UNIVERSITY OF MARMARA

EUROPEAN UNION INSTITUTE

DEPARTMENT OF EUROPEAN UNION LAW

FUNDAMENTAL PRINCIPLES
OF
EUROPEAN UNION BANKING LAW

(PhD Dissertation)

by

MUSTAFA KEMAL MAMAK

İstanbul, 2009

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Supervisor : PROF.DR.MERİH KEMAL OMAĞ

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TABLE OFCONTENTS

ABBREVIATIONS

BAC	Banking Advisory Committee
BCD	Banking Consolidation Directive
BRSA	Banking Regulation and Supervision Agency
CBRT	Central Bank of Republic of Turkey
CEBS	Committee of European Banking Supervisors
CMB	Capital Markets Board
EBC	European Banking Committee
EC	European Community
EC Treaty	Treaty of Rome (Treaty Establishing the European Community)
ECB	European Central Bank
ECJ	European Court of Justice
ESCB	European System of Central Banks
EU	European Union
FSAP	Financial Services Action Plan
FSPG	Financial Services Policy Group
GDP	Gross Domestic Product
SBD	Second Banking Directive
SEA	Single European Act
SDIF	Savings Deposit Insurance Fund
UT	Undersecretariat of Treasury
UK	United Kingdom of Great Britain and Northern Ireland

ABSTRACT

The subject of this study is to analyze the basic principles of the EU Banking law namely, the Mutual Recognition, Home Country Control and Essential Harmonization. According to the principle of Home Country control, the supervision of a credit institution is the responsibility of the competence authorities of the Member State where it was licensed. As per the principle of Mutual Recognition any licensed credit institution may establish local branch or provide cross-border banking services throughout the EU (the so-called "single license" concept). For these purposes, the EU legislation provides for the minimum harmonization of basic concepts, including the notion of a credit institution, criteria for bank licensing and common standards for prudential supervision and accounting principles.

The EC Treaty provides limited basis for EU banking law including the supervision of credit institutions. Hence, the EU law has evolved under the secondary legislation and case law of the ECJ and is based on various general principles of law including, among others, public interest, public good, subsidiaritiy, proportionality etc. Hence, any EU legislation, including the banking laws, would be interpreted in light of these principles.

It can be said that the secondary legislation has filled the lack of banking related provisions in the EC Treaty and the EU banking legislation has been harmonized to a certain extent. Nonetheless, it seems like there are potential problems relating to the so-called principle of home country supervision. Although, there are a number of institutions and committees active in the field of the monetary policy, financial stability and the regulation and supervision of financial institutions, the EU system lacks a central authority for the regulation and prudential supervision of the credit institutions operating within the EU.

This study argues that in light of the developments in the field of banking, in particular the recent banking crisis and the current management of such crisis as well as the increase in the number of cross sectoral and cross border transactions, it is preferable to have a more centralized financial institutions supervisor. For this purpose, Article 105 of the Treaty is of particular importance since under the said Article, the ECB may be given the tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

In fact, the ECB has stated in its opinion of 25 May 2001 issued at the request of the Austrian Ministry of Finance on a draft Article of the Federal law establishing and organising the financial market supervisory authority and amending the laws relating to banking, securities supervision, investment funds, equities funds, savings banks, building societies, mortgage banks, mortgage bonds, the IAPL, the stock exchange, insurance supervision, motor vehicle third party liability insurance, pension funds capital markets, the Commercial Code, companies limited by shares, limited liability companies and the National Bank that the EC Treaty contains a provision relying on the central bank to address supervisory issues which may arise in increasingly integrated financial markets and Article 105(6) of the EC Treaty envisages a simplified procedure to confer upon the ECB specific tasks in the context of supervision of credit institutions and other financial institutions with the exception of insurance firms. More importantly, the ECB itself goes on to state in the same opinion that central banks are in general in an advantageous position to fulfil the responsibility for financial stability, given their insight into money and financial market developments and involvement in payment systems and monetary policy operations and in view of its financial stability role, the OeNB (Central Bank of Austria) should be expressly assigned the task of contributing to the conduct of prudential supervision of financial intermediaries, in close cooperation with the Finanzmarktaufsichtsbehörde (FMA).

ÖZET

İşbu çalışmanın konusu AB Bankacılık Hukukunun temel ilkeleri olan Karşılıklı Tanıma, Ev Sahibi Ülke Kontrolü ve Gerekli Harmonizasyon analiz edilmesidir. Ev Sahibi Ülke Kontrolü İlkesine göre bir kredi kuruluşunun denetlenmesi söz konusu kredi kuruluşunun lisans aldığı ilgili üye ülkenin yetkili kurumlarının sorumluluğundadır. Karşılıklı Tanıma İlkesi uyarınca lisans almış bir kredi kuruluşu tüm diğer AB üye ülkelerinde yerel şubeler açabilir veya sınır-ötesi bankacılık hizmetleri sağlayabilir ("tek lisans" olarak tanımlanan kavram). Bu amaçlarla, AB mevzuatı kredi kuruluşu tanımı, banka lisansı için temel kriterler, basiretli banka denetimi için ortak standartlar ve muhasebe ilkeleri de dahil olmak üzere temel kavramların asgari harmonizasyonu öngörmektedir.

AT Antlaşması kredi kuruluşlarının denetimi de dahil AB bankacılık hukuku için sınırlı dayanak ihtiva etmektedir. Bu nedenle, AB hukuku ikincil mevzuat ve AB Adalet Divanının kararları çerçevesinde gelişim göstermiştir ve kamu yararı, kamu menfaati, ikincillik ve orantılılık ilkeleri gibi çeşitli genel ilkelere dayanmaktadır. Buna göre, AB mevzuatı, bankacılık mevzuatı da dahil, bu genel ilkeler ışığında yorumlanmalıdır.

AT Antlaşmasındaki bankacılık ile ilgili düzenleme eksikliğinin ikincil mevzuat tarafından doldurulduğunun ve AB bankacılık mevzuatının belirli bir düzeye kadar uyumlaştırılmış olduğu söylenebilir. Bununla birlikte, özellikle Üye Ülke Kontrolü ilkesi ile ilgili potansiyel problemlerin bulunduğu gözlemlenmektedir. Para politikası, finansal istikrar ve finansal kuruluşların düzenlenmesi ve denetlenmesi alanında faaliyet gösteren birçok kurum ve komitenin bulunmasına rağmen, AB ölçeğinde faaliyet gösteren kredi kuruluşlarının düzenlenmesi ve denetlenmesi ile ilgili olarak AB sisteminde bir merkezi otorite boşluğu bulunmaktadır.

İşbu çalışmada, bankacılık alanındaki gelişmeler özelikle de yakın tarihli bankacılık krizi ve bu krizin mevcut yönetimi ile farklı sektörlerde ve sınırları aşan işlemlerin sayısının arttığı gerçeği ışığında daha merkezi bir finansal kuruluşlar denetleme kurumunun mevcudiyetinin tercih edilir olduğu öne sürülmektedir. Bu maksatla, AT Antlaşmasının 105nci Maddesi özellikle önemlidir çünkü söz konu maddeye göre Avrupa Merkez Bankası

(AMB)'na, kredi kuruluşları ve de sigorta kuruluşları hariç diğer finansal kuruluşların basiretli denetimine ilişkin politikalarla ilgili görevler verilebilecektir.

