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Empowering the ECB to Supervise Banks:

A Choice-Based Approach

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Abstract

Banking supervision in the European Union has failed. The main institutional reforms currently being proposed are also likely to fail. It is thus worth considering alternatives. This paper explores the merits of a choice-oriented approach under which individual Member states have the option to delegate prudential supervision of their largest banks to the European Central Bank, while still retaining the right to re-assume such a role for themselves at a later date. Responsibilities, commitments and costs are allocated by means of a binding agreement with the ECB that can be tailored to Member states' specific circumstances, to the extent permitted by supervisory coherence and equal treatment. While our approach is not perfect, it is believed superior to both existing supervisory arrangements and the main proposed alternatives, and also the best feasible choice in the current circumstances.

I. INTRODUCTION

Empowering the European Central Bank (ECB) to supervise banks is not a new proposal. Moreover, all previous attempts to make the ECB the pan-European supervisor have been successfully opposed, based upon various economic and political considerations. The financial crisis that started in August 2007 has, however, unveiled deficiencies in the

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regulation and supervision of banks, leading to calls for institutional changes and providing an opportunity to suggest a new approach. This paper proposes the adoption of a choice-oriented model of ECB banking supervision that is believed both clearly superior to existing supervisory arrangements and the main proposed alternatives, and also the best feasible choice in the current circumstances.

Whilst the European Community (EC) has harmonized banking regulation, banking supervision remains decentralized. Member states must subject credit institutions to prudential, market and consumer protection supervision, but remain free to adopt the institutional design that they deem best suited to their needs. Harmonization is, however, complete enough for banks supervised in one (home) Member state to be able to offer banking services or establish a branch in another (host) Member state without becoming subject to prudential supervision by that state.

Decentralized banking supervision has the advantage of empowering the agency closest to the main domain of activity of most banks. However, it also implies the need for close international collaboration in the supervision of those banks that have significant cross-border operations. Consequently, EC law requires Member states to enter into written coordination and cooperation agreements not only for banks with branches outside the home Member state, but also for those with subsidiaries in other Member states. The approach employed is that a subsidiary should be supervised by the Member state in which it is incorporated, while the parent bank's home Member state should be responsible for consolidated supervision at the group level.

Many bilateral Memoranda of Understanding establish regular exchanges of information and procedures for on-site inspections. In addition, European Union (EU) banking supervisors have signed three multilateral Memoranda of Understanding on financial crisis management which also involve central banks and treasuries. The efficiency of these non-legally binding cooperative arrangements, especially their robustness in times of crisis, has previously been questioned by commentators, and the current financial crisis that emerged in August 2007 has shown that these concerns were justified.

Banking supervisors across the EU have often played down financial difficulties faced by credit institutions operating in their jurisdictions. Although this can be understood as an

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effort to prevent a downward spiral in confidence that could lead to bank runs and payment system disruptions, such downplaying is also likely to reflect opportunistic behaviour. So, some home supervisor optimism can be seen as an attempt to protect local depositors—for example, by constraining the transfer of liquidity of assets from branches or subsidiaries to a parent bank. Similarly, some host supervisor optimism may reflect an effort to avoid corrective actions by a home supervisor, for example, by constraining subsidiary or branch activity.

Cross-border financial distress situations provide more direct evidence of failures in supervisory coordination and cooperation. In theory, financial distress operations should have been swiftly handled by the supervisory colleges created in the application of EU law, which provide a forum for close cooperation among banking supervisors, with the home Member state supervisor as the chair. While the evidence remains scarce and partly anecdotal, the emerging view is that the involvement of multiple supervisors and the lack of clarity regarding decision-making and financial burden-sharing have resulted in cooperation and coordination failures.

Thus, it comes as no surprise that the EU finance ministers have called for improvement in EU financial supervision and the European Central Bank (ECB) has indicated it is in favour of assuming banking supervision powers. At the same time, a number of institutional reform proposals have emerged, including the establishment of a 'global' regulatory body, of 'European' supervisory colleges, and of a European System of Financial Supervisors. While there is little enthusiasm for creating a global body, some commentators contend, without citing much evidence, that introducing European supervisory colleges might prove more effective than the supervisory colleges previously established by the Member states. A more centralized approach to European supervision has been advanced by representatives of financial firms and policy centres. More specifically, they propose to go beyond the supervisory colleges and establish a European System of Financial Supervision, which would require deep institutional changes similar to those undertaken in the creation of the European System of Central Banks. ECB representatives have also recently started to angle for more supervisory coordination between the ECB and Member state supervisory authorities, and even suggested the allocation of banking supervision powers to the ECB.

In this article, we propose a policy approach that is more effective, less interventionist, and more feasible politically, than the alternatives currently being proposed. In essence, we suggest that Member states be given the *option t*o subject their largest banks to supervision by the ECB. Under our choice-oriented proposal, it would be possible for Member states to opt in and out of ECB banking supervision. Responsibilities, commitments and costs would be allocated by means of a binding agreement between a Member state and the ECB, that could be tailored to the Member state's specific circumstances, to the extent permitted by supervisory coherence and equal treatment. The approach is based upon an established EC regulatory technique, which has been implemented within as well as outside the financial services area. ECB banking supervision authority would be based upon Article 105 (6) of the Treaty, according to which specific tasks concerning policies relating to the prudential supervision of credit institutions may be conferred upon the ECB.

While this choice-oriented proposal does have some disadvantages, we consider it to be both clearly superior to existing supervisory arrangements and the main proposed alternatives, and also the best feasible choice in the current circumstances.The proposal provides Member states dissatisfied with their existing supervision arrangements with an alternative tailored to their needs while ensuring accountability of the ECB, and allowing further institutional changes. ECB supervision increases the likelihood that the proper risks rather than political factors, such as the promotion of "national champions", are the main driver of supervisory interventions. It allows for different supervisory approaches to be adopted by different Member states, both regarding the principle of ECB supervision and its timing. This avoids the deficiencies of a "one size fits all" approach and furthermore allows shifts in supervision to occur gradually. Last but not least, the proposal does not require a Treaty amendment, as the Treaty already provides that the ECB can be empowered with banking supervision tasks.

The paper is organized as follows. Section II describes the circumstances that have led to calls for institutional change. Section III assesses the main institutional reform proposals. Section IV frames a choice-oriented alternative, makes the case for adopting it and argues that possible objections are not persuasive. Section V concludes.

