



TOBIAS H. TRÖGER

Organizational Choices of Banks and the Effective Supervision of Transnational Financial Institutions

Institute for Monetary and Financial Stability
GOETHE UNIVERSITY FRANKFURT AM MAIN

WORKING PAPER SERIES NO. 54 (2012)

Institute for Monetary and Financial Stability
Goethe University Frankfurt
House of Finance
Grüneburgplatz 1
D-60323 Frankfurt am Main
www.imfs-frankfurt.de | info@imfs-frankfurt.de

ORGANIZATIONAL CHOICES OF BANKS AND THE EFFECTIVE SUPERVISION OF TRANSNATIONAL FINANCIAL INSTITUTIONS

(July 19, 2012)

Tobias H. Tröger

Professor of Private Law, Trade and Business Law, Jurisprudence
Goethe-University, Frankfurt am Main, Department of Law

Grüneburgplatz 1

60323 Frankfurt am Main

Germany

Phone +49 69 798 34236

Fax +49 69 798 34536

troeger@jur.uni-frankfurt.de

Abstract: This paper outlines relatively easy to implement reforms for the supervision of transnational banking-groups in the E.U. that should not be primarily based on legal form but on the actual risk structures of the pertinent financial institutions. The proposal also aims at paying close attention to the economics of public administration and international relations in allocating competences among national and supranational supervisory bodies.

Before detailing the own proposition, this paper looks into the relationship between sovereign debt and banking crises that drive regulatory reactions to the financial turmoil in the Euro area. These initiatives *inter alia* affirm effective prudential supervision as a pivotal element of crisis prevention.

In order to arrive at a more informed idea, which determinants apart from a perceived appetite for regulatory arbitrage drive banks' organizational choices, this paper scrutinizes the merits of either a branch or subsidiary structure for the cross-border business of financial institutions. In doing so, it also considers the policy-makers perspective. The analysis shows that no one size fits all organizational structure is available and concludes that banks' choices should generally not be second-guessed, particularly because they are subject to (some) market discipline.

The analysis proceeds with describing and evaluating how competences in prudential supervision are currently allocated among national and supranational supervisory authorities. In order to assess the findings the appraisal adopts insights from the economics of public administration and international relations. It argues that the supervisory architecture has to be more aligned with bureaucrats' incentives and that inefficient requirements to cooperate and share information should be reduced. Contrary to a widespread perception, shifting responsibility to a supranational authority cannot solve all the problems identified.

Resting on these foundations, the last part of this paper finally sketches an alternative solution that dwells on far-reaching mutual recognition of national supervisory regimes and allocates competences in line with supervisors' incentives and the risk inherent in cross-border banking groups.

JEL classification: G21, G28, H77, K22, K23, L22.

Keywords: cross-border banking, micro-prudential supervision, consolidating supervision, banking union, subsidiaries, branches

ORGANIZATIONAL CHOICES OF BANKS AND THE EFFECTIVE SUPER- VISION OF TRANSNATIONAL FINANCIAL INSTITUTIONS

TOBIAS H. TRÖGER *

1	Transnational challenges in banking regulation and supervision.....	2
1.1	The regulatory challenges associated with integrated cross-border banking groups	2
1.2	Intra-group restructurings as a sign of regulatory arbitrage?	5
1.2.1	Europe.....	5
1.2.2	United States	6
1.3	Misconceptions and the pivotal question.....	7
2	The importance of micro-prudential supervision: Lessons from the ongoing sovereign debt and banking crises in the Euro area.....	10
2.1	Sovereign debt and banking crises through the ages	10
2.1.1	Historical anecdotes.....	10
2.1.2	Bail-Out Rationality and moral hazard.....	11
2.2	The contemporary European angle and one regulatory response	14
2.2.1	Confidence crisis July 2011	14
2.2.2	Micro-prudential regulatory reactions.....	14
3	Organizational choices of banks.....	16
3.1	Branches and subsidiaries: main features of prototypical organizational structures	16
3.2	The bank's perspective.....	17
3.2.1	General considerations	17
3.2.2	Assets and drawbacks depending on the bank's business model	19
3.2.3	Business judgment and market reactions	20
3.3	The policymaker's perspective	21
3.4	The regulatory arbitrage debate revisited.....	23
4	The supervisory regime for E.U. cross-border banking-groups	24
4.1	General determinants	24
4.2	The E.U.-architecture of micro-prudential banking supervision	25
4.2.1	Supervision of business entities	25
4.2.1.1	Subsidiaries	25
4.2.1.2	Branches (E.U.-passport)	26
4.2.2	Consolidated supervision.....	27
4.2.3	Colleges of supervisors	29
4.2.4	Supranational competences as an insufficient remedy	30
4.2.4.1	Harmonization of substantive Law.....	31

* Professor of Private Law, Trade and Business Law, Legal Theory, Goethe University Frankfurt am Main, Germany.

4.2.4.2	Current supranational competences in micro-prudential supervision	32
4.2.4.3	Banking Union 2012.....	34
4.3	Evaluation.....	35
4.3.1	Political economics of public administration and International Relations	35
4.3.2	Supervision of cross-border banking-groups in particular	37
4.3.2.1	Subsidiaries	37
4.3.2.2	Branches	38
4.3.2.3	Supranational cure.....	39
5	Sketching an alternative approach to transnational banking supervision	40

1 TRANSNATIONAL CHALLENGES IN BANKING REGULATION AND SUPERVISION

1.1 THE REGULATORY CHALLENGES ASSOCIATED WITH INTEGRATED CROSS-BORDER BANKING GROUPS

The conventional wisdom in banking theory suggests that allowing financial institutions to provide their services across jurisdictions generates significant benefits for society.¹ Efficiency gains accrue with regard to banks' core function as financial intermediaries: economies of scale lower the costs of bringing together capital surpluses with capital needs. The demand-side benefits from improved access to credit where the funds stem from a larger pool of capital under management. The supply-side sees savings allotted to the best investment opportunity picked from those available not only in the domestic market but in many countries. The latter makes banks' portfolios more diverse and hence decreases the dependence of lending on local business cycles. Moreover, local capital markets also receive a boost from the arrival of international actors who bring with them advanced technologies of risk management, payments and other service offerings as well as methods of information analysis and distribution that local competitors can replicate.²

¹ E.g. Michael H. Moskow, *Cross-Border Banking: Forces Driving Change and Resulting Regulatory Challenges*, in CROSS-BORDER BANKING : REGULATORY CHALLENGES 3, 4-5 (Gerard Caprio, Jr., Douglas D. Evanoff & George G. Kaufman eds., 2006); Jonathan Fiechter, İnci Ötker-Robe, Anna Ilyina, Michael Hsu, André Santos & Jay Surti, *Subsidiaries or Branches: Does One Size Fit All?* 5 (Int'l Monetary Fund, Working Paper SDN/11/04, 2011), available at <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf>. But see also *infra* note 44.

² For empirical evidence corroborating the latter hypothesis *cf.* Stijn Claessens, Asli Demirgüç-Kunt & Harry Huizinga, *The Role of Foreign Banks in Domestic Banking Systems*, in THE INTERNATIONALIZATION OF FINANCIAL SERVICES: ISSUES AND LESSONS FOR DEVELOPING COUNTRIES 117 (Stijn Claessens & Marion Jansen eds., 2000); Stijn Claessens, Asli Demirgüç-Kunt & Harry Huizinga, *How Does Foreign Entry Affect Domestic Banking Markets?*, 25 J. BANKING & FIN. 891-911 (2001) (both studies showing an increase in technical efficiency at domestic banks subsequent to the arrival of foreign banks in a sample of 80 countries); see also Douglas Evanoff & Evren Ors, *The Competitive Dynamics of Geographic Deregulation in Banking: The Implications for Productive Efficiency*, 40 J. MONEY FIN. & BANKING 897-928 (2008) (showing the same effect on incumbent banks following a compet-

On the other hand, the trade-off associated with the advantages of cross-border banking is also straightforward: financial systems around the world become more and more interconnected which in turn expands the potential for negative spillover effects in times of crises.³ Exogenous shocks can affect national economies which originally did not face any problems in their banking sector. The availability of credit may decline, either because institutions troubled at home (or elsewhere) at least confine their activities on foreign markets where they formerly played a prominent role in providing finance to local businesses⁴ or because international banks cut back on lending in their home country as a consequence of losses incurred abroad.⁵ In the latter case, the magnitude of the shocks originating overseas and the importance of the financial institutions affected may ultimately compel fiscally expensive⁶ and politically unpopular government bail-outs in order to avoid the disruptive consequences of a pivotal bank's failure.

itor's out-of-state merger in the U.S.-banking sector between 1984 and 1999 using a sample of 2.309 such business combinations).

³ For an assessment of the likelihood of cross-border spillovers in scenarios of credit and liquidity shocks, INT'L MONETARY FUND, CROSS-CUTTING THEMES IN ECONOMIES WITH LARGE BANKING SYSTEMS 11-12 (2010) *available at* <http://www.imf.org/external/np/pp/eng/2010/041610.pdf> (considering economies of various sizes with large banking systems finding only a low risk of outward spillovers but a rather high risk of inward contagion from abroad).

⁴ For evidence that the current global financial crisis affected foreign lending of international banks precisely in this way see *e.g.* Ralph de Haas & Iman van Lelyveld, *Multinational Banks and the Global Financial Crisis: Weathering the Perfect Storm?* (European Bank for Reconstruction and Development, Working Paper No. 135, 2011) *available at* <http://www.ebrd.com/downloads/research/economics/workingpapers/wp0135.pdf> (finding a slowdown in credit growth twice as rapid in a sample of the 48 largest multinational banks compared to a control group of 202 purely domestic banks); but *see also* John P. Bonin, *From Reputation amidst Uncertainty to Commitment under Stress: More Than a Decade of Foreign-Owned Banking in Transition Economies*, 52 COMP. ECON. STUDIES 466 (2010) (arguing that foreign banks largely sustained their commitment to the markets of 10 European transition economies).

⁵ With regard to the losses cross-border banking groups incurred as a result of the recent crisis in Eastern Europe's transition economies *see* Thomas Dietz, Tetiana Protysk & Erich Keller, *Similar but Different? The Financial Crisis in Matured Western and Emerging Eastern European Countries*, 4 BANKS & BANK SYSTEMS 20, 28 (2009) (arguing that Western European banks' significant engagement in Eastern Europe constitutes a potential for (re-)contagion in the ongoing financial crisis); Ewald Nowotny, *The Financial Crisis and the Role of Austrian Banks in Central, Eastern and Southeastern Europe*, 17 ECON. & FIN. REV. 3 (2010) (showing that the credit risk provisioning by Austrian banks' Central, Eastern and Southeastern European subsidiaries rose sharply as a result of the 2008 crisis occurring on those foreign markets). For a description of the events leading to the collapse of the Icelandic banking sector as a result of its disproportionate and mismanaged cross-border activities *see* Már Gudmundsson & Thorsteinn Thorgeirsson, *The Fault Lines in Cross-Border Banking: Lessons from the Icelandic Case*, in CONTAGION AND SPILLOVERS: NEW INSIGHTS FROM THE CRISIS 141 (Peter Backe, Ernest Gnan and Philipp Hartmann eds., 2010).

⁶ For preliminary evidence that the recent bank bail-outs during the financial crisis were not as costly for governments as originally perceived and suggested by the enormous figures used in the recapitalizations, *see* Gérard Hertig, *The Profitability of Bank Bail-Outs, Credit Crisis Comparative Case Studies*, 48 TEX. INT'L L.J. ■■■ in this issue ■■■ (2012).

Public policy hence faces the challenge to minimize these potential downsides of cross-border banking without impeding its upside. One key element of the institutional framework targeted at this ambitious goal is the prudential supervision of banks.⁷ The distinctive feature in the context of cross-border banking is that policymakers and regulators operate in a quintessentially transnational setting where legislative intervention and its enforcement on a national level almost naturally create externalities,⁸ e.g. if a country deploys resources to facilitate the adequate micro-prudential⁹ supervision of banks incorporated under its jurisdiction this will also benefit all other countries where the respective financial institutions conduct business. Yet, if these other countries engage in supervisory activities themselves, redundancies and frictions in the legal framework, turf-wars among authorities etc. will raise the costs of doing business abroad and may compromise the effectiveness of the regulatory regime cross-border banks are subjected to.¹⁰

The latter is all the more important, as a pivotal determinant of the regulatory framework seems endogenous from the perspective of the supervised financial insti-

⁷ For the general rationale of sovereign supervision of banks which *in grosso modo* aims at minimizing the probability and the impact of financial distress in the sector under the assumption that these goals are inadequately achieved through market discipline alone see already ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 756 (Roy Hutcheson Campbell & Andrew S. Skinner eds., Clarendon Press 1976) (1776); for modern economists arguments cf. MILTON FRIEDMAN, A PROGRAM FOR MONETARY STABILITY (1959); MATHIAS DEWATRIPONT & JEAN TIROLE, THE PRUDENTIAL REGULATION OF BANKS (1995); George J. Benston & George G. Kaufman, *Is the Banking and Payments System Fragile?*, 9 J. FIN. SERVICES RES. 209 (1995); PETER D. SPENCER, THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS 193-208 (2000); Charles W. Calomiris, *Blueprints for a new global financial architecture*, in INTERNATIONAL FINANCIAL MARKETS 259 (Leonardo Auernheimer ed., 2003); for a (critical) account of the history of banking regulation see CHARLES W. CALOMIRIS, UNITED STATES BANK DEREGULATION IN HISTORICAL PERSPECTIVE 1-79 (2000); for the libertarian skepticism regarding the legitimacy of any regulatory interference in the banking sector FRIEDRICH AUGUST HAYEK, DENATIONALIZING MONEY (1976); DAVID GLASNER, FREE BANKING AND MONETARY REFORM (1989); KEVIN DOWD, THE STATE AND THE MONETARY SYSTEM (1989).

⁸ For the reasons, why banks were traditionally regulated on a national level cf. Maximilian J.B. Hall & George G. Kaufman, *International Banking Regulation*, in THE STRUCTURAL FOUNDATIONS OF INTERNATIONAL FINANCE 92 (Pier Carlo Padoan, Paul Brenton & Gavin Boyd eds. 2003).

⁹ The term refers to a regulatory approach that aims at securing individual financial institutions resilience *vis-à-vis* external shocks and diverges in this limited goal from a macro-prudential approach that is targeted towards the soundness and viability of the financial system as a whole and accepts the existence of risk originating within the system, see e.g. Claudio Borrio, *Towards a macroprudential framework for financial supervision and regulation?* 2-3 (Bank for Int'l Settlements, Working Paper No. 138, 2003); Samuel G. Hanson, Anil K Kashyap & Jeremy C. Stein, *A macroprudential approach to financial regulation*, 25 J. ECON. PERSP. 3, 4-7 (2011).

¹⁰ For a pre-crisis view on the regulatory challenges that cross-border banking posed to the emerging markets to which banks extend their business see Guillermo Ortiz, *Cross Border Banking and the Challenges Faced by Host-Country Authorities*, in CROSS-BORDER BANKING: REGULATORY CHALLENGES 11, 14-18 (Gerard Caprio, Jr., Douglas D. Evanoff & George G. Kaufman eds., 2006) (accurately identifying differences in regulation and stakeholder interests, the lack of market discipline, and the problems of cross-border crisis management as critical aspects).

tutions: as will be discussed in more detail,¹¹ currently the applicable supervisory regime hinges upon how banks choose to organize their international activities. In principle, a financial institution faces two alternatives if it seeks to establish a continuous and meaningful presence in a foreign market.¹² It can either organize its foreign operations as a subsidiary, *i.e.* a legally independent, yet wholly owned entity incorporated under the laws of the foreign jurisdiction, or it can establish a branch, *i.e.* a legally dependent satellite of its main establishment fully recognized under the laws of the foreign country where the respective banking services will be provided.¹³ Clearly, where the applicable law depends on choices of the regulated concern over potential regulatory arbitrage looms.¹⁴ Recent intra-group restructurings that at least coincided with some tightening in the regulatory regimes applicable to banks operating across borders at first glance seem to corroborate these apprehensions.

