

Forum on financial cross-border groups

March 2009
Discussion paper

“**Cross-border
banking in Europe:
what regulation
and supervision?**”

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2009

Abstract

The free movement of capital is a key element of the European Union and underpins the Single European Market. Cross-border banks are a European and global reality and they are crucial in maintaining and developing financial and economic integration. Their internal capital markets create a cross-border market in retail banking and contribute to efficiently managing risks. The parent company defines a group and the group's strategy. **However, cross-border banks also need effective regulation and supervision to function properly.**

New regulation should level the playing field and eliminate obstacles to the effective functioning of a group.

Concerning supervision, we welcome the de Larosière Group's recommendations and agree that a European solution is necessary. In this context, we stress the importance of a new regulation for multinational banking groups which should set out the powers and responsibilities of the parent company within the group. Day-to-day supervision requires supervisors to be close to a business and therefore national supervision is vital. Supervision of strategic decisions at the consolidated level requires a college of supervisors to understand the global effects and externalities of those decisions.

A European Banking Authority should set supervisory standards, participate within each college and define issues and, if necessary, have the final legally binding decision in the college.

In the event of a crisis, the European Banking Authority can also play a key role in **early intervention** to help reduce costs.

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Index

| | |
|-----------|-------------------------------------------------------------------------------------------|
| 3 | Preface |
| 4 | Executive Summary |
| 8 | I. Analysis |
| 8 | Lessons from the financial crisis |
| 9 | The free movement of capital |
| 9 | Multinational banks, the internal capital market and international financial integration. |
| 10 | The economic impact of cross-border banking |
| 12 | The regulatory barriers to the well-functioning of the ICM |
| 16 | II. Proposals |
| 16 | A European System of Banking Supervisors |
| 18 | A new regulation for financial groups |
| 19 | Early Intervention Mechanism and Burden Sharing Issues |
| 21 | Appendices |
| 26 | Bibliography |

Preface

In October 2008, the Institutional and Regulatory Strategic Advisory (IRSA) of UniCredit Group asked an expert group (Forum) to discuss the main issues in banking regulation in Europe.

This report is the final output of the Forum. It has been written with special emphasis on the perspective of multinational banks (MNBs). The reasons for adopting this perspective are three. First, because MNBs are the largest players in the European financial system. Second, their cross-border activities represent a significant share in banking in several EU host countries. Third, the international financial integration of non-tradable activities, such as retail banking, can only be achieved through the cross-border operations of MNBs.

As this report is being completed, the results of the High Level Group on European Financial Supervision, established by the President of the European Commission (EC) José Manuel Barroso and chaired by Jacques de Larosière have been made public. Our report shares most of the conclusions of the de Larosière Group, particularly the view that there is an urgent need to reform and harmonise the European financial regulatory and supervisory framework. Yet, the cross-border banking perspective adopted in this report brings useful insights into the broader and comprehensive approach taken by the de Larosière Group, whose mandate was to analyse financial markets overall. Finally, our report makes some suggestions on how to accelerate the implementation of the de Larosière Group's findings, as expressed by the subsequent EU Commission Communication.

The Forum, chaired by Carmine Lamanda (Senior Executive Vice President, UniCredit Group), comprised of experts in law, such as Guido Ferrarini (University of Genoa), Klaus Hopt (Max Planck Institute for Private Law, Hamburg), Bernardino Libonati (University of Rome, La Sapienza), Alberto Santa Maria (University of Milan) and leading economists included Giorgio Barba Navaretti (University of Milan), Giacomo Calzolari (University of Bologna) and Alberto Pozzolo (University of Molise).

Filippo Chiodini, Edoardo Gambaro and Stefano Mechelli cooperated with the law experts and Micol Levi with the economists. Sergio Lugaresi (Head of Regulatory Affairs, UniCredit Group), with the contribution of Marco Laganà (UniCredit Group) and supported by Alessandro Paladini (Head of Research and Analysis Staff, UniCredit Group), Costanza Bufalini (Head of Institutional Relations with the European Union) and Andrew Manship (consultant to IRSA) acted as Secretariat of the Forum. Colleagues from IRSA and the Legal Department of UniCredit also participated in the work of the Forum.



Executive Summary

It is urgent to reform the European regulatory and supervisory architecture for the financial sector and, specifically, for large multinational banks (MNBs). A new architecture for European banking regulation and supervision, aimed at further progressing toward financial market integration and stability, is required. It should be based on the acknowledgement of the international dimension of financial markets, the coordination failure of colleges of supervisors in crisis management and the concerns of host countries to delegate powers to home country authorities.

The jury is still out on the causes, consequences and remedies of the present financial crisis. **Undoubtedly, MNBs feature as central characters in it.** Whereas initially the crisis apparently only affected investment banks and banks specialised in the mortgage market, it gradually extended to some of the major players in commercial banking, in the US as well as in Europe. As the financial crisis unfolded, the size and geographic scope in the activities of such MNBs were perceived to be potential sources of systemic financial risk.

For the purposes of this report a MNB shall mean a banking group consisting of branches and/or subsidiaries located in more than one country, which are managed and coordinated by a parent company and characterised by common business objectives and unitary direction. This report adopts the perspective of MNBs and takes stock of the financial crisis in discussing the main shortcomings of the present European regulatory and supervisory framework and the steps required to improve it. This distinctive approach also provides useful insights into the results of the High Level Group on European Financial Supervision, established by EC President José Manuel Barroso and chaired by Jacques de Larosière, which had the broad mandate of analysing financial markets overall.

In particular, this report emphasises how the fragmented European regulatory and supervisory frameworks prevent the efficient functioning of MNBs and are ineffective in overseeing cross-border activities. It therefore fully shares the de Larosière Group's call for swift and rapid reform and for convergence of European financial regulation and supervision. Our report also argues that it is equally urgent to introduce a new regulation for MNBs that clearly defines the responsibilities and powers of the parent company, subsidiaries and branches. This substantive regulation would also provide a framework for a clearer allocation of responsibilities between competent supervisors and for the definition of institutional mechanisms for early intervention in a bank crisis situation.

This report argues that multinational banking per se, as a structural banking model, does not necessarily contribute to systemic risk and crisis contagion. Even though inappropriate strategic choices and management practices in large financial institutions inevitably have systemic implications, **the cross-border nature of financial activities and the size of banking institutions in themselves can, rather, be a powerful force for financial stabilisation.**

MNBs are crucial in fulfilling the free movement of capital, as set out in the Treaty of the European Community (TEC), and to continuing integration in the European financial market. Cross-border retail banking activities channel localised resources from savers to end-users. The **internal capital market (ICM) of MNBs** offers opportunities for optimal capital allocation, efficient liquidity and risk management, the development of new markets and opportunities for risk diversification.

However, such positive outcomes are less likely to materialise in the absence of an adequate regulatory and supervisory environment. Financial markets need sound and adequate institutions. An ingredient of the current financial crisis is the mismatch between the geographic scope of the activities of such banks, the regulatory framework and the institutions supervising their activities. The problem is obviously global, but it is especially severe and sensitive in the European Union, given the degree of integration in its financial market. It is necessary to combine the strength of national supervision with sharing information and relevant decisions at European level. A cohesive and well-designed European institutional framework will be an essential first step towards the global coordination of the supervision and regulation of cross-border banking.

During the turmoil the banking situation in the European Union was assessed mainly at the national level and remedial action was defined almost exclusively at country level. The fragmentation of national regulatory systems and their non-neutrality with respect to the organisation of MNBs into branches or subsidiaries have hindered the efficient use and allocation of private resources through the ICM. These inefficiencies may have increased the overall cost of crisis management to public finances. Coordination and cooperation between national supervisors have proved ineffective for the crisis management of MNBs where speediness was essential. Bilateral negotiations have prevailed over multinational coordination within colleges. Burden sharing agreements were not coupled with rescue plans looking at the group as a single entity.

In times of stressed financial conditions, the current institutional framework does not give due consideration to the cross-border externalities and negative spillovers resulting from individual supervisory decisions. The crisis demonstrates the effect cross-border bank lending has in the real economies of host territories. Such externalities undermine the collective efficiency of supervisory colleges. In addition, the absence of an effective common framework for crisis management leads to collective action problems.

Even though the limits of the European regulatory infrastructure have become clear in times of severe financial distress, **the problem is rooted in the supervision and crisis prevention activities in ordinary times.**

The inadequacy of the present international and European supervisory architecture, with respect to cross-border externalities and its inefficacy and inefficiency in crisis management, has had **two further side effects:**

- I. cross-border groups' market valuation has suffered more than the valuation of purely national banks, in part due to a perceived lack in an adequate regulatory framework to oversee these institutions;
- II. countries with largely foreign-owned banking sectors oppose more than before the delegation of supervisory powers to the home authority of the parent company (lead supervisor); the home country bias of the supervisory system, in fact, may lead to agency problems.

In essence, a shortfall in cross-border coordination and information-sharing has increased the possibility of national government interventions and of rising economic nationalism. This is challenging the cross-border banking business model.