II. WHY INSTITUTIONAL CHANGE?

2.1 Banking supervision design: a historical perspective

Banks, that is institutions granting loans and receiving deposits from the public, are nowadays subject to state supervision in most, if not all jurisdictions. Theorists generally agree that banks perform four basic functions: offering liquidity and payment services; transforming assets; managing risks; and processing information and monitoring borrowers.[1] There is disagreement, however, over whether and how banks should be supervised. For a few, there is no good reason to supervise banks at all.[2] Others would limit supervision to making sure that banks with state deposit insurance invest only in very liquid assets.[3] Nowadays, however, most theorists favour a broader supervisory domain, although there is significant divergence about the extent to which supervisory discretion should be constrained.[4]

Historical evolution reflects these various models. During the 19th century, many countries favoured a predominantly laissez-faire approach to banking supervision—often cited examples being the U.S., Sweden and Scotland. Increases in bank-size and financial inter-actions as well as ownership dilution resulted in a more interventionist approach. This development was driven by the realization that it had become more likely for losses at one bank to spread across banks, hurting depositors and, ultimately, the real economy. The threat to financial stability was tackled by the adoption of "prudential" supervision aiming at reducing the risk of bank runs and disruption in payment systems. Over the years, this original goal was supplemented by two additional goals, consumer protection (to prevent

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1 See Xavier Freixas and Jean-Charles Rochet, MICROECONOMICS OF BANKING (2d ed. 2008).

2 See F. A. Hayek, DENATIONALIZING MONEY: THE ARGUMENT REFINED (1978); Kevin Dowd, THE STATE AND THE MONETARY SYSTEM (1989); David Glasner, FREE BANKING AND MONETARY REFORM (1989).

3 James Tobin, *Financial Innovation and Deregulation in Perspective*, 3 BANK OF JAPAN MONETARY AND ECONOMIC STUDIES (1985); Robert E. Litan, WHAT SHOULD BANKS DO? (1987);

4 Compare Milton Friedman, A PROGRAM FOR MONETARY STABILITY (1959); Mathias Dewatripont and Jean Tirole, THE PRUDENTIAL REGULATION OF BANKS (1994); George J. Benston and George G. Kaufmann, *Is the Banking and Payments System Fragile?* 9 JOURNAL OF FINANCIAL SERVICES RESEARCH 209 (1995); Charles W. Calomiris, *Blueprints for a New Global Financial Architecture*, in Leonardo Auernheimer (ed.), INTERNATIONAL FINANCIAL MARKETS: THE CHALLENGE OF GLOBALIZATION 259 (2000); Peter D. Spencer, THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS (2000).

banks from acting opportunistically vis-à-vis depositors) and financial market efficiency (by improving financial transaction transparency and orderliness).

The scope of banking supervision has also varied over time and across jurisdictions.[5] One very restrictive approach, implemented in the U.S. during much of the 20th century, constrained banks from undertaking almost all activities, except those linked to deposit-taking and loan-making. A much more liberal approach, valid until recently in France and Germany, allowed banks to undertake a wide range of activities, with the ultimate result that all financial services providers were considered banks and supervised as such. Under an intermediate approach, adopted in the European Union and in many other jurisdictions, only deposit-takers and loans-makers are considered banks, but the latter are allowed to undertake a wide range of activities.

The design of supervisory institutions has also evolved. State supervision was originally imposed as a *quid pro quo* for banks being granted access to central bank liquidity support in times of emergency. As a result, it was generally central banks rather than specialized agencies that first supervised banks. In most jurisdictions, this model is still applicable.[6] However, various major jurisdictions have redesigned the model in a way that curtailed the supervisory powers of central banks in favour of various specialized agencies.[7] Over time, the integration of the banking, securities and insurance markets brought some of these jurisdictions to integrate financial supervision within a single authority.

The single authority supervision model was first adopted by the UK and thereafter by several continental European jurisdictions, including Germany, Austria, Ireland and Belgium. Its adoption generally coincided with further declines in central bank supervisory involvement.[8] The single supervisor is responsible for supervising and regulating all financial

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[5] See also Tommaso Padoa-Schioppa, REGULATING FINANCE (2004).

[6] See Marco Arnone and Allessandro, *Architectures of Supervisory Authorities and Banking Supervision*, in Donato Masciandaro and Marc Quintyn (eds.), DESIGNING FINANCIAL SUPERVISION INSTITUTIONS 262 (2007).

[7] For a an overview of theoretical models and their practical application, see Giorgio di Girogio and Carmine Di Noia, *Financial Supervisors: Alternative Models*, in Masciandaro and Quintyn, *supra* note 6, 342.

[8] See Donato Masciandaro, *Divide et Impera: Financial Supervision Unification and Central Bank Frangmentation Effect*, 23 EUROPEAN JOURNAL OF POLITICAL ECONOMY 285 (2007). Questions have arisen about the effectiveness of the single supervisor model in light of the financial crisis in the

industry segments and should have three regulatory objectives: stability, transparency and competition.[9] Other major jurisdictions, including Italy, The Netherland and the U.S., have adopted the so-called Twin Peaks model. Under this model, one supervisory authority has a prudential role (ensuring financial stability both at the single bank and financial system levels) and one supervisory authority deals with consumer protection and financial market transactions. Central banks continue to play an important role under the Twin Peaks model, as they are often the agency in charge of prudential supervision, at least for larger banks.

2.2 Institutional deficiencies in EU banking supervision

The EC has enacted several banking directives.[10] However, banking supervision effectively remains decentralized. Member states must subject banks (or to use EC terminology "credit institutions") to prudential, market and consumer protection supervision, but remain free to adopt the institutional design that they deem best suited to their needs. Nevertheless, harmonization is "complete" enough for banks supervised in one Member state (the home state) to be able to offer banking services or establish a branch in another Member state (the host state) without becoming subject to prudential supervision by that state. Under this "home country control" approach, a bank can essentially do business throughout Europe under the banking law of its home state. The host state remains, nevertheless, empowered to impose additional compliance with rules it has adopted in the interests of the general good.

Decentralized banking supervision has the advantage of empowering the agency closest to the main domain of activity of most banks. It also, however, requires close international collaboration in the supervision of those banks that have significant cross-border operations. Hence, EC law requires Member states to enter into written coordination and

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UK and changes proposed in the allocation of responsibilities between the Treasury, the Financial Services Authority (FSA) and the Bank of England. See Barry Eichengreen, *Thirteen Questions about the Subprime Crisis* (Working Paper 2008, available at econ.berkeley.edu).

[9] See C. Hawkesby, *The Institutional Structure of Financial Supervision: A Cost-Benefit Analysis*, 2000 JOURNAL OF INTERNATIONAL BANKING REGULATION 36. Compare the three core market supervision objective as defined by the International Organization of Securities Commissions: the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk. See IOSCO, *Objectives and Principles of Securities Regulation* 5 (2002).

[10] See, in particular, Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ [2006] L 177/1.

cooperation arrangements not only for banks with branches outside their home Member state, but also for those with subsidiaries in other Member states.[11] While a subsidiary is supervised by the Member state in which it is incorporated, the parent bank's home Member state is responsible for consolidated supervision at the group level.[12]

Many bilateral Memoranda of Understanding between Member states establish regular exchanges of information and procedures for on-site inspections. In addition, EU banking supervisors have signed three multilateral Memoranda of Understanding on financial crisis management which also involve central banks and treasuries. The efficacy of these cooperation arrangements, which are not legally binding, and especially their robustness in times of crisis, has been questioned by commentators.[13] The financial crisis that started in August 2007 has justified such concerns by revealing the arrangements' failure to address properly conflicts of interests among supervisors, diversity in deposit insurance schemes, and financial distress situations.[14]

Conflicts of interest. Banking supervisors across Europe have often downplayed financial difficulties faced by banks operating in their jurisdictions. This can be understood as an effort to prevent a downward spiral in confidence that could lead to bank runs and payment system disruptions. As will be illustrated below for financial distress situations, however, it is

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[11] See Art. 129 of the Credit Institution Directive, *supra* note 10, and Art. 38 Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions, OJ [2006] L 177/201.

