EUROPEAN MONETARY UNION, THE EUROPEAN SYSTEM OF CENTRAL BANKS, AND BANKING SUPERVISION: A NEGLECTED ASPECT OF THE MAASTRICHT TREATY

CHRISTOS HADJIEMMANUIL*

* LL.B. (University of Athens), LL.M., Ph.D. (University of London); Attorney at law, Athens Bar Association; Fellow in European Monetary Law, Center for Commercial Law Studies, Queen Mary and Westfield College, University of London.

I. THE PROGRESS OF MONETARY UNIFICATION IN THE EUROPEAN COMMUNITY

The signing of the Treaty on European Union (Maastricht Treaty) on February 7, 1992, has opened a new chapter in the integration of the economies of the Member States of the European Community (EC).[1] In particular, the provisions of the Maastricht Treaty made extensive amendments to the Treaty establishing the European Community (Treaty of Rome or EC Treaty) for the purpose of ensuring a gradual (phased in three stages) but irreversible movement of the Member States towards full economic and monetary union (EMU),[2] in accordance with the prescriptions of the Delors Report of June 1989.[3]

At the heart of the new arrangements lies the prospective adoption by a first core group of Member States of a single currency by January 1, 1999, at the latest,[4] with the rest of the Member States ("states with a derogation") to follow as soon as they have achieved a sufficient degree of economic convergence allowing them to participate in the fully-fledged monetary union without placing it under undue strains.[5] The preparedness of Member States for participation is to be judged by

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1. For brief introductions to the Maastricht Treaty, see, for example, Michael H. Abbey & Nicholas Bromfield, *A Practitioner's Guide to the Maastricht Treaty*, 15 MICH. J. INT'L L. 1329 (1994); Dieter Kugelmann, *The Maastricht Treaty and the Design of a European Federal State*, 8 TEMP. INT'L & COMP. L.J. 335 (1994). On the drafting efforts, negotiations and compromises leading to the final Treaty provisions on monetary union, see RICHARD CORBETT, THE TREATY OF MAASTRICHT, FROM CONCEPTION TO RATIFICATION: A COMPREHENSIVE REFERENCE GUIDE (1993), which reproduces the most important primary documents; Lorenzo Bini-Smaghi et al., *The Transition to EMU in the Maastricht Treaty*, ESSAYS IN INTERNATIONAL FINANCE No. 194 (1994); and Alexander Italianer, *Mastering Maastricht: EMU Issues and How They Were Settled*, *in* ECONOMIC AND MONETARY UNION: IMPLICATIONS FOR NATIONAL POLICY-MAKERS 51 (Klaus Gretschmann ed., 1993).

2. *See* TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 3 [hereinafter EC TREATY], pt. I, arts. 2 to 3a, 4a, and pt. III, title VI, arts. 102a to 109m, as replaced or inserted by the TREATY ON EUROPEAN UNION, Feb. 7, 1992, 1992 O.J. (C 224) 1 [hereinafter MAASTRICHT TREATY], title II, art. G(2)-(4) and (25). *See also* Protocol on the Statute of the European System of Central Banks and the European Central Bank, 1992 O.J. (C 191) 68 [hereinafter ESCB Protocol]; Protocol on the Statute of the European Monetary Institute, 1992 O.J. (C 191) 79 [hereinafter EMI Protocol]; Protocol on the Excessive Deficit Procedure, 1992 O.J. (C 191) 84; Protocol on the Convergence Criteria Referred to in Article 109j of the Treaty Establishing the European Community, 1992 O.J. (C 191) 85 [hereinafter Convergence Protocol]; Protocol on Denmark, 1992 O.J. (C 191) 89; and Protocol on the Transition to the Third Stage of Economic and Monetary Union, 1992 O.J. (C 191) 1.

3. *See* Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community* (June 1989), presented to the Madrid European Council meeting of June 26-27, 1989 (the "Delors Committee Report").

4. *See* EC TREATY arts. 109j(4), 109*l*(4).

5. On the position of "states with a derogation," see *id.* art. 109k.

reference to a number of criteria set out in the Maastricht Treaty.[6] However, two Member States, the United Kingdom and Denmark, have retained the right of "opting out" of the third and final stage of monetary unification under the Maastricht Treaty.[7]

The first stage of the process of monetary unification began prior to the Maastricht Treaty, on July 1, 1989, and comprised increased coordination of the monetary and economic policies of Member States. The second, and current, stage began on January 1, 1994. Its most important feature was the establishment in Frankfurt of a transitional monetary institution, the European Monetary Institute (EMI),[8] the predecessor to a permanent institution, the European Central Bank (ECB), which will come into existence and take over the tasks of the EMI soon before the beginning of the third and final stage.[9] The ECB and the national central banks of the Member States will compose the European System of Central Banks (ESCB),[10] which will have full responsibility for defining and implementing the monetary policy of the single currency

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6. *See id.* art. 109j(1); Convergence Protocol, *supra* note 2. The criteria include: (1) the achievement of high degree of price stability, apparent from a rate of inflation not exceeding by more than 1.5% that of, at most, the three best-performing Member States; (2) sustainability of government financial position, apparent from achievement of a budgetary position without an excessive deficit (in this context, the Protocol on the Excessive Deficit Procedure, *supra* note 2, art. 1, sets the reference values for the existence a sound budgetary position at less than 3% for the ratio of the planned or actual government deficit to gross domestic product and less than 60% for the ratio of government debt to gross domestic product); (3) observance of normal fluctuation margins of the exchange-rate mechanism (ERM) of the European Monetary System for at least two years, without devaluing against the currency of any other Member State; and (4) durability of convergence and participation in ERM, as reflected by an average nominal long-term interest-rate level that does not exceed by more than 2% that of, at most, the three best-performing Member States. On the interpretation of the convergence criteria and the progress of individual Member States in meeting them, see EUROPEAN MONETARY INSTITUTE, PROGRESS TOWARDS CONVERGENCE: REPORT PREPARED IN ACCORDANCE WITH ARTICLE 7 OF THE EMI STATUTE, ch. 1 (Nov. 1995).

7. *See* Protocol on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland, 1992 O.J. (C 191) 87; Protocol on Certain Provisions Relating to Denmark, *supra* note 2. Denmark has already notified its partners that it will not participate in the third stage. *See* Conclusions of the Edinburgh Meeting of the European Council, Dec. 11-12, 1992, section on Denmark and the Treaty on European Union, annex 1 ("Decision of the Heads of State and Government, meeting within the European Council, concerning certain problems raised by Denmark on the Treaty on European Union") & § B ("Economic and Monetary Union"). If it insists on its position, Denmark will not participate in the single currency, will continue to exercise its existing powers in the field of monetary policy in accordance with the provision of its national law and will be exempt from any EC Treaty provisions on economic policy, which apply only to those Member States participating in the third stage. On the other hand, Denmark will continue to participate fully in the second stage and be bound by the relevant rules and will take part in exchange-rate cooperation within the European Monetary System.

8. *See* EC TREATY art. 109f; EMI Protocol, *supra* note 2.

9. *See* EC TREATY arts. 4a, 109l(1)-(2); ESCB Protocol, *supra* note 2, art. 1.1.

10. *See* EC TREATY art. 106(1); ESCB Protocol, *supra* note 2, art. 1.2.

area, conducting its foreign-exchange operations, holding and managing the official foreign reserves of the Member States and promoting the smooth operation of the payment system.[11]

According to the Maastricht Treaty, the third stage of the process of monetary unification, which will involve the actual replacement of the existing national currencies by the single currency, could begin as early as January 1, 1997, if the Council (meeting in its composition of Heads of State or Government) determined in late 1996 that a majority of the Member States fulfill the conditions for participation.[12] In reality, the third stage is likely to commence on January 1, 1999, at the latest, even if only a minority of Member States fulfill the conditions.[13] The Council will set, by unanimous agreement of the Member States participating in the third stage, the modalities and definitive implementation date for the transition to the single currency.[14]

Not only the governments of the Member States, but also a vast majority of organized political forces across the Community, were convinced of the benefits of the Maastricht Treaty. However, to the surprise of many observers, following the signing of the Maastricht Treaty, unexpected difficulties delayed the ratification process (which was only completed in October 1993, with the Maastricht Treaty entering into force on November 1, 1993, just in time for the beginning of the second stage two months later) and raised doubts as to the viability of the project. Great turbulence in the European exchange markets, culminating in two successive crises in the Exchange Rate Mechanism (ERM) in September 1992 and July 1993, undermined the European Monetary System (previously thought as an anchor of monetary stability and a preparatory mechanism for the irrevocable fixing of exchange rates at the beginning of the third stage), leading to the exit of the sterling and the lira from the ERM and the broadening of the bands of fluctuation for the other participating currencies from +/- 2.25% to +/- 15% around their bilateral central parities.[15] There were also clear signs of a wave of popular opposition to the Maastricht Treaty, and in particular to the project of economic and monetary union, fueled by dissatisfaction with the prolonged and severe recession in Continental Europe (which can be

11. *See* EC TREATY art. 105(2); ESCB Protocol, *supra* note 2, art. 3.1.
12. *See* EC TREATY art. 109j(3).
13. *See id.* art. 109j(4).
14. *See id.*
15. On the reasons of the ERM crises, see the research commissioned by the European Parliament and published as THE MONETARY ECONOMICS OF EUROPE: CAUSES OF THE EMS CRISIS (Christopher Johnson & Stefan Collignon eds., 1994).

explained in part by the deflationary policies pursued by the governments of the Member States in their attempt to meet the demanding convergence criteria of the Maastricht Treaty).[16] Referenda for the ratification of the Maastricht Treaty in Denmark, Ireland and France proved the extent of discontent. In its referendum of June 2, 1992, Denmark originally rejected the Treaty by a majority of 50.7%, approving it only after a second referendum a year later by 56.8%, with the help of certain concessions by its partners, who recognized a special status for Denmark. The French referendum gave only 51% in favor, while only in Ireland was there a comfortable majority. In the UK, the Treaty was ratified only after months of heated parliamentary maneuvering. In Germany, the Federal Constitutional Court upheld the constitutionality of the Maastricht Treaty, opening the road for Germany's participation in the EMU, while reaffirming in principle the residual sovereignty of the German state and the constitutional obligation of its organs to refuse to apply legal acts of the European institutions that transgress the limits of the sovereign powers transferred to them under the Treaty.[17]

Faced with negative attitudes of significant segments of European public opinion, markedly pessimistic predictions of the market participants concerning the prospects of monetary unification on schedule,[18] persisting uncertainty about the ability of certain key Member States, such as France, Italy, and even Germany, to meet the convergence criteria and growing talk of postponement of the third stage,[19] during the

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16. For a (rather unconvincing) argument that the unexpected popular dissatisfaction with the Maastricht Treaty, rather than reflecting a previously latent lack of support for the European project or a change of heart on the part of electorates as a result of increased awareness about the Treaty's implications, can be largely explained by a combination of national political factors (search for partisan advantage, unpopularity of governments and myopic preoccupation of national parties with their prospects at forthcoming national elections), see Mark Franklin et al., *Uncorking the Bottle: Popular Opposition to European Unification in the Wake of Maastricht*, 32 J. COMMON MKT. STUD. 455 (1994).

17. *See* Brunner v. The European Union Treaty, Cases 2 BvR 2134/92 & 2159/92, *Bundesverfassungsgericht*, Oct. 12, 1993, BVerGE 89, 155, *translated in* 1994 C.M.L.R. 57 (confirming the compatibility of the Maastricht Treaty with the German Basic Law). On the constitutional implications of the decision, see Steve J. Boom, *The European Union After the Maastricht Decision: Will Germany Be the "Virginia of Europe"?*, 43 AM. J. COMP. L. 177 (1995); and Matthias Herdegen, *Maastricht and the German Constitutional Court: Constitutional Restraints for an "Ever Closer Union,"* 31 COMMON MKT. L. REV. 235 (1994).

18. For a typical expression of such doubts, which reached a climax in late 1995 and early 1996, see, for example, Gavyn Davies, *Will a European Recession Kill the Single Currency?*, Goldman Sachs EMU Briefing No. 4 (Jan. 18, 1996).

19. According to a controversial interpretation of the EC Treaty, art. 109j(3), third indent, provides a basis for a decision of the Council setting the beginning of the third stage at a date later than January 1, 1999.

course of 1995 the institutions of the European Community nonetheless made considerable efforts to keep the Maastricht project on track.

In May 1995, the European Commission published a discussion document (Green Paper), attempting to provide a provisional answer to the question of how (rather than with whom and when) the single currency can be achieved and listing the various technical, legal, and psychological problems, for the purpose of initiating the debate on the technical preparations for the transition.[20] Per se, this debate cannot affect the decisions concerning the date for entering into the final stage of monetary unification and the eligibility of Member States for participation. These decisions remain fully within the hands of the Council, in whose eventual deliberations political considerations may be expected to play a crucial role. However, the availability of a concrete practical framework for the introduction of the single currency is bound to increase the credibility of the whole project, facilitating the future political decision to move to the final stage.

In view of the reactions to the Green Paper and in response to the request of the European Council meeting in Cannes on June 27, 1995, which mandated the Council in its composition of economic and finance ministers (Ecofin) to define, in consultation with the Commission and the EMI, a reference scenario for the changeover to the single currency, on November 14, 1995, the EMI published a document setting out a proposed timetable for the introduction of the single currency in the countries meeting the convergence criteria for participation in the third stage.[21] This paper, together with further proposals by the Commission, was presented to the Ecofin Council on November 27 and to the

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20. *See* One Currency for Europe: Green Paper on the Practical Arrangements for the Introduction of the Single Currency, COM(95)333 final. The Green Paper pursued a threefold objective: to remove as far as possible the uncertainties still surrounding the changeover; to demonstrate the technical feasibility of the transition; and to define possible approaches for encouraging public acceptance of the changeover to the single currency. *See id.* at 19-20.

21. EUROPEAN MONETARY INSTITUTE, THE CHANGEOVER TO THE SINGLE CURRENCY (Nov. 1995). In fulfillment of its responsibility under Art. 109f of the EC Treaty to "prepare the instruments and procedures necessary for carrying out a single monetary policy in the third stage" and to "specify the regulatory, organizational and logistical framework necessary for the ESCB to perform its tasks in the third stage," the EMI also continued its work on the preparation of the monetary and foreign exchange policy operational frameworks and on the establishment of appropriate payment systems arrangements and statistics, issuing European banknotes, accounting rules, and standards and information systems. EUROPEAN MONETARY INSTITUTE, ANNUAL REPORT 1994 (1995) [hereinafter ANNUAL REPORT 1994], at 63-64, 73-81; EUROPEAN MONETARY INSTITUTE, PROGRESS TOWARDS CONVERGENCE: REPORT PREPARED IN ACCORDANCE WITH ARTICLE 7 OF THE EMI STATUTE (Nov. 1995), ch.2; EUROPEAN MONETARY INSTITUTE, ANNUAL REPORT 1995 (1996) [hereinafter ANNUAL REPORT 1995], at 51-67.

