

# **European Prudential Banking Regulation and Supervision**

The legal dimension

**Larisa Dragomir**

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# European Prudential Banking Regulation and Supervision

The financial market events in 2007–9 have spurred renewed interest and controversy in debates regarding financial regulation and supervision. This book takes stock of the developments in EU legislation, case-law and institutional structures with regards to banking regulation and supervision, which preceded and followed the recent financial crisis. It does not merely provide an update, but anchors these developments in the broader EU law context, challenging past paradigms and anticipating possible developments. The author provides a systematic analysis of the interactions between the content of prudential rules and the mechanisms behind their production and application.

*European Prudential Banking Regulation and Supervision* includes discussions of the European banking market structure and of regulatory theory that both aim to circumscribe prudential concerns. It scrutinises the content of prudential norms, proposes a qualification of these norms and an assessment of their interaction with other types of norms (corporate, auditing and accounting, consumer protection, competition rules). It also features an analysis of the underpinning institutional set-up and its envisaged reforms, focusing on the typical EU concerns related to checks and balances. Finally, the book attempts to revive the debate on supervisory liability, in light of the developments discussed.

This book will be of great value to all those interested in financial stability matters (practitioners, policy-makers, students, academics), as well as to EU law scholars.

**Larisa Dragomir** completed her PhD at the EUI and Master of Arts at the College of Europe. She is an expert in EU banking law and supervisory issues. She has worked with the European Savings Banks Group (Brussels) and the European Central Bank (Frankfurt).

**To my parents**

***Quidquid agis, prudenter agas, et respice finem***

# Abbreviations

AMA	Advanced Measurement Approach
APFSE	Advisory Panel of Financial Services Experts
BAC	Banking Advisory Committee
BCBS	Basel Committee on Banking Supervision (or Basel Committee)
BIS	Bank of International Settlements
BSC	Banking Supervision Committee of the ESCB
CAD	Capital Adequacy Directive
CBD	Codified Banking Directive
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEIS	Centre for International Studies in Economic Growth
CEPS	Centre for European Policy Studies
CERF	Cambridge Endowment for Research in Finance
CESR	Committee of European Securities Regulators
CIUs	Collective investment undertakings
COREPER	Committee of Permanent Representatives
CRD	Capital Requirements Directive
DGS	Deposit Guarantee Schemes
EAD	Exposure at default
EBA	European Banking Authority
EBC	European Banking Committee
EC	European Community
ECB	European Central Bank
ECJ	European Court of Justice
Ecofin	Economic and Financial Affairs Council
ECON	Committee on Economic and Monetary Affairs
ECR	European Court Reports
ECU	European Currency Unit
EEA	European Economic Area
EEC	European Economic Community
EFC	Economic and Financial Committee

EFR	European Financial Services Roundtable
EFTA	European Free Trade Area
EIB	European Investment Bank
ELEC	European League for Economic Cooperation
EMAC	Committee on Economic and Monetary Affairs
EMU	Economic and Monetary Union
EP	European Parliament
ESA	European Supervisory Authority
ESC	European Securities Committee
ESCB	European System of Central Banks
ESFR	European System of Financial Regulators
ESFS	European System of Financial Supervisors
ESRB/ESRC	European Systemic Risk Board/Council
ESRC	Economic and Social Research Council
EU	European Union
FBD	First Banking Directive
FESCO	Forum of European Securities Commissions
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
FSB	Financial Stability Board
FSC	Financial Services Committee
FSF	Financial Stability Forum
FSPG	Financial Services Policy Group
G10	Group of Ten
G20	Group of Twenty
GATS	General Agreement on Trade in Services
GdC	Groupe de Contact
ICAAP	Internal adequacy assessment process
IIMG	Inter-Institutional Monitoring Group
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IRB	Internal ratings-based (approach)
ISD	Investment Services Directive
JURI	Committee on Legal Affairs
LGD	Loss given default
LOLR	Lender of last resort
M&A	Mergers and acquisitions
MiFID	Directive 2004/39/EC on financial instruments markets
MoU	Memorandum of Understanding
NBER	National Bureau of Economic Research
NCB	National Central Bank
OECD	Organisation for Economic Cooperation and Development
OJ	Official Journal
OLAF	European Anti-Fraud Office
OTD	Originate-to-distribute