[12] See Art. 131 Credit Institution Directive, supra note 10.

[13] See Maria J. Nieto, *The Debate on the EMU Institutional Framework for Dealing with Banking Crisis*, in David G. Mayes and Geoffrey E. Wood (eds.), THE STRUCTURE OF FINANCIAL REGULATION __ (2007); Garry J. Schinasi and Pedro Gustavo Teixeeira, *The Lender of Last Resort in the European Single Financial Market*, in Gerard Caprio, Douglas D. Evanoff and George G. Kaufman (eds.), CROSS-BORDER BANKING: REGULATORY CHALLENGES 349 (2006); Xavier Freixas, *Crisis Management in Europe*, in Jeroen J.M. Kremers, Dirk Schoenmaker and Peter J. Wierts, FINANCIAL SUPERVISION IN EUROPE 102 (2003).

[14] See also Maria J. Nieto and Gary J. Schinasi, *EU Framework for Safeguarding Financial Stability: Toward an Analytical Benchmark for Assessing its Effectiveness* (IMF Working Paper 2007, available at ssrn.com); Maria J. Nieto and Larry D. Wall, *Preconditions for a Successful Implementation of Supervisors' Prompt Corrective Action: Is There a Case for a Banking Standard in the European Union?* 7 JOURNAL OF BANKING REGULATION 191 (2006); Christos Hadjiemmanuil, *Europe's Universalist Approach to Cross-Border Bank Resolution Approach*, in Douglas D. Evanoff and George G. Kaufman (eds.), SYSTEMIC FINANCIAL CRISES: RESOLVING LARGE BANK INSOLVENCIES 217 (2005).

also likely to reflect opportunistic behaviour. So, home supervisor optimism can be seen as an attempt to prevent less informed host supervisors from taking preemptive measures to protect local depositors—for example by constraining the transfer of liquidity or assets from branches or subsidiaries to the parent bank. Similarly, host supervisor optimism may reflect an effort to avoid corrective actions by the home supervisor (for example, by constraining subsidiary or branch activity), or to obtain a free ride (for example, by having the home supervisor support the monetary and reputation costs of corrective actions).[15] In other words, deficiencies in *ex ante* information exchange and cooperation agreements among supervisors have facilitated *ex post* exploitation of asymmetric information and externalities.

Deposit insurance. EC law provides that Member states must implement deposit-guarantee schemes covering a minimum of €20,000 per depositor.[16] Originally, most Member states adopted schemes deemed sufficient for dealing with the failure of a mid-sized bank, but there were differences in coverage—both in general, and in the treatment of foreign branches and depositors.[17] Hence, the decentralized approach to deposit insurance added regulatory competition issues to the usual cross-border regulatory conflicts of interests.[18] In past years, there were indications that new Member states were engaging in a race to the bottom, by trying to attract international depositors with lower insurance premiums.[19] The trend was reversed post August 2007. Ireland and Germany launched a race to the top,

[15] See also Harald Benink, Charles AE Goodhart and Rosa Maria Lastra (eds.), PROMPT CORRECTIVE ACTION & CROSS-BORDER SUPERVISORY ISSUES IN EUROPE (2007).

[16] See Directive 94/19/EC of 30 May 1994 on deposit-guarantee schemes, OJ [1994] L 135/5.

[17] See European Commission, *Report: Investigating the Efficiency of EU Deposit Guarantee Schemes* (May 2008, available at ec.europa.eu).

[18] See Robert A. Eisenbeis and George G. Kaufman, *Cross-Border Banking and Financial Stability in the EU*, 4 JOURNAL OF FINANCIAL STABILITY 168 (2008); Harry Huizinga *The EU Deposit Insurance Directive, Does One Size Fit All?,* in Aslı Demirgüç-Kunt, Edward J. Kane and Luc Laeven (eds.), DEPOSIT INSURANCE AROUND THE WORLD 253 (2008).

[19] See Nikolay Nenovsky and Kalina Dimitrova, *Deposit Overinsurance in EU Accession Countries*, in Demirgüç-Kunt *et al*., supra note 18, 281.

trying to improve the competitiveness of their banks by introducing unlimited state deposit guarantees.[20]

These measures may or may not have had the intended effect, as other Member states quickly responded with their own deposit guarantee measures. In any event, the Irish and German actions provide examples of Member states acting in what they consider their best interest, even though this may have negative effects for banks in other Member states.[21] Ireland tried to give six major Irish-owned banks a first mover advantage by providing them with blanket deposit guarantee coverage for private and corporate depositors. The (real or perceived) impact on the competitiveness of non-Irish-owned banks led many Member states, including Germany and the UK, to object strongly — forcing Ireland to soften its policy by extending the blanket guarantee to subsidiaries owned by various banks incorporated in other Member states. Another consequence of the Irish move was to prod leaders of Europe's largest economies to meet to discuss greater coordination of deposit guarantee schemes. Ironically, one of the participants, Germany chose to announce unilaterally a blanket deposit guarantee the very day following the meeting, reportedly blindsiding and definitely angering the other summit participants.

The extent to which cross-border supervisory coordination and cooperation has been further weakened by these events remains unclear. However, given that cross-border banking supervision requires mutual trust, it is unlikely that these public rows among senior public officials have reinforced it.

Financial distress. Cross-border financial distress situations provide more direct evidence of supervisory coordination and cooperation failures. Member states have generally set up dedicated supervisory colleges for each bank with cross-border activities, with the home

[20] Albeit not strictly a EU example, the UK's seizure of the UK assets of failing Icelandic banks to protect UK depositors against the risk of Iceland refusing to make deposit guarantee payments to depositors outside Iceland is another way of racing to the top.

[21] See also Alan Bollard, Being a Responsible Host: Supervising a Foreign-Owned Banks, in Evanoff and Kaufman, supra note 13, 3.

Member state supervisor serving as the chair. [22] Prior to the crisis, these colleges were expected to respond to any financial distress in a swift and efficient manner.

In reality, the available evidence suggests that this was not the case.[23] A good example is provided by the rescue of Fortis, a major bank based in Belgium, with significant operations also in Luxemburg and The Netherlands. It has been reported that financial distress information was not properly shared and supervisory authorities waited for each other to initiate emergency contacts.[24] As a result, decisive action was delayed, forcing a last-minute emergency bail-out to prevent a bank run. Similar issues apparently plagued the rescue of Dexia, a French bank with operations in Belgium and Luxembourg. To be sure, the evidence remains scarce and partly anecdotal. However, the general view is that the involvement of multiple supervisors and the lack of clarity regarding financial burden-sharing resulted in coordination and cooperation failures, with many bail-outs being very close calls.

