

## **Banking crisis management in the European Union: Multiple regulators and resolution authorities<sup>1</sup>**

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### **Abstract**

Failures of internationally active banks some years ago pointed to deficiencies in private and public governance for such banks as Banco Ambrosiano, BCCI, and Barings. As the European Union makes progress toward integrating the financial system within the enlarged EU, the financial safety net has again become a topic of prominent discussion. This article presents the national institutional arrangements to preserve financial stability and focuses on the coordination among prudential regulators/supervisors, deposit insurance and resolution authorities between EU countries. Regulators incentives to share information on banks financial condition and coordinated action in a context of asymmetric information deserve especial attention. The paper concludes that the EU's safety net is a work in progress—much has already been accomplished, but its development is still ongoing.

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## Introduction

There is a growing awareness in the international community that consolidation in the financial services industry and increasing cross-border activities by large complex financial institutions may pose a threat to international financial stability. These changes present a challenge to regulators responsible for preventing and managing financial crises should one of these large international institutions fail. This danger exists worldwide: it is also present within the European Union (EU), where increasing integration in financial markets may exacerbate the risks.<sup>2</sup> This article discusses the challenges facing the regulators who are responsible for financial stability in the EU. It also discusses, without endorsing, some approaches suggested by academics and policymakers for dealing with them. In doing so, it focuses principally on credit institutions, referred to as “banks” in the article.

There has been awareness of threats to financial stability in domestic financial markets for decades. It is now accepted almost as common knowledge that certain regulators—the lender of last resort (LOLR), a system of prudential regulation and supervision, and deposit insurance—can form a safety net to alleviate financial distress at one financial institution and prevent it from causing a domestic financial crisis. Also laws and procedures for bank resolution importantly influence the safety net’s ability to succeed and might even be construed as a fourth arm of the safety net. Concern has more recently shifted to the international arena where the safety net does not exist for the most part and where coordination of domestic institutions has at times proved unable to avoid, or deal effectively with, bank failures.<sup>3</sup>

The USA has been grappling with this issue for two centuries, while the EU has recognized a need to address the problem more recently when financial markets are more integrated. There is a long-standing tension in the USA between Federal authority and the sovereign States’ Rights, but few people doubt that federal power would prevail in any dispute. In the US the safety net is largely federally provided—by one LOLR for any bank and one separate deposit insurer, who also resolves failed banks under federal law. There are, however, duplicative, state and federal systems of supervision. In the EU, the member countries retain sovereignty and the safety net is provided entirely by member states. Centralized power in the EU is constrained by the principle of subsidiarity. According to this principle, centralization can only be justified when the “objectives of the proposed action cannot be sufficiently achieved by Member States and can, therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.”<sup>4</sup>

Herring’s work (2002, 2004) on international bank failures illustrates the problems that arise when the safety net does not exist at the international level and where domestic institutions do not cooperate sufficiently to provide a substitute.<sup>5</sup> Pondering Herring’s and other cases raises a further question—what characteristics do safety net institutions need in order to succeed? The academic debate on financial stability in the EU has focused

more narrowly on whether the institutions within individual member states have the incentives to cooperate sufficiently and promptly to avoid a financial crisis.<sup>6</sup>

This paper analyzes the safety net institutions of the EU countries in light of the economic/finance literature as well as the international experience. More specifically, it focuses on regulation and supervision, banking resolution, deposit insurance, and to a lesser extent on LOLR. It does so in five parts following this introduction. Failures among internationally active banks during the past thirty years illustrate the regulatory and other deficiencies that have permitted, even encouraged, these failures. Consequently the paper's first section inquires what is needed to resolve bank failures efficiently in domestic markets and in the international arena. The paper's second section describes the financial regulatory process in the EU and the objectives of its reform as proposed under the Lamfalussy process. The challenges posed to prudential supervisors by the cross-border activity of EU banks as well as the mechanism of coordination among regulators are discussed in section three. The EU's resolution policies for distressed banks are analyzed in section four. The main objectives and features of depositor and investor protection in the EU are presented in part five. Finally, the sixth section discusses potential remedies to the coordination problem among regulators. As the paper's purpose is to stimulate discussion, it presents possible remedies, without endorsing any of them. This last section also presents some final reflections.

## **1. The Ingredients of Effective Bank Resolutions**

The failures of Bankhaus Herstatt in 1974, Drexel Burnham Lambert in 1989, the Bank of Credit and Commerce International (BCCI) in 1991, Barings PLC in 1995, and the near collapse of Long-Term Capital Management (LTCM) in 1998 illustrate the difficulties of resolving the failures of large complex institutions that are operating in several countries.<sup>7</sup> Other failures, including those of Continental Illinois in 1982, Banco Ambrosiano in 1982, provide additional evidence that highlights the dangers of not dealing with the problems effectively.<sup>8</sup> All of these cases raise the question of what features are necessary to enable the authorities to use their financial safety net to resolve the problems of complex financial firms operating nationally and internationally. Five characteristics come to mind.

The first feature is timely access to accurate information for regulators and markets to overcome the problem of asymmetric information where a bank knows its condition better than anyone else. Gaining access to adequate information is difficult even in the domestic markets where it will require different regulators (LOLR, supervisor, deposit insurer, resolution authority) to share information. The regulators also have to decide what information to reveal publicly to promote market discipline without encouraging panic. It is incomparably more difficult for regulators to obtain and share in the international arena, where nations that are in competition with, or hostile to, one another may need to cooperate. Incentives may be more favorably aligned within the EU where common fora and multilateral agreements do exist, but obtaining and sharing information there may still be problematic.

Secondly, it is easier in many instances if a single body of law governs the safety net's provision and where one body is responsible and accountable for ensuring the stability of the domestic financial markets. From the academic viewpoint, Kahn and Santos (2004) have examined the issue of the optimal allocation of regulators' responsibilities for preventing and managing banking crisis.<sup>9</sup> Allocating responsibility to one institution is feasible in a domestic market, but is not possible currently in a wider geographical context. While countries will differ over the means and the extent to which their central bank is held accountable for ensuring domestic financial stability, this responsibility typically falls, implicitly if not explicitly, to the central bank.<sup>10</sup> The central bank may or may not also be responsible for supervising financial institutions, resolving failed institutions, and compensating depositors. Individual countries are currently taking different positions with regard to centralizing or decentralizing these responsibilities. But no institution undertakes these responsibilities in the international markets. These responsibilities have to be shared cooperatively in order to preserve international financial stability.<sup>11</sup>

Thirdly, regardless of how many or which institutions are responsible for financial stability in any country, holding them accountable is essential. Accountability is necessary to contain the risk of regulatory capture where the regulators identify with the institutions in the industry they are regulating instead of protecting the interests of the public at large. Moreover, regulators need to be accountable to a political body that acts with integrity and has not also itself been captured by the regulated industry.<sup>12</sup> This implies that the regulators have a clear legal mandate with explicit and measurable objectives. Although maintaining financial stability is generally seen as one of the main functions of a central bank, in practice most central banks lack a clear legal basis that describes their powers and functions and the absence of a clear mandate restricts accountability.<sup>13</sup>

Fourthly, safety net regulators need to be adequately empowered by laws and regulations as well as provided with qualified staff to carry out their responsibilities successfully. In the realm of banking supervision, this need is recognized as a Core Principle for Effective Banking Supervision.<sup>14</sup> The Financial Stability Forum has stressed the importance of staffing for deposit insurers.

