities due to, inter alia, its ability to create international reserves and money, see Robert Keleher, *An International Lender of Last Resort, the IMF, and the Federal Reserve, A Joint Economic Committee Report of the US Congress* 10 (February 1999) <http://www.house.gov/jec/imf/lolr.pdf>. It should be noted that this comment discusses LOLR in reference to liquidity support to governments for dealing with macroeconomic disturbances in general. In contrast, my analysis addresses the issue of liquidity support to illiquid, but solvent, internationally active and system-important banks.

3 CONCLUSIONS

The GATS financial services regime should be reformed, if its objective for free trade in financial services is to be attained. The analysis here has focused on the problems related to the need for special regulation of banks and subsequent justifications for trade-restrictive domestic regulation. The prudential carve-out, even if further developed, or the Basel standards, even if incorporated in the GATS process, cannot ensure certainty for either more or sound international banking. The DSP would retain wide discretion in determining the optimum mix of trade and regulation objectives, and this has efficiency and accountability risks.

Strengthening the institutional links between the WTO and the international financial organizations will facilitate the interface of trade and banking regulation. Further institution building may ultimately be necessary for financial services liberalization to proceed on a sustainable basis. This could take place through the formal, international treaty making, process or through the informal cooperation process of specialized state agencies. Whatever the preferred process, the EU integration model and its mechanisms for banking regulation and supervision could inform it. This is attempted in Chapter IV which follows, in which deficiencies of the EU 'decentralized' prudential supervision model and the reaction of its institutional machinery are examined.

IV

EC Internal Banking Market and Prudential Supervision

THE INTRODUCTION OF the single European currency and the single monetary policy intensify the development of an integrated European banking system. Common low interest rates, denominations in a single currency, and further deregulation should contribute to pan-European banking activities, increased interbank links, competition and further integration of the capital markets. The 'peoples'[1] of Europe should enjoy efficiency gains due to portfolio diversification opportunities,[2] enhanced market liquidity and stable prices. Increased banking activity at the European level, however, also poses challenges for the regulators, since financial stability risks will no longer be confined at the national level.[3]

So far, minimum standards and cooperation frameworks constitute the 'prudential' institutional foundation of the EC internal banking market. Prudential supervision by the home country authorities, supported by essential harmonization of banking regulation and mutual recognition, provides the basis for both the reduction of national barriers to financial services and the supervision of cross-border banking activity. There is no centralized prudential mechanism at the Community level.[4] The European

[1] See Joseph HH Weiler, 'European models: Polity, people and system', *Lawmaking in the European Union* 3, 7 (Paul Craig & Carol Harlow eds., 1998), for 'peoples' in pursuit of further integration instead of a people or a nation.
[2] '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 (Charles AE Goodhart ed., 2000).
[3] *Ibid.* at 44.
[4] It could be said 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 prudential supervision and its LOLR responsibility, as argued below, constitute elements of *macro-prudential* supervision competence. See European Central Bank, *The Role of Central Banks in Prudential Supervision* (March 2001), <http://www.ecb.int/pub/pdf/prudentialsupcbrole_en.pdf> [hereinafter ECB, *Role of Central Banks in Prudential Supervision*], for the distinction between micro- and macro-prudential supervision: '[*M*]*icro-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

System of Central Banks (ESCB),[5] and more precisely the European Central Bank (ECB),[6] is responsible for the single monetary policy[7] and the smooth functioning of the banking system,[8] but it does not have express *de jure* supervision powers. The ECB has oversight and regulatory power over the payment systems[9] and an advisory and coordinating role regarding prudential supervision,[10] while it is uncertain whether it enjoys Lender of Last

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.' For our understanding of macro-prudential supervision, see Chapter I, Section 1.3.

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[5] The ESCB is composed of the ECB and the national central banks. EC Treaty art. 107(1) (ex art. 106(1)), article 1(1) of the Statute of the ESCB, for the references to the EC Treaty and the ESCB Statute, see below note 15. The ESCB lacks legal personality and 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 Zilioli & Martin Selmayr, '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 (November 27, 1990) [hereinafter *Draft ESCB Statute, Introductory Report*]; Committee of Governors of the Central Banks of the Member States of the European Economic Community, *Draft Statute of the European System of Central Banks and of the European Central Bank (Commentary*), 1 (November 27, 1990) [hereinafter *Draft ESCB Statute, Commentary*]. See Chiara Zilioli & Martin Selmayr, above, at 194, for a comprehensive review of the two-level organizational 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.

[6] It is the ECB (EC Treaty arts. 8 (ex art. 4a), 123 (ex art. 109l)), 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. 45). See Chiara Zilioli & Martin Selmayr, 'The External Relations of the Euro Area: Legal Aspects', 36 *Common Market Law Review* 273, 284 (1999) [hereinafter Chiara Zilioli & Martin Selmayr, 'The External Relations of the Euro Area'], for the accurate interpretation of article 107(2) (ex article 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 organization of Community law, see Chiara Zilioli & Martin Selmayr, 'The European Central Bank: An Independent Specialized Organization of Community Law', 37 *Common Market Law Review* 591, 621 (2000) [hereinafter Chiara Zilioli & Martin Selmayr, 'The European Central Bank']. 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 be, and has been, further delegated to the national central banks in their capacity as integral parts of the ESCB. See *Draft ESCB Statute, Commentary*, above note 5, at 7, for the debate on the ECB's role in the day-to-day monetary management, where all the Community central banks, except the Deutsche Bundesbank (Bundesbank), had proposed that the necessary powers be delegated by the Council to the Executive Board.

[7] '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).

[8] EC Treaty art. 105(5), ESCB Statute art. 3(3)).

[9] EC Treaty art. 105(2), ESCB Statute arts. 3(1), 22.

[10] EC Treaty art. 105(4)–(5), ESCB Statute arts. 3(3), 4, 25.

Resort (LOLR) status even under conditions of 'constructive ambiguity'.[11] The Council may also confer upon the ECB additional prudential supervision powers through the activation of the so-called 'enabling clause'.[12]

In this chapter, I argue that the home country control model may not be the most efficient solution either for the realization of the EC internal banking market or for the safety and soundness of a 'Europeanized'[13] banking system. Host country rules, even when non-discriminatory, have proved to be barriers to Community-wide financial services trade. Arguably, 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. The 'general good' exception provides further justifications for host country regulation. The problem becomes more complex due to the reliance of the allocation of powers mechanism on the indeterminate 'prudential' concept.[14] Besides the internal market concerns, the home country control model may not be adequate for financial stability in the context of a further Europeanized banking market. The current banking supervision framework does not address Lender of Last Resort issues for pan-European banks and cooperation may not ensure the necessary real-time information sharing and real-time action.

It is submitted here that the existing institutional framework is adequate to deal with prudential concerns arising from the integration of the European banking systems. The adoption of minimum rules through harmonization and the home country control principle combined with cooperation arrangements, together 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. However, the success of the current system in the context of a further Europeanization of the banking systems depends on the development of a centralized prudential mechanism at the Community level.

I argue that under the EC Treaty[15] centralization of certain macro-prudential functions is possible at the ECB level, even without activating the

[11] See Tommaso Padoa-Schioppa, 'EMU and Banking Supervision', Lecture at the London School of Economics, Financial Markets Group, London (February 24, 1999), at para. 29. <http://www.ecb.int/key/sp990224.htm>. For the concept of 'constructive ambiguity', see EG Corrigan, 'Statement Before US Senate Committee on Banking, Housing and Urban Affairs' (1990); Gary Hufbauer & Erika Wada, 'Can Financiers Learn from Traders', 2 n. 4 *Journal of International Economic Law* 567, 592 (1999).

[12] EC Treaty art. 105(6). See also ESCB Statute art. 25(2).

[13] I use the term 'Europeanized' and 'Europeanization' to denote the evolutionary process toward a pan-European banking system.

[14] See Chapter I, Section 1, for the 'prudential' concept and problems with its use in the legal texts of the EU and the GATS (General Agreement on Trade in Services).

[15] The term EC Treaty is used here for reference to the EEC Treaty (Treaty Establishing the European Economic Community [EEC Treaty], 1957, 298 UNTS 3) as amended. See Chapter II, note 51, for these reference issues. Being an integral part of the Treaty, the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute) applies

'enabling clause'. The Treaty does not attempt to delineate the reach of the ECB's monetary policy competence and the language concerning prudential supervision competences is rather 'soft': monetary policy is not defined, and only its primary, macroeconomic, objective of price stability is mandated.[16] Thus, my argument goes, the Treaty can be interpreted to provide for the dynamic form of monetary policy, 'the applied monetary policy', which would cover banking stability considerations. In addition, the Treaty language is vague and does not itself preclude expansion of ECB's supervision powers: '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*' (emphasis added).[17] My analysis will use foreign exchange policy as an example of how applied monetary policy and the 'softness' of the Treaty language allow expansion of ECB's competences. It applies this further to LOLR functions.

The analysis of banking supervision in the EU is undertaken in order to identify the limits of a decentralized supervisory framework as the foundation for a sustainable liberalization of trade in financial services. Even in the EU, with the 'integrated' operation of legislative mechanisms for the reduction of trade barriers and development of prudential standards,[18] the existence of advanced cooperation arrangements, and the certainty of a monetary union and a coordinated macroeconomic environment, centralization of prudential institutions appears necessary for a complete and safe internal banking market. Otherwise, there is considerable room for trade-restrictive domestic measures, and in any case there are weaknesses in maintaining the stability of the integrated banking systems.

Admittedly, liberalization of financial services trade in the General Agreement on Trade in Services (GATS)[19] does not contemplate a global banking market. However, its less intense liberalization scheme is ridden with uncertainty as to both the mandated reduction of trade barriers and the

as primary Community law. EC Treaty art. 8 (ex art. 4a), art. 311 (ex art. 239). Treaty on European Union – Protocol (No. 18) (ex No. 3) on the statute of the European system of central banks and of the European Central Bank, 1992 OJ (C 191) 68, also available at <http://www.ecb.int>.

[16] EC Treaty arts. 4(2) (ex art. 3a), 105(1), ESCB Statute art. 2.

[17] EC Treaty art. 105(5), ESCB Statute art. 3(3).

[18] I talk about 'integrated' operation of the EU legislative mechanisms to contrast them with the GATS machinery. As shown in Chapters II and III, the GATS only establishes trade disciplines and leaves prudential issues to be decided by the Members, or ultimately by the dispute settlement process. Effectively, the development of prudential standards through a separate international norm making process, for example that of the Basel Committee, can be taken into account. This is different from the integrated EU framework, where development of trade disciplines is premised on, and interacts with, the establishment of prudential arrangements through Community law.

[19] General Agreement on Trade in Services and Annexes, Agreement Establishing the World Trade Organization, Marrakesh, April 15, 1994, 33 ILM 1144 (1994), Annex 1B [hereinafter GATS].

adequacy of prudential arrangements. This is because the system has to rely on a continuous trade-off between trade and regulatory benefits, using the undefined concept of 'prudential' as a criterion for affordable deregulation. The absence of centralized prudential mechanisms enhances uncertainty, as domestic regulation may prove inadequate, irrespective of its quality and stringency.

This chapter explores fundamental variables for the operation of a centralized supervision mechanism in the context of a coordinated macroeconomic environment. These variables are price stability and representation. Price stability pursued by a single monetary institution, the ECB, allows centralization of banking supervision powers through the same institution due to the interdependence of monetary management and bank supervision. Representation ensures that the centralization process takes place for the benefit of the people's welfare and that legitimacy flaws do not undermine the sustainability of the system. The ultimate objective of the analysis is that these variables further inform international institution building.

The discussion of these issues is organized in the following way. Section 1 sets out the decentralization model for bank supervision in the EU, and offers internal market and financial stability arguments for its reform. Section 2 argues for the interdependence of monetary policy and bank supervision, and the implications for centralization of bank supervision at the EU level. It further applies this argumentation to foreign exchange policy. The importance of LOLR arrangements and their centralization as part of applied monetary policy are examined in Section 3. I discuss issues of accountability regarding centralization of banking supervision in both Sections 2 and 3. Section 4 presents some lessons for regional integration.

1 BANKING SUPERVISION: THE DECENTRALIZATION MODEL

1.1 Decentralization

Essential harmonization, mutual recognition, the home country control principle and consolidated supervision[20] are the foundations for the EC internal banking market.[21] Credit institutions[22] authorized in a Member

[20] 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 (North American Free Trade Agreement) liberalization models, see Joel P Trachtman, 'Trade In Financial Services under GATS, NAFTA, and the EC: A Regulatory Jurisdiction Analysis', 34 *Columbia Journal of Transnational Law* 37 (1995).

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

[22] The EU Directives use the term 'credit institution' for commercial banks and define it as an

State can establish branches[23] (or provide cross-border services) in another Member State subject only to home country prudential supervision.[24, 25] Host Member States can (and should) rely on minimum prudential regulation adopted by the home authorities after harmonization,[26] and can (and

'undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account'. The terms 'credit institution' and 'bank' are used interchangeably in this book to denote commercial banking. Banking Consolidation Directive art. 1(1) (ex First Banking Directive art. 1, 2BD arts. 1(1), 2(2)). First Council Directive 77/780 of 12 December 1977 on the coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive, 1977 OJ (L 322) 30 [hereinafter First Banking Directive]. Second Council Directive 89/646 of 15 December 1989 on the coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780, 1989 OJ (L 386) 1, as amended by Council Directives 92/30/EC, 1992 OJ (L 110) 52 and 95/26/EC, 1995 OJ (L 168) 7 [hereinafter 2BD]. For the purpose of clarity, the First Banking Directive and the Second Banking Directive, as subsequently amended, have now been codified and combined (along with the 73/183 Directive, the Own Funds Directive, the Solvency Ratio Directive, the Large Exposures Directive and the Consolidated Supervision Directive) in a single Directive: EP and Council Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, 2000 OJ (L 126) 1, as amended by EP and Council Directive 2000/28/EC, 2000 OJ (L 275) 37 [hereinafter Banking Consolidation Directive] (the Commission proposal for a Directive establishing a new financial services committees' structure calls the 2000/12 Directive the 'Codified Banking Directive'). References here will be to the Banking Consolidation Directive, with the respective provisions in the Second Banking Directive indicated in parentheses.

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[23] Subsidiaries have to be authorized and supervised by the host competent authority.

[24] Banking Consolidation Directive Preamble 14th whereas clause, art. 18, Annex I (ex 2BD art. 18(1), 2BD Annex 'List of Activities Subject to Mutual Recognition').

[25] Banking Consolidation 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. Banking Consolidation Directive Preamble 22nd whereas clause, arts. 27, 22 (ex 2BD Preamble 10th whereas clause, 2BD arts. 14(2), (21). See Chapter II, Section 2.1.2.

[26] The Second Banking Directive itself provided for minimum requirements regarding the prudential regulation and supervision of banks. Banking Consolidation Directive arts. 5(1), 7, 16, 51, 17 (ex 2BD arts. 4(1), 5, 11, 12, 13). Further harmonization of prudential regulation and supervision has been effected through Directives establishing minimum standards: The Solvency Ratio Directive, the Own Funds Directive, the Large Exposures Directive, the Capital Adequacy Directive, the Deposit-Guarantee Directive, the Post-BCCI Directive and the Consolidated Supervision Directive provided prudential safeguards in respect of the principle of home country supervision. The *Solvency Ratio Directive* established minimum requirements for 'own funds' in relation to asset and off-balance sheet items so that both prudential implications of credit risk and competition distortions from divergent capital requirements were addressed. The *Own Funds Directive* provided a definition of 'own funds' for the purpose of implementation of Community prudential standards by the Member States. The *Large Exposures Directive* dealt with solvency risk by placing limits on credit exposures to a single client or a group of 'connected' clients and requiring that credit institutions had the capacity to identify and record large exposures. The *Capital Adequacy Directive* established capital requirements for both credit institutions and investment firms as a cushion against market risk, position risk, counterparty/settlement risk and foreign-exchange risk and expanded consolidated supervision requirements to include groups that comprise only investment firms. Following the adoption of the new Basel Capital Accord (Basel II), the EU Commission proposed changes to its capital adequacy requirements through amendments to existing Directives, mainly the Banking Consolidation Directive and the Capital

should) rely on home authorities' prudential supervision. Further, the national supervisory authorities are expected to cooperate with each other through exchanging information and providing enforcement assistance.[27]

There is no provision, however, for a centralized banking supervisory institution at the Community level. The national central banks (NCBs), or other national authority entities in cases of separation of monetary policy and bank supervision, remain responsible for bank supervision. This also applies to the Eurosystem,[28] where only monetary policy is to be carried

Adequacy Directive (the EU's legislative proposal is widely known as Capital Adequacy Directive 3 (CAD 3) or the Capital Requirements Directive). The *Deposit-Guarantee Directive* provided for minimum deposit insurance for which responsibility lay with the home country regulator. The *Post-BCCI Directive* dealt with supervision issues relating to international banking groups and set outs rules for the exchange of information between supervisors. The *Consolidated Supervision Directive* provided for 'consolidated supervision' of credit institutions. In addition, the Directive on the Reorganization and Compulsory Winding Up of Credit Institutions deals with the bankruptcy or reorganization of a credit institution with cross-border banking activity and subjects credit institutions to the insolvency proceedings and the law of the home Member State. Council Directive 89/299 of 17 April 1989 on the own funds of credit institutions, 1989 OJ (L 124) 16 [hereinafter Own Funds Directive]; Council Directive 89/647 of 18 December 1989 on a solvency ratio for credit institutions, 1989 OJ (L 386) 14, as amended by EP and Council Directives 98/32/EC, 1998 OJ (L 204) 26 and 98/33/EC, 1998 OJ (L 204) 29 [hereinafter Solvency Ratio Directive]; Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis, 1992 OJ (L 110) 52 [hereinafter Consolidated Supervision Directive]; Council Directive 92/121 of 21 December 1992 on the monitoring and control of large exposures of credit institutions, 1992 OJ (L 29) 1 [hereinafter Large Exposures Directive]; Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, 1993 OJ (L 141) 1, as amended by EP and Council Directives 98/31/EC, 1998 OJ (L 204) 13 and 98/33/EC, 1998 OJ (L 204) 29 [hereinafter Capital Adequacy Directive]; Council Directive 94/19/EC of 30 May 1994 on deposit-guarantee schemes, 1994 OJ (L 135) 5 [hereinafter Deposit-Guarantee Directive]; EP and Council Directive 95/26 of 29 June 1995, amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non-life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities (UCITS), with a view to reinforcing prudential supervision, 1995 OJ (L 168) 7 [hereinafter Post-BCCI Directive]. EP and Council Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, 2001 OJ (L 125) 15. The Consolidated Supervision Directive repealed the Council Directive 83/350/EEC of 13 June 1983 on the supervision of credit institutions on a consolidated basis, 1983 OJ (L 193) 18. The Own Funds Directive, the Solvency Ratio Directive, the Large Exposures Directive and the Consolidated Supervision Directive have been incorporated into the Banking Consolidation Directive.

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[27] Banking Consolidation Directive Preamble 23rd, 24th whereas clauses, arts. 12, 29, 20–22, 28, 66th whereas clause, art. 56(4) (ex 2BD Preamble 21st, 22nd whereas clauses, arts. 7, 15 19–21, First Banking Directive art. 7, 15th whereas clause, Consolidated Supervision Directive art. 7(4)), Capital Adequacy Directive art. 9(4).

[28] See European Central Bank, 'The Eurosystem and the European System of Central Banks', *ECB Monthly Bulletin*, January 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. I should note that I 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, below note 49, at 352, 359; René Smits, below note 32, at 46.

on by the ESCB while bank supervision is still a national competence. When national central banks of Eurosystem countries are in charge of bank supervision they carry out their relevant responsibilities as autonomous entities organized under national law and not as sub-divisions of the ESCB system, the latter being the case in the context of monetary policy.

1.2 Cooperation

Cooperation, bilateral or through various Community committees,[29] is an important instrument for dealing with financial stability risks from Europeanization of the banking systems. The national authorities, the 'competent authorities',[30] are expected to cooperate in the execution of their supervision tasks and exchange information regarding the management and ownership of banks, their authorization and their liquidity and solvency.[31] Bilateral cooperation has mostly taken the form of Memoranda of Understanding (MOU), which provide for detailed provisions on information sharing and supervision coordination.[32] Cooperation at the Community level takes place in the context of the Banking Supervision Committee, the Banking Advisory Committee, as recently replaced by the European Banking Committee, and the Groupe de Contact (or Contact Group).[33] These fora

[29] For the stand-alone, bilateral and multilateral mode of supervision in the EMU context, see Tommaso Padoa-Schioppa, above note 11, at para. 18. For the importance of the multilateral mode of cooperation, see Interview: Tommaso Padoa-Schioppa, 4 n. 1 *The Financial Regulator* 51, 51 (1999).
[30] 'Competent authorities shall mean the national authorities which are empowered by law or regulation to supervise credit institutions.' Banking Consolidation Directive art. 1(4) (ex 2BD art. 1(5), Consolidated Supervision Directive art. 1). The Capital Adequacy Directive requires that the competent authorities be 'public authorities or bodies officially recognized by national law or by public authorities as part of the supervisory system in operation in the Member State concerned'. Article 9(2). See also article 22(2) of the Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, 1993 OJ (L 141) 27 [hereinafter Investment Services Directive].
[31] See above note 27.
[32] For the extensive use of MOUs after the enactment of the Second Banking Directive, see Tommaso Padoa-Schioppa, above note 11, at para. 18. For the potential inconsistency of bilateral MOUs with the objective of an EU-wide 'level playing field' based on common supervisory 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 which can be justified by moral hazard and liability considerations but also entails transparency concerns.
[33] See below Section 1.4.1, for the new financial services committees' structure, including the European Banking Committee and the Committee of European Banking Supervisors.

have only an advisory and coordinating role, and no formal[34] rule making or supervisory power.[35]

The Banking Supervision Committee (BSC) is part of the structure of the ESCB (since 1998)[36] and its members are the ECB, the national central banks and other national supervisory authorities (when separate from the national central banks).[37] The BSC contributes to the ESCB's rule making and supervision functions and facilitates consultations among the EU banking supervisors on issues 'outside' the supervisory jurisdiction of the ECB.[38]

The Banking Advisory Committee (BAC), recently replaced by the European Banking Committee, was established by the First Banking Directive[39] (which is now codified in the Banking Consolidation Directive)[40] to 'assist the Commission in the preparation of new proposals to the Council concerning further co-ordination in the sphere of credit institutions'.[41] The BAC is not part of the ECB[42] and comprises representatives of the Commission, supervisory authorities and Ministries of Finance. The BAC advises the Commission with respect to prudential regulation and assists in the implementation as well as the technical adaptation of the EU Banking Directives.[43] The BAC may effect changes in technical provisions by assisting the Commission in accordance with the so-called 'comitology' procedure.[44] It also examines issues arising from the application of host

[34] I say, formal, because I 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 to the Banking Directives in accordance with the 'comitology' procedure.

[35] It should be noted that, before the European Banking Committee replacing the Banking Advisory Committee, the national supervisory authorities and the Commission were 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 (Banking Consolidation Directive arts. 4, 22(9)–(10), 23(1), 24(2), 49, 52(9). There remain requirements to report to the European Banking Committee issues relating to third country jurisdictions. See article 3 of the Directive on new financial services committees (below note 84).

[36] The BSC was 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' of the European Monetary Institute.

[37] The Commission and the Groupe de Contact can also participate as observers.

[38] See René Smits, 'Banking Supervision in the Monetary Union', 1 n. 2 *Journal of International Banking Regulation* 122, 126 (1999), for a discussion of the advisory role of the Banking Supervision Committee. See also Michel Aglietta, above note 2, at 53 (arguing against the ability of the Banking Supervision Committee to deal with liquidity crises).

[39] 'Advisory Committee of the Competent Authorities of the Member States of the European Economic Community'. First Banking Directive art. 11.

[40] See above note 22.

[41] First Banking Directive art. 11(2).

[42] The ECB may participate in BAC's meetings as observer.

[43] Banking Consolidation Directive Preamble 67th whereas clause, arts. 2(4)–(5), 57–59, 60.

[44] Banking Consolidation Directive Preamble 67th whereas clause, art. 60(2). The Committee established by the Second Banking Directive (now codified in the Banking Consolidation Directive) to effect such changes is 'legally and technically' a different institution from the BAC but its composition is the same (the only difference is that the Commission, and not a Member State representative, chairs, BAC when the BAC is acting in this regulatory capacity).

country rules in the 'general good' interest as well as bank supervision issues in relation to third countries. It should be noted that, although the Committee is concerned with macro-prudential developments, it cannot deal with '*concrete* problems relating to *individual* credit institutions' (emphasis added).[45] Nevertheless, its agenda can cover individual institutions to the extent crises in individual institutions may have an impact on financial stability.[46]

The Contact Group was established in 1972 as a policy forum for the discussion of supervisory issues and comprises 'mid-management' bank supervisors. It is interesting that the Contact Group is concerned more with micro-prudential supervision and individual institutions,[47] while the relevant discussions are confidential and without the presence of a Commission observer. Although solely an informal forum, the Contact Group has often provided the basis for banking supervision cooperation, and it is more within its structure that micro-prudential issues are addressed.[48]

1.3 European Central Bank (ECB)

Although the Maastricht Treaty did not adopt the proposals for prescribing prudential supervision as one of the basic tasks of the ESCB,[49] it still entrusted the ESCB with significant supervisory responsibilities. The ECB has an advisory and coordinating role regarding prudential supervision, which can be expanded through acts of the Council. The Eurosystem is

Directorate General/Internal Market, *The European Commission, Institutional Arrangements for the Regulation and Supervision of the Financial Sector* 7 (January 2000), <http://www.europa.eu.int/comm/internal_market/en/finances/general/index.htm> [hereinafter *Institutional Arrangements Report*].

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[45] Banking Consolidation Directive art. 57(3) (ex First Banking Directive art. 11(3)).

[46] For a comprehensive review of the structure and tasks of the Banking Advisory Committee, see *Institutional Arrangements Report*, above note 44.

