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Organizational choices of banks and the effective supervision of transnational financial institutions

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Tobias H. Tröger

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

Institute for Monetary and Financial Stability
Goethe University Frankfurt am Main

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

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

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

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

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


Keywords: cross-border banking, micro-prudential supervision, consolidating supervision, banking union, subsidiaries, branches
ORGANIZATIONAL CHOICES OF BANKS AND THE EFFECTIVE SUPERVISION OF TRANSNATIONAL FINANCIAL INSTITUTIONS

TOBIAS H. TRÖGER∗

1 Transnational challenges in banking regulation and supervision .................... 2
  1.1 The regulatory challenges associated with integrated cross-border banking groups 2
  1.2 Intra-group restructurings as a sign of regulatory arbitrage? ................. 5
    1.2.1 Europe ................................................................. 5
    1.2.2 United States ......................................................... 6
  1.3 Misconceptions and the pivotal question .............................................. 7

2 The importance of micro-prudential supervision: Lessons from the ongoing sovereign debt and banking crises in the Euro area ............................................. 10
  2.1 Sovereign debt and banking crises through the ages ........................... 10
    2.1.1 Historical anecdotes ............................................. 10
    2.1.2 Bail-Out Rationality and moral hazard ........................... 11
  2.2 The contemporary European angle and one regulatory response ............ 14
    2.2.1 Confidence crisis July 2011 .................................... 14
    2.2.2 Micro-prudential regulatory reactions ............................ 14

3 Organizational choices of banks .................................................................... 16
  3.1 Branches and subsidiaries: main features of prototypical organizational structures 16
  3.2 The bank's perspective ......................................................................... 17
    3.2.1 General considerations ........................................... 17
    3.2.2 Assets and drawbacks depending on the bank's business model ....... 19
    3.2.3 Business judgment and market reactions ....................... 20
  3.3 The policymaker's perspective ............................................................ 21
  3.4 The regulatory arbitrage debate revisited ............................................. 23

4 The supervisory regime for E.U. cross-border banking-groups .................. 24
  4.1 General determinants ............................................................................ 24
  4.2 The E.U.-architecture of micro-prudential banking supervision .......... 25
    4.2.1 Supervision of business entities .................................... 25
    4.2.1.1 Subsidiaries ..................................................... 25
    4.2.1.2 Branches (E.U.-passport) .................................... 26
    4.2.2 Consolidated supervision ............................................ 27
    4.2.3 Colleges of supervisors ............................................. 29
    4.2.4 Supranational competences as an insufficient remedy .............. 30
    4.2.4.1 Harmonization of substantive Law .......................... 31

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


² For empirical evidence corroborating the latter hypothesis cf. Stijn Claessens, Aslı Demirgüc-Kunt & Harry Huizinga, The Role of Foreign Banks in Domestic Banking Systems, in THE INTERNATIONALIZATION OF FINANCIAL SERVICES: ISSUES AND LESSONS FOR DEVELOPING COUNTRIES 117 (Stijn Claessens & Marion Jansen eds., 2000); Stijn Claessens, Aslı Demirgüc-Kunt & Harry Huizinga, How Does Foreign Entry Affect Domestic Banking Markets?, 25 J. BANKING & FIN. 891-911 (2001) (both studies showing an increase in technical efficiency at domestic banks subsequent to the arrival of foreign banks in a sample of 80 countries); see also Douglas Evanoff & Evren Ors, The Competitive Dynamics of Geographic Deregulation in Banking: The Implications for Productive Efficiency, 40 J. MONEY FIN. & BANKING 897-928 (2008) (showing the same effect on incumbent banks following a compet-
On the other hand, the trade-off associated with the advantages of cross-border banking is also straightforward: financial systems around the world become more and more interconnected which in turn expands the potential for negative spillover effects in times of crises. Exogenous shocks can affect national economies which originally did not face any problems in their banking sector. The availability of credit may decline, either because institutions troubled at home (or elsewhere) at least confine their activities on foreign markets where they formerly played a prominent role in providing finance to local businesses or because international banks cut back on lending in their home country as a consequence of losses incurred abroad. In the latter case, the magnitude of the shocks originating overseas and the importance of the financial institutions affected may ultimately compel fiscally expensive and politically unpopular government bail-outs in order to avoid the disruptive consequences of a pivotal bank’s failure.


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

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

6 For preliminary evidence that the recent bank bail-outs during the financial crisis were not as costly for governments as originally perceived and suggested by the enormous figures used in the recapitalizations, see Gérard Hertig, The Profitability of Bank Bail-Outs, Credit Crisis Comparative Case Studies, 48 TEX. INT’L L.J. *** in this issue *** (2012).
Public policy hence faces the challenge to minimize these potential downsides of cross-border banking without impeding its upside. One key element of the institutional framework targeted at this ambitious goal is the prudential supervision of banks.\textsuperscript{7} The distinctive feature in the context of cross-border banking is that policymakers and regulators operate in a quintessentially transnational setting where legislative intervention and its enforcement on a national level almost naturally create externalities,\textsuperscript{8} e.g. if a country deploys resources to facilitate the adequate micro-prudential\textsuperscript{9} supervision of banks incorporated under its jurisdiction this will also benefit all other countries where the respective financial institutions conduct business. Yet, if these other countries engage in supervisory activities themselves, redundancies and frictions in the legal framework, turf-wars among authorities etc. will raise the costs of doing business abroad and may compromise the effectiveness of the regulatory regime cross-border banks are subjected to.\textsuperscript{10}

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

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

\textsuperscript{8} For the reasons, why banks were traditionally regulated on a national level cf. Maximilian J.B. Hall & George G. Kaufman, \textit{International Banking Regulation, in The Structural Foundations of International Finance} 92 (Pier Carlo Padoan, Paul Brenton & Gavin Boyd eds. 2003).