Fifthly, the regulators manning the safety net need to have clearly defined and publicly recognized objectives. This raises the issue of the lack of common unambiguous definition of financial stability. In domestic markets the safety net will see its main responsibility to be maintaining stability in the domestic markets. An international safety net would need to pursue international objectives to the extent these can be identified. Pursuing international objectives would be more difficult where it would involve giving preference to institutions in some countries as compared to others.

## **2- The regulatory process in the EU: From minimal harmonization to flexible and homogeneous secondary legislation**

Regulation in the EU has focused on integrating the financial markets of the member States. With this objective, the policy makers have traditionally relied on regulatory harmonization to achieve that integration. The underlying rationale has been that regulation should support a level playing field between different financial institutions in different countries, thereby reducing opportunities for regulatory arbitrage. In effect, regulatory harmonization in the EU has set a lower bound on safety and soundness and implicitly has made regulatory coordination possible among countries. Harmonization of bank regulation started to take place in the EU in the late 1970's: the First Banking Directive was issued in 1977.<sup>15</sup> This Directive established the principle of home country control and shifted the responsibility for the consolidated supervision of credit institutions operating with branches in two or more countries to the home country where the bank is headquartered. At the same time, it established a general duty for supervisors to cooperate. This principle has been applicable ever since in the EU regulation.

In addition to the home country principle, two other principles have inspired the regulatory harmonization in the EU since 1977. The first is the mutual recognition of the supervisory authorities within the EU. The second is the establishment of minimum standards for authorizing banks, for meeting solvency requirements, and for providing deposit insurance. In general, the harmonization process has been characterized by minimum interference with national regulators, subject to the restrictions imposed by the harmonization process itself, which often allows a considerable scope for diversity in the transposition to national regulations. For example, the EU Directive on deposit-guarantee gives member States latitude in regard to financing ("ex ante" vs "ex post" funding) and administering the schemes publicly or privately.<sup>16</sup>

At the turn of this century it was recognized that the EU's existing legislative process could not ensure a homogenous transposition of the EU directives' agreed principles into national regulations. Moreover, confronted with a rapidly growing and innovating financial sector, commentators strongly criticized the EU legislative process itself as slow, rigid, leading to ambiguous results, and neglecting the role of markets and institutions in shaping the design of rules.<sup>17</sup> In order to remedy these limitations, the Council of Economic and Financial Affairs (ECOFIN) approved a fully-fledged reform of the institutional architecture for financial regulation and supervision within the EU in December 2002.<sup>18</sup> The key idea, adopted first by the Lamfalussy Committee for the securities industry but subsequently applied to the banking and insurance industries, is to separate the process of preparing and approving the main principles (so-called "primary legislation") from the development of such principles into more detailed rules (so-called secondary legislation), which could then be more efficiently modified.<sup>19</sup>

This new architecture foresees a sectoral and decentralized model of financial regulation of financial intermediaries in the EU. It is sectoral because it has separate legislative processes and supervisory cooperation fora for securities firms, banks, and insurance companies. It is decentralized because the regulatory/supervisory functions remain at

national level. Moreover, the new architecture is neutral with regard to the national institutional arrangements. This architecture envisages improved co-operation with market participants and among national financial market regulators and supervisors and across financial sectors.<sup>20</sup> Coordination between supervisors beyond the Euro area seems to have inspired these arrangements.

This new architecture, however, will have to demonstrate that it is a faster and more efficient procedure for passing secondary legislation (technical rules) and that they can be amended via simple procedures. But it will also have to assure an appropriate degree of homogeneity of national regulations throughout the EU. In so doing it will have to reduce the present scope for diversity in the transposition of EU directives into national laws and regulations. Furthermore, the new architecture would need to encourage a more consistent application of the secondary legislation in order to promote homogeneous and transparent supervisory practices throughout the EU. If the new architecture does not fulfill these objectives, the Lamfalussy Committee foresees that secondary powers of legislation, execution and implementation would be delegated to a new European financial regulatory institution for securities.<sup>21</sup>

### **3- Prudential supervision in the EU: Information asymmetries and information sharing with other regulators**

The euro area acknowledged the problems of permitting information to be asymmetrically distributed between banks and their regulators (LOLR and prudential supervisors). It also recognized that it is costly to obtain the information on banks' financial situation needed to alleviate the regulators' informational disadvantage. The view of the European Central Bank (ECB) at the time of the publication of the Lamfalussy Report was that prudential supervision (for banks and even for other financial institutions) in the Euro area should be the responsibility of the national central banks, rather than other separate supervisory agencies. From the ECB's perspective, this attribution of responsibility was desirable from two points of view. First, it would allow central banks to understand better the financial condition of banks and other financial intermediaries. Second, it would implicitly improve coordination between the supervisory and monetary policy functions.<sup>22</sup> The ECB approach also seems consistent with Kahn and Santos' (2004) conclusions on the regulators' incentives to gather and share information: First, that regulators incentives to gather information are not independent of their responsibilities and second, that regulators may find advantageous not to share with other regulators the private information they possess.<sup>23</sup>

From the point of view of the ECB, centralization of prudential supervisory functions across the banking, securities, and insurance industries in the national central banks would have aligned the incentives of both the central banks and the supervisors to gather information and would have avoided the duplication of monitoring costs within the European System of Central Banks (ESCBs). Further, giving prudential supervisory powers to national central banks has become more acceptable given their recent independence from the political process.

At the national level, the institutional structures for the supervision of financial intermediaries are diverse in the EU. Some countries have centralized supervision across banking, securities and insurance. Sometimes the central bank has taken this responsibility, as in the Netherlands.<sup>24</sup> In other instances, the combined authority has been transferred to a separate supervisory agency, as in the United Kingdom. Other countries retain separate sectoral supervisors. Masciandaro shows an inverse correlation between the central bank involvement in prudential supervision and the degree of consolidation of the sectoral supervisors in a sample of sixty-eight countries.<sup>25</sup> However, the separation of prudential supervision and central banking does not necessarily imply that regulators and central bankers will not share costly information. As shown in Table 1, all central banks of the EU countries with the exception of Luxembourg and Denmark have, in principle, some mechanism to access to supervisory information. However, this raises the question of how effective are those mechanisms for sharing information on the financial condition of banks.

Information asymmetry is more problematic with regard to the financial condition of banks. To reduce this asymmetry, the ECB, the central banks and the supervisory agencies have signed a Memorandum of Understanding (MoU) on the exchange of information on the financial condition of distressed banks.<sup>26</sup> Nonetheless, this approach has limitations. First, while it provides moral suasion in favor of cooperation, the MoU lacks legal enforceability and as a result no penalties are envisaged in case the contract is breached. Secondly, in the absence of full regulatory harmonization, differences in accounting rules leave room for a lax interpretation of a bank's financial condition. Thirdly, the MoU is confidential, which could limit accountability for the institutions involved. Thus far, the roles of the deposit insurers and the ministers of finance have not been considered.