The implementation of a **new European financial supervisory architecture followed by substantive European regulation of MNBs** is particularly urgent. Investors, markets and individuals need to be reassured that the activities of MNBs in Europe are supervised within an adequate and effective framework. Finally, a revised framework will enable supervisory authorities to implement and deploy effective tools for early intervention. The EU institutional and legal framework and years of experience in Community cooperation provide an opportunity for concrete and immediate improvements at the EU level. This could be a first step towards extensive global supervisory coordination and integration.

Therefore, the conclusions of this report fully support the proposals advanced by the High Level Group chaired by Mr. de Larosière to move towards a European System of Banking Supervision (ESBS) which would operate along the same lines, in terms of independence, governance and mechanisms, as the present Eurosystem model. Such a step, driven by the crisis management focus, is possible within the existing European legal

framework and in a reasonable timeframe that is compatible with the protracted situation of financial instability.

In addition, this report develops proposals regarding micro-prudential supervision. Our proposal has two main components.

1) **The rapid creation of a European supervisory architecture (along similar lines to the de Larosière proposal) conceived as follows:**

- **the supervision of national banks would function in the same way as at the present**, although harmonisation and enhancement could be achieved by the standards of supervision set by a European Banking Authority described below.
- **the supervision of cross-border banks would be based on three tiers:**
 - **day-to-day supervision, which requires supervisors to be close to a business, will remain with national supervisors;**
 - **strategic decisions affecting the entire group will be supervised by colleges of supervisors**, with enhanced, legally binding supervisory powers for each cross-border institution;
 - **a European Banking Authority (EBA), whose independence, governance and mechanisms could follow the proposal of the de Larosière Group, would:**
 - enhance coordination in supervision and information sharing (including supervisory standard-setting);
 - participate within each college of supervisors, define issues and, if necessary, have the final legally binding decision in the college;
 - coordinate early intervention mechanisms.

The door should not be closed on non-EU countries participating in the ESBS.

2) In the medium term, **a new regulation for MNBs** that defines the responsibilities and powers of the parent company, subsidiaries and branches. Due protection to minorities and creditors should be recognised. This substantive regulation would also be instrumental in addressing regulatory issues not explicitly tackled by the de Larosière Group, such as **achieving the neutrality of banking regulation and supervision** with respect to the organisational structure of cross-border activities (branches vs. subsidiaries). Consequently, this step would enable a better and clearer allocation of responsibilities between competent authorities and the definition of institutional mechanisms for early intervention in a bank crisis situation.

This report welcomes the European Commission's intention to accelerate the implementation of the de Larosière Group's findings. In the absence of unanimous European political agreement, there are two possible avenues to speedily implement the ESBS:

- either, **a group of EU Member States, willing to move forward the integration of banking supervision for MNBs, could propose an Enhanced Cooperation to the European Commission, as foreseen by art. 11 Treaty of the European Community (TEC) and art. 43 Treaty of the European Union (TEU), or**
- following an alternative path, under article 105 (6) TEC, **the European Central Bank (ECB) could be temporarily attributed with the role of EBA.**

Alternative routes that offer a legal basis to achieving the same powers for an EBA with a broad membership should not be ruled out, provided it does not require Treaty amendments and can be implemented in a short timeframe (the case of the European Aviation Safety Agency has sometimes been advocated).

In any case, the ESBS will act according to existing EU and national legislation and within the EU institutional framework.

This includes following the principle of subsidiarity. National legislators and national supervisors/regulators will be committed to exploiting to the maximum extent the opportunities granted by the existing European legislation to ensure full recognition of the unity of MNBs and the opportunity to subject them to a unitary supervision. Thanks to the EBA, the college of supervisors will have greater and better access to information on an MNB and take part in relevant supervisory decisions.

We do not exclude any option to achieving the goal of creating an **International Central Coordinating Authority which, along with national supervisors, will have the power to share responsibility in supervising MNBs.** Therefore, an option could be to investigate the scope for **inter-governmental agreement** as a way to further integration in banking supervision. This could go beyond European supervision to a more global framework.

The remainder of the report is structured into two parts. The first part discusses the role of MNBs in the context of financial integration in Europe and looks at how the present regulatory framework hinders the functioning of the ICM. The second part offers some insights on how to implement the de Larosière Group's recommendations on reforming the regulatory and supervisory framework for MNBs in Europe.

Forum on
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Groups

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“Analysis”



I. Analysis

Lessons from the financial crisis

- The financial crisis has shown the devastating effects for host countries from decisions taken on a solo basis by home country authorities.
- In the European Union the situation in the banking system during the turmoil was assessed mainly at the national level and remedial action was also defined at country level. This may have prevented the efficient use of private resources and may have increased the overall cost to public finances.
- The crisis has also unveiled a remarkable shortfall in the current institutional framework: the financial ability of some EU countries to deal with the bail-out costs of large cross-border banks (the small country relative to “too large to save” bank issue).
- Countries with largely foreign-owned banking sectors oppose more than before delegating powers to the home authority of the parent company (lead supervisor).
- The market valuation for cross-border groups has suffered more than the valuation of purely national banks.
- Re-nationalisation, national government interventions, and the lack of international coordination in crisis management are challenging the cross-border banking business model.

During the financial crisis the situation of the banking system was assessed mainly at the national level and remedial action was also defined at country level in the European Union (EU). This may have prevented the efficient use of private resources and may have increased the overall cost to public finances.

Coordination and cooperation between national supervisors have proved ineffective in the crisis management of multinational financial institutions where speediness was required (Fortis). Bilateral cooperation channels have prevailed over multinational coordination within colleges. The non-legally binding Memorandum of Understanding on cross-border financial crisis, signed in July 2008 by all relevant EU authorities, was of no use for crisis management. Burden sharing agreements were not coupled with rescue plans looking at the group as a single entity which, outside of the banking sector, applies under the principles of the European general insolvency law (EC Regulation no. 1346/2000). In the case of Fortis, the group was split along national lines, and re-nationalisation was a precondition for any bail-out plan to be funded out of national budgets.

The crisis has unveiled a crucial shortfall in the current institutional framework: **in times of stressed financial conditions,**

crisis management, when handled separately by national supervisors, does not take due consideration of cross-border externalities and negative spillovers and, in addition, may lead to collective action problems. The economic literature shows that the cross-border externalities of independent decisions by national supervisors, result in overall inefficiency.

Examples of cross-border externalities, affecting the real economy of the host country, include:

- **The cross-border cost of closure:** since the home authority has the right to decide on a foreign branch's closure in the event of a crisis the host country regulator has no power to act early to minimise losses and may be forced to bail a foreign branch out to guarantee internal financial stability even if it is not responsible for its supervision. It may also happen that the host authority cannot manage a bail-out, even if willing to do so, due to ring-fencing procedures related to foreign bankruptcy law. EU insolvency legislation is still in its infancy and EU law does not directly address the specifics of the home country treatment of banks whose failure might present systemically important implications for a host country¹;
- **The cross-border effect on banks' lending activity:** a shock to a cross-border bank may negatively impact on the host's real economy²;
- **The cross-border impact on the transfer of assets:** there is a risk that the home supervisor might collude with the parent company to transfer a subsidiary's assets to the parent³.

The crisis has also unveiled a further shortfall in the current institutional framework: the mismatch between the size of a cross-border bank relative to the home authorities' resources.

On the one hand, some EU countries do not have the financial ability to manage the bail-out costs of a large cross-border bank (the small country relative to “too large to save” bank issue). On the other hand, the potential legal complexity of putting a large bank into receivership may create an incentive for well-resourced governments to, nevertheless, carry out a bail-out (“too big and too complex to fail” issue).

Therefore, a new supervisory architecture in Europe should recognise the cross-border externalities associated with

1) Eisenbeis and Kaufman (2006).

2) Economic analyses (Peek and Rosengren 2000) demonstrated that the Japanese stock market collapse in the '90s negatively impacted on the US real economy, where Japanese banks were active, via a reduction in lending supply.

3) Goldberg et al. (2005).

financial groups through better coordination and more effective procedures for early prevention and crisis management.

The inadequacy of the present international and European supervisory architecture, with respect to cross-border externalities, and its inefficacy and inefficiency in crisis management has had **two further side effects, both on the market and political attitude toward MNBs**:

- I. The market valuation of cross-border groups has suffered more than the valuation of purely national banks, partly due to a perceived lack of an adequate regulatory framework overseeing these institutions;
- II. countries with largely foreign-owned banking sectors oppose more than before the delegation of supervisory powers to the home authority of the parent company (lead supervisor); the home country bias of the supervisory system, in fact, may lead to agency problems.

As a result, the possibility of national government interventions, as a consequence of the lack of international coordination, are challenging the cross-border banking business model.

For all these reasons, we need to reassess the costs and benefits of cross-border banking, particularly in the context of the European Union.