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

\textsuperscript{10} For a pre-crisis view on the regulatory challenges that cross-border banking posed to the emerging markets to which banks extend their business see Guillermo Ortiz, \textit{Cross Border Banking and the Challenges Faced by Host-Country Authorities, in CROSS-BORDER BANKING: REGULATORY CHALLENGES 11, 14-18} (Gerard Caprio, Jr., Douglas D. Evanoff & George G. Kaufman eds., 2006) (accurately identifying differences in regulation and stakeholder interests, the lack of market discipline, and the problems of cross-border crisis management as critical aspects).
tutions: as will be discussed in more detail, currently the applicable supervisory regime hinges upon how banks choose to organize their international activities. In principle, a financial institution faces two alternatives if it seeks to establish a continuous and meaningful presence in a foreign market. It can either organize its foreign operations as a subsidiary, i.e. a legally independent, yet wholly owned entity incorporated under the laws of the foreign jurisdiction, or it can establish a branch, i.e. a legally dependent satellite of its main establishment fully recognized under the laws of the foreign country where the respective banking services will be provided. Clearly, where the applicable law depends on choices of the regulated concern over potential regulatory arbitrage looms. Recent intra-group restructurings that at least coincided with some tightening in the regulatory regimes applicable to banks operating across borders at first glance seem to corroborate these apprehensions.

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

1.2.1 Europe

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

11 Cf. infra 4.

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

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


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

**Banks Find New Wrinkle in Regulatory Arbitrage**

....

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

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

1.2.2 **UNITED STATES**

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

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16 Regulatory and supervisory competences in international banking are tied to the legal entities’ banking licenses, i.e. where a banking group establishes subsidiaries in a multitude of jurisdictions, its operations will require several banking licenses. Hence, several regulators and supervisors will be tasked with the group’s supervision and hence have to cooperate according to the ground rules laid down under the auspices of the Bank for International Settlements (BIS), see Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision 40-42 (1997), available at http://www.bis.org/publ/bcbs30a.pdf. For a more detailed account see infra 4.1.


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


20 §2(a)(p) of the Bank Holding Company Act (12 U.S.C. § 1841 (2012)) define a financial holding company as a company that has direct or indirect control over a depository banking subsidiary and meets the mandatory capital requirements of §4(l)(1) of the Bank Holding Company Act (12 U.S.C. § 1843 (2012)).
regard was promulgated in the course of the Dodd-Frank Act overhaul and invariably requires any bank holding company to be well capitalized itself. In particular, the tightened legislation cancels the prior leeway to grant exemptions to large intermediate holding companies of international banking-groups which may be backed by a strong financial institution outside the U.S. and hence do not necessarily depend on own funds to be sufficiently resilient as a stand-alone U.S.-holding company does. Estimates gauged the additional capital requirements one of the intermediate financial holding companies faced under the new regulation at $20 bn. The rather simple move to avoid this massive burden of having to inject new capital into the groups’ U.S.-business was to transfer the shares of the wholly owned U.S.-depository bank from the intermediate holding company to the mother registered outside the U.S. As a result, the groups’ U.S. intermediate holding companies were left with equity stakes only in subsidiaries that conduct non-depository financial activities. Hence, they no longer fall under the Bank Holding Company Act’s definition of a bank holding company.

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

1.3 MISCONCEPTIONS AND THE PIVOTAL QUESTION

22 The substantive regulation is contained in the Federal Reserve’s amendments to Regulation Y (12 C.F.R. § 225.8 (2012)). They require any large bank holding companies to submit capital plans that adhere to rigorous own funds requirements.
27 Cf. Enrich & Stevens, supra note 23 (quoting Deutsche Bank spokesman Duncan King as saying that the “action, which does not diminish any of our regulatory oversight, allows us to streamline our organizational structure, strengthening an already strong institution.”).
Even though the restructurings delineated above seem obvious cases of regulatory arbitrage at first glance, a critique focusing mainly on the circumvention of specific substantive rules still deals with rather peripheral aspects and ultimately misses the crucial issue at hand.

Clearly, stricter requirements regarding subsidiaries’ or the banking-group’s own-funds and a design of executives’ compensation packages that rewards sustainable growth have been duly identified as mechanisms that can enhance banks’ resilience and do away with detrimental incentives for excessive risk taking.\(^{28}\) However, it seems implausible that a strategy geared at avoiding particularly austere national regulation promulgated in certain European countries\(^ {29}\) actually motivated the branch-conversions described above. When the restructurings were initiated a general tightening and further harmonization of the pertinent E.U.-regimes had already become visible on the international horizon and in critical part even arrived prior to the closing of the restructurings.\(^ {30}\) These were hence inapt to escape from the regulator’s tighter grip in the longer run.