The advent of the Euro is encouraging the development of markets and financial institutions. Once pan European institutions have emerged, the existing arrangements, based on the MoU and on Committee decisions, may prove too complex to manage effectively.<sup>27</sup> Furthermore, the existing arrangements may not allow for a rapid assessment of the systemic implications of a banking crisis.<sup>28</sup> The EC Treaty (article 105(6)), and the ESCB Statute (article 25.2) leave open the possibility that the ECB might gain responsibility for the prudential supervision of credit institutions and other financial entities, with the exception of insurance companies. In order to assign these responsibilities, a qualified majority of the EU Council must decide in favour according to the new Constitutional Treaty.

The creation of Euro-level safety net institutions has been widely debated among academics. Kahn and Santos (2002), for example, analyzed the consequences of the allocation of LOLR and supervisory functions in the Euro area for the degree of forbearance in closing distressed banks and for the level of diligence in bank supervision.<sup>29</sup> The authors conclude that the lack of centralization of LOLR and supervision in an integrated banking market increases forbearance and reduces the diligence of supervision. At the same time, centralizing these regulatory functions would

tend to reverse these effects. Kahn and Santos also analyze the consequences of the order of centralization of LOLR and prudential supervision and show that the centralization of supervision (but not the LOLR) offers advantages by increasing supervisors' incentives to invest in monitoring and reducing the financing costs of the LOLR. Policymakers defend the proposition that centralizing some regulatory institutions (LOLR, deposit insurance and supervision) and not others in a piecemeal approach may create adverse incentives.<sup>30</sup>

The launching of the Lamfalussy architecture has made the possibility of the ECB's assuming responsibilities for prudential supervision more remote. The architecture provided for a third-level supervisors' coordination forum (the Committee of European Banking Supervisors) in which the ECB is represented as an observer.<sup>31</sup> Furthermore, the Lamfalussy Report foresees a possibility that secondary powers of execution and implementation will be delegated to a new European financial regulatory institution.<sup>32</sup> Under this scenario, Goodhart raises a question as to the relationships of this new regulatory institution with the national supervisors, the ECB, and the national fiscal authorities.<sup>33</sup> The authors of this article also question these relationships with the national schemes of deposit insurance. Goodhart focuses particularly on the issue of political accountability in the event taxpayers' money is at stake.

In a hypothetical case in which either the ECB or a new European financial regulatory institution would assume responsibilities on bank prudential supervision, the principle of subsidiarity contained in article 5 of the EC Treaty need to be respected.<sup>34</sup> It would be respected if it could be shown that cross border externalities would be serious enough to be taken into consideration at the time of dealing with a banking crisis, as might be the case for pan-European banks.

**Table 1. Prudential Supervision and Central Banks involvement in the EU (15 countries)**

Country	No. Institutions responsible for prudential supervision (banks, insurance and securities)	The Central Bank is the bank supervisor	Central bank has access to banks' prudential information	Comments
Austria	1	No	Yes	CB is involved in the management of the banking supervisor and carries out monitoring in specific areas
Belgium	2	No	Yes	CB is involved in the management of the banking supervisor
Denmark	1	No	No	Separate supervisory agency
Finland	2	No	Yes	CB is involved in the management of the banking supervisor and carries out monitoring in specific areas. The CB and supervisor share resources
France	6*	No	Yes	CB is involved in the management of the banking supervisor. The CB and banking supervisor share resources
Germany	1	No	Yes	The CB carries out monitoring in specific areas (off-site). The CB and supervisor share resources.
Greece	3	Yes	Yes	
Ireland	1	No	Yes	The unified supervisor is an autonomous part of the CB. The latter and the single supervisory authority share IT and other resources.
Italy	3	Yes	Yes	
Luxembourg	2	No	No	
Netherlands	2	Yes	Yes	The central bank supervises the banking and securities markets. After January 2005 it will also supervise the pensions and insurance industries.
Portugal	3	Yes	Yes	
Spain	3	Yes	Yes	
Sweden	1	No	Yes	CB is involved in the management of the banking supervisor. In addition the CB and the single supervisor have signed MoU to share information
United Kingdom	1	No	Yes	The CB and the single supervisor have signed an MoU to share information

Sources: ECB Monthly Bulletin and authors

\* **Responsible institutions:** Banking Commission; Committee on Banking and Financial Regulation; Committee for the Establishment of Credit Institutions and Investment Companies; Financial Markets Authority; Insurance Supervision Commission; National Credit and Securities Council; and the Ministry of Economic Affairs and Finance.

#### **4- Resolving Failed Banks and Coordinating with Safety Net Regulators**

There are a number of important dimensions where countries worldwide currently differ with regard to resolving failing banks. In the 19<sup>th</sup> century, insolvency law focused on each sovereign state, which had authority over all of the assets of a bankrupt entity within, but not outside, its jurisdiction. The insolvency of a firm/bank with cross-border activities would therefore be resolved territorially in a number of separate bankruptcy proceedings conducted in different countries. Vestiges of territoriality still remain and are often associated with separate-entity resolution. Today, however, bankruptcy is trending away from territorial approach toward universality, where all of the bankrupt entity's assets and the claims against these assets—regardless of their location—are settled together in one proceeding held in one jurisdiction. In this single-entity resolution all of the bank's foreign and domestic creditors are included in the estate of the failed bank. Another case of disparity arises when the courts in one jurisdiction may practice comity by recognizing the laws and judicial decisions of another jurisdiction, while courts in another country may not recognize other countries' decisions.<sup>35</sup>

Some countries ring-fence the assets of a foreign bank to protect local creditors; other countries do not. Ring-fencing implies that the assets of the branch of a failed bank will be used to satisfy creditors in transactions arising from that branch. Remaining assets will then be used to satisfy claims in any other of the failed bank's branches in the host country. Subsequently, any still-remaining assets will be transferred to the home country. For example, Australia ring-fences the assets of branches of foreign banks, in order to favor creditors in their country. Some EU countries, such as Germany, effectively ring-fence assets of the branches of non EU banks in Germany through secondary proceedings. This practice is not allowed for branches of EU banks in the EU according to the EU Winding-Up Directive for Credit Institutions, whose content is presented below. Another disparity is that some countries give depositors preference over the assets of a failed bank; others do not. Moreover, some countries allow depositors to gain additional protection by offsetting their loans to a failed institution against their deposits at that bank before the insurance coverage kicks in. The principal differences adopted by some different countries around the world are illustrated in Table 2.

**Table 2. Examples of Different Resolution Practices Worldwide: EU and Rest of the World**

Region	Separate Insolvency for Banks	Banks Subject to General Insolvency Laws	Universal Proceeding	Territorial Approach	Single Entity	Separate Entities	Comity	Depositor Preference	No Depositor Preference	Ring-fencing
EU		Ireland UK Spain	EU Directive for EU banks and branches of EU banks within the EU (with exceptions)	EU Directive for non-EU banks	EU Directive for EU banks	EU Directive for branches of non-EU banks	EU Directive within the EU	Austria Italy Norway UK	Belgium Denmark Finland France Germany Ireland Netherlands Portugal Spain Sweden	Germany  Possibly also for branches of foreign banks in the EU
RoW	Japan USA <sup>36</sup>	Hong Kong US Bank Holding Companies		US for foreign financial firms with US branches	US for US banks	US for non-US banks		Australia Hong Kong USA	New Zealand	Australia  USA for branches of foreign banks

Source: Authors' analysis

Financial institutions are excluded from EU Insolvency Proceedings Regulation, and resolution proceedings for banks vary widely among member states.<sup>37</sup> Further Hadjiemmanuil notes that there is no common definition of bank insolvency among EU countries, which may apply different determinants of weakness when taking action to contain or resolve bank problems and employ different remedies for banking distress.<sup>38</sup> In face of such diversity, EU members have pursued the harmonization of certain rules, but it took more than two decades before agreement was finally reached on the 2001 Directive on the Reorganization and Winding-Up of Credit Institutions.<sup>39</sup> The Directive went into effect on May 5, 2004 and applies to all EU countries, although at the time of writing this article, transposition has not been fully completed in all the EU countries. Moreover, the Winding-Up Directive does not apply to the insurance, securities, and other non-bank activities of the banking group.<sup>40</sup> There is a separate EU Directive to govern the insolvency of insurance firms, but there is no parallel directive for investment firms.