[47] Banking Consolidation Directive Preamble 23rd whereas clause, art. 28.

[48] See *Institutional Arrangements Report*, above note 44, at 14. Banking Consolidation Directive Preamble 66th whereas clause (ex First Banking Directive 15th whereas clause).

[49] See Draft Statute of the European System of Central Banks and of the European Central Bank, No. 1669/1670 (December 8, 1990), *Agence Europe Documents* [hereinafter Draft ESCB Statute]. Article 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 article 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.' Article 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.' Article 25(2). See also *Draft ESCB Statute, Commentary*, above note 5, at 12. On the legislative history of the ESCB provisions, see René Smits, *The European Central Bank, Institutional Aspects* 334 (1997).

concerned with banking soundness and financial stability by contributing to the prudential supervision policies of the 'competent authorities'[50] of the Member States.[51] Also, the ECB may offer advice and be consulted on the 'scope' and 'implementation' of *Community* legislation relating to prudential supervision of banks and the stability of the financial system.[52] In addition, the ECB has an advisory competence with respect to *Community* and *national* legislation in its field of competence.[53] Macro-prudential concerns are within the ECB's competence and thus the ECB's advisory role should extend to the directly linked, micro-prudential issues of national legislation.[54]

A direct prudential supervisory task is also established for the purpose of maintaining the soundness of the payment systems.[55] Finally, the ECB can

[50] For the definition of 'competent authorities', see above note 30.

[51] '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(5), ESCB Statute art. 3(3). I agree with the wide interpretation of the ESCB's task under article 3(3), which does not confine it to an advisory role and extends it to a coordinating role. See René Smits, above note 49, at 339–43. See also René Smits, above note 32, at 45.

[52] '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(1). For a comprehensive interpretation of article 25(1), see René Smits, above note 49, at 345.

[53] EC Treaty art. 105(4), ESCB Statute art. 4(1). The ECB may also submit opinions to appropriate Community institutions or bodies, besides the Council or the Commission, as well as to other national authorities on matters in its field of competence. EC Treaty art. 105(4), second sentence, ESCB Statute art. 4(2). Thus, for example, the ECB may provide opinions to the European Court of Justice (ECJ) or to the European Banking Committee (which replaced the Banking Advisory Committee). See René Smits, above note 49, at 347.

[54] EC Treaty art. 105(4), ESCB Statute art. 4. An example of the ECB's exercise of relevant powers is the opinion which 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, article 3(1) of the ESCB Statute and article 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) (Finanzmarktaufsichtgesetz – FMAG), CON(2001)10, also available at <http://www.ecb.int> [hereinafter ECB Opinion – Austria Reform].

[55] The Treaty empowers the ECB to promote the smooth operation of the payment systems and to regulate for their efficient and sound operation. EC Treaty art. 105(2), ESCB Statute arts. 3(1), 22. See below Section 1.4.2.1, for the ECB's oversight and regulatory responsibilities over the payment systems.

undertake further direct prudential 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').[56]

1.4 Reform

The European single market, awaiting intensification of its integration after the advent of the Euro on January 1, 2002,[57] may prove not to have adequate institutional levers to deal with financial stability. According to various views the current decentralized supervisory framework is inadequate[58, 59] and supervision should be further centralized. Although certain of these views regard the existing supervision framework to be effective, there is concern about its capacity when Europeanization of the banking systems proceeds further. They propose further institutionalization of supervision coordination with more clear allocation of responsibilities[60] that should eventually be underpinned by a centralized body.[61]

[56] '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. 25(2).

[57] On January 1, 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 January 1 1999, the official book money for the participating countries.

[58] See Franco Bruni, *The System of European Central Banks and Prudential Regulation*, <http://www.ecsanet.org/conferences/1fbruni.htm> (last visited August 23, 2000), for an interesting analysis of the rationale of EU's opting for decentralization of prudential regulation and supervision. Bruni considers the decentralization model to be in 'dangerous' contrast with the more ambitious EMU objectives and attributes it to the lack of strong political institutions in the EU.

[59] The European Shadow Financial Regulatory Committee (ESFRC) believes that the existing framework is inadequate to handle potential risks: 'Within a European context, monetary union is 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'. European Shadow Financial Regulatory Committee, *EMU, The ECB and Financial Supervision, Statement No. 2* (October 19, 1998), <http://www.aei.org/shdw/shdw.htm> (last visited February 29 2000) [hereinafter *ESFRC: EMU, The ECB and Financial Supervision*]. See also Rosa Maria Lastra, 'Banking Regulation in the 1990s', 14 n. 2 *Journal of International Banking Law* 45 (1999).

[60] The ESFRC proposes as a first step a more institutionalized coordination of supervisory authorities by the European Central Bank. The ESFRC 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. *ESFRC: EMU, The ECB and Financial Supervision*, above note 59.

[61] For example, the operation of a sub-committee in the context of the Banking Supervision 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 of a European Liquidity Consortium

My response is that the Treaty establishes adequate prudential safeguards for a sound and stable integrated banking system and that no major reform, Treaty amendment or establishment of a new institution, is needed. In the current state of the internal market, establishment of a new institution would have only limited financial stability benefits, which would be outweighed by transaction costs of institutional designing and administration of the new institution. Benefits from enhanced certainty would be limited, as long as financial institutions retain their local (national) character by being incorporated and having their head office in a specific Member State and by carrying on limited cross-border activity. In this context, close monitoring by the national authorities on a consolidated basis ensures effective prudential supervision. This is further supported by the fact that the European financial market consists of developed financial systems with advanced regulatory structures and with a few fragile financial institutions. On the other hand, the integration benefits are very significant to the extent centralization of banking supervision will allow Europeanization of the banking systems to intensify. In that case, I argue, the Treaty allows 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 policy and bank supervision instruments, and the ambiguity of the Treaty language allow the ECB to undertake certain, macro-prudential, supervisory functions. I first discuss why the internal banking market objective calls for centralization of banking supervision and why the centralization is needed for the stability of a completed internal banking market. I then examine how the Treaty allows this to take place at the ECB level.

The merits of the interesting proposition for a centralized mechanism served by the Banking Supervision Committee are not addressed here. Such a development would also be helpful. The Banking Supervision Committee already coordinates European banking regulators and its composition of influential European regulators can lead to a 'Basel-type'[62] rule making power.[63]

is also proposed. Lorenzo Bini-Smaghi & Daniel Gros, *Open Issues in European Central Banking* 172 (2000).

[62] I use here the 'Basel-type' term to denote the nature of the rule making in the context of the Basel Committee. Although it lacks the status of an international organization (it is not established by treaty, its members are not states and its rules have no formal legal effect), the Basel Committee issues regulations which are effectively legally binding due to the influential role of its member banking regulators. See Chapter III, Section 2.3.3.1, for 'informal' norm making as compared with formal, international treaty making.

[63] See Dirk Schoenmaker, 'Banking Supervision and Lender-of-Last-Resort in EMU', in *European Economic and Monetary Union: The Institutional Framework* 421, 439 (Mads Andenas et al. eds., 1997).

1.4.1 Internal market

Centralization of the European supervisory framework will contribute to integration of the currently fragmented European banking systems[64] and will effectively deal with subsequent Euro-wide systemic stability risks.[65] The dominance of domestic financial institutions in a context of developed national financial systems does not entail significant Euro-wide systemic stability risks, which would necessitate centralization of prudential supervision responsibilities. Such a 'systemic stability'-led centralization will be necessary once Europeanization of the financial systems intensifies. At this stage, it is the reduction of trade barriers and the efficiency gains[66] from Europeanized financial markets that call for centralization.

Despite the establishment of the single banking licence[67] 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 banking market.[68] The Report on Financial Stability of the Economic and Financial Committee[69]

[64] Antonio Saínz de Vicuña, ECB's General Counsel, also expresses his personal view for a revision of the current supervisory framework towards centralization if the internal market is to develop. Antonio Saínz de Vicuña, 'The ECB and Its Role in Banking Supervision', 34 n. 1 *International Lawyer* 117, 122 (2000).

[65] It is interesting that fiscal inflexibility, envisaged by the EMU, creates an additional source fsystemic instability. Fiscal inflexibility prevents governments from inflating away government debt, which upon default can trigger a crisis in banks that hold bonds of this Member country. In this case, however, the centralization or not of the supervisory framework is not of relevance. It is submitted that a remedy could be a change of 'the risk characteristics of nations bonds . . . [accompanied by change in the prudential regulation of banks' exposure to such positions'. Karel Lannoo, *From 1992 to EMU: The Implications for Prudential Supervision* 8–9 (Centre for European Policy Studies, Research Report No. 23, May 1998).

[66] Efficiency gains are expected from more portfolio diversification opportunities, enhanced market liquidity, reduced costs and stable prices.

[67] For a comprehensive analysis, see Michael Gruson & Wolfgang Feuring, 'A European Community Banking Law: The Second Banking and Related Directives', *The Single Market and the Law of Banking* 25 (Ross Cranston ed., 1995).

[68] 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 Lannoo, *Financial Supervision in EMU* 59 (Centre for European Policy Studies, Brussels 1999): '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 or 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.'

[69] The Economic and Financial Committee (EFC), a successor of the Monetary Committee, advises the Council and the Commission in relation to economic and financial affairs. The EFC is very influential, as the Council without often much discussion relies on its opinions and documents. EC Treaty art. 114 (ex art. 109(c). For the EFC and its influential role, see Jean-Victor Louis, 'The Euro-group and Economic Policy Co-ordination', *The Euro in the National*

('Henk-Brouwer Report'), using four criteria – cross-border establishment, mergers and acquisitions, geographical distribution of earnings and interbank claims – to assess the degree of Europeanization, concluded that European banking activity remains primarily local:[70]

> 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 Europe top 50 of The Banker, based on total assets end 1998)] [while] [m]ore than half of this foreign income of EU banks is earned in countries outside the EU. . . . [I]n the fourth quarter of 1998 international claims from banks located in the EU, on banks located outside the EU, cover 7 per cent 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 per cent of the balance sheet total of the EU banking system – source: BIS Databank (block M), International Banking Statistics.[71]

Deficiencies of the decentralized banking supervision framework seem to impede realization of the EC internal banking market.[72] The Second Banking Directive, now the Banking Consolidation Directive,[73] does not provide for a European banking licence and covers cross-border banking only through branches and cross-border provision of services. Banks still

Context 351, 362 (Jean-Victor Louis ed., 2002). See Council Decision 98/743 of 21 December 1998 on the detailed provisions concerning the composition of the Economic and Financial Committee, 1998 OJ (L 358) 109; Council Decision 1999/8 of 31 December 1998 adopting the Statutes of the Economic and Financial Committee, 1999 OJ (L 5) 71.

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[70] It is also reported that international interbank claims from banks located in the EU on banks located in and outside the EU are becoming a serious source of contagion risk.

[71] EFC, *Report on financial stability*, above note 68. According to a Commission staff working paper (relying on an ECB source), the level of cross-border merger and acquisitions in the EU banking sector had remained low until 2000. This working paper states that this may be due to the fact that cross-border consolidation takes different forms. The European Commission, Commission Staff Working Paper, *Tracking EU financial integration 30* (SEC(2003) 628, May 26, 2003), <http://www.europa.eu.int/comm/internal_market/en/finances/cross-sector/reporting/tracking-financial-integration_en.pdf>.

[72] For other obstacles to the development of the internal banking market, see Georgios S Zavvos, 'EC Financial Markets: Regulation for Stability and Openness', in *Further Perspectives in Financial Integration in Europe* 27 (Eddy Wymeersch ed., 1994). See also Karel Lannoo, above note 68, for other industry considerations and national biases that prevent further integration of the EU financial markets: '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.'

[73] See above note 22.

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.[74] Prudential regulation also remains available for the host country to the extent not harmonized and if justified by 'general good' considerations.[75] The indeterminacy of the term 'prudential' and the ultimate assessment by the ECJ of what constitutes sufficient harmonization barring host country regulation suggest that certain prudential rules may still fall within the jurisdiction of the host regulator.[76] The home country control principle itself does not clearly mark the limits of host country jurisdiction,[77] as it does not constitute a fundamental Community law principle.[78] Article 58 (ex article 73d) of the EC Treaty explicitly acknowledges competence of the Member States for prudential supervision of financial institutions and so allows derogation from the free movement of capital. In addition, banks that are established in a Member State as subsidiaries of a bank from another Member State are not covered by the Banking Consolidation Directive and so further restrictions may apply.[78a] Overlaps in the responsibilities of the home and host supervisor of a banking group and divergence in their respective supervisory practices become of increased concern, as banking groups tend more and more to manage their business and risk centrally. Furthermore, Member States may hinder cross-border banking mergers and acquisitions by relying on article 16 of the Banking Consolidation Directive, which allows national supervisors to oppose the acquisition of a 'qualifying' holding (10% or more of the voting rights or

[74] See Chapter II, Section 2.1.2. For the negative effect of the operation of the 'general good' doctrine on the integration of the EU financial market, see Michel Tison, 'Unravelling the General Good Exception, The case of Financial Services', in *Services and Free Movement in EU law* (Mads Andenas & Wulf-Henning Roth eds., 2003). See also Georgios S Zavvos, above note 72, 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 concerning the financial services industry.

[75] Banking Consolidation 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).

[76] For prudential regulation and the 'general good' exception, see Chapter II, Section 2.1.2.

[77] For limitations of the home country control principle in the context of the Investment Services Directive, see Eva Lomnicka, 'The Home Country Control Principle in The Financial Services Directives and the Case Law', *Services and Free Movement in EU Law* (Mads Andenas & Wulf-Henning Roth eds., 2003). See also *ibid.*, for burdens on cross-border business due to the notification requirements.

[78] Case 233/94 *Federal Republic of Germany v European Parliament and Council of the European Union*, 1997 ECR I–2405. See also Mads Andenas, 'Directive on Deposit Guarantee Schemes Challenged', 16 *Company Lawyer*. 18 (1995).

[78a] However, the recent *CaixaBank France* case has shown that a Member State's measures which restrict the pursuit of foreign banks' activities through subsidiaries may not be sustainable under the EC Treaty's principle of freedom of establishment (article 43) even when they are non-discriminatory. Such non-discriminatory measures of a Member State may not

the capital) in a bank if they are concerned about its effect on the 'sound and prudent management' of the target bank.[78b]

A supervisory institution with prudential rule making power at the Community level will further harmonize supervisory rules and procedures and will thus allow banks to expand their Community-wide business. It will save them unnecessary duplicatory efforts to conform to different rules and supervisory practices. In addition, it will be difficult to justify national restrictions on cross-border banking as prudential. Furthermore, a common supervisory framework developed and administered by a body at the 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 easier access to capital and business markets.[79] Banks will be able to expand across Europe without fearing non-tariff barriers due to unfavorable regulation.

The negative effect from regulatory fragmentation on the internal banking market has been acknowledged by the Community institutions[80] and so the Commission has extended the Lamfalussy law making model, which is

be consistent with the freedom of establishment if they affect access to its banking market (but not when they only reduce the economic attractiveness of carrying on the relevant banking activity). Opinion of Advocate General Tizzano delivered on 25 March 2004 in Case 442/02, *CaixaBank France v Ministère de l'Economie, des Finances et de l'Industrie* [2004] ECR I-08961; Case 442/02, *CaixaBank France v Ministère de l'Economie, des Finances et de l'Industrie* [2004] ECR I-08961.

[78b] It should be noted that the Council Regulation on the control of concentrations between undertakings (EC Merger Regulation) (article 21) allows Member States to take appropriate measures to protect legitimate interests, including prudential rules in connection with concentrations with a Community dimension (Council Regulation 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation), 2004 OJ (L 24) 1). The European Commission intends to deal with obstacles to cross-border banking, for example by enhancing the transparency of the relevant decisions of national supervisors. It is reviewing how the EU financial services Directives are impacting on cross-border banking mergers and has asked the Committee of European Banking Supervisors (CEBS) to identify relevant legal obstacles, with a focus on supervisory processes relating to article 16 of the Banking Consolidation Directive. The Commission has also presented a proposal for a Directive on cross-border mergers in order to deal with national legal obstacles (Proposal for a Directive of the European Parliament and of the Council on cross-border mergers of companies with share capital, COM(2003) final at 703).

[79] I 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 decentralized 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 centralization of EU banking regulation and supervision is supported in the first place by trade and financial stability considerations. For analysis of the issues regarding regulatory competition, see Joel P. Trachtman, International Regulatory Competition, Externalization, and Jurisdiction, 34 *Harvard International Law Journal* 47 (1993). See also Howell E Jackson, Centralization, Competition, and Privatization in Financial Regulation, 2 *Theoretical Inquiries in the Law* 649 (2001), for centralization, regulatory competition and privatization of regulatory standards as alternative approaches to financial regulation.

[80] For background to these discussions, see Economic and Financial Committee, *Report By the Economic and Financial Committee (EFC) on EU Financial Integration* 23 (May 2002),

already used for securities regulation,[81] to banking (as well as insurance and investment funds) through establishing at the EU level new financial services committees with advisory and regulatory powers in the field of banking.[82]

A new European Banking Committee (EBC), comprised of high level Member State representatives, has replaced the Banking Advisory Committee, assuming most of its functions and acting in both an advisory[83] and a regulatory[84] capacity.[85] A new Committee of European Banking Supervisors (CEBS), comprised of high level representatives of national supervisory authorities, including central banks, has been established in order to advise the Commission on technical implementing measures and assist with actual implementation and supervisory cooperation.[85a]

This is a four level regulatory process, where framework Directives setting out basic principles and the nature and scope of technical implementing measures are agreed through the normal co-decision process (Level 1), while technical implementing measures are adopted – through the simpler comitology process – by the Commission assisted by the EBC and relying on technical advice from the CEBS (Level 2). The CEBS will also contribute to the consistent implementation of the Directives and to the convergence of national supervisory practices, and will work to enhance supervisory

<http://europa.eu.int/comm/economy_finance/publications/economic_papers/2002/ecp171en.pdf>.

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[81] See Chapter III, Section 2.3.2.1.

[82] For background to the new financial services committees, see Directorate General/Internal Market, The European Commission, 'Financial services: Commission presents measures to improve regulation of banking, insurance and investment funds', Press Release IP/03/1507, November 6, 2003.

[83] The advisory capacity of the European Banking Committee (EBC) is prescribed in the Commission Decision establishing the EBC, and thus articles 57 and 58 of the Banking Consolidation Directive (which provided for the advisory capacity of the Banking Advisory Committee) have been repealed. Commission Decision 2004/10 of 5 November 2003 establishing the European Banking Committee, 2004 OJ (L 3) 36.

[84] The EBC is established in its regulatory capacity by the recently adopted Directive on establishing a new organizational structure for financial services committees (EP and Council Directive 2005/1/EC of 9 March 2005 amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 92/49/EEC and 93/6/EEC and Directives 94/19/EC, 98/78/EC, 2000/12/EC, 2001/34/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees, 2005 OJ (L 79) 9 [hereinafter Directive on new financial services committees]). The Decision establishing the EBC in its advisory capacity (replacing the Banking Advisory Committee) came into force on the day of the entry into force of this Directive.

[85] The European Banking Committee differs from the Banking Advisory Committee in two respects: its members do not include supervisors (however, the chair person of the Committee of European Banking Supervisors and of the European Central Bank participate as observers), and it is chaired by a Commission representative (and not by a Member State).

[85a] Commission Decision 2004/5 of 5 November 2003 establishing the Committee of European Banking Supervisors, 2004 OJ (L 3) 28. The CEBS will also include high level representatives from national central banks, including the European Central Bank, even when the central banks are not directly involved in the supervision of individual credit institutions.

cooperation, including the exchange of information on individual supervised institutions (Level 3), while the Commission in cooperation with the Member States, the national regulators and market forces will strengthen enforcement of Community law (Level 4).

The objective is to produce more harmonized regulation and improve supervisory cooperation and implementation, which will in turn contribute to more and stable cross-border financial services trade. It is also contemplated that this legislative process will be fast and efficient in responding to market and theory developments.[86]

The CEBS is expected to contribute significantly to EU cross-border banking through, among others, its work relating to the new EU capital adequacy framework (also referred to as the new Capital Adequacy Directive (CAD 3) or Capital Requirements Directive) and the EU financial and risk reporting frameworks.

In implementing the new Basel Capital Accord (Basel II), the new Capital Requirements Directive will provide for enhanced supervisory review, for example in respect of supervising a bank's internal risk management models.[86a] So, it will be important that the Member States' supervisors who are responsible for the entities of a banking group do not use different techniques in supervising the internal risk management models of the various group entities, particularly because banking groups are likely to manage risk centrally and use a common approach to risk management for the whole group, and therefore any overlap or divergence in the relevant supervisory requirements will impact on their cross-border activity. The Capital Requirements Directive deals with the allocation of responsibilities between the supervisors of the group entities with respect to validating their internal risk management models. In that context, it introduces the concept of a 'consolidating supervisor' (this will be the supervisor in charge of consolidated supervision of the group), who, if no decision is reached

[86] It will be interesting to see how the new banking committees will affect the regulatory and supervisory role of the national central banks. See also Tommaso Padoa-Schioppa, 'EU Structures for Financial Regulation, Supervision and Stability', Statement at the public hearing on 'After Enron: financial supervision in Europe' at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels (July 10, 2002), <http://www.ecb.int/key/02/sp020710.pdf> (rightly stating that banking regulation is already more extensively harmonized and that the Wise Men report does not exclude the regulatory or supervisory role of the central banks in the banking sector).

[86a] Following the adoption of the new Basel Capital Accord (Basel II) (see Chapter II, note 217), the EU Commission proposed changes to its capital adequacy requirements. These changes implement Basel II, which provides for the use by 'sophisticated' banks of internal credit ratings and portfolio models in combination with the existing 'standardized' approach for the minimum capital requirements, a supervisory review and more extensive market discipline. The EU's legislative proposal is widely known as Capital Adequacy Directive 3 (CAD 3) or the Capital Requirements Directive, but in fact there is no self-standing amending Directive. Rather, the proposal comprises amendments to existing Directives, mainly the Banking Consolidation Directive and the Capital Adequacy Directive. For CAD 3, see http://www.europa.eu.int/comm/internal_market/regcapital/index_en.htm.

between the home and the host supervisors on the preferred approach within a six month consultation period, will have the competence to decide.

The CEBS also works towards convergence of the Member States' supervisory requirements and practices regarding financial and risk reporting. CEBS's work covers a common reporting framework for solvency ratio and consolidated financial statements prepared in accordance with international accounting standards (IAS/IFRS).[86b] Adoption by the Member States of similar reporting requirements and formats will contribute to a level playing field and reduce duplicatory compliance burdens for cross-border banking groups.

This section has reviewed the policy considerations regarding centralization of prudential supervision for the purposes of the internal banking market. In the following section, centralization of supervision, and in particular of LOLR responsibilities, is considered from the perspective of a sound operation of a European banking market.

1.4.2 Financial stability

Europeanization of the banking systems of the Member States means stronger presence of banks outside their home Member State, increased interbank lending across the borders and more intense involvement in the payment systems (due to integration of the EU business and capital markets). This section shows that the existing prudential framework, although good for the current state of integration, will not be adequate to ensure the sustainability of a Europeanized banking market.

The decentralized banking supervision framework in combination with the ECB's responsibilities regarding prudential supervision and payment systems are adequate to deal with the current state of the still-fragmented EU banking market. Prudential regulation and supervision by the home country on the basis of mutual recognition of harmonized regulation, and supervisory cooperation, provide a solid basis for the liberalization of the intra-EU banking business. The remaining host country jurisdiction for

[86b] The EC Regulation on international accounting standards has implemented the international accounting standards, IAS/IFRS, in the EU. EP and Council Regulation 1606/2002 of 19 July 2002 on the application of international accounting standards, 2002 OJ (L 243) 1. As of 1 January 2005, all listed EU credit institutions are required to use IAS/IFRS for their consolidated financial statements while Member States may also apply this to unlisted credit institutions. International Accounting Standards (IAS) are developed by the International Accounting Standards Committee (IASC), an independent, privately-funded accounting standard-setter, whose purpose is to develop a single set of international accounting standards and works with national accounting standard-setters in order to achieve convergence in accounting standards. On 1 April 2001, IASC was renamed the International Accounting Standards Board (IASB) and, as regards standards from then on, IAS were known as International Financial Reporting Standards (IFRS).

prudential matters, allowed by 'general good' considerations and the 'non-constitutional' character of the home country control principle, may further fill gaps in the decentralized supervision framework. Moreover, the ECB contributes to financial stability with its advisory and coordinating role. Finally, the ECB's competence in overseeing and regulating payment systems addresses risks from the increase in relevant interbank links.

A detailed analysis of the ECB power over payment systems follows, in particular because it sheds light on Treaty language with relevance for prudential supervision. This is carried out before the case is presented for centralization of supervisory functions towards realizing the EC internal banking market.

1.4.2.1 Payment systems Enhanced risk in the payment systems[87] will be managed by the ECB, which is entrusted with oversight[88] and regulatory[89] powers over the payment systems. Article 105(2) of the EC Treaty (ESCB Statute art. 3(1)) confers *oversight* power upon the ESCB: '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 ESCB's power of overseeing the payment systems is a concurrent competence, which is shared with the national central banks as autonomous national entities, and hence, it is subject to the subsidiarity principle.[90] This should not[91] hinder the ESCB in performing acts of oversight which are necessary for the stability of a Europeanized financial system. Formulation and implementation of oversight policy by the ESCB, as opposed to oversight policy by the national central banks as autonomous entities, will be necessary when the payment system at issue has significant implications for EU-wide systemic risk or for the single monetary policy (with which financial stability is interdependent). In these cases, the relevant concerns are not likely to be

[87] For payment systems and related financial stability risks, see Bank of England, 'The Bank of England's Oversight of Payment Systems', 9 *Financial Stability Review* 169, 171 (2000) [hereinafter Bank of England, 'The Bank of England's Oversight of Payment Systems'].

[88] EC Treaty art. 105(2), ESCB Statute art. 3(1). See below Section 2.4.2.2 and accompanying notes, for the ECB's oversight competence.