It thus comes as no surprise that EU finance ministers have called for improvement in EU financial supervision. This prompted the European Commission to set-up a High Level Group with quite an open-ended mandate.[25] The Group has been requested to make proposals to strengthen European supervisory arrangements covering financial sectors, with the objective of establishing a more efficient, integrated and sustainable European system of supervision. This mandate clearly targets cross-border coordination and cooperation failures. Given that banking supervision deficiencies also occurred at the Member state level, the High Level Group has also been mandated to examine the allocation of tasks and responsibilities between the national and European levels.[26]

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[22] These colleges are based upon ad hoc agreements or the Memoranda of Understanding mentioned above.

[23] See, for example, Nicolas Veron, *Supervisory Colleges: Way Forward or Red Herring?* (2008, available at bruegel.org); Joellen Perry, *Trichet Shifts Gears on Euro-Zone Policy*, WALL STREET JOURNAL (European edition) December 5-7, 2008 at 9 (describing the ECB's efforts to press Member states into action in the Fortis, Dexia and Hypo Real Estate bail-out situations).

[24] See Pascal Dendooven, *Arrogante Bank in Crisise*, DE STANDAARD, November 15, 2008, at 34-35.

[25] The independent High Level Group on financial supervision is chaired by Jacques de Larosière and held its initial meeting on November 12, 2008. For its mandate, see europa.eu.

[26] Supervisory failures at the Member state level are in line with empirical studies having shown that no supervisory model is clearly superior to the others.

III. MAIN INSTITUTIONAL PROPOSALS AND THEIR DEFICIENCIES

The supervisory failures revealed since August 2007 have generated various institutional reform proposals. Most of them seek to establish new international bodies or to reinforce existing ones. The key reason for such approaches is that no domestic supervisor saw the crisis coming or was able to minimize its impact significantly, despite the existing diversity in supervisory models at the national level. Domestic institutional reform is, therefore, deemed likely to fail to target the real problem: the globalization of financial activities and its negative impact in terms of information and decision-making capabilities by national supervisors.[27]

Taking into account their political backing and institutional coherence, four reform proposals deserve particular attention: the establishment of a 'global' supervisory body in the form of global supervisory colleges, the establishment of European supervisory colleges, the creation of a European System of Financial Regulators, and the allocation of banking supervision powers to the ECB.

'Global' Supervisory Colleges. Various academics, regulators and politicians have recently called for the creation of a "global" regulator.[28] The idea is not new. Commentators have been suggesting for some time that a single international agency be empowered to supervise or, at least, monitor financial institutions.[29] The most prominent and detailed proposal is the one submitted by the European Union to the G-20.[30] It proposed that supervisory colleges for all large cross-border financial companies be set up. The colleges would be composed of representatives of regulatory agencies from major countries and

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[27] See Group of Thirty, *The Structure of Financial Supervision* (2008).

[28] See Carmen Reinhart and Kenneth Rogoff, *We Need an International Regulator*, FINANCIAL TIMES, November 29, 2008; Financial Stability Forum, *Report on Enhancing Market and Institutional Resilience* 52 (2008); European Council, Economics and Financial Affairs, November 4, 2008 meeting, Press Release 7 (available at www.consilium.europa.eu).

[29] See Richard Dale and Simon Wolfe, *The Structure of Financial Regulation*. 6 JOURNAL OF FINANCIAL REGULATIONS AND COMPLIANCE 326 (1998); Henry Kaufman, *Structural Changes in the Financial Markets: Economic and Policy Significance*, in Federal Reserve Bank of Kansas City, ECONOMIC REVIEW 5 (1994)

[30] See Tony Barber, *EU Calls for Tighter Financial Controls*, FINANCIAL TIMES, November 5, 2008.

financial centres. Approximately 30 firms would be targeted, the aim being to enhance communication among national regulators and develop response plans for financial distress situations.

This proposal seems very unlikely to be adopted, both because major countries have already signaled their opposition to it, and in view of past failures to set up such 'global' regulatory bodies.[31] In addition, even if it were adopted, the proposal would not resolve many of the deficiencies identified above due to its limited ambitions: it essentially boils down to greater information-sharing.

European Supervisory Colleges. The "regional" version of the proposal discussed above is not a new idea either. Supervisory colleges for banking institutions were set up by Member states several years ago, and committees of supervisors have proliferated at the European level in the wake of the 2001 Lamfalussy report.[32] However, deficiencies in information-sharing and the decision-making effectiveness of existing supervisory colleges and committees have been thought serious enough to warrant an evolutionary step on the Lamfalussy Report path.[33]

The main institutional proposal is a plan promoted by the European Commission. EC law would require that each bank with cross-border activities has to answer to a supervisory college formed of representatives from supervisory authorities from each country in which it operates. The college would share information, discuss risks and coordinate policy in case of problems under the leadership of the bank's home country supervisor. The proposal has not been received with much enthusiasm within the European Council, which merely agreed to have regulatory colleges meeting at least once a month to exchange information — a possible second step being the development of common information formats.

These are very modest developments. Whether colleges should have decision-making powers has been left open, as has the crucial issue of whether the head of the college —

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[31] See Barry Eichengreen, TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE (1999) (reminding those who made such proposals in the wake of the 1997-98 Asian crisis that politics remain local).

[32] See *Final Report of the Committee of Wise Men on The Regulation of European Securities Market* (2001, available at ec.europa.eu).

[33] See also Tommaso Padoa-Schioppa, *Europe Needs a Single Financial Rule Book*, FINANCIAL TIMES, December 11, 2007.

namely the home supervisor — should have the authority to ensure that its members exercise their separate sovereign powers in an identical way.[34] It follows that European supervisory colleges are unlikely to prove much more effective than the current supervisory colleges set-up by Member states.

European System of Financial Supervisors. A more centralized approach to European supervision has been put forward by representatives of financial firms and policy centres.[35] It is proposed to go beyond supervisory colleges and establish a European System of Financial Supervision (ESFS). This is a quantum rather than an evolutionary step on the Lamfalussy Report path. It requires deep institutional changes, similar to those that resulted in the creation of the European System of Central Banks. All European financial supervisory authorities would be working under a single institutional roof, while maintaining plurality in their operational structure. Prudential supervision of large and systematically important banks and insurance companies would be conducted at the European level, possibly in cooperation with national supervisors. Prudential supervision of other banks and insurance companies, as well as conduct of business supervision (consumer protection and market transactions) would remain the province of Member states.

This proposal has the clear advantage over the other two of addressing more credibly the above mentioned effectiveness issues. There are, however, several fundamental problems with its implementation. First, a Treaty amendment would be required to establish an ESFS, which would be both time consuming and politically risky due to the likelihood of popular referenda. Second, the ESFS would have to be built from scratch following a step-by-step approach, which makes the final framework difficult to predict. This is probably why proponents of this approach are very discreet when it comes to crucial issues like decision-making authority and procedures at the European level, cooperation and coordination with supervisory and treasury authorities at the Member state level, as well as relationships with

[34] Howard Davies and David Green, *A Better Way to Regulate European Finance*, FINANCIAL TIMES, Seotember 11, 2008.