European Council meeting on December 15-16, held in Madrid. The European Council endorsed a changeover scenario consistent with that proposed by EMI, confirmed January 1, 1999, as the starting date for the third stage and, in a further sign of commitment to the completion of the monetary union, decided to name the single currency the "euro."[22]

The introduction of a specific time frame and the acceleration of the technical preparations for the changeover, together with the reaffirmation by the governments of France and Germany of their political will to meet the Maastricht schedule and participate in monetary union from 1999, have contributed to a significant reappraisal of the prospects of completion of European monetary unification, which looks now much more likely, at least for an initial group of Member States, before the end of the century.

The immediacy of the fundamental change of institutional regime, which is inherent in the move to the third stage as a result of the creation of a single monetary authority for the Community as a whole, makes not only timely but also imperative a detailed discussion of the provisions of the Maastricht Treaty on the organization and functions of the ECB and the ESCB[23] and the identification of yet unresolved policy dilemmas in this area.

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22. *See* Conclusions of the Madrid European Council meeting, Dec. 15-16, 1995, 1996 O.J. (C 22) 2, points 1-8 & annex 1. In accordance to the changeover scenario, the transition will take place in three periods. The first period will commence with the confirmation by the Council in its composition of Heads of State or Government, as soon as possible in 1998, of the Member States which fulfill the conditions for participating in the third stage from the beginning. During this period, the decisions necessary for completing the preparations for the third stage will be taken and the ECB will be established early enough so that preparations for the full operation of the ESCB may be completed in time for the beginning of the third stage on January 1, 1999. A second period will begin on that date, with the replacement of the bilateral exchange rates of the currencies of the participating countries by irrevocably locked conversion factors; from this point, monetary policy will be defined and implemented by the ESCB in euros. During the second period, the euro will begin to be used as a unit of account and a means of settlement in the domestic banking systems alongside existing national currencies, but there will be no physical euro banknotes or coins. A Council regulation entering into force on January 1, 1999, will provide the legal framework for the use of the euro, which will become from this point "a currency in its own right," in accordance with Article 109l(4) of the Treaty. The third and final period will begin with the introduction, by January 1, 2002, at the latest, of euro banknotes and coins, which will circulate alongside existing national ones. The period of parallel circulation will be kept at a minimum, with the existing national banknotes and coins ceasing to be legal tender within six months at the latest. At this point the transition to the euro will be officially complete, although national central banks will continue to exchange any remaining national means for euros.

23. On the institutional design of the ECB and the ESCB, see Rosa Maria Lastra, *The Independence of the European System of Central Banks*, 33 HARV. INT'L L.J. 475 (1992); Ian Harden, *The European Central Bank and the Role of National Central Banks in Economic and Monetary Union*, *in* Gretschmann, *supra* note 1, at 149; Hugo J. Hahn, *The European Central*

Even a cursory examination reveals that the provisions of the Maastricht Treaty provide detailed solutions almost exclusively to issues concerning the monetary responsibilities of the new central banking system, which is set up with the paramount objective of achieving price stability within the monetary union.[24] On the other hand, important questions remain unresolved in relation to the nonmonetary functions of the new central banking system. In particular, the Maastricht Treaty provides only limited guidance to the problem of institutional organization of banking policy (including such matters as prudential supervision, the lending of last resort function and the operation of the payment system) in the monetary union. This, however, is an area where the introduction of a new monetary authority at Community level will necessarily have major repercussions.

II. BANKING POLICY IN A SINGLE CURRENCY AREA

A. Prudential Regulation in the Single Market in Financial Services

The integration of European markets and the Community-wide provision of services by their suppliers under conditions of competitive equality are fundamental principles of EC law, enshrined in the Treaty of Rome.[25] In the area of banking, the initial Community strategy sought to introduce a compulsory common legislative framework for all European banks. However, the attempts undertaken in this direction in the early

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Bank: Key to European Monetary Union or Target?, 28 COMMON MKT. L. REV. 783, 795-815 (1991).

24. *See* EC TREATY art. 105(1); ESCB Protocol, *supra* note 2, art. 2. The commitment to price stability is also binding on the Community as a whole. *See* EC TREATY art. 3a(2)-(3). The full priority given to price stability is underpinned by the belief that there can be no trade-off between higher and variable inflation and a sustainably improved performance in respect of other economic objectives, such as growth or employment. In this sense, it represents a rejection of the Phillips-curve-based assumptions of neo-Keynesian thinking. *See* A.W. Phillips, *The Relationship Between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957*, 25 ECONOMICA 283 (1958). However, political decision-makers in governments and parliaments are likely to abandon their professed commitment to price stability. The structure of their incentives is such that their economic policies will probably be influenced much less by long-term considerations of sound money than by the desire to finance public spending and to manipulate monetary conditions for the purpose of achieving short-term economic growth, in order to procure political benefits and alleviate electoral pressures. Instead, an independent central bank with a clear counter-inflationary mandate is much more likely to yield the desired results. The EC Treaty contains provisions to this effect, ensuring the independence of the ECB and the ESCB from both the governments of the Member States and the political institutions and bodies of the Community. The constitutional mandate provides a legitimate basis for the ECB and the ESCB to resist pressures to inflate the economy.

25. EC TREATY arts. 52-58 (on the right of establishment), 59-66 (on the freedom to provide services).

1970s failed, as the Member States were unable to reach agreement on the content of the relevant legislation. As a result, a new approach was adopted which, without abandoning the aim of substantial uniformity,[26] attempted to implement it gradually. The legal form of directives was chosen for this purpose, because directives (unlike regulations, which are legislative acts of general application of the Community institutions, whose provisions are binding in their entirety and directly applicable in all Member States) are binding only as to the result to be achieved but leave to each Member State the choice of the form and methods for their implementation in its territory,[27] thus preserving a degree of national discretion, at least in the details. For some time, however, even this approach yielded only modest results.

The First Banking Directive was adopted in 1977 as a first measure of harmonization, in the hope that, following further measures harmonizing prudential requirements, banks with their head office in a Member State wishing to operate in another Member State through a branch would eventually be exempted from the latter's regulatory requirements.[28] In this manner, home country supervisory control was recognized in principle as an objective of Community banking law. The Directive imposed authorization requirements on "credit institutions," i.e. undertakings whose business is to receive deposits or other repayable funds from the public and to grant credits for their own account,[29] and set out minimum conditions for authorization, including the adequate and separate capitalization of the applicant institution, the effective direction of its business by at least two persons of good repute and appropriate experience, and the submission to the authorities of a program of operations.[30] As this limited harmonization of prudential standards did not provide a sufficient basis for the operation of the principle of home country control, the authorization and regulation of local branches remained in the hands of the host Member State, pending further coordination.[31]

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26. *See* First Council Directive 77/780 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30 [hereinafter First Banking Directive], pmbl. recital 8.

27. *See* EC TREATY art. 189.

28. *See* First Banking Directive, *supra* note 26, pmbl. recital 10.

29. *See id.* art. 3(1). The concept of "credit institution" is defined in art. 1.

30. *See id.* arts. 3(2), (4).

31. *See id.* art. 4(1).

For a number of years, however, little additional progress was made,[32] and national approaches to a host of basic prudential issues, including solvency requirements, continued to diverge widely.

The breakthrough in this connection was the decision for the completion of the internal market by the end of 1992.[33] The new emphasis on market integration and the amendment of the Treaty of Rome by the Single European Act, which amended the Community's decision-making procedures (making possible the adoption of banking directives in the Council by qualified majority voting, rather than unanimity[34]) created the conditions for further harmonization. At the same time, the full liberalization of capital movements which was accomplished on July 1, 1990,[35] made the opening up of banking markets unavoidable.[36] This necessitated regulatory approximation as a means of ensuring that the banks of all Member States would compete on equal terms in the single market and that these terms would not be dictated by the most liberal national regime, but would reflect the concerns of the major jurisdictions. The Community's close involvement in the efforts for the international convergence of prudential standards in the Committee on Banking Regulations and Supervisory Practices, better known as the "Basle Committee,"[37] in which seven Member States were

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32. However, in response to the failure of Banco Ambrosiano, the principle of consolidated supervision of banking groups was adopted by the Community. *See* Council Directive 83/350 on the Supervision of Credit Institutions on a Consolidated Basis, 1993 O.J. (L 193) 18, *repealed by* Directive 92/30, 1992 O.J. (L 110) 52, art. 10(1) (introducing reformed framework of consolidated supervision).

33. *See* Completing the Internal Market: White Paper from the Commission to the European Council, COM (85)310 final at 7 [hereinafter Completing the Internal Market]; amendments to the Treaty of Rome made by the Single European Act.

34. *See* EC TREATY art. 100a (as inserted by art. 18 of the Single European Act).

35. *See* Council Directive 86/566 on Removing All Restrictions on Capital Movements Ancillary to Trade and Direct Investment, 1986 O.J. (L 332) 22; Council Directive 88/361 on Liberalizing All Remaining Restrictions on Capital Movements, 1988 O.J. (L 178) 5 (both directives implementing art. 67 of the Treaty of Rome).

36. The close link between the liberalization of capital movements and banking services was recognized by EC Treaty art. 61(2).

37. The Committee, whose full name has since been changed to the Basle Committee on Banking Supervision, is made up of representatives of the central banks and banking supervisory authorities of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. For an introduction to the Committee's work, see A. Cornford, *The Role of the Basle Committee on Banking Supervision in the Regulation of International Banking* (Sept. 1993); JOSEPH J. NORTON, DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS, ch. 4 (1995); CHRISTOS HADJIEMMANUIL, BANKING REGULATION AND THE BANK OF ENGLAND 55-70 (1996). On the Basle Committee's links with the EC, see NORTON, *id.* at 163-67.

represented,[38] and which promulgated its Capital Accord in 1988, provided the Community with commonly accepted understandings and a framework of regulatory standards on which to build.

Even so, comprehensive harmonization still appeared to be politically unattainable. A solution to this problem emerged when the objective of full harmonization was abandoned in favor of the mutual recognition of the authorization procedures and regulatory standards of the Member States, subject to the harmonization of only those basic elements of prudential regulation, as to which convergence was accepted to be essential.[39]

The new strategy permitted the adoption of the Second Banking Directive in December 1989,[40] the main measure of Community law giving effect to the European Commission's designs for the completion of a single market in the field of banking. The Second Banking Directive established firmly the shift from host-country control of branches to the mutual recognition of national licenses, opening the way to the

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38. As a consequence of the accession of Sweden to the European Union, the Community is currently represented in the Basle Committee by eight Member States.

39. The mutual recognition of regulatory standards in matters of lesser importance or of a contentious nature was a key component of the Commission's strategy for the construction of a single market in financial services. Despite the introduction of qualified-majority voting in the Council, the traditional approach of comprehensive harmonization had very few prospects of producing results, especially within the tight time-limits imposed by the December 31, 1992 deadline. To solve this problem, the Commission abandoned the idea of uniformity in favor of the mutual recognition of national standards in nonessential matters. The concept of mutual recognition was originally developed in the jurisprudence of the European Court of Justice (ECJ) on the free movement of goods, most notably in Case 120/78, Rewe-Zentral A.G. v. Bundesmonopolverwaltung für Branntwein ("Cassis de Dijon"), 1979 E.C.R. 649. The adaptation of this concept to the context of services provided the solution, because it simplified dramatically the negotiations and made politically feasible the harmonization of those minimum standards, without which most Member States, fearful of the competitive advantages that would accrue to the least regulated banks in a single market but unwilling to undertake drastic deregulation of their domestic banking systems, would resist the liberalization of banking services and the opening up of the national banking markets to direct and unrestricted competition. On the Commission's policy for the accomplishment of a single banking market, see Completing the Internal Market, *supra* note 33, paras. 100-107; G.S. Zavvos, *Towards a European Banking Act*, 25 COMMON MKT. L. REV. 263 (1988); G.S. Zavvos, *The Integration of Banking Markets in the EEC: The Second Banking Coordination Directive*, 3 J. INT'L BANKING LAW 53 (1988); G.S. Zavvos, *Banking Integration and 1992: Legal Issues and Policy Implications*, 31 HARV. INT'L L.J. 463 (1990). *See also* U.H. Schneider, *The Harmonization of EC Banking Laws: The Euro-Passport to Profitability and International Competitiveness of Financial Institutions*, 22 LAW & POL'Y INT'L BUS. 261, 267-76 (1991).

40. Second Council Directive 89/646 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780, 1919 O.J. (L 386) 1 [hereinafter Second Banking Directive].

Community-wide banking operations by means of direct cross-border provision of services or through the establishment of local branches, on the basis of a credit institution's home state authorization ("single banking license").[41] The single license is based on the model of the "universal bank." Accordingly, credit institutions can carry on a broad range of banking activities throughout the Community,[42] provided that these are covered by their home authorization. The Directive allocates the responsibility for the prudential control and supervision of credit institutions to the regulatory authorities ("competent authorities") of the home Member State, with only limited exceptions.[43] The main limitation of the single

41. *See id.* arts. 6(1), 18(1).

42. These are listed in the Annex to the Second Banking Directive, *supra* note 40.

43. *See id.* arts. 13-14. The host authorities can conduct on-the-spot investigations and request regulatory and statistical information from the branches of credit institutions from other Member States; *see id.* arts. 15(3) & 21(1), respectively. The host Member State's right to enforce the legal rules that it has adopted in "the interest of the general good" against incoming institutions is not affected. *Id.*, pmbl. recitals 15, 16 & art. 21(5); *see also* art. 21(8). However, the jurisprudence of the ECJ has established that the restriction of the freedom to provide services by national rules for reasons of general good will only be accepted under strict conditions. In particular, the national rules must be justified on one of the grounds of general interest listed in Article 36 of the Treaty of Rome (public security, protection of public health, protection of industrial and commercial property) or otherwise recognized as legitimate in the ECJ's case law (consumer protection, improvement of working conditions, fair trading, effectiveness of fiscal policies, protection of the environment); they must not lead to overt or disguised discrimination on grounds of nationality; they must not duplicate comparable regulatory requirements imposed by the home Member States; they must be objectively justified, that is, they must be necessary for the achievement of their aims, in the sense that a less restrictive alternative is not available, and proportional to both their aims and actual results; and they must only apply to matters which have not yet been harmonized. *See* Joined Cases 110 and 111/78, Ministère Public v. van Wesemeal, 1979 E.C.R. 35; Case 205/84, Commission of the European Communities v. Federal Republic of Germany, 1986 E.C.R. 3755. In the formulation used by the ECJ in Sšger v. Dennemeyer & Co. Ltd.,

> the freedom to provide services may be limited only by rules which are justified by imperative reasons relating to the public interest and which apply to all persons or undertakings pursuing an activity in the State of destination, in so far as that interest is not protected by the rules to which the person providing the services is subject in the Member State in which he is established. In particular, those requirements must be objectively necessary in order to ensure compliance with professional rules and to guarantee the protection of the recipient of services and they must not exceed what is necessary to attain those objectives.