[89] Article 22 of the ESCB Statute (clearing and payment systems) provides: '[T]he ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries.' Relevant functions can be exercised by the ECB on the basis of articles 4 (advisory role with regard to Community and national legislation or other matters in its field of competence), 17 (open accounts for and accept assets as collateral from credit institutions, public entities and other market participants), and 23 (conduct of external operations) of the ESCB Statute.

[90] EC Treaty art. 5 (ex art. 3b). But see below Section 2.4.2.2 and accompanying notes, for views in the ECB supporting the exclusive character of the ECB's oversight competence. This is interesting because the language used to support the ECB's role in the payment systems is similar to the language that is used to exclude other prudential functions from the ECB's competence.

[91] In theory there will only be some uncertainty, inherent in the application of the subsidiarity test, about the allocation of responsibilities between the ECB and the national central banks.

addressed effectively by the national regulators and thus the ECB's functions will be consistent with the subsidiarity principle. This should at least be the case with cross-border payments or large-value payments with systemic implications.

The *regulatory* power over the payment systems[92] within the Community and with third countries is within the exclusive competence of the ECB,[93] and hence, outside the subsidiarity scrutiny. The exclusive competence of the ECB is derived from the wording of article 22 of the ESCB Statute, which, although empowering both the ECB and the national central banks to provide clearing and payment facilities, mentions only the ECB as competent to regulate them.[94] The ECB's regulatory power covers conditions for the operation and access to payment systems as well as regulation of participants to the systems. Participants to the systems include authorized credit institutions and undertakings established by them.[95]

From the accountability standpoint, it is worth noting that the ECB's regulatory power is shielded from political control.[96] This is justified by the technical nature of the field and by the interdependence with monetary policy, and is consistent with the traditional absence of political interference. Such arrangement conforms with my position that accountability should not be a main concern in the event the ECB's competence extends to other prudential supervision functions of similar character to the regulation of the payment systems.

[92] ECB's regulatory power should cover securities clearing and settlement systems. See European Central Bank, 'The Role of the Eurosystem in Payment and Clearing Systems', *ECB Monthly Bulletin*, April 2002, at 47, 52, <http://www.ecb.int/pub/pdf/mb200204en.pdf> [hereinafter *ECB Monthly Bulletin*, April 2002].

[93] The ECB enjoys exclusive competence vis-à-vis national authorities. This exclusive competence, however, is limited by the Community's competence in regulating related issues. Thus, issues of internal market, that are not directly linked to efficient and sound payment systems will fall within the Community's competence. For issues, such as the irrevocability of payment orders or general civil law issues, which are outside the ECB's regulatory competence, see René Smits, above note 49, at 305. See also Christoph Keller, 'Regulation of Payment Systems – Some Reflections on Article 22 of the Statute of the ESCB', 3 *Euredia* 455, 464 (2001/2002). However, as argued in the *ECB Monthly Bulletin* of April 2002, technical issues may spill over into civil and insolvency law issues, and in that case the ECB's competence should not be denied.

[94] 'The ECB *and national central banks* may provide facilities, *and the ECB* may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries' (emphasis added). ESCB Statute art. 22.

[95] René Smits, above note 49, at 304, for the scope of the ECB's regulatory power.

[96] See *ibid*. at 305 n. 375 (stating that the traditional absence of political control in the area should have been one of the reasons for the proposed draft article 22 not referring to a role for the Ecofin Council in ECB regulations).

In addition to its oversight and regulatory powers and in compliance with its operational role[97] in payment systems,[98] the ECB has developed and operates TARGET[99] (Trans-European Automated Real-Time Gross Settlement Express Transfer System). TARGET is a settlement system for Euro payments and its aim is to safeguard and facilitate the use of the Euro, and accommodate the implementation of monetary policy. The operation of TARGET as a gross settlement system[100] with collateralized overdrafts reduces credit risk[101] from interbank credit exposures. Nevertheless, significant credit risk remains,[102] since a considerable number of large-value transactions are likely to be effected through the private payment systems, [103] like the Euro System (Euro 1)[104] and Euro Access Frankfurt (EAF).[105] Both these private payment systems are net settlement systems, which, unlike TARGET, require collateral only in the form of a pool[106] and thus entail lower costs[107] but also more credit risk.[108] The oversight and regulatory competence of the ECB should be adequate to deal effectively with risks arising from these payment systems. In particular with regard to Euro 1, the Governing Council has entrusted the ECB with oversight responsi-

[97] See Tommaso Padoa-Schioppa, '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 (November 9, 2000), <http://www.ecb.int>, for the basic instruments available to central banks in dealing with payment systems: *co-operation* (preferred mode), *operational involvement* and *regulation*.

[98] 'The ECB and national central banks may provide facilities . . . to ensure efficient and sound clearing and payment systems within the Community and with other countries.' ESCB Statute art. 22.

[99] See European Central Bank, *Target: the Trans-European Automated Real-Time Gross Settlement Express Transfer System* – update 2000 (September 2000), <http://www.ecb.int/target/gi/tagi01.htm>.

[100] TARGET links national large-value payment systems for which settlement will be provided at the ECB level.

[101] The ECB assumes the credit risk on the basis of collateral.

[102] In addition, there is always the risk from securities and foreign exchange operations. See Charles AE Goodhart & Dirk Schoenmaker, 'Institutional Separation between Supervisory and Monetary Agencies', *The Central Bank and the Financial System* 333, 348 (Charles AE Goodhart, 1995).

[103] See Jean-Pierre Danthine et al., *The Future of European Central Banking* 91 (1999), for the competitive advantage of private net settlement systems due to low costs.

[104] The Euro System is operated by the Clearing Company of the Euro Banking Association.

[105] The Euro Access Frankfurt is run by the Landeszentralbank in Hessen.

[106] See Jean-Pierre Danthine et al., above note 103, at 91 n. 4.

[107] TARGET presents high costs due to the high opportunity cost for tied-up individualized collateral. See Charles AE Goodhart & Dirk Schoenmaker, above note 102, at 345–49, for the opportunity cost of collateral and for an analysis of the trade-off between credit and liquidity risk and costs in designing payment systems. See also Xavier Freixas & Bruno Parigi, 'Contagion and Efficiency in Gross and Net Interbank Payment Systems', 7 n. 1 *Journal of Financial Intermediation* 3 (1998). See Jean-Pierre Danthine et al., above note 103, at 92, for the low cost of gross settlement systems with collateralized overdrafts in countries, like France, with a developed market for repurchase agreements.

[108] See Charles AE Goodhart & Dirk Schoenmaker, above note 102, at 345.

bility.[109] Also, the operation of private large-value systems that process payments in Euro[110] has already been assessed and found to conform with[111] the standards and access criteria of the 'Lamfalussy Report'.[112]

1.4.2.2 The case for centralization Increased cross-border activity is expected to create additional prudential supervision problems, outside the operation of the payment systems, whereby the decentralized supervision system may not be adequate. Risks may arise from lax regulation, as operation on the basis of the home country control principle – despite its limits – encourages banks to seek jurisdictions more favourable to risk-taking. In this vein, effective national LOLR systems and depositor insurance schemes provide additional incentives.[113] Also, a Member State-based banking supervision system lacks the necessary information and resources to assess the Community implications of illiquid but solvent pan-European banks or those whose solvency is in doubt.[114]. Although supervision by national authorities ensures accurate information and has the advantage of perception of local market conditions, it may not be able to deal with Euro-wide systemic problems. Bilateral cooperation through MOUs, combined with the generally prescribed ECB coordinating role, do not provide the real-time information and coordination needed to detect and provide a timely

[109] European Central Bank, *Role of the Eurosystem in the field of payment systems oversight* 3 (June 2000), <http://www.ecb.int/pub/pdf/paysysover.pdf> [hereinafter ECB, *Eurosystem and Payment Systems Oversight*].

[110] Euro System, Euro Access Frankfurt-Germany, Servicio Espanõl de Pagos Interbancarios-Spain, Systémé Net Protégé (replaced by Paris Net Settlement)-France, Pankkien O-nline Pikasiiot ja Sekit järjestelmä-Finland. *Ibid.* at 4.

[111] 'The Minimum Common Features of Domestic Payment Systems', a report prepared by the Working Group on EC Payment Systems ('Padoa-Schioppa Group') and approved by the Committee of Governors of the Central Banks of the Member States of the EC, required that each country should have a gross settlement system and conditioned the operation of other large-value payment systems on compliance with standards prescribed in the Lamfalussy Report. *Ibid.* See also *ibid.*, for 'terms of reference' required for legal opinions for the participants in large-value payment systems.

[112] Committee on Interbank Netting Schemes, *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (CPSS Publications No. 4, November 1990), <http://www.bis.org/publ/cpss04.htm#pgtop> [hereinafter Lamfalussy Report]. The Lamfalussy Report provides for standards and access criteria of payment systems.

[113] See Michel Aglietta, above note 2, at 63.

[114] 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 doubt 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, December 1999), <http://cep.lse.ac.uk/fmg/publications>. The Federal Deposit Corporation Improvement Act (FDICIA) has been amended to address problems arising from extending LOLR to insolvent institutions. Rosa Maria Lastra, Lender of Last Resort: An International Perspective', 48 *International & Comparative Law Quarterly* 340, 346–50 (1999).

response to systemic crises. Moreover, decentralized supervision may fail to adequately integrate price stability concerns in decisions related to financial stability.[115] Centralization of supervision appears to be a more suitable solution toward the stability of the EC internal banking market.

An institution at the Community level with prudential supervision responsibilities will be able to deal with potential Euro-wide systemic risk and assess the interaction between financial and monetary stability. It will also lead to a unified framework that will reduce regulatory arbitrage and related moral hazard problems.

A centralized banking supervision system will also avoid discrepancies in the implementation of the Directives and their implications for depositors' protection and financial stability. In the Bank of Credit and Commercial International (BCCI)[116] litigation in England and France, conflicting interpretations of secondary Community law and the ruling as to the responsible national supervisor have saved the bank supervisors' liability costs at the expense of depositors' protection. In interpreting the First Banking Directive, English courts ruled for a limited role for 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.[117]

I argue below that centralization of certain, mainly macroprudential, supervisory 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 ECB can assume supervisory responsibilities which are compatible with its monetary policy mandate and do not conflict with democracy concerns.

2 MONETARY POLICY AND BANK SUPERVISION

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 while

[115] However, it should be noted that article 14(4) of the ESCB Statute empowers the ECB to prevent functions of the national central banks that 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.

[116] For some background to the BCCI affair, see the references in note 113 of Chapter II, Section 2.1.2.

[117] See Chapter III, Section 2.3.1, for the prudential implications of the decentralized model in light of the BCCI litigation.

national authorities are responsible for bank supervision. Only a complementary supervision role is expressly centralized. This resembles the institutional separation of monetary policy and banking supervision in several national jurisdictions. A separate financial regulator, eg a single financial regulator, exercises bank supervision while the national central banks are in charge of monetary policy. However, neither institutional nor geographical separation may greatly limit the prudential supervision power of the central bank. Monetary policy power does include prudential supervision powers. A concepts clarification unveils this in the context of the EC Treaty. This is important so that a more formal delineation of the exact responsibilities follows, which in turn will make the relevant powers more efficient and the institutions more accountable. This is all the more so because of the political intensity of the relevant competences which alone can marginalize the legal texts: 'We did not have the Maastricht treaty lying open on the table. It was all done informally' an EMU decision-maker is quoted to have said in the context of the foreign exchange intervention in favour of the Euro in 2000.[118]

I submit that centralization of bank supervision in the EU is possible under the Treaty, with no further legal process being necessary.[119] The ECB can undertake supervisory 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 policy and bank supervision functions do allow extension of the ECB's competences to prudential supervision. As the Treaty does not define monetary policy or prudential supervision and uses elusive terms when it comes to allocation of supervision competences, there can hardly be any legal impediment in centralizing bank supervision. This will mainly concern macro-prudential supervision.

2.1 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.[120] However, it does not provide a definition of monetary policy. It only sets price stability as the overriding objective of the ECB's mon-

[118] Alan Beattle & Stephen Fidler, 'Careful planning behind banks' euro surprise', *Financial Times*, September 25, 2000, at 3.
[119] Activation of the enabling clause will not be necessary either.
[120] EC Treaty art. 105(2), ESCB Statute 3(1).

etary policy[121] and prescribes its monetary functions and operations.[122] The Member States have agreed[123] 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 the argument that price stability has no long-term impact on growth and employment but only benefits for the economies.[124] The theory based on the 'expectations-augmented Philips curve' finds that there is no trade-off between low inflation, and employment and growth in the medium and long run.[125] Instead, there is even a long-term positive impact from low inflation on employment and growth.[126] Empirical evidence has shown that low level and variability of inflation due to monetary discipline by an independent central bank have no negative impact on 'real macroeconomic performance'.[127]

[121] '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 ESCB 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 note 49, at 184–86.

[122] ESCB Statute Ch IV, arts. 17–24.

[123] 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 similar to the case of the Fed, whose mandate is to pursue the optimum mix of inflation, growth and employment goals. See Robert Elgie & Helen Thompson, *The Politics of Central Banks* 31, 32 (1998), for Fed's role in juxtaposition to Bundesbank's policy: '[W]hereas 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 provides 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). But see Interview with Tommaso Padoa-Schioppa, below note 148 (arguing that the *de facto* difference today between the ECB and the Fed is much less than the respective underlying legislation suggests).

[124] For the monetarists' position, see Taxiarchis Cocores (Kokores), *Monetary Policy and Money Supply Policy, The Implications of 'Monetarism*' (University of Birmingham, Series A., Economic Theory and Econometrics, Discussion Paper No. 164, December 1973), reprinted in ΚΘ′ 1 ΣΠΟΥΔΑΙ 66, 75 n. 36 (1979). Referring to LC Andersen ('The State of the Monetarist Debate', *FRB St. Louis Review*, September 1973), Kokores 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.'

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

[126] See Robert Elgie & Helen Thompson, above note 123, at 17, 18.

[127] Alberto Alesina & Lawrence H Summers, 'Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence', 25 n. 2 *Journal of Money, Credit & 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'.

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 European Central Bank.[128] The Treaty establishes the independence of the ECB providing – among other safeguards[129] – for protection from influence by the political authorities.[130] Again, both economic theory and empirical evidence[131] support that an independent central bank, uninfluenced by short-term political considerations that may distort monetary policy (the so-called *time-inconsistency* problem)[132] is the most effective institutional[133] mechanism toward low inflation and long-term

[128] But see André Szász, 'Introductory Remarks on 50 years of the Bundesbank: lessons for the ECB', *The History of the Bundesbank, Lessons for the European Central Bank* 1, 3 (Jacob de Haan ed., 2000), for 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.

[129] For such 'organic' ('personal') and 'functional' ('operational') safeguards, see Rosa Maria Lastra, 'The Independence of the European System of Central Banks', 33 n. 2 *Harvard International Law Journal* 475, 482 (1992). The 'assured tenure' of the members of the Governing Council and of the Executive Board, enshrined in articles 11 and 14 of the ESCB Statute, is deemed to be an important such safeguard. See *Draft ESCB Statute, Introductory Report*, above note 5, at 5.

[130] '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 art. 108 (ex art. 107), ESCB Statute art. 7. For a comparison of article 108 with the respective provision for the independence of the Commission's members, article 213(3) (ex article 157(2)), see Jean-Victor Louis, 'A Legal and Institutional Approach for Building a Monetary Union', 35 *Common Market Law Review* 33, 43 (1998).

[131] Padoa-Schioppa points that it is historical experience that 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' (March 8, 2000), <http://www.ecb.int> [hereinafter, Padoa-Schioppa, 'An institutional glossary of the Eurosystem'].

[132] The time-inconsistency problem consists of the inflation bias of the economy agents who, distrusting the monetary authority, expect 'surprise inflation' and incorporate this into their decision making. This only leads to inflationary policies without any positive effect on growth and employment. A politically controlled monetary authority is expected to be less credible as political forces are likely to favour easing of monetary policy when there is a pressing need for short-term growth and employment gains, eg during an election, 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, November 1993), <http://cep.lse.ac.uk/fmg/publications> (last visited March 27, 2000) [hereinafter Goodhart, *Central Bank Independence*].

[133] 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', *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).

growth.[134] Economic theory suggests that a rule-based monetary system[135] run[136] by an independent central bank can produce low inflation. Empirical evidence shows that there is positive correlation between central bank independence and low inflation,[137] and in some cases positive growth.[138]

Section 2.2 examines how the interdependence of banking stability with price stability allows the ECB to extend its competences over prudential supervisory functions.

2.2 Default prudential supervision of central banks

My argument is that neither institutional nor geographical separation of monetary policy and bank supervision means no prudential supervision power for the central bank. The central bank always retains a significant, in the worst case residual, bank supervision responsibility. In the case of *institutional* separation the relevant functions of the national central banks are a case in point. Even when a separate agency is in charge of bank supervision, the central bank can undertake prudential supervision functions, 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 policy 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,[139] it can also fall

[134] There can also be pure political considerations for assigning monetary policy to an independent central bank. Politicians might favour 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, workers and manufacturers. Politicians will also be concerned about the complexities of monetary issues, especially in the current regime of deregulation, capital liberalization and fluctuating exchange rates. Robert Elgie & Helen Thompson, above note 123, at 144, 21–2.

[135] Robert J Barro & David B Gordon, 'Rules, discretion and reputation in a model of monetary policy', 12 *Journal of Monetary Economics* 101 (1983).

[136] See Robert Elgie & Helen Thompson, above note 123, at 18, for the influence of work on political business cycles.

[137] See *ibid.* at 20 (citing Alberto Alesina & Lawrence H Summers, 'Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence', 25 n. 2 *Journal of Money, Credit & Banking* 151, 159 (1993)). But see Rosa Maria Lastra, *Central Banking and Banking Regulation* 15–18 (1996), for caveats regarding related empirical evidence.

[138] See Robert Elgie & Helen Thompson, above note 123, at 20 (citing De Long et al., 'Macroeconomic Policy and Long-Run Growth', 77 No. 4 *Federal Reserve Bank of Kansas Economic Review* 5, 14 (1992)). See also *ibid.*, for challenges on the economic rationale of central bank independence (citing Jeffrey 'C Fuhrer, Central Bank Independence and Inflation Targeting: Monetary Policy Paradigms for the Next Millennium', New England Economic Review, Federal Reserve Bank of Boston, January–February 19 (1997)).

[139] See above note 4, for the distinction between micro- and macro-prudential supervision. For my understanding of macro-prudential supervision, see Chapter 1, Section 1.3.

within the monetary policy function. All these supervisory functions can effectively be exercised through the use by the central banks of their monetary instruments. The same applies also to *geographical* separation. This is the case of the Eurosystem, where monetary policy constitutes a Community competence while banking supervision remains within the jurisdiction of the national authorities. The ESCB can extend its formally limited supervision responsibility for both macro- and micro-prudential purposes on the basis of its monetary policy competence and its monetary instruments.

I demonstrate below how both macro- and micro-prudential supervision functions of a central bank can develop on the basis of the interdependence of price stability and banking soundness, and through the conduct of monetary policy functions and operations. The statement is not that the central bank should undertake both macro- and micro-prudential supervision functions. The purpose is only to show that there may not be any serious legal or factual obstacles in such expansion of the central bank powers. The normative implication is 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. The issue of a single regulator, a regulator covering banking, securities and insurance activity, is beyond the purpose of the analysis here. Section 2.4.4 provides only an overview of related current developments with an emphasis on the need for clear delineation of the macro-prudential role of the central banks.

2.3 Monetary policy and bank supervision

The interdependence of monetary policy and bank supervision, of price stability and banking soundness, as well as the commonality of the tools employed 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, eg bank supervision, foreign exchange policy.

Bank supervision cannot but be considered as a function of monetary policy. Monetary policy aims at price stability and bank supervision at banking soundness. Yet banking soundness is pursued for reasons of depositor protection and systemic stability *per se* as well as of price stability. Actually, it is primarily the health of the overall economy with a focus on the effectiveness of the monetary policy and on the operation of the payment systems that has been of concern to bank supervision. The focus has been on systemic stability aspects and bank supervision has mainly been about macro-prudential considerations and their implications for monetary policy. It is also important that even with regard to systemic stability and

macro-prudential considerations the only relevant functions were those of the central banks and these were largely emanating from the core functions of the central banking itself rather than from a formalized attribution of bank supervision powers to the central banks. The relevant functions of the central bank traditionally relate to its power as issuer of money, and subsequent channelling of it to the economy through the banking system, and to its role in ensuring stable payment systems and conditions of adequate liquidity.

The interdependence of banking soundness and price stability is demonstrated by the importance of a sound banking system in 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. Second, an ailing banking system will be likely to need extra liquidity support, which can endanger price stability. Third, 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 the earnings or liquidity of banks. Depositors will demand higher returns and borrowers will have increased

[140] Manuel Guitián 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 monetary policy 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 Guitián, 'Banking Soundness: The Other Dimension of Monetary Policy', in *Banking Soundness and Monetary Policy, Issues and Experiences in the Global Economy* 41, 44, 58 (Charles Enoch & John H Green eds., 1997). The same interdependence is argued between banking soundness and exchange rate stability. *Ibid.* at 48–50. It is worth noting that the second LSE Bank of England lecture in 1992 was titled 'The pursuit of financial stability', while the first one was on price stability. Eddie George, the Bank of England Governor, giving reasons for the theme of his speech argued that 'monetary stability cannot be divorced from financial stability'. Eddie AJ George, 'The Pursuit of Financial Stability', 34 n. 1 *Bank of England Quarterly Bulletin* 60, 60 (1994). In consideration of this interdependence, the Austria central bank has initiated a new publication, the *Financial Stability Report*:

> Central banks' aim to secure stable financial markets and a stable banking system is a *fun-*

difficulty in repaying their loans.[140] Ultimately, the value of the money stock depends on the financial state of the banks and thus the prudential aspects of the banking system are part of monetary policy management.

This interdependence shows that possible conflicts[141] between monetary policy and banking supervision objectives are by no means resolved by assigning monetary policy and banking supervision functions to separate bodies.[142] Effective monetary policy has to take into account the conditions of the banking system, as banking soundness is a variable of price stability.[143] 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 policy and bank supervision but only an 'intertemporal' trade-off that the monetary authority has to conduct in any case, whether having bank supervision powers or not.[144] The monetary authority will have to consider how an increase in the interest rates addresses inflation concerns without endangering the soundness of banks, that is without put-

> *damental prerequisite* for effective monetary policy-making. It is crucial to note that *price stability and financial stability are interdependent aims*: Reaching one goal supports the attainment of the other; therefore, both tasks are *equally important* for central bank policy-making to succeed. (emphasis added)

Oesterreichische Nationalbank, *Financial Stability Report 2* 4 (October 10, 2001), <http://www2.oenb.at/english/engl_p.htm> [hereinafter *OeNB Financial Stability Report 2*]. Nout Wellink, the De Nederlandsche Bank President, refers to the fact that a Financial Stability Review has recently been launched by ('a dozen or so') other central banks. Nout Wellink, 'Central Banks as guardians of financial stability', Speech at the seminar 'Current issues in central banking', Central Bank of Aruba, Oranjestad (November 14, 2002), <http://www.dnb.nl/english/e_speeches/2002/e_we021114.htm>.

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[141] For a critical review of conflicts of interest between bank supervision and monetary policy objectives, see Charles AE Goodhart & Dirk Schoenmaker, above note 102, at 339.
[142] See also René Smits, above note 49, 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 bank supervision. But see H Robert Heller, 'Prudential Supervision and Monetary Policy', *The Evolving Role of Central Banks* 57, 63 (Patrick Downes & Reza Vaez-Zadeh eds., 1991) (arguing that Chinese Walls defy the purpose of combining monetary policy and bank supervision).
[143] In light of the interdependence of banking soundness and price stability, I 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 (January 21, 2002), <http://www.ecb.int/key/02/sp020221.pdf> (last visited February 24 2002).
[144]

> 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 Guitián, above note 140, at 72.

ting at risk the mechanism needed for long-term price stability.

2.3.1 Distorted separation of monetary policy and bank supervision powers

But even in case of theoretical objections to extending monetary management to banking soundness, arguments in favour of separating monetary policy and bank supervision powers are valid only in theory,[145] as far as benefits to bank supervision policies are concerned. This is because separa-

[145] For arguments against separation, see Charles AE Goodhart & Dirk Schoenmaker, above note 102, at 345. See also *ibid.* at 360, app. 1A, for the allocation of monetary policy and bank 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, 83–84 (Paul JJ Welfens & Holger C Wolf eds., 1997), for a summary of arguments *in favour of* (supervision is 'natural extension' of central banking, economies of scope, efficient use of information, supervisory information needed for LOLR, supervision of participants important for payment system oversight) and *against* (conflict of interest, impact of failure on credibility of central bank, concentration of power, independent character of central bank) combination of monetary policy and bank supervision powers. See also Rosa Maria Lastra, above note 137, at 148–56. See also *ECB*, *Role of Central Banks in Prudential Supervision*, above note 4, for arguments *in favour 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 favour 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 ECB supports the argument 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 policy 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 supervisory 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. This is interesting. The ECB advocates a supervision role for the NCBs, because the NCBs are the only agencies that can cooperate at the EU level due to their participation in the Euro system as arms of the ECB. That is, supervision by the NCBs is good for the following reasons: first, because bank supervision is combined with the monetary policy function of the NCBs. The ECB paper does not expressly say this but the argument for bank supervision by the NCBs follows the presentation of the link between monetary policy and bank supervision. Second, bank supervision by the NCBs entails centralization because of the EU character of the NCBs. Otherwise, supervision remains national competence simply because the NCBs are technically national entities when it comes to supervision. This is a very interesting decentralization of the ECB's functions that avoids accountability risks. A unique 'dédoublement fonctionnel' with accountability still at the national level. I do agree with the argumentation in favour of prudential supervision by the central banks, and even more so in the context of the Euro-system. But I also argue for a more clear attribution of supervision powers to the Euro-system. Supervision powers could be further delegated to national central banks. These supervision powers should cover macro-prudential responsibilities. Micro-prudential functions can stay with a national single regulator (perhaps eventually assigned to a single regulator at the Community level) while the NCBs should be closely involved.