The free movement of capital

- According to the Treaty of the European Community (TEC) a basic principle of the European Union is the free movement of capital. Financial market integration is a key objective pursued by the European Commission and the ECB. To move towards a more efficient single European financial market and effectively pursue financial stability it is necessary to harmonise and integrate, as much as possible, banking supervision.

The free movement of capital is one of the four fundamental freedoms regulated by the Treaty of the European Community (TEC). The freedom, for its importance, has substantially remained the same through the various amendments of the Treaty and is set forth in articles 56-58 TEC. It extends to any movement of capital between Member States, as well as – differently from the other freedoms – also towards third countries, thus showing the rationale and ultimate goal of this freedom: to create a free capital market across Europe.

It is, however, true that restrictions to this freedom are admissible: as well as restrictions towards third countries existing on 31st December, 1993. **Restrictions are possible** for overriding reasons of general interest, as well as for the specific grounds given in article 58 TEC, i.e. to prevent infringements of national tax or financial supervision rules. Nevertheless, such restrictions, in the light of the fundamental importance of the freedom and of the underlining ultimate goal,

- must comply with the principle of proportionality; hence,
- interests protected by national rules are allowed only to the extent that no Community harmonising measures already exist;
 - must be applied in a non-discriminatory manner;
 - shall be narrowly construed and interpreted.

We argue that fragmentation in banking supervision and regulation is not only an obstacle to a fully-integrated financial market but it is also a source of ineffectiveness in the supervision of MNBs. Therefore, to move towards a more efficient single European financial market and effectively pursue financial stability it is necessary to harmonise and integrate as much as possible banking supervision.

Multinational banks, the internal capital market and international financial integration.

- MNBs are complex organisations composed of several units located in different countries, **managed and coordinated by a parent company and characterised by common business objective and unitary direction.** They function through internal capital markets (ICMs), which direct assets, liquidity and payments across countries.
- The ICMs of MNBs thus contribute – inter alia - to the cross-border integration of retail markets, a business area which is less tradable and still more fragmented compared to capital markets and wholesale activities.
- If exogenous restraints do not distort their functioning, ICMs increase the efficiency and the stability of the financial markets.

The efficiency of a financial system is measured by its ability to channel funds towards the best investment opportunities, independent of their geographical location. As argued in the previous section, recognising the importance of the free movement of capital, the Treaty establishing the European Community has explicitly included, among its primary objectives, the creation of a single European financial market.

MNBs are complex organisations composed of several units located in different countries, managed and coordinated by a parent company and characterised by common business objective and unitary direction. They function through ICMs, which direct assets, liquidity and payments across countries. **MNBs, through their ICMs⁴, have a fundamental function in increasing capital mobility and the efficiency of the financial systems where they operate.**

4) An ICM is a component of a multi-unit enterprise (or group) that allows the management of funds in the most efficient way by pooling and investing funds in the best activities available to the units. This process may contemplate transfers across units, internal credit or equity markets and it is advantaged by proprietary and internal information that is often missing outside the firm (Stein 2003).

The ICM allows an MNB to allocate its capital across business units (either branches or subsidiaries) without the need to access external capital markets, such as the inter-bank or bond markets. As such, a well-functioning and properly designed ICM allows external market transactions to be substituted with transactions which take place within the MNB. The advantage of the ICM, even compared to open and freely accessible markets, is that this is done on the basis of more reliable (internal) information and mutual trust. In channelling resources from savers to end-users, the ICM directly interfaces with families, consumers and small and large firms. This is particularly true for retail banking⁵.

Multinational activities in retail are essential to fostering market integration because most of the services of cross-border banking are not easily tradable. Such services can only be offered to foreign participants through branches or subsidiaries operating in foreign countries. In this respect, deposits and loans are bound to be more geographically fragmented than interbank transactions or capital market operations. Country specific factors - such as conditions in the national economy, institutional features and other idiosyncratic characteristics of the financial structures - affect local market conditions more than in other segments of finance.

Retail banking is still relatively fragmented because retail markets are harder to integrate than other financial activities. This remains the case despite an increase in cross-border mergers/acquisitions and the growing signs of integration in interbank (wholesale) and capital market activities. According to the ECB, the cross-border dispersion of interest rates on loans and deposits from banks to non-financial corporations and households is still large and has been fairly constant. The dispersion has even increased since the introduction of the Euro.

The retail banking market does not fulfil the ECB definition of an integrated market. A market is considered fully integrated if 'all potential participants (i) are subject to a single set of rules when deciding to buy or sell those financial instrument or services; (ii) have equal access to this set of financial instruments or services; (iii) are treated equally when they operate in the market'⁶. If comparisons are made between participants in retail banking across the EU, and even the euro zone, these conditions are not met.

In the light of a non-integrated retail banking market, MNBs may have a crucial role in achieving the objective of full capital mobility and financial market integration within the EU.

In a crisis situation, while external market transactions may be blocked due to a lack of information and trust, a well-functioning and properly designed ICM can still continue to work on the basis of more reliable internal information and mutual trust. Although the economic literature has illustrated the possibility that a poorly designed ICM generates distortions, it is important here to note that for institutions operating in financial sectors, such as cross-border banks, ICMs offer a specific plus.

In fact, it is well-known that the main impediment to a well-functioning financial market is the lack of information and of trust between trading parties. The current systemic crisis has clearly shown that these issues may abruptly block the functioning of the interbank market.

However, **the functioning of the ICM crucially depends on how the foreign operation of the bank is organised (branches vs. subsidiaries) and on the overall regulatory framework overseeing the activities of MNBs.**

ICMs work well when capital and liquidity are truly free to flow and information is available, reported truthfully and flows to the "top". This happens if the organisation of the ICM provides adequate incentives for CEOs and managers in headquarters and peripheral units.

Although the dominant share of foreign activities in the EU is undertaken through subsidiaries, we argue that each organisational structure has merits, depending on the functions carried out by foreign operations. Consequently, regulatory frameworks should be neutral with respect to the organisational format chosen by the bank. Cross-border banks face different options on how to organise their international activities, whereby they trade-off the costs and benefits of hierarchy and centralised control (branch structure) against those of a higher degree of autonomy in foreign operations (subsidiaries).

A first crucial issue is **optimising the flow of information within the bank.** The ICM can work effectively if information flows freely from peripheral activities to the headquarters and vice-versa. Organisation has a crucial impact on information flows. For example, local branches are better at processing hard (i.e. codifiable) information that can be easily collected and conveyed to central decision-making nodes at headquarters. Subsidiaries can deal better with soft information, where local managers need autonomy to acquire and evaluate often complex and country-specific knowledge (Stein, 2002, Berger, 2007).

A second issue is that **capital and liquidity must flow freely towards the best investment opportunities.** Again, organisation affects the efficient allocation of capital. In general subsidiaries with a clear identification of responsibilities allow for a better design of local manager incentives.

Hence, an optimal design of the organisation (and the associated ICM) coupled with sound incentives allows the financial system to reap the benefits of ICMs, thus minimising the costs of geographical fragmentation.

The economic impact of cross-border banking

- MNBs have a positive impact on the efficiency and the level of competition in host and home countries. There is no evidence, neither it can be argued unequivocally, that MNBs increase the risk of crisis contagion. On the contrary, financial integration through cross-border banking can have a positive effect on financial stability.

5) Retail activities of cross-border banks have been increasing steadily since 2000, particularly in the Single European Market. According to the Bank for International Settlements, local claims on foreign-owned banks in the EU27 as a percentage of GDP went from 10% in 2000 to 30% in 2007. Most of these cross-border activities were intra-EU.

6) European Central Bank, 2008.

Cross-border banking enables the integration of non-tradable activities dispersed in different locations: capital is collected and invested by means of country-specific retail banking activities. The allocation of capital across locations within the bank takes place through the ICM. **The ICM, if efficient and well-functioning, in principle, can generate smarter and safer money than the external capital market.** As argued, the organisational design of the ICM and the incentives ruling its activities are crucial.

Despite these potentially positive effects, the market entry of foreign banks has traditionally been a concern for policymakers in the host countries.

It must be recognised that under certain circumstances **there might be a tension between the efficient allocation of capital within the ICM and financial stability in the host country.** The geographic mobility of resources may, in some instances, make some host markets thin in terms of capital assets and liquidity.

A sound regulatory framework for MNBs must create an adequate monitoring system that closely scrutinises and limits excessive country imbalances so as to safeguard the stability of any national market. If cross-border banks' ICMs are given all the opportunities to reach full efficiency, it is clear that national decision-makers may be concerned by situations of temporary liquidity shortages in their countries.

All the same, it is essential to take stock of two sets of key facts emerging from the empirical literature.

The first fact is that MNBs are not per se a source of systemic crisis and financial stability.

With the recent financial crisis, **MNBs have been put under severe stress.** Their size and the geographic span of their activities has emerged as a sign of frailty rather than strength. Moreover, they have been accused of increasing the degree of financial instability, causing cross-border systemic events in financial markets and contagion.