Gerçekten de, Avusturya Maliye Bakanlığının talebi üzerine, finansal piyasalar denetleme kurumunun kurulması ve organizasyonu hakkında ve de bankacılık, menkul kıymetlerin denetimi, yatırım fonları, sermaye fonları, mevduat bankaları, kooperatif bankalar (*building society*), mortgage (konut kredisi) bankaları, mortgage (konut kredisi) tahvilleri, menkul kıymetler borsası, sigortacılık denetimi, motorlu araç üçüncü kişi sorumluluk sigortası, emeklilik fonları, sermaye piyasası, sermaye şirketleri, sınırlı sorumlu şirketler ve Ulusal Bank (National Bank)'a ilişkin kanunlar ile Ticaret Kanununu değiştiren Federal Kanunun taslak düzenlemesine ilişkin olarak verdiği 25 Mayıs 2001 tarihli mütalaasında AMB, giderek artan şekilde entegre olan finansal piyasalarda ortaya çıkabilecek denetim konularına çözüm amacıyla AT Antlaşmasının merkez bankasına dayanan bir düzenleme ihtiva ettiğini ve AT Antlaşmasının 105(6) Maddesinin, AMB'na kredi kuruluşlarının ve de sigorta şirketleri hariç diğer finansal kuruluşların denetlenmesi çerçevesinde özel görevler verilmesine dair basitleştirilmiş bir süreç öngördüğünü belirtmiştir. AMB aynı mütalaasında ayrıca, para ve finansal piyasalardaki gelişmeler hakkında sahibi oldukları bilgi ve deneyim ve ödeme sistemleri ile para politikası işlemlerindeki rolleri nedeniyle merkez bankalarının finansal istikrar ile ilgili sorumluluğun yerine getirilmesi konusunda genellikle daha avantajlı bir konumda olduklarını ve de sahip olduğu finansal istikrar rolü ışığında OeNB (Avusturya Merkez Bankası)'nin, Finanzmarktaufsichtsbehörde (FMA) ile yakın işbirliği içerisinde, finansal aracıların basiretli denetiminin yerine getirilmesine katkıda bulunması amacıyla açıkça görevlendirilmesi gerektiğini belirtmiştir.

§ 1. INTRODUCTION

Banking sector together with other financial institutions provide a number of essential intermediation services, including deposit and loan facilities, necessary supporting clearing and settlement systems, without which any market based economy could not operate. It is beyond any doubt that a well-functioning banking and financial services systems is essential for the healthiness and competitiveness of an economy. Banks are seen as crucial to the functioning of markets, since they add value by reducing the costs of participation in markets for individuals and firms.[1]

Due to its impact on the national economies and customers, the banking sector has long since been regulated and supervised at national levels and special statutory or administrative measures have been adopted to protect the stability of the banking sector and all related parties. The major purpose of this regulation and supervision has historically been to avoid or minimize the risks inherent in this sector in order to protect the customers against the financial failure of the banks. In other words, banking laws generally aim at preventing the failures of banks, so that banking depositors are not at risk. This is manly based on the assumption that banking depositors are not in a position to make their own judgment upon the financial strength of the banks and for economic and social reasons, people should be encouraged to put their savings in the banks, who invest them again for the benefit of the economy.[2] This informational asymmetry, however, between banks and other economic agents, such as borrowers, lenders, and regulators, can give rise to various problems.[3]

Nonetheless, as will be discussed herein below, in view of the core support function and crucial role of the financial markets and financial intermediaries, this purpose has been broadened over the decades. Deregulation, technology, and financial innovation are transforming banking and banking is no longer the business

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[1] International Monetary Fund Working Paper, Emerging Issues in Banking Regulation prepared by Ralph Chami, Mohsin S. Khan, and Sunil Sharma, May 2003, pg.3, Available at (11 December 2008) http: www.imf.org.

[2] Alain Hirsch, "Worldwide Legal Harmonization of Banking Law and Securities Regulation" published in European Business Law – Legal and Economic Analyses on Integration and Harmonization edited by M. Buxbaum, Gerard Hertig, Alain Hirsch, Klaus J. Hopt and Walter de Gruyter, 1991, New York, USA, pg. 350-351.

[3] International Monetary Fund Working Paper, ibid., pg. 14.

it was even a few decades ago. Hence, banks have been moving rapidly into new areas of business.[4] According to one commentator, the rationale of the whole banking regulation is mainly about prudential concerns and related market imperfections.[5]

The European Community ("EC"), now called the European Union ("EU"), established by the 6 founding Member States as per the Treaty of Rome of 1957. The EC is a regional market consisted of mixed economic systems and has remained, since its inception in constant motion towards a remote goal of realization of the common/internal market. As envisaged under the Treaty of Rome (now the EC Treaty), the fundamental objective of the EC is the abolition of obstacles to the free movement of goods, persons, services and capital between the Member States.

The EC can be considered as the most complex and sophisticated single system of financial integration attempted to date. It is now the largest regional trading, industrial and commercial market of the world. The development of economic integration within the EC can be justified in terms of various economic advantages, including among others, the reduction of the transaction costs, increased growth and competition with consequent higher earnings and investment and related social benefits in terms of higher employment and better living standards.[6] Accordingly, the contemplated single market in services would have been incomplete without the inclusion of banking and other financial intermediaries.

According to the EC Commission, achieving an integrated market for banks is a core component of the European policy in the area of financial services.[7] For this purpose, the European Community has adopted a complex set of legal rules and requirements in connection with the regulation and supervision of the banking sector, which together with the insurance sector, represents 6% of the EC's gross domestic product (GDP) and provides 2.45% of employment and constitutes one of the sectors where EC has the greatest potential for employment expansion.[8] Further, there are currently more than 8,000 credit institutions in the enlarged EC and a number of these institutions have cross border business.[9]

In general, the goals of the EC legislation in connection with the banking sector can be summarized as follows: to implement the freedoms of free movements of capital, establishment and provision of services in the banking sector; to preserve the stability of the

[4] International Monetary Fund Working Paper, ibid., pg. 3.
[5] Lazaros E. Panourgias, Banking Regulation and World Trade Law, Hart Publishing, Oxford and Portland, Oregon, USA, 2006, pg. 5.
[6] Available at (10 October) 2008www.eu.int.
[7] Available at (10 October 2008) www.eu.int.
[8] George Alexander Walker, European Banking Law, published by British Institute of International and Comparative Law, London, UK, 2007, pg. 6.
[9] Available at (6 July 2008) http://www.c-ebs.org.

banking sector; to prevent money laundering and financing of terrorist activities; to create a single European payment area; and to contribute to the protection of consumers of banking services.

The principles of **essential harmonization**, **mutual recognition** and **home country supervision**, which allow for the application of the **single passport**, are the foundations for the EC internal banking market. Banks authorized in a Member State can establish branches (or provide cross-border services) in another Member State subject only to home country prudential supervision.

This study is an attempt to analyze these fundamental principles of the EC banking law namely, **Principle of Mutual Recognition**, **Principle of Essential Harmonization**, and **Principle of Home Country Supervision** and to discuss the related banking and financial integration problems, including among others, securing the appropriate balance between market access and market control within a regional system etc. For this purpose, the following chapter, namely **Chapter II** examines the main sources, characteristics and principles of the EC law. In Chapter II, there will be a special focus on the relevant framework principle of EC law namely the Principle of Free Movement of Capital, Goods, Services and Right of Establishment. The role of the European Court of Justice ("ECJ"), the responsible judicial body for the uniform interpretation and implementation of the EC legislation, with regards to the implementation and interpretation of the EC law regarding the free movement of capital, goods, services and right of establishment will also be analyzed briefly. Accordingly, the relevant case law of the ECJ and the principles established by ECJ, including the principles of subsidiarity and the general good, will also be examined in this Chapter.