Sšger v. Dennemeyer & Co. Ltd., 1991 E.C.R. I-4221, at I-4244. Evidently, host-State measures of a prudential nature cannot be justified on this ground, because the Directive's provisions determine exclusively the remaining competencies of the host Member State in this area. On the other hand, the permitted measures could include a variety of conduct-of-business rules, designed to protect the investing public or the borrowers of credit institutions, as well as rules of market organization, relating, for example, to the standardization of financial instruments or the conditions of participation in clearing houses, provided that the home Member State does not have in place substantially equivalent rules. *See* W. van Gerven, *The Second Banking Directive and the Case-Law of the Court of Justice*, 10 Y.B. EUR. L. 57, 63-70 (1990); S.E. Katz, *The General Good and*

license is that it does not extend to the establishment of subsidiaries in host Member States.

The minimum harmonization which was thought to be necessary for the mutual recognition of national regulatory standards was achieved in part by certain provisions in the Second Banking Directive, which set an absolute minimum capital requirement of ECU 5 million for credit institutions, required the vetting of their owners and imposed limits on their participations in nonfinancial undertakings. The more significant element of harmonization, however, consisted in the formal adoption, by means of the Own Funds Directive[44] and the Solvency Ratio Directive,[45] of common risk-related capital requirements based on the Basle Committee's Accord,[46] requiring that all credit institutions operating within the Community observe a minimum ratio of 8% of eligible capital items ("own funds") to risk-weighted assets.

The harmonization of a limited number of minimum rules only has been criticized by some commentators, on the ground that it does not lead to a truly unified market.[47] On this view, if there is to be a truly European market, regulation should be conducted at the Community level because the mutual recognition approach does not remove the incentives of national authorities to lower their supervisory standards for the purpose of attracting financial activity in their territory.

Nonetheless, even disregarding considerations of subsidiarity and political-constitutional objections to the centralist idea of Europe as a super-state in waiting, the political impossibility of wholesale agreement by the Member States on uniform prudential standards and the need for gradual convergence must be borne in mind.[48] Despite this constraint, the single license made redundant the anti-competitive effects of the

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the Second Banking Directive: A Major Loophole?, 8 BUTTERWORTHS J. INT'L BANKING & FIN. L. 166 (1993).

44. Council Directive 89/299 on the Own Funds of Credit Institutions, 1989 O.J. Comm. Euro. (L 124) 16 [hereinafter Own Funds Directive]. This technical directive determined the items which may be included in the calculation of a bank's capital ("own funds").

45. Council Directive 89/647 on a Solvency Ratio for Credit Institutions, 1989 O.J. Comm. Euro. (L 386) 14 [hereinafter Solvency Ratio Directive]. This establishes common rules for the risk-weighting of assets and off-balance sheet items and set the minimum ratio of eight percent.

46. Basle Committee, *International Convergence of Capital Measurement and Capital Standards* (Accord) (July 1988). On the Accord, see Joseph J. Norton, *The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on "International Convergence of Capital Measurement and Capital Standards,"* 23 INT'L LAW. 245 (1989).

47. *See, e.g.*, C. Bradley, *1992: The Case of Financial Services*, 12 NW. J. INT'L L. & BUS. 124 (1991).

48. *See supra* note 39.

higher regulatory standards of certain Member States, as incoming banks can now secure access to their markets simply by conforming to their home country rules.

Furthermore, in view of the uniform minimum capital standards, it is doubtful whether individual Member States can in fact unilaterally relax their regulatory standards for competitive reasons, as the critics claim. Rather than encouraging "competition in laxity," the capital standards can be interpreted as introducing an effective constraint on the growth of banks originating in the weaker Member States, which may find it difficult to meet them, due to their low profitability and limited ability to raise new capital. In addition, the credible implicit safety-nets provided by the authorities of the stronger Member States in the form of lending of last resort and lifeboat practices for ailing institutions, discourages the drift of banking business to jurisdictions with low supervisory standards.[49]

The fundamental success of the mutual recognition approach is displayed by the fact that it has actually accelerated the trend of regulatory convergence, gradually leveling the remaining differences in substantive prudential standards. In 1992, directives introducing a revised framework for the consolidated supervision of banking groups[50] and setting limits on large exposures[51] were adopted. The following year, in conjunction with the application of the single license approach to the securities industry,[52] uniform capital requirements for both investment firms and credit institutions were promulgated in the Capital Adequacy Directive,[53] with the aim of covering risks arising from the securities and foreign-exchange trading activities of these institutions. In combination with the Own Funds and Solvency Ratio Directives, the Capital Adequacy Directive completes the risk-related framework of capital adequacy for banks. In May 1994, the Deposit-Guarantee Directive was adopted, requiring the introduction by the Member States of deposit-guarantee schemes ensuring a minimum degree of protection for the depositors of credit institutions on

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49. For a game-theoretical analysis of the effects of the mutual-recognition approach, see P. van Cayseele & D. Heremans, *Legal Principles of Financial Market Integration in 1992: An Economic Analysis*, 11 INT. REV. L. & ECON. 83 (1991).

50. Council Directive 92/30 on the Supervision of Credit Institutions on a Consolidated Basis, 1992 O.J. (L 110) 52 [hereinafter Second Consolidated Supervision Directive].

51. Council Directive 92/121 on the Monitoring and Control of Large Exposures of Credit Institutions, 1993 O.J. (L 29) 1 [hereinafter Large Exposures Directive].

52. Council Directive 93/22 on Investment Services in the Securities Field, 1993 O.J. (L 141) 27 [hereinafter Investment Services Directive].

53. Council Directive 93/6 on the Capital Adequacy of Investment Firms and Credit Institutions, 1993 O.J. (L 141) 1 [hereinafter Capital Adequacy Directive].

a Europe-wide basis.[54] Deposit insurance under the Deposit-Guarantee Directive is based on the home country principle. As a result, the costs of bank failures are shifted, at least insofar as formal deposit insurance is concerned, to the national authorities who are responsible for exercising supervisory control. This is an important disincentive to competition in laxity, because it dissuades Member States which act as centers for international financial operations, such as Luxembourg, from tolerating the operation of weak banks from their jurisdiction or exercising inadequate prudential supervision, in the expectation that the costs of failure will be shouldered by other countries.

With the adoption of these measures, and in particular of the common capital rules for the securities activities of banks, the Community has achieved significant convergence in substantive regulatory standards without attempting to affect the institutional organization of the supervisory function by establishing a supra-national supervisory authority or imposing on the Member States a specific scheme of organization of their national agencies. The institutional organization of the supervisory function and, in particular, of the executive stage of actual exercise of supervision *stricto sensu* remains within the national discretion of the Member States.[55]

The Community regime only demands cooperation between the various "competent authorities" to which the Member States delegate functions in the area of prudential supervision.[56] It is significant that the relevant rules do not require the supervisory authorities, where these are organized as separate institutions, to cooperate with their national central banks. European Community law simply qualifies the supervisory

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54. Directive 94/19 of the European Parliament and of the Council on Deposit-Guarantee Schemes, 1994 O.J. (L 135) 5 [hereinafter Deposit-Guarantee Directive].

55. For a discussion of the allocation of responsibilities for specific tasks in the field of banking supervision to various types of competent authorities within each Member State (the central bank, a separate public agency with general supervisory responsibilities, autonomous bodies with limited tasks or other persons appointed by the primary supervisory authority, including auditors) and the total lack of uniformity in organizational structure across Member States, see TOMMASO PADOA-SCHIOPPA, THE ROAD TO MONETARY UNION IN EUROPE: THE EMPEROR, THE KINGS, AND THE GENIES 223, 229-35 (1994).

56. The First Banking Directive, art. 7(1), already required close collaboration between the competent national authorities regarding the supervision of institutions operating in more than one Member State and the exchange of all information likely to facilitate the monitoring of their liquidity and solvency. *See* First Banking Directive, *supra* note 26, art. 7(1), as amended by the Second Banking Directive, *supra* note 40, art. 14(1); Second Banking Directive, *supra* note 40, arts. 7, 15(2); Second Consolidated Supervision Directive, *supra* note 50, art. 7(2)-(4), (7); Investment Services Directive, *supra* note 52, art. 23; and Capital Adequacy Directive, *supra* note 52, arts. 7(3), eighth indent & 9(4).

authorities' duty of secrecy by allowing them to exchange confidential information with the monetary authorities,[57] but otherwise leaves the question of their cooperation to the discretion of each Member State.

The residual discrepancies between national regulatory regimes seem to reflect, not as much conscious competitive strategies aimed at attracting banking business by manipulating the prudential standards, as more mundane differences in the quality of supervisory performance, which can be explained by the limited manpower, sophistication or resources of the national authorities of the smaller Member States. By requiring them to supervise groups headed by credit institutions authorized by them on a consolidated basis, the current allocation of regulatory responsibilities increases unduly the regulatory burden on these authorities.[58]

B. Arguments for the Centralization of Supervisory Powers in the Monetary Union

Many commentators maintain that the present organization of supervisory responsibilities at the national level cannot be sustained in a monetary union: a much higher degree of coordination, and even centralization of prudential supervision at Community level, will be required.[59]

One reason why these commentators believe the case for centralization to be particularly compelling relates to the growing integration of EC financial markets, characterized by the rise of large financial conglomerates operating across national borders. In the words of Xavier Vives:

> As European financial markets become more integrated and competition increases, both externalities among countries and the potential instability of the system will

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57. *See* First Banking Directive, *supra* note 26, art. 12(6), as substituted by art. 4 of Directive 95/26.

58. *See* M. DASSESSE ET AL., E.C. BANKING LAW 107 (2d ed. 1994).

59. *See, e.g.*, PETER B. KENEN, ECONOMIC AND MONETARY UNION IN EUROPE: MOVING BEYOND MAASTRICHT 32-35 (1995); Barry Eichengreen, *Should the Maastricht Treaty be Saved?*, PRINCETON STUD. IN INT'L FINANCE No. 74, at 42-47 (December 1992). Ray Kinsella speaks in dramatic terms about a "regulatory gap" and a "black hole" at the center of Europe's emerging central banking system, as a result of the lack of a clear supervisory role for the ECB; his argument, however, rests on the questionable premise of the "indivisibility" of monetary policy and supervisory responsibilities. *See* Ray Kinsella, *The European Central Bank and the Emerging EC "Regulatory Deficit," in* EMU AFTER MAASTRICHT: TRANSITION OR REVALUATION? 93, 103 (David Currie & John D. Whitley eds., 1995).

> increase. [. . .] Increased cross-country external effects mean that the role for coordinating and centralizing regulation and supervision will increase correspondingly. The EMI could be a natural candidate to perform this function. Indeed, [. . .] national regulators will tend to pay insufficient attention to overseas customers of domestic banks; systemic risks in overseas countries in which domestic banks trade (both instances present in the BCCI case); systemic risks in the EC as links in interbank markets grow; and finally, risks to the EC payments system with a single currency. The solution proposed involves a European regulatory process with increasing degrees of coordination and centralization and with a European wide deposit insurance system.[60]

Despite Vives's reference to a prudential role for the EMI (and, presumably, in the third stage of EMU, to the ECB and the ESCB), the main thrust of his and similar arguments concerns the choice of the level of government at which the supervisory function must be located in the single market. This is a "vertical" choice, which raises issues of subsidiarity,[61] but leaves open the question of the distribution of roles between particular institutions operating at Community level.

Assuming that the organizational centralization of banking policy, and in particular prudential supervision, is indeed necessary, one could envisage several candidates for the role of European banking authority. Generally, the design and execution of Community policies is a matter for the various Directorates General of the Commission. Nevertheless, the allocation of executive supervisory responsibilities in the field of banking to the Commission would probably be too drastic a departure from current institutional practices. As the Commission would appear to lack the appropriate expertise and suitable institutional structure, the relevant functions could be assigned, instead, either to the ESCB or to a specially constituted agency.[62] This agency could, for instance, be based on, and

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60. Xavier Vives, *The Supervisory Function of the European System of Central Banks*, 51 GIORNALE DEGLI ECONOMISTI E ANNALI DI ECONOMIA 523, 530-31 (1992). *See also* the similar remarks of M. Onado, *Monetary Policy, Regulation and Growing Bank Risks. Comments*, 51 GIORNALE DEGLI ECONOMISTI E ANNALI DI ECONOMIA 505, 510 (1992).

61. *See infra* Part IV.A.

62. On the power of the Community to create agencies with distinct legal personality and entrust them with specific tasks, see Koen Lenaerts, *Regulating the Regulatory Process: "Delegation of Powers" in the European Community*, 18 EUR. L. REV. 23, 40-49 (1993). The Community's experience in matters of delegation of powers is still limited. "The crucial question

absorb, the three existing fora for supervisory cooperation at Community level, that is: the Contact Group of EU Supervisory Authorities, the informal and largely autonomous forum where views are exchanged on policy matters and individual cases of supervisory concern; the Banking Advisory Committee,[63] composed of representatives of the central banks, competent authorities, and finance departments of the Member States and of the Commission, which plays an advisory role with regard to proposed EC banking legislation and also participates, in its capacity as a regulatory committee, in the making of technical amendments to the existing banking directives,[64] but does not discuss individual cases; and the Banking Supervisory Sub-Committee of the EMI, consisting of representatives of the central banks of the Member States or, in cases where the central banks do not have legal responsibility for banking supervision,[65] of the separate supervisory authorities, which assists the EMI in the performance of its limited consultative and advisory functions in the area of banking supervision, to be assumed in the third stage by the ECB.[66]

Accordingly, insofar as it is only a question of centralizing certain supervisory tasks at Community level, the involvement of the ESCB

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indeed remains the political accountability for open-ended policy choices, [. . .] even if the exercise of such powers occurs at the 'executive' level." *Id.* at 46-47. Participation by representatives of the Member States, the Commission and sometimes the European Parliament may contribute in taking into account the affected interests, but should not substitute the operation of the carefully balanced mechanisms of political control set out in the EC Treaty, which vary in important respects from one area to another. "The bottom line of institutional inventiveness is probably that the margin of political discretion which might be left to a newly-established internal body may not remain unchecked before it produces rules with a Community law status, which is in the end what 'balance of powers' and representative democracy are all about." *Id.* at 49.