[35] See Bernhard Speyer and Norbert Walter, *Towards a New Structure for EU Financial Supervision* (2007, available at dbresearch.com); Karel Lannoo, *Concrete Steps towards More Integrated Financial Oversight: The EU's Policy Response to the Crisis* (2008, available at ceps.eu).

central banks.[36] In other words, there is no guarantee that the proposed institutional change will deliver the required improvements in supervisory effectiveness. Finally, implementation of the proposal would require a mandatory, one-size-fits-all approach: Member states would be left with no choice other than subject their largest banks to centralized crisis management and macro-prudential oversight.

Extending the ECB's Powers. ECB representatives have recently started to angle for more supervisory coordination between the ECB and Member state supervisory authorities, or even suggested the allocation of banking supervision powers to the ECB.[37] No specific proposals have been made yet. Full-blown ECB supervision of the larger EU banks with cross-border activities is however, and as in the past, likely to generate significant Member state opposition.

IV. A CHOICE-BASED INSTITUTIONAL ALTERNATIVE

Given the problems with the main institutional reforms proposed in response to the failure of banking supervision in the EU, we propose an alternative, namely that Member states be given the option to subject their largest banks to supervision by the ECB.[38] This proposal is more effective, less interventionist, and more feasible politically, than the alternatives: the supervisory colleges proposals, the ESFS proposal, or mandatory ECB supervision.[39] The institutional design of such a regime, the incentives of Member states to exercise their option, the case for a choice-oriented approach and the lack of persuasiveness of possible objections, are outlined here in turn.

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[36] Coordination and cooperation is very generally dealt with, and only in terms of information sharing and consolidation failure. It is suggested to create a European Resolution Trust (as a safety net for short term problems in financial institutions of a certain size) and a Federal Deposit Protection Fund, but neither *ex ante* rules for Member state fiscal contributions nor insolvency procedures are addressed.

[37] See Monica Houston-Waesch and Terence Roth, *Will ECB get Wider Watchdog Role?*, WALL STREET JOURNAL (European ed.) September 11, 2008 at 19; Ralph Atkins, *ECB Seeks Wider Policing Role*, FINANCIAL TIMES, January 5, 2008 at 1; John Thornhill, *Paris Kicks Off Flurry of Crisis Forums*, FINANCIAL TIMES, January 10, 2008 (one-line ed.).

[38] Our proposal builds upon Gerard Hertig and Joseph A. McCahery, *Optional rather than Mandatory EU Company Law: Framework and Specific Proposals*, 4 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 341 (2006) and Gerard Hertig and Ruben Lee, *Four Predictions about the Future of Securities Regulation*, 3 JOURNAL OF CORPORATE LAW STUDIES 359 (2003).

[39] See also Howard Davies and David Green, GLOBAL FINANCIAL REGULATION: THE ESSENTIAL GUIDE (2008); Lorenzo Bini Smaghi and Daniel Gros, OPEN ISSUES IN EUROPEAN CENTRAL BANKING (2000).

4.1 Basic institutional design

Under our choice-oriented proposal, Member states will be able to opt in and out of ECB banking supervision. The approach is based upon an established EC regulatory technique, which has been implemented within as well as outside the financial services area.[40] The legal authority for ECB banking supervision is Article 105 (6) of the Treaty, according to which specific tasks concerning policies relating to the prudential supervision of credit institutions may be conferred upon the ECB.[41]

Scope. ECB supervision will be limited to managing EU-wide prudential risks.[42] The primary threshold will be set in terms of minimum deposits and total assets within a single bank or banking group. Additional criteria may be used to expand or limit the scope of ECB supervision, possibly on a Member state by Member state basis. They could be quantitative, based on the importance of a bank's cross-border operations for example, or qualitative, using a bank's risk profile for example. Overall, around 50 EU banks are likely to satisfy these thresholds.[43]

Opting-in agreement. An opt-in will become effective upon the conclusion of an agreement between the ECB and the Member state. The aim will be to ensure a robust allocation of responsibilities (who does what), commitments (what happens in financial distress situations, how can the agreement be terminated) and costs (who pays for what). Such an agreement will be superior to both existing Memoranda of Understanding framework and proposed reforms: it will be binding; it will clearly allocate decision-making powers; and it will allow for detailed arrangements as it can be tailored to Member state-specific circumstances—within, of course, the constraints set by supervisory coherence and equal treatment.

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[40] See, for example, Takeover Bids Directive 2204/25/EC, [2004] OJ L 142/12; Directive on Markets in Financial Instruments 2002/58/EC, [2002] OJ L 201/37; Fourth Directive on Annual Accounts, 78/660/EEC, [1978] OJ L 222/11.

[41] See already Working Group of the ECU Institute, BANKING SUPERVISION IN THE EUROPEAN COMMUNITY 44-5 (1995).

[42] See also Masciandaro, *supra* note 8.

[43] See *infra* about the supervision of subsidiaries.

The agreement's core provisions will address cooperation and coordination between the ECB and the Member state in normal times as well as in periods of crisis. The agreement will clarify the operational distinction between normal times ECB supervision and monetary activities in terms of reporting lines, personnel and geographical location. It will also allocate day-to-day supervision powers between the ECB and the Member state's banking supervisor—macro-prudential (systemic risk) responsibilities remaining within the ECB—and state the relationship between prudential and market supervisors. As far as situations where a bank faces financial distress or periods of crisis are concerned, the parties will have to agree on 1) when and how a failing bank will be taken over by a third party or bailed out, and 2) orderly resolution procedures in case of an insolvency. The agreement will have to detail the parties' required contributions in bail-out and resolution situations, distinguishing between the ECB's liquidity contributions and the Member state's fiscal contributions and guarantees.

Experiences made during the financial crisis that started in August 2007 will facilitate agreement drafting. In particular, the ECB as well as Member states are better aware of the issues they face and more willing to address them *ex ante*. As a result, familiar pre-crisis objections to having the ECB acting as lender-of-last resort or making the agreement specify bail-out or resolution procedures are unlikely to carry much weight.[44]

To be sure, the creation of an agreement between the ECB and a Member state with provisions specific to that state is likely to raise some opposition, as other Member states may feel at a competitive disadvantage. The agreement will thus have to take into account its pan-European impact. For example, the potential reputation and solvency benefits of ECB supervision for parents, subsidiaries or branches located in other Member states will have to be balanced with the unexpected costs the agreement may have in terms of ECB liquidity provision or balance-sheet deterioration. Moreover, to further assuage other Member states' concerns, the agreement could require an opting-in Member state to bear a share of

[44] See also Joellen Perry, Trichet Shifts Gears on Euro-Zone Policy, Wall Street Journal (European ed.) December 5-7, 2008 at 10 (reporting on the lack of common principles to govern rescues and allocation of costs in case of cross-border bail-outs or resolutions).

unexpected costs and to participate in the funding of a European Resolution Trust that would provide a safety net for financial distress situations.[45]

Applicability to individual banks. A given Member state's opt-in will be applicable to all banks incorporated in its jurisdiction that satisfy the thresholds mentioned above, i.e. that create EU-wide risks on a standalone or consolidated basis. The ECB could thus end-up having prudential supervision over parents as well as over subsidiaries, including those with non-EU parents.