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


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

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

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

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

\textsuperscript{31} \textit{Infra 2.2.2.}
affirm effective prudential supervision as a pivotal element of their implementation. In order to arrive at a more informed idea, which determinants apart from a perceived appetite for regulatory arbitrage drive banks’ organizational choices, part 3 scrutinizes the merits of either a branch or subsidiary structure for the cross-border business of financial institutions. In doing so, it also considers the policy-makers perspective. The analysis shows that no one size fits all organizational structure is available and concludes that banks’ choices should generally not be second-guessed, particularly because they are subject to (some) market discipline. Part 4 describes and evaluates how competences in prudential supervision are currently allocated among national and supranational supervisory authorities. In order to evaluate the findings the appraisal adopts insights form the economics of public administration and international relations. It argues that the supervisory architecture has to be more aligned with bureaucrats’ incentives and that inefficient requirements to cooperate and share information should be reduced. Contrary to a widespread perception, shifting responsibility to a supranational authority cannot solve all the problems identified. Resting on these foundations, part 5 finally sketches an independent solution that dwells on far-reaching mutual recognition of national supervisory regimes and allocates competences in line with supervisors’ incentives and the risk inherent in cross-border banking groups.

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

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

2.1 SOVEREIGN DEBT AND BANKING CRISES THROUGH THE AGES

2.1.1 HISTORICAL ANECDOTES

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

32 Max Winkler, Foreign Bonds an Autopsy 22 (1933).
ruptency and thus causing the collapse of an entire financial system.\textsuperscript{33} The scenario reoccurred in 1557 A.D when King Philip II of Spain ruined the powerful merchant banks owned by the South German families of the Fugger and Welser.\textsuperscript{34} Yet, Germans were not always the bereaved but also the bankrupts: During the 19\textsuperscript{th} century German states defaulted five times on their debt, jointly with Austria and Portugal outdistancing Greece, which disappointed its lenders four times.\textsuperscript{35} All these events put severe stress on or increased the already existing distress in the banking system at least in the immediately affected economies.

### 2.1.2 Bail-Out Rationality and Moral Hazard

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

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


\textsuperscript{34} \textit{id.}


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

\textsuperscript{37} Jonathan Eaton, Mark Gersovitz & Joseph E. Stiglitz, \textit{The pure theory of country risk}, 30 \textit{EUR. ECON. REV.} 481 (1986). While the immediate costs of servicing debt simply consist of interest and redemption payments the pertinent costs of default are more complex: the sovereign debtor will be excluded from international financial markets and will thus be unable to smooth consumption and face impediments to investments for a certain time. The magnitude of these effects obviously depends on the period of exclusion. Yet, even after regaining access to international financial markets, risk premiums will be influenced by the sovereign debtor’s prior default. Moreover, further costs are associated with the economic downturn that usually accompanies a sovereign default or trade sanctions in reaction to it.
the default of a sovereign as too high, even though legal restrictions on sovereign bail-outs may exist.\(^{38}\)

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

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

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

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

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

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

Moreover, bank bail-outs put tremendous fiscal burdens on the rescuing country’s budget,\footnote{Between October 2008 and May 2010 the 27 Member States of the E.U. spent a total of €235.1 bn ($288.6 bn) on bank recapitalizations. Guarantees for bonds and other debentures were issued to an amount of €957.7 bn ($1175.7 bn) and further asset support to safeguard banks financial stability accounted for the assumption of risk worth €346.5 bn ($425.4 bn). The pertinent figures for Euro-zone members amounted to €160.1 bn ($196.5 bn) in recapitalizations, €735.2 bn ($ 02.6 bn) in guarantees, and €128.7 bn ($ 157.9 bn) in risk assumptions, cf. Stéphanie Marie Stolz & Michael Wedow, Extraordinary Measures in Extraordinary Times 24 (ECB Occasional Paper No. 137, 2010) available at http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp117.pdf. (Dollar conversions as of May 31, 2010).} which in turn may cast doubts on its ability to service its debt. These doubts will lead to a rise in risk premiums and will hence make the country’s future debt service even more burdensome. Once again the overall economic development (recession) may add to the fiscal hassles. Finally, the sovereign debt crisis will backlash on the (national) banking system insofar as banks will typically be the main holders of a shaky country’s bonds. Hence their financial stability will be severely impacted if a country declares its insolvency or restructures its debt. This is even more so, as sovereign debtors will find it harder or at least more expensive to refinance themselves on international financial markets and will consequently have the sovereign debt-load absorbed mainly by domestic banks. The collapse of a national banking system will affect the international banking system depending on its size and interconnectedness.\footnote{For a theoretical assessment see Joseph E. Stiglitz, Risk and Global Economic Architecture: Why Full Financial Integration May Be Undesirable, 100 AM. ECON. REV. 388}
2.2 THE CONTEMPORARY EUROPEAN ANGLE AND ONE REGULATORY RESPONSE