63. Established under the First Banking Directive, *supra* note 26, art. 11.

64. A regulatory committee is a group of officials from specialized agencies of the Member States entrusted with the task of reviewing Commission proposals for technical measures within their field. The relevant proposals become law once the regulatory committee gives the green light ("comitology procedure"). Council Decision 87/373 of July 13, 1987, laid down the procedures for the exercise of implementing powers conferred on the Commission. Council Decision 87/373, 1987 O.J. (L 197) 33. If the regulatory committee withholds its concurrence, a decision may be taken by the Council. *Id.*

65. *See* ANNUAL REPORT 1994, *supra* note 21, at 70.

66. For an account of recent activities of the Banking Advisory Committee, the Contact Group of Banking Supervisory Authorities, and the Banking Supervisory Sub-Committee of the EMI, see BASLE COMMITTEE ON BANKING SUPERVISION, REPORT ON INTERNATIONAL DEVELOPMENTS IN BANKING SUPERVISION No. 10, at 215-24 (June 1996). These bodies do not have a hierarchical relationship, nor official lines of communication. However, their membership overlaps and in practice there is continuous exchange of information between them, ensuring informal coordination and division of labor.

would not be necessary.[67] A related but conceptually distinct line of argument, however, insists on a direct supervisory role for the ECB and ESCB in particular, on the ground that this is essential for the performance of their other functions, including the conduct of monetary policy. On this view, banking policy in the monetary union should not only be centralized, but also combined with the monetary policy function. This "horizontal" choice of competent authority transforms the question from one concerning the operation of the single market to one inherently linked to the construction of a monetary union. At the same time, it raises questions of legitimation, given the ESCB's very high degree of independence from the Community's and Member States' political institutions.[68]

The combination of monetary and prudential functions is sometimes espoused on the ground that the soundness of the banking system is a prerequisite to the maintenance of monetary stability.[69] It is indeed the case that, in financial environments dominated by insolvent banking institutions, a number of special problems arise which put in question the effectiveness of a central bank's market-oriented instruments of monetary control.[70] This observation, however, does not have direct policy implications for the organization of the prudential function in the Community, since the banking systems of the Member States are not as fragile as to potentially impede the effective conduct of monetary policy. Furthermore, the central bank's interest in a safe and robust banking system as a condition for the performance of its monetary functions does not necessarily provide a valid justification for assigning the responsibility for prudential policy to the central bank itself. In fact, the combination of monetary and prudential functions could be counterproductive. It could create perverse incentives, leading the central bank, on occasions, to relax its monetary policy and accommodate the liquidity requirements of banking institutions in order to protect their solvency and profitability,

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67. Indeed, a separate Community agency might be able to bring within its jurisdiction nonbank financial groups more easily than the ECB and would also avoid the over-concentration of powers in the hands of the Community's central bankers. *See* WORKING GROUP OF THE ECU INSTITUTE, BANKING SUPERVISION IN THE EUROPEAN COMMUNITY: INSTITUTIONAL ASPECTS 16 (1995).

68. *See infra* Part IV.B.

69. *See, e.g.*, ROSA MARIA LASTRA, CENTRAL BANKING AND BANKING REGULATION 61-62 (1996); Kinsella, *supra* note 59.

70. *See* Donald J. Mathieson & Richard D. Haas, *Establishing Monetary Control in Financial Systems with Insolvent Institutions*, 42 IMF STAFF PAPERS 184 (1995).

even though this may be inconsistent with monetary stability.[71] At any rate, the empirical evidence does not provide clear support either for the combination of these functions in the central bank or for their separation.[72]

In practice, even in countries such as Germany and Belgium, where the two functions are separated, the central bank usually collaborates closely with the supervisory authorities in the elaboration of prudential policy and rules and in the collection and analysis of statistical banking returns, with a view to avoiding policy conflicts and ensuring the efficient sharing of information.[73] This, however, does not require the transfer of decision-making powers to the central bank.[74]

The more persuasive arguments for the allocation of supervisory responsibilities to the ESCB do not relate to the supposed complementarity of the monetary and banking policies, but to the need to control credit exposures that it might undertake as lender of last resort or through its involvement in the operation of European payment systems.[75]

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71. *See* Donato Masciandaro, *Monetary Policy, Banking Supervision and Inflation*, 51 GIORNALE DEGLI ECONOMISTI E ANNALI DI ECONOMIA 533 (1992). On the other hand, a central bank may be more resistant than a separate supervisory authority to "capture" by private banking interests, because its reputation depends primarily in achieving its macroeconomic objectives. *See* Banking Industry Regulatory Consolidation: Hearings on the Need for Major Consolidation and Overhaul of the Bank Regulatory Agencies into a New and Independent Banking Structure, 103d Cong. (testimony of Allan Greenspan, Chairman, Board of Governors, Federal Reserve Board, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, Mar. 2, 1994).

72. *See* Charles Goodhart & Dirk Schoenmaker, *Institutional Separation between Supervisory and Monetary Agencies*, 51 GIORNALE DEGLI ECONOMISTI E ANNALI DI ECONOMIA 353 (1992) [hereinafter *Institutional Separation*]; Charles Goodhart & Dirk Schoenmaker, *Should the Functions of Monetary Policy and Banking Supervision Be Separated?*, 47 OXFORD ECONOMIC PAPERS 539 (1995) [hereinafter *Functions of Monetary Policy*]. The authors' study of 24 countries, of which 11 could be classified as following the combined system and 13 the separate one during the 1980s, did not reveal an unambiguous advantage for any of the two systems in terms of either a better inflation record or a more stable banking system.

73. *See* PADOA-SCHIOPPA, *supra* note 55, at 230-31; WORKING GROUP OF THE ECU INSTITUTE, *supra* note 67, at 69; Johannes Priesemann, *Policy Options for Prudential Supervision in Stage Three of Monetary Union* 5-6 (revised version of a paper presented at the Conference on Banking, International Capital Flows and Growth in Europe, University of Potsdam, Potsdam, Oct. 13-14, 1995).

74. The formal responsibility of a separate authority can even be seen as a means of protecting the central bank's reputation in the event of bank failures. *See* Priesemann, *supra* note 73, at 6.

75. More generally, the active involvement of the central bank in supervision will be justified to the extent that the central bank underwrites, openly or implicitly, the operations of the private banking system, because the central bank must limit the attendant risks. In this context, Goodhart and Schoenmaker identify a tendency for decreasing central bank involvement in the organization and funding of bank rescues, in favor of explicit deposit insurance schemes and government-financed bail-outs. *See Functions of Monetary Policy*, *supra* note 72, at 554-56. This may be a major factor encouraging the separation of functions.

In theory, the lender of last resort function shares with banking supervision in the strict sense common objectives, that is, to ensure the smooth and continuous operation of banking markets, and thus the long-term stability of, and confidence in, the financial system.[76] Generally, however, in lending of last resort the emphasis is placed almost exclusively on macroprudential concerns, while the theoretical arguments for supervision also encompass microprudential objectives, such as the protection of the users of the financial system, regardless of systemic repercussions. Furthermore, supervision operates ex ante, while lending of last resort consists in ex post interventions, once problems have been identified.

As lender of last resort, the central bank can act either by standing ready to increase the liquidity of the banking system as a whole whenever there are signs of an impending system-wide liquidity crises or by providing support to individual banking institutions under pressure. Such support is often justified on the ground that the prevention of individual failures is necessary to avoid the contagion, through interbank credit exposures, of other institutions and the eruption of crises of confidence, which might potentially engulf large segments of the banking system.[77]

In a monetary union, support to individual banks may still be provided by the national central banks on a decentralized basis, but system-wide problems will require ECB intervention, because the injection of liquidity has direct implications for the single monetary policy. Furthermore, with increasing integration of banking markets and the emergence of very large cross-border groups, even in the case of individual banks the initiative for lending of last resort may have to rest with the ECB (assuming, of course, that similar operations are within its legal powers[78]) and conducted on the account of the ESCB as a whole.[79] This can constitute an argument for giving supervisory responsibilities to the ESCB, because the information-gathering activities which are necessary for the enforcement of prudential standards overlap with the

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76. For the central bank, an operational benefit of acting as lender of last resort is that the commercial banking system becomes dependent on it for its liquidity.

77. In truth, however, lending of last resort may be used to bail-out insolvent institutions, under the pretext of providing "liquidity support." In this case, it constitutes a covert form of public safety-net and a source of moral hazard, similar to a system of comprehensive deposit insurance or outright rescue operations, since the expectation of public support in times of crisis creates incentives for banking institutions to increase risk-taking.

78. *See infra* Part III.

79. *See* Dirk Schoenmaker, *Banking Supervision in Stage Three of EMU*, at 11-13 (Financial Markets Group, London School of Economics Special Paper No. 72, June 1995) [hereinafter *Banking Supervision*].

assessment of financial soundness for the purpose of deciding whether or not to extend credit to particular institutions.

It is significant, in this context, to draw a clear distinction between lending of last resort to the market as a whole and support for individual institutions. It is only the latter type of intervention which requires individualized screening of applicants for central bank credit, and thus raises directly issues of moral hazard. Similar concerns do not arise with the same force where a central bank refrains from providing support to individual institutions. In principle, the monetary authority could refuse to lend on an individual basis and act as lender of last resort only to the banking system as a whole, when it appears to face a generalized liquidity crisis. A crisis of this type could make necessary a rapid liquidation of bank assets at distressed prices, thus triggering a deflationary spiral, where the attempt of banks to dispose of their assets immediately and simultaneously would in itself magnify the initial fall in prices, eventually driving otherwise sound banks to insolvency. As a liquidity crisis has important implications not for the survival of the banking system but also for the economy's stock of money, the intervention of the central bank in this case would constitute in essence a monetary operation. Its purpose would be to counteract the monetary contraction caused by a provisional fall in asset prices, caused by a shift to base money, until normal conditions are restored. The role of the central bank as lender of last resort in this context would simply involve indiscriminate lending to the market as a whole and the accommodation of the temporary liquidity pressures through open-market or discount operations, without need for screening the soundness of individual borrowers.[80] Accordingly, the function of the lender of last resort could be undertaken quite independently of any prudential responsibility. The only real issue in this case would be whether, in view of the prevailing monetary circumstances of the moment, a temporary expansionary intervention of the central bank is compatible with the main long-term objective of price stability.

To answer this question, however, the central bank must be able to discriminate between a temporary liquidity problem and a permanent decline of asset prices, due to a reassessment of their fundamental value. If it mistakes the latter for the former and is led to provide lending of last resort, its actions may contribute to the overexpansion of the monetary supply and create inflationary pressures in the economy, while the

80. *See* Marvin Goodfriend & Robert G. King, *Financial Deregulation, Monetary Policy, and Central Banking*, 74**:**3 FED. RES. B. RICHMOND ECON. REV. 3 (May-June 1988).

concentration of assets of questionable long-term value at its hands as collateral for its lending may even force it to absorb part of the financial system's losses. Some authors argue that, given the high potential costs of the lack of relevant information, the attribution to the central bank of supervisory powers would increase the efficiency of the lender of last resort function.[81] In a European context, in particular, the ECB needs such powers because without them the national authorities may exploit their own superior information and misrepresent the true state of their domestic banking system, emphasizing potential threats to the stability of the financial system in order to put pressure on the ECB to provide lending of last resort facilities in inappropriate cases.[82]

While this may be a valid reason for giving to the ECB full access to the supervisory information gathered by the national competent authorities, it does not necessarily support a direct regulatory and supervisory role for the ECB. Moreover, it is questionable whether, in order to discriminate between true liquidity crises and fundamental shifts in asset values, a central bank must have recourse to privileged supervisory information relating to the situation of individual banking institutions. The type of information required for this purpose relates primarily to the evaluation of the aggregate situation of the financial markets, which probably can be carried out on the basis of statistical information. More importantly, the combination of monetary and supervisory responsibilities in the central bank may create incentives for neglecting price stability and misusing lending of last resort as a means of supporting the banking system and avoiding failures, which might reflect badly on the central bank as regulator.[83]

A more clear-cut case for the involvement of the ESCB (or at least of the national central banks which compose it) with prudential issues can be made in the context of the operation of European payment systems. For the completion of the single market and the achievement of the attendant efficiency gains, the reform and integration of national payment systems is required. In this context, considerations of competitive equality and efficient operation dictate the need for consistent rules governing matters such as conditions of access to clearing and settlement systems, legal arrangements, technical standards, working hours, pricing of central bank services and, last but not least, risk

81. *See* ALBERTO GIOVANNINI, THE DEBATE ON MONEY IN EUROPE 358-61 (1995).
82. *See id.* at 360.
83. *See* Vives, *supra* note 60, at 527-28.

management policies.[84] The devise of such rules comes naturally within the field of interest of the central banking authorities which operate the payment systems.

At the same time, the active involvement of national central banks in the provision of settlement services necessitates that they screen individual participants, set credit limits, impose collateral requirements, take corrective action, investigate irregularities, etc. It will need privileged information, often within minutes, in which case the possibility of cooperation with national central banks will be narrowly limited. It can obtain such information only through supervision. As the relevant decisions must be taken within a very short time frame and require privileged information, central bank supervision of the payment system participants becomes unavoidable.

The potential introduction of an integrated European-wide payment system, managed at the centre by the ECB, would imply similar functions for the ECB itself.[85] However, the pan-European large-value payment system for the third stage of EMU, the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system, which is currently designed by the EMI and the national central banks of the Member States,[86] does not appear to require a direct supervisory role for the ECB because the system will be decentralized, with membership confined at a national level and the ECB providing only the interlinking between the national components.

At any rate, to the extent that participation to the payment system provides significant commercial benefits to the members, a central bank may not need to resort to legal regulation and administrative supervision. It can instead use its contractual capacity to ensure that the members accept conditions of access which combine a high degree of safety and efficiency.[87]

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84. *See* COMMITTEE OF GOVERNORS, AD-HOC WORKING GROUP ON EC PAYMENT SYSTEMS, ISSUES OF COMMON CONCERN TO EC CENTRAL BANKS IN THE FIELD OF PAYMENT SYSTEMS (May 1992).

85. *See* GIOVANNINI, *supra* note 81, at 361-62; Paolo Angelini & Franco Passacantando, *Central Banks' Role in the Payment System and its Relationship with Banking Supervision*, 51 GIORNALE DEGLI ECONOMISTI E ANNALI DI ECONOMIA 453, 475-81 (1992).

86. *See infra* note 148.

87. *See* Angelini & Passacantando, *supra* note 85, at 479. For an example of the ways in which a central bank can apply its contractual capacity to control the behavior of its counterparties, see HADJIEMMANUIL, *supra* note 37, ch. 4.

III. THE FUNCTIONS OF THE ESCB IN THE FIELD OF PRUDENTIAL SUPERVISION AND BANKING POLICY UNDER THE MAASTRICHT TREATY

Turning from the policy arguments to the positive legal situation, it becomes evident that, although the EC Treaty assigns to the ECB and ESCB certain competences in the field of banking policy, including prudential supervision, it does so only reluctantly and subject to considerable limitations.