The EU Winding-Up Directive for Credit Institutions aims for a resolution of a troubled bank and its branches as a single entity in a universal approach with mutual recognition of the home country's reorganization measures and winding up proceedings and with equal treatment for creditors. There are certain exceptions to the EU's principal of universality. For example, host-country laws apply to contracts made by branches of foreign banks for employment, immovable property, ships and aircraft. The contracts that govern netting and repurchase agreements continue to apply in a resolution. The home country has sole responsibility to resolve (reorganize or wind-up) its domestic banks and their branches in other EU-Member states under the home-country laws. As shown in

Table 3, the host country resolves failing subsidiaries of foreign banks under its own laws.

**Table 3: Supervision, Deposit Insurance and Resolution Authorities' Jurisdiction in the EU**

	<b>Prudential Supervisor</b> <sup>41</sup>	<b>Deposit Insurance Regulator</b> <sup>42</sup>	<b>Reorganization and Winding-Up Authority</b> <sup>43</sup>
<b>Banks legally incorporated</b>			
Parent banks authorized in home country	Home country authorizing parent bank (consolidated supervision - solvency)	Home country	Home country
Subsidiaries of parent banks headquartered and authorized in another EU country	Home country authorizing parent bank (consolidated supervision - solvency) Host country authorizing the subsidiary ("solo" basis)	Host country	Host country
Subsidiaries of parent banks headquartered and authorized in a non- EU country	Host country authorizing the subsidiary <sup>44</sup>	Host country	Host country
<b>Branches</b>			
Branches of banks headquartered and authorized in other EU country	Home country of head office (consolidated supervision - solvency) Host country <sup>45</sup> (liquidity)	Home country (possibility of supplementing the guarantee by host country) <sup>46</sup>	Home country
Branches of banks headquartered and authorized in a non- EU country	Host country <sup>47</sup>	Host country , if cover provided by home country is not equivalent to that prescribed by Directive <sup>48</sup>	Host country in case that foreign bank has branches in more than one Member State. <sup>49</sup>

Source: Authors' analysis

In cases where a foreign bank has branches in two or more EU States, the authority conducting a resolution is obliged to notify other EU countries. The apportionment of responsibility between home and host authorities parallels that in the depositor and investor protection directives, as discussed below, but it differs from that in the supervision directive, as is shown in Table 3.

The disparity in political accountability among the regulators involved in prudential supervision, deposit insurance, and resolution that is envisaged in the directives may deter speedy responses in a crisis situation. The distinction that runs throughout EU legislation between the treatment of the branches and subsidiaries of other Members'

banks may pose a challenge to the effectiveness in resolving troubled banks. It also raises a question whether it is feasible to successfully separate the prudential supervision of a subsidiary from its parent, to insure and resolve it separately in a fair and efficient manner. As Hadjiemmanuil points out, the failure of Banco Ambrosiano's unregulated holding-company subsidiary in Luxembourg effectively brought down the Italian banking group. Even though a subsidiary has separate accounts, the parent can lose its deposits and investments in the subsidiary and may suffer reputational damage from the subsidiary's failure.

The current arrangements in the EU rely heavily on cooperation in information exchange not only between different regulators (supervisor, resolution body, deposit insurer, LOLR and the ministry of finance) within each country but also between these regulators in different countries. The number of bodies required to cooperate can rapidly escalate as banks cross more and more borders in the enlarged EU. Prompt action may be particularly problematic where reorganization requires political negotiation to share the cost burden among several countries.<sup>50</sup> National regulators, may have the incentive to delay and not cooperate with other member State authorities. In this regard, Kane argues that a poor incentive structure, heightened by a lack of democratic accountability—a lack that is typically in a transnational banking crisis—undermines the footings for the fair and efficient resolution of large banks.<sup>51</sup>

## **5- Deposit Insurance Protection in the EU**

Deposit insurance protection is intended, on one hand, to protect small depositors and, on the other hand, to discourage runs on banks in order to maintain financial stability.<sup>52</sup> The 1994 Directive on Depositor Protection was designed with the aim of discouraging deposit institutions within the EU from using protection's different features to compete with each other.<sup>53</sup> The lack of integration of EU financial markets at that time explains why the Directives were not particularly aimed at preserving financial stability in the EU.<sup>54</sup> Nevertheless, the deposit protection schemes are only partially harmonized: their divergent features are described below in Table 4.<sup>55</sup>

First, EU different countries subject to the Directive take different positions with respect to the coverage limit, exclusions from coverage, coinsurance, offsetting, and priority granted to depositors among other things.<sup>56</sup> Depositors may not know these facts, yet they need this information if they are to protect their interests and exert healthy market discipline.

Secondly, the EU is seeking to encourage greater reliance on market forces. This seems the reason why it discourages governments from providing ongoing funding for their protection systems. As a corollary, the Directive is unclear on the governments' responsibility to provide financial backing to their systems even in an emergency when normal funding sources prove to be insufficient.<sup>57</sup>

Moreover, there are limitations, imposed by the EC Treaty, on lending to governments or institutions (article 101) by the ECB and/or the national central banks (NCBs). There are also limitations on the EU Community's ability to "bail out" governments and/or public entities (article 103). These limitations may present a challenge to the deposit insurer's ability to compensate depositors were a large bank to fail, which is possible given the increasingly concentrated nature of banking in many EU countries.<sup>58</sup>

Thirdly, the coverage limit in a number of EU countries is above the €20,000 compulsory lower limit and transitionally below it in some countries that have recently joined the EU. Higher coverage may attract bank subsidiaries and branches from other EU countries that seek to "top-up" their coverage. Topping-up could expose host countries to additional costs if any pan European bank were to fail so that a question could arise concerning who would foot the bill. The EU has no central fiscal authority and the EC Treaty places limitations on government support, as mentioned above. Against this background, domestic banks in the host country would be expected to carry this burden although they could be reluctant to do so. They would be especially reluctant in an *ex post* system where a failed bank, possibly a foreign bank, would not have contributed toward compensating its depositors. Such reluctance would pose a challenge for the level playing field on deposit insurance protection in the EU.