[146] See Charles Goodhart, The *Organizational Structure of Banking Supervision* 9, n. 6 (Financial Markets Group Special Paper 127, October 2000), <http://cep.lse.ac.uk/fmg/publications>.

tion cannot but be 'distorted': monetary policy and bank supervision powers cannot be separated in practice.[146]

The model of the Deutsche Bundesbank (Bundesbank), the central bank of Germany, before the recent financial supervision reform in Germany, demonstrates this 'distorted separation' of central banking and bank supervision. The Bundesbank was formally deprived of the basic supervisory responsibility. Nevertheless, it was the Bundesbank that effectively exercised supervisory power through close cooperation with the supervisory authority, the Federal Banking Supervisory Office.[147] This was also reflected in the recent reform of the German system of financial supervision. The plans of the German Ministry of Finance for the creation of a sin-

[147] For example, it was the Bundesbank officials who would collect supervision information for the Bank Supervisory Office. Alessandro Prati & 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 Deutsche Bundesbank and the Federal Banking Supervisory Office shall communicate to each other any observations and 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)

Ibid. at 101.

> *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. (emphasis added)

Brian Quinn, 'The Bank of England's role in prudential supervision', 33 n. 2 *Bank of England Quarterly Bulletin* (1993). See also Bertold Wahlig, 'Who Should Be the Banking Supervisors? A German Perspective', *4 Current Legal Issues Affecting Central Banks* 336, 342 (Robert C Effros ed., 1997).

> 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. (emphasis added)

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 (March 2, 1994).

[148] Deutsche Bundesbank, Press Release, Frankfurt am Main, January 25, 2001, <http://www.bundesbank.de/en/presse/pressenotizen/archiv01/pdf/cross_sec250101.pdf>; Klaus Engelen, 'Eichel's shock to the system', 5 n. 4 *The Financial Regulator* 38 (2001), <http://www.centralbanking.co.uk/publications/journals/pdf/Eichel_shock.pdf>. The Bundesbank's reaction becomes very interesting if we consider that arguments against a supervisory role by the

gle financial regulator did not please the Bundesbank establishment, which perceived this development as abolition of its bank supervision powers.[148]

My argument goes beyond the proposition that banking soundness is part of the monetary management, which taken along with arguments favouring combining monetary policy and bank supervision functions and claiming 'distorted separation' in practice, suggests assignment of supervisory responsibilities to the central bank. I support that bank supervision is incident to monetary policy, and that the considerations and tools for bank soundness overlap with those for price stability.[149] In any case, monetary policy transfuses over bank supervision. A more clear assignment of certain, macro-prudential, supervision competences to the central bank is proposed both for efficiency and accountability purposes.

2.3.2 Commonality of tools

The central bank can and does exercise *de facto* bank supervision, mainly macro-prudential supervision, while performing its monetary policy tasks. Open market and credit operations result in an intense interaction of the central bank with the bank counterparties which allows the central bank both to evaluate effectively the financial state 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 develop its macro-prudential role. This will also include the power to intervene in case of serious liquidity problems. It can take place through open market operations, mainly in the case of general liquidity problems, or credit operations with individual banks under serious liquidity distress. Responsibility for gathering statistical information is an additional monetary policy tool that a central bank could use for bank supervision purposes. Statistical information provides significant insight in the banks' operations and it can be used for timely supervisory action. Also, minimum reserves can be used to deal with financial stability problems, both systemic and individual. Their temporary reduction can help the credit institution to overcome liquidity problems or deal with liquidity strains of a tight monetary policy.

As far as micro-prudential supervision is concerned, it should be

ECB were based on views in Germany and the Bundesbank against banking supervision by the central bank. Interview with Tommaso Padoa-Schioppa, The Region (Federal Reserve Bank of Minneapolis, December 2001), <http://minneapolisfed.org/pubs/region/01–12/padoa-schioppa.html> [hereinafter Interview with Tommaso Padoa-Schioppa].

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[149] Without going that far, Padoa-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, suppliers of payment services, managers of the stock of savings and counterparties of central bank operations.' Tommaso Padoa-Schioppa, above note 11, at para. 4.

acknowledged that micro-prudential supervision has become more formalized and thus it becomes difficult to undertake micro-prudential tasks only on the basis of monetary policy functions. Thus, a precise framework is needed for a supervisory institution to be responsible for functions such as risk assessment and regular reporting by auditors. Legal obstacles, mainly relating to principles of administrative law, may also prevent statistics gathered for monetary policy purposes from being used for bank supervision purposes.

2.4 ECB and prudential supervision

2.4.1 Commonality of tools

The ECB's monetary policy competence may extend to prudential supervision functions. Its power to conduct open market and credit operations with individual credit institutions on the basis of adequate collateral[150] means that the ECB can act as LOLR in case of both systemic and individual liquidity crises. The ECB can also exercise micro-prudential supervision while collecting statistical information.[151] It can evaluate the financial condition of credit institutions and recommend or effect changes. It can also promote the internal market by harmonizing the relevant rules and practices,[152] which means reduction of duplicatory costs and more equal competitive conditions. Nevertheless, we should acknowledge that the increased formalization of micro-prudential supervision in our era of formal banking regulation as well as legal obstacles relating to administrative law principles set limits on the expansion of micro-prudential functions.

2.4.2 Legal basis

2.4.2.1 Article 105(6): 'Enabling clause' The Treaty expressly provides for expansion of the ECB's prudential supervision competence. The Council can activate the enabling clause and entrust the ECB with responsibility for prudential supervision:

> The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European

[150] ESCB Statute arts. 17, 18. It is worth noting that some central banks had proposed that there should not be a requirement of adequate collateral for lending to credit institutions. *Draft ESCB Statute, Commentary*, above note 5, at 10.
[151] ESCB Statute art. 5.
[152] ESCB Statute art. 5(3).
[153] EC Treaty art. 105(6), ESCB Statute art. 25(2).

> 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.[153]

Further responsibility could include prudential rule making with positive effect on integration. Although article 105(6) of the EC Treaty (article 25(2) of the ESCB Statute) refers only to prudential *supervision policies*,[154] the Treaty does not seem to employ a systematic distinction between prudential regulation and supervision. When that is viewed in the more general context of blurred boundaries between prudential regulation and supervision,[155] tasks concerning prudential supervision policies can be interpreted to include rule making power. Such an interpretation can be further supported by the 'softness' of the expression of article 105(6) (article 25(2) of the ESCB Statute): 'tasks *concerning*', '*policies*', '*relating*', 'to the *prudential*[156] supervision' (emphasis added). Prudential rule making by the ECB would allow further harmonization of prudential and conduct of business rules, and hence reduce duplicatory regulatory costs and level the playing field.

Scholars argue that the rigid process for the activation of the enabling clause, and in particular the 'unanimity' condition for the Council's action, is a significant legal barrier to the evolution of bank supervision at the EU level. I agree that this makes activation of the enabling clause difficult at

[154] 'The Council may . . . confer upon the ECB *specific tasks* concerning *policies relating* to the *prudential supervision* of credit institutions and other financial institution . . .' (emphasis added). EC Treaty art. 105(6). See also ESCB art. 25(2).

[155] 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 v Discretion: the case of banking supervision in the light of the debate on monetary policy', in *The Emerging Framework of Financial Regulation* 119, 127 (Charles AE Goodhart ed 1998). 'Most supervisors will also be regulators in exercising part of their responsibilities – eg designing tests of solvency or liquidity and, equally, important, they make a separate judgement about whether and how sanctions available under the laws should be applied in particular cases. In a way they will be obliged to take a broader view of an institution and about the consequences of any disciplinary or corrective action required of the institution or individual.' *Ibid*. at 128.

[156] In contrast to its significance for bank regulation, 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' reasons exception to the GATS trade disciplines. For a critical analysis of the term 'prudential' in the context of Community law, see Mads Andenas & Christos Hadjiemmanuil, below note 161, at 403. My 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 see Johannes Priesemann, above note 145, at 82, 83. Priesemann considers the lender of last resort function as part of monetary management, and distinguishes payment systems from prudential supervision. It is also worth noting that the term used in the Greek translation of the EC Treaty is 'προληπτική εποπτεία', that is '*preventive* supervision'. For all these issues, see Chapter I, Section 1 (see Section 1.3 for my working definition of 'prudential').

present. However, it is important that the possibility exists for the Council to act and that centralization of prudential supervision tasks at the ECB level is 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 centralization.

In activating the enabling clause, subsidiarity should not be a significant concern either.[157] The subsidiarity principle should not apply here, since the Community enjoys exclusive competence in reforming the prudential supervision arrangements.[158] Of course, the enabling clause can be interpreted that it operates at the constitutional level of the Community, where subsidiarity always applies as a guiding principle of the Community institutional design.[159] But even under this interpretation, subsidiarity concerns will not be important if viewed in light of the shortcomings of the decentralized bank supervision system. Inadequacy of decentralized supervision to lead to integration of the financial systems and deal with the risks of a single financial market enhance[160] the justifications for centralizing supervisory responsibilities at the Community level.[161]

[157] EC Treaty art. 5. (ex art. 3b). For the subsidiarity principle, see *Quadragesimo Anno Encyclical of Pope Pius XI*, *On Reconstruction of the Social Order* (May 15 1931), <http://www.vatican.va/holy_father/pius_xi/encyclicals/documents/hf_p-xi_enc_19310515_quadragesimo-anno_en.html>, para. 79:

> 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)

[158] '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, 'Beyond Preemption? Shared Competence and Constitutional Change in the European Community', in *Legal Issues of the Maastricht Treaty* 13, 27 (David O' Keeffe & Patrick M Twomey eds., 1994), for the weakness of the subsidiarity principle even when applicable: 'Whatever its political impact, Article 3b is not the legal rule which will, at last, provide a brake on expanding Community competence.'

[159] 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* 37–40 (1998).

[160] See Franco Bruni, above note 58, for the need to adopt a 'deeper prudential policy of subsidiarity' in the context of the EMU. Franco Bruni interestingly calls the existing harmonization process a 'textbook application of the principle of subsidiarity'.

[161] See Mads Andenas & Christos Hadjiemmanuil, 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 that eliminates subsidiarity concerns.

2.4.2.2 Article 105(5) – Monetary policy and the 'implied powers' doctrine Article 105(5) of the EC Treaty in combination with the ECB's monetary policy competence offer an additional legal basis for expansion of the ECB's prudential supervision powers. The Community law doctrine of 'implied powers' may apply here to lend further support.

Article 105(5) of the EC Treaty (article 3(3) of the ESCB Statute) expressly prescribes the ECB's responsibility to *contribute* to the *smooth* conduct of national *policies relating* to *prudential* supervision of banks and *financial stability*, and this should be interpreted to cover extensive ECB banking supervision functions. The ambiguity of the terms used and the importance of prudential supervision for monetary policy suggest against reading significant restrictions on possible ECB supervision functions.

The prevailing narrow interpretation of article 105(5) of the EC Treaty (article 3(3) of the ESCB Statute) should be compared with the wider interpretation of the similarly worded article 105(2) (article 3(1) of the ESCB Statute). The role of the ECB under article 105(5) (article 3(3) of the ESCB Statute) to contribute to the smooth conduct of national policies relating to prudential supervision of banks and financial stability is interpreted as to exclude any direct banking supervision function by the ECB with the exception of a limited coordinating role. Instead, article 105(2) (ESCB Statute art. 3(1)) is interpreted to confer upon the ECB *oversight* competence for the payment systems,[162] despite the fact that its wording is not drafted that differently from that of article 105(5): 'The basic tasks

[162] EC Treaty art. 105(2), ESCB Statute art. 3(1). But see Maria Chiara Malaguti, *The Payments System in the European Union, Law and Practice* 318 (1997) (founding ESCB's 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 'a clear and indisputable interpretation' of article 105 of the EC Treaty). Malaguti also argues that the ECB will likely share responsibilities with the national central banks only in cases where its power derives from the central bank practice and not solely from the Treaty. This argument does not seem to take into account that the Treaty, even when the sole source of Community competence, can still, as in this case, provide for concurrent competences.

[163] 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 Toth, 'A Legal Analysis of Subsidiarity', in *Legal Issues of the Maastricht Treaty* 37, 41 (David O'Keeffe & Patrick M Twomey eds., 1994). Of course, recourse to language is not 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. Josephine Steiner, Subsidiarity under the Maastricht Treaty', in *Legal Issues of the Maastricht Treaty* 49, 54 (David O'Keeffe & Patrick M Twomey eds., 1994). See Stephen Weatherill, above note 158, at 16, 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', 33 *Common Market Law Review* 633, 655–64 (1996), for exclusive competences 'a priori' and by preemption.

to be carried out through the ESCB shall be . . . to promote the smooth operation of payment systems'. The wording[163] of article 105(2) suggests

[164] An ECB paper submits that decentralization (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 subsidiarity) applies to areas not falling within the common oversight policy:

> In line with the provisions 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 with 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.

ECB, *Eurosystem and Payment Systems Oversight*, above note 109, at 2, 3. This position is reaffirmed by Padoa-Schioppa in a reference to this ECB paper. However, Padoa-Schioppa proceeds to state that payment system oversight has '*clearly* been entrusted to the Eurosystem' (emphasis added), and hence, decentralization, and not subsidiarity, is the 'modality' that governs the exercise of these powers. Tommaso Padoa-Schioppa, above note 97. 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 that differently from the provision for prudential supervision (EC Treaty art. 105(5), ESCB Statute art. 3(3)). At the same time, article 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 banks? With regard to bank regulation and supervision, I argue that similar ECB tasks should be read in the Treaty. As for the payment systems oversight, my position is that the Treaty gives the ECB only a shared competence. The language used by the Statute *clearly* suggests a shared competence and the subsidiarity principle should apply. I support an exclusive competence only to the extent that the oversight act also aims toward the realization of the internal market. See AG Toth, above note 163, 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 note 49, at 305. See also Chiara Zilioli & Martin Selmayr, 'The European Central Bank', above note 6, at 634–36, 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 AG Toth, above note 163, at 42. Finally, it should be underscored 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 & Gráinne de Búrca, *EU Law: Text, Cases and Materials* 124 (2nd edn., 1998). The problem is more accentuated in the case of prudential supervision: first, because most of the provisions are drafted 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); and second, because of the powerful effect of monetary policy, which is exclusively entrusted to the Eurosystem. The competence to exercise monetary policy being interdependent with the com-

that the ECB's power of overseeing the payment systems is a concurrent competence, shared with the national central banks as autonomous national entities. Interestingly, views in the ECB leave room for considering the ECB's oversight competence as exclusive.[164, 165] Irrespective of the character – shared or exclusive – of the ECB's oversight power over the payment systems, it is important that the ECB's competence for the oversight of payment systems is founded upon language which is similar to that used to exclude other prudential functions from the ECB's competence. A justification offered for this different interpretation is that article 105(5) makes an explicit reference to national prudential supervision competences to which the ECB should contribute, while article 105(2) refers in general to the role of the ECB to promote the smooth operation of payment systems. Yet, neither article 105(5) nor article 105(2) determine what the precise responsibility of the ECB should be and in any case they equally avoid determining the boundaries between the ECB's role and national supervision competence.

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.

It is true that the EC Treaty provides for a specific procedure – the activation of the enabling clause by the Council – in conferring further prudential tasks upon the ECB. Yet, it is unclear what the prudential tasks are that only the Council can further confer. It is unclear where to draw the line between prudential tasks expressly defined 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 additional prudential supervision

petence to regulate and supervise individual banks and systems (eg 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 realization of the internal market – this will come into play, however, only after the existence of a power at all has been established either expressly by the Treaty or impliedly through the effect of the monetary policy).

[165] Arguably, a more affirmative position for the shared character of the oversight competence, which was expressed in the *ECB Monthly Bulletin*, April 2005, reduces the weight of conflicting views. *ECB Monthly Bulletin*, April 2002, above note 92, at 50.

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[166] EC Treaty arts. 5 (ex art. 3b), 7(1) (ex art. 4).

[167] 'It follows from article 3b [currently article 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 March 26 delivered pursuant to article 228 of the EC Treaty, 1996 ECR I–1759, 1787.

tasks that the ECB can exercise irrespective of the enabling clause.

The 'implied powers' doctrine provides that the Community has not only competence which is expressly prescribed[166] by specific Treaty provisions but also competence that is *implied from them*.[167] The 'implied power' doctrine applies to the ECB, as the ECB is 'in the constellation of the EC legal order'[168] and is 'fully subject to the principles of primary Community law and to the jurisdiction of the ECJ'.[169] Thus, the ECB can exercise powers, which are conferred upon it by the Treaty,[170] being expressly established thereby or implied therefrom.

As far as prudential supervision is concerned, further powers of the ECB can be implied from the Treaty provisions establishing the ECB's monetary policy competence. A wide interpretation of the 'implied powers' doctrine allows us to infer from the Treaty powers necessary for the attainment of the objective in question as well as powers necessary for the exercise of the expressly prescribed powers. In the Treaty, monetary policy is strictly defined only in relation to its primary objective and its tools. Prudential supervision may fall within the monetary policy competence, as the interdependence of monetary policy and banking supervision and of price stability and banking soundness establishes the necessary 'inseparable link' between monetary policy and prudential supervision. As shown above, monetary policy involves interaction with the banking system and responsibilities for its soundness, and prudential supervision at the ECB level is necessary for the attainment of price stability in the Euro zone. Thus, prudential supervision powers may be exercised by the ECB not only to the extent they are specifically prescribed in the Treaty but also to the degree they intertwine with the ECB's monetary policy.

Again, this exercise in concepts clarification only purports to show that there may not be serious legal or factual obstacles to the ECB's expansion of bank supervision competence. And this is necessary for the system to be efficient and accountable. Recognition of the ECB's supervision responsibility will make the ECB accountable for supervision malfunctions. A clarification of the exact supervision competence of the ECB should lead in its

[168] Jean-Victor Louis, above note 130, at 73.
[169] Chiara Zilioli & Martin Selmayr, 'The European Central Bank', above note 6, at 623.
[170] EC Treaty art. 8 (ex art. 4a).
[171] For the use of the term 'macro-prudential supervision' in this volume, see Chapter 1, Section 1.3. 'Macro-prudential supervision' includes information gathering from financial institutions and assessment of risks for systemic stability, analysis of macroeconomic conditions and financial markets, regulation of payment systems and management of liquidity crises.
[172] See, eg Charles AE Goodhart & Dirk Schoenmaker, above note 102, at 356 (stating the importance the closing of a bank (micro-prudential function) can have for macro-prudential functions).

building the necessary capability and ensuring efficient supervision of the integrated EU banking system. This is important mainly with regard to macro-prudential supervision[171] functions. Micro-prudential supervision, although linked to macro-prudential supervision,[172] may remain in the hands of the national bank regulator while, when the bank regulator is separate from the central bank, strong cooperation with the national central bank is further institutionalized.

2.4.3 Efficiency and representation

2.4.3.1 Efficiency

Clear delineation of a central bank's supervision responsibilities contributes to the efficiency of bank supervision. There is more efficient planning, duplicatory costs of the regulatees are avoided and market certainty is enhanced. Furthermore, making the central bank formally responsible has a positive effect on the sum of monetary and financial stability benefits. If the central bank does not have formal bank supervision responsibility, there is a risk that the central bank will handle conflicts of monetary and bank supervision policies at the expense of supervision objectives. It is likely that the central bank will give priority to its monetary policy function since, although independent, its reputation depends on, and its accountability relates to, the effectiveness of its monetary policy. Formal responsibility for bank supervision will lead to a more efficient trade-off between monetary and bank supervision policies. The central bank will then be forced to seek optimization of monetary policy and bank supervision benefits, since its reputation will depend on both, and it will be accountable for both.

This will apply in the case of centralization of bank supervisory competences at the EU level. The sum of monetary policy and bank supervision benefits will be higher if the European Central Bank has formal responsibility for its part of supervision functions. Formal responsibility will create reputation and accountability constraints, which in turn will lead to an efficient trade-off between monetary policy and bank supervision objectives. In addition, the ECB will be accountable for the exercise of supervision powers.

The negative effect on bank supervision from the absence of formal supervision responsibility of the central bank can be demonstrated by examining a bank supervision function with monetary policy implications.[173] The LOLR, which is based on the use of taxpayers' money, is such

[173] In case of monetary functions with bank supervision implications, such as an interest rate increase, the issue of formal bank supervision responsibility does not matter. Irrespective of the legal character of its supervision responsibility, the central bank will not be hindered in giving priority to monetary policy.

[174] See Charles AE Goodhart & Dirk Schoenmaker, above note 102, at 357.

a supervisory function. According to Goodhart's argument that 'he who pays the piper, calls the tune',[174] LOLR should be performed by the institution that provides the money in crises. If it is mostly taxpayers' money used in liquidity crises, since the central bank's reserves will most of the time be inadequate, then a separate institution, and in fact a 'quasi-autonomous body',[175] should be entrusted with LOLR responsibilities. Here we are faced with an LOLR category which is not within the legal power of the central bank. This LOLR category constitutes a bank supervision responsibility with monetary implications that is outside the 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*,[176] will exercise actual supervision and affect the LOLR decision without formal responsibility.[177] This may be at the expense of the supervisory function, since monetary policy remains the central bank's responsibility and its priority. The use of taxpayers' money affects the monetary base (although this is debatable) and the central bank will influence the LOLR decision accordingly.

More efficient bank 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 market fragmentation. But before helping the functioning of a fully internal market, more efficient bank supervision contributes to the process towards integration. It does so by taking away the prudential rationale for trade-restrictive national regulation. For example, financial stability-driven objections of the national regulator to cross-border mergers and acquisitions[178] diminish in the context of a bank supervision framework based not only on essential harmonization, home country consolidated supervision and supervisory cooperation but also on the supervision competence of an institution at the Community level. In addition, centralized bank supervi-

[175] *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, authorization, closure and insurance.'

[176] *Ibid.*

[177] *Ibid.*

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

[179] For the relevant competence of the ECB under article 5 of the ESCB Statute vis-à-vis the Community's competence, see Chiara Zilioli & Martin Selmayr, 'The European Central Bank', above note 6, at 635.

sion contributes to reduction of regulatory divergence. A case in point is further harmonization of rules on statistics and other reporting.[179]

2.4.3.2 Representation Centralization of bank supervision at the Community level raises concerns about the effective representation of all affected interests. Representation claims are related first to the 'distance'[180] aspect of the democratic deficit discourse, that is the shift of the decision-making process away from the citizen. The criticism of democratic deficit intensifies, when the ECB is proposed as the responsible body for the centralized supervision. In that case, the ECB's independence will cover prudential supervision powers, as its independent status covers all its tasks and duties prescribed by the EC Treaty and the ESCB Statute.[181] The independence of the ECB from the political process augments the democratic deficit problem extending to all its aspects: 'executive dominance issue', 'by-passing of democracy argument', 'transparency and complexity issue', 'substantive imbalance issue', 'weakening of judicial control issue'.[182] In particular, there is concern for the rigid form of the ECB independence, which is reflected in its endorsement at the Treaty level, that is at the level of a 'constitutional charter of a Community based on the rule of law',[183] and its amendment only through[184] the intergovernmental process and ratification by the national parliaments.[185]

In determining the substance of these concerns, first the interdependence of monetary policy and bank supervision, and the extension of the 'politically neutral' argument to prudential supervision are examined. We then turn to the mechanisms whose aim is to ensure accountability of the ECB's powers. Finally, the accountability of a centralized bank supervision framework is compared to the accountability of alternative arrangements.

[180] For a summary of democratic deficit features following Joseph Weiler's work, see Paul Craig, 'The Nature of the Community: Integration, Democracy and Legitimacy', *The Evolution of EU Law* 1, 23–24 (Paul Craig & Gráinne de Búrca eds., 1999).
[181] EC Treaty art. 108 (ex art. 107), ESCB Statute art. 7.
[182] See Paul Craig, above note 180.
[183] Opinion 1/91, Opinion of the Court of 14 December 1991 delivered pursuant to the second subparagraph of Article 228(1) of the Treaty, 1991 ECR I–6079.
[184] Article 48 (ex article N) of the Treaty on European Union, 1992 OJ (C 191). The ECB should also be consulted.
[185] This is compared to other jurisdictions where central bank independence is established only through an ordinary legislative act, eg the Bundesbank's independence is prescribed in the Bundesbank Act (under the old Bundesbank Act a veto over Bundesbank's decisions was also available to Government representatives present in the meetings of the central bank council (Zentralbankrat) – although this had never been exercised). See also Fabian Amtenbrink, *The Democratic Accountability of Central Banks, A Comparative Study of the European Central Bank* 161 (1999) (rejecting the proposition that a constitutional guarantee of the Bundesbank's independence is found in article 188 of the Basic Law). See also *ibid.* at 167, for an analysis of Acts of Parliaments as the legal basis of central bank independence in jurisdictions examined therein. But see Rosa Maria Lastra, above note 129, at 491 (arguing that the Bundesbank's independence has been enhanced through its provision in the German Unification Treaty).

2.4.3.3 Independence rationale and prudential supervision An assessment of the value of democratic control over a centralized bank supervision system should take into account the rationale of the independence of monetary policy and the link between prudential supervision and monetary policy. As described in Section 2.1 above, economic theory has established that there is no trade-off in the long run between price stability and employment or growth, and that monetary policy involves no balancing of diverse 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 favour inflationary policies. The interdependence of banking soundness with price stability can justify '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.[186, 187]

2.4.3.4 Accountability, transparency and regime control Accountability mechanisms ensure control by the political authorities and effective representation of diverse interests. At present, various instruments exist through which the democratic character of the ECB is advanced. First, it is important that the institutional status of the ECB has been decided through the established Treaty amendment process, where all Member States equally participate and ratification by the national assemblies follows. Beyond the point of democratic creation, a role for the European Parliament, the

[186] See also Group Recommendations, *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) (arguing that supervision is an administrative issue that does not call for a particular governmental control).