The original proposals for Economic and Monetary Union in the Delors Committee Report envisaged that, as part of its mandate and functions, the Community's future monetary institution, the European System of Central Banks, "would participate in the coordination of banking supervision policies of the supervisory authorities,"[88] but did not specify in greater detail its role in this area. It was the Committee of Central Bank Governors[89] which pressed for the inclusion in the Treaty of specific provisions for this purpose. In its draft statute for a future European central bank, forming the basis of the statute of the ESCB in the Maastricht text,[90] the Committee of Governors placed prudential control within the basic tasks of the new monetary institution,[91] and provided for specific prudential functions to be conferred to the ESCB. Not only should the ECSB be consulted on new prudential legislation, but it should also be given independent decision-making responsibilities.[92] The

88. Delors Committee Report, *supra* note 3, point 32.

89. The Committee of Governors of the central banks of the Member States was formed in 1964, as a forum for cooperation between the central banks of the Member States. *See* Council Decision 64/300 on International Monetary Relations Cooperation, 1964 J.O. 1206. With the establishment of the European Monetary Mechanism in 1979, the Committee of Governors acquired new responsibilities, in particular in the management of the ERM. At the beginning of the first stage of EMU on July 1, 1990, the responsibilities of the Committee of Governors were strengthened, in order to ensure the coordination of monetary policies in the Member State for the purpose of promoting price stability. *See* Council Decision 90/142, 1990 O.J. (L 78) 25, amending the 1964 Decision. At the start of the second stage on January 1, 1994, the Committee of Governors was dissolved and replaced by the transitional monetary institution, the EMI, whose responsibilities are set out in the EC Treaty, art. 109f, and the Statute of the EMI.

90. *See* CORBETT, *supra* note 1, at 13; Italianer, *supra* note 1, at 65.

91. *See* Committee of Governors, *Draft Statute of the European System of Central Banks and of the European Central Bank* (draft of Nov. 27, 1990), art. 3.1, second indent.

92. Italianer attributes to the special position of the Committee of Governors (which was not merely a contributor to the preparation of the Intergovernmental Conference but also an interested party) the inclusion in its draft Statute of

> some provisions which gave particular emphasis to the responsibilities of the ESCB and the ECB. Examples are the relative autonomy created in the field of exchange rate policy, the role foreseen for the ESCB in the field of prudential supervision and the requirement that coins be put into circulation by the ECB

Commission endorsed the Committee of Governors' approach, including prudential supervision as one of the tasks of the proposed "Eurofed" in its draft treaty on economic and monetary union.[93]

In the course of the Intergovernmental Conference on EMU, the Committee of Governors explained that its draft provisions relating to prudential supervision

> were introduced into the Statutes with three considerations in mind. Firstly, the System, even though operating strictly at the macro-economic level, will have a broad oversight of developments in financial markets and institutions and, therefore, should possess a detailed working knowledge which would be of value to the exercise of supervisory functions. Secondly, the ESCB's primary objective of price stability will be supported by the stability and soundness of the banking system in the Community as it evolves. Thirdly, measures to deal with fragility or disturbance in the banking system must take account of their effect on monetary objectives and policies.[94]

In other words, in the Governors' view the ESCB should be given a prudential role for three reasons. First, because of its privileged vantage point as a central bank, facilitating effective information-gathering. Second, because of the long-term complementarity of its monetary tasks with the aim of banking stability. Third, because of the need for coordination of the instruments employed for the avoidance of financial fragility and crises with the objective of price stability.

> and/or the national central banks. No related articles survived unchanged in the final text. However, the main thrust of the Committee's draft was maintained.

See Italianer, *supra* note 1, at 65.

93. See Commission of the European Communities, Proposal for a Draft Treaty Amending the Treaty Establishing the European Economic Community with a View to Achieving Economic and Monetary Union (Aug. 21, 1990). Paragraph three of the Explanatory Memorandum underlies the close affinity of the Commission's own views with the Governors' draft statute; draft art. 106b(1)(vii) provides that one of Eurofed's tasks should be "to participate as necessary in the formulation, coordination and execution of policies relating to banking supervision and the stability of the financial system." Draft arts. 106b(3) and 109e(2) recognize specifically the Eurofed's advisory role regarding any draft Community or national legislation or proposed international agreement on prudential supervision and banking or financial matters.

94. Letter of the President of the Committee of Governors to the President of the Intergovernmental Conference on EMU concerning the Statute of the ESCB and the ECB, dated Sept. 2, 1991, Doc. CONF/EMU 1617/91, Sept. 5, 1991, pt. II, "Prudential Supervision" at 4-5.

This assessment was not endorsed by all Member States. There were wide differences of opinion between them on this point, explicable by a variety reasons, such as: the lack of a common concept of prudential supervision and of a consistent approach to the institutional organization of the responsibilities for prudential policy; different expectations concerning the viability of the Second Banking Directive's system of supervision on a cross-border basis by the competent authorities coupled with national discretion in the organization of prudential responsibilities, which at the time of the Intergovernmental Conference had not yet been tested in practice; the reluctance of certain Member States to countenance the transferal of supervisory competences to the Community; and fears of concentrating excessive power at the hands of an independent ESCB.[95] The draft provisions presented by the French Government confined the ESCB to purely monetary functions and did not envisage any participation in the exercise of prudential control.[96] Germany, following domestically the separate system, was also reluctant to accept a significant prudential function for the new monetary institution, for fear that this might lead to conflicts of policies and weaken its resolve to pursue its primary objective of price stability. During the Intergovernmental Conference, the relevant provisions appeared for some time in the text of the draft statute of the ESCB within brackets.[97]

The Intergovernmental Conference failed to reach agreement on the principles that might guide the allocation of supervisory responsibilities in the monetary union between the Community and the national levels ("vertical" allocation) and between different institutions (central banks or other agencies) at each level ("horizontal" allocation), or on the precise role that the ESCB might play in this area.[98]

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95. *See* WORKING GROUP OF THE ECU INSTITUTE, *supra* note 67, at 14, 42; LASTRA, *supra* note 69, at 241-42; KENEN, *supra* note 59, at 34.

96. French Government, *Proposal for a Draft Treaty on Economic and Monetary Union* (Jan. 1991). Even with regard to advisory functions, the French draft confined the ESCB's consultative function to draft legislation or international agreements "having implications for the Community's monetary policy," but not for measures relating to prudential supervision or general banking and financial policy. *See id.* art. 2-4(4). On the other hand, the French draft left open the possibility that additional functions could be delegated to the ESCB by unanimous decision of the Council. *See id.* arts. 2-4(2), 7th indent, & 5-7(2).

97. *See* Jean-Victor Louis, *L'Union Economique et Monetaire*, 6 COMMENTAIRE MEGRET: LE DROIT DE LA CEE 1, 92 (2d. ed. 1995).

98. In fact, several practical issues were ignored in the negotiations, in an attempt to facilitate agreement on principle on EMU. Tim Congdon, *Problems That Were Neglected at Maastricht*, 3:1 CENTRAL BANKING 54 (Summer 1992), claims that the neglect of the operational aspects of monetary and banking policies in the third stage was so thorough as to raise basic questions about the viability of the whole project. Instead, the discussions focused on the

Although the references to a prudential role for the ESCB were not eliminated altogether from the final text, the drafting of the relevant provisions of the EC Treaty and the Statute of the ESCB is characterized by considerable imprecision and a limiting spirit.[99] Instead of figuring among the basic tasks of the ESCB,[100] prudential supervision is treated as a separate, supplementary function.[101] More importantly, the wording of the relevant provisions is significantly different from the Committee of Governors' draft. The Governors had envisaged that it would be the ESCB's task "to participate as necessary in the formulation, coordination and execution of policies relating to prudential supervision and the stability of the financial system." In the final text, however, it is only a matter of the ESCB's "contribution" to "the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."[102]

The provisions do not clarify the nature of the expected involvement in prudential matters. Should the ECB concentrate on purely advisory, facilitative or coordinating tasks, or may it exercise independent functions in connection to policy or rule-making? May it be involved in the implementation of prudential policy and exercise direct supervisory functions in connection to individual institutions? Nor is any attempt made to define the content and outer limits of the supervisory function. Conceivably, this could include, beyond prudential regulation *stricto sensu* (encompassing the adoption of standards of financial soundness for individual institutions and their enforcement through licensing, continuous supervision and the imposition of sanctions), conduct-of-business regulation, the lender of last resort function, the operation of

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conditions for the acceptance of Member States to the third stage and on the question whether the ESCB should be created from the start of the second stage or whether a transitional monetary institution, the EMI, should be used during the second stage. *See* Bini-Smaghi et al., *supra* note 1.

99. *See* Louis, *supra* note 97, at 92-94.

100. *See* Committee of Governors, *supra* note 91, draft art. 3.1, second indent.

101. *See* EC TREATY art. 105(5); ESCB Protocol, *supra* note 2, art. 3.3.

102. The specific provisions of Article 25 of the Committee of Governors' draft statute were incorporated in the final Treaty text with similar changes. While the draft statute envisaged that the ECB would be "entitled to offer advise and to be consulted" on the interpretation and implementation of EC legislation on prudential matters, Art. 25.1 of the Statute of the ESCB provides that it "may" do so. Furthermore, while the draft statute stated that the ECB would "formulate, interpret and implement policies relating to the prudential supervision of credit and other financial institutions for which it is designated as competent supervisory authority," Art. 25.2 of the Statute of the ESCB provides, instead, a procedure for the attribution by unanimous decision of the Council to the ECB of specific supervisory tasks and excludes insurance undertakings from the range of institutions in connection with which such tasks may be attributed.

payment systems, and the organization of deposit insurance, since all of them are of potential relevance for the stability of the financial system.

Any imprecision in this area can be the source of particular legal difficulties, especially since the competence of the ESCB in matters of banking (as opposed to monetary) policy is neither complete nor exclusive. It is on the basis of the relevant Treaty provisions that the regulatory competence of the ESCB must be determined, the legitimacy of its potential interventions judged, and lines drawn, both horizontally and vertically, between its powers and those of other Community and national bodies with related legislative and administrative competencies. These provisions, however, provide only tentative guidance as to the level and type of action that the ESCB and the ECB can undertake.

A. Advisory Functions

The clearest direction in the Maastricht Treaty is given in connection to the advisory functions that the ECB is called to perform. The ECB must be consulted on any proposed Community act (regulation, directive, decision or recommendation or opinion) within its field of competence.[103] It must also be consulted by the Member States on domestic legislation falling within its fields of competence, but in this case the requirement of consultation is subject to limits and conditions set out by the Council.[104] In addition to its consultative role in the legislative process, the ECB may submit opinions to the appropriate Community institutions or bodies and to the national authorities on any matter within its field of competence.[105] This power allows the ECB to influence the performance of the administrative tasks of these bodies but also, conceivably, to take the initiative itself for changes in the law.

To the extent that prudential supervision is one of its fields of competence,[106] these provisions could in themselves justify a consultative or advisory role for the ECB in relation to legislation and other aspects of the prudential supervision of banks or the stability of the financial system. A more explicit basis for the consultation of the ECB

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103. *See* EC TREATY art. 105(4), first indent; ESCB Protocol, *supra* note 2, art. 4(a), first indent.

104. *See* EC TREATY art. 105(4), second indent; ESCB Protocol, *supra* note 2, art. 4(a), second indent. The Council must reach its decision by qualified majority, either on a proposal by the Commission, in which case it must first consult the European Parliament, or on a recommendation from the ECB itself, in which case it must consult both the European Parliament and the Commission. *See* EC TREATY art. 106(6); ESCB Protocol, *supra* note 2, art. 42.

105. *See* EC TREATY art. 105(4); ESCB Protocol, *supra* note 2, art. 4(b).

106. *See* EC TREATY art. 105(5), ESCB Protocol, *supra* note 2, art. 3.3.

by the institutions of the Community and the competent authorities of the Member States in matters relating to the prudential supervision of credit institutions and to the stability of the financial system is provided by Article 25.1 of the Statute of the ESCB, but only insofar as the question concerns specifically the scope or implementation of Community (but not national) legislation in this field.[107]

During the second stage of EMU, the EMI exercises analogous consultative functions in relation to Community and national legislation within its more limited field of competence, including prudential regulation.[108] In line with the arrangements for the third stage, the relevant provisions require that the limits and conditions of the EMI's consultative role in relation to legislative activities at national level be set out by the Council. For this purpose, shortly before the establishment of the EMI, the Council, acting on a proposal of the Commission and after consultation with the Parliament and the Committee of Governors adopted a decision[109] which could, in the future, serve as a basis for the decision governing the consultation of the ECB.

Reflecting the formulation used in the Maastricht Treaty to describe the EMI's consultative tasks in the field of prudential policy,[110] the Council Decision recognizes "rules applicable to financial institutions in so far as they influence the stability of financial institutions and markets" to be within the EMI's field of competence.[111] The Council Decision confines the meaning of "draft legislative provisions," regarding

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107. Conceivably, one might argue that the limited and derivative responsibility of the ESCB to contribute to the conduct of prudential policies in accordance to Art. 105(5) of the EC Treaty does not constitute "a field of competence." On this assumption, Art. 105(4) could not provide a basis for the ECB's advisory role on questions of a prudential nature. Accordingly, Art. 25.1 of the Statute of the ESCB would need to be interpreted in the context of Art. 105(5) of the EC Treaty, and not as a specific instance of the general advisory functions of Art. 105(4). In this case, the ECB's advisory role in this field would be confined by the express terms of Art. 25.1 to issues concerning the enactment and implementation of legislative measures reached at the Community level, leaving outside purely national legislation and all nonlegislative matters of a prudential nature. *See* Priesemann, *supra* note 73, at 12. Significantly, although the general provisions of Art. 105(4) of the EC Treaty and Art. 4 of the Statute of the ESCB requiring the consultation of the ECB on draft legislation shall not apply to the United Kingdom if it does participate in the third stage of EMU, Art. 25.1 is not covered by the United Kingdom's "opt-out" and will apply automatically. *See* Protocol on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland, *supra* note 7, arts. 5, 8.

108. *See* EC TREATY art. 109f(6); EMI Protocol, *supra* note 2, art. 5.3.

109. Council Decision 93/717 on the Consultation of the European Monetary Institute by the Authorities of the Member States on Draft Legislative Provisions.

110. *See* EC TREATY art. 109f(2), fourth indent; EMI Protocol, *supra* note 2, art. 4.1, fourth indent.