1.2 INTRA-GROUP RESTRUCTURINGS AS A SIGN OF REGULATORY ARBITRAGE?

1.2.1 EUROPE

In Europe several transactions occurred very recently that followed a common template: in certain jurisdictions, the activities of large cross-border banking groups were transformed from subsidiaries into branches. The transactions were executed through a cross-border merger of the thus far independent foreign subsidiary into the parent corporation¹⁵ that instantaneously assigned the received assets to the newly established foreign branch on its balance sheet. As a consequence, the real-world appearances of the banks' foreign operations were not affected by the legal maneuver. Yet, the regime of prudential bank regulation and supervision of the re-

¹¹ *Cf. infra* 4.

¹² The additional option to set up a representative office that can provide some auxiliary services abroad to the bank's main operations is also well established under WTO rules, *cf.* General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1b, art. XXVIII (g) footnote 12, 33 I.L.M. 1167 (1994). Yet, a representative office may be well suited to serve niche-markets, but it is practically inapt to establish a presence that broadly competes with domestic firms. This is even more true with regard to providing banking services directly across borders as permitted under The Treaty on the Functioning of the European Union, March 30, 2010, art. 56, 2010 O.J. (C 83), 47 [hereinafter TFEU].

¹³ For a broad survey of banks' organizational preferences, see Eugenio Cerutti, Giovanni Dell'Araccia & Maria Soledad Martínez Pería, *How Banks Go Abroad: Branches or Subsidiaries*, 31 J. BANKING & FIN. 1669, 1685-1691 (2007) (identifying tax rates, regulatory barriers, diverging business models – commercial vs. retail banking – and economic and political risks as driving forces in a sample of the world's 100 largest banks' operations in Latin America and Eastern Europe).

¹⁴ On the generally negative comprehension of the term that indicates a race for laxity in regulatory standards, Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 567, 636 (1998); Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L. L.J. 32, 52 (2007).

¹⁵ Such cross-jurisdictional transactions are facilitated by Parliament and Council Directive 2005/56 of 26 October 2005 on Cross-border Mergers of Limited Liability Companies, 2005 O.J. (L 310) 1 and its implementation in the Member States' merger statutes.

spective host countries ceded to apply.¹⁶ The restructurings caught the attention of the business press where they were regarded as blatant acts of regulatory arbitrage:

Banks Find New Wrinkle in Regulatory Arbitrage

....

European Banks are restructuring their businesses outside their home countries in ways that mute the impact of tough new regulations that were adopted as a response to the financial crisis. In the U.S., U.K. and Portugal, at least a handful of large European banks have altered their legal structures or shifted assets and business lines between units, partly in an attempt to avoid local rules and oversight, according to bank disclosures and people familiar with the matter.¹⁷

In stark contrast, the banks involved invoke efficiency considerations as the main motive for converting their subsidiaries into branches when they declare a simplification of the group structure¹⁸ and a more efficient allocation of resources as key objectives of the conversion-schemes.¹⁹

1.2.2 UNITED STATES

Similar concerns were voiced in the aftermath of restructurings that involved the U.S.-operations of some global banking-groups headquartered in Europe, to wit U.K.'s Barclays and Germany's Deutsche Bank. The criticized transactions sought to avoid the status of a "financial holding company" for the respective groups' top U.S.-units under the Bank Holding Company Act of 1956.²⁰ The critical reform in this

¹⁶ Regulatory and supervisory competences in international banking are tied to the legal entities' banking licenses, *i.e.* where a banking group establishes subsidiaries in a multitude of jurisdictions, its operations will require several banking licenses. Hence, several regulators and supervisors will be tasked with the group's supervision and hence have to cooperate according to the ground rules laid down under the auspices of the Bank for International Settlements (BIS), *see* BASEL COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 40-42 (1997), *available at* <http://www.bis.org/publ/bcbs30a.pdf>. For a more detailed account *see infra* 4.1.

¹⁷ Patricia Kowsmann, David Enrich & Laura Stevens, *Banks Find New Wrinkle In Regulatory Arbitrage*, WALL ST. J. (Europe), Dec. 2, 2011, at 1.

¹⁸ For empirical evidence that financial institutions are organized indeed in a significantly more complex manner than non-financial firms *cf.* Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety & Soundness*, in THE OXFORD HANDBOOK OF BANKING 195-232 (Allen N. Berger, Phillip Molyneux & John O. S. Wilson, 2012) (showing that the sixteen largest financial institutions in the world have 2.5-times more affiliates than the sixteen largest non-financial firms)

¹⁹ *See* for instance Deutsche Bank, Transformation of Deutsche Bank ZRT. into a branch of Deutsche Bank AG (May 31, 2011) *available at* https://www.db.com/hungary/docs/Branch_client_communication_letter.pdf.

²⁰ §2(a)(p) of the Bank Holding Company Act (12 U.S.C. § 1841 (2012)) define a financial holding company as a company that has direct or indirect control over a depository banking subsidiary and meets the mandatory capital requirements of §4(l)(1) of the Bank Holding Company Act (12 U.S.C. § 1843 (2012)).

regard was promulgated in the course of the Dodd-Frank Act overhaul²¹ and invariably requires any bank holding company to be well capitalized itself. In particular, the tightened legislation cancels the prior leeway to grant exemptions to large intermediate holding companies of international banking-groups²² which may be backed by a strong financial institution outside the U.S. and hence do not necessarily depend on own funds to be sufficiently resilient as a stand-alone U.S.-holding company does. Estimates gauged the additional capital requirements one of the intermediate financial holding companies faced under the new regulation at \$20 bn.²³ The rather simple move to avoid this massive burden of having to inject new capital into the groups' U.S.-business was to transfer the shares of the wholly owned U.S.-depository bank from the intermediate holding company to the mother registered outside the U.S. As a result, the groups' U.S. intermediate holding companies were left with equity stakes only in subsidiaries that conduct non-depository financial activities. Hence, they no longer fall under the Bank Holding Company Act's definition of a bank holding company.²⁴

Again, the momentous change in the applicable regulatory and supervisory regime could be achieved in an instant without altering the cross-border banking-groups' real-world appearance. No wonder, that leading business newspapers unanimously regarded the changes in the involved groups' legal structure as aimed at "avoiding" stricter regulation,²⁵ a reputable German daily even characterizing the transaction as "tricking" U.S.-supervisors.²⁶ On the other hand, a spokesman of one of the banks involved justified the changes as a measure to enhance the efficiency of the group's organizational structure.²⁷

1.3 MISCONCEPTIONS AND THE PIVOTAL QUESTION

²¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. No. 111-203, §606(a), 124 Stat. 1376, 1607 (2010).

²² The substantive regulation is contained in the Federal Reserve's amendments to Regulation Y (12 C.F.R. § 225.8 (2012)). They require any large bank holding companies to submit capital plans that adhere to rigorous own funds requirements.

²³ David Enrich & Laura Stevens, *Deutsche Avoids Dodd-Frank Rule*, WALL ST. J., March 22, 2012, at C1.

²⁴ For a detailed description of the transaction *cf.* David Enrich, Laura Stevens & Alexandra Berzon, *Deutsche Maneuvers Around New Law*, Wall St. J., April 13, 2012, at ■■■.

²⁵ Tom Braithwaite & Shahien Nasiripour, *Deutsche Bank avoids US capital rules*, FINANCIAL TIMES, March 22, 2012, at ■■■; Enrich & Stevens, *supra* note 23.

²⁶ Moritz Koch, *Tricksen mit Taunus*, SÜDDEUTSCHE ZEITUNG, March 23, 2012, at 26. For another harsh critique from the perspective of a U.S.-trade union *cf.* Letter from Marty R. Leary, Unitehere!, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System *available at* http://www.federalreserve.gov/SECRS/2011/August/20110831/R-1425/R-1425_080411_87623_491541684764_1.pdf.

²⁷ *Cf.* Enrich & Stevens, *supra* note 23 (quoting Deutsche Bank spokesman Duncan King as saying that the "action, which does not diminish any of our regulatory oversight, allows us to streamline our organizational structure, strengthening an already strong institution.").

Even though the restructurings delineated above seem obvious cases of regulatory arbitrage at first glance, a critique focusing mainly on the circumvention of specific substantive rules still deals with rather peripheral aspects and ultimately misses the crucial issue at hand.

Clearly, stricter requirements regarding subsidiaries' or the banking-group's own-funds and a design of executives' compensation packages that rewards sustainable growth have been duly identified as mechanisms that can enhance banks' resilience and do away with detrimental incentives for excessive risk taking.²⁸ However, it seems implausible that a strategy geared at avoiding particularly austere national regulation promulgated in certain European countries²⁹ actually motivated the branch-conversions described above. When the restructurings were initiated a general tightening and further harmonization of the pertinent E.U.-regimes had already become visible on the international horizon and in critical part even arrived prior to the closing of the restructurings.³⁰ These were hence inapt to escape from the regulator's tighter grip in the longer run.

Similarly, the efforts to avoid the pertinent Dodd-Frank reforms do not necessarily indicate the affected banks' proclivity to race for laxity at all cost. The pivotal

²⁸ How ill-designed executive pay in banks contributed to the financial crisis has been broadly analyzed, mostly with regard to the short-term orientation of high-powered incentive schemes (for an account of the broad consensus in this respect *cf.* Lucian A. Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1917-1919 (2010)) but also with regard to more structural issues in the banking sector *see e.g.* Günther Franke & Jan Pieter Krahen, *The Future of Securitization*, *in*: PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN 105, 126-139 (Yasuyuki Fuchita, Richard Herring & Robert E. Litan eds., 2009) (presenting evidence on how non-negative bonus payments induce high leverage ratios that increase default-risk and potentially threaten financial stability); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, GEO. L.J. 247, 255-274 (2010) (analyzing how equity-based incentive compensation induces a managerial bet on the bank's highly levered assets).

²⁹ For an overview of the European reforms implementing the international consensus on sound compensation practices achieved among the G-20 nations (*cf.* Financial Stability Forum, *Principles for Sound Compensation Practices* (April 2, 2009) *available at* http://www.financialstabilityboard.org/publications/r_0904b.pdf); for a detailed analysis of European practices *see* Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation Practices: an Analysis of Executive Pay at European Banks*, 64 VAND. L. REV. 431, 454-53, 483-96 (2011).

³⁰ Parliament and Council Directive 2010/76, As Regards Capital Requirements for the Trading Book and for Re-securitisations, and the Supervisory Review of Remuneration Policies, 2010 O.J. (L 329) 3 [hereinafter: CRD III]. Moreover, as is well known, an even more fundamental reform, aimed at completely leveling the playing field for E.U.-banks by basing prudential supervision on a single, harmonized rulebook is also in the making, *see Commission Proposal for a Directive of the European Parliament and the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate*, COM(2011) 453 final (July 20, 2011) and *Commission Proposal for a Regulation of the European Parliament and the Council on prudential requirements for credit institutions and investment firms*, COM(2011) 452 final (July 20, 2011) [hereinafter: CRD IV Directive and CRD IV Regulation].

fact under the reform legislation, that some international banks' organizational structure features an intermediate holding corporation that controls the groups' incorporated U.S.-depository banking units ties the massively augmented capital requirements to rather formal aspects. The severely tightened own funds-requisites do neither hinge upon the actual risk-structure of the group nor upon its supervisory regime. Thus, they outright negate the possibility that the U.S.-intermediate holding may benefit from the support of an overseas parent that is itself subject to a rigid regime of consolidated banking supervision which also accounts for the risks that accrue from the U.S.-business entity. Seen from this vantage, submitting to the Dodd-Frank reforms could also be regarded as generating a windfall profit for the U.S.-banking system as a result of a quasi-protectionist legislation that intentionally disregards the transnational nature of cross-border banking groups.

As a consequence, the reproach that transnational banking groups engaged in regulatory arbitrage when they restructured their organizations should not be based on a narrow analysis that constricts the view on the applicability of specific rules of the supervisory regime prior and after the restructurings. Regardless of the merits of discrete substantive rules, the more momentous question that should be posed in light of the delineated developments is whether the organizational choices of cross-border banking groups in general are adequately resorbed by the applicable regime of prudential supervision in a transnational context. This implies that the supervisory architecture should neither drive opportunistic choices nor hamper an efficient organization of transnational banking groups.

This article explores precisely this fundamental question against the background of the ongoing sovereign debt crisis in the Euro area. The short sequence of financial disasters that were neither prevented nor mitigated in a meaningful way under the current E.U.-regime of shared responsibility among Member States debunks significant shortcomings. Recently promulgated and currently proposed reforms tackle the deficiencies only in an insufficient manner. This is all the more worrying as the Euro area crisis together with the ramifications and sequels of the Lehmann-debacle highlight the importance of effective "normal-times" prudential supervision. The latter is and will remain a key determinant when it comes to enhancing the resilience of a transnationally intertwined financial system where market discipline in its most pristine occurrence as the exit of failing participants is partly unavailable.³¹

With this in mind, this article outlines relatively easy to implement reforms for the supervision of transnational banking-groups in the E.U. that is no longer based on legal form but more on the actual risk structure of the pertinent financial institutions. It also aims at paying close attention to the economics of public administration and international relations in allocating competences among national and supranational supervisory bodies. Before detailing the own proposition, part 2 of this article looks into the relationship between sovereign debt and banking crises that drive regulatory reactions to the financial turmoil in the Euro area that *inter alia*

³¹ *Infra* 2.2.2.

affirm effective prudential supervision as a pivotal element of their implementation. In order to arrive at a more informed idea, which determinants apart from a perceived appetite for regulatory arbitrage drive banks' organizational choices, part 3 scrutinizes the merits of either a branch or subsidiary structure for the cross-border business of financial institutions. In doing so, it also considers the policy-makers perspective. The analysis shows that no one size fits all organizational structure is available and concludes that banks' choices should generally not be second-guessed, particularly because they are subject to (some) market discipline. Part 4 describes and evaluates how competences in prudential supervision are currently allocated among national and supranational supervisory authorities. In order to evaluate the findings the appraisal adopts insights from the economics of public administration and international relations. It argues that the supervisory architecture has to be more aligned with bureaucrats' incentives and that inefficient requirements to cooperate and share information should be reduced. Contrary to a widespread perception, shifting responsibility to a supranational authority cannot solve all the problems identified. Resting on these foundations, part 5 finally sketches an independent solution that dwells on far-reaching mutual recognition of national supervisory regimes and allocates competences in line with supervisors' incentives and the risk inherent in cross-border banking groups.

2 THE IMPORTANCE OF MICRO-PRUDENTIAL SUPERVISION: LESSONS FROM THE ONGOING SOVEREIGN DEBT AND BANKING CRISES IN THE EURO AREA

Sovereign debt and banking crises frequently correlate in history, a finding which confirms the connections delineated in economic theory (2.1). These basic insights serve as a starting point that helps understand not only the repercussions that the ongoing Euro area crisis exerts on the European banking system but also how the calamities in the financial sector impacted on sovereign debtors. Finally, it provides the necessary background for conceiving the role of prudential supervision of transnational banking-groups as an important component of the European initiatives targeted at long-term hazard control (2.2).