[187] For the position favouring extension of protection from political influences to the national regulators, see European Shadow Financial Regulatory Committee, *Dealing with problem banks in Europe, Statement No. 1* (June 22, 1998), <http://www.aei.org/shdw/shdw.htm> (last visited March 2, 2000):

> 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.

[188] See Christa Randzio-Plath, *A new political culture in the EU – democratic accountability of the ECB* 10 (ZEI Working Paper B4, 2000, February 2000), <http://www.zei.de>, for the content of reports to the European Parliament and proposals for their improvement.

[189] EC Treaty art. 113(3) (ex art. 119b), ESCB Statute art. 15. In fact, the President of the ECB has been appearing quite frequently before the European Parliament.

Council and the Commission is prescribed. Thus, the ECB has to submit a report on an annual basis, or in the case of the European Parliament,[188] upon the initiative either of the ECB President or other members of the Executive Board, or of European deputies.[189] Also, the President of the Ecofin Council[190] and a member of the Commission can influence the ECB's agenda through their participation,[191] albeit with no voting rights, in the meetings of the Governing Council (although they cannot be present at the meetings of the Executive Board).[192] The Treaty also requires that the ECB President be invited to participate in Council meetings that involve issues of relevance for the ECB's objectives and tasks.[193] Moreover, judicial review secures the compatibility of the ECB's acts or omissions with Community law and with its underlying objectives.[194] Although it is difficult for private applicants to establish standing,[195] the Community institutions should be able to seek judicial scrutiny.[196] The ECB itself is also willing to subject its operation to the review of the European Ombudsman,[197] who is appointed by the European Parliament.

[190] The Economic and Financial Affairs Council of the European Union is known as the Ecofin Council.

[191] The President of the Council may also submit a motion for deliberation.

[192] It is interesting to compare this to the old Bundesbank regime where the members of the executive participating in the Bundesbank's governing council enjoyed a right of suspension over any decision (although this right had never been exercised). Bundesbank Act ex art. 13(2).

[193] EC Treaty art. 113(2) (ex art. 119b).

[194] 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 arts. 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, below note 277.

[195] For an analysis of issues of standing for non-privileged applicants, see Paul Craig, below note 277, at 100; Paul Craig & Gráinne de Búrca, above note 164, at 461. A recent judgement of the Court of First Instance of the European Communities holds promise for significant expansion of the rights of individuals to challenge Community measures of general application. Case 177/01, *Jégo-Quéré & Cie SA v Commission*, ECR (Ct. First Instance, 2002) available at >http://europa.eu.int>.

[196] However, see below note 279, for the high degree of deference expected for 'macroeconomic policy-intensive' decisions of the ECB.

[197] For the ECB's positive response to the Ombudsman's inquiry about public access in documents, see The European Ombudsman, 'European Ombudsman inquires into public access to documents of the European Central Bank', Press Release No. 4/99, April 13, 1999, <http://www.euro-ombudsman.eu.int/release/en/transp99.htm>; The European Ombudsman, 'European Central Bank responds positively to the Ombudsman's inquiry into public access to documents', Press Release No. 6/99, May 17, 1999, <http://www.euro-ombudsman.eu.int/release/en/ecb1.htm>.

[198] Accountability to political institutions in the EU is admittedly weak, as there is no real principal, a legitimized body that will effectively represent the European people's perceptions and interests in controlling the ECB. See Jürgen von Hagen, *The ECB: Transparency and Accountability* (ZEI, University of Bonn, and CEPR, December 1998), <http://www.zei.de/download/zei_emu/emu_2_vonhagen.pdf>. Jürgen von Hagen argues that the European Parliament can be a legitimate and effective principal only if pan-European elections are held, and that the European government cannot be such a principal simply because it does not exist.

Besides the formal arrangements for accountability, which some scholars criticize as inherently flawed,[198] transparency and the residual control by the financial markets and the political system help in securing compliance of the ECB with its democratically defined objectives.

Transparency is a very important parameter in evaluating the democratic character of the ECB, especially since the ECB puts emphasis on transparency in achieving both effectiveness and democratic legitimacy.[199] Transparency relates more to the effective, real-time, communication of the ECB's policy to the interested parties, namely the financial markets, the media and the public at large, rather than the retroactive justification of its policies and decisions. This is mainly the aim of the extensive press conferences, that are held by the ECB President after the Governing Council meetings. The Governing Council decisions are explained immediately after they occur, so that in real-time the financial markets perceive their message and they structure their activities accordingly. Detailed press conferences have been chosen instead of publication of the minutes,[200] which – when they are the preferred instrument – are published with delay and are thus considered to be ineffective in conveying real-time information.[201] Also, in the case of the ECB voting records, any publication may allow political influence on the national central bank governors.[202] As an additional means for enhancing

[199] Padoa-Schioppa maintains that transparency and accountability, although overlapping, should not be used interchangeably, and offers an elegant conceptual distinction between the two: accountability is a 'political duty' relating to *ex post* justifications of policy while transparency is an 'economic requirement' relating to the effectiveness of the policy-making. Padoa-Schioppa, 'An institutional glossary of the Eurosystem', above note 131.

[200] The minutes are confidential and only the Governing Council may decide for disclosure of relevant information. ESCB Statute art. 10(4).

[201] For example, minutes of the meetings of the Federal Open Market Committee (FOMC) in the US are published approximately six weeks after the meeting (there are eight regularly scheduled FOMC meetings during the year and the minutes for each meeting are published on the Thursday following the next meeting) whereas the minutes of the Monetary Policy Committee (MPC) of the Bank of England are now published with only a two-week delay, ie on the Wednesday of the second week after the MPC's monthly meeting (until October 1998 it used to be about five weeks, in line with the requirement of the Bank of England Act 1998, s. 15, for publication within six weeks from the meeting). For the reasons of the relevant MPC decision, see Letter from the Governor of the Bank of England to Giles Radice Esq, Chairman, Treasury Committee, House of Commons (October 7, 1998), available at <http://www.bankofengland.co.uk/mpc/radice.pdf>.

[202] But see Jürgen von Hagen, above note at 198, at 8 (setting out problems with press conferences as a means of transparency).

[203] ECB Press Release, 'Publication of staff economic projections', November 16. 2000, <http://www.ecb.int/press/00/pr001116_1en.htm>.

[204] European Central Bank, 'Staff economic projections for the Euro area', *ECB Monthly Bulletin*, December 2000, at 49, <http://www.ecb.int>, European Central Bank, 'The Publication of Eurosystem staff economic projections by the ECB', *ECB Annual Report 2000* 11 (ECB 2000), <http://www.ecb.int>.

[205] Sir Edward George, the former Bank of England governor, regards forecasts as a complicated monetary policy tool and in his view they should be forecasts of the Monetary Policy Committee and not staff forecasts. Ed Crooks, 'Transcript of interview with Sir Edward George', *Financial Times*, May 7, 2002, <http://www.news.ft.com>.

transparency, the ECB Governing Council has decided to publish staff macro-economic projections.[203] They appeared for the first time in the *ECB Monthly Bulletin* of December 2000 and are to be prepared on a biannual basis.[204] The name 'projections', instead of 'forecasts',[205] was chosen to signify their limited predictive value, which is related to their dependence on various 'conditioning assumptions', in particular on unchanged short-term interest and Euro exchange rates.[206] Nevertheless, projections are an important input into the deliberations of the Governing Council and their publication contributes to the transparency and effectiveness of the ECB monetary policy. All these transparency instruments establish reasonable expectations that policy becomes more effective, while democratic legitimacy is promoted through the subsequent enhancement of welfare benefits.

Moreover, despite their independent status, central banks are always subject to a *'regime' control*.[207] The success of central bank policy is interdependent with the political and market environment. The consensus of the political system in favour of the monetary policy objectives contributes to their attainment and the success of monetary policy is necessary for the continuous support by the political and market forces. Interestingly, this becomes more the case once central banks become independent, as they then become more visible for the political debate.[208] The ECB's effectiveness and legitimacy depends on its ability to produce the price stability output envisaged by the 'expectations-augmented Philips curve' theory. For this, it is important that the attitudes of the market, the political system and the public at large are shaped and are also taken into account. In this vein,

[206] For the importance of the distinction between 'projections' and 'forecasts' and the role of 'projections', see Otmar Issing, 'The euro and the ECB, Successful start – challenges ahead', Speech at Market News Seminar, London (May 3, 2001) <http://www.ecb.int/key/01/sp010503.htm>.

[207] See Robert Elgie & Helen Thompson, above note 123, at 48, for an illustrative historical example of political influence on central banks in the context of the Bank of England:

> Norman [then Governor of the Bank of England] himself was essentially unsympathetic to Churchill's instinct that the return to gold and an externally-oriented monetary policy was to blame for Britain's economic problems in the late 1920s, believing that the country simply had to get used to changing patterns of international demand. But, while Churchill could not stop the Governor once the latter had made up his mind to act, Norman *certainly felt constrained* by ministerial views and was *only* prepared to raise rates when a transparent external rationale presented itself, and he had secured co-operation from other central banks . . . Indeed, by the time Labour took office in 1929 the new Chancellor, Philip Snowden, was able to exercise *sufficient moral pressure* on Norman in his Mansion House speech to delay a rise in interest rates by three months. (emphasis added)

[208] For the interplay of central banks and the political system, see Goodhart, *Central Bank Independence*, above note 132. See also below note 217, on independence and visibility of central banking.

[209] However, it should be stressed that by no means should this undermine the primacy of the price stability objective. This is particularly important in the first years of the ECB. Due to lack of track record for the ECB monetary policy, more than strict adherence to the price stability objective might be necessary for establishing the ECB's 'credibility' with respect to avoiding 'surprise inflation'.

the 'other' Community welfare objectives, although subordinate to price stability, need to be considered.[209] Otherwise, in the event of severe, even short-term, negative effects on these 'other' Community economic objectives, it is likely that the Treaty will not prevent the political system from exerting influence on the ECB policy. Ultimately, it cannot be excluded that the political forces will resort to an institutional rearrangement.[210, 211]
A good example of the de facto regime control is the strong reaction of the markets and the political system to the ECB's policy on the Euro and to subsequent statements by Wim Duisenberg, the ECB President at the time. Although the independence of the ECB and its governor remained intact,[212] Mr Duisenberg had to account to the financial community for his statements, and the political system called for 'consistency' in the ECB's actions and policy.[213]

[210] In the words of Professor Goodhart: 'Treaties can also be amended, or rescinded; it just takes rather longer'. Goodhart, *Central Bank Independence*, above note 132, at 9, 10.
[211] See Charles W Calomiris, 'The Impending Collapse of the European Monetary Union', 18 n. 3 *Cato Journal* 445, 446 (1999), <http://www.cato.org>, for the threat for exit as a control mechanism over monetary policy: 'European members of the monetary union will retain the option to exit. That not only means that the monetary union may fall apart; it also means that the (implicit or explicit) threat of exit will be used by member countries to influence monetary policy . . .'.
[212] Still, we should note that it was rather concerns for the negative effects on the Euro, than the 'hard' nature of the ECB's independence, that prevented the political system from triggering changes in the ECB governing and policy. The surrounding political circumstances were also of concern:

> But the whispering campaign against Wim Duisenberg among finance ministers serves no purpose. Mr Duisenberg's departure might well be taken as a sign of panic, which *would do nothing for the euro's fortunes*. It would also call the independence of the ECB into question. Replacing Mr Duisenberg *now would also be difficult in practice*: his successor, Jean-Claude Trichet, governor of the Bank of France, has been drawn into the French judicial investigation into accounting irregularities at Crédit Lyonnais. (emphasis added)

'Euro Troubles', Editorial Comment, *Financial Times*, October 19, 2000.
[213]

> The Euro lurched to a record low against the US dollar yesterday amid mounting criticism by politicians across Europe of the performance of Wim Duisenberg, the European Central Bank's president . . . Mr Duisenberg is due to hold a *press conference* in Paris today after a fortnightly meeting of the ECB's policymaking governing council. The event is expected to be *one of the biggest challenges of his two years in office*. He will be asked to explain his controversial remarks on the ECB's policy on foreign exchange market intervention in a newspaper interview . . . Although some experts said they suspected there was pressure from governments in the euro-zone to force Mr Duisenberg's resignation, politicians across Europe have declined to criticise him publicly. Even if they did criticise him it would not affect his status as an independent bank governor – and many fear that any change would drive the Euro lower. (emphasis added)

International Staff, 'Embattled euro falls to new low', *Financial Times*, October 19, 2000.
[214] Of course, there is also the flaw of discussing the democratic legitimacy of the European Union, which is not a state, by using modern democracy discourse which centres 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 HH Weiler, above note 1, at 7.

2.4.3.5 Alternative arrangements: national – international The debate on the democratic deficit of bank supervision centralization should be judged against the alternative arrangements, existing or potential, at both national and international level.[214] 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).[215]

Thus, at the *national* level, the democratic character of the bank supervision systems is not unquestionable. Taking into account the technical character of the bank supervision issues and the lack of expertise by the national parliaments, it is unclear how national parliamentary control has added to the political scrutiny of bank supervision. On the contrary, national parliaments have not traditionally been participants in the 'public sphere'[216] regarding central banking activity.[217] Also, bank supervision has not been formally subject to political control in all cases. This is demonstrated by the arrangements in relation to the Bank of England. The Bank of England was independent in the conduct of bank supervision, while it lacked independence with regard to monetary policy.[218] 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 bank supervisors, although not prohibited, will be found unacceptable to the extent it intrudes on their monetary policy tasks. This intrusion can happen quite frequently if one considers the interdependence of price stability and bank soundness and the commonality of the instruments employed for their attainment. In any case, effective accountability of the national supervisors to national constituencies does not lead to accountability of bank supervision with respect to European Union interests. Accountability to national

[215] Paul Craig, above note 180, at 27.

[216] On the notion of the 'public sphere' in the context of the discussion about an EU-wide public sphere as an empirical condition for the formation of a European identity, see Jürgen Habermas, 'Why does the European Union need a Constitutional Frame?' 13, Paper delivered at the Convegno Internazionale: Sfera Pubblica e Costituzione Europea, Conference organized by the Fondazione Lelio e Lisli Basso Issoco, Rome, December 16, 2000.

[217] See Paul Magnette, 'Towards "Accountable Independence"? Parliamentary Controls of the European Central Bank and the Rise of a New Democratic Model', 6 n. 4 *European Law Journal* 326, 328 (2000), for a very interesting point on the 'opaqueness' of central banking until the 1980s, that is before central bank independence became the norm: '[Central bank decisions] were hardly debated at all. They were the result of long and secret bargaining between ministers, central bankers, international institutions and private organizations, of which the public only knew the final conclusion . . . most MPs [were] . . . more interested by subjects on which public attention could be more easily drawn.'

[218] For an analysis of the discretionary character of supervision by the Bank of England and accountability implications, see Christos Hadjiemmanuil, *Banking Regulation and the Bank of England* (1996).

[219] ESCB Statute art. 14(4).

parliaments does not provide enough legitimacy to decisions that impact on the European banking system. Finally, even in a 'fully accountable' decentralized bank 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 ESCB'.[219]

Viewing the democratic deficit issue against existing *international* arrangements, we observe that centralized macro-prudential rule making would involve balancing of the same type of policies that the Basel Committee evaluates in formulating its standards. The scholars finding democratic deficit in a centralized EU bank supervision system should extend their scrutiny to the standards of the non-accountable Basel Committee,[220] that is standards that the Community has already followed[221] in building its prudential regulation and supervision without effective political control. As a 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,

[220] As a group of central bank governors the Basel Committee is not subject to any review or transparency requirements. Nevertheless, its promulgations are legally binding in effect due to the influence of its members' economies. For analysis of the accountability and efficiency of Basel-type rule making and a comparison with international treaty making, see Chapter III, Section 2.3.3.1. See also Chapter III, Section 2.1.1.2, for the varying degree of accountability in the case of incorporation of the Basel standards in the GATS and in the EU.

[221] See, eg Michel Aglietta, above note 2, at 52: 'In Europe the Commission has issued directives which *endeavour* 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 n. 1 *Journal of International Banking Regulation* 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', *International Monetary Law* 3, 40, para. 1.55 (Mario Giovanoli ed., 2000): '[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).

[222] See *Institutional Arrangements Report*, above note 44, 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).

[223] '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.

[224] For issues of democratic legitimacy in relation to '*infra*nationalism' and its main arena in the EU context, ie comitology, see Joseph HH Weiler, above note 1, at 15, 21.

[225] '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 direc-

(emphasis added).[222] In addition, a review of the accountability of the current system should take into account the influential role[223] of the Banking Advisory Committee (which has recently been replaced by the European Banking Committee) in the development of the EU supervision system.[224] The Banking Advisory Committee has been *de facto*[225] the body that effects technical amendments to the banking directives in the context of the 'comitology' process.[226] 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).[227]

In the absence of a centralized bank supervisor, the alternative is likely to be sought in bilateral or international agreements, which are primarily based on the will and initiative of the executive[228] or of other sub-governmental entities.[229] Moreover, democratic deficit arguments should take into account the potential evolution of the EMU supervision system, if no clear delineation of bank supervision competences toward centralization takes place. A 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

tive is called for under a comitology' procedure, the BAC changes its chairmanship in its meetings to permit the Commission to assume the chair and assists the Commission in carrying out technical adaptations to the Banking Directives'. *Institutional Arrangements Report*, above note 44, at 7.

[226] Technical provisions of the banking directives are subject to amendment through the simple 'comitology' process. *Ibid.* at 6.

[227] Banking Consolidation Directive art. 60 (ex 2BD art. 22).

[228] Cross-border activities produce externalities which can be managed better through international cooperation. Therefore, if Community institutions were not in place, the substitute would be international agreements by the executive with limited control by national parliaments. See Paul Craig, above note 180, at 26–27.

[229] 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 *European Journal of International Law* 503 (1995); Anne-Marie Slaughter, 'The Real New World Order', 76 *Foreign Affairs* 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 bank supervision authorities. It should be noted that Slaughter sees enhanced accountability in international cooperation and norm making through sub-state agencies. For a critical review of this position, see Chapter III, Section 2.3.3.1.

[230] My argument has been that centralization of bank supervision contributes to financial and monetary stability. Enhanced financial and monetary stability reflect surplus on the output side of the democratic process. Sharpf distinguishes between the input and the output side of the

will have to be recognized that enhanced efficiency from a centralized system will promote legitimacy. Centralized supervision will lead to democratic surplus (enhanced systemic stability) on the output side of the financial system which will outweigh democratic deficit (lack of accountability) on the input side.[230]

2.4.4 Macro-prudential supervision vis-à-vis micro-prudential supervision – Financial supervision developments in the EU

It is mainly macro-prudential supervision that my analysis is concerned with Micro-prudential supervision may remain with the bank regulator, which could be the national central bank as autonomous entity or a separate national institution. The argument is developed for the ECB to be in charge of macro-prudential supervision. The ECB should also intervene in micro-prudential supervision when there is a compelling financial stability or internal market consideration (eg reporting rules).

The institutional choice for the micro-prudential supervisor is beyond the scope of the analysis here. The same applies to the issue of micro-prudential supervision at the Community level. However, it is submitted that the macro-prudential supervisor has to be close to the first-line, micro-prudential, supervisor so that real-time sharing of information and cooperation is ensured. Thus, for the Eurosystem to perform its macro-prudential supervisory role, the macro-prudential role of the national central banks should be secured. An overview of related developments in the EU provides some interesting insights into the designing of macro- and micro-prudential supervision. Yet, it should not be forgotten that macro-prudential responsibility already includes micro-prudential functions and that a clear demarcation line between the two is difficult to draw, both conceptually and in practice.

democratic process. While the input side refers to the accountability of the decision-making bodies to those governed, the output side refers to the efficiency impact of their decisions. Von Fritz W Sharpf, *Economic Integration, Democracy and the Welfare State* (MPIfG Working Paper 96/2, July 1996), <http://www.mpi-fg-koeln.mpg.de/pu/workpap/wp96–2/wp96–2.html>.

[231] 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 2000 (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.

[232] 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) upon it.

Prudential supervision in the UK provides an interesting model. First-line prudential supervision (micro-prudential supervision) has been transferred to the Financial Services Authority (FSA),[231] while the Bank of England remains the primary macro-prudential supervisor.[232] The Bank of England has retained its responsibility for macro-prudential supervision including oversight over payment systems and lender of last resort. Although there is no statutory basis for the relevant responsibility, the *Memorandum of Understanding between the Treasury, the Bank of England and the FSA* expressly prescribes it.[233] The *Memorandum* also provides for information gathering and sharing arrangements between the Bank of England and the FSA, as well as for cross-representation in their decision-making bodies and a Standing Committee of representatives of the Treasury, the Bank and the FSA.[234] Also, a statutory basis for gathering information and analyzing the reporting from banks is provided in the Bank of England Act 1998.[235] This is in the context of the monetary policy competence of the Bank of England but it should also be possible for it to be used for its macro-prudential role. Finally, in the case of LOLR the *Memorandum* provides for consultations in the context of the Standing Committee and for timely solicitation of Treasury approval. [236]

Germany and Austria have also adopted the single financial regulator model but they have provided for extensive macro-prudential functions of the respective central banks and this on a statutory basis. Germany recently established (May 1, 2002) a single authority for the supervision of banking, securities markets and insurance, the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BAFin),[237] through merg-

[233] *Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority*, <http://www.bankofengland.co.uk/financialstability/mou.htm> [hereinafter, *Memorandum*], secs. 2, 11–13. With respect to the payment systems, the Regulations implementing the Settlement Finality Directive (EP and Council Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems, 1998 OJ (L 166) 45) also provide that the Bank of England designates the payment systems, which can avail from the Directive. See Bank of England, 'The Bank of England's Oversight of Payment Systems', above note 87; David Clementi, 'UK Financial Services following the Launch of the Euro', Speech at the Economist Conferences (April 23, 1999), <http://www.bankofengland.co.uk/speeches/subject.htm>.

[234] *Memorandum*, secs. 5–9, 10–13, 19. Following the September 11 terrorist attacks in the US, the Treasury, the Bank and the FSA have established a framework for coordinating financial sector continuity. This is to ensure a timely and effective handling of financial sector crises triggered by such events. See <http://www.financialsectorcontinuity.gov.uk/home/HomePage.htm>.

[235] Bank of England Act 1998, Part II, s. 17.

[236] Apart from continuous contacts and a program 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. *Memorandum*, secs. 8, 9.

[237] See <http://www.bafin.de/>.

[238] It appears that the exclusion of the Landeszentralbanken from the small management board considered by the Bundesbank as its new management board (Vorstand) was critical in

ing the respective agencies, namely the Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen – BAKred), the Federal Securities Supervisory Office (Bundesaufsichtsamt für den Wertpapierhandel – BAWe) and the Federal Insurance Supervisory Office (Bundesaufsichtsamt für das Versicherungswesen – BAV). This took place despite the Bundesbank's ambition to integrate supervision under its roof and become itself the single financial market regulator.[238] However, pursuant to the new section 7(1) of the Banking Act (Gesetz über das Kreditwesen),[239] the Bundesbank has now an express responsibility for the ongoing supervision of credit and other financial institutions. Ongoing supervision includes analysis of the reporting from the supervised institutions, and conduct and evaluations of audits regarding the supervised institutions' capital base and risk management procedures. The Federal Financial Supervisory Authority has the responsibility for taking regulatory measures concerning institutions on the basis of the Bundesbank's audit findings and appraisals. Finally, the Bundesbank participates in the Forum for Financial Market Supervision and shares legal responsibility for financial stability.[240]

In Austria, a new law on financial market supervision (Finanzmarktaufsichtsgesetz) was enacted in summer 2001 and a single financial authority, the Financial Market Supervisory Authority (Finanzmarktaufsichtsbehörde – FMA), started its operation in April 2002 with responsibility for banking, securities and insurance supervision.[241] Following the ECB's opinion,[242] the law on financial market supervision (Finanz-marktaufsichtsgesetz)[243] has provided for the responsibility of

Länder governments' decision to withdraw their support from the Bundesbank's reform plans and instead back the Eichel proposal. For some background to the German supervision reform, see Klaus Engelen, above note 148, at 38. Interestingly, the earlier plan of the 'Pöhl Commission', an expert Commission under the former president of the Bundesbank, Karl Otto Pöhl, had suggested that the BAKred (the Federal Banking Supervisory Office) be integrated in the Bundesbank. Klaus Engelen, ' "High noon" for German supervision', 5 n. 2 *The Financial Regulator* 38 (2000).

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[239] For an English translation of the German Banking Act, see <http://www.bundesbank.de/download/bankenaufsicht/pdf/kwg_e.pdf>.

[240] Deutsche Bundesbank, *Annual Report 2001* 163 (April 2002), <http://www.bundesbank.de/en/monatsbericht/geschaeftsbericht/gb01_e.pdf>. Deutsche Bundesbank, *The functions of the Deutsche Bundesbank*, <http://www.bundesbank.de/en/presse/kurzdarstellung/aufgab.htm>.

[241] *OeNB Financial Stability Report 2*, above note 140, at 5. For a review of Austria's supervision reform, see Michael Würz, 'Reform of Financial Market Supervision in Austria — The New Financial Market Supervision Act (Finanzmarktaufsichtsgesetz — FMAG)', *Oesterreichische Nationalbank, Financial Stability Report 2* 111 (October 10, 2001), <http://www2.oenb.at/english/engl_p.htm>. It is interesting that initially the idea was to entrust the OeNB with integrated supervision but the Bill, even though it passed the review process, was not approved by the Council of Ministers.

[242] ECB Opinion – Austria Reform, above note 54.

[243] *OeNB Financial Stability Report 2*, above note 140, at 5; Oesterreichische Nationalbank, 'Reports: Financial Intermediaries in Austria', *Oesterreichische Nationalbank, Financial Stability Report 3* 8, 25 (May 10, 2002), <http://www.oenb.co.at/downloads/fsr_3–en.pdf>.

the Oesterreichische Nationalbank (OeNB), the central bank of Austria, for the overall stability of the financial system. The OeNB also has an operational involvement in prudential supervision, covering both market and credit risk, and should cooperate with the FMA regarding prudential supervision. In addition, it has the power for collection and analysis of supervisory information and is entrusted with a responsibility for the oversight of payment and securities settlement systems.