PD	Probability of default
RAS	Risk assessment system
SA	Standardised Approach
SBD	Second Banking Directive
SEA	Single European Act
SREP	Supervisory review and evaluation process
TFEU	Treaty on the Functioning of the European Union
UCITS	Undertakings for collective investment in transferable securities
UN	United Nations
VaR	Value at risk
WTO	World Trade Organisation

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# Preface

This book is a study of the European normative and institutional framework for prudential banking regulation and supervision. It is based on the research I undertook in 2000–5 at the European University Institute in Florence (Italy) in obtaining my doctoral degree. When I first approached the topic the European Union had just codified most of its disparate pieces of legislation into a single directive. I considered then that the creation of a consolidated banking code provided a good opportunity for assessing the stage of integration of the EU banking market and a good basis for analysing the interactions between regulation and supervision and between the European and the national levels, as well as the nature and legal effects of prudential standards. Soon after I engaged on this path of analysis, developments in the field precipitated and the static approach had to be abandoned in favour of an evolutionary perspective that attempted to keep abreast of the remarkable multi-faceted transformations affecting prudential issues.

There is hardly any prudential aspect that has been left unchanged in the past decade. Two main factors drove the comprehensive changes in the EU's regulatory and supervisory framework at the junction of the millennia. These are the outstanding evolution of the financial industry worldwide, with its peaks and lows, and the renewed acceleration of the integration process in the European Union following the introduction of the single currency. They are reflected in the current fine-tuned prudential rules enshrined in the Capital Requirements Directive and the Basel II Accord and the streamlined decision-making process provided by the four-level Lamfalussy framework. This book anchors these developments into the broader EU law paradigm and attempts to identify their specificities. It provides a systematic analysis of the interactions between the content of prudential rules and the procedural and institutional mechanisms underpinning their production and application. The dynamic aspects are emphasised and examined by challenging past paradigms and anticipating possible future developments.

The 2007–9 financial crisis unveiled important failures in the current EU regulatory and supervisory framework. Financial stability was profoundly shaken and policy-makers, as well as other stakeholders are now determined

to repair the whole prudential system. They propose to fill in gaps in regulation and to reshuffle the distribution of competences for supervision with the aim of preventing any such dramatic and wide-ranging events from occurring in the future. These recent developments place our evolutionary analysis very much into real events. What seemed, only a few years ago, merely a theoretical discourse – especially as regards the EU supervisory architecture – now constitutes a tangible challenge, on top of the agendas of EU policy-makers. This book attempts to facilitate understanding of the complex multiple layers underpinning prudential supervision and to point to the legal effects attached to specific developments.

This book contains my personal views, and all mistakes are ultimately mine. When undertaking this research I have benefited enormously from the support of many people, and I am thankful to all of them. Especially, I would like to express my warmest gratitude to Professor Jean-Victor Louis for introducing me to this topic and for his always enlightening and very useful remarks on my writings. I am immensely appreciative of Professor Louis' invaluable advice on this manuscript and for his having kindly agreed to write the foreword to this book. I am particularly thankful also to Professor Rosa Maria Lastra, both for her useful comments and for her belief in my research and her encouragement to publish it. I would equally like to thank Professor Fabrizio Cafaggi and Dr Mauro Grande for their valuable comments and encouragements on earlier drafts. I have benefited enormously from the fruitful discussions I had in the stimulating professional environments of the European University Institute, the European Central Bank, Columbia University and New York University, as well as from access to their rich libraries and resource centres. I am grateful especially to Professor Valentin Constantin, Professor Christian Joerges, Professor Jacques Ziller, Dr Chiara Zilioli, Christian Kroppenstedt, Luc Roeges, Giacomo Caviglia, Pedro Teixeira, Professor Geoffrey Miller and Professor Petros Mavroidis, for thought-provoking exchanges of views. The European Savings Banks Group provided me with valuable opportunities to be in direct touch with policy-makers and the banking industry during exciting times of reform and I am most grateful for that. I am also thankful to the two anonymous reviewers of an earlier version of the manuscript, whose useful suggestions I tried to incorporate into the final version. Last but not least, I would like to express my sincerest appreciation to the editorial and publishing team at Routledge, particularly to Ms Khanam Virjee, Ms Jessica Moody and Ms Liz Jones.

I owe a debt of gratitude to my dearest friend, Floarea Virban, who patiently scrutinised the manuscript and made most valuable comments. I am thankful to Thomas Fetzner for his useful suggestions on parts of this book and to Barbara Gabor, Isabela Atanasiu, Gerhard Salzer and Luca Di Preso for having consistently encouraged my efforts.