There are two ways in which a bank might contaminate another financial intermediary: through real exposure (e.g. on the interbank markets or in the payment system), **or through the disclosure of new information** not previously available⁷. In the second case, shocks hitting bank 'A' may be processed by imperfectly informed agents as a signal about the health of financial institution 'B', and coordinate their expectations based upon these assumptions. Unfortunately, due to the intrinsic fragility of banks' balance sheets, even if these expectations are wrong, such a coordination can cause a run on bank 'B' and even lead to it defaulting. This highlights the need for extra supervisory oversight to inform the markets.

Only the second type of contagion is inefficient. Contagion through the real markets or through disclosure of true information is part of the self-stabilising adjustments of the system to a new equilibrium, emerging after a shock. These adjustments may be painful, but they are not inefficient. A shock which hits a parent company and is transmitted to a foreign subsidiary is not an example of inefficient contagion.

Instead, it is an adjustment to a new equilibrium with a lower aggregate level of credit supply. The absence of cross-border financial flows would have shielded the subsidiary, and the foreign country, from the shock hitting the parent company. However, the cost would have been of a lower credit supply before the shock. It is inconsistent to claim the benefits of financial integration – granting a more efficient allocation of financial resources and a lower degree of aggregate risk thanks to diversification – without being ready to accept that with such integration a shock in one country may spread elsewhere.

The question is, therefore, whether MNBs increase the probability of systemic events leading to episodes of inefficient contagion. The answer is 'no'.

Apart from what still remains to be seen in the exceptional circumstances of the current crisis, **the only sound empirical evidence of inefficient contagion is confined to the Great Depression and it is limited to some specific regions of the US⁸.**

A further important point is **that there is no reason why an MNB should be more subject to the risk of contagion than a national bank with strong cross-border positions on the interbank market.** On the contrary, idiosyncratic shocks are more likely to be withstood within a large multinational intermediary that can internalise the negative network and "sequential service constraint" externalities that affect interbank markets, than a group of smaller, local banks could.

For a given degree of cross-border integration in the financial markets, MNBs therefore pose fewer problems for financial instability than a cross-border network of domestic banks. It is a mistake to confuse the effects of globalisation with the role played by MNBs.

The second fact emerging from the empirical literature is that MNBs are, on average, more efficient than domestic banks, particularly in developing economies.

Foreign banks can increase the welfare of the host economy through a better allocation of credit. Indeed, foreign banks, when entering less developed economies, have been shown to:

- a) have stronger loan growth and a greater ability to absorb losses than their national counterparts⁹;
- b) grant a higher share of loans to SMEs and start-ups, that are typically more likely to be credit constrained, than domestic banks¹⁰;
- c) help unbanked firms to access the credit market and maintain longer lasting lending relationships¹¹;
- d) improve efficiency and transparency in poor lending decisions which can afflict developing countries¹².

7) De Bandt and Hartmann (2000).

8) Calomiris and Mason (1997).

9) Crystal et al. (2001); Dages et al. (2000).

10) Clarke et al. (2001) and (2002).

11) Giannetti and Ongena (2008).

12) Laeven (2001); La Porta et al. (2003).

In central and eastern European Union countries **foreign banks had a positive effect in the host economy by increasing the overall efficiency of the banking and financial sector.** Part of the improvement was the direct effect of foreign banks' presence, especially when it was sizeable and took the form of relationship lending with the local clientele¹³.

In general, **a foreign banking presence has the effect of enhancing competition and encouraging local competitors to adopt international best practices.** Thus leading to cost reduction, efficiency gains, improvement in the diversity and quality of the financial services offered and advancement in human capital and in management skills¹⁴.

Finally, **MNBs can make a positive contribution to local regulation and improve the dialogue with supervisory authorities**¹⁵.

The positive effects of the presence of foreign banks are more pronounced in developing countries, as they generally account for a larger market share than in developed ones and because the level of development in the local market leaves larger margins for improvement. Assessing the impact of multinational banking in developed countries is also more difficult because multinational retail banking is a relatively recent phenomenon with a limited time span for observation¹⁶.

The regulatory barriers to the well-functioning of the ICM

- An obstacle to a fully integrated European financial market is the fragmentation in banking supervision and regulation.
- The fragmentation in supervision generates barriers to intra-group optimal asset and liquidity allocation, restrictions on consumer data transfer and duplication in internal control units.
- The shortfalls of the current institutional framework become even more compelling in situations of financial stress, when cross-border externalities and lacks in coordination emerge.
- Authorities need to supervise the group as an entity, collect and monitor all relevant information at the consolidated level and clearly define powers and responsibilities of the parent company including with respect to local minorities and creditors.

The current EU institutional framework - based on the principle of a minimum set of uniform banking regulation, mutual recognition and the single banking license scheme- leaves scope for improvement in terms of efficiency and effectiveness.

For instance, under the current legal framework, cross-border banks operating in the EU are subject to multiple regulatory jurisdictions and regulators. Banking laws often differ significantly and may even conflict between countries. As a consequence, regulators and supervisors often operate only in the interest of their own country without due considerations to cross-border externalities.

The existence of multiple national authorities involved in the supervision of an MNB could imply supervisory duplication costs, with negative repercussions on taxpayers, banks and customers and, according to the literature, may lead to distortionary behaviour by market participants. An example refers to the Capital Requirements Directive (CRD). The CRD's original intent was to ensure a sound and prudential framework while guaranteeing a level-playing field for credit institutions from the point of view of both the freedom of establishment and the freedom to provide financial services across the Single European Market. However, numerous differences remain due to national discretions and different interpretations by national authorities (e.g. definition of capital, treatment of consolidated goodwill, migration to the internal rating-based models, treatment of financial instruments managing credit risk such as securitised products etc.).

The fragmentation in supervision in the EU can hamper the ability of the parent company and its supervisor to pursue the interests of the group and for it to be a source of financial stability in itself. Fragmentation in European supervision directly impacts on the intra-group activity of an MNB, which is itself an ICM. In order to be effective, the ICM has to be fully integrated and it should continue to work even during distressed market conditions. On one hand, the benefits of a cross-border financial group can be gathered to the extent that the parent company receives accurate and timely data and, on this basis, optimises the transfer of liquidity, assets, risks and capital (the financial resources) with the group's constituents, under normal and especially distressed market conditions. On the other hand, authorities need to supervise the group as an entity, collect and monitor all relevant information at the consolidated level and clearly define the powers and responsibilities of the parent company including with respect to local minorities and creditors.

Asset transferability within the group is one of the key issues for a cross-border group's fully centralised risk management and compliance with capital requirements. Even in the conditions required for the waiver to compliance with the prudential requirements on an individual basis, currently set out in art. 69 of the CRD, is the proviso that "there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities [by or] to the parent credit institution".

Asset transfers from one entity to another within the same group may take different legal forms such as the transfer of capital and collateral, interbank lending (on preferential terms or on an arms-length basis), up to financial support.

13) Havrylychuk (2006); Isik and Hassan (2002); Hasan and Marton (2003); Matousek and Taci (2004); Grigorian and Manole (2002); Fries and Taci (2005)
14) Barajas et al. (2000); Claessens et al. (2001); Claessens and Lee (2002); Martinez-Peria and Mody (2004); Claessens and Laeven (2004); Bayraktar and Wang (2005).
15) Claessens et al. (2001).
16) Focarelli and Pozzolo (2001) and (2008).

The crucial aspect with regard to asset transfers in banking is timing, as assets are expected to be promptly transferable (e.g. 24 hours in the case of a liquidity crisis), being identified as a bank-driven crisis management tool. However, asset transfers from one entity to another face several obstacles in the legislation of Member States. In fact, no harmonisation has been achieved on that point as to company, insolvency and banking law.

In general, the different provisions of national company laws tend to protect the interest of each company and its shareholders. Subsidiaries are considered as a single and separate entity despite their being part of a group and the directors of any subsidiary are deemed to act in the interest of the company and its shareholders. The extent to which Member States recognise the group interest and, as a consequence, the extent a parent company may instruct a subsidiary to engage in certain transactions diverges and is subject to different conditions and authorisations. This might jeopardise the speediness required for transfers in the case of a liquidity crisis. Insolvency provisions in most Member States allow intra-group transactions to be ruled void and ineffective when carried out in the so-called “suspect period”.

While banking law does not prevent asset transfers that do not compromise the solvency and liquidity status of the transferor (besides the provisions on large exposures), information and prior approval required for such operations in some jurisdictions could hinder their effectiveness for the purposes of crisis management. In addition, “ring fencing” of a local bank’s assets could be the outcome of supervisors safeguarding the financial soundness of their domestic banks, under national banking law.

Concerning liquidity transfers within the ICM, barriers arise regarding:

- a) the rapid execution of “upstream loans” from the subsidiary to the parent company. In some countries this may encounter constraints especially when most needed in distressed market conditions;
- b) pooling cash and collateral in a single location;
- c) the lack of an integrated approach for the whole group, concerning a qualitative supervision of liquidity risk.