111. Council Decision 93/717, *supra* note 109, art. 1(1), fifth indent.

which consultation is obligatory, to legally binding measures of a general character (that is, rules for an indefinite number of cases and addressed to an indefinite number of persons), excluding rules of local applicability only.[112] Measures consisting merely in the national implementation of Community directives are excluded from the requirement of consultation, because the relevant rules have already been the subject of consultation at the time of their adoption at Community level.[113] To guarantee that the consultation is not a mere formality, the decision requires that the Member States ensure that

> the EMI is consulted at an appropriate stage enabling the authority initiating the draft legislative provision to have the EMI's opinion before taking its decision on the substance and that the opinion received by the EMI is brought to the knowledge of the adopting authority if the latter is an authority other than that which has prepared the legislative provisions concerned.[114]

Except in cases of extreme urgency, the EMI must be given at least one month to submit its opinion.[115]

In its first two years of operation, the EMI received thirty requests for consultation, nine of which originated from the Council and twenty-one from national authorities; three of the requests by the Council and eight by the national authorities involved matters of prudential interest. While the primary criterion used by the EMI for assessing the proposed legislative measures was their compatibility with the EC Treaty, their potential impact on the arrangements for the third stage of EMU and their effect on the stability of financial institutions and markets were also taken into account.[116]

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112. *See id.* art. 2(1).

113. *See id.* art. 2(2). This guarantees the discretion of Member States to choose the form and method of implementation when this type of Community legislation is used. *See* EC TREATY art. 189.

114. *Id.* art. 3.

115. *See id.* art. 4.

116. *See* ANNUAL REPORT 1994, *supra* note 21, at 96-97; ANNUAL REPORT 1995, *supra* note 21, at 79. In particular, the requests by the Council concerned: (1) an amendment of the Solvency Ratio Directive, for the purpose of accepting various forms of (bilateral) contractual netting; (2) an amendment of the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS); and (3) a draft directive on investors' compensation schemes.

B. Direct Prudential Tasks: Rule-Making Role, Administrative Decision-Making Functions or a Facilitative and Coordinating Role Only?

The position regarding the direct regulatory responsibilities of the ESCB in the field of prudential supervision is much less clear than that regarding its advisory functions. The Maastricht Treaty does not contemplate a general transfer of competence to the ESCB in this field in the third stage of EMU. Instead, the responsibility for prudential supervision may remain within the hands of the competent authorities at the national level, in accordance with current secondary EC banking legislation. Although the national central banks may exercise specific supervisory functions, they may do so only in their capacity as national authorities under domestic law, not as part of the ESCB.[117]

Nonetheless, the Maastricht Treaty does not exclude altogether a role for the ESCB per se in matters relating to prudential supervision. In fact, the ESCB is required to "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."[118] During the second stage of EMU, a limited consultative role with regard to matters "within the competence of the national central bank and affecting the stability of financial institutions and markets" is given to the EMI as one of its primary tasks.[119]

The role of the ESCB under the provision quoted above can be described as consultative and coordinating. It is clear that the ECB is not intended to replace the competent authorities, but only to assist in the performance of their functions. It is less evident whether the ESCB can resort to formal rule-making or decision-making for this purpose.[120]

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117. The national central banks are an integral part of the ESCB and must act in accordance with the guidelines and instructions of the ECB. *See* ESCB Protocol, *supra* note 2, art. 14.3. Nevertheless, they may perform additional functions on their own account and under domestic law, although the Governing Council of the ECB has a reserve power to divest them of these functions if it decides, by a majority of two-thirds of the votes cast, that these functions are incompatible with the performance of the responsibilities of the ESCB. *See id.* art. 14.4.

118. EC TREATY art. 105(5); ESCB Protocol, *supra* note 2, art. 3.3.

119. EC TREATY art. 109f(2), fourth indent; ESCB Protocol, *supra* note 2, art. 4.1, fourth indent. On this basis, the EMI held consulations in 1995 among supervisory authorities on a number of issues, including credit risk management, central credit registers, and internal control systems, the public disclosure of derivatives activities, and some aspects related to implementation of home country control. *See* ANNUAL REPORT 1995, *supra* note 21, at 74-76.

120. Certain authors distinguish between an agreed minimum interpretation of the provision and a bolder, more controversial one. *See, e.g.*, WORKING GROUP OF THE ECU INSTITUTE, *supra* note 67, at 45, 54; Priesemann, *supra* note 73, at 10-11. The former interpretation holds that the

Another very restrictive possibility, supported by the fact that the provision does not apply to those Member States which do not participate in the third stage of EMU (either, in the case of UK and Denmark, because of their specific right to opt-out or because of their inability to meet the convergence criteria),[121] is that the ESCB must contribute to the smooth conduct of prudential policies in the monetary union by factoring the likely impact of its monetary operations on these policies in its monetary decision-making, rather than by playing a direct part in the conduct of banking policy.

The Maastricht Treaty also leaves open the prospect that the ECB might be entrusted with specific tasks concerning supervisory policies by providing that the Ecofin Council

> may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.[122]

This enabling clause makes it possible—although, in view of the substantial procedural difficulties, not very probable—for the ECB to acquire direct pan-European supervisory powers. The specific tasks must "concern" prudential supervisory policies, but it is not absolutely clear whether this may include the conduct of first-line supervisory functions over individual financial institutions. It is more likely that the provision envisages the conferring of specific aspects of supervisory policy and rule-making. This is supported by the fact that the ECB is specifically authorized to issue regulations, that is, legal acts of general and direct

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drafters' intention was only to involve the ESCB in prudential policy-making in a consultative capacity, while the latter would also see a role for the ESCB in encouraging the adoption of new prudential rules and policies and taking action to ensure the proper implementation of the common framework of banking supervisory standards in the day-to-day practice of supervisory agencies. The wider interpretation emphasizes that Article 105(5) of the EC Treaty gives to the ESCB a coordinating role in prudential matters, rather than a consultative one, which is the focus of Article 25.1 of the Statute of the ESCB. It also discovers in the wording of the provision a flexibility appropriate for an expansive, teleological application, evolving over time in pace with the experiences of the single market and the monetary union.

121. *See* EC TREATY art. 109k(3); ESCB Protocol, *supra* note 2, art. 43.1; Protocol on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland, *supra* note 7, arts. 4, 8. At any rate, the exclusion of these countries reduces considerably the ability of the ESCB to coordinate prudential supervision in a pan-European manner.

122. EC TREATY art. 105(6); *see also* ESCB Protocol, *supra* note 2, art. 25.2.

application, for the purposes of implementing the prudential tasks that may be transferred to it.[123] According to certain interpretations, however, the provision aims to ensure the ability of the ECB to exercise supervisory duties *stricto sensu* in the event that the development of multinational financial institutions undermines the effectiveness of supervision by the national competent authorities. Accordingly, a potential delegation of tasks would confer on the ECB both rule-making powers and direct supervisory responsibilities regarding monitoring and enforcement.[124]

For the purposes of any supervisory responsibilities, the ECB may have resort to its general power to collect (through the national central banks) statistical information, either from the competent national authorities or directly from the private sector.[125] It is for the Ecofin Council to define, by qualified majority, the exact scope of the reporting requirements, including the natural and legal persons subject to them, the confidentiality regime and the means of enforcement.[126] In all cases, a duty of professional secrecy applies to all information collected by the ECB and the national central banks in the performance of their functions, including those relating to prudential supervision,[127] in line with the similar obligations imposed by secondary EC law on national competent authorities.[128]

C. Substantive Scope of the ESCB's Prudential Functions

Significantly, to define the limits of the ESCB's competence in matters of banking regulation, the Maastricht Treaty relies on the concept of prudential supervision, without specifying further what this means. The use of the words "prudential supervision of credit institutions" in immediate conjunction with "the stability of the financial system"[129] leaves no doubt that the ECB's interventions in this field may be guided by concerns of both microprudential and macroprudential nature. On the

123. *See* EC TREATY art. 108a; ESCB Protocol, *supra* note 2, art. 34. However, the same provisions give to the ECB a general power to make decisions, that is, measures binding only upon those to whom they are addressed, whenever this is necessary for carrying out any of its tasks, and also to impose fines or periodic penalty payments on undertakings which fail to comply with its regulations and decisions.

124. *See* Harden, *supra* note 23, at 161.

125. *See* ESCB Protocol, *supra* note 2, art. 4(1)-(2).

126. *See id.* arts. 5.4 & 42.

127. *See id.* art. 38. However, the duty of secrecy is not precisely defined in the relevant provision of the Statute and requires further specification for its enforcement.

128. *See* First Banking Directive, *supra* note 26, art. 12, as substituted by art. 4 of the Second Banking Directive, *supra* note 40, and subsequently amended by art. 4 of Directive 95/26.

129. EC TREATY art. 105(5); ESCB Protocol, *supra* note 2, arts. 3.3, 25.1.

other hand, it is not clear what the outer boundaries of the supervisory function are in an exact legal sense.

The potential attribution of direct discretionary powers to the ECB for the performance of specific regulatory tasks[130] makes the lack of a precise definition particularly unfortunate. An expansive notion of prudential supervision may potentially be used as a tool for an unjustified concentration of administrative powers in the hands of the ECB. It may also result in a confused horizontal and vertical allocation of responsibilities for banking policy, with overlapping competencies and a proliferation of jurisdictional disputes.

It could be argued, for instance, that the words "prudential supervision" are meant to cover, in addition to the definition and implementation of prudential standards intended to prevent failures of financial institutions, policies relating to deposit insurance, rules of market organization or conduct-of-business rules, the regulation of payment systems, and lending of last resort. Although all these aspects of banking policy are more or less interdependent,[131] to answer the questions concerning the constitutional limits of the ESCB's attributed powers it becomes necessary to draw the conceptual lines between them.

Existing secondary Community law can provide only limited assistance regarding the boundaries of prudential supervision for the purposes of the provisions of the Maastricht Treaty. This applies to the Second Banking Directive and the Investment Services Directive, which established the framework for the mutual recognition of the licensing and prudential supervision systems of the Member States.[132] It is clear from the harmonized prudential rules that prudential supervision focuses on the financial soundness and, in particular, the solvency of financial institutions, the fitness of their owners and senior managers and the existence of appropriate internal administrative and accounting systems and controls, ensuring effective managerial control over their activities.

As one moves beyond these core aspects of prudential supervision, a degree of confusion appears to prevail regarding the

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130. *See* EC TREATY art. 105(6); ESCB Protocol, *supra* note 2, art. 25.2.

131. In certain ways, they also form a continuum with monetary policy. It has been shown already that this is the case with the lender of last resort function. Similarly, minimum reserve requirements are an instrument of monetary policy, but they also have an impact on the liquidity of banks and thus on their prudential situation. *Cf.* art. 19 of the Statute of the ESCB (conferring on the ECB the power to impose minimum reserve requirements).

132. *See* Second Banking Directive, *supra* note 40, pmbl. recital 4; Investment Services Directive, *supra* note 52, pmbl. recital 3.

classification of regulatory standards as prudential or otherwise. Thus, many commentators classify the provisions of the Second Banking Directive by virtue of which certain matters are specifically reserved for the authorities of the host Member State as "exceptions" to the principle of home country control.[133] These so-called "exceptions" include, beyond the supervision of liquidity, which is clearly a prudential matter,[134] the implementation of monetary policy,[135] statistical return requirements[136] and rules adopted in the interest of the general good.[137] It is very questionable whether such matters are indeed of prudential nature, which in the absence of express reservation for the host Member State would be the responsibility of the home country.[138]

It is true that the directives appear in certain cases to treat all regulatory measures as essentially prudential. For instance, the Investment Services Directive assumes in its Preamble an intrinsic link of rules adopted in the interest of general good with the objective of systemic stability—a fundamental prudential concern—stating that

> the stability and sound operation of the financial system and the protection of investors presuppose that a host Member State has the right and responsibility both to prevent and to penalize any action within its territory by investment firms contrary to the rules of conduct and other legal or regulatory provisions it has adopted in the interest of the general good and to take action in emergencies.[139]

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133. *Cf.* Second Banking Directive, *supra* note 40, art. 13(1).

134. It should be noted that the reason for maintaining host country regulatory powers in matters of liquidity is that this aspect of prudential supervision is closely linked to the conduct of monetary policy. With the introduction of a single currency and a common monetary policy in the third stage of EMU, the need for special treatment will vanish.

135. *See* Second Banking Directive, *supra* note 40, art. 14(2).

136. *See id.* art. 21(1).

137. *See id.* art. 21(5).

138. Indeed, even if they were not expressly reserved for the host Member State, they might still be within its competence, since the principle of home country control should apply only to the prudential supervision of credit institutions and investment firms. *See id.* art. 13(1). *Compare* Investment Services Directive, *supra* note 52, pmbl. recitals 2, 3 *with id.*, pmbl. recitals 33, 39. In the earlier recitals of the Investment Services Directive' Preamble the mutual recognition of authorization is linked to the mutual recognition of prudential supervision systems. This, however, does not seem to affect the operation of host Member State laws and regulations adopted for the protection of the general good or for purposes of market organization. Such regulations appear, accordingly, to consist in independent systems of rules outside the scope of prudential supervision.

139. Investment Services Directive, *supra* note 52, pmbl. recital 41.

On the other hand, in its operative provisions, the same directive draws a sharp distinction between the prudential supervision of nonbank financial institutions, which is a matter for home country control,[140] and conduct-of-business rules, which are applied by a Member State to all firms operating in its markets, including incoming institutions authorized and supervised by another Member State.[141] Although the classification of particular matters under each of the two general categories displays a lack of conceptual coherence and the influence of political compromises, it is significant that the Investment Services Directive entrenches a clear distinction between them as a matter of secondary Community law.

It should, indeed, be recognized that the various rules of market organization and conduct-of-business rules are concerned primarily with the fairness of individual transactions and the orderly conduct of financial markets but neither fall within the concept of prudential supervision nor concern the stability of the financial system as a whole and are, accordingly, outside the field of competence of the ESCB. On the other hand, questions concerning deposit insurance, the operation of payment systems, and lending of last resort can have major implications for the stability of the financial system, which might justify a degree of involvement of the ESCB in support of the policies of the competent national authorities in these areas or in an advisory capacity.[142] Furthermore, in the case of the lender of last resort function, the responsibility will invariably belong to the national central bank of each Member State, subject possibly to the consent of the government in the case of individual rescue operations.

Nevertheless, insofar as the operation of payment systems is concerned, the ESCB does not need to rely on the ambiguous and limiting provisions concerning its supervisory competency because the Maastricht Treaty contains special provisions giving it jurisdiction in this field. Likewise, its involvement in lending of last resort activities does not depend primarily on the question concerning regulatory competence but on the ability of the ECB and the national central banks to apply their financial resources for this purpose, although it should be asked whether the relevant operations are conducted under the authority and on account of the ESCB or by the individual national central banks as domestic institutions.

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140. *See id.* art. 10.