Member states could make ECB prudential supervision mandatory for all banks that satisfy the relevant thresholds or adopt a default (opting-out) approach. Offering individual banks the possibility to opt-out is, however, likely to make contracting between the ECB and the Member state significantly more difficult. Therefore, individual banks should not be allowed to choose whether or not they will be supervised by the ECB. In that, our proposal differs from the approach supported by dual banking advocates.[46] Opting-out will be limited to three situations, which are also those that are most likely to provide a real regulatory alternative:[47] 1) when a bank stops satisfying the thresholds for ECB prudential supervision; 2) when a subsidiary has its debt fully guaranteed by a parent bank located in a Member state that has not opted-in (which would be in line with subsidiaries nowadays being the functional equivalent of branches); or 3) when a bank reincorporates into a Member state that has not opted in.

Member state opt-out. A Member state will be able to opt-out at any time—even in the middle of a financial crisis—provided it fulfills all obligations that have been triggered by virtue of the opting-in agreement. Such an open-ended approach reflects the choice-oriented character of an option approach while minimizing the risk of opportunistic

[45] See the proposal made by Speyer and Walter, *supra* note 34, at 17 and Lanoo, *supra* note 34, at 27.

[46] See Kenneth Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STANFORD LAW REVIEW 1 (1977); George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane and George G. Kaufman, PERSPECTIVES ON SAFE AND SOUND BANKING: PAST, PRESENT AND FUTURE 276-78 (2006); Ivan Mortimer-Schutts, *EU Regulatory and Supervisory Convergence: The Case for a Dual-System with Choice* (Working Paper 2005, available aei-brookings.org).

[47] See also Henry N. Butler and Jonathan R. Macey, *The Myth of Competition in Dual Banking*, 73 CORNELL LAW REVIEW 677 (1988).

behaviour. Member states that opt-in keep the freedom to recover supervisory sovereignty should the ECB performance fail to meet their expectations or unforeseen developments occur. At the same time, ECB and third party expectations will be protected against Member states reneging upon their commitments precisely when they become relevant, namely in the middle of a financial crisis.

4.2 Member states' incentives to opt into ECB supervision

When system-wide problems and problems of individual domestic banks converge, Member states are uniformly inclined to take individual stakes, to guarantee liabilities and to provide capital injections to deal with problems at troubled banks. However, moral hazard and differences in the sizes and resources of national regulators make it unlikely that Member states have similar incentives when the troubled bank has extensive cross-border activities.

This may not be a problem for a Member state with a large number of parent banks with branches in other Member states or for a smaller Member state where financial activities are mostly domestic. Generally, within this setting, home bias in banking supervision is unlikely to result in the Member state incurring significant costs because of deficient supervision of banks incorporated in another jurisdiction. By contrast, the stakes are clearly different in a Member state where financial activities by foreign parent banks play a significant role or for a smaller Member state with a few parent banks with subsidiaries in other Member states. Within this setting, deficient supervision by the parent bank's home supervisor or deficient coordination and cooperation with foreign supervisors may result in the Member state incurring significant costs in terms of economic disruption, bail-out contributions, deposit insurance and resolution procedures.

We hypothesize that it is primarily these Member states that will have an incentive to opt into the ECB prudential framework. Entering into an agreement with the ECB provides them with tailor-made supervision by a reliable institution with incentives that are more closely aligned with the Member state's goals than those of other national supervisors. While the latter are primarily concerned by the impact of their intervention (or lack thereof) on *their* domestic markets, cross-border externalities are high on the ECB's priority list. Moreover, ECB independence and its lender-of-last resort function are likely to provide reputation benefits to any banks it supervises. Third parties will not expect supervision to be tainted by

purely national considerations, be they economic or political, and will assume that the ECB's priority is to minimize the risk of financial distress. Most importantly, allocating banking supervision to the ECB will facilitate supervision coordination and cooperation regarding parents or subsidiaries incorporated in other Member states. This will obviously be the case if the latter Member states have also opted into ECB supervision, as there will be only one supervisor for the whole banking group. Coordination and cooperation will also be facilitated, however, if a parent or a subsidiary is incorporated in a Member state that has not opted into ECB supervision due to the ECB being independent—and thus less inclined to distort competition —and also in charge of monetary policy—and thus interested in financial stability across the EU. For example, we expect coordination and cooperation to function better between the ECB acting as the supervisor of Irish banks and UK supervisory authorities than between the latter and the Irish supervisory authorities.

Generally speaking, a Member state that is opting into ECB supervision reduces the risk of having to contribute to bail-out and other costs generated by foreign supervisory failures. In addition, as we show below, ECB supervision may also reduce supervisory costs for smaller Member states. It is also likely to reduce competition objections to the Member state providing financial aid to banks in distress. Finally, ECB supervision may have domestic political advantages for an opting-in Member state, to the extent it avoids giving too much power to a domestic agency or allows for the external allocation of blame in the case of a financial scandal.

To be sure, entering into the ECB prudential framework also has its disadvantages. The choice implies some loss of sovereignty, although this consequence can be minimized by having a domestic institution (for example the national central bank) contributing to day-to-day supervision. It also reduces the range of measures available to foster 'national champions'. Finally, it is likely to prevent the conduct of a supervisory policy that is in the interest of a Member state but contrary to the interests of the EU.

Let us address the issue of whether the incentives to opt into ECB supervision outweigh the incentives not to do so by sketching a few scenarios that cast light on the circumstances that would lead a Member state to consider such a move. Our first scenario is one under which the level of domestic banking activity is low relative to the size of the cross-border banking

activities of the one or two parent banks incorporated in that Member state—Belgium being a prototypical example. Such a Member state will find it difficult to devote the resources necessary to the supervision of the banking group headed by the parent as this would essentially benefit non-citizens and foreign jurisdictions. At the same time, foreign supervisors are likely to under invest in cooperation and coordination efforts, as they will not reap the full benefits of their efforts. The likely outcome is obvious: supervisory arrangements will prove inadequate and the risk of a banking meltdown will be very significant in case of a financial crisis. We deem the probability of an opt-in by such a Member state to be high, especially in the current environment.

Our second scenario is one under which a large Member state essentially relies on subsidiaries with parent banks in other member state to finance its economy—Poland being a prototypical example. In this situation, the Member state in which the parent is incorporated may under invest in supervision as to do so would disproportionately benefit market participants outside its jurisdiction. At the same time, the supervisor of the subsidiary may not be able to off-set this imbalance through cooperation and coordination efforts due to a lack of expertise or political clout. This supervisory arrangement is likely to prove inadequate and increase the risk of a credit crunch in the Member state in which the subsidiaries are incorporated.[48] Here we deem the probability of an opt-in by the latter Member state to be significant, again especially in the current environment.