2.1 SOVEREIGN DEBT AND BANKING CRISES THROUGH THE AGES

2.1.1 HISTORICAL ANECDOTES

The first documented sovereign debt crisis occurred when most of the municipalities of the Attic Maritime Association were unable to repay a loan from the Delos temple (377-373 B.C.).³² But as early as in 1343 A.D. shock waves triggered by a sovereign debtor's woes were sent across Europe when King Edward III of England defaulted on his obligations at the largest Florentine banks, sending them into bank-

³² Max Winkler, *Foreign Bonds an Autopsy* 22 (1933).

ruptcy and thus causing the collapse of an entire financial system.³³ The scenario reoccurred in 1557 A.D when King Philip II of Spain ruined the powerful merchant banks owned by the South German families of the Fugger and Welser.³⁴ Yet, Germans were not always the bereaved but also the bankrupts: During the 19th century German states defaulted five times on their debt, jointly with Austria and Portugal outdistancing Greece, which disappointed its lenders four times.³⁵ All these events put severe stress on or increased the already existing distress in the banking system at least in the immediately affected economies.

2.1.2 BAIL-OUT RATIONALITY AND MORAL HAZARD

At the outset, major banking and sovereign debt crises share a critical common feature because the option to force a failing debtor's restructuring or resolution in bankruptcy does neither constitute a credible scenario for systemically important financial Institutions (SIFIs) nor for sovereign debtors. Moreover, where outside help is foreseeably available, market discipline is dulled and moral hazard occurs.³⁶

With regard to sovereign debtors, the probability and magnitude of default in general does not depend critically on their ability to pay but on their willingness to pay: without an executable enforcement mechanism that coerces debt-servicing, sovereign debtors will default once the anticipated costs of doing so have become lower than the costs of redeeming the obligation.³⁷ Moreover, sovereign debtors although by their very nature fiscally independent bodies can rely on outside help where other public actors deem their overall economic, social and political costs of

³³ Meir Kohn, *Merchant banking in the medieval and early modern economy* 20 (Dartmouth College, Dept. of Econ. Working Paper 99-05, 1999) available at <http://www.dartmouth.edu/~mkohn/Papers/99-05.pdf>.

³⁴ *id.*

³⁵ Carmen M. Reinhart, Kenneth S. Rogoff & Miguel A. Savastano, *Debt Intolerance* 11 (NBER Working Paper 9908, 2003) available at <http://www.nber.org/papers/w9908>. The last German default occurred during the 1930s, cf. FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, *DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES* 7 (2006); Eduardo Borensztein and Ugo Panizza, *The Costs of Sovereign Default* 44 (IMF Working Paper WP/08/238, 2008) available at <http://www.imf.org/external/pubs/ft/wp/2008/wp08238.pdf>.

³⁶ For a general macroeconomic assessment with a special view to the Euro area see Jay C. Shambaugh, *The Euro's Three Crisis* 24-27 (Brookings Papers on Econ. Activity, 2012) available at http://www.brookings.edu/~media/Files/Programs/ES/BPEA/2012_spring_bpea_papers/2012_spring_BPEA_shambaugh.pdf.

³⁷ Jonathan Eaton, Mark Gersovitz & Joseph E. Stiglitz, *The pure theory of country risk*, 30 EUR. ECON. REV. 481 (1986). While the immediate costs of servicing debt simply consist of interest and redemption payments the pertinent costs of default are more complex: the sovereign debtor will be excluded from international financial markets and will thus be unable to smooth consumption and face impediments to investments for a certain time. The magnitude of these effects obviously depends on the period of exclusion. Yet, even after regaining access to international financial markets, risk premiums will be influenced by the sovereign debtor's prior default. Moreover, further costs are associated with the economic downturn that usually accompanies a sovereign default or trade sanctions in reaction to it.

the default of a sovereign as too high, even though legal restrictions on sovereign bail-outs may exist.³⁸

SIFIs, as private business corporations, on the other hand, are in principle subject to insolvency proceedings. Yet, their market exit, by definition, sends ripples through the financial system that create incentives for policy-makers to rescue failing banks, even if the handling of a systemic crisis in the banking sector was consciously left unclear to induce caution and discipline among SIFIs in an atmosphere of “constructive uncertainty”. Even though political decisions makers may have pledged not to bail-out SIFIs they tend to behave inconsistently over time and will take rescue measures in order to prevent a chain reaction in the banking sector which would ultimately lead to its total collapse.³⁹ The latter would precipitate severe negative consequences for the affected economy’s production and employment. That is the case, because in a major banking crisis, financial institutions either go bankrupt or at least clamp down on loan approvals. Both, the losses of assets dealt to institutional and private investors in the former event as well as the decreased number of loan approvals in the latter inhibit the propensity to invest and decrease consumer demand. Thus, they hinder macroeconomic output.

At the same time, the economic crunch exacerbates the crisis, as a recession makes it harder for sovereign borrowers to service their debt which in turn will put banks even deeper into the quagmire. Finally, the political costs are high as well, as basically no elected government will survive the economic downturn, the decline in household income and the ensuing asset losses.⁴⁰ On the other hand, the incentives to “gamble for resurrection” are high for political actors, particularly because there is no external mechanism that can force sovereign debtors to declare insolvency, i.e. to apply for loans from the International Monetary Fund or other institutions.

The anticipation of such time-inconsistencies leads to significant moral hazard and excessive risk-taking *ex ante*. There is an inherent market failure as a consequence of the lack of a predictable insolvency regime which leads to incorrect debt-pricing. Risk premiums hinge not only on the probability of default but also on the probability of declining a bail-out or at least asking for a private sector contribution to the rescue efforts. Hence, risk premiums are distorted and the pricing mechanism fails to induce adequate risk-taking, i.e. sovereign debtors and SIFIs can borrow too cheap, as part of their liability is externalized. Moreover the participation in the losses following the default of a sovereign debtor or a SIFI is attributed on a case by case

³⁸ The Founding Treaty of the E.U. explicitly prohibits a bail-out of Member States’ central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings, TFEU art. 125(1). However, the massive sovereign bail-outs in the Euro area were not barred by this constitutional restriction, cf. Jean-Paul Keppenne, *A Challenge for the Lawyers – Coping with States in Financial Difficulties Within the European Union Treaties*, 48 TEX. INT’L L.J. ■■■ in this issue ■■■ (2012).

³⁹ For the economics of bailouts see also Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REG. 121, 123-129 (2012).

⁴⁰ For the reasons, why pre-committed politicians will bail-out SIFIs they deem too-big-to-fail Jonathan R. Macey & James P. Holdcroft, Jr., *Failure is an Option: an Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1375-1383 (2011).

basis that follows the specific political and institutional preconditions prevailing at the time insolvency is declared, and thus can hardly be predicted *ex ante*, thus handicapping a stringent ranking among groups of creditors. As an observable consequence, sovereign debtors – and SIFIs – face relatively low risk premiums for a long time but interest rates spike in the vicinity of insolvency.⁴¹ Hence a debt crisis exhibits the typical elements of a self-fulfilling prophecy where a sudden change in market participants' expectations generates entirely different results although all other economic determinants remain unchanged:⁴² only as long as creditors expect other creditors to renew their existing loans or extend even larger ones will they be willing to do the same. Investor panic may plunge the debtor into a liquidity crisis, as her long-term claims don't work to cover her short-term liabilities. Where unfavorable refinancing conditions persist, a solvency crisis will ensue.

Moreover, bank bail-outs put tremendous fiscal burdens on the rescuing country's budget,⁴³ which in turn may cast doubts on its ability to service its debt. These doubts will lead to a rise in risk premiums and will hence make the country's future debt service even more burdensome. Once again the overall economic development (recession) may add to the fiscal hassles. Finally, the sovereign debt crisis will backlash on the (national) banking system insofar as banks will typically be the main holders of a shaky country's bonds. Hence their financial stability will be severely impacted if a country declares its insolvency or restructures its debt. This is even more so, as sovereign debtors will find it harder or at least more expensive to refinance themselves on international financial markets and will consequentially have the sovereign debt-load absorbed mainly by domestic banks. The collapse of a national banking system will affect the international banking system depending on its size and interconnectedness.⁴⁴

⁴¹ Mardi Dungey, Renée Fry, Brenda González-Hermosillo & Vance Martin, *International Contagion Effects from the Russian Crisis and the LTCM Near-Collapse* (April 2002), IMF Working Paper No. 02/74, available at <http://www.imf.org/external/pubs/ft/wp/2002/wp0274.pdf>; Giovanni Dell'Ariccia, Isabel Schnabel & Jeromin Zettelmayer, *How Do Official Bailouts Affect the Risk of Investing in Emerging Markets?*, 38 J. MONEY CREDIT & BANKING 1689 (2006).

⁴² Douglas W. Diamond & Philip H. Dybvig, *Bank Runs*, 91 J. POL. ECON. 401 (1983); Jeffrey Sachs, *Theoretical Issues in International Borrowing* (NBER Working Paper No. 1189, 1983) available at <http://www.nber.org/papers/w1189.pdf>; Paul De Grauwe, *The Governing of a Fragile Eurozone* (CEPS Working Paper Nr. 346, 2011) available at <http://www.ceps.be/ceps/download/5523>.

⁴³ Between October 2008 and May 2010 the 27 Member States of the E.U. spent a total of €235.1 bn (\$288.6 bn) on bank recapitalizations. Guarantees for bonds and other debentures were issued to an amount of €957.7 bn (\$1175.7 bn) and further asset support to safeguard banks financial stability accounted for the assumption of risk worth €346.5 bn (\$425.4 bn). The pertinent figures for Euro-zone members amounted to €160.1 bn (\$196.5 bn) in recapitalizations, €735.2 bn (\$ 02.6 bn) in guarantees, and €128.7 bn (\$ 157.9 bn) in risk assumptions, cf. Stéphanie Marie Stolz & Michael Wedow, *Extraordinary Measures in Extraordinary Times* 24 (ECB Occasional Paper No. 137, 2010) available at <http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp117.pdf>. (Dollar conversions as of May 31, 2010).

⁴⁴ For a theoretical assessment see Joseph E. Stiglitz, *Risk and Global Economic Architecture: Why Full Financial Integration May Be Undesirable*, 100 AM. ECON. REV. 388

2.2 THE CONTEMPORARY EUROPEAN ANGLE AND ONE REGULATORY RESPONSE

The contemporary European angle of these general relationships between sovereign debt and banking crises followed the general pattern and threatened to spin out of control during July 2011 (2.2.1). The events prompted coordinated regulatory reactions that highlight the relevance of effective prudential supervision (2.2.2).

2.2.1 CONFIDENCE CRISIS JULY 2011

The events that occurred during the summer of 2011 elucidate the interconnection between the banking and the sovereign debt crisis in the Euro area.⁴⁵ The crisis indicators in the banking sector flashed red alert again when the usually highly liquid interbank markets ran dry, U.S. banks and money-market funds withdrew their deposits, and the stock prices of European banks declined, while credit default swap spreads climbed. The trigger for the resurging banking troubles was pulled when Greece was ostensibly facing the abyss. Rumors had it that the so called troika consisting of representatives from the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) would assess Greece negatively thereby calling into question further fiscal aid and making a ‘voluntary’ write-off of private sector creditors more likely. Credit rating agencies had already announced to consider such a ‘voluntary’ participation in Greece’s rescue as a “selective default” which in turn would have led the ECB to no longer accept Greek bonds as collateral for refinancing purposes sending the largest Greek banks immediately into bankruptcy. Although the severe confidence crisis shaking the whole European banking system could be countered by short term measures of hazard control, the need for more fundamental reactions to eventually reestablish trust in the financial sector had become undeniable.

2.2.2 MICRO-PRUDENTIAL REGULATORY REACTIONS

On October 26, 2011 European politics reacted to the dwindling confidence in the European banking system with far reaching coordinated measures. *Inter alia* a recommendation by the European Banking Authority (EBA)⁴⁶ sought to tighten rel-

(2010) (providing an analytical framework that demonstrates the technological conditions under which financial autarky is preferable to full integration as the associated risk-sharing lowers expected utility).

⁴⁵ For a detailed account of the following see GERMAN COUNCIL OF ECONOMIC ADVISORS, ANNUAL REPORT 2011/2012 130-134 (2011) *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_four_2011.pdf. For a general chronology of the main events during the Euro area crisis *id.* at 121-122 *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_three_2011.pdf.

⁴⁶ According to Parliament and Council Regulation 1093/2010 (EU) of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), art. 16, 2010 O.J. (L 331) 12, 27 [hereinafter: EBA-Regulation] a formal recommendation addressed to Member States’ banking supervisors is not legally binding but subject to a comply-or-

evant micro-prudential regulation to reestablish confidence in SIFIs' resilience.⁴⁷ A core capital (Tier 1)⁴⁸ to risk-weighted assets ratio⁴⁹ of 9% should be reached by June 30, 2012.⁵⁰ Furthermore, all banks with a capital shortfall as of September 30, 2011, according to the EBA's capital exercise⁵¹ had to file a steps plan no later than January 20, 2012 which indicated how they would satisfy their capital needs, primarily by raising new capital in private markets and cutting dividends and bonuses.⁵² Finally, an extraordinary buffer for risky sovereign bonds had to be put in place, i.e. the core capital requirement had to be met after the removal of the prudential filter on the sovereign assets in the available-for-sale portfolio and the conservative valuation of sovereign debt exposures in the held-to-maturity and loans and receivables portfolios, reflecting market prices as of 30 September 2011.⁵³ Banks that cannot raise sufficient capital in private markets were to be compulsorily recapitalized with public funds from their home Member States who could borrow funds at the European Financial Stability Facility (EFSF) if they became overstrained or

explain-mechanism (*see also infra* 4.2.4.2): the national authority has to declare its non-compliance within two months after the issuance of the recommendation and communicate its reasons to the EBA, which has to publish the fact that the national authority deviates from the recommendation and may choose to publish the reasons for doing so, EBA-Regulation, art. 16(3).

⁴⁷EBA, Recommendation of 8 December 2011 on the creation and supervisory oversight of temporary capital buffers to restore market confidence, *available at* <http://stress-test.eba.europa.eu/capitalexercise/EBA%20BS%202011%20173%20Recommendation%20FINAL.pdf> [hereinafter EBA-Recommendation].

⁴⁸The definition of Core Tier 1 is based on existing E.U.-legislation in the Capital Requirements Directive, *see infra* at note 137. This definition of capital comprises the highest quality capital instruments (common equity) and hybrid instruments provided by governments. It strips out other hybrid instruments including existing preferred stock.

⁴⁹The risk-weighting of assets means that a bank's assets and its off-balance sheet exposure are valued according to the risk of depreciations. Asset-classes with lower risk of devaluation can be deducted accordingly, the simplest example being a riskless (0%-possibility of depreciation) asset that can be deducted entirely from a bank's risk-weighted assets.

⁵⁰Generally for the significance of capital requirements in reducing systemic risk see Hal S. Scott, *Reducing Systemic Risk Through the Reform of Capital Regulation*, 13 J. Int'l Econ. L. 763, 764 (2010).

⁵¹The EBA ultimately calculated the capital shortfall of all relevant European banks in its recapitalization exercise at €114 bn (\$186 bn), *cf.* EBA Communication of 8 December 2011 *available at* <http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-publishes-Recommendation-and-final-results.aspx>. However, in June 2012 Spain acquiesced to a bailout package of €100 bn (\$125 bn) to rescue its banks alone made these estimates crumble away soon, see Charles Forelle & Gabriele Steinhäuser, *Latest Europe Rescue Aims to Prop Up Spain*, WALL ST. J., June 11, 2012 at A1. The dependence on the methodology was already illustrated by the earlier estimations of the German Council of Economic Experts that based their gauges on the balance sheet positions published by the EBA in July 2011: the capital shortfall of European banks would amount to €106 bn (\$150 bn) if a write-down of 50% was applied to Greek bonds. If a mark-to-market approach was applied to all sovereign debt-positions, allowing for both depreciations and appreciations, the capital shortfall of European banks would rise to €137 bn (\$194 bn), GERMAN COUNCIL OF ECONOMIC EXPERTS *supra* note 45 at 132.