The recent developments in the EC banking sector including the advent of the Euro, establishment of the European Central Bank and the introduction of innovations such as globalization of financial services, transmission and processing of information, increasing consolidation and electronic commerce which are driven by the integration of infrastructures, technological innovation and the fall of physical borders in the provision of banking services are very impressive. **Chapter III** provides an overview of the sources and fundamental principles of EC banking legislation. This Chapter also discusses the general framework and the historical development of EC banking law. In light of the general EC law framework, the Chapter also attempts to identify and examine the goals of the EC financial services regulations and the legal framework of EC banking sector as well as the legal actions to achieve the goals of the relevant EC legislation. Institutions that are subject to EC banking

legislation are also discussed under Chapter III. Each of the chapters following Chapter III discusses each major principle of EC banking law.

Chapter IV focuses on the **Principle of Mutual Recognition**, which may be considered to be the main tool in the EC integration. The Chapter attempts to define this main principle and discusses its origin, validity, relevant case law, the 1985 White Paper and the so-called New Approach and provides an examination of the Principle of Mutual Recognition. According to the EC Commission, soundly regulated and safe financial institutions underpin the principles of mutual recognition and the single passport.

The purpose of **Chapter V** is to examine the second major principle of EC Banking law, namely the **Principle of Essential Harmonization**. This Chapter also provides a historical development, background and evolution of the said principle.

Chapter VI focuses on the other fundamental principle of the EC banking law, namely the **Principle of Home Country Supervision**, which may be considered as the major principle constituting the guiding principle which has prevailed in the harmonization of the EC financial services sector. The Chapter, which discusses the need for a single supervisory authority, also provides an assessment of the said principle which has evolved primarily from the major decision of the ECJ in the famous *Cassis de Dijon* case. As known, the Eurozone is the only known monetary area where the conduct of monetary policy is assigned to a federal institution (namely the European Central Bank), whilst banking supervision is entrusted to national supervisory authorities (namely the national supervisory authorities).

Chapter VII provides a general overview of the major principles of the Turkish banking legislation. It also provides a discussion regarding the influence of the EC banking legislation on the Turkish banking legislation and the interaction between these two legislations. The effects of Turkey's potential EU membership are also examined in this Chapter VII.

Chapter VIII provides a general discussion regarding the relationship among the fundamental principles of the EC banking law examined in the earlier chapters namely Mutual Recognition, Home Country Supervision and Essential Harmonization together with the so-called principle of General Good and examines the effects of the said principles. In light of the assessments made in the earlier chapters of the study, Chapter VIII also provides analysis of the fundamental principles of the EC Banking Law together with criticisms and recommendations.

The final chapter, **Chapter IX**, which summarizes and concludes the study, attempts to provide a general assessment of the overall study and provides a conclusion of the findings

thereof in light of the discussions in the former chapters. As will be discussed below, the Eurozone is the only monetary area where the conduct of monetary policy is assigned to a supranational institution namely the European Central Bank, the conduct of monetary policy is assigned to national authorities of now 27 Member States. As also a result of the globalization, the necessity to create the best regulatory and supervisory framework is very significant.

§ 2. SOURCES AND FUNDAMENTAL PRINCIPLES OF EC LAW

I. General

It is beyond any doubt that the establishment of a common market is the cornerstone of the EC and its legislation. One of the most major purposes, among others, of the Treaty of Rome dated 25 March 1957, which came into force on 1 January 1958 set up the European Economic Community (later the "European Community"), as amended various times[10], was the formation of a common market for economic activities which is characterized by the free movement of goods, employees, capital, services and the freedom of establishment. The Treaty of Rome (or the "EC Treaty") and a number of subsequent treaties amending the Treaty of Rome are legal treaties under public international law, which creates binding obligations among the signatory national states.

The uniqueness of the EC Treaty is that it establishes a separate and distinct Community legal order and system as per which the EC has independent law making powers. Nonetheless, it must be added that the law making powers of the Community under the Treaty

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[10] The Treaty of Rome, establishing the European Economic Community (EEC), signed in Rome on 25 March 1957, and entered into force on 1 January 1958. The Treaty was amended various times by the following treaties:
(1) The Merger Treaty (or Brussels Treaty) signed in Brussels on 8 April 1965 and in force since 1 July 1967, which provided for a Single Commission and a Single Council of the then three European Communities. Published in the Official Journal of the European Communities 152 of 13 July 1967;
(2) Treaty amending certain budgetary provisions (1970) (Official Journal of the European Communities L 2 of 2 January 1971);
(3) Treaty amending certain financial provisions (1975) (Official Journal of the European Communities L 359 of 31 December 1977);
(4) The Single European Act (SEA) - signed at Luxembourg on February 17, 1986, and at The Hague on February 28, 1986. (It went into effect on July 1, 1987, under the Delors Commission - Official Journal of the European Communities L 169 of 29 June 1987);
(5) The Maastricht Treaty (formally, the Treaty on European Union, TEU) was signed on February 7, 1992 in Maastricht, the Netherlands after final negotiations on December 9, 1991 between the members of the European Community and entered into force on November 1, 1993 during the Delors Commission (Official Journal of the European Communities C 191 of 29 July 1992);
(6) The Treaty of Amsterdam amending the Treaty of the European Union, the Treaties establishing the European Communities and certain related acts, commonly known as the Amsterdam Treaty, was signed on October 2, 1997, and entered into force on May 1, 1999 (Official Journal of the European Communities C 340 of 10 November 1997); and
(7) The Treaty of Nice was signed by European leaders on 26 February 2001 and came into force on 1 February 2003 (Official Journal of the European Communities Official Journal of the European Communities C 80 of 10 March 2001).
(8) The Treaty of Lisbon was signed on 13 December 2007, but will only enter into force once it has been ratified by all Member States. It amends both the Treaty establishing the European Community and the Treaty on European Union. As per the Treaty of Lisbon, the current pillar structure will cease to exist and the EC will be replaced by the EU which will have legal personality.

are not limited to individual fields of private or commercial law, but instead extend to all economically relevant areas of private law. Article 94 (former Article 100) of the Treaty provides a very general authority to the Community that extends to private law and can even constitute the legal basis for more general authority for harmonization measures in other fields of law. Article 94 (former Article 100) explicitly states that *the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the* ***approximation*** *of such laws, regulations or administrative provisions of the Member States as* ***directly affect*** *the establishment or functioning of the common market.*

Under the EC Treaty, there are various types of secondary legislation and legal instruments to be enacted by the EC organs namely regulation, directive, decision, recommendation etc. Nonetheless, this list of legal instruments is not exhaustive and other tools such as resolution, declaration and conclusion are also used. Article 249 of the Treaty provides that these legislative instruments can be adopted by, the European Parliament acting together with the Council; the Council; and the Commission.[11] The legal effects of these instruments vary from full binding force in the case of regulations and to no binding force in the case of recommendations and opinions. According to Walker, the genius of the EC within it is that the EC operates as a complex series of inter-connected integration structures designed to achieve a number of stated objectives and based on a number of common policies or activities. Rather than constitute a single type of integration facility, the EC is made up of a number of overlapping devices or mechanisms including a free-trade area, a customs union and a common market as well as an economic and monetary union.[12]