National corporate laws usually prescribe that the agreements between the intra-group parties must not be detrimental to any of them. Therefore, these agreements are generally requested to be at market condition. However, how does this operate if markets are closed and conditions are prohibitive? Is it the case that there is no fair value for transfer agreements within the group? The market failure should not lead to the failure of the “economic group concept”. The regulator should put the parent company (and its supervisor) in a position to process all the information, trust it and act accordingly to pursue the interest of the group as a whole.

Furthermore, the transfer of customer risk position across entities in the group is limited by some national laws on data protection and banking secrecy grounds.

More coordination of national authorities and the integration of banking supervision for MNBs is therefore necessary to make the ICM work efficiently and to enhance financial stability. Coordination and integration will facilitate the harmonisation of national regulations.

A new regulation for MNBs is necessary to define the responsibilities and powers of the parent company and establish neutrality with respect to the organisational structure of the cross-border group (branches vs. subsidiaries).

Forum on
Financial Cross-Border
Groups

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“Proposals”



II. Proposals

The recent crisis has shown **it is urgent to reform the European supervisory architecture** to recognise the international dimension of financial markets. Reform is necessary to ensure the final goal of a single European financial market which is open and positively integrated into the global financial system. There is a need to acknowledge the coordination failure of colleges of supervisors in crisis management and the concerns of host countries to delegate powers to the home country. The ultimate goal is supported by economic analysis and is fully backed by the current European legal framework. The Treaty of the European Union clearly implies this as laid out in the free movement of capital.

The implementation of a new European supervisory architecture is particularly pressing because state interventions to support the banking system have strengthened the national dimension of deposits and lending and undermined the cross-border nature of the activities of MNBs. Given the size and the geographic span of MNBs in Europe, investors, markets and individuals need to be reassured that the MNBs' activities are supervised within an adequate and effective framework. Furthermore, a revised framework will enable supervisory authorities to implement and deploy effective tools in early intervention.

At EU level the institutional and legal framework as well as years of common experience provide an opportunity for concrete and immediate improvements. This can be a first step towards more international supervisory coordination and integration.

Therefore, we welcome the proposals advanced by the High Level Group chaired by Mr. de Larosière to move towards a European System of Banking Supervision which would operate along the same lines, in terms of independence, governance and mechanisms, as the present Eurosystem model. Such a step, driven by the crisis management focus, is possible within the existing European legal framework and in a reasonable timeframe that is compatible with the protracted situation of financial instability.

In addition, regarding micro-prudential supervision, we propose:

1) The rapid creation of a European supervisory architecture as follows:

- the supervision of national banks would function in the same way as at the present, although harmonisation and enhancement could be achieved through standards of supervision set by the EBA, described below.
- the supervision of cross-border banks would be based on three tiers:

- day-to-day supervision, which requires supervisors to be close to a business, will remain to national supervisors;
- strategic decisions affecting the entire group will be supervised by colleges of supervisors, with enhanced, legally binding supervisory powers for each cross-border institution;
- The EBA would:
 - enhance coordination in supervision and information sharing (including supervisory standard-setting);
 - participate within each college of supervisors and define issues and, if necessary, have the final legally binding decision in the college;
 - coordinate early intervention mechanisms.

The door should not be closed on non-EU countries participating in the ESBS.

2) In the medium term, there is a need for new regulation for MNBs which defines the responsibilities and powers of the parent company and subsidiaries/branches and institutional mechanisms for early intervention. This would also allow neutrality toward the organisational structure of a banking group (branches vs. subsidiaries) and better and clearer allocation of responsibilities between national supervisors, colleges and the EBS.

A European System of Banking Supervisors

A voluntary agreement between Member States should establish the ESBS coordinated by the EBA.

The ESBS would be made up of national banking supervisors for nationally operating banks; national supervisors would form colleges of supervisors for relevant cross-border banks¹⁷. Both national supervisors and colleges of supervisors would be coordinated by the EBA. The ESBS would operate along the same lines, in terms of independence, governance and mechanisms, as the present Eurosystem model.

Each national supervisor would be jointly accountable for the supervision of the cross-border groups operating in their own territory and participate in the appropriate colleges of supervisors. This would make all parties internalise the externalities caused by (the lack of) supervision, thus avoiding

¹⁷ The Revision of the Capital Requirements Directive, presently under the co-decision process, envisages the obligation and the legal framework for the set-up of colleges.

regulatory arbitrage. The risk of home country bias would be reduced and it would provide the right incentives to fully cooperate in and exchange all relevant information. Although independent, the ESBS (including the EBA) should be accountable to political authorities for financial stability and crisis prevention and management.

According to the principle of subsidiarity¹⁸ all powers not explicitly delegated to the EBA will remain in the hands of national authorities to be exercised within the college of supervisors. **However, relevant decisions relating to strategic, consolidated supervision of the group should be delegated to the competent college of supervisors, under the coordination of the EBA. The EBA would retain legally binding last-say powers in the case of a dispute between national supervisory authorities within the college.**

Colleges of supervisors should be strengthened through the participation of representatives from the EBA (de Larosière Group, paragraph 186). Competences regarding the banking group as a whole should be allocated to the strengthened college¹⁹. The efficient and effective working method, organisation and decision-making of colleges would imply, inter alia, regular and frequent activity by the college of supervisors with an authoritative chairmanship, for instance a member of the main decision-making body of the EBA, and a stable secretariat, coordinated by the home supervisor and staffed with experts seconded from the **college of supervisors. Regular meetings of the college of supervisors would take place** in the Member State of the parent institution of the cross-border banking group (home Member State).

Colleges of supervisors would have binding supervisory powers, performed by the national supervisors within the college. In the case of dispute (or lack of agreement) between national supervisors, the relevant decisions would be taken by the representatives from the EBA.

A clear allocation of powers and responsibilities for the parent company through appropriate regulation could facilitate the allocation of supervisory competences (for example, in the areas of the assessment of group capital adequacy, internal governance and control, large exposures requirements and the provisioning policy) to the college of supervisors and the EBA.

Banks operating domestically would remain under the supervision of national authorities, in conformity with the principle of subsidiarity. A level-playing field, however, would be created for all banks, as a result of supervisory convergence, policy harmonisation and supervisory standard-setting by the EBA, tasked to ensure the consistency of prudential supervision for all institutions. To avoid unfair competition, as proposed by the de

Larosière Group (paragraph 208i), any financial institution (including purely domestic ones) should be able to submit complaints to the EBA in the case of alleged discrimination vis-à-vis other financial institutions supervised by other national authorities of colleges of supervisors. **Any dispute or lack of cooperation between national supervisors should be able to be submitted by any supervisor or supervised bank to the EBA,** who would be empowered to take all appropriate measures, possibly making supervisory decisions or legally binding interpretations of harmonised supervisory rules which are directly applicable to the institution concerned.

There are a number of ways to implement the ESBS model rapidly. In this regard we welcome the European Commission's intention to accelerate the implementation of the de Larosière Group's findings.²⁰

As mentioned by the de Larosière Group itself (paragraph 190), if there is a lack of European political consensus, an option would be for a variable geometry approach, with **a group of EU Member States²¹, willing to move forward the integration of banking supervision for MNBs, could propose to the European Commission an Enhanced Cooperation, foreseen by art. 11 TEC and art. 43 TEU** (see Appendix 1). Enhanced Cooperation should be approved by the European Council by qualified majority. This would allow for the creation of a new EBA on the basis of an agreement between Member States interested in the enhanced supervision of cross-border banking groups. Other Member States would be entitled to join at a later stage. Only the Member States joining the network would be entitled to participate in the relevant decisions.

Another option would be, under article 105 (6) TEC, to allow specific tasks relating to the prudential supervision of cross-border banks to be **temporarily** conferred to the **European Central Bank**, possibly through its Banking Supervision Committee.²² The ECB and the Eurosystem already have the adequate resources, instruments, governance structure and institutional capabilities to perform immediately the role of cross-border bank supervision for certain banking groups whose parent companies are established in the euro area. With the exception of Luxembourg, the proximity of the national central banks and national supervisors is sufficient to undertake such a task. Moreover, the ECB General Council composition²³ could be smoothly adapted, if non-euro area Member States decided to a) entrust the ECB and the European System of Central Banks with additional supervisory responsibilities, b) strengthen the links between the national central banks and national banking supervisors. The decision, to be taken by the European Council by unanimity, could be under the condition of reviewing it after a pre-defined number of years.

18) "In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community." (art. 5, TEC).

19) For the urgent decisions affecting an individual banking group, the competent supervisor should promptly take the decision. The banking group subject to the decision may ask the EBA to enquire into national supervisory practices on similar decisions as a "peer review" for transparency and accountability purposes.

20) Commission of the European Communities (March 2009), p. 6, Communication for the Spring European Council.

21) At least eight, according to the Treaty.

22) The Banking Supervision Committee (BSC) consists of all 27 European System Central Banks and EU banking supervisors; the BSC could allow the ECB Governing Council to exercise its powers in the whole EU (see Appendix 2).

