European Prudential Banking Regulation and Supervision: The Legal Dimension

Larisa Dragomir
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In December 2012, at a meeting of the European Union's ("EU") finance ministers, an agreement was reached on the adoption of a Single Supervisory Mechanism[1] for the oversight of credit institutions. It is envisaged that, in March 2014, the European Central Bank will become the single bank regulator overseeing banks within the Eurozone.[2] The rationale for a single supervisor is, broadly, derived from the belief that the competing regulatory regimes within the EU have made it difficult to resolve the EU debt crisis.[3] The December 2012 agreement sets out a road map for completion of economic and monetary union and anticipates new rules for a single resolution regime and deposit guarantee scheme. Much discussion remains to be had on these topics as well as on the mechanisms necessary to ensure a voice for those member states which have not adopted the euro.

In view of these developments, it has been interesting to read this text for the light it sheds on how we have reached this point. Published in 2010 and reflecting the law in 2009, the book considers the development of banking regulation at European level and seeks to place these regulatory changes within the context of EU law. Dragomir began studying the European framework for banking regulation and supervision in the early noughties during a period of relative economic stability and growth within Europe which suggests that she is well placed to comment on the changes that have taken place since then. As she acknowledges, since the financial crisis began in 2007, banking regulation has moved at a rapid pace as a result of an "unprecedented willingness to address common concerns at a global level"[4] and at the time of the book's publication, many of the regulatory changes that followed the crisis were (and some still are) works in progress.

The book, which is in four parts, focuses on the prudential aspects of regulation and explores the European architecture for regulation and supervision. Part I

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1 European Council 13/14 December 2012, Conclusions (EUCO 205/12).

2 See the European Council's press release of 13 December 2012 "Council agrees position on bank supervision"17739/12 PRESSE 528.

3 EUCO 205/12: Conclusion 10 begins "It is imperative to break the vicious circle between banks and sovereigns".

4 *European Prudential Banking Regulation and Supervision* at 20.

begins by setting out the background against which the book was written before going on to consider some insights from regulatory theory. She outlines the impact of certain structural developments (globalisation, technological development and financial innovation) on regulation as well as the "special" nature of banks. The liberalisation and de-regulation that came with globalisation led to international recognition that their consequences needed to be counter-balanced through regulation created at an international level. New technologies and new financial products have created new kinds of risk that need to be identified and addressed through regulation. She considers that banks remain "special", broadly, as a consequence of their credit intermediation function and through the risks they bear. The process of increased harmonisation of EU banking regulation over the last twenty or so years coupled with the adoption of the euro by the majority of Member States led her to conclude that, at the time of writing, a single European banking market was under construction and that the financial crisis had provided an impetus to achieve it.

She briefly examines certain aspects of regulatory theory in a bid to understand the rationale for banking regulation. This overview is, as she admits, descriptive and is not an attempt to set prudential matters within a coherent regulatory theory. She distinguishes "economic" regulation (used to restrain market power) from "social" regulation (used to protect consumers) and picks up on market imperfections, such as information asymmetries and negative externalities. She concludes that the most successful approach to regulation is likely to be one that seeks to reconcile the "public interest" approach (which is, broadly, altruistic but inefficient/costly) with the "self-interest" approach (in which institutions satisfy their own objectives without altruism) with participants being encouraged to assume public goals and where matters are regulated by a trustworthy outsider.

As this is a book about prudential regulation it is, clearly, important to understand her definition of "prudential". She identifies three categories of rules: prudential rules, conduct of business rules and protective rules. She concluded for the purpose of her research that, although artificial, she would consider prudential measures to be those which safeguard institutions (micro-prudential measures) and the system as a whole (macro-prudential measures) in order to prevent failures from occurring: essentially measures which ensure "safety and soundness". The artificiality she identifies lies in the fact that it is also prudent to plan for failure through crisis management and safety-net arrangements which are, essentially, a form of protective regulation. It does not, however, seem an unreasonable definition, first, because she is conscious of the overlap between the categories of rules and second, because her study focuses on preventative (*i.e., ex ante)* measures rather than resolution (*ex post*) measures.

Having set the scene in Part I, Part II seeks to explain how prudential issues have been addressed as the regulation of the European banking system has progressed. Chapter 3 traces the development of European legislation from the Segré Report of 1966 (which led to the First Banking Directive[5]), chronologically to the revised Capital Requirements Directive (CRD2[6]) of 2009. She stresses the importance of the First Banking Directive: although it had limited concern with the

5 77/780/EEC.

6 2009/111/EC.

"safety and soundness" principles of prudential regulation, it primed the market place for future legislation relating to solvency and liquidity requirements. Chapter 4 includes an interesting discussion of the role played by the Basel Committee on Banking Supervision and the importance of the Lamfalussy framework in influencing the direction of EU prudential rules. In addition to these influences, she identifies other laws (corporate, consumer and competition laws) and rules (accounting and auditing rules) which also have an impact on prudential regulation.

She discusses the tension between Member States and the EU and traces the gradual extension of substantive prudential regulation leading to a discussion of CRD 2 (which anticipates CRD 3 and CRD 4). The reasons for the change in the focus of financial regulation are analysed: initially, the main concern was to ensure that regulation provided "a level playing field" across Member States. As she identifies, over time, the need for financial stability arising from cross-border banking arrangements and the interconnectedness of banks has led to a recognition that other matters — in particular supervision — have to be addressed beyond home country control for the common good.

Part III builds on the discussion of the deficiencies in the EU system deriving from the fact that prudential regulation of the banking industry has become increasingly centralised, whilst supervision still (largely) takes place at a national level. She considers that the application of the Lamfalussy framework to banking regulation has been significant in terms of ensuring political acceptability as it addressed the matter of the distribution of power within the EU. At the time of writing, she could only anticipate the changes to the Level 3 committees (the Committee of European Banking Supervisors has now been replaced by the European Banking Authority) but identified that any new arrangements for an integrated supervisory authority would have to address governance structures to ensure their legitimacy and accountability.

Part IV considers questions of supervisory liability: in particular, how far should a supervisor be liable to depositors for failing properly to supervise a bank? She examined the CRD and concluded that it allowed depositors to claim a right of adequate supervision, although whether they could actually make a claim would depend on fulfilling the necessary EU jurisprudential requirements (seriousness of breach, causal link between breach and damage and so forth). In her concluding remarks, she identifies that a common platform to supervisory liability regimes is needed to ensure consistent responses across the EU to claims based on EU law.[7]

This book provides an extremely useful and comprehensive overview of the development of European prudential banking regulation and will be a helpful reference source for academics and students alike. The legal context and the background information that it provides will be of use to anyone researching or teaching banking regulation and it is coherently and logically presented. If the book has a disadvantage, it is that there have been a number of changes to the regulatory framework since it was written. This should not, however, detract from the book's many strengths. Any legal text book will become out of date after publication as it can only ever provide a snapshot of the law at a particular time. It is particularly difficult for anyone writing about financial regulation to keep pace with the changes in

7 *European Prudential Banking Regulation and Supervision* at 377.

this arena as the banking crisis has led to almost every aspect of banking regulation being reviewed and amended in some shape or form. It is, clearly, a thoroughly researched piece of work and contains much useful technical detail and background for anyone wishing to understand how the European regulatory framework for banking has developed.