In the Netherlands, although there is no plan for a single regulator, since September 2002 there has been reform under which financial supervision is organized along the lines of the supervision objectives. De Nederlandsche Bank (DNB), the central bank of the Netherlands, is responsible for systemic stability and prudential supervision of banks, investment funds and securities firms, the Pension and Insurance Supervisory Authority of the Netherlands (Pensioen- en Verzekeringskamer) is in charge of prudential supervision of insurance companies, while the new Authority for Financial Markets has been entrusted with the supervision of securities markets and conduct of business in respect of all financial institutions.[244] It should be noted that already, since August 1, 1999, cooperation between the DNB, the Insurance Supervisory Authority (Verzekeringskamer) and the Securities Board of the Netherlands (Stichting Toezicht Effectenverkeer) has been institutionalized with the operation of the Council of Financial Supervisors.[245]

It remains to be seen how the EU bank supervision system evolves. In a letter to the Council of Ministers, the UK and German Ministers of Finance, Gordon Brown and Hans Eichel, have endorsed the trend for a single financial regulator and have taken it further by envisaging a similar structure at the EU level.[246] Whatever the follow-up, it is important that any future plans secure an express macro-prudential responsibility for the national central banks. Calls for an express micro-prudential role by the central banks should not be overestimated. A macro-prudential responsibility already includes micro-prudential functions. The same is true for macro-prudential responsibility itself, which can always develop as the

[244] For the decision to retain De Nederlandsche Bank as the competent authority for prudential supervision, see Nout Wellink et al., *The role of national central banks within the European System of Central Banks: The example of De Nederlandsche Bank* (De Nederlandsche Bank MEB Series 2002 No. 13, August 2002), <http://www.dnb.nl/monetair_beleid/pdf/serie2002–13.pdf>. There are plans for the integration of the De Nederlandsche Bank and the Pension and Insurance Supervisory Authority, as well as for the introduction of a new Financial Supervision Act by January 2005. De Nederlandsche Bank nv, *Annual Report 2002* 108–10 (2003), <http://www.dnb.nl/publicaties/pdf/jv02_alg_uk.pdf>.

[245] Council of Financial Supervisors, The Netherlands, *Interim Report August 1999–August 2000* (September 2000), <http://www.dnb.nl/publicaties/pdf/rtf-uk.pdf>.

[246] Tony Barber, Germany and UK in move over banking supervision, *Financial Times*, April 12, 2002; ‘Germany, Britain, Seek Reform of EU Banking Supervision’, *Handelsblatt*, April 11, 2002, <http://www.handelsblatt.com>. For a proposal for a Community single regulator, see also Norbert Walter, above note 178.

micro-aspect of monetary policy. On the other hand, it is admitted that express delineation of the relevant responsibilities will make the macro-prudential supervision by the national central banks more efficient and accountable. This in turn will contribute to the macro-prudential functions of the Eurosystem. Yet, the same efficiency and accountability considerations require that we acknowledge the inherent limitations in drawing clear lines between the macro- and micro-prudential functions.

I examine below the Treaty arrangements for foreign exchange policy to show how the 'implied powers' doctrine has provided a basis for extension of the ECB's monetary policy competence into powers implied from it. Finally, I apply the 'implied powers' doctrine to the LOLR function. Again, the risk of a wide interpretation of the monetary policy concept is acknowledged. The purpose, however, is more to signal the potential evolution of the EU bank supervision system in line with the Europeanization of the banking system, and stress the efficiency and accountability arguments for a clear delineation of the institutional setting.

2.5 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 the ECB's powers. As the ECB is not explicitly entrusted with a power over 'informal' foreign exchange policy, I argue that its relevant actions could be justified only on the basis of its monetary policy competence and its objective of price stability. The analysis here employs the term 'informal' foreign exchange pol-

[247] For the complexity of article 111 (ex article 109), see René Smits, above note 49, at 375. The uncertainty as to the responsible authorities is reflected in the phrase 'no-one is in charge' and has been blamed for past weakness of the Euro vis-à-vis the US dollar. See Ben Patterson et al., *Exchange Rates and Monetary Policy 8*, 35 (Directorate-General for Research, European Parliament, Working Paper ECON–120 EN, August 2000), <http://www.europarl.eu.int/workingpapers/econ/pdf/120_en.pdf>.

[248] '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). I agree with Zilioli and Selmayr that article 111(3) not only prescribes the process for entering into agreements under article 111(1) but that it deals itself with allocation of external competences. Chiara Zilioli & Martin Selmayr, 'The External Relations of the Euro Area', above note 6, at 295, 296. See also *ibid.* at 299, for the scope of 'agreements concerning monetary or foreign exchange regime matters'. But see René Smits, above note 49, at 402 (treating article 111(3) as a procedural provision).

[249] '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

icy to denote foreign exchange policy, which does not take the form of more structured articulation or commitment *vis-à-vis* third countries as in the case of the Treaty-prescribed foreign exchange policy arrangements.

The Treaty does not establish a clear allocation of competences in the area of foreign exchange policy.[247] With respect to public international law agreements on monetary or foreign exchange regime matters,[248] including[249] 'formal' agreements, that is Bretton-Woods type of agreements which establish parity regimes with obligations to intervene for maintaining the agreed exchange rate levels,[250] the Treaty confers upon the (Ecofin)[251] Council the competence to negotiate and conclude such agreements. In the absence of such public international law agreements, the Council can promulgate general exchange rate policy orientations,[252] which would cover 'informal' foreign exchange policy as well as foreign exchange guidelines emanating from accords like the Plaza and Louvre accords.[253] Such competence of the Council can also be founded upon the internal competence of the Council to target economic policies to a certain foreign exchange rate. 'Informal' foreign exchange policy always falls 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. Some scholars argue that article 105(2) of the EC Treaty provides a legal basis for the ECB's competence over foreign

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).

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[250] It has been clarified that the term 'formal agreements' in article 109 (current article 111(1)) does not mean a new category of international agreement under Community law. Declaration on Article 109 of the Treaty establishing the European Community Treaty on European Union, 1992 OJ (C 191) 99. For the use of the term 'formal agreements' to denote Bretton-Woods type of agreements, see René Smits, above note 49, at 386.

[251] Declaration on Part Three, Titles III and VI [currently Title VII], of the Treaty establishing the European Community, 1992 OJ (C 191) 98. It should be noted that Member States with a derogation, as well as Denmark and the UK, do not have the right to vote in respect of acts of the Council under article 111 (ex article 109) of the EC Treaty. EC Treaty arts. 122(3), (5) (ex art. 109K); Treaty on European Union – Protocol on certain provisions relating to Denmark, 1992 OJ (C 191) 89, art. 2; Treaty on European Union – Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, 1992 OJ (C 191) 87, arts. 5, 7.

[252] '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).

[253] For the Plaza and Louvre accords, see René Smits, above note 49, at 380, nn. 57–8.

[254] Of course, the ECB will carry out its monetary policy in accordance with its price stability objective and the Euro exchange rate will reflect this policy.

exchange policy. However, article 105(2) only empowers the ECB to conduct foreign exchange operations and this only in conformity with the division of responsibilities specified in article 111. There has only been 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.[254] The negotiations on the relevant issues confirm this. There was no acceptance of the proposals for a direct role for the ECB in the formulation of the Community's foreign exchange policy.[255] Article 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. In our reference, they indicate the alternative

[255] See Charles Goodhart, 'A European Central Bank', *The Central Bank and the Financial System* 303, 323 (Charles A E Goodhart, 1995). See also Hugo J Hahn, 'European Union Exchange Rate Policy?', *International Monetary Law* 195, 201 (Mario Giovanoli eds., 2000), for the French position in favour of the authority of the Ecofin Council to decide the exchange rate policy with respect to non-Community currencies, while the ECB's role is confined to implementation of this policy through daily foreign exchange operations. The French position was not accepted either, as a role for the ECB in the formulation of exchange rate decisions has been ensured.

[256] 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 article 111(2) but only on general principles of Community law. The absence 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 factors which are employed to support the non-binding effect of article 111(2). The argument goes that the absence of these safeguards, in contrast to their provision in articles 111(1), (3), means that the orientations are not binding and that the ECB is free to follow its own course of action. I do not agree. The absence of these safeguards is only related to the less severe and the short-term effect of general orientations on price stability, as, for example, there would be no obligations in public international law to maintain the envisaged exchange rates. I agree that the ECB can deviate from the general orientations of the Council to the extent that the price stability objective is impaired. But, I still hold that the general orientations should be binding, and that the Council will enjoy exclusive competence in defining the 'informal' foreign exchange policy. This is supported by article 105(2) of the EC Treaty, which subjects the ECB's competence to conduct foreign exchange operations to article 111. Zilioli and Selmayr themselves accept that the 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 Zilioli & Martin Selmayr, 'The External Relations of the Euro Area', above note 6, at 308 n. 136. Otmar Issing, member of the ECB Executive Board, also seems to accept the binding character of the general orientations: 'ECB will not be obliged to follow any "general orientations" that it judges inconsistent with achieving price stability.' Otmar Issing, 'The European Central Bank as a new institution and the problem of accountability', in *The History of the Bundesbank, Lessons for the European Central Bank* 143, 146 (Jacob de Haan ed., 2000). But see Hugo J Hahn, above note 255, at 196, for the negotiations background and the choice of the term 'orientations' instead of 'directives' or 'guidelines' as suggestive of

wording of article 4(3) as suggested by the Bundesbank. The Bundesbank's proposal for a role for 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 so was not incorporated in the final Treaty provisions.

Therefore, the Council has an exclusive competence in shaping the 'informal' foreign exchange policy through its other economic policies, binding orientations[256] or *ad hoc* decisions. That is, in the absence of the agreements specified in the Treaty, the determination as to the exchange rate level between the Euro and third currencies, and mainly the major currencies, the US dollar and the yen, that is desirable for the European economy rests with the Council alone. The Council's policy will be primarily implemented through the ECB, as among the ECB's basic tasks[257] is to conduct foreign exchange operations. The ECB will be free[258] not to abide by the orientations to the extent its price stability mandate so requires.[259]

Of course the European Council's exchange rate policy will be determined by its general economic policies in consistency with the economic growth and price stability mandates and will respect the ECB independence. As stated in the European Council's Resolution at the Luxembourg summit in December 1997, the exchange rates should reflect all other economic policies, while general orientations are expected to be promulgated

the non-binding character of the Council's orientations for exchange rate policy. Reference is made to the reaction of Hans Tietmeyer, the Deutsche Bundesbank President at the time of the negotiations, to statements by the German and French Finance Minister for adoption of 'orientations' or 'guidelines' (the terms used respectively) against 'excessive appreciation of the Euro' in the context of article 111(2) (ex article 109(2)) of the EC Treaty. Both statements were criticized as indicating that such orientations are binding. Finally, it should be noted that article 108 (ex article 107) establishing freedom of the ECB from instructions by Community institutions or Member State governments is also invoked to support the non-binding character of the general orientations. This is not a valid argument either. Article 108 calls for freedom from instructions with regard to competences of the ECB. The conduct of monetary policy is entrusted to the ECB and for this freedom from instructions is ensured. That is, general orientations which affect monetary policy impacting on its primary objective of price stability cannot be binding on the ECB, as they would constitute prohibited instructions.

[257] EC Treaty art. 105 (2), ESCB Statute art. 3(1).

[258] Likewise the Emminger clause allowed the Bundesbank freedom from interventions required by formal exchange rate arrangements concluded by the German government when such interventions would impair its monetary policy.

[259] '. . . 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).

[260] Resolution of the European Council of 13 December 1997 on economic policy coordination in stage 3 of EMU and on Treaty Articles 109 and 109b of the EC Treaty, 1998 OJ (C 35) 1.

[261] See Chiara Zilioli & Martin Selmayr, 'The External Relations of the Euro Area', above note 6, at 309, 310.

[262] I am grateful to Professor Jean-Victor Louis for sharing with me his views on this and other EU matters. His criticism has greatly helped me to clarify my argumentation regarding the exchange rate issues. Of course, all errors remain mine.

by the Council only 'in exceptional circumstances, for example in the case of a clear misalignment'.[260] This reflects the current economic approach to exchange rates which favors the markets as determinants of exchange rates and discourages interventionist attitudes.[261] Further, as envisaged by the Council Resolution, it is expected that there will be close cooperation between the Council and the European Central Bank and that careful consideration will be had to the price stability objective.[262]

However, the Council did not seem to have a role when the ECB 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 US dollar. Interest rate increases at that time were interpreted by the market as aiming to the Euro exchange rate.[263] 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[264] that the Council convened prior to intervention to adopt an exchange rate policy orientation or decision for the Euro against the US dollar. There was no indication that the Council's role in the whole effort was significant at all.[265]

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

[263] Helmut Lang, 'Austria Report, Political and economic aspects', *The Euro in the National Context* 1, 11–12 (Jean-Victor Louis ed., 2002).

[264] A small reservation should be expressed, as there is no requirement for general orientations under article 111(2) to be published and such publication is within the discretion of the Council. For publication of the general orientations under certain circumstances, see René Smits, above note 49, at 400; see also Hugo J Hahn, above note 255, at 206.

[265] It should not be ignored, however, that the Council of Economics and Finance Ministers of the Euro group had already – in their meeting in September 2000 – expressed their preference for a strong Euro policy. In addition, the Belgian Finance Minister, Didier Reynders, expressed his satisfaction for the ECB intervention, which he perceived as 'responding to the reactions expressed by the Finance Ministers of the Euro-zone'. Previously, he had been critical of Mr. Duisenberg's absence from the Euro-group meeting in Versailles in September 2000, at a critical time for the Euro's external value. See Paul Magnette, 'Belgium Report, The political framework', in *The Euro in the National Context* 33, 34 (Jean-Victor Louis ed., 2002) (citing *L'Echo de la Bourse*, September 23, 2000 and September 12, 2000).

[266] Case 22/70 *Commission v Council*, 1971 ECR 263, CMLR 335 (1971); Opinion 1/94, Opinion of the Court delivered pursuant to article 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.

[267] See above Section 2.4.2.2 and notes 168–69, for the application of Community law to the ECB.

[268] Opinion 2/94, Opinion of the Court of 28 March 26 delivered pursuant to article 228 of the EC Treaty, 1996 ECR I–1759, 1787. See above note 167 and accompanying text.

This extension of the ECB's competence to exercise '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'.[266] The 'implied powers' doctrine applies to the ECB[267] and entails powers which are implied from the Treaty.[268] Thus, the ECB's competence for foreign exchange policy can be founded upon its competence for the single monetary policy to the extent price stability establishes interdependence of the two competences. Where 'informal' foreign exchange policy involves external acts, as, for example, in the 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,[269] applies to the ECB[270] and provides for external competences of the Community and the Member States when such competences are 'inseparably linked'[271] 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 the ECB's competence over foreign exchange policy. Zilioli and Selmayr also identify this inseparable link between foreign exchange and monetary policy, and the subsequent foreign exchange policy competence of the ECB on the basis of the doctrine of parallelism.[272]

This shows that the doctrines of 'implied powers' and of 'parallelism' make it difficult to prevent the ECB from undertaking tasks which,

[269] Case 22/70 *Commission v Council*, 1971 ECR 263, CMLR 335 (1971); Opinion 1/94, Opinion of the Court delivered pursuant to article 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 article 228) determines the voting process in the Council and the participation by the European Parliament in accordance with the respective internal processes in the same field.

[270] Zilioli 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 calls for 'identity between the bearer of internal and external competences'. Chiara Zilioli & Martin Selmayr, 'The External Relations of the Euro Area', above note 6, at 292.

[271] Opinion 1/94, Opinion of the Court delivered pursuant to article 228(6) of the EC Treaty 1994 ECR 5267.

[272] Chiara Zilioli & Martin Selmayr above note 6, at 292. It should be noted that Zilioli 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. I do agree with this to the extent that they both aim at price stability. This also proves the 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.

[273] It seems that Duisenberg subscribes to the view that the ECB's power to intervene in this case is derived from article 105(2): '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.' Alan Beattle & Stephen Fidler, above note 118.

[274] 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.' See Alan Beattle & Stephen Fidler, above note 118. 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

although not expressly conferred by the Treaty, are closely linked to its monetary policy power. In the case of foreign exchange policy, the monetary policy objective of price stability can serve not only as a restraint to foreign exchange policy measures but also as a legal basis for such measures. It should be underscored that in the last ECB intervention, the ECB did not even attempt to justify the intervention on price stability considerations.[273, 274] Only to add to uncertainty, Wim Duisenberg, the Governor of the ECB of the time, responded to past pressure for an ECB foreign exchange market intervention in support of the Euro by saying that the ECB will intervene and can do so only if its price stability mandate so requires.

It will be interesting to see how the EU framework evolves. Unhindered and unaccountable operation of the 'applied monetary policy' toward expansion of ECB's competences entrenched in the European economic constitution? Treaty reform toward more clear delineation of competences? Overruling of the system by the ECJ? In particular the last possibility could be enormously interesting as well as alarming: challenging by individuals or the Commission of the ECB's exchange rate acts, eg interest rate changes or direct market operations, due to lack of competence. Individuals with a very large amount of US dollar-denominated assets could seek review of the legality of exchange rate interventions in support of the Euro *vis-à-vis* the US dollar, when such interventions have been decided solely by the ECB. There will be two significant difficulties to overcome for relevant actions to

Treaty level, cannot, beyond a certain point, restrict the monetary and political authorities in the management of critical situations.

[275] EC Treaty art. 230 (ex art. 173).

[276] Otherwise the restrictive *Plaumann* approach applies. For standing to be established *Plaumann* 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 *Plaumann & Co. v Commission*, 1963 ECR 95, CMLR 29 (1964). This requirement could hardly be met by individuals whose high US dollar asset holdings are affected.

[277] 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, 'EMU, the European Central Bank and Judicial Review', *Legal Framework of the Single European Currency* 95, 107 (Paul Beaumont & Neil Walker eds., 1999).

[278] The 'degree of factual injury' approach has been applied in the context of anti-dumping regulation. Although the *Codorniu* case (Case 309/89 *Codorniu SA v Council*, 1994 ECR I–1853, 2 CMLR 561 (1995)) builds on this approach, it still requires application of the prohibitive *Plaumann* test. For a comprehensive analysis of the related issues and the ECJ jurisprudence, see Paul Craig & Gráinne de Búrca, above note 164, at 468. But see Case 177/01, 3 May 2002, available only in French and Portugese as of May 28, 2002 in <http://europa.eu.int/cj/en/jurisp/index.htm>. This recent judgment of the Court of First Instance of the European Communities might significantly expand the standing of individuals with respect to Community measures of general application.

[279] See Paul Craig, above note 277, at 111; Hugo J Hahn, above note 255, at 208. For the ECJ's deference to decisions regarding complex economic issues, and the expectation for

succeed. First, in the case of exchange rate losses, 'individual concern', as the requirement for the standing of individuals,[275] could be established only[276] by reliance on the 'degree of factual injury' approach,[277] and this approach remains to be followed by the ECJ.[278] Second, finding illegality of the ECB's act will involve a delicate demarcation of the lines between price stability-led intervention and intervention for other exchange rate policy objectives. In that case, the ECJ will be likely[279] to accord a high degree of deference to the macro-economic judgement of the ECB (after all taking into account that central banking is an art). Still, it would be interesting to see how a future challenge would be dealt with and what its possible effect on the Community macro economic edifice would be.

3 LENDER OF LAST RESORT

Community law does not provide for clear allocation of LOLR[280] competences.[281] The problem is that there is no Community competence for LOLR in the case of liquidity problems at individual financial institutions. In addition, in case of a systemic liquidity crisis, the necessary arrangements seem to be absent. I argue that attributing relevant LOLR competence to the European Central Bank may redress these problems. Again, the 'applied monetary policy' concept will be critical. LOLR may be undertaken on the basis of its inseparable link with monetary policy and the commonality of the instruments used for LOLR and monetary policy.

As stated above,[282] I interpret prudential supervision to encompass the

continuation of this approach in relation to the ECB's policy, see Chiara Zilioli & Martin Selmayr, *The Law of the European Central Bank* ix (2001) (citing Asso, 'Le contrôle de l' opportunité de la décision économique devant la Cour européenne de justice' [1976] *RTDE* 21 and 177; Pache, 'Die Kontrolldicthe in der Rechtsprechung des Gerichtshofs der Europäischen Gemeinschaften' [1998] *DVBl* 380; Schmid-Lossberg, *Kontrolldichte im EG-Wirtschaftsrecht. Eine Untersuchung am Beispeil der Rechtsprechung des EuGH zu den Verordnungen im Währungsausgleich* (Frankfurt am Main, 1992)).

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[280] I use the term LOLR to include liquidity support in case of both systemic and individual liquidity crises. Professor Goodhart rightly argues that it is practically almost impossible to distinguish between LOLR and open market operations in case of liquidity injections to the market as a whole and hence that the term LOLR should not be used in this case. However, when, even if rarely – Goodhart mentions the Fed's decision after the 1987 crash to provide liquidity to the market through OMO (Open Market Operations) 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 to examine its legality accordingly. See Charles Goodhart, above note 114, at 11 and n. 9.

[281] In general, conditions for the activation of a LOLR are normally not spelled out in advance, so that 'moral hazard' is avoided. The 'moral hazard' doctrine says that excessive risk-taking is to be encouraged and market discipline wanes if there are firm guarantees for protection of banks in case of financial distress. See RM Pecchioli, *Prudential Supervision In Banking* 133 (1987).

[282] See above note 156, for the term 'prudential' and the interpretation employed in this book.

LOLR function as an *ex post* measure that aims toward systemic stability. Thus, the Treaty provisions on prudential supervision apply to LOLR functions. *Prima facie*, the national central banks, as autonomous national entities, appear to have exclusive competence to exercise LOLR functions. The ECB is explicitly entrusted only with an advisory and coordinating role regarding prudential supervision 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 a case of systemic, pan-European, liquidity crisis the ECB has the power to act on the basis of its responsibility for the smooth conduct of national policies pertaining to prudential supervision and financial stability.[283] This ECB competence to intervene may further 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[284] of systemic liquidity problems to monetary policy. In this case, the monetary policy tools of open market and credit operations, which are already available to the ECB,[285] enable intervention by the ECB.[286] Admittedly, the ECB's monetary policy instruments allow the ECB to perform a LOLR role even without a specific legal basis for this and without most of the time it being possible to trace the LOLR elements of the ECB's liquidity intervention. Still, this does not mean that there is no value in identifying such activity as a LOLR function and seeking for a legal basis.

Second, in case of a liquidity crisis generated in the payments system, the ECB shares the LOLR competence with national central banks,[287] as the Treaty provides for the ECB's competence[288] to oversee the payment sys-

[283] EC Treaty art. 105(5), ESCB Statute art. 3(3). The ECB has already responded to a systemic liquidity crisis in the aftermath of September 11. See Interview with Tommaso Padoa-Schioppa, above note 148.
[284] See also Johannes Priesemann, above note 145, at 82–83. Priesemann goes further to claim the inseparability of LOLR from monetary policy in all cases of liquidity assistance.
[285] ESCB Statute arts. 17, 18.
[286] See above Sections 2.3.2 and 2.4.1.
[287] See Rosa Maria Lastra, above note 61 (treating the Bank of England's obligation to contribute substantial collateral in order to take part in TARGET as indicative of the ECB's LOLR responsibility in respect of payment systems).
[288] See above Section 2.4.2.2 and note 164 (interpreting article 105(2) to establish the ECB's shared competence for payment systems oversight).
[289] EC Treaty art. 105(2), ESCB Statute art. 3(1).
[290] ESCB Statute art. 18(1). Prati and Schinasi rightly point out that the ECB may accept non-eligible collateral in cases of liquidity crisis. Alessandro Prati & Garry J Schinasi, above note 147, at 108. The Governing Council will be able to change the characteristics of eligible collateral, since article 18(1) of the ESCB Statute requires only that the collateral is 'adequate' without determining the characteristics of 'adequate' collateral. This contrasts to the Bundesbank arrangements, where the 'eligibility' characteristics are prescribed, and a legislative act is required in order to accept non-eligible collateral. *Ibid.* at 102 n.34.

tems: 'The basic tasks to be carried out through the ESCB shall be . . . to promote the smooth operation of payment systems.'[289] The ECB can provide liquidity through intra-day credit on the basis of adequate collateral[290] and through open market operations.

The situation becomes less clear in the case of liquidity problems at individual financial institutions. Scholars are of the view that before the enabling clause of article 105(6) (article 25(2) of the ESCB Statute) is activated, the national central banks as autonomous entities are solely competent for prudential supervision, including LOLR for liquidity problems at individual financial institutions.

Further, scholarly analysis claims that this decentralized LOLR, along with other liquidity mechanisms, is an effective arrangement. I argue, instead, that the current LOLR framework is inadequate and that further centralization should take place. Again, the legal basis for such centralization can be found in the 'applied monetary policy' concept.

My view is that the existing LOLR arrangements in the EU, which, it can be said are modelled on the market approach,[291] are not adequate to deal with liquidity issues in the context of a Europeanized banking system. This is the case for both systemic and individual liquidity crises. In the case of a systemic problem, the ECB lacks the supervisory information[292] to judge on the systemic effect of liquidity problems and decide quickly regarding the eligible collateral.[293] In the case of liquidity problems of 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.[294] Even if they are concerned with the implications for the European market,

[291] *Ibid.* at 102. On the 'market-operations' v the 'banking-policy' approach, see *ibid.* at 91–93.

[292] See Michel Aglietta, above note 2, at 52 (identifying problems with the current system of information exchange).

[293] Alessandro Prati & Garry J Schinasi, above note 147, at 108.

[294] See Dirk Schoenmaker, above note 63, at 432 (identifying deficiencies of the operation of the home country control principle regarding LOLR functions).