23) The ECB General Council is composed of the ECB president and vice-president with the 27 governors of the central banks in the EU.

Alternative routes that offer a legal basis to achieving the same powers for an EBA with a broad membership should not be ruled out, provided it does not require amending the Treaty and can be implemented in a short timeframe (the case of the European Aviation Safety Agency has sometimes been advocated).

In all cases, the European System of Banking Supervisors would act according to existing EU and national legislation and within the EU institutional framework. National legislators and national supervisors/regulators would be committed to exploiting to the maximum extent the opportunities granted by the existing European legislation to ensure full recognition of the unity of MNBs and the opportunity to subject them to a unitary supervision. Thanks to the EBA, the host country supervisor would have greater and better access to information on MNBs and take part in relevant supervisory decisions.

We do not exclude any option to achieving the goal of creating a **Central Co-ordinating Authority which, along with national supervisors, will have the power to share responsibility in supervising MNBs.** Therefore, another option could be to investigate the scope for **inter-governmental agreement** as a way to further integration in banking supervision. This could go beyond European supervision to a more global framework.

A new regulation for financial groups

The European Commission should propose a harmonised regulation for MNBs. This regulation should harmonise risk management rules and define the responsibilities and powers of the parent company and the branches/subsidiaries within the specific context of the banking sector and of a more efficient centralised supervision, thereby also granting a sector-specific form of protection to minorities and creditors. In addition, it should set out the mechanisms for early intervention and crisis management.

In the medium term, an integrated European supervisory model will pave the way for a European Banking Group, by setting out the **core regulatory framework for cross-border banking groups in Europe.** Further rules could be adopted by the EC through a second level regulation within the Lamfalussy regulatory architecture (as in the cases of the Market Abuse Directive and MiFID).

The proposal for a European Commission regulation is grounded on the following arguments:

■ **the legal instrument of a directive is not appropriate for our purposes, as discretion is left to Member States in implementation.** A regulation would be better suited, as the relevant rules would be directly applicable and uniform in all Member States. The ESBS would clearly benefit from regulatory uniformity and the EBA could further enhance it by adopting common policies, standards and interpretations of harmonised supervisory rules which would be binding for all members of the supervisory network;²⁴

■ in order to achieve full harmonisation, **common implementing measures could be provided by an EC regulation** (in line with what occurred in the cases of the Market Abuse Directive and MiFID).

The European Banking Groups Regulation (EBGR) should apply to banks with at least one branch or subsidiary in a Member State different from the home Member State. No distinction should be made between branches or subsidiaries in order to achieve neutrality with respect to the legal structure of the group.

The regulation should guarantee an enhanced role of coordination for the parent company towards its subsidiaries/branches. Such a solution has been envisaged by the Forum Europeum on Corporate Group Law²⁵, and consists of the recognition of the overall group interest prevailing over the interest of individual companies within the group, upon the following conditions:

- **the group structure must be firmly established.** This means that the group as a whole must make up a logical and economic unit. However, individual companies must retain a certain degree of independence, i.e. the parent company may not treat its subsidiaries merely as “departments”, thereby completely, or even significantly, ignoring the interests of the subsidiaries;
- **a coherent overall policy for the entire group must be in place.** Actions and decisions (even if speediness is required) have to be coordinated with mid and long-term planning for the group and its constituents. The management of the parent company should be at the centre of group planning and decision-making;
- **benefits and burdens must be appropriately distributed within the group so that a balance is maintained.** There is no need for exact and immediate compensation for the unequal burdening of an individual subsidiary. Compensation might even occur years later and indirectly, through the benefits to the group as a whole with the individually burdened subsidiary being a part of it. The relevant interests, in fact, shall always be assessed on a mid to long-term basis. However, even in the pursuit of the group interest as a whole, individual subsidiaries may not be either unreasonably burdened or arbitrarily advantaged at the expense of other group members. In any case, the burden of individual subsidiaries may never exceed its capacity to pay or jeopardise its soundness.

Within this framework the parent company shall be free to enact its role of direction and coordination of the group as a whole, thereby enabling the effective functioning of the ICM within the MNB.

This would allow group-wide, centralised risk management and compliance with capital requirements. In particular, in addition to the rules on information exchange between parent and

24) If the ECB were the EBA, Article 105 (6) TEC would offer the relevant legal basis.

25) Hommelhoff et al. (2000). The solution proposed by the Forum Europeum is based on the so called “Rozenblum” concept of corporate group adopted by the French Cour de Cassation.

subsidiaries²⁶ and relevant supervisors²⁷, already provided for by the CRD, the regulation would set core rules for the exemption of subsidiaries under consolidated supervision from complying with capital and risk management requirements individually, allowing compliance on a group basis.

This solution is already foreseen by the CRD²⁸, although discretion on whether to adopt it is left to Member States, that can apply it only on a national (sub-consolidated) basis.

The regulation would allow a uniform set of rules creating a level playing field, ensuring the effective functioning of the ICM and achieving neutrality with respect of the legal structure of an MNB.

The EBGR would allow asset transfers between subsidiaries, from and to the parent bank, provided that the abovementioned conditions for the recognition of the group are met and that no insolvency procedure has started.

In this regard, the Italian Banking Law and the Supervisory Instructions from the Bank of Italy including provisions on the banking group which could be taken into consideration in drafting the new regulation (see Appendix 3).

The protection of minority and creditor interest should be taken into account within the context of the specifics of the banking sector and the information advantage obtained through an effective central supervisory system.

The clear allocation of powers and responsibilities to the parent company could facilitate the allocation of supervisory competences to the colleges of supervisors and the EBA.

Early intervention mechanism and burden sharing issues

- The current financial turmoil has shown the importance of defining a consistent regulatory framework for crisis management applied across EU countries and developed on the assumption of the MNB as a single undertaking. Ex-ante precise rules on burden sharing using public money would originate risks of moral hazard. Stronger emphasis should be given to trigger mechanisms for automatic adjustment and early intervention mechanisms in order to minimise the need to resort to public money. A reform of Deposit Guarantee Schemes should facilitate this approach.

26) Article 139 (1) of the CRD states that "Member States shall take the necessary steps to ensure that there are no legal impediments preventing the exchange, as between undertakings included within the scope of supervision on a consolidated basis, mixed-activity holding companies and their subsidiaries, or subsidiaries of the kind covered in Article 127(3), of any information which would be relevant for the purposes of supervision".

27) Article 132 of the CRD.

28) Article 68 (1) of the CRD requires credit institutions to comply with article 22, article 75 and section 5 on an individual basis, whereby:

- Article 22 requires organisational structure and internal controls as a condition for access, taking up and pursuit of the business of credit institutions.
- Article 75 sets a minimum level of own funds.
- Section 5 provides for rules concerning large exposures.

The current financial turmoil has shown the importance of defining a consistent regulatory framework for crisis prevention, management and resolution. A macro-supervision scheme, such as the one proposed by the de Larosière Group, represents from this point of view a crucial element that must nonetheless be effectively combined with arrangements defined at micro-level. With respect to micro-level, a uniform framework should be applied across countries and developed on the assumption of an MNB being a single undertaking. This framework should address, inter alia, the crucial issue of negative spillovers arising in the event of a branch of a foreign institution going bankrupt and the Deposit Guarantee Scheme (DGS) of the host country being inadequate to fulfil its obligation towards foreign depositors (the small country issue).

Any proposal relating to crisis prevention should imply an a priori consideration on how to deal with the trade-off between moral hazard for banks and effectiveness in crisis management. While, in principle, the risk of moral hazard can be effectively dealt with by combining a well-defined and transparent framework for crisis management with "constructive ambiguity" in the application of those arrangements on a case-by-case basis, this would also logically imply a full harmonisation of DGSs across the EU and the adoption of burden sharing rules by Member States. We strongly support a DGS reform, but we envisage a risk in the adoption of ex-ante precise rules on burden sharing, since we believe they may lead to moral hazard behaviour. In addition, the definition of widely accepted ex-ante burden sharing rules is a complex and delicate process that may risk impairing development in regulatory reform. Hence, less emphasis on ex-ante rules compared to early intervention schemes should also allow this possible issue to be by-passed.

In the management of a crisis, priority should always be given to private-sector solutions, with public authorities playing a more prominent role only when these solutions looks unfeasible (see de Larosière, paragraph 128).

We believe that the adoption of a **unified early intervention scheme**²⁹ may encourage private-sector solutions (e.g.: restructuring of the bank via private sector capital) as well as discouraging moral hazard behaviour. A 'Prompt Corrective Action' (PCA) scheme reduces the risk of bank failure by requiring action to be taken in the early stages of financial distress to try to stop the problem from escalating and, eventually, to take away a bank's charter while the economic value of its capital is still positive. It could include some form of intervention so that the losses could be absorbed by an industry-based DGS organised along the lines discussed in the next section. A PCA is likely to reduce the need for a public bail-out, although it cannot prevent losses due to fraud or sudden drops in portfolio values.