**Table 4. Deposit Protection in the EU (25 countries)**

Systems in EU Countries	Supervisor	Deposit Insurer	Funded	Fund Target	Risk-Based	Coverage	Co-Insure	Off-set	Timing (months)
Austria	Separate	Private co.	Ex post	No	No	€20,000	Yes	Yes	3+
Belgium	Separate	Supervisor	Fund	Yes	No	€20,000	No	Yes	3+
Cyprus	Central Bank	Separate	Mixed	Yes	No	€20,000	Yes	Yes	3+
Czech Republic	Central Bank	Separate	Fund	No	No	Higher	Yes	Yes	3+
Denmark	Separate	Separate at Central Bank	Mixed	Yes	No	Higher	No	Yes	3+
Estonia	Separate	Separate	Fund	Yes	No	Lower*	Yes	Yes	< 3
Finland	Separate	Supervisor	Mixed	Yes	Yes	Higher	No	Yes	3
France	Separate	Private co.	Fund	No	Yes	Higher	No	No	3+
Germany	Separate	Supervisor	Fund	Yes	No	€20,000	Yes	Yes	3+
Germany	Separate	Private co.	Ex post	No	Yes	Higher	No	Yes	>21days
Greece	Central Bank	Separate	Fund	Yes	No	€20,000	No	Yes	3+
Hungary	Separate	Separate	Fund	Yes	Yes	Higher	Yes	Yes	< 3
Ireland	Central Bank	Central Bank	Fund	No	No	€20,000	Yes	Yes	3+
Italy	Central Bank	Private co.	Ex post	Yes?	Yes	Very high	No	Yes	3+
Latvia	Central Bank	MoF/Cen.Bank	Fund	No	...	Lower*	Yes	No	3+
Lithuania	Central Bank	MoF/Govt	Fund	Yes	No	Lower*	Yes	Yes	3+
Luxembourg	Separate	Separate	Ex post	No	No	€20,000	Yes	No	3+
Malta	Separate	Separate	Mixed	Yes	No	€20,000	Yes	Yes	3+
Netherlands	Central Bank	Central Bank	Ex post	No	No	€20,000	No	Yes	3+
Poland	Central Bank	Separate at MoF	Fund	No	No	Higher	Yes	Yes	< 3
Portugal	Central Bank	Central Bank	Fund	No	Yes	Higher	No	No	3+
Slovakia	Central Bank	Separate	Fund	Yes	No	Lower*	Yes	Yes	3+
Slovenia	Central Bank	Central Bank	Banks make deposit atCB	Yes	No	Higher	No	Yes	< 3
Spain	Central Bank	Separate at Central Bank	Fund	Yes	No	€20,000	No	No	3+
Sweden	Separate	Separate	Fund	Yes	Yes	Higher	No	Yes	3+
U.K.	Separate	Separate	Fund	Yes	No	Higher	Yes	Yes	3+
<b>TOTAL =26 (Table shows Germany's public and private systems)</b>	<b>Separate=14 Central Bank=12</b>	<b>Separate = 13 Private = 4 Central Bank = 4 Supervisor= 3 MoF = 2</b>	<b>Fund = 16 Ex post = 5 Mixed = 4 Other = 1</b>	<b>Y: 16 N: 10</b>	<b>RB= 7 N= 18</b>	<b>Base= 10 H= 12 L = 4</b>	<b>Y = 14 N= 12</b>	<b>Y=21 N= 5</b>	<b>20 &gt; 3m</b>

Sources: Garcia (2000, updated) and the International Association of Deposit Insurers (2002).

Fourthly, the Directive's un-ambitious timing for the receipt of compensation might call into question the effectiveness of the guarantee should a bank's soundness become suspect. In most EU countries depositors need to file a claim and then wait for their claim to be verified and satisfied. That can take between three months and a year. Kaufman stresses the importance of timely compensation "depositors may suffer both losses in the value of their deposits (credit losses) and, possibly more importantly, restrictions in access to their deposits (liquidity losses)."<sup>59</sup>

Fifthly, the depositor protection Directive gives each member country discretion over the governance of the protection body or bodies. The protection schemes can be privately or publicly run. In the latter case they may be operated by the central bank, by a separate

prudential supervisor, or by a separate and independent protection agency. Sometimes, the deposit insurer is a separate legal entity but it may be housed at another agency, such as the ministry of finance or the central bank. The disparity in arrangements has two disadvantages: it proliferates the number of regulators that need to share information on the banks financial condition and cooperate in providing protection within a country as well as across borders.<sup>60</sup> The challenges to information sharing are particularly pressing where deposit insurance is privately run. The prudential supervisor would be inhibited from sharing confidential information on banks' financial condition with bankers running the deposit protection agency, because this would present the bankers with conflicts of interest (see Table 4).

Last but not least, an important shortcoming of the depositor and investor protection schemes in the EU stems from the fact that European banks frequently offer cross-border services to other EU member states through subsidiaries (separate legal entities). Whether a bank prefers to expand internationally through a branch or a subsidiary may be linked to differences in taxation, limited liability and even protection schemes.<sup>61</sup> However, from the prudential supervision point of view, the scope of control by host country authority is limited because effective control of the solvency of the consolidated banking group lies with the home country supervisor. This institutional arrangement implies that the host country deposit insurer (and ultimately host country tax payers) is responsible for guaranteeing the deposits of subsidiaries of other EU member states' banks. A disparity in responsibilities arises because the host country is not the supervisor of the consolidated entity. Moreover, the home country supervisor, which does supervise the consolidated entity, is not democratically accountable to host-country's taxpayers. Similarly, the 2001 Winding-Up Directive allocates subsidiaries to the host country authorities for rescue or winding up under host country laws (see Table 3). Nordea's conversion of its foreign subsidiaries into branches raises an issue for EU systems of deposit protection. There are no arrangements in most countries for withdrawing from one deposit insurance system in order to join another or for transferring a bank's past contributions from the old deposit insurance system to the new one.

In these ways, the present institutional arrangements for dealing with cross-border banking crises rely heavily on the co-operation of home and host prudential supervisors and between these and the LOLR, the resolution authorities, deposit insurers and eventually on the taxpayers' willingness to support foreign banks. But cooperation may be discouraged by a different allocation of responsibilities between home and host prudential supervisors and deposit insurance regulators. Further, as Baxter (2004) points out, there is always a potential for conflict among supervisors from different countries and this potential becomes particularly ominous when a bank weakens.<sup>62</sup> Baxter observes that conflict, rather than cooperation, characterizes the resolution process for troubled banks. Non-cooperative behavior between regulators (supervisors, deposit insurers and LOLRs) may delay dealing with individual crisis, which, in turn, may convert a problem in one institution into a systemic crisis. Moreover, national regulators, to the extent that are exempted from any obligation to financially support its protection schemes even in the context of a banking crisis, have the incentive to delay and not cooperate with other member state authorities.

Eisenbeis maintains that the existing arrangements in the EU between home and host deposit insurers and prudential supervisors raise potential problems. First, vulnerable systems of protection could have spill-over effects to other countries' protection systems by triggering a liquidity crisis at an international branch. Second, resolution problems may arise because there are country-to-country differences in bankruptcy laws.

In sum, the deposit insurance Directive fell short of harmonizing the existing member states depositors' protection schemes.

## **6- Potential remedies and final reflections**

How could this situation be improved? Different countries have dealt with the problem posed by international banks in different manners. New Zealand requires foreign banks operating in the country to be subsidiaries that are legally separate from their parent, and not branches. As separate legal entities they would be clearly subject to New Zealand law with unambiguous responsibilities.<sup>63</sup> A requirement to operate as subsidiaries might clarify responsibilities but subsidiaries might well prove to be a less efficient mode of organizations for banks. In fact, legal separation may not reflect economic reality. Cross-country cooperation would still be necessary to resolve subsidiaries because consolidated prudential supervision is the responsibility of the home country supervisor. Furthermore, the demise of one subsidiary could threaten the viability of the whole financial group. In fact, developments in Europe are in the other direction—toward branches rather than subsidiaries.