⁵²EBA-Recommendation at 13-14.

⁵³EBA-Recommendation at 13.

were put under severe pressure by financial markets as a consequence of such recapitalizations.

Even though significant steps to enhance the regulatory framework for SIFIs and reestablish market discipline have been taken in the meantime,⁵⁴ micro-prudential regulation will constitute a pivotal building block in the attempts to erect a stable and sustainable structure for the financial sector in the E.U. It is thus of critical importance to ensure an effective administration of these rules. Clearly, with the supervisory structure depending on a transnational banking group's legal structure,⁵⁵ organizational choices of banks impact on the administration of these rules which is why the next part turns to the basic characteristics of the available alternatives in order to evaluate the driving forces behind banks' pertinent decisions.

3 ORGANIZATIONAL CHOICES OF BANKS

This part briefly reviews the most important characteristics of the organizational structures prevalent in cross-border banking (3.1).⁵⁶ Benefits and detriments associated with either the branch- or the subsidiary model are rather scattered so that neither structure dominates over the other from the banks' (3.2) or the policy-makers' (3.3) perspective. The findings corroborate the posit that the simple allegation of regulatory arbitrage underestimates the complexity of the choice of organizational form and misdirects the attention away from the central issue of how prudential supervision can best serve its end regardless of the legal structure banks opt for in their cross-border operations (3.4).

3.1 BRANCHES AND SUBSIDIARIES: MAIN FEATURES OF PROTOTYPICAL ORGANIZATIONAL STRUCTURES

In an ideal world, the branch-structure under which all foreign operations are conducted from within a single legal entity, allows for a centralized organization where capital and liquidity flow freely across business units and across borders.⁵⁷ Capital is raised in the market where it is least expensive and deployed where it yields the highest return, thus offering cost-reducing arbitrage options across jurisdictions. In times of crisis, the integrated risk management can move excess capital and liquidity that is available anywhere within the group to the business unit under stress.

⁵⁴ Most notably the *Commission Proposal for a Parliament and Council Directive establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010*, COM (2012) 280 final (June 6, 2012) [hereinafter Proposal Resolution Directive] that aims at establishing a cross-border resolution regime for SIFIs and a viable bail-in mechanism and thus goes to the heart of the moral hazard problem (supra 2.1.2) in the banking sector.

⁵⁵ For a detailed analysis see *infra* 4.

⁵⁶ See already *supra* 1.1.

⁵⁷ The closest real world example of such an idealized branch-structure occurs in the E.U. see *infra* 4.2.1.2.

On the other hand, opting for an archetypical subsidiary-structure under which foreign business units are legally independent, incorporated entities, entails decentralized operations subject to local capital and liquidity requirements. Legal restrictions on the transfer of capital and liquidity hamper respective intra-group transactions, whereas the transfer of knowledge and technology is by and large unimpeded. Parent and subsidiaries are subject to the sufficient own funds and liquidity requirements of local jurisdictions. Individual risk-management of the group's entities is required to make them resilient as stand-alone as in times of crisis financial aid is guaranteed neither from the parent nor from any other group-affiliate. In fact, capital maintenance requirements in corporate law serve as a (weak) form of ring-fencing⁵⁸ which raises the operating costs of the transnational banking-group that requires overall higher levels of capital.⁵⁹

It has to be noted here that for the purpose of analysis simplifications are useful, although reality is significantly more complex. For instance, on a regulatory level, some jurisdictions treat (foreign) branches and subsidiaries alike when it comes to capital and liquidity requirements for the hosted business unit.⁶⁰ As will be discussed in more detail,⁶¹ this is only one example where the legal differences between branch- and subsidiary-model that are clear-cut at the outset are significantly leveled with regard to micro-prudential supervision.

3.2 THE BANK'S PERSPECTIVE

3.2.1 GENERAL CONSIDERATIONS

⁵⁸ Usually, the term signifies a separation of business units that aims at limiting the risk of contagion without proscribing their consolidation under the roof of a single financial institution, Julian T.S. Chow & Jay Surti, *Making Banks Safer: Can Volcker and Vickers Do It?* 22-23 (Int'l Monetary Fund, Working Paper WP/11/236, 2011), available at <http://www.imf.org/external/pubs/ft/wp/2011/wp11236.pdf>. The most prominent proposal in this direction comes from a U.K.-commission and seeks to shield (domestic) retail operations from the risks of (international) investment banking without prohibiting that these lines of business be organizationally united within a so called universal bank that arguably attains diversification benefits, see INDEPENDENT COMMISSION ON BANKING, FINAL REPORT RECOMMENDATIONS 35-77, 76-77 (2011) (U.K.) available at <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf>.

⁵⁹ Cf. Eugenio Cerutti, Anna Ilyina, Yulia Makarova & Christian Schmieder, *Bankers Without Borders? Implications of Ring-Fencing for European Cross-Border Banks* (Int'l Monetary Fund, Working Paper WP/10/247, 2011) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1750736 (devising a stylized model that indicates that cross-border banking groups need larger capital buffers at the subsidiary and parent level under ring-fencing to survive a credit shock).

⁶⁰ Fiechter, Ötler-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 7 note 4.

⁶¹ *Infra* 3.4.

The principal characteristics of the organizational options translate into costs and benefits for a banking group that seeks to optimize the legal structure of its cross-border business.⁶²

Intuitively, a branch structure entails lower costs of doing business for the banking-group compared to operating under a subsidiary-structure. Independent legal personality in principle requires subsidiaries to sustain themselves as stand-alone entities and thus leads to a need for higher capital- and liquidity buffers. Moreover, the latter have to be filled at higher lending costs for the individual entities.⁶³ The pertinent restrictions on the transfer of capital and liquidity attenuate opportunities for arbitrage when capital is raised and deployed under a subsidiary structure.

Furthermore, the branch structure can strengthen the group's resilience if locally contained, adverse developments occur. Obviously, the latter constitutes an advantage from the bank's perspective if the group's survival in its current structure is deemed desirable.⁶⁴ The unimpeded transfer of funds allows overcoming country specific negative shocks, as long as the magnitude of the adverse developments does not consume the group's entire capital and liquidity reserves. On the other hand, legal restrictions that can result from general corporate law (e.g. minimum capital requirements⁶⁵) as well as specific regulations applying to banks⁶⁶ may hamper the quick transfer of much needed funds under a subsidiary structure.⁶⁷

⁶² For a more detailed discussion of the following see Fiechter, Ötoker-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 8-9.

⁶³ For some empirical evidence corroborating the general posit *cf.* Ata Can Bertay, Asli Demirguc-Kunt & Harry Huizinga, *Is the financial safety net a barrier to cross-border banking?* (World Bank Policy Research Working Paper No. 5947, 2012) available at http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2012/01/17/000158349_20120117092544/Rendered/PDF/WPS5947.pdf (showing that the cost of funds increase by 1.5% to 2.4% if they are raised through a foreign subsidiary compared to domestic banks).

⁶⁴ For evidence, that international bank's retained their presence – subsidiaries though – despite a severe downturn in central and southern European economies, see Bonin *supra* note 4.

⁶⁵ For instance, European legislation prohibits any corporation to distribute funds if its net assets are or would through such distribution drop below the amount of the subscribed capital established in the corporate charter, Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, art. 15, 1977 O.J. (L 26) 1.

⁶⁶ See already *supra* 2.2.2.

⁶⁷ A group of experts assigned by the European Commission identified a multitude of restrictions on intra-group transfers that can form an obstacle to containing a banking crisis and thus proposed to lift these barriers under certain conditions, EUROPEAN COMMISSION, STUDY ON THE FEASIBILITY OF REDUCING OBSTACLES TO THE TRANSFER OF ASSETS WITHIN A CROSS BORDER BANKING GROUP DURING A FINANCIAL CRISIS 7 (proposal No. 1), 31-113 (2011) *available at* http://ec.europa.eu/internal_market/bank/docs/windingup/200908/final_report20091218_e

Conversely, however, the subsidiary structure may facilitate the containment of losses that accrue at a single group unit. The crisis or even the bankruptcy of a battered, legally independent affiliate or of the parent corporation as a matter of principle does not affect the going concern of other group entities.⁶⁸

3.2.2 ASSETS AND DRAWBACKS DEPENDING ON THE BANK'S BUSINESS MODEL

Some advantages accrue depending on the business model the banking-group intends to pursue in its transnational expansion.⁶⁹ The branch structure allows corporate clients to borrow against the entire group's (global) balance sheet and hence to push large exposure limits⁷⁰ and to improve borrowing conditions.

On the other hand, (only) the subsidiary structure allows to access local deposit insurance schemes⁷¹ and thus to appeal to consumer confidence if the latter is rooted in a larger faith in domestic institutions.⁷² Moreover, the advantages of a centralized liquidity- and risk-management may be smaller if the business model is fo-

n.pdf. The Commission intends to follow the expert advice *cf.* Proposal Resolution Directive artt. 17-23.

⁶⁸ For a review of the empirical literature that indicates under which conditions banks retain their presence through subsidiaries in transition economies even in times of crisis, see P. Bonin, *supra* note 4 (arguing that the acquisition of a majority stake during the privatization of formerly state-owned banks accounts for a long-term commitment).

⁶⁹ For a broader discussion of the following issues *cf.* Fiechter, Ötcher-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 9-10.

⁷⁰ In order to allow for a reasonable diversification, micro-prudential regulation of banks restricts the permissible concentration of credit risk by setting a limit on how much a single counter-party can borrow from the bank, i.e. large exposure limits relate the maximum that is available for lending to a single borrower to the bank's total capital base, *see generally* BASEL COMMITTEE ON BANKING SUPERVISION, MEASURING AND CONTROLLING LARGE CREDIT EXPOSURES 5 (1991) *available at* <http://www.bis.org/publ/bcbsc121.pdf>.

⁷¹ For example, under current European legislation, credit institutions, i.e. incorporated entities, are covered by the Member State's guarantee scheme that issued their banking license with the institution's branches included in the pertinent national system, Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, art. 3(1), 4(1), 1994 O.J. (L 135) 5. For a similar best practice recommendation *see* BASEL COMMITTEE ON BANKING SUPERVISION & INTERNATIONAL ASSOCIATION OF DEPOSIT INSURERS, CORE PRINCIPLES FOR EFFECTIVE DEPOSIT INSURANCE SYSTEMS 3, 12 (2009) *available at* <http://www.bis.org/publ/bcbs156.pdf>.

⁷² The Euro area crisis serves as a reminder that this need not be the case, with depositors from the troubled Member States at least engaging in a 'bank jog' in which they transfer their funds to foreign banks as a consequence of their mistrust in local guarantee schemes, *cf.* Noémie Bisserbe, *Greek Banks Under Pressure*, WALL ST. J., June 14, 2012 at A1. See also the Belgian press echo to Deutsche Bank's branch-conversion that pointed to improvements for retail customers that came under the protection of the (limitless) German depositor guarantee scheme as a consequence of the intra-group restructurings (*see supra* 1.2.1), P.D-D, *Protection sans plafond*, LA LIBRE, Oct. 15, 2011 *available at* <https://www.deutschebank.be/media/pdf/presse-libre-protection-sans-plafond-15-10-2011.pdf>; F.M., *Les clients belges de Deutsche Bank protégés... en Allemagne*, L'ECHO, Oct. 15, 2011, *available at* <https://www.deutschebank.be/media/pdf/presse-echo-clients-proteges-15-10-2011.pdf>.

cused on retail clients where local fund-raising and a deepened understanding of local markets seems more important.⁷³

3.2.3 BUSINESS JUDGMENT AND MARKET REACTIONS

The noteworthy aspect of this brief overview – which does not aim at exhausting the subject⁷⁴ – lies in the observation that both the subsidiary and the branch-structure support business models that cannot be regarded as abusive or opportunistic, an observation that becomes even more stringent if the policy-maker's perspective is taken into account in more detail.⁷⁵ Ultimately, the organizational choices seem to hinge upon the context-dependent business judgment of cross-border banks' decision-makers because no model clearly dominates the other in terms of effectiveness and practicality.⁷⁶

After all, some market discipline can be expected at least with regard to palpably opportunistic choices. Although SIFIs do not face the terminal sanction of a forced market exit in bankruptcy,⁷⁷ their creditors face at least uncertainty and potentially losses on the nominal value of their claims in the event of financial distress. As a consequence, it is plausible that a bank's choice of an inferior regime of prudential regulation and supervision will have a negative impact on its prospects.⁷⁸ The mounting mistrust in certain countries' deposit guarantee schemes and the general public alertness *vis-à-vis* the details of such schemes supports this notion.⁷⁹ Furthermore, there is robust evidence that markets are sensitive with regard to the effectiveness of public enforcement of the regulatory framework designed to protect their interest. Admittedly, with regard to banking supervision, this can only be ex-

⁷³ See Fiechter, Ötoker-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 10, 22 (attributing the organizational structure of Spanish cross-border banking to its retail-customer orientation).

⁷⁴ An in-depth analysis identifies further determinants that account for the organizational choices in transnational banking and points to (i) the treatment of branches and subsidiaries in tax law in the home as well as in the host jurisdiction, (ii) the development and the structure of the foreign markets which may or may not provide sufficient opportunities to source capital, and (iii) macroeconomic and political risks abroad which may less severely affect branches than locally incorporated subsidiaries, Cerutti, Dell'Araccia & Martínez Pería, *supra* note 13, at 1685-1691 (scrutinizing the world's 100 largest banks' operations in Latin America and Eastern Europe).

⁷⁵ *Infra* 3.3.

⁷⁶ For a similar assessment INT'L MONETARY FUND, *supra* note 3, at 9.

⁷⁷ On the underlying too big to fail/too interconnected to fail dilemma *supra* 2.1.2.

⁷⁸ Generally on (sophisticated) debt-holders significant sensitivity to bank risk e.g. Andrea Sironi, *Testing for Market Discipline in the European Banking Industry: Evidence from Subordinated Debt Issues*, 35 J. MONEY CREDIT & BANKING 443-472 (2003) (showing sensitivity to bank-risk among investors in subordinated notes and debentures); for the contemporary approaches to measuring credit risk see Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293, 311-322 (2012).

⁷⁹ See *supra* note 72. For robust empirical evidence Maria Soledad Martinez Peria & Sergio L. Schmukler, *Do Depositors Punish Banks for Bad Behavior? Market Discipline, Deposit Insurance, and Banking Crises*, 56 J. FIN. 1029 (2001) (showing how depositors disciplined weak banks by withdrawing deposits and by requiring higher interest rates in Argentina, Chile, and Mexico during the 1980s and 1990s).

trapolated from certain studies that establish markets' general capacity to assess available information on banks' default risk correctly even in times of crisis.⁸⁰ However, if prudential regulation is at least potentially suited to mitigate the risk of bank failure, creditors should be attuned to its quality and enforcement. And it is precisely such awareness of market participants that has been particularly well documented with regard to the enforcement of investor protecting securities laws.⁸¹ As a consequence, choosing "bad" prudential supervision should be penalized by credit markets which hence serve as a counterbalance to opportunistic choices.⁸² It can be justified on these grounds to accept banks' organizational choices and design the supervisory regime accordingly instead of cramming them into certain structures in cross-border banking by alleging maneuvers of regulatory arbitrage.