Our third scenario is one under which a medium-sized Member state where the level of domestic bank activity is high enough to make it a financial centre and several parent banks with significant cross-border operations are incorporated—Ireland being the prototypical example. For reasons similar to the ones mentioned in the first two scenarios, both the Member state where the parents are incorporated and jurisdictions where they have subsidiaries will under-invest in supervision. Again, this supervisory arrangement is likely to prove inadequate in case of financial crisis, with significant economic and reputation costs for the parents' Member state. Here we deem the probability of an opt-in by the latter member state to be moderate, especially in the current environment.

[48] See Giamco Calzolari and Gyongi Loranth, *Regulation of Multinational Banks, A Theoretical Perspective*, (European Central Bank Working Papers Series, no. 432/January 2005).

The existence of a viable regulatory alternative, such as our proposed reform, could improve matters for these types of countries.

4.3 The case for a choice-oriented approach

A choice-oriented approach is superior to both the *status quo* and proposed reforms. Compared to the *status quo* and the European supervisory colleges proposal, it allows for more efficient supervision in normal times and is preferable in periods of crisis. Compared to the ESFS proposal, it allows for rapid implementation and is preferable in terms of flexibility, financial stability and political acceptability. These advantages of the choice are explained in turn.

Efficient supervision. Many smaller Member states will find it efficient to opt into "normal times" ECB banking supervision. This is most likely to be the case when the parent bank of a group that generates EU-wide prudential risks is incorporated in such a Member state, due to economies of scale and also difficulties in attracting and keeping experienced supervisors at the Member state level. Outsourcing supervision could also prove efficient if the incorporated bank is a subsidiary of a large group. To begin with, the subsidiary's supervisory authority may have difficulties having sufficient influence within the supervisory college when the parent is incorporated in a much larger Member state, which chairs the college. In addition, when both a subsidiary and its parent are incorporated in small Member states, collective action problems are pervasive in the absence of a "major" supervisory authority, as evidenced by the experience in the Fortis and Dexia cases.

Speedy implementation. A choice-oriented approach does not require a Treaty amendment in order to be implemented. Article 105 (6) of the Treaty already permits the devolution of prudential supervision to the ECB.[49] By contrast, the ESFS proposal can only be implemented following the time consuming and step-by-step procedures required for a Treaty amendment.

Flexibility. Under an opt-in regime, choice is not only about whether or not to transfer banking supervision powers to the ECB—which is already a significant option. The agreement with the ECB need not be standardized and may indeed contain Member state-

[49] See also David Howarth and Peter Loedel, THE EUROPEAN CENTRAL BANK, A NEW EUROPEAN LEVIATHAN? 95-7 (2003).

specific provisions. Obviously, there are limits to the flexibility of such an agreement. The ECB must have the power to pursue a coherent EU supervision policy, and equal treatment and competitive neutrality must be warranted. These constraints will not, however, prevent the creation of differentiated agreements.

A Member state that has opted in also keeps the option to opt-out. This will both improve its bargaining position and provide a clean way out should the transfer of banking supervision powers prove to have been a mistake. Admittedly, opting out may be costly if the Member state has to rebuild a large bank supervisory capacity, but such costs are unlikely to prove significant in comparison to the costs of continued (and mistaken) ECB supervision.

One may ask whether granting a Member state such a continuous option may compromise good banking supervision. In particular, it could be argued that Member states will engage in strategic behaviour that prevents the ECB from efficiently exercising its powers or result in a return to (worsened) supervision by the Member state. In practice, however, allowing a Member state to opt out of ECB supervision at any time likely to lead to three benefits. First, strategic bargaining by Member states may force the ECB to take into account Member state-specific issues in order for mutual consent to be reach on an initial agreement, and to any subsequent changes to it. Second, returning to the *status quo ante* by way of an opt-out is unlikely to make banking supervision worse than it would have been had the Member state not opted into ECB banking supervision in the first place. Third, there is no reason to believe that providing Member states with a continuous opt-out choice would result in worse banking supervision outcomes than would mandating centralized supervision by the ECB or by a new ESFS, especially when taking into account the one-size-fits-all and the comparative lack of accountability vis-à-vis individual Member states that will necessarily accompany such a mandatory approach.

Financial stability and crisis management. Substituting decentralized by centralized banking supervision has a number of financial stability and crisis management advantages. First, the ECB will obtain better information on bank liquidity and solvency as well as a better grip on the payment system—especially if the Member state's central bank is associated with day-to-day supervision. This will contribute not only to financial stability as it facilitates the

conduct of monetary policy. In times of crisis; it will allow the ECB to improve its lender-of-last-resort interventions.[50] Second, the ECB's banking supervision powers and activities, as well as the existence of a binding agreement will insure for effective bail-out and resolution cooperation with opting-in Member states that have banks in financial distress. Third, bail-out and resolution cooperation will also be facilitated among Member states that have opted into ECB banking supervision as they will share the same banking supervisor. Fourth, bail-out and resolution cooperation will also be improved between opting-in and non-opting in Member states due to the number of involved supervisors being reduced to one for Member states that have opted in. Fifth, ECB supervision increases the likelihood that EU-wide risks rather than the protection of "national champions" are the main driver of prudential interventions—not least because it reduce the risk of supervisory capture due to individual banks having less political influence at the EU-level than at the home Member state level.

While these advantages cannot be replicated within either the existing regulatory regime or the European supervisory colleges proposal, and would also be harder to generate under the ESFS proposal (as monetary policy powers would remain with the ECB), they would obviously also be present in a system requiring ECB supervision for all banks that generate EU-wide prudential risks.

Political acceptability. There is no decisive objection to the centralization of banking supervision powers, as shown by the existence of a Treaty provision permitting the devolution of prudential supervision to the ECB. Actually, it has been argued that the ECB did not originally obtain banking supervision authority mainly because the probability of a major EU-wide financial crisis was deemed to be low.[51] However, all proposals to grant banking supervisory powers to the ECB have been systematically defeated thereafter. Recent events have reviewed interest in the centralization of banking supervision in Europe

[50] See Emmanual Apel, CENTRAL BANKING SYSTEMS COMPARED, THE ECB, THE PRE-EURO BUNDESBANK AND THE FEDERAL RESERVE SYSTEM 177, 183 (2003) (.ECB is acting as lender of last resort within the Euro-system even though such power is not explicitly assigned to it by the Treaty or the ESCB Statute); Thomas I. Humprey and Robert E. Keleher, The *Lender of Last Resort: A Historical Perspective*, 4 CATO JOURNAL 275 (1984) (combining monetary policy and banking supervision facilitates the performance of the lender-of-last-resort function).

[51] See Raphaël Franck & Miriam Krausz, *Why Separate Monetary Policy from Banking Supervision,* 36 JOURNAL OF COMPARATIVE ECONOMICS 388 – 2008.