In Europe, the Nordea group has adopted a very different approach under the *Societas Europaeae* enforced since October 2004.<sup>64</sup> By 2006 Nordea will operate as a single bank based in Sweden with branches in all other countries. By then, the Swedish prudential supervisors would be the primarily responsible for the solvency of the bank. Moreover, in principle, Swedish deposit insurance would cover all deposits eligible under the EU Directive, although, as mentioned above, the Directive allows the branches of a foreign bank to top-up their coverage where the host country offers more generous limit above the EU minimum. In this fashion, the Nordea approach under the *Societas Europaeae* seems to have resolved a large part of the problem of disparate home and host regulators with regard to prudential supervision as compared to depositor insurance and resolution. In principle, Nordea will match the political accountability of prudential supervisors; deposit insurance and resolution authorities—the latter would act under the Swedish insolvency law.

In general, the need to preserve financial stability at the EU level demands an increased commitment to information exchange and to coordination of action between the home and host country supervisors as well as between those and the other safety net regulators (LOLR, deposit insurance and resolution authority).

Faced with unpopular public outlays to resolve failures in its banking and thrift industries, the US enacted a system of prompt corrective action (PCA), which is also referred to as structured early intervention and resolution (SEIR), for banks in 1991. To discourage supervisory forbearance, banks receive additional scrutiny and growing restrictions as their condition deteriorates. Moreover, the chartering agencies are required to close a bank when its capital ratio falls below two percent of its total assets. It is intended that Supervisors will turn a troubled bank around at a manageable stage and, if they fail in this quest, that they will resolve it before insolvency. This approach has not been adopted in Europe, however. Instead the focus is being placed on institutional change.

Any consideration of centralization of prudential supervision at the Euro area/EU level as foreseen in the EC Treaty (article 105(6)) and the ESCB Statute (article 25.2) or in the Lamfalussy Report might require an overhaul of the existing regulatory arrangements for deposit insurance. This may solve the two potential problems of the present deposit insurance arrangements in the EU that were identified by Eisenbeis, but it still faces the limitation posed by the inability to tap into taxpayers' resources as needed in order to provide the credibility of the deposit guarantee. To date deposit insurance reform has been largely neglected in policymaking debate. Further harmonization of the national deposit schemes as well as formalization of information exchange among them and with supervisors and central banks would be reforms to be considered in the short term.

If such centralization of prudential supervision ever happens, the question arises of whether this single supervisor would still be the initiator of the insolvency process as it is the case now in the EU or it would be preferable to confer this power to a centralized deposit insurance regulator that would also be a resolution agency. The case where the supervisor would be the initiator raises the question of how both regulators (prudential supervision and deposit insurance) and the central banks (including the ECB) would share information on a bank's financial condition. If and when reform—of supervision, resolution practices, or deposit insurance—takes place, it needs to be consistent with the principle of subsidiarity, contained in article 5 of the EC Treaty.<sup>65</sup>

There might be a need for an *ex ante* agreement to share costs among the national treasuries in the event that a pan European bank failed and its resolution costs exceeded the funding available in the deposit insurance fund.<sup>66</sup> Such agreement would be needed in light of the absence of a single tax authority in the EU and the limitations imposed by the EC Treaty. However, disagreement may arise as to whether a particular action would maximize the funds available.<sup>67</sup>

This far, the EU approach is to sign MoUs, in which the regulators involved (supervisors, central banks-including the ECB-) have agreed on a set of principles and procedures for identifying the authorities responsible for a crisis; ensuring required flows of information between involved authorities and providing practical conditions for sharing information on distressed banks. A consensus exists among academics and policymakers that is currently infeasible and non-advisable to centralize the institutional framework to deal with cross-border banking crisis in the EU.<sup>68</sup> There is, in fact, no consensus among

member states in favour of creating new structures or institutions. Against this background, the existing mechanisms of cooperation and exchange of information on the financial condition of banks, based on MoUs, currently constitute a step in the right direction for dealing with cross-border banking crises in the EU. While preserving the independence of supervisors and central banks, the limitations of MoUs, including their lack of legal enforceability and political accountability, need to be recognized.

## References

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<sup>1</sup> The authors express their gratitude to Chryssa Papathanassiou and Larry Wall for their extremely helpful comments on a preliminary draft of the paper. The opinions stated herein are those of the authors. Any errors are the authors' responsibility.

<sup>2</sup> European Central Bank (2003) "Structural Analysis of the EU Banking Sector: Year 2002" <http://www.ecb.int/pub/pdf/other/eubksectorstructure2003en.pdf>, and Schoenmaker, D. and Oosterloo, S. (2004) "Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities". Financial and Monetary Studies 22-01. Ministry of Finance. The Netherlands.

<sup>3</sup> There has been debate as to what extent the International Monetary Fund acts as a lender of last resort to governments, although it does not lend directly to financial institutions. The Basel Committee's capital framework is a step towards minimum regulatory harmonization and its Core Principles of Banking Supervision are minimum requirements for effective banking supervision.

<sup>4</sup> Consolidated version of the Treaty Establishing the European Community - EC Treaty. Official Journal of the European Communities 2002/ C 325 of 24.12.2002.

<sup>5</sup> Herring, R. J. (2002) "International Financial Conglomerates: Implications for Bank Insolvency Regimes", unpublished draft, Wharton School, University of Pennsylvania, July; Herring, R. J. (2004) "BCCI and Barings: Bank Resolutions Complicated by Fraud and Global Corporate Structure," paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, September 30-October 1, and Hadjiemmanuil, Ch. (2004) "Europe's Universalist Approach to Cross-Border Bank Resolution Issues", paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, September 30-October 1.

<sup>6</sup> Kahn, Ch. M., and Santos J. A. C. (2002) "Allocating Lending of Last Resort and Supervision in the Euro Area" in (V. Alexander, J. Melitz and G.M. von Furstenberg eds.) Monetary Union: Why, How, and What Follows?, chapter 19, Oxford University Press, London; Freixas, X. (2003) "Crisis Management in Europe," in (J.J.M. Kremers, D. Schoenmaker and P.J. Wierds, eds.) Financial Supervision in Europe, pp. 102-119, Edward Elgar and Schoenmaker, D. and Oosterloo, S. (2004). "Financial Supervision in an Integrating Europe: Measuring Cross-border externalities" Financial and Monetary Studies 22-01. Ministry of Finance. The Netherlands.

<sup>7</sup> Herring, R.J (2002) ref. 5 above.

<sup>8</sup> Hadjiemmanuil, Ch. ref. 5 above.

<sup>9</sup> Kahn, Ch. M., and Santos J. A. C. (forthcoming 2004) "Allocating Bank Regulatory Powers: Lender of Last Resort, Deposit Insurance and Supervision" Forthcoming in the European Economic Review.

<sup>10</sup> Ferguson, R. W. (2002) "Challenges to Central Banking from Globalized Financial Systems," IMF Conference: Should financial stability be an explicit central bank objective? September 16-17.