3.3 THE POLICYMAKER'S PERSPECTIVE

To have the full picture, the policy-maker's view on transnational banks' choices between the branch- and the subsidiary model must be assessed. The critical issues from the vantage of a cross-border bank's home and host country seem to be the relative growth perspectives under either organizational model and their respective impact on financial stability.⁸³ Once again, however, the findings remain ambiguous.

Intuitively, a growth-hungry policy-maker should prefer to see transnational banks to branch into her economy as the branch model potentially grants easier access to credit.⁸⁴ Yet, the empirical evidence with very successful transition economies being served through subsidiaries of large international banks casts doubt on the ex-

⁸⁰ John S. Jordan, Joe Peek & Eric S. Rosengren, *The Market Reaction to the Disclosure of Supervisory Actions: Implications for Bank Transparency*, 9 J. FIN. INTERMEDIATION 298, 307-317 (2000) (showing how increased disclosure of supervisory actions even during a banking crisis in the U.S. had no destabilizing effect but contributed to a more effective allocation of resources in the U.S. banking sector).

⁸¹ For recent empirical papers see John Armour, Colin Mayer & Andrea Polo, *Regulatory Sanctions and Reputational Damage in Financial Markets* (Oxford Legal Studies Res. Paper No. 62/2010, 2010) available at <http://ssrn.com/abstract=1678028> (finding that fines administered by public enforcement agencies serve as a clear signal to the market that momentarily punishes wrongdoers); Howell Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. Fin. Econ. 207 (2009) (establishing the correlation between public enforcement of securities laws and market development).

⁸² For a more pessimistic view in light of the financial crisis but underestimating the significance of unknown supervisory deficits and palpable opportunism Joel P. Trachtman, *The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation*, 13 J. INT'L ECON. L. 719, 723-25 (2010).

⁸³ For an extensive discussion and review of the literature regarding the effect of cross-border banking on financial stability cf. FRANKLIN ALLEN, THORSTEN BECK, ELENA CARLETTI, PHILIP R. LANE, DIRK SCHOENMAKER & WOLF WAGNER, CROSS-BORDER BANKING IN EUROPE: IMPLICATIONS FOR FINANCIAL STABILITY AND MACROECONOMIC POLICIES 47-53 (2011). See also Fiechter, Ötcher-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 15-17.

⁸⁴ For the underlying reasons see *supra* 3.2.1 and 3.2.2.

istence of such a clear-cut preference.⁸⁵ Moreover, if the subsidiary structure hampers the intra-group transfer of funds and hence compels to rely more on local deposits,⁸⁶ it can contribute to the development of credit markets in host countries. Yet, as has already been mentioned, where savings are limited due to market development, large exposure limits may quickly preclude corporate clients from borrowing from local subsidiaries⁸⁷ and in turn coerce these actors into bypassing local credit markets thus handicapping their development.⁸⁸

The competing organizational models' influence on financial stability reveals a dichotomy of interests between the banks' host- and home countries. Assuming that the subsidiary model allows containing local crises,⁸⁹ greater resilience should result with regard to individual group members, if the shock is external. Conversely, under the branch model the readily available, group-wide support⁹⁰ should make it easier to weather the storm if the crisis has a domestic source. However, saving a foreign business unit puts stress on the banking group. As a result, policy-makers will be reserved with regard to rescue obligations that originate abroad but weaken the institution and entail the risk of contagion.⁹¹ Policy-makers in a banking group's home country will thus prefer a subsidiary structure, if the financial crisis arises abroad, and will welcome a branch structure if foreign entities shall contribute to averting a crisis in the group's home country. The host country agenda is diametrical.

This stark contrast of interest only varies in degree, if a failing bank has to be rescued with public funds. Absent transnational burden-sharing arrangements⁹² host countries are under no obligation to participate in bail-outs under the branch-model, whereas home countries do not have to contribute to the rescue of a foreign incorporated affiliate under the subsidiary model.⁹³

Clearly, from the perspective of those responsible for public policy there is no abstract preference for either organizational structure. This is particularly true once

⁸⁵ Ralph de Haas & Iman van Lelyveld, *Internal capital markets and lending by multinational bank subsidiaries*, 19 J. FIN. INTERMEDIATION 1, 10-16 (2010) (finding evidence for the existence of internal capital markets that allow subsidiaries of financially strong parents to expand their lending faster than domestic competitors). However, for evidence to the contrary see *supra* note 4. See also *supra* note 68.

⁸⁶ *Supra* 3.2.2.

⁸⁷ *Supra* 3.2.2.

⁸⁸ Fiechter, Ötcker-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 15.

⁸⁹ *Supra* 3.2.1.

⁹⁰ *Supra* 3.2.1.

⁹¹ *Supra* 1.1.

⁹² It is a critical feature of the recent reform initiatives in the E.U. that such risk-sharing agreements will be concluded among the Member States involved in a bail-out of a transnational financial institution, *cf.* Proposal Resolution Directive art. 98. For a discussion of various models of ex post and ex ante agreements Charles Goodhart & Dirk Schoenmaker, *Fiscal Burden Sharing in Cross-Border Banking Crises*, 5 INT'L J. CENTRAL BANK. 141 (2009).

⁹³ From the vantage of a (small) country that is the domicile of large international banking groups but has only confined fiscal firepower, it may be prudent to encourage a subsidiary structure. For a correspondent recommendation *cf.* INT'L MONETARY FUND, *supra* note 3, at 23.

policy considerations are not ruthlessly confined to national interests: where a polity reaps all the social gains from a branch's successful operations it seems hard to justify and creates a free-rider problem if it is in fact under no obligation to contribute to alleviating distress originating at this very entity.

3.4 THE REGULATORY ARBITRAGE DEBATE REVISITED

This brief survey indicates that neither from the banks' nor from the policy-makers' perspective one organizational model dominates the other. Importantly, many effects identified as core features of either organizational model can be molded in practice to a significant degree. For instance, centralized group financing and liquidity management typically involves independently incorporated affiliates, i.e. with qualified corporate and accounting counsel capital flows are largely independent of the group's legal structure. Similarly, group-wide guarantees, letters of comfort etc. may create liability risks although the originally chosen subsidiary structure created firewalls between business units. The latter can also be undone if looming negative reputational effects of an affiliate's failure *de facto* compel its support. Hence, it takes no wonder that in practice rather complex organizational hybrids can be observed, mainly as a function of the cross-border banks' business models.⁹⁴

All this affirms the perception that banks' organizational choices in their cross-border business cannot easily be identified as serving or militating against social welfare.⁹⁵ In general, they should hence be acquiesced, not least because banks will have to live with a variety of consequences other than their choices' impact on the regulatory framework. As a consequence the attention of policy-makers should be turned to designing a supervisory architecture that achieves its stated goal of minimizing the probability and consequences of financial distress in the banking sector regardless of banks' organizational choices.

With this in mind, an important consequence of the discussion should not go unnoted. As polities are affected in different ways by the financial distress of independently incorporated or legally dependent business units of a transnational bank,⁹⁶ their incentives in micro-prudential supervision diverge accordingly. If failure of an affiliate or branch does not affect the supervisor's economy, she will only have low-powered incentives to engage in preventive efforts. On the other hand, if the viability of the respective business units impacts on the economy, public policy has reasons to seek influence in their prudential supervision and execute it adequately. This observation is important, because it indicates that charging authorities with responsibilities creates an externality problem if the benefits from reducing the risk of failure or the damages from doing so suboptimally accrue in foreign economies. These external effects get exacerbated if the allocation of supervisory compe-

⁹⁴ For rich data compiled from central banks, supervisory, and regulatory authorities see Fiechter, Ötoker-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 13-14. *See also supra* note 18.

⁹⁵ *See already supra* 3.2.3.

⁹⁶ *Supra* 3.3.

tence prevents authorities from contributing to micro-prudential efforts even though their economies are massively affected.

Dwelling on these observations, the following part of this article turns to the supervisory regime for E.U. transnational banking groups. It explains which shortcomings contributed to the current banking-crisis and why the attempts to remedy the problems identified may be only a half-hearted step into the right direction.

4 THE SUPERVISORY REGIME FOR E.U. CROSS-BORDER BANKING-GROUPS

Public supervision of banks generally constitutes a reserve of sovereign countries which requires at least some division of labor once banks expand their business across borders. However, organizational choices affect the institutional setup in a significant manner: where an international banking-group opts for the subsidiary model, host country supervisors get more clout in the cooperative game as the separate legal entity has to be furnished with a domestic license and is thus supervised by host country authorities, whereas under a branch structure host-country watchdogs are largely deemed to remain idle.⁹⁷

Tying the whole supervisory regime to the referred distinction seems somewhat stuck in 19th-century formalism. Moreover, it stands in stark contrast to the efforts made elsewhere in current banking law to gear micro-prudential supervision towards the actual risk posed by the regulated institution's business.⁹⁸ To bolster this argument, the general determinants of the division of competences between the national supervisors involved will be outlined (4.1) before turning to the E.U.-regime in more detail (4.2) and evaluating the findings (4.3).

4.1 GENERAL DETERMINANTS

A basic concept for the effective supervision of cross-border banking-groups was laid out in the Basel Concordat⁹⁹ and later transformed into rather lofty ground rules in the Basel Core Principles (BCP)¹⁰⁰ devised by the Basel Committee on Banking Supervision (BCBS) at the Bank for International Settlements (BIS).

BCP 23 obliges home country supervisors of internationally active banking groups to “practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.”¹⁰¹

⁹⁷ For a detailed account *see infra* 4.2.

⁹⁸ For this overall end of the substantive rules under the so called Basel II- and Basel III-Accords *see infra* 4.2.4.1.

⁹⁹ Basel Committee on Banking Supervision & Offshore Group of Banking Supervisors, The Supervision of Cross-Border Banking (1996) *available at* <http://www.bis.org/publ/bcbs27.pdf>.

¹⁰⁰ Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision (1997) *available at* <http://www.bis.org/publ/bcbs30a.pdf>.

¹⁰¹ *Id.*, at 40.

Furthermore, BCP 24 underlines that a “key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.” Correspondingly, pursuant to BCP 25 host country supervisors “must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.”¹⁰²

It is worth noting that the pertinent Section of the BCP underscores the importance of unconfined cooperation between home and host country authorities and at this juncture does not distinguish between the different organizational structures of cross-border banks.

4.2 THE E.U.-ARCHITECTURE OF MICRO-PRUDENTIAL BANKING SUPERVISION

The European regulatory framework responds to the BCP and transforms them into supranational law that binds E.U. Member States.¹⁰³ To this end, supranational law makes rather detailed prescripts when it comes to delineating national authorities competences that leave Member States little to no latitude in implementing the pertinent Directive. With regard to cross-border banking groups, European law frames an elaborate regime that governs both, the monitoring of individual business entities (4.2.1) and the consolidated supervision of the whole group (4.2.2). In that, it makes a pivotal distinction between subsidiaries and branches. In general, the supervisory architecture requires a relatively high degree of cooperation and the constant exchange of information between national authorities. The necessary coordination shall generally be facilitated by colleges of supervisors (4.2.3) as well as supranational authorities established on the E.U.-level where most-recently initiated reforms will significantly alter the scenario (4.2.4).

4.2.1 SUPERVISION OF BUSINESS ENTITIES

The prudential supervision of individual business entities is linked directly to the authorization of the pertinent activities: the competent authority that granted the banking license is responsible for the institutions ongoing supervision (4.2.1.1), i.e. where cross-border activities require no separate authorization, national banking supervision encompasses permanent activities on foreign markets (4.2.1.2).

4.2.1.1 SUBSIDIARIES

Independently incorporated business entities of a cross-border banking group constitute themselves “credit institutions” within the scope of the pertinent supranational regulation¹⁰⁴ and hence have to be authorized by the Member State of incor-

¹⁰² *Id.*

¹⁰³ The relevant European Directive (*infra* note 104) prescribes to which ends and to what extent national laws shall be harmonized and obliges Member States to implement the specifications in their domestic legislation, TFEU art. 288(2).

¹⁰⁴ Directive 2006/48 of the European Parliament and the Council relating to the taking up and pursuit of the business of credit institutions, art. 4(1)(13), 2006 O.J. (L 177) 1

poration.¹⁰⁵ As a consequence these home Member States assume the primary responsibility for the pertinent institutions' prudential supervision regardless of their group-affiliation.¹⁰⁶

The necessary coordination and cooperation among multiple supervisory authorities that are simultaneously tasked with controlling the cross-border banking-groups' affiliates incorporated in different jurisdictions is supposed to be achieved on a macro-level within the European Financial Supervisory System and, for Europe's largest banks, on the micro-level within Colleges of Supervisors.¹⁰⁷

This supervision of individual credit institutions which at the outset considers each independently incorporated deposit institution as a stand-alone is complemented by the consolidated supervision of the whole group that represents a duty of the competent authority that authorized the parent institution.¹⁰⁸

4.2.1.2 BRANCHES (E.U.-PASSPORT)

Banking-Directive art. 40(1) [CRD IV Directive art. 49 (1)] refers to Banking-Directive art. 23 [CRD IV Directive art. 33] and thus indicates expressly that prudential supervision of a credit institution encompasses the cross-border activities carried out through a branch or the direct provision of services.¹⁰⁹ Correspondingly, Banking Directive art. 16 [CRD IV Directive art. 17] prohibits host Member States to require a separate authorization or to prescribe a specific capital endowment for the branches of those credit institutions that received a banking license from their home Member State. This regulatory framework warrants describing the banking license of the incorporated credit institution as a "European passport".¹¹⁰ In fact, the latter allows credit institutions to "travel" on their domestic banking authorizations throughout the E.U. without significant restrictions. Transnational credit institutions merely have to notify host Member States' authorities prior to commencing their cross-border activities, with the depth of required disclosures varying between branch establishment and provision of services.¹¹¹

As home Member States' competent authorities almost completely predominate in the prudential supervision of cross-border activities carried out through branches, host Member States' authorities are confined to providing information to

[hereinafter Banking Directive]. The allocation of competences is supposed to remain untouched in its substance under the Proposed CRD IV legislation (*supra* at note 30). The following refers to the CRD IV equivalents of the Banking Directive in square brackets.

¹⁰⁵ Banking Directive artt. 6 et seq [CRD IV Directive artt. 9 et seq].

¹⁰⁶ *Cf.* Banking Directive artt. 40(1), 4(7). The system will remain intact under CRD IV Directive, art. 49(1), CRD IV Regulation art. 4(61).

¹⁰⁷ *Cf. infra* 4.2.4.2.

¹⁰⁸ Banking Directive art. 40(2); same CRD IV Directive art. 49(2). *Cf. infra* 4.2.2.

¹⁰⁹ *See supra* note 12.

¹¹⁰ *Cf.* Banking Directive artt. 23, 25 et seq.; for the basically identical rules of the proposed legislation *cf.* CRD IV Directive artt. 33, 35 et seq.

¹¹¹ Banking Directive artt. 25 et seq., 28. Same in CRD IV Directive artt. 35 et seq., 38.

facilitate home Member State supervision, although the duty to cooperate under Banking Directive art. 42 [CRD IV Directive art. 146, art. 51 (1)] is by design a mutual obligation. The home Member States' competent authorities are even authorized to conduct on-site-examinations, i.e. act in a sovereign capacity on foreign territory in order to obtain information pertinent to their supervisory activities that were not adequately supplied by host Member States' watchdogs.¹¹²

After all, the competent authority of a branch's host Member State retains the responsibility for *inter alia* the supervision of the branch's liquidity.¹¹³ However, these functions have to be exercised in cooperation with the home Member State's competent authority in accordance with the procedures laid out in Banking Directive art. 30:¹¹⁴ The host Member State's authority may require a branch to improve on its liquidity endowment but has to turn to the home Member State's supervisor in case the credit institution does not comply voluntarily. Only if the home Member State's authority fails to put an end to the branch's irregular situation may the host Member State's supervisor step in and enforce the required measures directly *vis-à-vis* the foreign credit institution.