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

2.2.1 CONFIDENCE CRISIS JULY 2011

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

2.2.2 MICRO-PRUDENTIAL REGULATORY REACTIONS

On October 26, 2011 European politics reacted to the dwindling confidence in the European banking system with far reaching coordinated measures. Inter alia a recommendation by the European Banking Authority (EBA) sought to tighten rel-
relevant micro-prudential regulation to reestablish confidence in SIFIs’ resilience. A core capital (Tier 1) to risk-weighted assets ratio of 9% should be reached by June 30, 2012. Furthermore, all banks with a capital shortfall as of September 30, 2011, according to the EBA’s capital exercise had to file a steps plan no later than January 20, 2012 which indicated how they would satisfy their capital needs, primarily by raising new capital in private markets and cutting dividends and bonuses. Finally, an extraordinary buffer for risky sovereign bonds had to be put in place, i.e. the core capital requirement had to be met after the removal of the prudential filter on the sovereign assets in the available-for-sale portfolio and the conservative valuation of sovereign debt exposures in the held-to-maturity and loans and receivables portfolios, reflecting market prices as of 30 September 2011. Banks that cannot raise sufficient capital in private markets were to be compulsorily recapitalized with public funds from their home Member States who could borrow funds at the European Financial Stability Facility (EFSF) if they became overstrained or explain-mechanism (see also infra 4.2.4.2): the national authority has to declare its non-compliance within two months after the issuance of the recommendation and communicate its reasons to the EBA, which has to publish the fact that the national authority deviates from the recommendation and may choose to publish the reasons for doing so, EBA-Regulation, art. 16(3).


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

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

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

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

52 EBA-Recommendation at 13-14.

53 EBA-Recommendation at 13.
were put under severe pressure by financial markets as a consequence of such recap-
citalizations.

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

3 ORGANIZATIONAL CHOICES OF BANKS

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

3.1 BRANCHES AND SUBSIDIARIES: MAIN FEATURES OF PROTOTYPICAL ORGANIZA-
TIONAL STRUCTURES

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

54 Most notably the Commission Proposal for a Parliament and Council Directive est-

55 For a detailed analysis see infra 4.

56 See already supra 1.1.

57 The closest real world example of such an idealized branch-structure occurs in the E.U. see infra 4.2.1.2.
On the other hand, opting for an archetypical subsidiary-structure under which foreign business units are legally independent, incorporated entities, entails decentralized operations subject to local capital and liquidity requirements. Legal restrictions on the transfer of capital and liquidity hamper respective intra-group transactions, whereas the transfer of knowledge and technology is by and large unimpeded. Parent and subsidiaries are subject to the sufficient own funds and liquidity requirements of local jurisdictions. Individual risk-management of the group’s entities is required to make them resilient as stand-alone as in times of crisis financial aid is guaranteed neither from the parent nor from any other group-affiliate. In fact, capital maintenance requirements in corporate law serve as a (weak) form of ring-fencing which raises the operating costs of the transnational banking-group that requires overall higher levels of capital.

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

3.2 The bank’s perspective

3.2.1 General Considerations


60 Fiechter, Ötker-Robe, Ilyina, Hsu, Santos & Šurti, supra note 1, at 7 note 4.

61 Infra 3.4.
The principal characteristics of the organizational options translate into costs and benefits for a banking group that seeks to optimize the legal structure of its cross-border business.\textsuperscript{62}

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

Furthermore, the branch structure can strengthen the group’s resilience if locally contained, adverse developments occur. Obviously, the latter constitutes an advantage from the bank’s perspective if the group’s survival in its current structure is deemed desirable.\textsuperscript{64} The unimpeded transfer of funds allows overcoming country specific negative shocks, as long as the magnitude of the adverse developments does not consume the group’s entire capital and liquidity reserves. On the other hand, legal restrictions that can result from general corporate law (e.g. minimum capital requirements\textsuperscript{65}) as well as specific regulations applying to banks\textsuperscript{66} may hamper the quick transfer of much needed funds under a subsidiary structure.\textsuperscript{67}

\begin{itemize}
  \item[\textsuperscript{62}] For a more detailed discussion of the following see Fiechter, Ötker-Robe, Ilyina, Hsu, Santos & Suri, supra note 1, at 8-9.
  \item[\textsuperscript{63}] For some empirical evidence corroborating the general posit cf. Ata Can Bertay, Asli Demirguc-Kunt & Harry Huizinga, Is the financial safety net a barrier to cross-border banking? (World Bank Policy Research Working Paper No. 5947, 2012) available at http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2012/01/17/000158349_20120117092544/Rendered/PDF/WPS5947.pdf (showing that the cost of funds increase by 1.5% to 2.4% if they are raised through a foreign subsidiary compared to domestic banks).
  \item[\textsuperscript{64}] For evidence, that international bank’s retained their presence – subsidiaries though – despite a severe downturn in central and southern European economies, see Bonin supra note 4.
  \item[\textsuperscript{65}] For instance, European legislation prohibits any corporation to distribute funds if its net assets are or would through such distribution drop below the amount of the subscribed capital established in the corporate charter, Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, art. 15, 1977 O.J. (L 26) 1.
  \item[\textsuperscript{66}] See already supra 2.2.2.
  \item[\textsuperscript{67}] A group of experts assigned by the European Commission identified a multitude of restrictions on intra-group transfers that can form an obstacle to containing a banking crisis and thus proposed to lift these barriers under certain conditions, EUROPEAN COMMISSION, STUDY ON THE FEASIBILITY OF REDUCING OBSTACLES TO THE TRANSFER OF ASSETS WITHIN A CROSS BORDER BANKING GROUP DURING A FINANCIAL CRISIS 7 (proposal No. 1), 31-113 (2011) available at http://ec.europa.eu/internal_market/bank/docs/windingup/200908/final_report20091218_e
Conversely, however, the subsidiary structure may facilitate the containment of losses that accrue at a single group unit. The crisis or even the bankruptcy of a battered, legally independent affiliate or of the parent corporation as a matter of principle does not affect the going concern of other group entities.  