In the case of an ailing MNB, the EBA could be empowered with the authority to nominate a task force for corrective action. The task force would collect information, review management decisions and coordinate private solutions looking at the group as a single entity and taking into account all possible externalities.

29) Benston and Kaufman (1988).

The appointment of a task force by the EBA should prevent nationally-based discrimination and ring-fencing, permitting a cross-border crisis management/resolution. The task force would propose a plan for the reorganisation and the winding-up of the banks belonging to a cross-border group mobilising private resources and deposit guarantee funds in order to minimise the eventual need for public money. Deposit guarantee funds will have to balance the costs of early intervention with the risk of higher costs in the case of bankruptcy. The task force should have powers to trace asset transfers within subsidiaries.

Deposit Guarantee: problems with the current arrangements and some ingredients for a desirable scheme.

Although a centralised supervisory system, such as the one proposed here, is in itself a fundamental improvement on the status quo, a joint reform of national DGSs would make it more effective and credible.³⁰ Both banking supervision and DGSs have implicit costs and benefits. Banking supervision helps maintain financial stability but it can be relatively more costly, both for banks and taxpayers. DGSs (or any other form of guarantee for bank claimants) can help prevent and contain the overall costs of a crisis but they have the downside of engendering moral hazard in normal times. In any case, both are instruments in the hands of policymakers that must be used in conjunction in order to grant financial stability, prevent potential crises and, when they happen, limit their effects.

The debate on the reform of banking supervision generally falls short of also discussing a reform in DGSs. Recently the EU has put forward a proposed 2009 reform of the Deposit Guarantee Scheme Directive. However, there is still little consensus on the direction this reform process should take. The possible reforms that have been investigated so far mainly concern the harmonisation of DGSs across Europe.

It should also be clear that, regardless of the type of reform, a DGS may not be sufficient in facing systemic events, such as diffuse episodes of financial distress or the failure of a large banking group³¹. In this case it is possible that DGSs will need to be topped up with public funds in order to preserve trust in the system (see also de Larosière, paragraph 135). In addition, besides recognising the fundamental psychological scope these funds have for reassuring depositors, **we envisage a scheme whereby they might be used in conjunction with other types of intervention and upon proposal of the task force nominated by the EBA to prevent the emergence of a more costly event such as a bank run or recapitalisation.** This type of intervention might be addressed by linking DGSs to automatic early prevention mechanisms and to the burden sharing mechanism implied by the guarantee scheme.

A well-designed and comprehensive DGS reform in the banking sector has not yet been proposed, probably due to the complexity of the issue, particularly for what concerns the definition of clear rules of burden sharing between countries. Whatever the degree of harmonisation of DGSs, as regards the proposed reform of cross-border banking supervision in Europe, **crucial aspects of future DGS reform should include a definition of a coherent and unified approach. Thus, national DGS funds could be used, upon proposal and coordination by the task force, for corrective action to prevent the emergence of a more costly event such as the need to fulfil guarantees in the case of a bankruptcy.** Such an approach includes:

- the **identification of who is in charge of using the fund, in line with the early prevention mechanism** outlined in the previous section;
- the **definition of a coherent and unified organisation** that avoids fragmentation.

Nevertheless, **if all these interventions are not sufficient, a bank bail-out, as an alternative to bankruptcy, becomes a political decision with extra funding normally provided by the taxpayer.** In this respect, some burden sharing rules have been proposed in the literature³² according to which national authorities commit to explicitly pre-determined (ex-ante) rules to share the costs of cross-border bank crisis management and resolution. However, such **ex-ante rules would generate moral hazard and the political feasibility of such an approach seems weak. It is also clear that a one-size-fits-all criterion does not exist.**

A feasible alternative is, rather, to leave the determination of burden sharing, when fiscal resources are involved, to the negotiation of national authorities (typically the ministers of finance in the relevant countries).

If there is no government agreement on burden sharing or the common decision of the EBA and relevant national governments is to let the group fail, national bankruptcy rules will be applied and the EBA would provide information to national judicial courts. Due to remarkable differences in domestic bankruptcy laws, we deem it highly unlikely, at least at this stage and in the medium term, that harmonisation in bankruptcy regulations across Europe will occur, although this may be an objective to pursue in the long run.

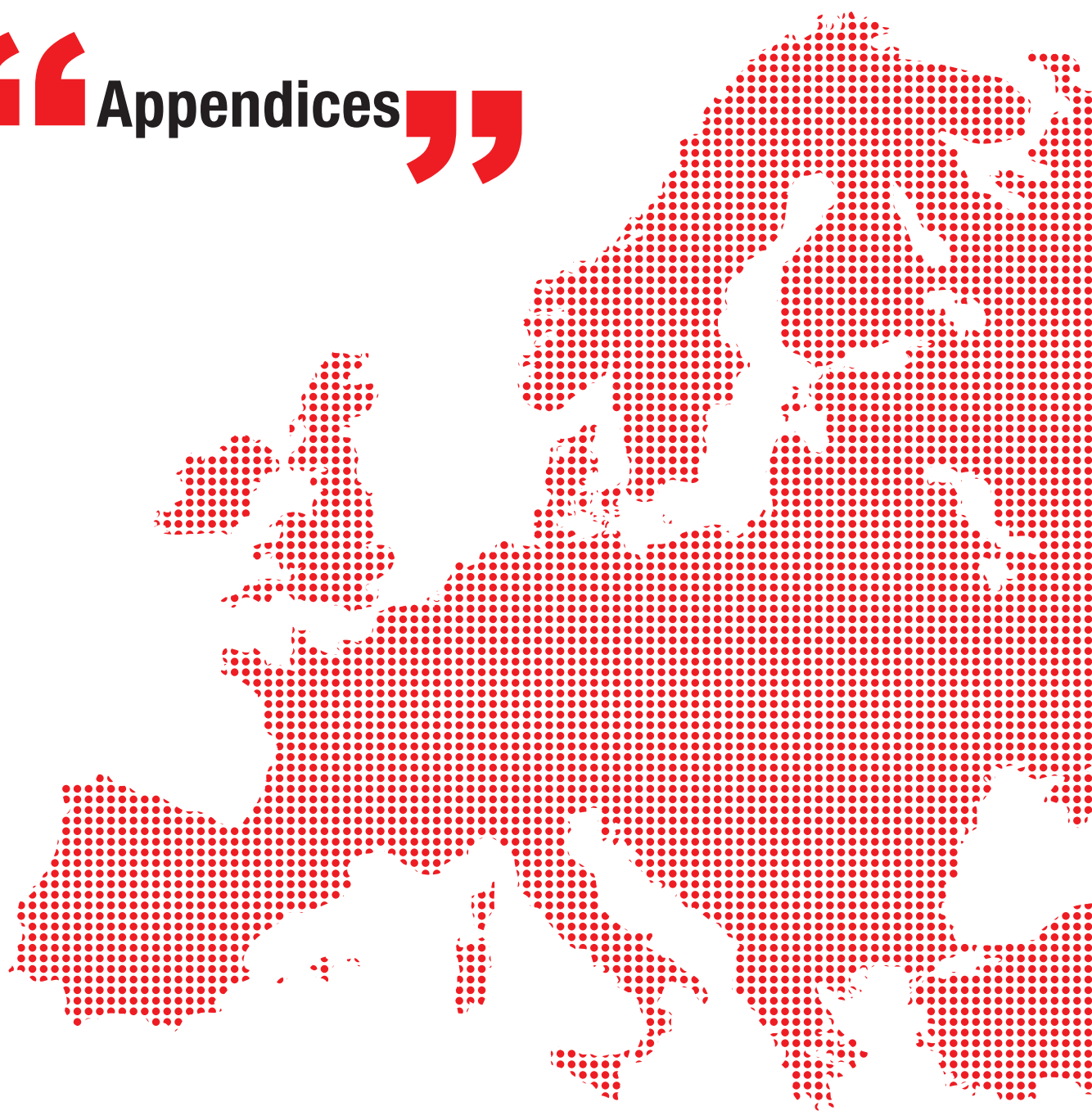
30) Hardy and Nieto (2008).

31) In Europe in 2004 the coverage ratio defined as the ratio between total eligible deposits and the size of the DGS funds ranged from 0.001 in the UK to 1.1 in Portugal.

32) Fonteyne (2007); Goodhart and Schoenmaker (2006).