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- <sup>11</sup> The Financial Stability Forum has given the International Monetary Fund and the World Bank incipient responsibilities for promoting financial stability through their Financial Stability Assessment Program (FSAP).
- <sup>12</sup> Resolving the 1980s crisis in the US savings and loan industry was hampered by the actions of some politicians who had been bought by campaign contributions from the owners of failing savings and loan.
- <sup>13</sup> De Haan, J. and Oosterloo, S. (2004) "The Role of Central Banks in Fostering Financial Stability" paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, September 30-October 1, 2004.
- <sup>14</sup> Core Principles for Effective Banking Supervision. Basle Committee on Banking Supervision. Basle. September, 1997. Core Principle 1.
- <sup>15</sup> Directive 77/780/CEE of the Council of 12 December 1977, The Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of Credit Institutions. Directives establish general principles that need to be transposed into national laws in order to be legally binding at national level.
- <sup>16</sup> Deposit Insurance was harmonized by Directive 94/19/EC of the European Parliament and of the Council of 30 May, 1994 on deposit-guarantee schemes. Official Journal of the European Communities 31 May, 1994. L 135.
- <sup>17</sup> The adoption of Directives in the field of financial regulation takes 2 or 3 years approximately, followed by a 1 to 2 years period of national transposition.
- <sup>18</sup> Note of the European Commission to the ECOFIN Council (Brussels, 3<sup>rd</sup> December, 2002), [http://www.europa.eu.int/comm/internal\\_market/en/finances/cross-sector/consultation/ecofin-note\\_en.pdf](http://www.europa.eu.int/comm/internal_market/en/finances/cross-sector/consultation/ecofin-note_en.pdf).
- <sup>19</sup> Nieto, M. J. and Peñalosa, J. M. (2004) "The European architecture of regulation, supervision and financial stability: A central bank perspective" Journal of International Banking Regulation. Vol. 5, No. 3, pp. 228-242.
- <sup>20</sup> Lastra, R. (2004). "The Governance Structure for Financial Regulation and Supervision in Europe", Columbia Journal of European Law, Vol. 10 (pp.49-68) and Nieto, M. J. and Peñalosa, J. M. ref. 19 above.
- <sup>21</sup> Lamfalussy Report: Final Report of the Committee of Wise Men on the Regulation of European Securities Markets [http://europa.eu.int/comm./internal\\_market/en/finances/general/lamfalussyen.pdf](http://europa.eu.int/comm./internal_market/en/finances/general/lamfalussyen.pdf). (p.41)
- <sup>22</sup> Duisenberg, W. (2000) "The future of banking supervision and the integration of financial markets". Conference organized by the Euro Group on improving integration of financial markets in Europe, 22 May.
- <sup>23</sup> Kahn and Santos ref. 9 above
- <sup>24</sup> Garcia, G.G.H. and Prast, H. (2004) "Depositor and Investor Protection in the Netherlands, Past, Present and Future", De Nederlandsche Bank Occasional Paper, No. \_\_\_\_, November and Nieto, M. J. and Peñalosa, J. M. ref. 19 above.
- <sup>25</sup> Masciandaro, D. (2005, forth "Financial Authorities? A Political Economy Approach" in (D. Masciandaro ed.), Central Banks and Single Financial Authorities in Europe, Edward Elgar.

<sup>26</sup> The MoU consists of a set of principles and procedures that deal specifically with the identification of the authorities responsible with the crisis and the required flows of information between all authorities and the practical conditions for sharing information at the cross-border level.

<sup>27</sup> Coordination among EU bank supervisors and national central banks takes place within committees under the umbrella of the ECB (Banking Supervisors Committee) or in the context of the Lamfalussy architecture (Committee of European Banking Supervisors). The mandate of the Banking Supervisors Committee is focused on financial stability as well as structural developments in the banking system of the EU, while the Committee of European Banking Supervisors' mandate is focused on convergence of supervisory practices and advice to the EU Commission.

<sup>28</sup> Bini Smaghi, L. (2000), "Who takes care of financial stability in Europe?" in (Ch. A. E. Goodhart ed.) *Which Lender of Last Resort for Europe*. Central Banks Publications. London (pp. 225-250); Prati, A. and Schinasi, G.J. (1999) "Financial Stability in the European Economic and Monetary Union", in (Ch. A. E. Goodhart ed.) *Which Lender of Last Resort for Europe*, London: Central Banking Publications (pp. 69 - 117) and Schoenmaker, D. and Oosterloo, S. ref. 2, above.

<sup>29</sup> Kahn, Ch. H. and Santos, J.A.C. ref. 6 above.

<sup>30</sup> Schoenmaker, D. commenting to Ernia, A. and Vesala, J. (2003), "Externalities in supervision: The European case" in (Jeroen J. M. Kremers, Dirk Schoenmaker and Peter J. Wierts eds.) *Financial Supervision in Europe*. Edward Elgar: Cheltenham. (p.97).

<sup>31</sup> Roldán, J.M. (2004) "Establishment of the Committee and Future Challenges" 26 April, <http://www.c-eps.org/SP2.htm>.

<sup>32</sup> Although, in principle the Report foresaw a new European financial regulator only for the securities market, when Lamfalussy was asked the question of whether such regulator would have to cover banking and insurance, he responded that it probably would have to do so. See Lastra, R.M. ref. 20 above.

<sup>33</sup> Goodhart, Ch.A.E, (2003) "The Political Economy of Financial Harmonisation in Europe," in ( Jeroen J.M. Kremers, Dirk Schoenmaker and Peter J. Wierts eds.) *Financial Supervision in Europe*. Edward Elgar: Cheltenham pp. 132-137.

<sup>34</sup> Consolidated version of the Treaty Establishing the European Community -EC Treaty- Ref. 4 above.

<sup>35</sup> Comity in the legal context may be defined as the recognition by the courts in one jurisdiction of the laws and judicial decisions of another.

<sup>36</sup> The authors are grateful to Larry Wall for bringing to their attention that most US banks belong to Bank or Financial Holding Companies. While banks face special bankruptcy laws, holding companies' non-banking subsidiaries are resolved by the bankruptcy courts.

<sup>37</sup> Council Regulation (EC) No. 1346/2000 of May 29, 2000 on Insolvency Proceedings.

<sup>38</sup> Hadjiemmanuil, Ch., ref. 5 above.

<sup>39</sup> Directive 2001/24/EC of the European Parliament and of the Council of 4 April on the reorganisation and winding up of credit institutions. Official Journal of the European Communities 5 May, 2001. L125.

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<sup>40</sup> Insurance activities are governed by Directive 2001/17/EC of the European Parliament and the Council of 19 March, 2001 on the reorganization and winding-up of insurance undertakings. Official Journal of the European Communities 20 March, 2001. L110/20.

<sup>41</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March, 2000 relating the taking up and pursuit of the business of credit institutions. Official Journal of the European Communities 25 May 2000. L 126.

<sup>42</sup> Directive 94/19/EC of the European Parliament and of the Council of 30 May, 1994 on deposit-guarantee schemes. Official Journal of the European Communities 31 May, 1994, No. L135/5 and Directive 97/9/EC of the European Parliament and the Council of 3 March 1997 on investor-compensation schemes. Official Journal of the European Communities 3 May 1997 No. L 84/22.