3.2.2 Assets and Drawbacks Depending on the Bank’s Business Model

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

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

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

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

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⁷³ See Fiechter, Ötker-Robe, Ilyina, Hsu, Santos & Surti, supra note 1, at 10, 22 (attributing the organizational structure of Spanish cross-border banking to its retail-customer orientation).
⁷⁴ An in-depth analysis identifies further determinants that account for the organizational choices in transnational banking and points to (i) the treatment of branches and subsidiaries in tax law in the home as well as in the host jurisdiction, (ii) the development and the structure of the foreign markets which may or may not provide sufficient opportunities to source capital, and (iii) macroeconomic and political risks abroad which may less severely affect branches than locally incorporated subsidiaries, Cerutti, Dell’Ariccia & Martínez Pería, supra note 13, at 1685-1691 (scrutinizing the world’s 100 largest banks’ operations in Latin America and Eastern Europe).
⁷⁵ Infra 3.3.
⁷⁶ For a similar assessment INT’L MONETARY FUND, supra note 3, at 9.
⁷⁷ On the underlying too big to fail/too interconnected to fail dilemma supra 2.1.2.
⁷⁹ See supra note 72. For robust empirical evidence Maria Soledad Martinez Peria & Sergio L. Schmukler, Do Depositors Punish Banks for Bad Behavior? Market Discipline, Deposit Insurance, and Banking Crises, 56 J. FIN. 1029 (2001) (showing how depositors disciplined weak banks by withdrawing deposits and by requiring higher interest rates in Argentina, Chile, and Mexico during the 1980s and 1990s).
trapolated from certain studies that establish markets’ general capacity to assess available information on banks’ default risk correctly even in times of crisis.\textsuperscript{80} However, if prudential regulation is at least potentially suited to mitigate the risk of bank failure, creditors should be attuned to its quality and enforcement. And it is precisely such awareness of market participants that has been particularly well documented with regard to the enforcement of investor protecting securities laws.\textsuperscript{81} As a consequence, choosing “bad” prudential supervision should be penalized by credit markets which hence serve as a counterbalance to opportunist choices.\textsuperscript{82} It can be justified on these grounds to accept banks’ organizational choices and design the supervisory regime accordingly instead of cramming them into certain structures in cross-border banking by alleging maneuvers of regulatory arbitrage.

\subsection*{3.3 The policymaker’s perspective}

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

Intuitively, a growth-hungry policy-maker should prefer to see transnational banks to branch into her economy as the branch model potentially grants easier access to credit.\textsuperscript{84} Yet, the empirical evidence with very successful transition economies being served through subsidiaries of large international banks casts doubt on the ex-
istence of such a clear-cut preference. Moreover, if the subsidiary structure hampers the intra-group transfer of funds and hence compels to rely more on local deposits, it can contribute to the development of credit markets in host countries. Yet, as has already been mentioned, where savings are limited due to market development, large exposure limits may quickly preclude corporate clients from borrowing form local subsidiaries and in turn coerce these actors into bypassing local credit markets thus handicapping their development.

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

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

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

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

86 Supra 3.2.2.
87 Supra 3.2.2.
88 Fiechter, Ötker-Robe, Ilyina, Hsu, Santos & Surti, *supra* note 1, at 15.
89 Supra 3.2.1.
90 Supra 3.2.1.
91 Supra 1.1.
93 From the vantage of a (small) country that is the domicile of large international banking groups but has only confined fiscal firepower, it may be prudent to encourage a subsidiary structure. For a correspondent recommendation cf. INT’L MONETARY FUND, *supra* note 3, at 23.
policy considerations are not ruthlessly confined to national interests: where a polity reaps all the social gains from a branch’s successful operations it seems hard to justify and creates a free-rider problem if it is in fact under no obligation to contribute to alleviating distress originating at this very entity.

3.4 THE REGULATORY ARBITRAGE DEBATE REVISITED

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

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

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

94 For rich data compiled from central banks, supervisory, and regulatory authorities see Fiechter, Ötker-Robe, Ilyina, Hsu, Santos & Surti, supra note 1, at 13-14. See also supra note 18.
95 See already supra 3.2.3.
96 Supra 3.3.
tence prevents authorities from contributing to micro-prudential efforts even though their economies are massively affected.

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

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

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

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

4.1 GENERAL DETERMINANTS

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

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

97 For a detailed account see infra 4.2.
98 For this overall end of the substantive rules under the so called Basel II- and Basel III-Accords see infra 4.2.4.1.
101 Id., at 40.
Furthermore, BCP 24 underlines that a “key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.” Correspondingly, pursuant to BCP 25 host country supervisors “must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.”

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

4.2 The E.U.-Architecture of Micro-Prudential Banking Supervision

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

4.2.1 Supervision of Business Entities

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

4.2.1.1 Subsidiaries

Independently incorporated business entities of a cross-border banking group constitute themselves “credit institutions” within the scope of the pertinent supranational regulation and hence have to be authorized by the Member State of incor-
poration. As a consequence these home Member States assume the primary responsibility for the pertinent institutions’ prudential supervision regardless of their group-affiliation.