Forum on
Financial Cross-Border
Groups

“Appendices”



Appendix 1

The consolidated treaty on the European Union (Lisbon Treaty)

Title IV

Provisions on enhanced cooperation

Article 20

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

1. Member States which wish to establish enhanced cooperation between themselves within the framework of the Union's non-exclusive competences may make use of its institutions and exercise those competences by applying the relevant provisions of the Treaties, subject to the limits and in accordance with the detailed arrangements laid down in this Article and in Articles 326 to 334 of the Treaty on the Functioning of the European Union. Enhanced cooperation shall aim to further the objectives of the Union, protect its interests and reinforce its integration process. Such cooperation shall be open at any time to all Member States, in accordance with Article 328 of the Treaty on the Functioning of the European Union.
2. The decision authorising enhanced cooperation shall be adopted by the Council as a last resort, when it has established that the objectives of such cooperation cannot be attained within a reasonable period by the Union as a whole, and provided that at least nine Member States participate in it. The Council shall act in accordance with the procedure laid down in Article 329 of the Treaty on the Functioning of the European Union.
3. All members of the Council may participate in its deliberations, but only members of the Council representing the Member States participating in enhanced cooperation shall take part in the vote. The voting rules are set out in Article 330 of the Treaty on the Functioning of the European Union.
4. Acts adopted in the framework of enhanced cooperation shall bind only participating Member States. They shall not be regarded as part of the *acquis* which has to be accepted by candidate States for accession to the Union.

The treaty on the functioning of the European Union (Lisbon Treaty)

Enhanced cooperation

Article 326

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

Any enhanced cooperation shall comply with the Treaties and Union law. Such cooperation shall not undermine the internal market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them.

Article 327

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

Any enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it. Those Member States shall not impede its implementation by the participating Member States.

Article 328

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

1. When enhanced cooperation is being established, it shall be open to all Member States, subject to compliance with any conditions of participation laid down by the authorising decision. It shall also be open to them at any other time, subject to compliance with the acts already adopted within that framework, in addition to those conditions. The Commission and the Member States participating in enhanced cooperation shall ensure that they promote participation by as many Member States as possible.
2. The Commission and, where appropriate, the High Representative of the Union for Foreign Affairs and Security Policy shall keep the European Parliament and the Council regularly informed regarding developments in enhanced cooperation.

Article 329

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

1. Member States which wish to establish enhanced cooperation between themselves in one of the areas covered by the Treaties, with the exception of fields of exclusive competence and the common foreign and security policy, shall address a request

to the Commission, specifying the scope and objectives of the enhanced cooperation proposed. The Commission may submit a proposal to the Council to that effect. In the event of the Commission not submitting a proposal, it shall inform the Member States concerned of the reasons for not doing so. Authorisation to proceed with the enhanced cooperation referred to in the first subparagraph shall be granted by the Council, on a proposal from the Commission and after obtaining the consent of the European Parliament.

2. The request of the Member States which wish to establish enhanced cooperation between themselves within the framework of the common foreign and security policy shall be addressed to the Council. It shall be forwarded to the High Representative of the Union for Foreign Affairs and Security Policy, who shall give an opinion on whether the enhanced cooperation proposed is consistent with the Union's common foreign and security policy, and to the Commission, which shall give its opinion in particular on whether the enhanced cooperation proposed is consistent with other Union policies. It shall also be forwarded to the European Parliament for information. Authorisation to proceed with enhanced cooperation shall be granted by a decision of the Council acting unanimously.

Article 330

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

All members of the Council may participate in its deliberations, but only members of the Council representing the Member States participating in enhanced cooperation shall take part in the vote. Unanimity shall be constituted by the votes of the representatives of the participating Member States only. A qualified majority shall be defined in accordance with Article 238(3).

Article 331

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

1. Any Member State which wishes to participate in enhanced cooperation in progress in one of the areas referred to in Article 329(1) shall notify its intention to the Council and the Commission. The Commission shall, within four months of the date of receipt of the notification, confirm the participation of the Member State concerned. It shall note where necessary that the conditions of participation have been fulfilled and shall adopt any transitional measures necessary with regard to the application of the acts already adopted within the framework of enhanced cooperation. However, if the Commission considers that the conditions of participation have not been fulfilled, it shall indicate the arrangements to be adopted to fulfil those conditions and shall set a deadline for re-examining the request. On the expiry of that deadline, it shall re-examine the request, in accordance with the procedure set out in the second subparagraph. If the Commission considers that the conditions of participation have still not been met, the Member State concerned may refer the matter to the Council, which shall decide on the request. The Council shall act in accordance with Article 330. It may also adopt the transitional measures referred to in the second subparagraph on a proposal from the Commission.

2. Any Member State which wishes to participate in enhanced cooperation in progress in the framework of the common foreign and security policy shall notify its intention to the Council, the High Representative of the Union for Foreign Affairs and Security Policy and the Commission. The Council shall confirm the participation of the Member State concerned, after consulting the High Representative of the Union for Foreign Affairs and Security Policy and after noting, where necessary, that the conditions of participation have been fulfilled. The Council, on a proposal from the High Representative, may also adopt any transitional measures necessary with regard to the application of the acts already adopted within the framework of enhanced cooperation. However, if the Council considers that the conditions of participation have not been fulfilled, it shall indicate the arrangements to be adopted to fulfil those conditions and shall set a deadline for re-examining the request for participation. For the purposes of this paragraph, the Council shall act unanimously and in accordance with Article 330.

Article 332

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

Expenditure resulting from implementation of enhanced cooperation, other than administrative costs entailed for the institutions, shall be borne by the participating Member States, unless all members of the Council, acting unanimously after consulting the European Parliament, decide otherwise.

Article 333

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

1. Where a provision of the Treaties which may be applied in the context of enhanced cooperation stipulates that the Council shall act unanimously, the Council, acting unanimously in accordance with the arrangements laid down in Article 330, may adopt a decision stipulating that it will act by a qualified majority.
2. Where a provision of the Treaties which may be applied in the context of enhanced cooperation stipulates that the Council shall adopt acts under a special legislative procedure, the Council, acting unanimously in accordance with the arrangements laid down in Article 330, may adopt a decision stipulating that it will act under the ordinary legislative procedure. The Council shall act after consulting the European Parliament.
3. Paragraphs 1 and 2 shall not apply to decisions having military or defence implications.

Article 334

(ex Articles 27a to 27e, 40 to 40b and 43 to 45 TEU and ex Articles 11 and 11a TEC)

The Council and the Commission shall ensure the consistency of activities undertaken in the context of enhanced cooperation and the consistency of such activities with the policies of the Union, and shall cooperate to that end.

Appendix 2

The treaty on the functioning of the European Union (Lisbon Treaty)

Chapter 2 Monetary policy

Article 127

(ex Article 105 TEC)

[...]

5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.
6. The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

Appendix 3

The Italian Banking Law on banking groups and on powers of the holding company

The Italian Banking Law (in Italian “Testo Unico Bancario”, hereinafter “TUB”) establishes under Article 61³³ that:

- 1) the parent company shall be the Italian bank or the financial company having its registered office in Italy which controls the component companies of the banking group and which is not, in turn, controlled by another Italian bank or another financial company having its registered office in Italy which can be considered a parent undertaking;
- 2) without prejudice to specific provisions governing banking, the parent undertaking shall be subject to the supervisory controls provided for in this Chapter. The Bank of Italy shall verify that the bylaws of the parent undertaking and amendments thereto are not in conflict with sound and prudent management of the group;
- 3) the parent company, in carrying out its activity of management and coordination, shall issue rules to the components of the group for the implementation of the instructions issued by the Bank of Italy in the interest of the stability of the group;
- 4) the directors of the companies belonging to the group shall supply all figures and information needed for the issue of such rules and shall cooperate in complying with the provisions on consolidated supervision.”

The rules of the TUB are developed in the “Supervisory Instructions”³⁴ of the Bank of Italy and are based on the following principles (Title I, Chapter II of the Supervisory Instructions):

1. the organizational structure adopted within the group is characterized by the common business objective, by a strong internal commitment and by the common submission to the “unitary direction”;
2. within the group the same common business objectives are carried out by the different units and this requires informative instruments, regulations and powers of control in order to exercise a consolidated supervision;

3. within the banking group discipline, the entrepreneur has the freedom to choose the most suitable structure that must in any case ensure the implementation of the Supervisory Instructions issued by Bank of Italy;
4. the Holding company is liable towards Bank of Italy for the consolidated supervision.

Section III of Title IV of the Instructions describes the “System of internal controls of the banking group”, further to which

“the parent company, in carrying out its direction and coordination activity of the group, must exercise:

- a) a strategic control on the evolution of the different areas of activity where the group operates and on the incumbent risks on the portfolio of activities. It is a control both on the expansion of the activities carried out by the companies belonging to the group and on the acquisitions and dismissal policy of the same companies;
- b) a managerial control, to ensure the maintenance of the conditions of economic, financial and asset balance of the single companies belonging to the group, as well as of the group as a whole. Such control has to be exercised preferably through the preparation of plans, programs and budget (of the single companies and of the group) and through the analysis of the periodic situations, of the infra-annual accounts, of the financial statements of the single companies and at consolidated level; this, for homogeneous fields of activity as well as with respect to the group as a whole;
- c) a technical-operational control finalized at the evaluation of the various risk profiles contributed to the group by the single subsidiaries.

The direction and coordination activity of the parent company has to be based on criteria of equity and reasonableness”.

33) Official translation of Bank of Italy.
34) Non-official translation.

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