As will be discussed below, the EC legislation adopted in the field of banking and the relevant legislation adopted under the Financial Services Action Plan is mostly in the form of directives e.g. Council Directive 73/183EEC dated 28 June 1973, Directive 2000/12/EC (Banking Consolidation Directive), Directive 2006/48/EC etc. The major issue with these various legislative measures is related with the direct effectiveness of the legislative measure concerned. A directly effective legislative tool is one that can be relied upon by an individual in an action before a national court without any need for implementing legislation in that Member State. In other words, an individual can directly benefit from any directly effective

[11] Article 249 of the Treaty provides that ... *In order to carry out their task and in accordance with the provisions of this Treaty, the European Parliament acting jointly with the Council, the Council and the Commission shall make regulations and issue directives, take decisions, make recommendations or deliver opinions.... A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods...*

[12] Walker, ibid., pg. 68.

measure where the Member States have lost their law making powers in the law-making process.[13]

As per the "principle of direct effect", certain provisions of the Treaty including the freedom of establishment and services provisions have the characteristic to be directly applicable within the Member States. Under the "principle of direct applicability" the provisions of the Treaty of Rome and the subsequent treaties amending the Treaty of Rome as well as the secondary legislation enacted by the EC organs within the framework of the Treaty establish direct rights within the national legal systems of the Member States without the intervention of pieces of any national legislation including the constitutions. In other words, as seen already from the case law of the European Court of Justice ("ECJ") that for example the maintenance of the primary and secondary rules of the EC legislation having direct effect is already the task of the national courts.[14]

According to the European Court of Justice, any EC legislation can be directly effective if it creates sufficiently clear, precise and unconditional rights and obligations such that intermediate national law is not required to translate the EC legislation into rights and obligations under national law. Article 249 of the EC Treaty provides that a **regulation** shall have general application and shall be binding in its entirety and directly applicable in all Member States. Thus, a regulation may be considered as the most powerful of the legal instruments available under the EC Treaty. Regulations are mainly used to create law of general and uniform application across the EC. On the other hand, a **directive** is a much more flexible form of instrument than the regulation and for that very reason it is much more complex.

Article 249 of the Treaty states that *a directive shall be binding as to the result to be achieved upon each member state to which it is addressed, but shall leave to the national authorities the choice of form and method*. As will be seen in the following sections, the EC has chosen "directive" as the type of the secondary legislation though which the banking reform has been attained.

Accordingly, under the Treaty, **directive** different from regulation is a legal device normally not directly applicable within a Member State and directive contemplates subsequent legal actions by the Member States at the national level. In other words, a directive therefore requires implementing legislation at Member State level to give it force.

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[13] Paul Craig & Grainne De Burca, EC Law Texts and Materials, Clarendon Press, 1997, Oxford, UK, pg. 155.
[14] Pieter Ver Loren Van Themaat, "Some Preliminary Observations on the Intergovernmental Conferences", Common Market Law Review 28, (1991), pg. 310.

Accordingly, directive creates legal obligations for Member States to attain the objectives and standards set forth under the directive. It reflects legal obligations among the Member States *vis-à-vis* the results and timing to be achieved, while preserving to the Member States the method by which the result would be achieved within the respective Member States.[15] The central idea behind the directive is to permit flexibility at a national level and, specifically, to allow individual Member States freedom to adjust the method of achieving the desired EC policy to fit within the complexities of the national legal system. Hence, directive requires implementing legislation at Member State level to give it force.[16] The Member States have the discretion to determine the method and form by which the implementation will be achieved. Accordingly, subject to the discussions below, full direct effect cannot be attributed to directives as it is to regulations.

Nonetheless, the ECJ has held in a number of cases that Article 249 of the EC Treaty does not prevent directives to have a certain degree of direct effect.[17] The ECJ decisions affirm the existence of the new legal order in which individuals as well as Member States may have rights and obligations and it lays down the criteria to be applied in deciding whether or not a particular provision may be invoked by individuals in national courts. These criteria were to be applied subsequently can be summarized as follows:

- the provision in question must be sufficiently clear and precise for judicial application;
- it must establish an unconditional obligation;
- the obligation must be complete and legally perfect, and its implementation must not depend on measures being subsequently taken by Community institutions or Member States with discretionary power in the matter.[18]

According to one commentator, the directive has become the most appropriate legal device for the implementation of the EC strategy of application of harmonization through selective directives in only essential areas of prudential and regulatory supervision and through the procedure of mutual recognition of national banking licenses. The EC is able to preserve the legal integrity of the national banking systems of the Member States while

[15] Paul Craig & Grainne De Burca, ibid., pg. 175.
[16] Janet Whittaker and David Ashton, "Introduction to EU Legislation" published in A Practitioner's Guide to EU Financial Services Directives by Freshfields Bruckhaus Deringer, edited by Michael Raffan, City & Financial Publishing, First Edition, Surrey, UK, 2003, pg. 4.
[17] Case 26/62, Van Gend en Loos v. Nederlandse Administraite der Belastingen [1963] ECR 1, [1963] CMLR 105.
[18] David Wyatt & Alan Dashwood, European Community Law, Third Edition, Sweet & Maxwell, London, UK, 1993, pg. 60.

establishing a legal framework of obligations and standards that are designed directly to institute major banking law reforms within a newly constituted EC common internal market for banking and other financial services through directive. Hence, directive can be considered as a **federalizing** tool promoting convergence of national approaches.[19]

One of the other major principles of EC law is the so-called, **Principle of Subsidiarity**. The Principle Subsidiarity was introduced by the Treaty on European Union (Treaty of Maastricht) signed on 7 February 1992 and entered into force on 1 November 1993. The principle aims to regulate the distribution of powers between the EC and the Member States. The present formulation is contained in Article 5 of the EC Treaty consolidated version following the Treaty of Nice, which entered into force on 1 February 2003.[20] Under the said Article 5 of the EC Treaty, the EC's authority to take actions is constrained by a number of general concepts:

- subsidiarity;
- proportionality, and
- non-discrimination.

As per the subsidiarity principle, matters must be handled by the smallest, lowest or least centralized competent authority and where possible less binding Community measures are allowed. The principle is generally defined as the idea that a central authority should have a subsidiary function, performing only those tasks which cannot be performed effectively at a more immediate or local level. Accordingly, within the EC, as per the Principle of Subsidiarity, harmonization of laws is permitted only where necessary and the need for a comprehensive harmonization of laws must be determined in each case.[21]

The Principle of Subsidiarity is intended to ensure that decisions are taken as closely as possible to the citizens and that constant checks are made as to whether action at EC level is justified in the light of the possibilities available at national, regional or local level. Specifically, it is the principle whereby the EC does not take action (except in the areas which

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[19] Joseph Jude Norton, "The European Community Banking Law Paradigm: A Paradox in Banking Regulation and Supervision", published in International Banking Regulation and Supervision: Change and Transformation in the 1990s, edited by J.J.Norton, Chia-Jui Cheng, I.Fletcher, Graham & Trotman / Martinus Nijhoff, London, UK, (1994) pg. 60.

[20] Article 5 of the EC Treaty, as amended, states that: … ***The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein.*** *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. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty ...*

[21] Craig & De Burca, ibid., pg. 116.

fall with in its exclusive competence) unless it is more effective than action taken at national, regional or local level. It is closely bound up with the principles of proportionality and necessity, which require that any action by the EC should not go beyond what is necessary to achieve the objectives of the EC Treaty.

The distribution of powers between the EC and its Member States makes a distinction between three different types of competence:

- concurrent or shared powers (the most common case);
- exclusive Community powers (the Member States have irrevocably relinquished all possibility of taking action); and
- supporting powers or areas of supporting action (the Community's sole task is to coordinate and encourage action by the Member States).