[295] The ECB may prohibit or restrict LOLR functions by the national central banks. ESCB Statute art. 14(4). Padoa-Schioppa suggests that the national central bank would ask for a 'decision or consultation' of the ECB's Governing Council if the amount involved was 'very big' and thus relevant for monetary policy purposes. Interview with Tommaso Padoa-Schioppa, above note 148.

[296] On the inadequacy of bilateral arrangements, like MOUs, in the context of a pan-European financial system where prompt reaction to crises would be essential, see Alessandro Prati & Garry J Schinasi, above note 147, at 113. The Economic and Financial Committee report on crisis management also acknowledges the problems. Although there are no legal obstacles to information sharing there is no obligation under Community law for exchange of information in liquidity crises. Yet, the recommendation of the report finds it sufficient that further arrangements might be established through MOUs. Economic and Financial Committee, *Report on Financial Crisis Management* 25 (April 17, 2001), <http://www.europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers156_en>. Following this report, the banking supervisors and the central banks of the EU have concluded a

they might lack both the necessary resources and the ability to assess the severity of the liquidity problems. Neither is it clear whether authorization by the ECB is also required and, in case it is, the ECB will not have the necessary information to assess the systemic impact of the liquidity crisis.[295] Cooperation on the basis of MOUs does not secure the necessary real-time information sharing and action,[296] while availability of resources is questionable.

The proposed alternatives cannot make up for LOLR centralization. First, it is argued that market operations[297] can effectively deal with liquidity problems and prevent bank runs from spreading through contagion. The Long-Term Capital Management (LTCM) rescue orchestrated by the Federal Reserve Bank of New York[298] is used as an example of managing successfully a major threatening liquidity crisis through the coordinated action of private banks. The ECB[299] will face no regulatory impediment in coordinating market forces in a similar fashion in order to prevent a financial institution from becoming insolvent and thus threatening financial stability. However, market operations may not be effective in a highly

Memorandum of Understanding for crisis management at the EU level. ECB Press Release, 'Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations', March 10, 2003, <http://www.ecb.int/press/03/pr030310_3en.htm>.

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

[298] For the issues regarding the LTCM rescue, see Shadow Financial Regulatory Committee, *The Issues Posed by the Near-Collapse of Long-Term Capital Management Statement No. 151* (September 28, 1998), <http://www.aei.org/shdw/shdw151.htm> (last visited February 29 2000). For a critical review of the LTCM episode, see Ibrahim Warde, 'Crony capitalism, LTCM, A Hedge Fund Above Suspicion', *Le Monde Dimplomatique*, November 1998, <http://www.monde-diplomatique.fr/en> (last visited November 10, 1998).

[299] Alternatively, the Banking Supervision Committee could assume a coordinating role. Tommaso Padoa-Schioppa, above note 11, at para. 23.

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> 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 & Dirk Schoenmaker, above note 102, at 355. See also Alessandro Prati & Garry J Schinasi, above note 147, at 106. On the other hand, in the LTCM rescue, coordination of private action took place in a very competitive environment. However, in that case Alan 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', 7 *Financial Stability Review* 151, 162 (1999) (referring to related problems in the rescue of Johnson Matthey Bankers Ltd).

[301] Charles Goodhart, above note 114, at 13. See also Dirk Schoenmaker, above note 63, at 434, for problems with 'life-boat' operations organized at a national level to deal with the emergence of pan-European banks.

competitive environment.[300] Even if feasible, they will often be 'time-consuming, somewhat expensive and subject to free-rider problems'.[301] The LTCM negotiations background should also be recalled. It was reported that in the discussions for a liquidity response, Alan Greenspan, the Chairman of the Federal Reserve Board, made immediately clear that none

[302] EC Treaty art. 87 (ex art. 92). Article 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 apply to liquidity assistance by the central bank to individual institutions. For the application of EC competition law to banks, see Case 172/80 *Züchner v Bayerische Vereinsbank*, 1981 ECR 2021. See also Rosa Maria Lastra, above note 114, at 350. See René Smits, above note 49, 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 which 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. In the Credit Lyonnais case, there was no evidence of systemic risk and the Commission conditionally approved the aid to Credit Lyonnais on the basis of article 87(3)(c) (that is, as 'aid to facilitate the development of certain economic activities . . . where such aid does not adversely affect trading conditions to an extent contrary to the common interest') and in particular upon compliance with the principles of the Commission Guidelines on State aid for rescuing and restructuring firms in difficulty (1994 OJ (C 368) 12). For the application of the EC State aid rules to State guarantees for German Landesbanken (public-law institutions) with regard to their international activities (as opposed to their public functions in furtherance of the local (regional) banking system), see Christian Koening & Ernst Röder, 'State Guarantees for the German Landesbanken and the EC-State Aid Regime', 9 nn. 11–12 *European Business Law Review* 381 (1998). See also Karel Lannoo, above note 32, for the competition implications of a proposed system for decentralization of the State aid rules on banking. See also Commission Decision 2000/392/EC, of 8 July 1999 on a measure implemented by the Federal Republic of Germany Westdeutche Landesbank – Girozentrale (WestLB), 2000 OJ (L 150) 1, for the Commission's decision that a certain transfer of funds by a German State from one bank (Wohnungsbauförderungsanstalt-Wfa) to another (Westdeutche Landesbank Girozentrale-WestLB) – both public-law institutions – through their merger and resulting in increase of the latter's own funds, was in contravention of the EC State aid rules.

[303] There is a view that State aid rules are not applicable to the Eurosystem, as the Eurosystem is governed by the ESCB Statute, whose provisions override conflicting State aid rules. See Mauro Grande, 'Possible decentralisation of state aid control in the banking sector', *European Competition Law Annual 1999: Vol. 4*, *Selected Issues in the Field of State Aids* 335 (Claus-Dieter Ehlermann & Michelle Everson eds., 1999). This should not be correct as far as primary Community law is concerned. The ECB is part of the Community legal order. See Jean-Victor Louis, above note 130, at 73. This is also accepted by Zilioli and Selmayr who argue for the special character of the ECB as a 'new Community', as an 'independent specialized organization of Community law'. Chiara Zilioli & Martin Selmayr, *The European Central Bank*, above note 6, at 623. It is also difficult to see conflicts with the primary Community law on State aid rules. The exemptions provided therein cover the special rationale of bank regulation and supervision. As for secondary Community law and Commission rules, their compatibility with the independent character of the ECB should be examined *in casu*. For the relationship of ECB law with secondary law adopted by Community institutions, see *ibid.* at 629. The pending decision of the ECJ on the OLAF case should help in delineating the ECB's relationship with the Community legal order. Barbara Dutzler, *OLAF or the*

of the financial institutions' representatives could leave the table before putting down a considerable amount of US dollars.

Second, Ministries of Finance are claimed to be another effective LOLR candidate, as they can use taxpayers' 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[302] and that they do not have any anti-competitive effect.[303] However, apart from the possible immediate[304] distortionary effect on taxpayers' burden-sharing, there will be problems of information, coordination and cost-allocation when the liquidity crisis involves a financial institution with strong multi-jurisdictional presence.[305]

I should raise here the problems with quoting Germany as an example of

Question of Applicability of Secondary Community Law to the ECB (European Integration online Papers (EIoP), 5 n. 1, 2001), <http://eiop.or.at/eiop/texte/2001–001.htm>. (It should be noted that the OLAF case was decided as this manuscript was being finalized. For some first thoughts on the OLAF case, see René Smits, 'The position of the European Central Bank in the European constitutional order' (Inaugural address, June 4, 2003), <http://europa.eu.int/futurum/documents/speech/sp040603_2_en.pdf>.) Finally, irrespective of the application of the Community State aid rules to the ECB, the ESCB itself is expected to address competition implications of its operations, as the ESCB Statute requires that '[t]he ESCB . . . act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources . . .'. ESCB Statute art. 2.

[304] See Charles Goodhart, 'Introduction', in *Which Lender of Last Resort for Europe 5* (CAE Goodhart ed., 2000), for the impact on taxpayers even in the case of LOLR operations undertaken by central banks.

[305] For additional problems, see Alessandro Prati & Garry J Schinasi, above note 147, at 105–6.

[306] 'Selected Issues in Mature Financial Systems: EMU, Banking System Performance, and Supervision and Regulation', *IMF International Capital Markets*, September 1998, at 104, 107, <http://www.imf.org>.

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> [A]nd, 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 & Garry J Schinasi, above 147, at 100, 101. See also *ibid.*, for the unanimity requirement regarding the LCB's decisions for liquidity assistance, and for information exchange arrangements with the Bundesbank.

[308] *Ibid.* at 105

[309] *Ibid.* The argument about the almost non-existent liquidity interventions in Germany is not well grounded either, since there is not sufficient public evidence. Prati & Schinasi are wisely cautious when referring to the Bundesbank's involvement in liquidity crises: 'The Bundesbank

successful liquidity crisis management in the absence of a Lender of Last Resort. Supporters of this argument ignore that in Germany there is a specialized agency, the Liquidity Consortium Bank,[306] that performs LOLR tasks and that the Bundesbank is 'closely associated' with it.[307] Moreover, the Liquidity Consortium Bank operates in an environment with broad public ownership of banks and weak capital markets.[308] This limits substantially the possibility of a major and abrupt liquidity crisis and hence reduces the importance of LOLR arrangements.[309]

A centralized LOLR competence at the ECB level will deal effectively[310] with most of the inadequacies of the current decentralized LOLR framework.[311] The ECB will be able to intervene effectively and in a timely manner when a pan-European financial institution faces liquidity problems. It will avoid coordination problems, which are present in a decentralized system involving discussions between the interested central banks and consultations at the ECB level, and will be able to decide quickly.[312] 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 an NCB's policies and decisions on collateral,[313] and of interven-

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.

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[310] Goodhart also supports the argument 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 constrained. He argues that the 'dysjunction' between a centralized monetary policy and decentralized fiscal policies 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 note 114, at 24.

[311] For example, it is submitted that under the current framework 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).

[312] Timely decisions are essential for liquidity interventions. Alessandro Prati & Garry J Schinasi, above note 147, at 96: '[A]n 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).

[313] Although an NCB's LOLR functions are subject to State aid rules, it is difficult to evaluate their 'arbitrariness' and subsequent negative externalities because of information problems.

[314] It should be mentioned that the ECB can already control these policies, as under article 14(4) of the ESCB Statute it may restrict national policies that interfere with the ECB's objectives and tasks.

[315] A significant development in this direction has been the recently agreed MOU between banking supervisors and central banks of the EU for crisis management at the EU level. The MOU sets out principles and procedures for identification of the responsible authorities in crisis situations, for producing relevant information and for information-sharing. There is also provision for a 'logistical infrastructure' to facilitate cross-border co operation of supervisors. See ECB Press Release, above note 296.

tions in support of insolvent institutions.[314] Still, a precondition for a successful LOLR role by the ECB is 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, for a decision on the adequate collateral and for a real-time intervention.[315]

The ECB may undertake LOLR functions in the case of both systemic and individual liquidity crises without Treaty reform. We saw already that the ECB has LOLR powers with regard to systemic liquidity crises. The same LOLR powers should be accepted in case of liquidity problems at individual banks. First, activation of the enabling clause of article 105(6) of the Treaty (article 25(2) of the ESCB Statute) may lead to allocation of such LOLR power to the ECB. Second, the ECB's responsibility for the smooth conduct of national policies regarding prudential supervision and financial stability[316] may extend to liquidity problems at individual financial institutions. Again, the 'applied monetary policy' concept enhances the justification for the ECB's LOLR role. The importance of systemically relevant banks for banking soundness and subsequently for stable money growth[317] establishes the 'inseparable link'[318] of LOLR with monetary policy. This allows an extension of the ECB's competence to LOLR responsibilities that is compliant with the Treaty.[319] Further, the ECB's monetary instruments 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, to inject liquidity against adequate collateral.[320] Nevertheless, effective information-transmitting mechanisms

[316] EC Treaty art. 105(5), ESCB Statute art. 3(3).

[317] Arguments for conflict between monetary policy and LOLR were used against entrusting the ECB with LOLR. For the drafting background and Bundesbank's concerns for inflation and moral hazard implications from entrusting the ECB with LOLR, see Charles Goodhart, above note 255, at 326. I explained in Section 2 of this chapter why I 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 the case of individual liquidity problems, injections of liquidity have an effect only on the synthesis of a bank's balance sheet. Interestingly, notwithstanding this, it is the former LOLR role for which the ECB's competence is not doubted.

[318] Borrowing the concept from the ECJ's doctrine of parallelism. See above notes 266, 269–70 and accompanying text.

[319] It is in this context that we could agree with Padoa-Schioppa on the adequacy of the existing system as operating under 'constructive ambiguity'.

[320] ESCB Statute arts. 17, 18. See above note 290 and accompanying text, for the flexibility of the ECB's Governing Council in determining what adequate collateral is.

[321] See above note 315.

[322] These benefits will be not only due 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 & Dirk Schoenmaker, above note 102, at 344.

should be built.[321] This can proceed alone or in the context of the proposed overall centralization of macro-prudential functions.

3.1. Accountability

There should not be significant concerns regarding the accountability of the ECB's LOLR role. Benefits of an effective LOLR function for the taxpayers[322] outweigh democracy costs from ineffective representation of various interests in the exercise of LOLR. Arguably, a parliamentary role is not desirable even when it is the Treasuries that provide liquidity to the system, since it could only cause delays in a time-sensitive operation.[323] Also, democracy costs are limited if the proposed centralized LOLR 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 carrying out their LOLR competence. In Germany, for example, the identity of the rescued financial institutions is never publicized.[324] Moreover, unpublicized cooperation arrangements between the ECB and the NCBs for the performance of LOLR tasks seem to exist already, and it is regarded sufficient that those directly concerned know who has the competence to act.[325] Finally, a centralized LOLR provides more guarantees that consideration is given to the interests of the European peoples rather than to local interests. These limited democracy costs can be further reduced. Accountability can be provided *ex post* through reports to the European Parliament. And, judicial review may always provide an ultimate check on arbitrary uses of the LOLR function.

4 THE EC INTERNAL BANKING MARKET AND LESSONS FOR REGIONAL INTEGRATION

There can be derived from the EU model lessons for regional financial integration. Reliance on the 'prudential' concept, as for instance in the NAFTA, will not be an efficient route. More harmonization of financial regulation and centralized supervision structures will be necessary if the goal is for financial integration that is not to be of limited scope. The EU

[323] Alessandro Prati & Garry J Schinasi, above note 147, at 106.

[324] 'The identities of the intervened institutions are publicly revealed neither at the time of the crisis nor after the fact.' *Ibid.* at 100. See also for similar secrecy surrounding LOLR by the Bank of England, albeit limited to the time of intervention. Eddie George, Governor of the Bank of England at the time, said: '[W]e usually try to keep the fact that we are providing systemic support secret at the time.' Eddie AJ George, above note 140, at 65.

[325] The recently agreed MOU between the bank supervisors and central banks for crisis management at the EU level is not a public document either. See ECB Press Release, above note 296.

model will be even more relevant for those regional efforts toward financial integration which aim at a single market and a monetary union and at the development of Community-like structures. Commonality of interests and objectives may allow a common approach to regulatory harmonization and reduction of trade barriers. The EU can provide a useful model for this. It can also inform the building of centralized structures and how a single central bank will matter. My analysis of the ECB has shown the interdependence of price stability and banking soundness and how monetary policy spills over prudential supervision.

Regional initiatives, like the Mercosur, the Andean Community,[326] the Common Market for Eastern and Southern Africa (COMESA), the Caribbean Community (CARICOM),[327] and the Economic Community Of West African States (ECOWAS),[328] that aim at a monetary union should consider the ECB role in the EC internal banking market when they design their own regulatory framework and, eventually, their single monetary system. The building of centralized prudential regulation and supervision needs to take into account the role of a single central bank and the interdependence of prudential supervision with monetary policy. Centralized supervision should be regarded as important for the realization of a single financial market and monetary policy, and prudential supervision competences should be clearly prescribed.

Further, the EC internal banking system informs financial reform in all countries that have a special relationship with the EU. The countries preparing for accession to the EU are required to comply with the Copenhagen criteria and thus implement the EU *acquis communautaire*, including the EU minimum financial standards.[329] They also need to reform their systems to become eligible for participation in the Eurosystem.

[326] See <http://www.comunidadandina.org/ingles/who/who.htm>.

[327] See <www.caricom.org>. It should be noted that six of the CARICOM members have established the Organization of Eastern Caribbean States with a single currency and a single central bank.

[328] See <http://www.sec.ecowas.int>/.

[329] For the importance the ECB ascribes to the implementation of EU financial regulation by the accession countries and ECB monitoring of the implementation process, see European Central Bank, *Status of legal preparation of accession countries in the areas of Community law which are of concern to the Eurosystem* (2000) (on file with author).

[330] Yet, prudential supervision in accession countries will not be subject to the coordinating role of the ESCB under article 3 of the ESCB Statute. Although accession countries become members of the ESCB upon accession, they are regarded as members with a derogation, in which case article 3 does not apply. EC Treaty art. 122 (ex art. 109K), ESCB Statute art. 43. René Smits regards this arrangement as an oversight of the Treaty authors. René Smits, above note 49, at 352. As accession countries do not become members of the Eurosystem immediately upon accession, the ECB's prudential supervision powers stemming from its monetary policy competence will not be applicable either.

[331] The countries of the European Economic Area (Norway, Iceland and Liechtenstein) adopt and implement the whole *acquis communautaire* in relation to the four freedoms.

[332] See <http://europa.eu.int/comm/external_relations/euromed/index.htm>.

This means that countries preparing for accession are expected to be strengthening their financial systems by adhering to the EU financial standards. Banking supervision and regulation of the accession countries will be covered by the advisory competence of the ECB.[330] The EC internal banking system is also influential in the countries of the European Economic Area (EEA),[331] as well as in the countries aspiring to enter the EU and in the wider Mediterranean area as this area becomes more integrated with the EU through the EU–Mediterranean Partnership ('Barcelona process') towards an EU–Mediterranean Free Trade area.[332] This will also be the case with the ACP (Africa, Caribbean and Pacific) and OCTs (Overseas Countries and Territories) in the context of their agreements with the EU for more trade and cooperation in financial reform. The recent EU–ACP Agreement (the Cotonou agreement) provides for cooperation in matters regarding trade in services and for assistance with financial reforms,[333] and the EC Treaty provides for special trade association of the Community with the OCTs.[334]

Reforms in all these areas should contribute to the stability of regional financial integration. They will also constitute building blocks for the stability of the international financial system as well as for a sustainable liberalization of financial services trade at the international level.

[333] 2000/483/EC, Partnership agreement between the members of the African, Caribbean and Pacific Group of States of the one part, and the European Community and its Member States, of the other part, signed in Cotonou on 23 June 2000, 2000 OJ (L 317) 3, arts. 22(1)(b)(iii), 23(h), 33(3)(d), (4)(c).

[334] EC Treaty arts. 182–88 (ex. arts. 131–36(a)).

5 CONCLUSIONS

The EC Treaty reinforces the model of institutional 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's competence for monetary policy could encompass functions incident to monetary management, and this would include prudential supervision functions. This is due to the operation of applied monetary policy, that is extension of monetary management over banking soundness as the micro-aspect of price stability. It will resemble exercise of respective functions in national jurisdictions, with institutional separation of monetary policy and bank supervision 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 policy may widen the competence of the ECB. Expansion of the macro-prudential functions of the ECB is supported as an institutional arrangement towards both the internal market and financial stability. These macro-prudential functions of the ECB should only be clearly delineated and be built so that the EU financial system grows more efficient and accountable.

Again, the central position of the 'prudential' concept should be stressed. The EU legislator has employed the concept at critical points in competence allocation. First, secondary Community law talks about harmonization of prudential rules and aspires to limit, if not abolish, related host country jurisdiction. Still, it does not delineate the exact scope of prudential regulation but it only specifies certain rules as the core of prudential regulation. The result is room for balancing of internal market and host country considerations. Second, the Treaty uses the concept in determining potential tasks for the ECB. A definition is not available in the Treaty either. This allows significant expansion of the ECB tasks.

The examination of prudential supervision issues in the EC internal banking market raises some interesting issues. It shows complexities that arise from using the term 'prudential' as a term of art in legal texts. The inherent indeterminacy of the concept does pose difficulties, in particular when the term is used to determine allocation of competences. Prudential supervision in the EU also reveals the importance of centralized mechanisms for both integration and financial stability. A system of decentralized supervision based on harmonization and home country control leaves room for trade barriers and stability risks. Trade-restrictive host country measures can find their way into the system to the extent prudential risks remain and home country control is not a fundamental Community law principle. Prudential risks also stay significant because decentralized

arrangements cannot deal with pan-European banking activity. EMU, the intensively coordinated EU macro-economic environment and the Eurosystem structures along with other Community bodies are helpful but not adequate. Thus, the certainty that would arise from a centralized supervision structure appears necessary. It will effectively address prudential risks and thus reduce the scope for domestic prudential structures that are trade restrictive. Prudential risks from intensified integration will also diminish.

The role of centralized structures in the realization of the EC internal banking market should inform the GATS financial liberalization edifice. First, it confirms the inadequacy of a decentralized system. Even the less ambitious GATS integration system may not proceed effectively without strong prudential guarantees. In the absence of centralized arrangements, integration has to rely on a continuous balancing of trade benefits and domestic regulatory considerations. This does happen in the EU despite the extensive harmonization and the operation of the home country control principle. It will be more the case with the GATS where, currently, harmonization and home country control can only take the form of reliance upon informally produced international standards. This is likely to mean more scope for domestic regulation. But even then financial stability risks will not diminish. Adding to concerns, the balancing in the GATS will be conducted mainly by the dispute settlement organs without much support from its rigid legislative machinery.

Second, the effect of the monetary arrangements on the evolution of the EU bank supervision structure may also guide prudential institution building as a foundation of world trade in financial services. Banking soundness has been presented here as intertwined with monetary stability and this link is employed to support a prudential supervision role for the ECB. Similar parallels could be sought at the international level so that a prudential system develops in consistency with international monetary arrangements. Finally, the accountability rhetoric should build on the EU discussion. The technical character of bank supervision and its interdependence with monetary policy should be critical parameters. In addition, there has to be continuous cross-reference to the democratic legitimacy of alternative arrangements, whether national or international.

V

Conclusions: Toward International Institution Building

INTERNATIONAL LEGAL NORMS promoting free trade involve a *balancing* of trade and regulatory objectives. The regulatory autonomy of the nation-state is called into doubt and only non-protectionist national regulation can be sustained. The WTO system is confronted with the conflict between trade and regulation, and the adjudication and the debate on the issues grow more intense. At the regional level, the European Union construct provides an advanced model for not only trade liberalization but also for an 'internal' market.

This book has purported to show the special features of this institutional incubation in the area of *banking*. Banking is important for fundamental welfare-producing functions, which are still operated by the nation-state. In addition, the core elements of banking regulation, depositor protection and systemic stability, are still mainly addressed at the national level. International trade in financial services does bring benefits to the national banking systems and the national economies but it also adds to the risks. The General Agreement on Trade in Services (GATS) is yet to give an answer on how the interplay of trade and these special banking regulation considerations of the nation-state is to proceed at the multilateral level.

1 GATS

1.1 Balancing of trade and banking regulation

1.1.1 Prudential carve-out

The GATS *prudential carve-out* cannot be the answer to the trade and banking regulation issue. Exemption from the GATS disciplines on the basis of merely a rational relationship of the measure to prudential

objectives (the means–ends test) is very broad. Prudential objectives, that is, *inter alia*, 'protection of investors, depositors, policyholders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system', are a very flexible criterion. Using systemic stability and depositor protection as elements of a regulation field has the potential of encompassing all banking regulation under this field. The reason for this is that the rationale *per se* of the whole banking regulation is mainly about prudential concerns and related market imperfections. In addition, any individual rule of national banking regulation acquires a prudential element simply because of the trade-led interdependence of the banking systems and of the inherent limits of a decentralized, nation-based, supervisory framework.

Identifying measures for prudential reasons with prudential regulation and supervision could be a warranted narrowing of the prudential carve-out, but it is still not a good answer. The literature has not defined 'prudential' regulation and supervision with adequate precision. There is some inconsistency in that protective *ex post* measures and practices are not always classified as prudential regulation and supervision. In addition, systemic issues are treated as either a separate category or being at the core of prudential regulation. Moreover, the distinction between conduct of business rules and prudential regulation is not always clear.

1.1.2 Means–ends plus other balancing tests

The *means-ends rationality test* is a low threshold for the availability of the prudential carve-out without it being free of administration problems. It requires only that national measures serve a legitimate end and not constitute an intentional attempt to avoid the GATS commitments or obligations. This should not be difficult to meet. However, evaluation of national regulation needs to consider international banking norms. The Basel Committee's minimum standards and supervision arrangements provide a yardstick for the adequacy or 'overzealousness' of national regulation. Domestic measures are likely to be in compliance if they implement the Basel standards or as long as they rationally relate to gaps and inadequacies of the Basel arrangements. However, it would be more complex if the prudential carve-out is interpreted to incorporate a least WTO–inconsistent alternative test, which is the case with measures falling outside the prudential carve-out.

The GATS allows more intensive balancing of trade and banking regulation with respect to banking rules for non-prudential reasons. Measures qualified as licensing and qualification requirements and technical standards can be sustained only if they are the least trade-restrictive alternative that is reasonably available. This means validating the national measure that is more consistent with the GATS, while requiring that the detriment

to the regulatory objective is not disproportionate to the trade benefit. The DSP has not explicitly said so, but a nuanced form of such balancing can already be discerned.

Interpretation of the *'likeness'* concept in the national treatment principle allows for application of a similar test to the rest of non-prudential measures. Discriminatory, *prima facie* or *de facto*, national regulation will be sustained to the extent that differential treatment addresses 'unlikeness' of the financial services or of the financial institutions due to regulatory considerations. Conversely, equal treatment will be judged against the degree of 'likeness', in determination of which regard should be had to the fact that the financial service or financial institution at issue is already subject to home country regulation. It is difficult to read in the 'likeness' concept limits to balancing. The Appellate Body has colourfully acknowledged the indeterminacy of the 'likeness' term by likening it to an 'accordion' and by pointing that the 'dictionary definition of "like" does not indicate from whose perspective "likeness" should be judged'.