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

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

4.2.1.2 Branches (E.U.-passport)

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

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

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

105 Banking Directive artt. 6 et seq [CRD IV Directive artt. 9 et seq].
107 Cf. infra 4.2.4.2.
108 Banking Directive art. 40(2); same CRD IV Directive art. 49(2). Cf. infra 4.2.2.
109 See supra note 12.
facilitate home Member State supervision, although the duty to cooperate under Banking Directive art. 42 [CRD IV Directive artt. 146, art. 51 (1)] is by design a mutual obligation. The home Member States’ competent authorities are even authorized to conduct on-site-examinations, i.e. act in a sovereign capacity on foreign territory in order to obtain information pertinent to their supervisory activities that were not adequately supplied by host Member States’ watchdogs.\textsuperscript{112}

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

\subsection*{4.2.2 Consolidated Supervision}

As recommended by the BCP\textsuperscript{115} a core feature of the European regulatory framework is consolidated supervision of the group. The prominence of this type of monitoring reflects the accurate perception, that even though the transnational banking group is comprised of legally independent affiliates (incorporated parents and subsidiaries) it represents a business unit that is economically integrated and hence poses a variety of risks that warrants a comprehensive micro-prudential view on the group’s operations.\textsuperscript{116}

\begin{itemize}
\item \textsuperscript{112} For details see Banking Directive art. 43(1); CRD IV Directive art. 53(1).
\item \textsuperscript{113} Banking Directive art. 41 which also grants host Member State’s authorities the necessary competences to implement national monetary policy where the latter is independent [until January 1, 2015 CRD IV Directive art. 145 shall contain an identical rule, \textit{cf.} CRD IV Directive art. 140. Yet, the latter will be replaced by the more complex regime in CRD IV artt. 41, 43 that, except for emergency situations, gives host Member States generally less clout in monitoring a branch’s liquidity as they can no longer act \textit{vis-à-vis} the foreign branch but only induce the home Member State competent authority to take action or appeal to the EBA to settle a dispute]. Under the Markets in Financial Instruments Directive (MiFID) the host Member States competent authority is also tasked with supervising the proper business conduct of the branch, Directive 2004/39 of the European Parliament and of the Council, art. 32(7), 2004 O.J. (L 145) 1, 26.
\item \textsuperscript{114} Until January 1, 2015 CRD IV Directive art. 142 which will give way to the division of labor outlined in CRD IV Directive artt. 41, 43 that give home Member States (and the EBA) a stronger position, \textit{see supra} note 113.
\item \textsuperscript{115} Supra 4.1.
\item \textsuperscript{116} Typical issues are the risk of intra-group contagion that is not necessarily limited to scenarios where the original shield of limited liability that protects incorporated affiliates from financial distress at other group-members has been undone, e.g. by a binding letter of comfort. It can also occur if, even without direct mutual financial exposure, negative information on specific group members corrupts the confidence of creditors in other affiliates. Similar problems may occur if the group members’ respective exposure to certain counter-
According to Banking Directive art. 125(1) [CRD IV Directive art. 106 (1)] consolidated supervision is exercised by the competent authority of the Member State that authorized the parent credit institution of a cross-border banking group.\textsuperscript{117} Banking Directive art. 126 [CRD IV Directive art. 106 (3)-(6)] aims at a similar concentration of competence for consolidated supervision of a group’s credit institutions if the head of the banking-group itself is not a credit institution (which accepts deposits) but provides any of an array of financial services and is thus deemed to be a E.U. financial holding company.\textsuperscript{118} The latter may in turn be included in consolidated supervisory activities pursuant Banking Directive art. 127 [CRD IV Directive art. 114].

Moreover, consolidated supervision also affects the supervision of a cross-border banking group’s subsidiaries and restricts the leeway for autonomous decision making of Member State’s supervisors that authorized affiliated credit institutions. The consolidating supervisor shall seek joint decisions with the competent authorities supervising the group’s subsidiaries on key-aspects of prudential group supervision, particularly the specifications on sufficient own funds on both the consolidated as well as the entity level with regard to the application of Banking Directive artt. 123, 124 and 136(2) [CRD IV Directive artt. 72(1), 92 (1), (2) and 100].\textsuperscript{119} The EBA may be consulted to reach a settlement if differences between the responsible authorities occur.\textsuperscript{120} Yet, ultimately the decision of the consolidating supervisor prevails.\textsuperscript{121} Furthermore, competent authorities responsible for the supervision of controlled credit institutions are under the obligation to contact the consolidating supervisor prior to implementing approaches and methodologies in order to obtain pertinent information available at the top level.\textsuperscript{122} Finally, competent authorities shall consult each other prior to taking any action with regard to certain critical issues at the supervised banks, in particular structural changes concerning a member parties accumulate and constitute a massive concentrated risk although individual large exposure limits (cf. supra note 70) are observed. For a brief review of the rationale for consolidate supervision see e.g. RONALD MACDONALD, CONSOLIDATED SUPERVISION OF BANKS 11-14 (1998) available at http://www.bankofengland.co.uk/education/Documents/cCBS/handbooks/pdf/cCBSHB15.pdf.

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

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

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

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

\textsuperscript{121} Banking Directive art. 129(3) para 3 [CRD Directive art. 108 (2)].

\textsuperscript{122} Banking Directive art. 132(2) [CRD IV Directive art. 112 (3)].
of the banking-group that require approval, major sanctions and exceptional supervisory measures.\textsuperscript{123}

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

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

4.2.3 Colleges of Supervisors

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

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

\textsuperscript{123} Banking Directive art. 132(3) [CRD IV Directive ar. 112 (4)].