4.2.2 CONSOLIDATED SUPERVISION

As recommended by the BCP¹¹⁵ a core feature of the European regulatory framework is consolidated supervision of the group. The prominence of this type of monitoring reflects the accurate perception, that even though the transnational banking group is comprised of legally independent affiliates (incorporated parents and subsidiaries) it represents a business unit that is economically integrated and hence poses a variety of risks that warrants a comprehensive micro-prudential view on the group's operations.¹¹⁶

¹¹² For details see Banking Directive art. 43(1); CRD IV Directive art. 53(1).

¹¹³ Banking Directive art. 41 which also grants host Member State's authorities the necessary competences to implement national monetary policy where the latter is independent [until January 1, 2015 CRD IV Directive art. 145 shall contain an identical rule, (*cf.* CRD IV Directive art. 140. Yet, the latter will be replaced by the more complex regime in CRD IV art. 41, 43 that, except for emergency situations, gives host Member States generally less clout in monitoring a branch's liquidity as they can no longer act *vis-à-vis* the foreign branch but only induce the home Member State competent authority to take action or appeal to the EBA to settle a dispute]. Under the Markets in Financial Instruments Directive (MiFID) the host Member States competent authority is also tasked with supervising the proper business conduct of the branch, Directive 2004/39 of the European Parliament and of the Council, art. 32(7), 2004 O.J. (L 145) 1, 26.

¹¹⁴ Until January 1, 2015 CRD IV Directive art. 142 which will give way to the division of labor outlined in CRD IV Directive art. 41, 43 that give home Member States (and the EBA) a stronger position, see *supra* note 113.

¹¹⁵ *Supra* 4.1.

¹¹⁶ Typical issues are the risk of intra-group contagion that is not necessarily limited to scenarios where the original shield of limited liability that protects incorporated affiliates from financial distress at other group-members has been undone, e.g. by a binding letter of comfort. It can also occur if, even without direct mutual financial exposure, negative information on specific group members corrupts the confidence of creditors in other affiliates. Similar problems may occur if the group members' respective exposure to certain counter-

According to Banking Directive art. 125(1) [CRD IV Directive art. 106 (1)] consolidated supervision is exercised by the competent authority of the Member State that authorized the parent credit institution of a cross-border banking group.¹¹⁷ Banking Directive art. 126 [CRD IV Directive art. 106 (3)-(6)] aims at a similar concentration of competence for consolidated supervision of a group's credit institutions if the head of the banking-group itself is not a credit institution (which accepts deposits) but provides any of an array of financial services and is thus deemed to be a E.U. financial holding company.¹¹⁸ The latter may in turn be included in consolidated supervisory activities pursuant Banking Directive art. 127 [CRD IV Directive art. 114].

Moreover, consolidated supervision also affects the supervision of a cross-border banking group's subsidiaries and restricts the leeway for autonomous decision making of Member State's supervisors that authorized affiliated credit institutions. The consolidating supervisor shall seek joint decisions with the competent authorities supervising the group's subsidiaries on key-aspects of prudential group-supervision, particularly the specifications on sufficient own funds on both the consolidated as well as the entity level with regard to the application of Banking Directive artt. 123, 124 and 136(2) [CRD IV Directive artt. 72(1), 92 (1), (2) and 100].¹¹⁹ The EBA may be consulted to reach a settlement if differences between the responsible authorities occur.¹²⁰ Yet, ultimately the decision of the consolidating supervisor prevails.¹²¹ Furthermore, competent authorities responsible for the supervision of controlled credit institutions are under the obligation to contact the consolidating supervisor prior to implementing approaches and methodologies in order to obtain pertinent information available at the top level.¹²² Finally, competent authorities shall consult each other prior to taking any action with regard to certain critical issues at the supervised banks, in particular structural changes concerning a member

parties accumulate and constitute a massive concentrated risk although individual large exposure limits (cf. *supra* note 70) are observed. For a brief review of the rationale for consolidate supervision see e.g. RONALD MACDONALD, CONSOLIDATED SUPERVISION OF BANKS 11-14 (1998) *available at* <http://www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ccbshb15.pdf>.

¹¹⁷ In a rather nested way, Banking Directive art. 4(1)(2)(4)(14)(15) defines the latter as the legal entity at the top of the cross-border banking-group within the E.U., i.e. the top-E.U. subsidiary of an international banking-group where the global parent is domiciled outside the E.U. is subject to E.U.-consolidated supervision. In fact, this approach is pretty similar to that under the U.S. Bank Holding Company Act, cf. *supra* 1.2.2.

¹¹⁸ Whereas a "credit institution" as defined by Banking Directive art. 4(1) engages in classical banking business (deposit and credit transactions), a "financial institution" within the scope of Banking Directive art. 4(5) provides any service from a broader array of financial activities listed in Banking Directive Annex I no. 2 to 12 and 15 ranging from consumer credit provision to investment banking and portfolio management. Same in CRD IV Regulation art. 4 (1) and (3).

¹¹⁹ Banking Directive art. 129(3) para 1 [CRD IV Directive art. 108 (1)(a)].

¹²⁰ Banking Directive art. 129(3) para 2 [CRD IV Directive art. 108 (2)(a)].

¹²¹ Banking Directive art. 129(3) para 3 [CRD Directive art. 108 (2)].

¹²² Banking Directive art. 132(2) [CRD IV Directive art. 112 (3)].

of the banking-group that require approval, major sanctions and exceptional supervisory measures.¹²³

	home Member State	host Member State
subsidiary-structure	authorization and supervision of parent consolidating supervision of group	authorization and supervision of legally independent subsidiaries in cooperation with consolidating supervisor (home Member State authority) participation in consolidating supervision
branch-structure	authorization and supervision of bank incl. Foreign activities (on-site investigations etc.)	no authorization (E.U.-passport) supervision of liquidity endowment in cooperation with home Member State authority

Table 1: home-/host-Member State competence and cooperation in micro-prudential bank supervision according to Banking Directive

4.2.3 COLLEGES OF SUPERVISORS

Both, the supervision of business entities and consolidated supervision of transnational banking groups requires a good deal of cooperation or at least information exchange. European law mandates permanent bodies that constitute an institutional framework which seeks to streamline and intensify but also keep flexible the procedures national supervisors follow in discharging their cooperative obligations.¹²⁴

Colleges of Supervisors provide the framework that facilitates the exchange of information and coordination among the consolidating supervisors and the other competent authorities involved in the supervision of a cross-border banking group.¹²⁵ However, supervisors in host Member States where the group carries out

¹²³ Banking Directive art. 132(3) [CRD IV Directive art. 112 (4)].

¹²⁴ Originally, the E.U. advocated plans to establish global Colleges of Supervisors with a detailed proposal to the G-20 Washington Summit in November 2008 *cf.* Tony Barber, *EU Calls for Tighter Financial Controls*, FIN. TIMES, Nov. 5, 2008. The idea also plays a prominent role in the envisioned regime for the resolution of cross-border banking groups where Proposal Resolution Directive, art. 81 mandates the establishment of European resolution colleges.

¹²⁵ Banking Directive art. 131a [CRD IV Directive art. 111]. On the particular tasks of a College, *see* Banking Directive art. 131a(1)(a)-(f). For a detailed guideline on carrying out the relevant duties and responsibilities, *see* COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS), GUIDELINES FOR THE OPERATIONAL FUNCTIONING OF SUPERVISORY COLLEGES (GL 34)

its activities through branches are usually not members of these Colleges. Banking Directive art. 42a(3) [CRD IV Directive art. 52 (3)] provides a notable exception if a branch is deemed systemically important (“significant”) from the perspective of its host Member State.¹²⁶ The critical determination whether a branch is significant is initiated by its host Member State and should be reached in consensus with the consolidating or home Member State supervisor. However, ultimately the assessment of the host Member State’s competent authority prevails.¹²⁷

Even where Colleges of Supervisors are established they merely provide a forum for exchange between national authorities, that is, they have no power to interfere with a Member States competent authority’s supervisory practice.¹²⁸

4.2.4 SUPRANATIONAL COMPETENCES AS AN INSUFFICIENT REMEDY

Obviously, where a cumbersome division of labor between national authorities potentially inhibits effective prudential supervision, elevating competences on a supranational level becomes appealing.¹²⁹ It takes no wonder that U.S. fiscal federalism, starting with the reforms initiated by Alexander Hamilton is analyzed as a template for Europe today.¹³⁰ Clearly, the E.U. with its long standing history of ever closer economic integration and legal harmonization provides an institutional framework that is, in theory, suitable in an unrivalled manner to follow down this road. However, until the very recent past, efforts to harmonize the regulatory framework of prudential bank supervision were largely limited to substantive law (4.2.4.1) and established only marginal supranational competences in the pertinent laws’ administration and enforcement (4.2.4.2). Bolder steps taken a few days ago as a reaction to the still lingering crisis in the Euro area’s banking sector aspire to establish a stronger supranational institution as a building block of a more closely inte-

(2010) *available at* <http://www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Colleges/CollegeGuidelines.aspx>.

¹²⁶ Banking Directive art. 42a(1)(a)-(c) [CRD IV Directive art. 52 (1)] give particular weight in determining the significance of a bank’s foreign branch to a three-factor test and look at (i) the branch’s share in the deposit market (>2%), (ii) its relevance for market liquidity and the payment and clearing and settlement system, (iii) the number of clients it serves.

¹²⁷ *Cf.* Banking Directive art. 42a(1) para 4 [CRD IV Directive art. 52 (1) para 4].

¹²⁸ Banking Directive art. 131a(1) [CRD IV Directive art. 111 (1)] explicitly stipulates that “The establishment of and functioning of colleges of supervisors shall not affect the rights and responsibilities of the competent authorities under this Directive.”

¹²⁹ See also Jean Dermine, *European Banking Integration: Don’t Put the Cart before the Horse*, 15 FIN. MARKETS INSTITUTIONS & INSTRUMENTS 57, 97-98 (2006) (mainly pointing to the shortcomings of the home country rule in bail-out situations).

¹³⁰ For an astute and differentiating essay that concludes *inter alia* with the recommendation to harmonize banking regulation *see* C. RANDALL HENNING & MARTIN KESSLER, FISCAL FEDERALISM: U.S. HISTORY FOR ARCHITECTS OF EUROPE’S FISCAL UNION 31 (2012) *available at* [http://www.bruegel.org/download/parent/669-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/](http://www.bruegel.org/download/parent/669-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/file/1537-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/). For a macroeconomic analysis of the much broader topic *see e.g.* the Nobel lecture of 2011’s laureate, Thomas J. Sargent, *United States then, Europe now* (Working Paper, 2011) *available at* https://files.nyu.edu/ts43/public/research/Sargent_Sweden_final.pdf.

grated European fiscal union (4.2.4.3). Yet, the emerging structure of the supranational supervisor seems to become only a somewhat halfhearted remedy for the shortcomings and pitfalls identified.

4.2.4.1 HARMONIZATION OF SUBSTANTIVE LAW

The critical importance of financial institutions for Europe's developed economies and the perceived need to foster competition by creating a level playing field accounted for an early start in a far reaching harmonization of substantive laws. The First Coordination Directive that harmonized the prerequisites for authorization was promulgated in 1977.¹³¹ It was followed by a series of smaller legislative advances¹³² until a Second Coordination Directive in 1989 was promulgated that facilitated cross-border banking through subsidiaries and branches in a meaningful way.¹³³ Prudential supervision of European credit institutions became early attuned to the recommendations of the BCBS with the transposition of the Basel I-Accord¹³⁴ in 1989.¹³⁵ This policy was maintained with the Basel II-Accord¹³⁶ becoming binding European law with the promulgation of the Capital Requirements Directive (CRD) in 2006.¹³⁷ These Directives were subsequently amended by the CRD II¹³⁸ and CRD

¹³¹ First Council Directive 77/780 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30.

¹³² For a brief account cf. Peter O. Mülbert & Alexander Wilhelm, *Reforms of EU Banking and Securities Regulation after the Financial Crisis*, 26 BANKING & FIN. L. REV. 187, 194 (2011).

¹³³ Second Council Directive 89/646 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1.

¹³⁴ BCBS, International Convergence of Capital Measurement and Capital Standards (1988) available at <http://www.bis.org/publ/bcbs04a.pdf>.

¹³⁵ Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions, 1989 O.J.(L 124) 16 which regarded a bank sufficiently capitalized if it held capital amounting to 8% of its risk-weighted assets with a tier 1-fraction of 50%, that is 4% of total assets.

¹³⁶ BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (2004) available at <http://www.bis.org/publ/bcbs107.pdf>, later incorporated into a more comprehensive version that reflected further amendments to the 1988 recommendations, see BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (2006) available at <http://www.bis.org/publ/bcbs128.pdf>.

¹³⁷ The Basel II-Accord and its implementation in the Banking Directive and the Parliament and Council Directive 2006/49 on the capital adequacy of investment firms and credit institutions, 2006 O.J. (L 177) 201 [hereinafter CAD] – jointly referred to as Capital Requirements Directive – aimed at improving the own funds-requirements by providing for a more accurate calculation of the risk actually inherent in a bank's business. Moreover, the new rules introduced two new "pillars" in prudential supervision, to wit ongoing supervision and disclosure to foster market discipline. For a critical review see e.g. Jan H. Dalhuisen, *Financial Services, Products, Risks and Regulation in Europe after the EU 1988 Action Plan and Basel II*, 18 EUR. BUS. L. REV. 819, 1032-39, 1081-82 (2007); for a general description of the recommendations content see Razeen Sappideen, *The Regulation of Credit, Market and Operational Risk Management under the Basel Accords*, 2004 J. BUS. L. 59.

¹³⁸ Parliament and Council Directive 2009/111 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards Banks Affiliated to Central Institutions, Certain

III¹³⁹ reform-packages that responded to lessons derived from the financial crisis.¹⁴⁰ Similarly, the most recent, profound overhaul of the BCBS' recommendations in reaction to the financial crisis (Basel III-Accord¹⁴¹) will most likely make its way into ambitious European legislation that aspires to base prudential supervision on a comprehensively harmonized and binding single rule book.¹⁴²

4.2.4.2 CURRENT SUPRANATIONAL COMPETENCES IN MICRO-PRUDENTIAL SUPERVISION

Despite these long-standing and significant advances in the harmonization of the substantive regulations, only consultative and coordinative functions were allocated on the supranational level. In 2003 the Commission appointed the European Banking Committee (EBC)¹⁴³ and the Committee of European Banking Supervisors (CEBS)¹⁴⁴ that should give expert advice to rulemakers and coordinate the administration of the promulgated regulatory framework.

Following a proposal from an expert group headed by Jacques de Larosière¹⁴⁵ the new European System of Financial Supervision (ESFS) was created.¹⁴⁶ With regard to the supervision of transnational credit institutions¹⁴⁷ the new architecture created several bodies at the European level, however without conferring sweeping competences in the ongoing supervision of banks to them. The EBA based in London became tasked with duties in micro-prudential supervision of individual finan-

Own Funds Items, Large Exposures, Supervisory Arrangements, and Crisis Management, 2009 O.J. (L 302) 97.