My heartfelt thanks go to my family for their untiring support and unlimited belief in me. They are so special. This book is dedicated to my parents, Elena and Toma Dragomir.

# Foreword

The author asked me to write a foreword to her book, which, as a matter of fact, does not need any introduction. The reader will observe by himself the merits of this well-thought-out work, which, as Larisa Dragomir recalls in her preface, was first a PhD thesis.

It is a difficult field of research for somebody with a background as a lawyer because the subject is by nature multidisciplinary, and the author has managed to penetrate its different aspects, helped not only by extensive readings of economic and legal literature but also by her practical experiences at the European Central Bank and, more recently, at the European Savings Banks Group.

The word 'European' in the title is important. It is a significant page of the process of European integration on which the book focuses. It is obviously a matter in flux, not only because banking regulation is part of the building of the single market and has followed the various stages of both it and, more generally, the European construction, but also because the banking industry worldwide has evolved. It is trivial to observe that banks are part of a global system. It is obviously true for cross-border banks but local banks are also influenced by what happens on the international scene, where they are more spectators than actors.

The reaction to the present crisis has been marked by the interplay between international and European actors. It was the G7 which as early as October 2007 asked for a thorough analysis of the situation and an agenda for solving the crisis to the then Financial Stability Forum (FSF). The EU elaborated its action plan at the same date and its progress depended considerably of the work done in parallel by the Standards Setting Bodies (SSBs), in particular the Basel Committee on Banking Supervision (BCBS) and the International Accounting Standards Board (IASB). A number of the same experts who are sitting in the so-called level 3 Lamfalussy Committees are present in most of the SSBs.

If the link between what happens at the global level and the EU level is a necessity, it doesn't mean that regulation has to proceed from the global to the regional to the national levels, or that it should always be so. Not only is the EU able to adapt standards – as, for example, those coming

from the Basel Committee – to the specificities of the Union, as recalled by Larisa Dragomir, but it can also take the lead and inspire solutions which could be adopted afterwards, for example by the G20 or by an international SSB. This was the case for the EU-proposed rules on credit-rating agencies (CRA), which are more preceptive than the Code of Conduct adopted by the International Organisation of Securities Commission (IOSCO).

The role of experts is of utmost importance in a matter which has so many technical aspects with important political implications. This raises in a specific context the classical question of the relations of experts and policy-makers. The author refers to an ‘epistemic community’. Commissioner McCreevy less emphatically once evoked the ‘tourist-committees’, alluding to the dispersion of their workplaces and their consequent nomadism. The author rightly observes that the EU does not have the position it should have in these bodies, and evokes its presumed role of coordinator. In most of them, the Commission has the status, formal or informal, of an observer. The task of the EU executive is made difficult because most of these committees, especially when composed of central bankers, are jealous of their independence. The role of the Commission is important because often, as for the Capital Requirements Directive (CRD), amendments to EU legislation result from the recommendations of these bodies. The Commission, as a guardian of the general interest, must also reflect the standpoint of those Member States which are not members of these bodies. The author rightly mentions that the representation and role of the EU in such bodies should be rethought.

Larisa Dragomir qualifies the Larosière report and the first steps made by both the Commission and the Council before the 2009 summer recess, as audacious, and she adopts an optimistic view on the prospective result of the current repair exercise on which – as the devil is in the detail – it is difficult to adopt a definitive judgement.

The readjustment now in progress – the author speaks about a ‘reshuffling’ – is a serious challenge for the ‘better regulation’ paradigm. Self-regulation that was presented as an alternative to legislation has proved not to be sufficient in the financial sector and the Larosière report has remarkably demonstrated that in order to fight the renewal of the crisis, action was needed at the level of the EU and its Member States in order to fight the causes of the turmoil. The question is now to draw the right balance between the need for central rules, a ‘single rulebook’, and the necessity to leave room for innovation, on condition, of course, that it is transparent and controlled by supervisory authorities. The author evokes the ‘light touch’ of the regulator, meaning that at the end of the day it is the bank itself which has to exercise due diligence. No rule can exempt the bank’s managers from the need to appreciate the risk. The legislation cannot dispense with common sense. Somebody evoked the ‘dangerous dogs’ regulation: you still need to act with caution with the dogs that are not on the list.