Both discriminatory and non-discriminatory measures may be subject to the trade disciplines of the GATS, and more specifically to the scrutiny of the trade-intensive least WTO-inconsistent alternative reasonably available test. This prepares for a considerable compromise on the national regulatory autonomy and in any case for an intensive weighing of conflicting values.

1.2 Trade and financial stability output

The GATS comes close to the EU construct in terms of trade and financial stability output. A considerable amount of domestic regulation is already subject to the GATS trade disciplines, and negotiations for further commitments by the Members are under way. Balancing of trade and banking regulation at the adjudicative level is also expected to produce more market access through mutual recognition and home country supervision. The dispute settlement body may hold that home country supervision on the basis of home country regulation is adequate to serve the regulatory considerations at issue. If both the home and the host country have adhered to the Basel promulgations, additional host country regulation and supervision may be more difficult to justify. In this way, the GATS also provides a mechanism for essential harmonization toward the Basel minimum arrangements, albeit through its adjudicative process (as opposed to production of minimum common standards in the EU mainly through Community legislation).

1.3 Reliance on adjudication

The problem is that the GATS adjudication body is left with wide discretion in evaluating national regulation and international banking norms. This has efficiency and accountability implications. There is little guidance for conducting the trade-off between trade and banking. It has not been determined how much more trade and how much less banking regulation will be welfare enhancing and whose welfare is in issue. Of course, there are the limitations relating to adherence to the politically agreed legal text. But this cannot help, as the wording of the GATS agreement in fact reflects the failure of the political process itself to weigh conflicting values. The legal text is bound to be ambiguous reflecting the political compromises.

Further legislative guidance as to the applicable trade-off devices and their content solves only some of the problems. Significant efficiency and legitimacy risks remain. The operation of balancing tests, like the proportionality or the cost–benefit test, by the dispute settlement process will consist of intense synthesis of competing interests which is more suitably undertaken at the legislative level. Although strong balancing at the adjudicative level should continue due to the inefficiency of the WTO legislative system, efficiency and legitimacy costs call for building more legislative capacity.

1.4 GATS *vis-à-vis* EU: macro-aspects

A review of the GATS and the EU macro-foundations reveals more clearly the weaknesses of the GATS system. The EU has an advanced *legislative* process for the operation of mutual recognition and of the home country control principle on the basis of essential harmonization, while the ECJ is *accountable,* and *subject to immediate legislative reversal*. This is in the context of the ECB (European Central Bank) prudential supervision 'umbrella' and of the EMU (European Economic Monetary Union) macroeconomic environment.

The GATS macro-legal mechanism, that is the substantive constitutional structure, is not as advanced as that of the EU. Its limited legislative machinery is not efficient. Authoritative interpretation of the agreements requires a majority of three-fourths of the GATS Members and amendments are subject to a more complex procedure and stronger majority voting. Instead, the GATS has to rely mainly on its adjudication body for building the necessary balancing devices. This only creates uncertainty for free trade of financial services as well as for financial stability. There are also legitimacy risks from the potential power of the adjudicative process. Adherence to the text of the GATS and a policy of deference to domestic policies do add to legitimacy, but most likely only if they fall short of a satisfactory balancing of trade and domestic regulation.

Moreover, the degree of democratic legitimacy in the two systems is not the same. The EU's approach to the interplay of trade and regulation corresponds to economic and political developments throughout its history. Its distancing from the discrimination element signifies the increasing consensus for the welfare-enhancing effect of the internal market. It also reflects its enhanced confidence in its regulatory machinery that has grown stronger through regulatory harmonization and creation of EU-wide institutions. Nevertheless, its increasing awareness of regulatory objectives is also served by the evolving 'general good' principle and the tendency to extend it to all trade-restrictive measures, whether non-discriminatory or not. It is along these lines that a claim can be made for the existence of a non-ethnos-based demos. This non-ethnos-based demos consists of European people without organic-type relations but with only shared values and interests who can add democratic legitimacy to the EU construct and contribute to its sustainability.

The GATS also promises a similar approach to the balancing of trade and banking regulation. However, its political process has not provided a sufficiently clear direction as to the desirable mix of trade and regulation objectives. The reason for this is disagreement on the content of the welfare and the means for its pursuit. The result is a political compromise, which can be seen in the ambiguities of the legal text. In any case, the GATS political process lacks the substantial legitimacy, which only a demos could furnish. Such demos does not yet exist in the EU either and it would be unrealistic to contemplate its development in the WTO context.

1.5. Reform

Clarifying the term 'prudential' at the legislative level or incorporating the Basel standards in the GATS system are sensible reform steps but not sufficient. A narrowing of the 'prudential' concept reduces the discretion of the adjudication body, allows less national regulation to be exempted and enhances predictability with benefits for the planning of cross-border banking business. Legislative recognition of the Basel standards as a condition for applying the GATS trade disciplines also contributes to certainty. Trade-restrictive regulation by the host authority will be sustained *to the extent* that home regulation does not apply the Basel standards *or* the Basel standards do not cover certain prudential concerns. The GATS mechanism for realizing the harmonization function of the Basel process is also enhanced. The GATS Members will adopt the Basel standards, so that banks incorporated in their jurisdiction benefit from the GATS disciplines. This should be more efficient than the IMF- and World Bank-led implementation of financial standards, which takes place in a fragmented mode, at a unilateral level, and is often non-compulsory.

However, expanding on the prudential carve-out has to overcome the inherently broad character of the 'prudential' concept, weaknesses of the literature and political objections. With regard to the proposition for incorporation of the Basel standards in the GATS system, consideration should be given to the inadequacies of the Basel arrangements and problems in updating the system to reflect Basel developments. Legitimacy objections are also strong. Through such linking of the GATS and the Basel system, the GATS formally becomes the *de facto* standard-setter for international banking regulation. This is inconsistent with the GATS mandate, which calls for the establishment of a multilateral framework for free and fair trade in services and does not provide a basis for regulating banks. Also, automatic incorporation of the Basel standards in the GATS means legalization at the multilateral level of international norms which have been developed by an international forum without the safeguards and the transparency of treaty making.

The EU also builds its regulatory framework on the Basel system but in the EU incorporation of the Basel standards takes place in a more efficient and accountable way. The Community has competence for developing the internal banking market and it can, in a relatively efficient manner, undertake necessary initiatives when market or theory developments, reflected or not in new Basel standards, call for reform of banking regulation and supervision. In contrast, the WTO legislative process for both the authoritative interpretation of the agreements and the adoption of new rules is rigid and is unlikely to give effect to reforms and Basel standards updates which would be similar to those in the EU legal system. The flexibility of the EU legislative system is also important for accountability purposes, as the various interests can more easily than in the GATS change legislative outcomes when a majority consensus toward such change is developed. In addition, the EU is extensively involved in the formulation of the Basel standards. The GATS is not likely to be efficient in updating its reference to the Basel standards, if representation of all interested constituencies has to be ensured.

2 PRUDENTIAL INSTITUTION BUILDING AT THE INTERNATIONAL LEVEL

2.1 Alternatives

More prudential institution building at the international level appears to be necessary for free and sound international banking. WTO balancing, legislative or adjudicative, has efficiency and legitimacy costs, which remain considerable, even after reforming the WTO system. Irrespective of the

balancing outcome, a decentralized 'prudential' system has limits in addressing prudential issues, as the Bank of Credit and Commercial International (BCCI) litigation and financial stability concerns in the EC internal banking market demonstrate.

In the medium run, *institutional linkages* between the WTO and international financial organizations may improve the WTO balancing of trade and banking regulation at both the adjudicative and the legislative level. The WTO could extend its cooperation with the IMF and the World Bank to cover issues of financial regulation. It could make use of the IMF and World Bank financial reform work and their findings in the context of the Financial Sector Assessment Program. In addition, institutional cooperation may develop between the WTO and the Basel fora. A better understanding of the Basel standards and supervisory arrangements will contribute to a better assessment of the possible protectionist rationale of national banking regulation as well as of financial stability risks from trade liberalization.

Further, more intensive institution building may be necessary. One type of prudential institution building can be treaty-based harmonization of banking regulation and supervision *in close relation* to the reduction of barriers to financial services trade. This will be a harmonization model, similar, but more advanced than, the incorporation of the Basel standards in the GATS proposed above and resembling the processes toward the EC internal banking market. It can be within the GATS framework or develop through a new institution while taking financial services away from the GATS jurisdiction.

This proposal has some serious disadvantages. First, political consensus will be unlikely, as the new institution will impinge upon complex sovereignty issues and demand extensive resources. Second, there will be efficiency and legitimacy costs similar to those in the case of incorporation of the Basel standards in the GATS. The new institution will have to follow Basel-type norms, as the role of Basel, or similar to Basel, organizations and networks is likely to remain significant in translating market and theory developments into international policy and norm making in the area of banking. In addition, an international treaty-based process will rely for its updating on intergovernmental cooperation and will therefore be inefficient as a legislative instrument that has to respond to the constant and rapid developments in banking. This will be the case even if the whole process relies upon the work of Basel-type committees.

A second alternative is the development of *centralized supervision structures*. An international prudential supervisor can be *imagined* to underpin the internationalization of banking. It could have responsibility for the supervision of internationally active banks which are also important for systemic stability purposes. Ideally, it would be responsible for both micro- and macro-prudential supervision. Yet, it is essential that it act as a macro-prudential supervisor with its focus on systemic risk. Macro-prudential

supervision should include lending of last resort (LOLR) functions with respect to liquidity problems of internationally active and systematically important banks (as opposed to LOLR in support of governments facing serious macro-economic disturbances). Lending of last resort could also be undertaken independently by a separate international institution, particularly if it is not feasible to develop a macro-prudentail supervisor.

2.2 Informal *vis-à-vis* formal norm making

Networks of national regulators, like the Basel Committee or IOSCO, could provide the institutional framework for an international prudential supervisor. They could expand their activity beyond the making of financial standards and undertake responsibility for the prudential supervision of international and systemically important banks including LOLR functions. Supervision by such networks could have many advantages. As Basel has shown, the small membership of these networks, consisting of a few authorities that also share common expertise and concerns about the international financial system, allows a strong consensus culture to develop and, subsequently, facilitates negotiations. Their flexible structure is more efficient as well as more responsive to banking developments than the complex and time-consuming processes of treaty making. The non-binding nature of the agreements has not been a problem, as the prestige of the networks themselves and of its members' economies results in wide adoption at the national level.

The main weaknesses of the Basel-type arrangements relate to implementation divergence and democratic legitimacy. Divergence and unpredictability in the implementation of the Basel financial standards, inherent in international 'soft law', reduce legal certainty and undermine the effectiveness of the standards. Democratic legitimacy is weak due to the absence of the safeguards of international treaty making. It is absent the strong legitimacy effect of the sovereigns' consent, as developed through the constitutional process of synthesizing the interests of the various national constituencies and of subsequent crystallizing of the state will. In addition, participation and a prevalent role are reserved only for the most important financial systems while non-transparent processes are the main mode of operation.

It is difficult to accept the arguments of the 'transgovernmentalism' rhetoric for accountability benefits from international norm making through cooperation of sub-state actors. Arguably, the government networks are an efficient alternative of internationalization, and accountability costs from their activity could be justified by the increased efficiency output. However, it is difficult to accept accountability benefits of this process, especially in the field of banking regulation and supervision. National banking

authorities are already away from the political debate due to the technical, complex and time-sensitive character of their subject matter. They become even less visible for the domestic political process by producing norms at the international level in the context of their cooperation with other regulators. It is exactly this reduced visibility which allows them to appear as a more efficient alternative. This also shows the oxymoron of the argument that transgovernmentalism, favoured for its efficiency, will also be accountable once the awareness of, and the control by, the legislature intensify. Furthermore, it is not true that their norm making activity is primarily related to enforcement of national regulation. The Basel Committee has been extensively engaged in the development of prudential standards and principles of supervision, and is a pioneer in banking regulation, very recently setting the tone for internal risk management, effective supervision and market discipline as the model for banking supervision. Finally, its composition from banking authorities of only the G-12 countries cannot be ignored when accountability is the issue.

My view is that a more solid legal footing is needed for the new structure. The advantages from developing financial standards through 'soft law' become less important in case of a new international institution with a supervision mandate. Consensus will not be any more difficult to develop once the benefits of more free and sound banking are presented. Rigidities of international treaty making will not be an issue, as the relevant cumbersome processes will be involved mainly at the stage of creation of the new international institution. An international prudential supervisor should be expected to function efficiently without the need for frequent amendments of its charter. This should be possible by prescribing a clear supervision mandate with adequate discretionary powers, controlled through strong accountability mechanisms. A strong role for the political system and judicial review of the supervisor's acts could provide adequate accountability. The political arms of the IMF, the World Bank or the GATS, or a political counterpart of the international prudential supervisor will contribute to the democratic control over it. In any case, accountability will be stronger than if the IMF, for example, were to act a LOLR without clearly defined criteria on the basis of its monetary stability mandate.

Moreover, the arguments of implementation and democratic legitimacy against informal rule making seem to be accentuated in the case of an international prudential supervisor. It is difficult to see how an international supervisor supported by a network of government authorities could effectively supervise banks. It is true that the IMF and World Bank mechanisms of conditionality and surveillance as well as the coordination efforts of the Financial Stability Forum can significantly help with inadequate or divergent implementation of financial standards. But how could they provide, for example, for authorization or sanctioning of certain, multinational and systemically important banks, by the international supervisor? Possibly, the

respective national authorities could prescribe rules under which internationally active and systemically important banks that are established in their jurisdiction would be subject to an international supervisor with respect to supervision of their international activities. But again, this is unlikely to avoid divergence in implementation or ensure effectiveness in its application. For example, it is likely that not all of the relevant regulators would agree as to the scope of subjecting the respective banking group entities to an international supervisor. The accountability concerns will also be formidable. It will be problematic to subject domestic financial institutions to the authority of an international institution, whose function is underpinned by a 'gentlemen's agreement' developed in a regulators' network. In any case, it will not address the issue of true responsibility and liability of the international supervisory institution, which, as the *Three Rivers* case has shown, is fundamental not only for accountability purposes but also for the protection of depositors and for financial stability.

2.3 Forum

The prudential supervisor could be an entirely new international institution or be built within the structure of one or more of the existing ones. In the latter case, the IMF and the Bank for International Settlements (BIS) appear as the most sensible choices.

The IMF's mandate for monetary and macro-economic stability could encompass prudential institution building for international banking. This actually means that the IMF could operate an international supervisor on the basis of its current mandate without needing extra political consensus. Lending of last resort could be undertaken on the same grounds due to its preventing systemic risk.

On the other hand, the BIS has a comparative advantage, because being the bank for central banks it is at the heart of the central banking system. The BIS enjoys a strong institutional relationship to most of the existing networks of central banks and supervision authorities by supplying a permanent secretariat for their functions. In addition, most of the international standards have come to be associated with the broader institutional machinery of the BIS. This could provide a solid and subject-related regulatory culture and consensus for an efficient building of the international prudential supervisor. The international prudential supervisor could be developed by transforming one of the Basel networks into a new international organization or into a similar structure within the BIS. For example, the Financial Stability Forum (FSF) could be this new international organization or could evolve into an arm of the BIS. It is already concerned with international financial stability and contributes to international cooperation in prudential norm making and implementation. It operates a Task

Force to strengthen implementation of standards and provides a forum for regulatory and supervisory authorities, both national and international, international financial institutions and committees of central bank experts, like the Committee on the Global Financial System and the Committee on Payment and Settlement Systems. Its functions can be expanded to cover authorization and monitoring of international and systemically important banks as well as LOLR operations. The existing connection of the FSF with all the relevant international financial institutions and regulators' networks will add to the regulatory culture of the new structure and contribute to efficient structuring of its supervision activity, effective coordination of the interested parties and the credibility of its role.

Lending of last resort could be operated autonomously. The IMF could extend its activities only to international LOLR leaving prudential supervision to a new institution. The Federal Reserve System with its capacity to shape world monetary conditions and its importance for the capital markets could be another candidate for a leading role in respect of international financial stability. And again, the BIS could undertake LOLR functions. The autonomous operation of a LOLR could proceed without the international supervisor being in place. In that case, a moral hazard problem should be acknowledged due to possible effect on the rigorousness of national supervision.

3 EC INTERNAL BANKING MARKET

3.1 The case for bank supervision at the Community level

The EC internal banking market can inform prudential institution building at the international level. In the first place, it reveals the effects of a decentralized supervision system on the mix of trade and banking regulation. To the extent the decentralized system is inadequate to address risks from EU-wide banking activity there is room for balancing of trade and national banking regulation and subsequently for preserving national banking regulation with trade-restrictive effect. Irrespective of the national banking regulation preserved, the decentralized system may fail to deal with financial stability risks from EU-wide banking activity.

Of course, unlike the objective for an EC internal banking market, there has not been a political agreement for creating a global banking market. All that has been acquiesced to is reduction of trade barriers and preservation of legitimate banking regulation with trade restrictive-effect with this is not inconsistent. In this vein, the GATS system does not have to eliminate all potential sources of trade barriers. However, in the GATS, decentralization of supervision is not the only element that produces more balancing and

more trade-restrictive domestic regulation. Gaps in harmonization of banking measures are the main justification for more domestic measures. As more extensive and formal harmonization has been shown not to be a realistic alternative, centralization of supervision can help with producing more trade by rendering domestic regulation less significant. It will also contribute to more financial stability for which risks exist even under a non-global, yet considerably internationalized, banking market.

The decentralized supervisory framework is to share a significant part of the blame for the remaining fragmentation of the European banking market. In the absence of Community legislation, host country measures addressing legitimate regulatory considerations can be maintained even if they hinder EU-wide trade. The host country can still apply its own conduct of business rules on the condition that they are in the 'general good' interest. Prudential regulation also remains available for the host country to the extent not harmonized and justified by 'general good' considerations. The home country control principle is not a fundamental Community law principle and valid deviations from it are possible. All this results in duplication of regulatory costs and discourages cross-border banking activity.

As far as financial stability is concerned, a Member State-based banking supervision system is also limited. It allows regulatory arbitrage as well as implementation divergence with risks for depositors and financial stability. In operating LOLR functions, the decentralized system lacks the necessary arrangements to assess the Euro-wide effect of liquidity problems. Although national supervision ensures accurate information and has the advantage of perception of local market conditions, it cannot cover Euro-wide liquidity problems of individual banks. Bilateral cooperation through MOUs combined with the ECB coordinating role does not ensure the real-time information and coordination needed for detecting and responding to systemic crises.

3.2 The EU macro-design

The form of the EU centralized arrangements is of relevance for the designing of international prudential institutions. In particular, it is useful to study the role of the EU monetary authority, the ECB, in the EU prudential system. In this book, the relationship of monetary policy and prudential supervision is laid open and the case is made for their interdependence. This leads to the argument for the ECB's competence to conduct prudential supervision. The critique for accountability costs is judged against the benefits from enhanced efficiency (input *vis-à-vis* output of the democratic process) and against the existing national and international arrangements.

3.2.1 Monetary policy and Prudential supervision

An examination of the concepts of monetary policy and prudential regulation and supervision and of their use in the EC Treaty shows the close relationship of these concepts. The claim for geographical separation of monetary policy and prudential supervision in the EU has to be discounted, as prudential supervision is intertwined with monetary policy. Monetary policy is prescribed in the Treaty with reference to its primary objective, which is price stability. It is to price stability that prudential supervision is closely linked. Banking soundness, the primary objective of prudential supervision, is very important for the proper operation of the monetary mechanisms. Safe and sound banks ensure that monetary policy decisions take their intended effect and that price stability is not affected by an unstable banking system.

Besides the inseparability of the objectives of banking supervision and monetary policy, commonality of tools is also observed. Responsibility for gathering statistical information provides significant insight into the banks' operations and can be used for timely supervisory action. The central bank can assess the financial condition of the banks and perform functions of first-line supervision. The central bank conducts open market and credit operations through the banking system and this entails its close interaction with banks. These operations also allow a LOLR for the central bank in the event of general liquidity problems or with banks under serious liquidity distress. Furthermore, minimum reserves can be used to deal with financial stability problems, both systemic and individual. Their temporary reduction can help a bank to overcome liquidity problems or deal with liquidity strains of a tight monetary policy.

Thus, the monetary policy tools of the ECB allow it to develop prudential supervision functions. Open market and credit operations with individual banks on the basis of adequate collateral can be conducted for LOLR purposes. Prudential supervision is also possible through the gathering of statistical information. The ECB can evaluate the financial state of banks and recommend or effect changes. It can also produce more common prudential rules and thus reduce the need for host country regulation.

There is no legal impediment to prudential supervision by the ECB. A formal and express legal competence for the ECB to exercise supervision powers can be provided by the activation of the enabling clause of the Treaty. The Council may decide to confer respective competences on the ECB. Furthermore, the Treaty expressly provides that the ECB shall *contribute* to the *smooth* conduct of national *policies relating* to *prudential* supervision and *financial stability*. Although this wording arguably gives the ECB only a coordinating responsibility, it is definitely vague. It should be viewed in light of similar language in the case of payment systems which, according to the prevailing view, gives the ECB a clear oversight

competence. In any case, the interdependence of banking soundness and price stability can provide the basis for prudential supervision by the ECB. The intertwining of the two objectives empowers the ECB to exercise prudential supervision as a function incident to monetary policy. The 'implied powers' doctrine offers further support to this argument. The 'implied powers' doctrine allows Community competence to extend to powers not only expressly conferred but also implied from the Treaty. In the case of the ECB, supervision powers can be implied as incident to monetary policy.

The centralized supervision structure offered by the ECB is good for financial stability and in turn for more and sustainable integration of the banking systems. The integrated market would proceed smoothly without the risk of disturbances that could reintroduce fragmentation. Before this, centralized supervision contributes to reduction of trade barriers, as there is less prudential rationale for trade restrictive national regulation. Thus, financial stability-driven objections of the national regulator, as for example in the case of cross-border mergers and acquisitions, diminish in the context of a centralized supervision framework. Further harmonization of rules, and thus less duplicatory costs, is also possible.

3.3 Prudential supervision at the community level and accountability

The criticism for the weak accountability of a bank supervisor operated by an independent authority, as the ECB is, should take into account the technical character of prudential supervision and its link with monetary policy. The interdependence of banking soundness and price stability may extend the arguments for independent monetary policy to prudential supervision. In the case of the ECB, the effect of existing accountability mechanisms and its emphasis on transparency should also be considered.

However, it is very important that any accountability discourse develops on a comparative basis. There cannot be claims about democratic deficit without a comparison with alternative institutional arrangements. At the national level, prudential supervision has hardly been at the centre of the public debate and there is little indication that parliamentary control over the technical issues involved has been effective. Also, to the extent prudential supervision lies with national central banks, political control over prudential supervision may be inconsistent with independence of monetary policy. Moreover, control of the national supervisors through the national democratic mechanisms does not translate into accountability regarding decisions with transnational effects. Finally, the former independent status of the Bank of England in respect of prudential supervision reminds us that political control over prudential supervision has not always been the case.

4 EC INTERNAL BANKING MARKET AND PRUDENTIAL INSTITUTION BUILDING AT THE INTERNATIONAL LEVEL

The EU macroeconomic framework reveals much about prudential institution building in the context of interconnected national banking systems. First, it tells us that home country supervision on the basis of essential harmonization of prudential rules has limits in respect of both full trade integration and financial stability in an integrated market, and that centralization of prudential supervision should take place. Second, monetary policy mechanisms and the operation of a single monetary authority have significant implications not only for the stability of the banking system but also for the structure of banking supervision. Third, sustainable macroeconomic arrangements of intertwined national banking systems depend upon price stability, banking stability and representation, and they should aim towards their optimum mix. Fourth, the concepts of 'prudential supervision' and 'monetary policy' have a critical and dynamic effect in the shaping of a supervisory framework and thus need to be clearly defined if legal engineering is to employ them.

The EU model has the following parallels at the international level. The need for centralized banking supervision is in line with the proposition for more prudential arrangements at the international level. Although the goal is not a global banking market, more prudential arrangements are mandated by the fact that the alternative is a constant and decentralized synthesis of trade and banking regulation objectives with uncertain outcome for both trade integration and financial stability. Systemic risk develops from greater interconnection of the national banking systems and, in the absence of international institutions, domestic regulation has to address the risks. The domestic regulator is in charge of the balancing of trade and regulation but the ultimate judge is now the GATS dispute settlement process. Enhancing institutional cooperation between the GATS and international financial organizations will improve this balancing but it will not address systemic risk from the increased interdependence of the national banking systems. To the extent international prudential structures prove necessary, they would have to be built, as such structures could not spring from international macroeconomic regime, as in the case of the macroprudential structures contemplated at the ECB level. International monetary arrangements are not at any rate comparable to a single monetary authority. The IMF has responsibility for international monetary stability and the G-countries are cooperating toward stable macro-economic conditions, but this does not translate to immediate authority for international prudential supervision. In building an international supervisory framework, price stability, banking stability and representation remain fundamental, as their maximization can ensure peoples' benefits at both the input and the output level of the resource allocation process. Finally, international prudential

structures should consider the indeterminacy of the critical concepts of 'prudential supervision' and 'monetary policy', and clear delineation of their reach should accompany allocation of respective responsibilities at the international level.

A natural next step to this work would be the use of the EU findings in international 'prudential' engineering. The following questions could be interesting to address: what EU-type mechanisms are available at the international level? What are the limitations in replicating EU structures? How do price stability, banking stability and representation translate? An International Banking Organization is a possible outcome. This may be good for a sustainable, globalized banking market. However, for the purposes of legal research, it would 'suffice' if this next exercise comes up with legal principles of international banking regulation. Then, doctrinal discussion will start becoming more serious and the establishment of a field of international banking law a realistic objective.

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