¹³⁹ Parliament and Council Directive 2010/76 amending Directives 2006/48/EC and 2006/49/EC as regards Capital Requirements for the Trading Book and for Resecuritisations, and the Supervisory Review of Remuneration Policies, 2010 O.J. (L 329) 3.

¹⁴⁰ For an overview Mülbert & Wilhelm, *supra* note 132 at 202-7.

¹⁴¹ BCBS, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (2010) *available at* <http://www.bis.org/publ/bcbs188.pdf>.

¹⁴² *Supra* note 30.

¹⁴³ Commission Decision 2004/10 (EC) of 5 November 2003 establishing the European Banking Committee, 2004 O.J. (L 3) 36 and Commission Decision 2004/5 (EC) of 5 November 2003 establishing the Committee of European Banking Supervisors 2004 O.J. (L 3) 28.

¹⁴⁴ Commission Decision 2004/10 (EC) of 5 November 2003 establishing the European Banking Committee, 2004 O.J. (L 3) 36.

¹⁴⁵ High Level Group on Financial Supervision in the EU, Report (Feb. 25, 2009) *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

¹⁴⁶ For detailed descriptions and assessments see Eddy Wymeersch, *The Reforms of the European Financial Supervisory System*, 7 EUR. COMPANY & FIN. L. REV. 240, 252-64 (2010); Niamh Moloney, *EU Financial Market Regulation after the Global Financial Crisis: 'More Europe' or more Risk?* 47 COMMON MKT. L. REV. 1317, 1332-35, 1365-72 (2010); Marco Lamandini, *When More is Needed: The European Financial Supervisory Reform and Its Legal Basis*, 6 EUR. COMPANY L. 197, 199-202 (2009).

¹⁴⁷ Identical structures were established for the supervision of securities markets, insurances and occupational pension schemes, *cf.* Parliament and Council Regulation 1095/2010(EU) of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331) 84 and Parliament and Council Regulation 1095/2010(EU) of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), 2010 O.J. (L 331) 48.

cial institutions in January 2011.¹⁴⁸ A non-trivial function of the EBA lies in its power to draft both regulatory and implementing technical standards.¹⁴⁹ Still, to become binding these standards require the formal endorsement of the Commission who has the power to reject standards in part or amend them,¹⁵⁰ thereby depriving the EBA of its already very limited propensity for independent rulemaking.¹⁵¹

The EBA may further issue guidelines and recommendations addressed to Member State's supervisors to achieve a homogenous supervisory practice. Yet, to realize this goal the EBA has to rely on a comply-or-explain-mechanism and the pressure that emanates from publishing the mere fact of non-compliance by a Member State's competent authority.¹⁵² Where disputes among Member States' competent authorities that supervise a transnational banking-group arise, the EBA at the request of a national authority or on its own initiative serves primarily as a mediator. But it can ultimately, albeit after a lengthy "conciliation phase" settle the controversy and issue a binding decision that requires national authorities to take or refrain from action.¹⁵³ Only where the EBA acts to stabilize financial markets after the Council has determined that an emergency situation exists, may it bypass national supervisors who do not comply with binding emergency-orders and take action directly *vis-à-vis* financial institutions.¹⁵⁴

Finally, in order to improve macro-prudential supervision a further new body, the European Systemic Risk Board (ESRB) was established and charged with monitoring and assessing the systemic risks threatening financial stability thereby cooperating and coordinating with international and non-E.U. country institutions.¹⁵⁵ Its main instrument to counter detected systemic risks in the financial system consists of warnings and recommendations addressed at either the European Union, the EBA, individual Member States or these Member States' banking authorities that are subject to a largely confidential comply-or-explain-mechanism.¹⁵⁶ Quite importantly, the ESRB receives its information within the network of the ESFS

¹⁴⁸ Parliament and Council Regulation 1095/2010(EU) of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), 2010 O.J. (L 331) 12 [hereinafter EBA-Regulation].

¹⁴⁹ EBA-Regulation art. 8(1)(a), 10, 15. The former seek to ensure the consistent harmonization of national laws where E.U. Directives have been promulgated, *cf.* TFEU art. 290(1). The latter aim at a uniform application of E.U.-Regulations, *cf.* TFEU art. 291(2).

¹⁵⁰ EBA-Regulation art. 10(1) subparagraph 5.

¹⁵¹ Niamh Moloney, *The Financial Crisis and EU Securities Law-Making: A Challenge Met?* in Festschrift für Klaus J. Hopt 2265, 2273 (Stefan Grundmann, Brigitte Haar, Hanno Merkt, Peter O. Mülberr & Marina Wellenhofer eds. 2010).

¹⁵² EBA-Regulation art. 16(2).

¹⁵³ EBA-Regulation art. 19.

¹⁵⁴ EBA-Regulation art. 18.

¹⁵⁵ Parliament and Council Regulation 1092/2010 (EU) of 24 November 2010 on European Union Macro-Prudential Oversight of the Financial System and Establishing a European Systemic Risk Board, artt. 3, 15, 2010 O.J. (L 331) 1 [hereinafter ERSB-Regulation]. For a critical assessment on the ESRB's effectiveness see Mülberr & Wilhelm, *supra* note 132 at 199; see also Giovanna De Mincio, *Regulators and Rules – President Obama's Reforms vs. Europe's Reforms*, 21 EUR. BUS. L. REV. 451, 454-457 (2010) (comparing the – then proposed – U.S. Financial Services Oversight Council with the ESRB).

¹⁵⁶ ERSB-Regulation artt. 16-18.

which is supposed to link national and supranational authorities making the ESRB depend on the exchange of information and cooperation among these agents.

4.2.4.3 BANKING UNION 2012

In the wake of the once again flaring and more and more deteriorating banking crisis in Spain¹⁵⁷ it became obvious that the counter-measures taken so far were insufficient to break the vicious cycle between the sovereign debt-crisis in the Euro area and the distress in the European financial sector.¹⁵⁸ As already hinted by observers of the European developments,¹⁵⁹ the way forward was seen in a further integration that included as a critical component establishing a single European banking supervisor, involving the ECB.¹⁶⁰ Clearly, this is in line with economic theory that relates the existence of international organizations to the desire to eliminate the risk of opportunism *ex post*¹⁶¹ – a specter dreaded by Member States who effectively provide the bail-out funds for other E.U.-members with a troubled and arguably insufficiently overseen banking sector.¹⁶² Moreover, it can be seen as a ‘regional version’ that follows suggestions from commentators¹⁶³ and prominent transnational bodies.¹⁶⁴

¹⁵⁷ See Forelle & Steinhauser, *supra* note 51.

¹⁵⁸ For the relationship see *supra* 2.1.2.

¹⁵⁹ Cf. *supra* note 129.

¹⁶⁰ This political determination clearly became manifest for the first time at the Euro Area Summit on June 29, 2012, cf. Press Release, Euro Area Summit Statement (June 29, 2012) [available at http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf](http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf). Earlier, the Commission had expressed the top E.U.-administration’s conviction that a single financial supervisor was of critical importance in establishing an ultimately comprehensive Economic and Monetary Union, cf. *Commission Communication, Action for Stability, Growth and Jobs*, at 5, COM(2012) 299 final (May 30, 2012).

¹⁶¹ JOEL P. TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW* 150-195 (2008) (analyzing international organizations in line with the *Coasean* theory of the firm in institutional economics); Barbara Koremos, Charles Lipson & Duncan Snidal, *The Rational Design of International Institutions*, 55 INT’L ORG. 761, 762 (2001) (understanding international organizations as a network of contracts between sovereign agents); on forming a union (integration) as a means to reduce the potential for opportunism in an anarchy see generally Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 21 (1985).

¹⁶² On the package deal that couples further injection of funds into troubled Member States’ banks with establishing a supranational supervisor see Francesco Guerrero, *A Fix for Europe Banks*, WALL ST. J., July 3, 2012 at C1.

¹⁶³ For calls for global regulators and/or monitors see e.g. Henry Kaufman, *Structural Changes in the Financial Markets: Economic and Policy Significance*, 79 FED. RES. BANK OF KAN. CITY ECON. REV. 5 (1994); Richard Dale & Simon Wolf, *The Structure of Financial Regulation*, 6 J. FIN. REG. & COMPLIANCE 326 (1998).

¹⁶⁴ Financial Stability Forum, Report on Enhancing Market and Institutional Resilience 52 (2008) [available at http://www.financialstabilityboard.org/publications/r_0804.pdf](http://www.financialstabilityboard.org/publications/r_0804.pdf); Press Release, European Council, 2901st Council Meeting Economic and Financial Affairs 7 (Nov. 4, 2008) [available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/103804.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/103804.pdf).

The Commission plans to make detailed proposals on such a single supervisory mechanism in September 2012 that the Council – which generally endorses the plans¹⁶⁵ – can consider as a matter of urgency at the end of the year.¹⁶⁶ Currently, the design and the scope of the new authority remain unclear. Speculations consider the most likely outcome of the cumbersome quest for a political compromise that significant reservations of Member States’ competence will remain intact despite the creation of a supranational watchdog: the “single” European supervisor shall probably only cover Europe’s largest banks,¹⁶⁷ leaving the oversight over mid-sized banking groups despite their sizeable cross-border operations in the national domains.

However, the attempt to couple further state-aid for the banking sector with a groundbreaking reform to achieve its more rigid supervision exhibits a deep mistrust in the existing supervisory architecture that seems justified.

4.3 EVALUATION

In order to assess if the current or the evolving European supervisory architecture provides or will provide an effective tool for micro-prudential supervision in light of banks’ organizational choices, agencies should not be treated as black-boxes. Instead, incentives of agents who actually discharge the duties of the supervisory authorities, who either offer or refuse to exchange information and collaborate with due diligence, have to be examined closely. To this end, general considerations on the political economics of public administration and international relations prove helpful (4.3.1) and can serve as analytical basis to reach a final evaluation of the E.U. supervisory architecture (4.3.2).

4.3.1 POLITICAL ECONOMICS OF PUBLIC ADMINISTRATION AND INTERNATIONAL RELATIONS

If it is true, that the success of the supervisory architecture depends on incentives of public officers (bureaucrats) in charge at the competent authorities, it is important to remember the motivating forces identified in the line of research that applies methodologies from organizational theory to the political and administrative process.¹⁶⁸ The line-up under scrutiny can be framed using the analytical inventory of agency-theory: bureaucrats constitute agents who have some discretion that al-

¹⁶⁵ Press Release, European Council, 3181st Council Meeting Economic and Financial Affairs 8 (July 10, 2012) *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131686.pdf

¹⁶⁶ Press Release, Eurogroup Statement on the follow-up of the 29 June Euro Summit (July 10, 2012) *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131648.pdf.

¹⁶⁷ See Matina Stevis & Stephen Fidler, *Tighter Control for Euro Banks*, WALL ST. J., July 9, 2012 at A1.

¹⁶⁸ For programmatic articles see Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress*, 96 J. POL. ECON. 132 (1988); Terry M. Moe, *Politics and the Theory of Organization*, 7 J. L. ECON. & ORG. 106 (1991); but also GORDON TULLOCK, *THE POLITICS OF BUREAUCRACY* (1965). See also *supra* note 161.

lows them to adapt the political system to unforeseen contingencies,¹⁶⁹ but also grants them leeway to take hidden action and pursue their own interest instead of that of their ultimate principals (the citizens).¹⁷⁰ The intrinsic motives that are commonly identified as driving agency personnel in their exercise of office account for actions that serve the principals' interest only suboptimally.¹⁷¹

Quite importantly, another source of departure from the social goal of effective supervision of cross-border banking-groups typical in the transnational context results from the observation that the obligations of national authorities to share information and to cooperate in micro-prudential supervision can, by and large, only be enforced through informal institutions that sanction non-cooperative behavior.¹⁷² If these insights are related to the prior findings on the political economics of bureaucracies it can be concluded that reputational losses,¹⁷³ the threat of reciprocity in case of breach,¹⁷⁴ and further retaliation¹⁷⁵ will only serve as a motivation if these sanctions not only exist in the relation between authorities but also translate into concurrent incentives of individual personnel.

According to standard analysis¹⁷⁶ bureaucrats are driven by a desire to increase their personal power and to augment their prestige. They thus seek to enlarge their agency's size, competence and right to intervene in the affairs of those falling within the scope its mandate. They will discharge their duties in a way that allows them to acquire a favorable reputation among their peers and/or in the general public and the media. Moreover, opportunities to advance their future career in administration, politics or the private sector motivate their behavior which makes them prone to promoting the interests of those who offer the most desirable job-

¹⁶⁹ On the importance of a mechanism for a discretionary adaption of the (incomplete) social contract see DOUGLAS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 80-81 (1990).

¹⁷⁰ For an overview of various models see TIMOTHY BEASLY, PRINCIPLED AGENTS 98-172 (2006). Bounded rationality of principals – ultimate (citizens) or intermediate (legislators) – who cannot devise complete contingent constitutions and laws to secure the proper pursuit of the common good, plays a prominent role in all these models.

¹⁷¹ See generally George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3 (1971); Canice Pendergast, *The Motivation and Bias of Bureaucrats*, 97 AM. ECON. REV. 180 (2007); for the role of cognitive biases that tend to aggravate the deviation from desirable outcomes cf. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); for an analysis with particular view to the governance of financial supervisors see Luca Enriques & Gérard Hertig, *Improving the Governance of Financial Supervisors*, 12 EUR. BUS. ORG. L. REV. 357, 362-63 (2011).

¹⁷² For a general analysis of the self-enforcing mechanisms in international law from an economists perspective cf. ANDREW T. GUZMAN, HOW INTERNATIONAL LAW WORKS 33-48 (2008).

¹⁷³ On this aspect Lester G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27, 29 (1980).

¹⁷⁴ GUZMAN *supra* note 172 at 45.

¹⁷⁵ *id.* at 48. See also ROBERT AXELROD, THE EVOLUTION OF COOPERATION 12-13 (1984) (describing a tit for tat-game where agents behave cooperatively in the first round and act in the second round as the counterparty did in the first).

¹⁷⁶ For the following see Stigler *supra* note 171; WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 36-42 (1971); Pendergast *supra* note 171.

opportunities in the long term and can result in regulatory capture.¹⁷⁷ Finally, agency personnel seek to avoid liability for false actions or forbearance and will consequentially have a proclivity to follow approved practices that can be verified in any review, even if new developments occur.

To be sure, the identified incentives do not necessarily warrant a pessimistic perception of bureaucrats' effectiveness,¹⁷⁸ e.g. their desire for prestige can constitute a powerful incentive to do "a good job" but it may also revert to a less desirable eagerness for media presence.¹⁷⁹ The observations only highlight the fact that these individuals are not robots that are automatically programmed to serve the public interest.

4.3.2 SUPERVISION OF CROSS-BORDER BANKING-GROUPS IN PARTICULAR

The convolute hierarchies and the necessary exchange of information and cooperation that the current E.U.-supervisory architecture mandates,¹⁸⁰ create particularly suboptimal incentives for decision-makers at the authorities involved and is prone for 'turf wars' among supervisors with diverging preferences. This can be illustrated with regard to those cross-border banking-groups that have organized according to the subsidiary model (4.3.2.1) but it also holds – albeit to a lesser degree – with respect to transnational branch-structures (4.3.2.2). Currently evolving supranational institutions may provide some improvement but no ultimate cure to the problems identified (4.3.2.3).