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

\textsuperscript{125} Banking Directive art. 131a [CRD IV Directive art. 111]. On the particular tasks of a College, see Banking Directive art. 131a(1)(a)-(f). For a detailed guideline on carrying out the relevant duties and responsibilities, see COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS), \textit{GUIDELINES FOR THE OPERATIONAL FUNCTIONING OF SUPERVISORY COLLEGES} (GL 34)
its activities through branches are usually not members of these Colleges. Banking Directive art. 42a(3) [CRD IV Directive art. 52 (3)] provides a notable exception if a branch is deemed systemically important (“significant”) from the perspective of its host Member State.\textsuperscript{126} The critical determination whether a branch is significant is initiated by its host Member State and should be reached in consensus with the consolidating or home Member State supervisor. However, ultimately the assessment of the host Member State’s competent authority prevails.\textsuperscript{127}

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

\subsection*{4.2.4 Supranational Competences as an Insufficient Remedy}

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

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

\textsuperscript{127} Cf. Banking Directive art. 42a(1) para 4 [CRD IV Directive art. 52 (1) para 4].

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

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

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

4.2.4.1 HARMONIZATION OF SUBSTANTIVE LAW

The critical importance of financial institutions for Europe’s developed economies and the perceived need to foster competition by creating a level playing field accounted for an early start in a far reaching harmonization of substantive laws. The First Coordination Directive that harmonized the prerequisites for authorization was promulgated in 1977. It was followed by a series of smaller legislative advances until a Second Coordination Directive in 1989 was promulgated that facilitated cross-border banking through subsidiaries and branches in a meaningful way. Prudential supervision of European credit institutions became early attuned to the recommendations of the BCBS with the transposition of the Basel I-Accord in 1989. This policy was maintained with the Basel II-Accord becoming binding European law with the promulgation of the Capital Requirements Directive (CRD) in 2006. These Directives were subsequently amended by the CRD II and CRD

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135 Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions, 1989 O.J. (L 124) 16 which regarded a bank sufficiently capitalized if it held capital amounting to 8% of its risk-weighted assets with a tier 1-fraction of 50%, that is 4% of total assets.
III\textsuperscript{139} reform-packages that responded to lessons derived from the financial crisis.\textsuperscript{140} Similarly, the most recent, profound overhaul of the BCBS’ recommendations in reaction to the financial crisis (Basel III-Accord\textsuperscript{141}) will most likely make its way into ambitious European legislation that aspires to base prudential supervision on a comprehensively harmonized and binding single rule book.\textsuperscript{142}

4.2.4.2 CURRENT SUPRANATIONAL COMPETENCES IN MICRO-PRUDENTIAL SUPERVISION

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

Following a proposal from an expert group headed by Jacques de Larosière\textsuperscript{145} the new European System of Financial Supervision (ESFS) was created.\textsuperscript{146} With regard to the supervision of transnational credit institutions\textsuperscript{147} the new architecture created several bodies at the European level, however without conferring sweeping competences in the ongoing supervision of banks to them. The EBA based in London became tasked with duties in micro-prudential supervision of individual finan-


\textsuperscript{140} For an overview Mülbert & Wilhelm, supra note 132 at 202-7.


\textsuperscript{142} Supra note 30.


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


\textsuperscript{147} Identical structures were established for the supervision of securities markets, insurances and occupational pension schemes, cf. Parliament and Council Regulation 1095/2010(EU) of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331) 84 and Parliament and Council Regulation 1095/2010(EU) of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), 2010 O.J. (L 331) 48.
cial institutions in January 2011. A non-trivial function of the EBA lies in its power to draft both regulatory and implementing technical standards. Still, to become binding these standards require the formal endorsement of the Commission who has the power to reject standards in part or amend them, thereby depriving the EBA of its already very limited propensity for independent rulemaking.

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

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

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

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


152 EBA-Regulation art. 16(2).

153 EBA-Regulation art. 19.

154 EBA-Regulation art. 18.


156 ERSB-Regulation artt. 16-18.
which is supposed to link national and supranational authorities making the ESRB depend on the exchange of information and cooperation among these agents.

## 4.2.4.3 Banking Union 2012

In the wake of the once again flaring and more and more deteriorating banking crisis in Spain\(^{157}\) it became obvious that the counter-measures taken so far were insufficient to break the vicious cycle between the sovereign debt-crisis in the Euro area and the distress in the European financial sector.\(^{158}\) As already hinted by observers of the European developments,\(^{159}\) the way forward was seen in a further integration that included as a critical component establishing a single European banking supervisor, involving the ECB.\(^{160}\) Clearly, this is in line with economic theory that relates the existence of international organizations to the desire to eliminate the risk of opportunism \textit{ex post}\(^{161}\) – a specter dreaded by Member States who effectively provide the bail-out funds for other E.U.-members with a troubled and arguably insufficiently overseen banking sector.\(^{162}\) Moreover, it can be seen as a ‘regional version’ that follows suggestions from commentators\(^{163}\) and prominent transnational bodies.\(^{164}\)

\(^{157}\) See Forelle & Steinhauser, \textit{supra} note 51.

\(^{158}\) For the relationship see \textit{supra} 2.1.2.

\(^{159}\) Cf. \textit{supra} note 129.