141. *See id.* art. 11.

142. *See, e.g.*, EC TREATY arts. 105(4), 105(5); ESCB Protocol, *supra* note 2, arts. 3.3, 4, 25.1.

As might be expected, the Maastricht Treaty does not recognize explicitly the ESCB's role as lender of last resort, since this could create moral hazard. However, it gives to the ECB and the national central banks the power to conduct credit operations with credit institutions and other market participants as a means of furthering the ESCB's objectives.[143] The ECB is required to establish general principles for the credit operations conducted by itself or by the national central banks.[144] Although such operations will in most cases constitute an instrument for achieving the ESCB's primary objective of price stability, they can also be relied upon for the purpose of supplying liquidity to the banking system and for the conduct of rescue operations. However, a major constraint on the use of the instrument is that any lending must be based on adequate collateral. A strict insistence on high-quality collateral would prevent in many cases the exercise of the lender of last resort function, because banks with a sufficient amount of high-quality, liquid collateral could sell it in the market and would not seek liquidity support from the central bank.[145] A relaxation of the rules of eligibility for paper used as collateral, on the other hand, beyond a certain point would constitute a breach of the EC Treaty by the ECB. The greatest contribution of the ESCB in terms of ensuring financial stability in the single market could concern the establishment and operation of efficient but safe payment and settlement systems. Indeed, the build-up of settlement and counterparty risks in the large-value payment and securities settlement systems can provide a major transmission mechanism for the spreading of bank failures, raising very important systemic concerns.

The Maastricht Treaty includes the promotion of the smooth operation of payment systems within the ESCB's (and, during the second

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143. *See* ESCB Protocol, *supra* note 2, art. 18.1, second indent.

144. *See id.* art. 18.2.

145. *See Banking Supervision*, *supra* note 79, at 7. In the opinion of the same author, if the ECB were to devise rules or guidelines for emergency assistance, these might include: (1) collateral requirements for lending of last resort operations and specification of eligible types of collateral, subject to overriding provisions for cases where the provision of liquidity appears necessary despite the absence of eligible collateral; (2) clear allocation of responsibilities for the decision to provide or withhold support to each institution, possibly on the basis of home central bank responsibility; and (3) methods for the coordination of the decisions and for taking into account the broader, supra-national implications of action or inaction. *See id.* at 8-11. As the national central banks may be overzealous in assisting their domestic banking system, even when there is no direct systemic impact, Schoenmaker discusses the possibility of giving a power of veto to the ECB, although he accepts that, to the extent that the potential costs of the operations are borne by the lending national central bank only, a degree of rivalry between the national central banks is acceptable. However, the rescue of clearly insolvent banks would constitute a competitive distortion and should not be permitted. *See id.*

stage, of the EMI's) basic tasks.[146] It also authorizes the ECB and the national central banks to provide facilities, and the ECB to issue regulations, for the purpose of ensuring efficient and sound clearing and payment systems, both within the Community and with third countries.[147] It is questionable whether this means that the ESCB can manage the payment systems directly, although in most Member States payment systems are run by the national central banks in their capacity as national authorities.

During the second stage of EMU, the EMI is given responsibility for promoting the efficiency of cross-border payments, in preparation for the third stage,[148] and for overseeing the functioning of the ECU clearing system.[149] Finally, there is cooperation between the national central

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146. *See* EC TREATY art. 105(2), fourth indent; ESCB Protocol, *supra* note 2, art. 3.1, third indent.

147. *See* ESCB Protocol, *supra* note 2, art. 22.

148. *See* EC TREATY art. 109f(3), fourth indent; EMI Protocol, *supra* note 2, art. 4.2, fourth indent. Although the EC Treaty does not distinguish between large-value and retail payments, the emphasis has been on large-value payments, which raise the main systemic concerns. Less attention has been devoted to retail payments and securities settlement systems. Analysis of the move to a single currency in connection to payment systems began under the aegis of the Committee of Governors in 1992 and was continued by the EMI, where a Working Group on EU Payment Systems, operating under the aegis of the EMI Council is responsible for coordinating central banks' initiatives in this area. *See* ANNUAL REPORT 1994, *supra* note 21, at 70. Work is already in progress with regard to establishing a large-value payment system for cross-border transactions in the area of the single currency. While today payment relations between EU countries rely on correspondent relationships between banks, it is planned that large-value payments within the EMU area should be effected through an integrated central-bank operated real-time gross payment system, which could ensure security, speed and efficiency. The EMI and the central banks of the Member States have adopted a strategy based on minimum harmonization of national systems and a common infrastructure that would allow them to implement new payment arrangements for the third stage, the TARGET system, based on the principles of efficiency, market-orientation and decentralization. While transactions related to monetary policy will have to be processed through TARGET, the execution of other payments through the proposed system will not be compulsory, and alternative large-value payment systems may remain in operation, provided that they meet equivalent safety standards. Other systems will also be used for retail payments. To achieve decentralization, infrastructures and payment systems will be maintained at the level of national central banks, rather than ECB level. *See* EUROPEAN MONETARY INSTITUTE, WORKING GROUP ON PAYMENT SYSTEMS, THE EMI'S INTENTIONS WITH REGARD TO CROSS-BORDER PAYMENTS IN STAGE THREE (November 1994); EUROPEAN MONETARY INSTITUTE, THE TARGET SYSTEM (TRANS-EUROPEAN AUTOMATED REAL-TIME GROSS SETTLEMENT EXPRESS TRANSFER SYSTEM): A PAYMENT SYSTEM ARRANGEMENT FOR STAGE THREE OF EMU) (May 1995); and ANNUAL REPORT 1995, *supra* note 21, at 61-63.

149. *See* EC TREATY art. 109f(2), third indent; EMI Protocol, *supra* note 2, art. 4.1, sixth indent. The EMI oversees the operation of the private ECU Clearing and Settlement System, which was set up in February 1986 and has been fully operational since April 1987, seeking to ensure that the ECU Banking Association, which manages the System, takes action to reduce substantially the level of systemic risks involved, consistently with risk-reduction policies pursued by the national central banks with regard to their domestic payments systems. *See* ANNUAL REPORT 1994, *supra* note 21, at 84-86; and ANNUAL REPORT 1995, *supra* note 21, at 73.

banks in this field within the EMI framework,[150] mainly concerning: the cooperative oversight of payment systems and the definition of minimum common features in domestic payment systems.[151]

IV. CONSTITUTIONAL CONCERNS CONCERNING THE ALLOCATION OF SUPERVISORY RESPONSIBILITIES TO THE ECB AND THE ESCB

A. The Question of Subsidiarity

Prudential supervision is evidently an area where the Community does not have exclusive competence and where, accordingly, it must respect the principle of subsidiarity.[152] The principle is enshrined in the Maastricht Treaty, which provides that:

> In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.[153]

This provision raises significant problems of interpretation, especially as it appears to introduce two different, and potentially conflicting, tests: a strict one based on the absolute necessity of the Community action for the sufficient performance of the relevant task and a less demanding one, based on the added value of that action. What is clear, however, is that an

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150. *See* EC TREATY art. 109f(2), first indent; EMI Protocol, *supra* note 2, art. 4.1, first indent.

151. *See* ANNUAL REPORT 1994, *supra* note 21, at 87-90; and ANNUAL REPORT 1995, *supra* note 21, at 70-72.

152. *See* EUROPEAN INSTITUTE OF PUBLIC ADMINISTRATION, SUBSIDIARITY: THE CHALLENGE OF CHANGE (1991) (reproducing the proceedings of the Jacques Delors Colloquium organized by the Institute, Mar. 21-22, 1991); Nicholas Emiliou, *Subsidiarity: An Effective Barrier Against the "Enterprises of Ambition"?*, 17 EUR. L. REV. 383 (1992); Deborah Z. Cass, *The Word That Saves Maastricht? The Principle of Subsidiarity and the Division of Powers within the European Community*, 29 COMMON MKT. L. REV. 1107 (1992). Cass notes the close relationship of the principle with federalist constitutional ideas and notes that the principle, rather than contributing to the decentralization of power, may in fact "lead to a transfer of power towards the Community, especially in view of there being a 'centralizing' and 'decentralizing' approach to its interpretation." *Id.* at 1108. For a hostile interpretation of the principle, which is said to be totally alien to the tradition of Community law as it evolved up to the Maastricht Treaty and incompatible with the process of gradual and purpose-oriented concentration of power to the Community institutions within the field of their attributed powers, which is inherent in the project of European integration, see A.G. Toth, *The Principle of Subsidiarity in the Maastricht Treat*y, 29 COMMON MKT. L. REV. 1079 (1992).

153. EC TREATY art. 3*a*, second paragraph (inserted by art. G(5) of the Maastricht Treaty).

action should not be taken at Community level if an equivalent result can be achieved by the Member States acting individually.[154]

Henning Christophersen, the former Vice-President of the Commission, has identified two sorts of circumstances in which the Community is better placed to act than the Member States: where there are cross-border spill-over effects giving rise to so-called externalities and where a policy function is characterized by economies of scale, allowing for efficiency gains when it is performed at a higher level of government.[155] "As it is a decentralist paradigm, subsidiarity requires both these circumstances to respect a degree of *proportionality*: it is only when independent national measures lead to significant externalities or fail to harvest considerable efficiency gains that competences should be transferred to the Community level."[156] The words "independent national measures" are significant in the present context: the mere decentralization of executive functions is not subsidiarity. Accordingly, the delegation by the ECB of particular actions to the national central banks, operating within the structure of the ESCB,[157] which exists at Community level, would not necessarily satisfy the requirements of subsidiarity, where this dictates action at national level, that is, national choice of the institutional means and substantive content of the action.[158]

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154. *See* Conclusions of the Edinburgh meeting of the European Council, Dec. 11-12, 1992, 1992 O.J. (C 348) 1, annex 1. With respect to the subsidiarity principle and Article 3*b* of the Treaty on European Union, the Council maintains that the principle permits action by the Community only "where an objective can better be attained at the level of the Community than at the level of the individual Member States" (value-added test) and only through means proportional to the objective pursued. *Id.* annex 1, ¶ 2(ii)-(iii). Renaud Dehousse claims that subsidiarity is an overrated concept, because the question is not one of allocating spheres of competence among different levels of government but of managing interdependence among overlapping areas of governmental action. Renaud Dehousse, *Does Subsidiarity Really Matter?*, EUR. PARL. DOC., Law 92/32 (Jan. 1993). In the opinion of Dehousse, even if the political value of the principle as a guideline in favor of decentralization is accepted, its direct utility as legal instrument is limited, especially because of the ambiguous drafting of the Treaty provision. *See id.* In contrast, José Palacio Gonzalez thinks that, while the principle is unsuitable for judicial review, due to its political content, it can play a significant role as a guiding principle for the relationships between the Community institutions and the Member States, providing for a division of powers consistent with a modern federal system. The principle sets the ground for a pre-federal pattern of organization of these relationships and as such is a factor conducive to integration. José Palacio Gonzalez, *The Principle of Subsidiarity (A Guide for Lawyers with a Particular Community Orientation)*, 20 EUR. L. REV. 355 (1995).

155. *Subsidiarity and Economic Monetary Union*, *in* EUROPEAN INSTITUTE OF PUBLIC ADMINISTRATION, *supra* note 152, at 67.

156. *Id.* (emphasis in the original).

157. In accordance with the requirement of decentralization of the ESCB's operations in the Statute of the ESCB, arts. 9.2 and 12.1, final paragraph.

158. *Cf.* WORKING GROUP OF THE ECU INSTITUTE, *supra* note 67, at 67-68 (finding little difference between subsidiarity and the requirement of decentralization). *See also* PADOA-SCHIOPPA, *supra* note 55, at 232, who notes that decentralization within the ESCB has sometimes

Any decision of the Council allocating specific tasks in the area of prudential supervision to the ECB,[159] aside of the procedural difficulties, should only be taken in the light of the principle of subsidiarity. The Council must be satisfied that the attribution of tasks to the ECB would present manifest advantages in comparison with action at the Member States level. This might be, for instance, the case if the emergence of large pan-European banking groups renders supervision by the authority of the home countries ineffective. In practice, it is doubtful whether considerations of subsidiarity could ever present an obstacle if the Council is willing to transfer responsibility to the ECB, since this would require unanimity and the unanimous consent of all Member States would render the question of subsidiarity purely academic. On the other hand, they could be precisely a factor preventing unanimous agreement. Assuming that the Council ever reaches a decision to confer responsibility, the principle might also be relevant in the exercise by the ECB of the transferred tasks. Conceivably, it can even play a role in relation to the type of contribution that the ECB can already make to the conduct of the supervisory policies directly under the Maastricht Treaty.[160]

B. Central Bank Independence and Prudential Responsibilities

The potential delegation to the ESCB of decision-making powers relating to the prudential supervision of financial institutions also raises significant questions of public control and accountability. This is a consequence of the ESCB's constitutionally guaranteed position of organic and functional independence.[161]

The principle of central bank independence is expressly enshrined in the Maastricht Treaty, which provides that:

> When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member

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been confused with the retention of strong national jurisdiction in supervision and that it may not always be clear whether, in carrying out supervisory responsibilities, a national central bank is acting under national powers or as part of the ESCB.

159. *See* EC TREATY art. 105(6); ESCB Protocol, *supra* note 2, art. 25.2.

160. *See* EC TREATY art. 105(5); ESCB Protocol, *supra* note 2, art. 3.3.

161. *See* Lastra, *supra* note 23.

> State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.[162]

This provision requires total functional autonomy for the ESCB and forbids outside interventions in its decision-making processes.

Other safeguards seek to ensure the personal and professional independence of the members of the ECB's governing bodies. Overall, the relevant provisions seek to guarantee that only professionally suitable persons, enjoying the trust of all national governments, are appointed as members of the Executive Board,[163] to protect these persons from financial and other pressures relating to their terms of employment,[164] to prevent conflicts of interest, and to ensure that the hope of reappointment will not be a factor which might lead them to accommodate political pressures in their decision-making.[165]

The independence of the ESCB is not confined to the ECB, but extends to the national central banks. During the second stage of EMU, and before the establishment of the ESCB, the Member States are required to take steps to achieve the independence of their central banks and the compatibility of their legislation to the relevant provisions of the Treaty and the Statute of the ESCB.[166]

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162. EC TREATY, art. 107; ESCB Protocol, *supra* note 2, art. 7.

163. The members of the Executive Board must be appointed among persons of recognized standing and professional experience in monetary or banking matters by common accord of the governments of the Member States at the highest level (Heads of State or Government), on a recommendation from the Council and after consultation with the European Parliament and the Governing Council of the ESCB. *See* EC TREATY art. 109a(2)(b); ESCB Protocol, *supra* note 2, art. 11.2.