<sup>43</sup> Directive 2001/24/EC of the European Parliament and of the Council of 4 April on the reorganisation and winding up of credit institutions. Official Journal of the European Communities 5 May, 2001. L125

<sup>44</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March, 2000 relating the taking up and pursuit of the business of credit institutions (art. 25): "The Commission may submit proposals to the Council, either at request of a Member State or on its own initiative, for the negotiation of agreements with one or more third countries regarding the means of exercising supervision on a consolidated basis over: credit institutions the parent undertakings of which have their head office situated in a third country."

<sup>45</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March, 2000 relating the taking up and pursuit of the business of credit institutions (art. 28): "The competent authorities of the Member States concerned shall collaborate closely in order to supervise the activities of [...] branches there, in one or more Member States other than that in which their head offices are situated. They shall supply one another with all the information concerning the management and ownership of such credit institutions that it is likely to facilitate their supervision and the examination of the conditions for their authorization, and all the information likely to facilitate the monitoring of such institutions, in particular with regard to liquidity, solvency, deposit guarantees, the limiting of large exposures, administrative and accounting procedures and internal control mechanisms."

<sup>46</sup> Directive 94/19/EC of the European Parliament and of the Council of 30 May, 1994 on deposit-guarantee schemes. Official Journal of the European Communities 31 May, 1994. L 135. (art. 4). "...Admission shall be conditional on fulfilment of the relevant obligations of membership, including in particular payment of any contributions and other charges."

<sup>47</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March, 2000 relating the taking up and pursuit of the business of credit institutions. Ref. 45 above and art. 24: "..., the Community may, through agreements concluded in accordance with the Treaty with one or more countries, agree to apply provisions which, on the basis of the principle of reciprocity, accord to branches of a credit institutions having its head office outside the Community identical treatment throughout the territory of the Community."

<sup>48</sup> Directive 94/19/EC of the European Parliament and of the Council of 30 May, 1994 on deposit-guarantee schemes. Official Journal of the European Communities 31 May, 1994. L 135 (art. 6).

<sup>49</sup> Directive 2001/24/EC of the European Parliament and of the Council of 4 April on the reorganisation and winding up of credit institutions. Official Journal of the European Communities 5 May, 2001. L125 (Introduction and art. 1) "...Branches located in the Community of a credit institution of which the head office is situated in a third country, the definitions of home, Member State, competent authorities and administrative or judicial authorities should be those of the Member State in which the branch is located."

<sup>50</sup> Goodhart, Ch.A.E (2004) "Multiple Regulators and Resolutions" paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, September 30-October 1.

<sup>51</sup> Kane, E. J. (2004) "Impediments to Efficient Resolution of Insolvencies at Large Banks and Banking Crises", paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, September 30-October 1, 2004.

<sup>52</sup> In the United States investor protection takes a different path. It is achieved more by encouraging the provision of information so that the investor can guard his/her own interests and less by offering guarantees. The authors are grateful to Larry Wall for pointing this out.

<sup>53</sup> Directive 94/19/EC of the European Parliament and of the Council of 30 May, 1994 on deposit-guarantee schemes. Official Journal of the European Communities 31 May, 1994, No. L135/5 and Directive 97/9/EC of the European Parliament and the Council of 3 March 1997 on investor-compensation schemes. Official Journal of the European Communities 3 May 1997 No. L 84/22.

<sup>54</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March, 2000 relating the taking up and pursuit of the business of credit institutions. Official Journal of the European Communities 25 May 2000. L 126 ( article 1) defines a credit institution as "an undertaking whose business is to receive deposits or other payable funds from the public and to grant credits for its own account." It does not apply to credit unions, friendly societies or post-office giro institutions.

<sup>55</sup> The depositor and investor protection directives extend beyond the EU to the European Economic Area (EEA), which consists of countries in the EU plus Iceland, Liechtenstein and Norway.

<sup>56</sup> Garcia, G. G. H. (2000) "Deposit Insurance: Actual and Good Practices", IMF Occasional Paper No. 197; and International Association of Deposit Insurers (2002) Survey available at: [www.iadi.org](http://www.iadi.org).

<sup>57</sup> Garcia, G. G. H. and Prast, H. ref. 24 above.

<sup>58</sup> Eisenbeis, R. A. (2004) "Agency Problems and Goal Conflicts in Achieving Financial Stability: The Case of the EMU," paper presented at the Bank of Finland Conference on the Structure of Financial Regulation, September 2-3. Eisenbeis points out that the systems in place in the EU are reminiscent of the under-funded, un-diversified and unsupported deposit insurance systems that were created for over 100 years in individual states in the US.

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<sup>59</sup> Kaufman, G. G. (2003) "Depositor Liquidity and Loss-Sharing in Bank Failure Resolutions," Federal Reserve Bank of Chicago Working Paper WP 2003-02.

<sup>60</sup> See Kahn and Santos, ref. 9 above on regulators incentives to share costly information.

<sup>61</sup> Differences exist between countries and between banks within the same country. In the Central and Eastern European Countries, EU foreign banks presence mainly takes place via subsidiary. While in the UK, this presence is mainly via branches. European Central Bank, (2001). Structural Analysis of the EU Banking Sector Year 2001. <http://www.ecb.int/pub/pdf/other/eubksectorstructureen.pdf>

<sup>62</sup> Baxter, Th. C. (2004) "Cross-Border Challenges in Resolving Financial Groups," paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, September 30-October 1.

<sup>63</sup> Bollard, A. (2004) Keynote Speech at the Conference on Systemic Financial Crisis: Resolving Large Bank Insolvencies. Federal Reserve Bank of Chicago. September 30-October 1.

<sup>64</sup> The Council regulation 2157/2001/EC came into force on 8 October, 2004.

<sup>65</sup> The U.S. experience in developing a national banking charter versus the existing state charter in the 19<sup>th</sup> century could be relevant in this respect. Initially the regulation and supervision was responsibility of the states in which banks were chartered. The National Banking Act of 1864 created a national banking charter to compete with state banks as well as a nationwide banking supervisor, the Office of Comptroller of the Currency. Although the "national" banks were still heavily circumscribed, typically confined to operating in just one state, national banks were required to have a national charter, and were supervised by the new supervisor. In the 20<sup>th</sup> century, the banking system in the US evolved and a small number of banks became strong national and international players while the majority of the institutions remained local. The Federal Reserve Act of 1913 made mandatory for national banks to become members of the Federal System in order to have access to liquidity in times of crisis. State chartered banks could choose whether to belong to the Federal Reserve System or not; most do not. If they are members, state banks are supervised by the Federal Reserve. State banks that are non members of the Federal Reserve System are supervised by the Federal Deposit Insurance Corporation.

<sup>66</sup> See Prati, A. and Schinasi, G. J. ref. 28 above for an analysis of the possible mechanisms to discourage runs on credit institutions in the Euro area: deposit-insurance schemes, liquidity consortia, pools of solvent banks, and national treasuries.

<sup>67</sup> Mayes, D. G. (2004) "The Role of the Safety Net in Resolving Large Financial Institutions," paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, September 30-October 1.

<sup>68</sup> Goodhart, Ch. A. E. ref. 50 above and Schoenmaker, D. (2003) "Financial Supervision: from National to European?" *Financial and Monetary Studies*, 22(1), Amsterdam: NIBE-SVV.