\(^{162}\) On the package deal that couples further injection of funds into troubled Member States’ banks with establishing a supranational supervisor \textit{see} Francesco Guerrera, \textit{A Fix for Europe Banks}, WALL ST. J., July 3, 2012 at C1.


The Commission plans to make detailed proposals on such a single supervisory mechanism in September 2012 that the Council – which generally endorses the plans\(^{165}\) – can consider as a matter of urgency at the end of the year.\(^{166}\) Currently, the design and the scope of the new authority remain unclear. Speculations consider the most likely outcome of the cumbersome quest for a political compromise that significant reservations of Member States’ competence will remain intact despite the creation of a supranational watchdog: the “single” European supervisor shall probably only cover Europe’s largest banks,\(^{167}\) leaving the oversight over mid-sized banking groups despite their sizeable cross-border operations in the national domains.

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

### 4.3 Evaluation

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

#### 4.3.1 Political Economics of Public Administration and International Relations

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


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

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

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

169 On the importance of a mechanism for a discretionary adaption of the (incomplete) social contract see Douglas C. North, Institutions, Institutional Change and Economic Performance 80-81 (1990).

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


174 GUZMAN supra note 172 at 45.

175 Id. at 48. See also Robert Axelrod, The Evolution of Cooperation 12-13 (1984) (describing a tit for tat-game where agents behave cooperatively in the first round and act in the second round as the counterparty did in the first).

176 For the following see Stigler supra note 171; William A. Niskanen, Jr., Bureaucracy and Representative Government 36-42 (1971); Pendergast supra note 171.
opportunities in the long term and can result in regulatory capture. Finally, agency personnel seek to avoid liability for false actions or forbearance and will consequently have a proclivity to follow approved practices that can be verified in any review, even if new developments occur.

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

4.3.2 Supervision of cross-border banking-groups in particular

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

4.3.2.1 Subsidiaries

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

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180 Supra 4.2.
duties also ensure the viability of group affiliates abroad.\textsuperscript{181} Obviously, the benefits to foreign economies\textsuperscript{182} accrue as a consequence of the operations of for-profit organizations whose success at least in part redounds to the incentives of bureaucrats at the consolidating supervisor: the growth of the supervised transnational financial institution can be associated with an increase in the regulator’s importance and reputation and therefore its bureaucrats’ prestige. Yet, the bulk of the advantages connected to a bank’s transnational activities constitutes positive externalities (growth perspectives, market development et al.) and is thus neither fully reproduced in the bank’s yields nor in the incentives that the consolidating supervisor and its officers incur. To a similar effect, good practices that are at least in part of an auxiliary character and mainly happen in the background do not naturally boost careers.

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

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

\subsection*{4.3.2.2 Branches}

The E.U.-supervisory regime applicable under a branch-structure\textsuperscript{185} exhibits some of the problematic characteristics discussed for transnational banks that adhere to a subsidiary-organization. This is particularly true with regard to the suboptimal

\textsuperscript{181} For the respective competences \textit{see supra} 4.2.1.1 and 4.2.3.
\textsuperscript{182} On the benefits of cross-border banking for market development, access to credit etc. \textit{see generally supra} 1.1 and 3.3.
\textsuperscript{184} \textit{Supra} 2.
\textsuperscript{185} \textit{Supra} 4.2.1.2.
incentives to cooperate and share information as a result of positive and negative externalities: The home Member State supervises the whole entity and thereby generates benefits and costs for the host Member State whereas the host Member State’s limited power and information sharing obligations have the same effect *vice versa.* Yet, it should not be overlooked, that under the branch-structure a clearer allocation of responsibilities occurs as a result of E.U.-passporting making the home Member State’s competent authority a stronger player that is less dependent on cooperation than the consolidating supervisor under a subsidiary structure.

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

### 4.3.2.3 Supranational Cure

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

In principle, the evolving single European banking supervisor could avoid many of the incentive deficits identified in respect of the current regime of micro-prudential supervision if and to the extent to which its competence in fact makes cooperation with national authorities superfluous. Although it comes to gazing into a crystal ball if the challenge is to foresee the future structure, it is not entirely im-
plausible that the E.U.-supervisor – at least initially until a full-fledged and autonomous agency is actually up and running – will have to rely on some cooperation and information sharing with national supervisors, ESFS authorities etc. Yet such a temporary backslide into the thickets of intra-agency cooperation could prove temporary. As of now, however, it seems that the political will does not suffice to indeed create an omnibus supranational agency.\textsuperscript{189} Moreover, it is even unlikely that the Commission that has to respond to severe time pressure will immediately provide for an opt-in solution that some commentators have advocated.\textsuperscript{190}

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

5 \textbf{Sketching an alternative approach to transnational banking supervision}

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

\textsuperscript{189} \textit{Supra} at note 167.


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

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

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

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

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


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

197 Supra 4.2.2.

198 Supra 4.2.3.
tional) lead-authority when it explicitly posits in its explanatory memorandum that it is of critical importance that ultimately a single decision prevails. 199 Of course, it strictly clings to the problematic distinction between a bank’s subsidiaries and branches.

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

200 Supra 4.2.4.1.
201 For an astute proposal of efficient governance-structures at financial supervisors, see Enriques & Hertig supra note 170 at 365-73; see also Anita Anand & Andrew Green, Regulating Financial Institutions: The Value of Opacity, 57 MCGILL L.J. 399, 408-422 (2012) (arguing for an opaque and insulated design of financial supervisors).
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