164. The terms and conditions of employment of members of the Executive Board, including their salaries, pensions and other benefits, shall be determined by the other members of the Governing Council, that is, the Governors of the national central banks. *See* ESCB Protocol, *supra* note 2, art. 11.3. Their removal from their position shall only be possible following a decision of the European Court of Justice, if they no longer fulfill the conditions required for the performance of their duties or if they have been guilty of serious misconduct. *Id.* art. 11.4.

165. Their appointment may only be for a nonrenewable, eight-year term, during which they shall be required to perform their duties on a full-time basis, without being permitted to engage in any other occupation. *See* EC TREATY art. 109a(2)(b); ESCB Protocol, *supra* note 2, art. 11.1-2.

166. *See* EC TREATY arts. 108, 109e(5); ESCB Protocol, *supra* note 2, art. 14.1. The Governors of the national central banks must be appointed for a term of office which may not be less than five years; they may be relieved from their duties only on the same grounds as the members of the Executive Council, and the decision to remove them is subject to referral to the ECJ. ESCB Protocol, *supra* note 2, art. 14.2.

As a result of these provisions, central banking in the EMU is removed from the ordinary mechanisms of executive and parliamentary control. The Treaty provides that the president of the Ecofin Council and a member of the Commission will have the right participate, without vote, in meetings of the ECB's Governing Council. Conversely, it requires the invitation of the President of the ECB to Ecofin meetings whenever matters relating to the ESCB's field of competence are discussed.[167] These institutional contacts are intended to provide opportunities for policy-making coordination through discussion between the Community institutions and the ESCB. However, the final responsibility for monetary decision-making is placed firmly in the hands of the ECB, which will have exclusive competence for the formulation and implementation of the monetary policy of the Community without need for participation or consent by any other body.[168] Moreover, the resources (capital and foreign reserve assets) which may be required for the effective conduct of monetary operations will be made available to the ECB, thus ensuring the ESCB's financial independence from the political authorities of the Community and the Member States.[169]

The elimination of political controls and influences in this area is justified on the basis that it ensures an institutional environment conducive to the attainment of the ESCB's primary objective of price stability.[170] However, the purely instrumental consideration that an independent central bank may be more likely to achieve price stability cannot in itself justify the removal of monetary policy from the political arena and its placing under the guardianship of an unelected professional elite, free from the constraints of democratic accountability.

Three other factors play an indispensable part in legitimizing the transferal of full decision-making power in the monetary field to a politically unaccountable body: first, the belief that its objective, price stability, is a fundamental economic good, which cannot be traded off against other objectives and whose superior value justifies its constitutional entrenchment and removal from the political process;[171]

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167. *See* EC TREATY art. 109b(1).

168. *See* EC TREATY art. 105(2); ESCB Protocol, *supra* note 2, arts. 3.1, 12.1.

169. *See* ESCB Protocol, *supra* note 2, arts. 28-30.

170. *See* EC TREATY art. 105(1); ESCB Protocol, *supra* note 2, art. 2.

171. It is only because price stability appears to be a fundamental longer-term precondition of any successful economic policy that its constitutional entrenchment is justified. If it were merely one of several mutually incompatible short-term economic objectives, which could be traded off for one another, the relevant decisions would clearly belong to the political arena. In signing the Maastricht Treaty, the Member States decided to vest full jurisdiction in monetary matters to the

second, the strict confinement of its mandate to the implementation of this peculiar objective, insofar as other areas of public policy should not unnecessarily be covered by the same immunity from the political process;[172] and third, a sufficiently precise and transparent formulation of its mandate, providing clear legal criteria for the exercise of its discretion and a basis for the ex post evaluation of its conduct.[173]

ESCB because they were convinced that this is not the case. For this reason, although it is provided that "the ESCB shall support the general economic policies in the Community," such support is made subject to the objective of price stability. EC TREATY art. 105(1).

172. *Cf.* Brunner v. The European Union Treaty 1994 C.M.L.R. 57, at 104:

> Placing most of the tasks of monetary policy on an autonomous basis in the hands of an independent central bank releases the exercise of sovereign powers of the state from direct national or supra-national control in order to withdraw monetary matters from the reach of interest groups and holders of political office concerned about re-election. This restriction of the democratic legitimation which proceeds from the voters in the Member States affects the principle of democracy, but, as a modification of that principle provided for in Article 88, second sentence, of the [German Basic Law], is compatible with Article 79 (3) [which, in conjunction with Article 20 (1)-(2) of the Basic Law, declares unassailable the democratic principle, protecting it against constitutional amendments]. The supplementation of Article 88 undertaken in view of the European Union allows a transfer of powers of the Bundesbank to a European central bank if to do so accords with "the strict criteria of the Maastricht Treaty and the Statute of the European System of Central Banks regarding the independence of the Central Bank and the priority of maintaining the value of the currency." The will of the legislature in amending the [Basic Law], therefore, is clearly aimed at creating a constitutional basis for the monetary union provided for in the [Maastricht Treaty], but restricting the creation of the powers and institutions which are connected therewith and given independence in the manner explained to that case. This modification of the democratic principle for the purpose of protecting the confidence placed in the redemption value of a currency is acceptable because it takes account of the special characteristics (tested and proven—in scientific terms as well—in the German legal system) that an independent central bank is a better guarantee of the value of the currency, and thus of a generally sound economic basis for the state's budgetary policies and for private planning and transactions in the exercise of the rights of economic freedom, than state bodies, which as regards their opportunities and means for action are essentially dependent on the supply and value of the currency, and rely on the short-term consent of political forces. To that extent the placing of monetary policy on an independent footing within the sovereign jurisdiction of an independent European Central Bank (a jurisdiction not transferable to other political areas) satisfies the constitutional requirements under which a modification may be made to the principle of democracy.

Id. at 104.

173. The EC Treaty envisages that, in the case of the ESCB, public accountability will be achieved through reporting commitments and official statements by the President and the other members of its Executive Board to the competent committees of the European Parliament. *See* EC TREATY art. 109b(3); ESCB Protocol, *supra* note 2, art. 15. The effectiveness of such mechanisms, however, depends primarily on the existence of objective criteria for assessing monetary

It has been observed that price stability is not a precise rule, but only a principle—and a vague principle, for that matter, vesting on the ESCB a considerable margin of discretion, not only in deciding the means for its implementation, but also in interpreting its meaning.[174] Nonetheless, while a precise definition of price stability may be lacking, changes in the rate of inflation provide a readily observable indicator of monetary developments and a benchmark against which to evaluate the ESCB's performance.

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performance. Assuming that discernible criteria do exist, the institutional prestige of the ESCB will depend primarily on the successful implementation of its mandate; without such criteria, however, moral pressure can play a very limited role in keeping the ESCB within its responsibilities. Nor can judicial review provide effective protection where there are no clear standards of performance. The Statute of the ESCB, art. 35(1), provides that the acts and omissions of the ECB will be open to review or interpretation by the ECJ. It is doubtful, however, whether judicial review could be used to enforce the objective of price stability. *See* Terence Daintith, *Between Domestic Democracy and an Alien Rule of Law? Some Thoughts on the "Independence" of the Bank of England*, PUBLIC LAW 118, 125-30 (1995).

174. Hahn emphasizes that the ESCB statute (which at the time of his comments existed still only in draft form)

> expressly and unequivocally commits the ESCB to maintain price stability as the primary objective of the System. However, in line with the legislative technique employed by national statutes equally devoted to the maintenance of a currency's value, the text adds that[,] without prejudice to the objective of price stability, the System shall support the general economic policy of the Community. Thus monetary policy is not considered to be conducted in isolation from other aims of economic policy. Yet this also amounts to saying that the general economic policy of the EC may be supported by the ESCB only in as much as that support would not interfere with the pursuit of its primary objective, namely, the maintenance of price stability. The form of words used in the draft statute defines the objective of the ESCB even more precisely than the statute establishing the German Federal Bank (*Bundesbankgesetz*) as the latter, in its section 3, refers only to the target of safeguarding the currency and thus expresses in rather relative terms that safeguarding the currency consists in the obligation to maintain the domestic value [i.e. not the external parity] of that currency. "Nonetheless, a degree of skepticism can be expressed as to the ability of the provision to provide unambiguous criteria for the ESCB's actions." As Harden observes, price stability "is not a rule which tells the ECB what to do. It is a principle to guide it in deciding what to do. Furthermore, it is a vague principle. 'Price stability' is not defined, either in quantitative or qualitative terms. It could mean zero inflation, though some economists have argued that a 1-2% annual rate of price increases is appropriate to reflect secular improvements in the quality of goods and services. A low and non-accelerating rate of inflation might also be described as 'price stability', especially if the costs of further reducing it are believed to outweigh the benefits. The ECB will thus have discretion in interpreting the meaning of price stability as well as in deciding how to achieve it."

Hahn, *supra* note 23, at 797-98 (citing Harden, *supra* note 23).

The exceptional character and conditional legitimacy of the ESCB's regime of constitutionally guaranteed functional independence should be clearly recognized. The special considerations which apply to its monetary functions should not provide an excuse for the wholesale elimination of political controls in the area of banking and financial policy. However, the allocation to the ESCB of broad discretionary responsibilities in the field of prudential regulation could have precisely this effect, because its independence is not confined to monetary matters but extends to all its activities under the Treaty.

Many commentators do not think that the ESCB's special status of independence presents an obstacle to the allocation of prudential responsibilities to it. In their opinion, banking supervision is a purely administrative matter, which (with the possible exception of rescue operations) does not justify political interventions, but only appropriate mechanisms of judicial review.[175]

However, none of the characteristics which provide the justification for central bank independence in the monetary field can be applied to regulatory responsibilities of a prudential nature.[176] Firstly, there is no reason to suppose that independence improves the quality of supervisory performance in the field of prudential tasks. One could even conjecture that the allocation of these tasks to an independent central bank with very close links with the banking and financial industry 0might facilitate the "capture" of the regulatory process and the effective determination of supervisory policy by that industry's narrow interests. Secondly, policy trade-offs are of essence in the field of prudential supervision. As more rigorous controls on risk-taking increase the cost of financial intermediation, reduce market efficiency, impede innovation, and stifle competition, the single-minded pursuance of prudential objectives cannot be the purpose of the regulatory system. Instead, by their very nature, these objectives must be constantly balanced against market efficiency and competition. However, drawing the balance between administrative intervention and market discipline is a matter, not simply of technical judgment, but of substantive political choice. Finally, the concepts of "financial stability" and "bank safety and soundness,"

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175. *See* WORKING GROUP OF THE ECU INSTITUTE, *supra* note 67, at 14, 61.

176. Lastra suggests that the independence of banking supervisors is justified as a natural extension of a central bank's independence in monetary matters. In her opinion, a sound banking system is a condition for maintaining price stability and this creates a need to distance banking policy from the political process, especially since politicians may be tempted to hijack the banking system in order to gain short-term advantage, thus undermining its soundness. This view cannot be accepted, for the reasons given in the text. *See* LASTRA, *supra* note 69, at 151-54.

which guide prudential supervision, are broad and imprecise. They do not provide operational criteria for administrative action but require application of discretion on an individual basis. Their operationalization can, of course, take place through the development of general rules or prudential policies. This, however, is an essentially legislative function, and it must be asked why it can be better performed by exercise of the ECB's rule-making powers[177] than through the normal constitutional channels, which permit the appropriate representation of all affected interests.

Functional independence would not present a problem in cases involving the concrete application of Community legislation to individual institutions. This should, indeed, be considered as a purely administrative matter, requiring detachment from political considerations and a quasi-judicial approach. Further than this, however, the delegation of decisive prudential responsibilities, especially of a rule-making nature, to an independent ESCB should not be easily accepted.

Significantly, similar reservations do not apply to the allocation to the central banks of the Member States, in their capacity as national competent authorities, of regulatory responsibilities under their national laws. As such additional responsibilities at the national level would not be regarded as being part of the functions of the ESCB,[178] their performance would not be subject to the same requirements of functional independence.

V. THE ROAD AHEAD

As integration accelerates and multinational financial conglomerates are likely to play an increasingly significant role in the European single market, there are good reasons for rethinking the institutional organization of prudential supervision in the prospective monetary union. In particular, a considerable strengthening of the bilateral and multilateral links between national supervisory authorities and an intensification of the cooperation requirements would appear to be in order.

There are also strong arguments, supported by the practice of most countries where the central bank is not responsible for banking supervision, for giving to the ECB and those national central banks without supervisory functions total access to supervisory information and

177. *See* EC TREATY art. 108a(1); ESCB Protocol, *supra* note 2, art. 34.1.
178. *See id.*

a right of consultation with the competent authorities.[179] This may be necessary for ensuring the coordination of monetary and banking policies in the monetary union, especially since the relevant responsibilities may not only be assigned to different institutions (horizontal separation) but also be conducted at different levels of government (vertical separation).

On the other hand, the arguments for the transfer of direct supervisory responsibilities to the ECB and the ESCB cannot easily be supported. Such arguments underestimate the level of potential opposition to the delegation of supervisory tasks to the Community's central banking system, which is reflected in the very limiting procedural preconditions for such a move in the Maastricht Treaty. More importantly, they fail to recognize explicitly the fundamental constitutional questions that the centralization and concentration of regulatory function in the hands of the ECB would involve.

The current system of EC banking law, based on the national organization of the supervisory function and the mutual recognition of regulatory standards, subject to minimum harmonization of essential prudential rules, provides a practical example of applied subsidiarity, with rather satisfactory results. Of course, the possibility that the new situation of increasing market integration and the internationalization of financial undertakings may eventually dictate the allocation of direct supervisory responsibilities to a pan-European banking authority (or, rather, to a European authority responsible for the supervision of financial conglomerates, including insurance undertakings, which are curiously excluded from the potential regulatory jurisdiction of the ECB under the Maastricht provisions) cannot be excluded in advance. This possibility is not particularly attractive, since it could open the way to excessive centralism, overregulation resulting from lack of regulatory competition, and the disregard of the special characteristics of particular national sub-markets, and should, accordingly, be explored with caution.[180]

Even if a pan-European supervisory authority is needed, however, it is neither self-evident nor clearly desirable that the ECB should play this role. Other possibilities should be explored, and it might be better if in this matter, as in so many others, the construction of the European central banking system remained faithful to its German prototype, the Bundesbank, which has never acquired formal supervisory

179. *See* KENEN, *supra* note 59, at 35.

180. *See* Rachel Lomax, *Supervision in the Single Market*, 4:3 CENTRAL BANKING 36 (Winter 1993-94).

responsibilities. Although the ECB cannot be expected to abstain from all involvement in banking policy, it might be preferable for such involvement in matters of prudential supervision to take the form of informal consultation and close cooperation with the competent authorities, underpinned by appropriate facilities for the exchange of information but avoiding the exercise of formal legal powers in this field.