As per the principle of subsidiarity, the EC may only act (i.e. enact legislation) where Member States agree that action of individual countries is insufficient. Under the principle of subsidiarity, in areas which do not fall within its exclusive competence the EC shall act only if and insofar as the objectives of the intended action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at EC level.

Finally, Article 308[22] of the EC Treaty provides a measure of flexibility with regard to the EC's areas of competence. Hence, the principle of subsidiarity allows the Community's powers to be adjusted to the objectives laid down by the Treaty when the latter has not provided the powers of action necessary to attain them. Article 308 of the EC Treaty thus cannot be used as a legal basis unless the following conditions are met:

- the action envisaged is "necessary to attain, in the operation of the common market, one of the objectives of the Community";
- no provision in the Treaty provides for action to attain the objective.

Consequently, Article 308 thus reflects awareness on the part of those who drafted the Treaty of Rome that the powers specifically conferred (functional competence) might not be adequate for the purpose of attaining the objectives expressly set by the Treaties themselves (*competence ratione materiae*). It cannot in any circumstances be used as a basis for extending the areas of competence of the Community.[23]

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[22] Article 308 of the Treaty provides that ... *If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community, and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, take the appropriate measures...*

[23] http://www.eu.int (10 September 2008).

The concept of subsidiarity therefore has both a legal and a political dimension. Consequently, there are varying views as to its legal and political consequences, and various criteria are put forward explaining the content of the principle. For example:

- The action must be necessary because actions of individuals or member-state governments alone will not achieve the objectives of the action (the sufficiency criterion)
- The action must bring added value over and above what could be achieved by individual or member-state government action alone (the benefit criterion).
- Decisions should be taken as closely as possible to the citizen (the close to the citizen criterion)
- The action should secure greater freedoms for the individual (the autonomy criterion).[24]

As will be discussed below, the implementation of the principles of Home Country Supervision and the Mutual Recognition is in compliance with the idea of a dynamic approach to the application of subsidiarity. The greater the conflict of rules between Member States, the greater the scope for subsidiarity in the sense of the responsibility for decisions being left at the national authorities level.[25]

[24] Craig & De Burca, ibid., pg. 117.
[25] Yannis V. Avgerinos, Regulating and Supervising Investment Services in the European Union, Palgrave Macmillan, New York, USA, 2003, pg. 104.

II. Establishment of Common Market

The primary objective of the EC Treaty has been the transformation of the national markets of the Member States into a single market which was then called common market and now internal market. This was already reflected in the preamble[26] of the Treaty of Rome by the six original Member States (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands) which pronounced their determination to establish the foundations of an ever closer union among the peoples of Europe. The founding Member States have resolved to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe. The means of achieving this is provided by the establishment of a common market characterized by the elimination of all obstacles to intra-Community trade. The Treaty of Rome explicitly provides that the internal market is to comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaty.

Accordingly, the major purpose of the EC Treaty is to achieve the so-called four freedoms of movement of goods, persons, services and capital. The provisions of Titles I and III of the Treaty provide the major legal bases for the creation of the internal or common market. It is important to note however that as will be discussed below the relevant Articles of the EC Treaty also contain derogations to such freedoms and that they contain derogations such as public policy, security or public health etc.

It is beyond any doubt that the evolution of a single or common market is both a legal process and political process. The concept of a single market requires the elimination of all barriers to inter-state trade and all national prohibitions on establishment and the ultimate harmonization of the legislation throughout the EC. However, it is noted that the political reality is that vested interests, both of national governments and of trade and professional organizations, seek to delay the creation of this kind of Single Market.[27]

Although, the EC was originally based on a free trade area and customs union with full free movement of production factors and certain common policies, an economic and monetary

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[26] *…DETERMINED to promote economic and social progress for their peoples, taking into account the principle of sustainable development and within the context of the accomplishment of the internal market and of reinforced cohesion and environmental protection, and to implement policies ensuring that advances in economic integration are accompanied by parallel progress in other fields…*

[27] Andrew McGee & Stephen Weatherill, "The Evolution of the Single Market – Harmonization or Liberalization" published in "The Modern Law Review" Vol. 53, Basil Blackwell Ltd., Oxford & Cambridge, UK, 1990, pg. 578.

union has since been established under the Maastricht Treaty while further cooperation still continues on defense and justice and other social affairs related matters.

In order to ensure that such a single European market as defined in the Treaty is achievable, the EC had to ensure that nothing would distort competition among the Member States and therefore to prohibit devices, which can impede the attainment of such a goal. The creation of a single market requires the abolishment of all hurdles to inter-state trade and all national prohibitions on establishment and the ultimate harmonization of relevant legislations within the EC.

Within this framework it can be said that the Treaty of Rome contains various provisions designed to remove barriers to trade among the Member States. Accordingly, the significance of the EC internal market in contrast with other similar regional or international blocks or unions is that the EC includes both an automatic or mandatory right of market entry and access as well as a still evolving supporting control system.[28] Major examples of these provisions are summarized as follows.[29] Customs duties on imports are outlawed by Article 12 and this prohibition on fiscal barriers is complemented by Article 95, which forbids systems of internal taxation which discriminate against imported goods. Article 30 outlaws quota systems and measures having equivalent effect and constitutes the heart of the Treaty rules designed to secure the free movement of goods. Workers are entitled to the freedom of movement among the Member States by virtue of Article 48 of the Treaty of Rome, and this right is extended beyond the individual worker to the self-employed and the provider of services by Articles 52 and 59 respectively. Individuals and entities are both beneficiaries of these provisions of the EC Treaty.

Nonetheless, it is important to note at the outset that, as will be discussed below, these provisions contain **derogations** which in certain circumstances allow Member States to retain barriers to trade. Hence, the free movement of goods, persons and services are all subject to the derogations on grounds including public policy, public security, and public health. Since these derogations have the potential to conflict with the basic objective of establishing free trade within the EC, as set forth in the various decisions of the European Court of Justice to be examined below, they are subject to a restrictive interpretation.

The free movement of services together with the free movement of goods, capital, and persons is the fundamental principle of the Treaty of Rome and the EC operates through a

[28] Walker, ibid., pg. 4.
[29] McGee & Weatherill, ibid., pg. 579.

common market and an economic and monetary union. Within this framework, Article 2 of the Treaty of Rome states that;

The Community shall have as its task, by establishing a common market an economic and monetary union and by implementing common policies or activities …to promote throughout the Community a harmonious, balanced and sustainable development of economic activities …

This is supplemented by a number of common policies and activities listed in Articles 3 and 4 of the Treaty of Rome. The most fundamental provision of the Treaty of Rome namely Article 3 of the Treaty states that;

For the purposes set out in Article 2 … the activities of the Community shall include …

(c) an internal market characterized by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital…

…

(h) the approximation of the laws of Member States to the extent required for the functioning of the common market…

Accordingly, the EC market integration and liberalization has two tools under the general provisions of the Treaty of Rome. The first tool is the provision aiming to achieve the internal market between the Member States by the **abolition of the obstacles** to the free movement of goods, services, capital and persons. The second tool is the provision regarding the **approximation of the laws** of Member States to the extent required for the functioning of the common market.

While the layers of economic integration are given effect to under the initial parts of the Treaty of Rome, the basic policies are set out in Part III of the Treaty. The basic policies include the objective of the full free movement of production factors, namely goods, workers (and establishment), capital and services. Whereas Title 1 of Part III provides for the free movement of goods with the establishment of a customs union and for the removal of quantitive restrictions and measures having equivalent effect, Title 3 of Part III provides for free movement of persons, services and capital.