(as evidenced by the ESFS), but the assertion that the transfer of supervisory powers from the Member state to the European level has significantly better chances of success if undertaken in a progressive way remains true.[52] From that perspective, the ESFS proposal has the political disadvantage of being mandatory, not limited to banks and requiring a Treaty amendment.[53] Even a pared down ESFS proposal limited to proposing banking supervision by the ECB will still have the political disadvantage of being mandatory and, in addition, raise significant concerns about the ECB becoming overly powerful—an always present fear in European politics.[54]

Even a choice-oriented approach to ECB supervision will raise concerns due to Member states' reluctance to set centralization precedents. However, the optional, progressive nature of the proposal is much more likely to overcome political opposition to granting supervisory powers to the ECB. This is a crucial element considering that the granting of banking supervision powers to the ECB requires a *unanimous* Council decision.[reference?] Hence, even Member states that do not wish to have the ECB supervise their larger banks are likely to find it in their interest to grant banking supervision powers to the ECB on a voluntary basis for several reasons. First, they will be able to keep banking supervision at the Member state level. Second, ECB supervision of some banks will facilitate supervisory cooperation by reducing the number of relevant institutions. Third, and most importantly, it will diminish the risk of opportunistic behaviour in crisis situations.

4.4 Unpersuasive objections to a choice-oriented approach

It could be objected that our proposal has five major flaws: it leaves fiscal and insolvency responsibilities at the Member state level; it combines supervision and monetary policy responsibilities within one institution; it will result in the supervision of 'lemon' banks being

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52 See Lorenzo Bini Smaghi and Daniel Gros, OPEN ISSUES IN EUROPEAN CENTRAL BANKING 51-5 (2000).

53 See also Andrea Freytag & Donato, *Financial Supervision Architecture and Central Bank Independence*, in Masciandaro & Quintyn (eds.), DESIGNING FINANCIAL SUPERVISION INSTITUTIONS 211 - 2008) (central bank supervision is more likely to be acceptable if limited to banks).

54 See also Donato Masciandaro, Politicians *and Financial Supervision Unification Outside the Central Bank: Why Do They Do It?*, Journal OF FINANCIAL STABILITY 2008 – forthcoming; Donato Masciandaro, Marc Quintyn and Michael W. Taylor, Inside *and Outside the Central Bank: Independence and Accountability in Financial Supervision*, EUROPEAN JOURNAL OF POLITICAL ECONOMY 2008 - forthcoming)

allocated to the ECB; incentives to opt-in will prove insufficient; and current supervisory failures will persist in Member state that do not opt in or opt out. All of these arguments are rejected as being significant here.

Financial distress. Coordination and cooperation problems may indeed persist in financial distress situations. There will, however, be an *ex ante* binding agreement between the ECB and the opting-in Member state that will address these issues. Even though this agreement will be incomplete, coordination and cooperation is likely to be less problematic under such agreements compared to what would occur under the current state of affairs or what they are likely to be under the other reform proposals.

Monetary policy. Combining prudential supervision and monetary policy responsibilities within the same institution may lead to sub-optimal policies due to conflicts between supervisory and monetary objectives.[55] Reasonable arguments have indeed been made for and against central banks undertaking both prudential supervision functions.[56] Central banks' supervision involvement has been declining in various Member states since the 1990's.[57] However, recent financial distress situations have made it clear that monetary policy and financial stability are linked, given that liquidity issues (which are core to monetary policy) and solvency issues (which are core to prudential supervision) are hard to untangle.[58] Hence, an orderly payment system is paramount for central banks: if depositors cannot access their cash, the banking system cannot continue to operate. Conversely, it is crucial for banking supervisors to prevent bank runs: if depositors race to get their cash, the banking system cannot continue to operate. In other words, central bankers and banking supervisors have overlapping responsibilities (the first dealing with money supply and the

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55 See Vasso P. Ioannidou, *Does Monetary Policy Affect the Central bank's Role in Bank Supervision*, 14 JOURNAL OF FINANCIAL INTERMEDIATION 58 (2005).

56 See e.g. Charles Goodhart and D. Schoenmaker, *Should the Functions of Monetary Policy and Banking Supervision be Separated?*, 47 OXFORD ECONOMIC PAPERS 539 (1995); Tommaso Padoa-Schioppa, *Financial Supervision: Inside or Outside Central Banks?*, in Jeroen J.M Kremers et al. (eds.), FINANCIAL SUPERVISION IN EUROPE 160 (2003).

57 See *supra* 2.1.

58 See Franklin Allen & Elena Carletti, *The Role of Liquidity in Financial Crises* (Working Paper 2008, available at ssrn.com); Tobias Adrian & Hyun Song Shin, *Financial Intermediaries, Financial Stability and Monetary Policy* (Working Paper 2008, available at ssrn.com); Xavier Freixas and Bruno M. Parigi, *Lender of Last Resort and Bank Closure Policy* (Working Paper 2008, available at ssrn.com).

latter with money demand) and there is nowadays no strong case against central banks having prudential supervision powers.

Lemons. It is possible that Member states with the weakest banks will be among those having the highest incentives to opt into ECB supervision. However, we see this as a benefit of our approach. The ECB will be aware of the financial strength, or lack thereof, of the banks it is asked to supervise. It will frame the agreement with the Member state accordingly, using this possibility to take into account Member state specific circumstances to impose the necessary commitments and contribution to costs by the Member state. In addition, even if the costs of supervising 'lemons' are not fully supported by their Member state of incorporation, it is likely to be in the wider interest of the EU to have them looked after by the ECB rather than any domestic supervisor.[Not sure about the last element of this argument. It leads to a moral hazard problem of giving the ECB the bad ones. I think I would delete the last sentence.]

No Member state opts in. The scenarios developed above lead us to expect opt-ins to occur. Let us assume, however, that our choice-oriented approach does not result in any Member state entering into an agreement with the ECB to supervise its banks. The costs of such a failure would be minimal in comparison to misguided mandatory approaches to regional or global supervision. They would mainly consist in the transaction costs generated in getting the European Council to agree to the opt-in proposal.

Persistent failures: By construction, a choice-oriented approach allows Member states to opt-out of ECB supervision or to decide not to opt into it. In such a situation, existing supervisory deficiencies could indeed persist if Member states are unable to undertake the required reforms at the national level. However, a choice-oriented approach is better than maintaining the *status quo* within a short-to-medium term horizon. Indeed, we deem our proposal to be the only effective supra-national reform that is feasible within this timeframe. Furthermore, the possibility of opting-out allows for opting into other preferred alternatives should they become available.

V. CONCLUSION

We propose the adoption of a choice-oriented approach to banking supervision by the European Central Bank. Under this approach, Member states have the option to transfer the supervision of banks that pose EU-wide prudential risks to the ECB. Opting-in requires a Member state to enter into a binding agreement with the ECB, which spells out coordination and cooperation in normal times as well as in periods of crisis, and which may also contain Member state-specific provisions.

Efficient supervision, speedy implementation, flexibility, enhanced financial stability and crisis management, and political acceptability make this approach superior to the status quo as well as to other reform proposals.