4.3.2.1 SUBSIDIARIES

An extraordinary dedication to performing supervisory functions that at least in part contribute to the benefit of foreign economies do not yield immediate gains in power or prestige for the bureaucrats at the acting authority compared to similar efforts in purely domestic line-ups. This is not only true with regard to a (subordinate) competent authority that is supposed to contribute to effective consolidated supervision but also with respect to a consolidating supervisor. To some extent, her

¹⁷⁷ For a general theory of how and when interest-group's dominate regulatory decision processes see Jean-Jacque Laffont & Jean Tirole, *The Politics of Government Decision Making. A Theory of Regulatory Capture*, 106 Q.J. ECON. 1089 (1991); with a specific view to the banking sector Daniel C. Hardy, *Regulatory Capture in Banking* (Int'l Monetary Fund, Working Paper WP/06/34, 2006) available at <http://www.imf.org/external/pubs/ft/wp/2006/wp0634.pdf>.

¹⁷⁸ For at least ambiguous assessments of the complex web of incentives and its inherent trade-offs see already Michael Levine & Jennifer Forrence, *Regulatory Capture, Public Interest and the Public Agenda: Toward a Synthesis*, 6 J. L. ECON. & ORG. 197 (1980); Gordon Tullock, *A (Partial) Rehabilitation of the Public Interest Theory*, 42 PUBL. CHOICE 89 (1984).

¹⁷⁹ Cf. Luca Enriques, *Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View*, 30 U. PA. J. INT'L L. 1147, 1150 (2009) (showing the ambivalence of regulators' intelligence).

¹⁸⁰ *Supra* 4.2.

duties also ensure the viability of group affiliates abroad.¹⁸¹ Obviously, the benefits to foreign economies¹⁸² accrue as a consequence of the operations of for-profit organizations whose success at least in part redounds to the incentives of bureaucrats at the consolidating supervisor: the growth of the supervised transnational financial institution can be associated with an increase in the regulator's importance and reputation and therefore its bureaucrats' prestige. Yet, the bulk of the advantages connected to a bank's transnational activities constitutes positive externalities (growth perspectives, market development et al.) and is thus neither fully reproduced in the bank's yields nor in the incentives that the consolidating supervisor and its officers incur. To a similar effect, good practices that are at least in part of an auxiliary character and mainly happen in the background do to not naturally boost careers.

Furthermore, incentives to cooperate and share information with other competent authorities are also suboptimal because lapses *mutatis mutandis* create negative external effects for the foreign economy where the group affiliate does business. Legal consequences are not a credible threat in the transnational context – even within the rather tightly integrated E.U.-supervisory regime no liability is attached to a breach of a competent authority's duties. Moreover, it cannot be expected that reputational mechanisms or the threat of reciprocity make authorities and bureaucrats internalize errors automatically or exhaustively. Quite importantly, where financial difficulties occur and hence information sharing and cooperation becomes pivotal, bureaucrats face strong motives not to reveal their private knowledge – which would amount to a confession of shortcomings in their own realm – but exploit informational asymmetries instead.¹⁸³

To be clear, the incentive-problem identified is not that of an outright blockade between Member States' supervisors or even of mutual sabotage. Yet, the lack of motivation 'to go the extra mile' in order to facilitate the socially optimal outcome should worry policy-makers enough if it is recalled what is at stake.¹⁸⁴

4.3.2.2 BRANCHES

The E.U.-supervisory regime applicable under a branch-structure¹⁸⁵ exhibits some of the problematic characteristics discussed for transnational banks that adhere to a subsidiary-organization. This is particularly true with regard to the suboptimal

¹⁸¹ For the respective competences *see supra* 4.2.1.1 and 4.2.3.

¹⁸² On the benefits of cross-border banking for market development, access to credit etc. *see generally supra* 1.1 and 3.3.

¹⁸³ Gérard Hertig, Ruben Lee & Joseph A. McCahery, *Empowering the ECB to Supervise Banks: A Choice-Based Approach*, 7 EUR. COMPANY & FIN. L. REV. 171, 178 (2010). For a formal analysis *see* Cornelia Holthausen & Thomas Rønde, *Cooperation in International Banking Supervision* 16-22 (ECB Working Paper No. 316, 2004) *available at* <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp316.pdf> (showing that host country supervisors have incentives to misreport private information if their preference for liquidating a bank's operations diverge from those of the home country supervisor responsible for the decision).

¹⁸⁴ *Supra* 2.

¹⁸⁵ *Supra* 4.2.1.2.

incentives to cooperate and share information as a result of positive and negative externalities: The home Member State supervises the whole entity and thereby generates benefits and costs for the host Member State whereas the host Member State's limited power and information sharing obligations have the same effect *vice versa*. Yet, it should not be overlooked, that under the branch-structure a clearer allocation of responsibilities occurs as a result of E.U.-passporting making the home Member State's competent authority a stronger player that is less dependent on cooperation than the consolidating supervisor under a subsidiary structure.

Another core feature of the supervisory-regime covering branch-structures deserves attention. It appropriately augments the participation rights, where the branch's operations are significant from the host Member States perspective, that is, where the externalities of exclusive home Member State supervision become large and host Member State's bureaucrats have better incentives to participate (e.g. by communicating macro-economic threats unforeseen by remote home Member State supervisors) as their efforts to prevent their national economy from the failure of a systemically important branch are likely to be honored more adequately. Hence, the criteria set out in Banking Directive art. 42a that warrant a stronger involvement of host Member States competent authorities are more attuned to the actual risk and incentive structures than those under the subsidiary-model where the strong host Member State participation is indiscriminately linked to the authorization of the affiliates.

4.3.2.3 SUPRANATIONAL CURE

It is obvious that the reforms promulgated thus far remedy the shortcomings of the current E.U.-supervisory regime only insufficiently as they leave the competences in micro-prudential supervision by and large vested with Member State's authorities.¹⁸⁶ As a result, the need for extensive cooperation and information sharing persists and the incentives of bureaucrats remain substantially unaltered. Supervisory Colleges may in fact have some impact in this respect as personal acquaintance among the responsible bureaucrats adds a stronger relational element to their relationship and makes the adherence to cooperative strategies more likely at the margin.¹⁸⁷ Yet, the effect can cut both ways and should not be overestimated anyway – the colleges of supervisors are no country clubs!

In principle, the evolving single European banking supervisor¹⁸⁸ could avoid many of the incentive deficits identified in respect of the current regime of micro-prudential supervision if and to the extent to which its competence in fact makes cooperation with national authorities superfluous. Although it comes to gazing into a crystal ball if the challenge is to foresee the future structure, it is not entirely im-

¹⁸⁶ *Supra* 4.2.4.2.

¹⁸⁷ Generally on relational elements as a core characteristic of self-enforcing (contractual) relationships see Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976); Oliver E. Williamson, *Franchise Bidding for Natural Monopolies – in General and With Respect to CATV*, 7 BELL J. ECON. 73 (1976).

¹⁸⁸ *Supra* 4.2.4.3.

plausible that the E.U.-supervisor – at least initially until a full-fledged and autonomous agency is actually up and running – will have to rely on some cooperation and information sharing with national supervisors, ESFS authorities etc. Yet such a temporary backslide into the thickets of intra-agency cooperation could prove temporary. As of now, however, it seems that the political will does not suffice to indeed create an omnibus supranational agency.¹⁸⁹ Moreover, it is even unlikely that the Commission that has to respond to severe time pressure will immediately provide for an opt-in solution that some commentators have advocated.¹⁹⁰

All in all it seems warranted to still think about improvements of the existing framework that will in any case remain applicable to those transnational banks that will not fall within the ambit of E.U.-supervision. Such alternative solutions are all the more relevant as the option of supranational concentration is not readily available on a global level. Hence, cooperation and exchange between national or – for that purpose – supranational authorities remains the only viable road to pursue.¹⁹¹ As a consequence, the Financial Stability Board recommends with a view to global SIFIs that „[j]urisdictions should provide for a national supervisory framework that enables effective consolidated supervision by addressing ambiguities of responsibilities, impairments related to information gathering and assessment when multiple supervisors are overseeing the institution and its affiliates.”¹⁹² Clearly, the institutional framework for such cooperative supervisions should be designed as efficiently as possible.

5 SKETCHING AN ALTERNATIVE APPROACH TO TRANSNATIONAL BANKING SUPERVISION

In light of the aforesaid, attempts to improve micro-prudential supervision through law reform that compels closer cooperation and improved exchange of in-

¹⁸⁹ *Supra* at note 167.

¹⁹⁰ Ivan Mortimer-Schutts, *EU Regulatory and Supervisory Convergence: The Case for a Dual System with Choice* (Am. Enterprise Inst. Working Paper No. 39, 2005) available at http://www.gem.sciences-po.fr/content/publications/pdf/IMS_1205_Dual_EU_Reg_Struct.pdf (arguing for individual banks' right to choose a 28th E.U.-supervisory regime); Martin Čihák & Jörg Decressin, *The Case for a European Banking Charter* (Int'l Monetary Fund, Working Paper No. WP/07/173, 2007) available at <http://www.imf.org/external/pubs/ft/wp/2007/wp07173.pdf>. (same); Hertig, Lee & McCahery *supra* note 183 at 181-89, 194-210 (2010) (favoring a solution that allows only individual jurisdictions to opt into supranational supervision).

¹⁹¹ On the implausibility of a global financial regulator – and *mutatis mutandis* – supervisor see Chris Brummer, *How International Financial Law Works (and How it Doesn't)*, 99 GEO. L.J. 257, 312-15 (2011); but see also Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243, 273-283 (2010) (advocating an international administrative law agency for financial supervision).

¹⁹² *Cf.* Financial Stability Board, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions*, Recommendation No. 33 (October 20, 2010) available at http://www.financialstabilityboard.org/publications/r_101111a.pdf. For the various institutions facilitating global coordination of financial regulators cf. Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243, 247-264 (2010).

formation between national and supranational supervisors will only be successful if the pertinent formal institutions are basically in line with the acting bureaucrats' incentives and minimize inefficient cooperative elements.

At the outset, competences in micro-prudential supervision should be allocated to one national or supranational competent authority as unambiguously as possible to capitalize on the expertise of established supervisors.¹⁹³ In fact, it is structurally possible to establish precisely the strong authority that is arguably required to break through the vicious cycle of banking and sovereign debt crises¹⁹⁴ on the national level, if the effective powers of such a single authority are mutually recognized¹⁹⁵ at least between E.U.-Member States. As a consequence, national authorities that are the home of a transnational banking group can function as *de facto* pan-European supervisors.¹⁹⁶ Importantly, the sole competence of such a pan-European supervisor should in principle be independent from the cross-border banking group's legal structure. Hence, subjecting the supervision of independently incorporated subsidiaries to the consolidating supervisor's authority¹⁹⁷ deserves approval, yet it does not go far enough in this subordination. It is preferable to generally follow the branch-model when it comes to defining the competences in micro-prudential supervision that gives host Member State authorities only very limited scope in monitoring ongoing operations.

As an exception, additional competences should be given to host Member States where the banking-group's activities are deemed significant from the perspective of the foreign economy. Once again, the branch-model can serve as the principal template where host Member States authorities are granted an additional right to participate in Colleges of Supervisors if the branch is deemed significant.¹⁹⁸ However, in the latter case – and only in this case – host Member State authorities should receive competences like those that currently accrue generally with regard to subsidiaries. Moreover, the binding determination if the group's activities on the pertinent market are in fact significant should be made by a supranational authority like the EBA or the evolving single European supervisor.

In the context of the evolving resolution regime for transnational banking groups, the Commission basically accepts the fundamental need for a strong (na-

¹⁹³ After all, the single European supervisor doesn't come cheaply: in the Annex to the Legislative Financial Statement the Commission estimates the additional costs for personnel, infrastructure and operation that would accrue were the relatively modest expansions of the EBA competences under the Proposal Resolution Directive actually promulgated at approximately € 5.2 bn (\$ 6.4 bn) for the years 2014 and 2015 alone, *cf.* Proposal Resolution Directive at 170.

¹⁹⁴ Press Release, Euro Area Summit Statement (June 29, 2012) *available at* http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

¹⁹⁵ On the theoretical foundations of the concept Pierre-Hugues Verdier, *Mutual Recognition in International Finance*, 52 HARV. INT'L L.J. 55, 60-71 (2011).

¹⁹⁶ The home Member State can be determined along the criteria that are relevant in assigning the consolidating supervisor, *cf.* Banking Directive artt. 125, 126 and *supra* 4.2.2.

¹⁹⁷ *Supra* 4.2.2.

¹⁹⁸ *Supra* 4.2.3.

tional) lead-authority when it explicitly posits in its explanatory memorandum that it is of critical importance that ultimately a single decision prevails.¹⁹⁹ Of course, it strictly clings to the problematic distinction between a bank's subsidiaries and branches.

The paradigm shift advocated here retraces the developments in the substantive law of prudential supervision that also went from a relatively inflexible approach to a set of rules that aims at capturing actual risks in banks.²⁰⁰ It also reflects the persuasion, that not only within the E.U. any potential for regulatory arbitrage by switching from one organizational model to the other are unwarranted. Furthermore, as banking supervision forces competent authorities to employ highly skilled personnel and compete with the private sector, it is doubtful that each and every Member State's agency can retain a sufficient number of qualified specialists. It may thus be a welcome side-effect of the proposed regime that it also avoids redundancies and requires host Member States only to monitor significant activities more closely. Of course, the suggested architecture – like any regulatory and supervisory regime that relies on public agencies – assumes that national authorities have efficient governance-structures that ensure a socially beneficial administration.²⁰¹

¹⁹⁹ Proposal Resolution Directive at 6.

²⁰⁰ *Supra* 4.2.4.1.

²⁰¹ For an astute proposal of efficient governance-structures at financial supervisors, see Enriques & Hertig *supra* note 170 at 365-73; see also Anita Anand & Andrew Green, *Regulating Financial Institutions: The Value of Opacity*, 57 MCGILL L.J. 399, 408-422 (2012) (arguing for an opaque and insulated design of financial supervisors).

IMFS WORKING PAPER SERIES

Recent Issues

53 / 2012	Sebastian Schmidt	Optimal Monetary and Fiscal Policy with a Zero Bound on Nominal Interest Rates
52 / 2012	Sebastian Schmidt Volker Wieland	The New Keynesian Approach to Dynamic General Equilibrium Modeling: Models, Methods, and Macroeconomic Policy Evaluation
51 / 2012	Vivien Lewis Arnoud Stevens	The Competition Effect in Business Cycles
50 / 2012	Vivien Lewis	Optimal Monetary Policy and Firm Entry
49 / 2012	Volker Wieland Tobias Cwik Gernot J. Müller Sebastian Schmidt Maik Wolters	A New Comparative Approach to Macroeconomic Modeling and Policy Analysis
48 / 2011	Helmut Siekmann	Die rechtliche Regulierung öffentlicher Banken in Deutschland
47 / 2011	Helmut Siekmann	Die Europäisierung der Finanzmarktaufsicht
46 / 2011	Christos Koulovatianos, Volker Wieland	Asset Pricing under Rational Learning about Rare Disasters
45 / 2011	Helmut Siekmann	Law and Economics of the Monetary Union
44 / 2011	Heinz Hilgert Jan Pieter Krahen Günther Merl Helmut Siekmann	On a Fundamental Reorganisation of the Landesbanks and Savings Banks Sector in Germany
43 / 2011	Helmut Siekmann	Die Bankenabgabe in Deutschland – ein geeignetes Instrument zur Prävention von Finanzkrisen?
42 / 2011	Heinz Hilgert Jan Pieter Krahen Günther Merl Helmut Siekmann	Streitschrift für eine grundlegende Neuordnung des Sparkassen- und Landesbankensektors in Deutschland
41 / 2010	Helmut Siekmann	Die Finanzmarktaufsicht in der Krise
40 / 2010	Helmut Siekmann	Die Entstehung des neuen Europäischen Finanzaufsichtssystems