Certain provisions of the EC Treaty are particularly relevant from this standpoint. Article 43 (former Article 52) and Article 49 (former Article 59) of the EC Treaty are the

fundamental provisions on the subject in the Treaty. Further, Article 48 (former Article 58) of the Treaty establishes national non-discriminatory treatment for Member State entities.

III. Internal Banking Market under the EC Treaty

According to one commentator, the banks and bankers are a component of economical and political environment. The banks are the merchants and corporations struggling for living without any change of achievement, and banking is the art of the ability to produce extra value as a good citizen. It entails to establish an oversensitive balance between undertaken risks and sources, in addition between the sources and own funds protected in a safe and liquidity position. The limitation of risk is the profit and the risks cannot be managed without setting a limit for profit and profitability.[30]

Within the aforementioned framework, banking and financial activities are dealt with under the general Treaty provisions regarding the establishment and services to a limited extent. The only reference in the original Treaty provisions to banking was in Article 51(2) and the original version of Article 57(2) which provided that harmonization in the area of banking would take place with the progressive liberalization of capital movements within the EC.

The effect of these limited references in the Treaty was to leave a policy vacuum in the banking and financial area and banking and financial services did not appear to have been expressly or specifically assessed in the negotiation and adoption of the various decisions, conference resolutions and treaties creating the new structure.[31] In other words, a basic vacuum had been left in the EC Treaty with regard to the structure and content of the new policy framework to be constructed.[32] Nonetheless, as will be discussed below, despite the lack of direction and guidance provided and the earlier problems that arose in trying to implement a full harmonization approach, a significant amount of progress has since been achieved with the work of the ECJ.

Article 51(2) of the Treaty explicitly provides that *the liberalization of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalization of movements of capital.* As will be discussed below, the policy vacuum and the control gap has constituted an obstacle for frustrating the exercise of the freedom to provide banking services until the entry into force on 1 July 1990 of the Capital Movements Directive. Until the Capital Movements Directive, Member States were free to

[30] Orhan Ökmen, The Inadequacy of Basels Convergences and the Alternative Model for Banking, Kora Yayın, İstanbul, 2005, pg. 9.
[31] Walker, ibid., pg. 90-91.
[32] Walker, ibid., pg. 291.

maintain in force exchange regulations which prevented individuals and legal entities from freely transferring or holding financial assets which were not directly related to the exercise of commercial operations.

As per former Article 63(1) of the Treaty of Rome which provided that … *the Council shall, acting unanimously on a proposal from the Commission and after consulting the Economic and Social Committee and the European Parliament, draw up general program for the abolition of existing restrictions on freedom to provide services within the Community… and the program shall set out the general conditions under which and the stages by which type of service is to be liberalised*, the aforementioned general provisions of the Treaty had to be worked out by means of general programs. Such general programs for the abolition of restrictions on freedom of establishment and on the freedom to provide services were accordingly laid down by the EC.[33] The Treaty contains certain other relevant provisions. Article 8 of the Treaty provides that a European system of central banks and a European Central Bank shall be established in accordance with the procedures set forth in the Treaty and ESCB and ECB shall act within the powers conferred upon them by the Treaty and by the Statute of the ESCB and ECB.

Further, Articles 105 to 111 of the Treaty[34] lay down the duties and authorities of the ESCB and ECB. Among the said Articles of the Treaty, the most major provision seems to be Articles 105(5) and 105(6) of the Treaty, which will be discussed below in details. As per Articles 105(5) of the Treaty, the ESCB has the task to 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, and under Article 105(6) of the Treaty, ECB may be conferred upon specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings..

The aforementioned provisions of the Treaty are reiterated in the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.[35] According to Article 9 (The European Central Bank) of the said Protocol, the ECB which, in accordance with Article 107 (2) of the Treaty, shall have legal personality, shall enjoy in each

[33] Article 49 of the Treaty now provides that ... *Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than of the person for whom the services are intended ...*

[34] Title VII – Chapter 2 titled Monetary Policy.

[35] Protocol annexed to the Treaty establishing the European Community (OJ C 191, 29.7.1992, p. 68), as amended.

of the Member States the most extensive legal capacity accorded to legal persons under its law; it may, in particular, acquire or dispose of movable and immovable property and may be a party to legal proceedings. Further, the ECB shall ensure that the tasks conferred upon the ESCB under Article 105(2), (3) and (5) of the Treaty are implemented either by its own activities pursuant to the Statute or through the national central banks pursuant to Articles 12.1 and 14.

According to Walker, financial market supervision is a complex and delicate process and while specific direction was provided in the EC Treaty with regard to the development of particular policies in such areas as agriculture, competition etc. no specific guidance was provided in the financial area.[36] Further, the core hurdle that has to be overcome within and regional trading system is that a major conflict generally arises between the need to promote enhanced market access at the same time as secure proper market control.[37]

Since the Treaty basis for the law in the area of banking is very limited, the general provisions regarding the freedom of establishment and the free provision of services together with free movement is the main basis for the EC banking law. On the other hand, the jurisprudence of the European Court of Justice and the secondary legislation namely directives enacted by the EC institutions provide the basis for the policy constructed to date.

The general principles developed by the European Court of Justice are capable of equal application in the banking and financial area. Accordingly, the fundamental economic freedoms guaranteed within the EC under the Treaty of Rome are the freedom of establishment and supply of services and the free movement of capital. In other words, the internal or common market in 9 the field of banking is to be achieved by means of three freedoms namely, capital movements, establishment, and provision of services. The first freedom (capital movements) requires the removal of all obstacles to capital movements among residents of the EC Member States. Liberalization of the movement of capital was addressed under the initial directives and subsequent additional directives. Since 1994, there is complete freedom of capital movements between all EC Member States.[38]

The second freedom (freedom of establishment) allows the opening of a bank office in another Member State. The third freedom (freedom of provision of services) entitles banks to offer banking services in another Member State without having a physical presence in the

[36] Walker, ibid., pg. 13.
[37] Walker, ibid., Introduction page.
[38] H.A. Benink & G.J.Benston, "The Future of Banking Regulation in Developed Countries – Lessons from and for Europe", Available at (19 July 2008) http://www.claaf.org/documents/benink-benston.doc, pg. 2.

Member State concerned. Nevertheless, these freedoms are subject to certain restrictions, i.e. the **Concept of General Good**, discussed under the relevant Chapter below.

Following the failure of the EC Commission's earlier efforts to correct the policy vacuum and control gap through a general process of **full harmonization** (**old approach**) within each industrial and commercial sector, a new approach was adopted based on the principles of **Mutual Recognition**, **Essential Harmonization**, and **Home Country Supervision**. In other words, the premise of the new approach involves three steps: (i) firstly, the imposition of common minimum standards in every Member State; (ii) secondly, the application of the **Principle of Mutual Recognition** or "single banking license"; and (iii) finally, the introduction of the **Principle of Home Country Supervision**, as a corollary of mutual recognition.[39]

[39] Avgerinos, ibid., pg. 53.

IV. Restrictions on Basic Freedoms and the General Good Concept

The establishment of a single banking market constitutes only one part of the larger European integration process or dynamic which is still under progress. It is important to underline that in the EC approach, the major principle of free movement of persons, goods and services as well as the right of establishment under the direct applicability of the relevant Treaty articles is and was always subject to a number of restrictions. These are a limited number of restrictions and mainly relate to public policy, public security, health and safety. Within this framework, the host Member State restrictions are allowed in general only on the grounds of public policy, public security and public health and safety. They lead to a form of discrimination against foreign goods or services. In reality, the general good has evolved over the past decade as a central, but yet very vague, notion in the balance of interests between Treaty freedoms and legitimate regulatory interests of the EC Member States.

The "general good" by its very essence is an open-ended concept, which implies that over time new legitimate motives might emerge in the case law of the ECJ.[40] When host country rule is imposed on the grounds of general good, there is a similar situation created, merely based on case law of the European Court of Justice. Nonetheless, the general good exemption is a dynamic one only available to the Member States insofar as the Member States have not agreed upon harmonization. As more and more activities are covered by harmonization, less and less room is left for arguing that the general good calls for exemptions to the rights originally envisaged by the Treaty.[41]

According to one commentator, the concept itself is not outrageous, if it serves better to fit the liberalization measures into the domestic environments of the various Member States to avoid undue stress in the liberalization process, to achieve better cooperation, or to deal promptly with emergencies, market manipulation or fraud.[42] In addition, the general good concept which is yet to be defined has become much more limited in the area of EC banking law in particular following the adoption of the Second Banking Directive which will be discussed below. Thus, the EC banking law which is considered to be based on three major

[40] Michel Tison, "Unravelling the General Good Exception", published in Services and Free Movement in EU Law, edited by Mads Andenas and Wulf-Henning Roth, Oxford University Press, Oxford, UK, 2002, pg. 342.
[41] Jesper Lau Hansen, "Full Circle: Freedom of Establishment and to Provide Services" published in Services and Free Movement in EU Law, edited by Mads Andenas and Wulf-Henning Roth, Oxford University Press, Oxford, UK, 2002, pg. 207.
[42] James H. Dalhuisen, "Financial Liberalization and Re-regulation", published in Services and Free Movement in EU Law edited by Mads Andenas and Wulf-Henning Roth, Oxford University Press, Oxford, UK, 2002, pg. 793.

principles, the Principle of Mutual Recognition, the Principle of Home Country Supervision (Control), and the Principle of Essential Harmonization also includes the Principle of General Good.

Although a number of attempts have been made to provide a definition of the concept of "general good", the ECJ has always refrained from building upon an abstract approach to the concept of "general good" in its case law. The concept is an open-ended concept, allowing the Member States to maintain, in the absence of the EC legislation, their regulation which ensures the protection of specific social values which are not incompatible with the objectives of the Treaty.[43]

It can be argued that the "general good" exception allows national regulation to be exempted from the EC trade disciplines. The general good doctrine has been developed by the European Court of Justice with a view to optimize the sum of liberalization benefits and domestic regulatory values. The following criteria have been developed by the ECJ for the implementation of the "general good" concept:[44]

- The legislation of a Member State rules must have not been subject to prior EC harmonization.
- The host Member State rules must not be discriminatory.
- The legislation of a Member State must be justified by a compelling reason to protect the general good (i.e. consumer protection, fraud prevention, cohesion of the tax system).
- The host Member State rules must not duplicate the rules applicable in the home Member State.
- The host Member State rules, from an objective point of view, be *necessary* and *proportionate* to the objective pursued.

In other words, the conditions under which a Member State is allowed to invoke the general good derogation as a barrier to free movement are well established in the ECJ's case law, and may be summarized as follows:[45]

[43] Tison, ibid., pg. 334.
[44] Panourgias, ibid., pg. 43-44.
[45] Wulf-Henning Roth, "The European Court of Justice's Case Law on Freedom to Provide Services: Is Keck Relevant?", in Services and Free Movement in EU Law edited by Mads Andenas and Wulf-Henning Roth, Oxford University Press, Oxford, UK, 2002, pg. 4.

(i) justification by a general good motive;

(ii) absence of harmonization;

(iii) absence of discrimination on grounds of nationality;

(iv) absence of duplication of home Member State rules;

(v) objective necessity (adequacy and proportionality).

Accordingly, the measures will have to be tested on the basis of the standards of appropriateness, necessity, and proportionality and whereby the rules of the State of origin will have to be taken into account.[46] As will be discussed below, the EC banking directives confirm the ability of the host Member State authorities in the interest of the "general good". The Directive 2000/12/EC (Banking Consolidation Directive) states in its Preamble that the Member States must ensure that there are no obstacles to carrying out activities receiving mutual recognition in the same manner as in the home Member State, as long as the latter do not conflict with legal provisions protecting the general good in the host Member State. Hence, host Member State prudential arrangements can be maintained if they meet the criteria of the general good concept. Accordingly, the host Member State authorities are able to implement prudential measures, which are equally applicable to national and non-national banks on a non-discriminatory basis, to the extent that minimum common prudential standards and home Member State supervision on a consolidated basis are not adequate to address risks for financial stability and depositor protection.

It is also noted that there are arguments that prudential measures have been subject to essential (and sufficient) harmonization, in which case there should be no room for the application of the general good exception by the home authorities. Nonetheless, this argument seems to ignore the fact that prudential regulation and supervision are not defined in the EC banking directives while the "prudential" concept is very broad and the EC legislation does not employ a clear and systematic distinction between prudential and non-prudential measures. In the most instances, prudential regulation and supervision are defined only for the purposes of the specific scholarly work and even then in broad terms.[47]

In relation to the foregoing, the Commission's "Financial services: building a framework for action" dated 28 October 1998 notes that a truly single market for retail financial services still remains to be achieved. In this framework, the need to protect

[46] Tison, ibid., pg. 334.

[47] Panourgias, ibid., pg. 45 – 46.

consumers allows Member States to use their prerogative of applying their own legislation, provided that it is proportionate to the objective sought (the **Principle of the General Good**). Nevertheless, application of this Principle should not create further obstacles to cross-border business. There is therefore a need to develop pragmatic ways of reconciling the aim of effective financial market integration with that of ensuring high levels of consumer protection. To that end, the Commission will:

- clarify the distinction between professional and non-professional users of financial services;
- identify the main differences between existing national measures that justify the application of home-country rules (to check whether they are proportionate);
- promote the convergence of national practices towards a high standard of consumer protection.

The Communication on the exercise of the freedom to provide cross-border services and the concept of "general good" in the Second Banking Directive was adopted by the EC Commission on 31 October 1995.[48] The Communication examines the concept of "general good" from two key perspectives. First, the host Member State is not required to communicate its "general good" rules to credit institutions intending to establish a branch office within its territory. Second, the Communication notes that the principle of mutual recognition should be applied irrespective of whether credit institutions are operating by way of the freedom to provide services or through a branch. The Communication also describes the legal framework in which the host country's **general good rules** can still be applied against a Community credit institution. Such rules are required to be:[49]

- in the interest of the "general good" (such as professional rules to protect the recipient of services, protect consumers, etc.);
- non-discriminatory (unless the host Member State can prove that such a discrimination is justified on public policy, security or health grounds);
- non-duplicatory (i.e. not duplicate rules applicable in the host Member States);
- objectively necessary; and
- proportionate to the objective pursued.

[48] http://ec.europa.eu/internal_market/smn (18 November 2008).
[49] http://ec.europa.eu/internal_market/smn (Single Market News – Second Banking Directive – consultation) (7 December 2008).

The approach of the ECJ on the matter can also be tested in a recent banking law case.[50] In response to the request of the Conseil d'Etat (France) for a preliminary ruling under Article 234 from the ECJ, the ECJ has stated that:

… the freedom of establishment provided for in Article 43 EC, read in conjunction with Article 48 EC, conferred both on natural persons who are nationals of a Member State and on legal persons within the meaning of Article 48 EC. Subject to the exceptions and conditions specified, it includes the right to take up and pursue all types of self-employed activity in the territory of any other Member State, to set up and manage undertakings, and to set up agencies, branches or subsidiaries.[51] *Article 43 EC requires the elimination of restrictions on the freedom of establishment. All measures, which prohibit, impede or render less attractive the exercise of that freedom must be regarded as such restrictions.*[52] *A prohibition on the remuneration of sight accounts such as that laid down by the French legislation constitutes, for companies from Member States other than the French Republic, a serious obstacle to the pursuit of their activities via a subsidiary in the latter Member State, affecting their access to the market. That prohibition is therefore to be regarded as a restriction within the meaning of Article 43 EC.*[53] *It is clear from the settled case-law that where, … such a measure applies to any person or undertaking carrying on an activity in the territory of the host Member State, it may be justified where it serves overriding requirements relating to the* ***public interest****, is suitable for securing the attainment of the objective it pursues and does not go beyond what is necessary in order to attain it.*[54] *… the answer to the questions referred for a preliminary ruling must be that Article 43 EC precludes legislation of a Member State which prohibits a credit institution which is a subsidiary of a company from another Member State from remunerating sight accounts in euros opened by residents of the former Member State.*[55]

[50] Case C-442/02, CaxiaBank France v. Ministére de l'Economie, des Finances and de I'Industrie.
[51] Paragraph 9 of the Preliminary Ruling.
[52] Paragraph 11 of the Preliminary Ruling.
[53] Paragraph 12 of the Preliminary Ruling.
[54] Paragraph 17 of the Preliminary Ruling.
[55] Paragraph 24 of the Preliminary Ruling.

V. Case Law of the European Court of Justice

According to some commentators, the European Court of Justice has been granted with unusual power to shape the development of the EC law.[56] Hence, the nature and importance of the contribution of the European Court of Justice must be assessed in considering the evolution of EC banking law. During the early stages of the EC, banking and financial services were not considered separately by the ECJ. The original general principles developed by the ECJ are capable of equal application while some recent specific guidance has been provided in these areas.[57] As a result, it is necessary to attempt to assess the role of the ECJ's case law in the banking area.

The most important early contributions of the ECJ were made in creating or at least confirming the legal or constitutional character and identity of the EC especially in terms of the doctrine of supremacy and principle of direct effect in 1963 and 1964. Until that time it had been assumed that the legal effect of the original Treaty of Rome as an international agreement would be governed by the constitutional law of each Member State.[58]

The importance of the judgment of the ECJ in the famous case *Van Gend en Loos*[59] in 1963 was to confirm the separate identity of the new European legal order with the parties to this new jurisdiction including individuals as well as their governments and EC institutions. The provisions of the EC Treaty could also have direct effect and that it was for the ECJ to determine which specific measures would be covered. The ECJ confirmed in the other famous case *Costa v. ENEL*[60] in 1964 the primacy or supremacy of the EC law as against any contravening national law. The impact of the decisions of the ECJ in *Van Gend en Loos* and *Costa v. ENEL* was to establish the constitutional identity and effective operational supremacy of the new EC legal order as well as the directly enforceable nature of many core Treaty provisions by individuals.[61]

In the absence of an effective body of supporting secondary legislative measures as intended and provided for under the Treaty, the ECJ established an almost wholly original new law of free movement by initially confirming the direct (effect) implementation of the core provisions in each functional area (goods, workers, capital, establishment and services)

[56] McGee & Weatherill, ibid., pg. 580.
[57] Walker, ibid., pg. 95.
[58] Craig & De Burca, ibid., pg. 151.
[59] Case 26/62, Van Gend en Loos v Nederlandse Administraitie der Belastingen [1963].
[60] Case 6/64, Costa (Flaminio) v ENEL [1964] ECR 585, [1964] CMLR 425.
[61] Walker, ibid., pg. 102.

and then interpreting them to extend the scope of the prohibition to include discriminatory as well as not overtly discriminatory but still restrictive provisions. On the other hand, the ECJ had to confirm the limits of the restrictive doctrines set out in the Treaty as well develop its own judicial derogation to support its extended interpretation of these core prohibitions. Difficulties have subsequently arisen in arriving at a coherent and consistent jurisprudence in each area as well as in establishing some unity of comparability across the separate sectors involved.[62] Accordingly, the activities of banks and related institutions are subject to the full jurisprudence of the ECJ in connection with activities not covered by the secondary measures adopted by the relevant EC institutions.

Within the EC, it was nevertheless unclear until the decision of the ECJ in *Dassonville*[63], whether an effects or discrimination based approach would be adopted with regard to non-financial rather than financial measures of equivalent effect. In other words, the ECJ has ruled that both discriminatory and non-discriminatory measures can be in contravention of the fundamental internal market freedoms. The decision of the ECJ in *Dassonville* was concerned with the validity of a Belgian requirement that goods bearing a destination of origin could only be imported if they were accompanied by a certificate from the government of the exporting country confirming their right to the destination applied. *Dassonville* had imported Scotch whisky from France into Belgium without the required certificate. The ECJ ruled that the requirement of a certificate of authenticity, which was less easily obtainable by importers of an authentic product that had been put into free circulation in a regular manner in another Member State than by importers of the same product directly from the country of origin, constituted a measure of equivalent effect. The ECJ further held that a requirement such as that laid down by the Belgian legislation in issue constituted a measure having equivalent effect, inasmuch as it favored direct imports from the country of origin over imports from a Member State where the goods were in free circulation.[64] In particular, in paragraph of 5 of its decision, the ECJ stated that:

> *…All trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions.*

[62] Wyatt & Dashwood, ibid., pg. 222.
[63] Case 8/74, Procureur du Roi v Dassonville [1974] ECR 837, [1974] 2 CMLR 436.
[64] Wyatt & Dashwood, ibid., pg. 211.

Accordingly, the definition of measures having equivalent effect which the ECJ has adopted has led it to conclude that measures are forbidden which favor, within the Community, particular trade channels or particular commercial operators in relation to others. According to one commentator, the problem that had arisen was that the Treaty of Rome had not expressly stated which test was to be applied to non-market entry related (non-financial) restrictions. The Treaty provided a distinction between market entry financial restrictions (customs duties and charges having an equivalent effect) and internal measures (taxation), although the same clear distinction was not adopted with regard to non-pecuniary restrictions. In *Dassonville*, the ECJ corrected this gap by applying the same test to both types of non-pecuniary measures. The absence of a provision in the Treaty gave the ECJ the opportunity to determine whether a discriminatory or a non-discriminatory based test should be applied and the Court took the opportunity to set out the applicable doctrine in as wide a manner as possible without any express reference to discrimination. Hence, the major importance of the Court's decision in *Dassonville* was in confirming how wide the scope of the underlying Treaty prohibition may extend as well as in providing judicial recognition of the entitlement of national governments to maintain some restrictions on imported goods.[65]

The ECJ reiterated its view in a number of cases (e.g. Case 104/75 [1976] ECR 613).[66] Among others, the decision of the ECJ in the so-called *Cassis de Dijon*[67] requires to be analysed closely. Because, prior to the milestone decision of the ECJ in the *Cassis de Dijon* case it was generally assumed that the relevant Treaty provision had no application to a national measure unless it could be proved that the measure in question discriminated in some way, formally or materially, between either imports or domestic products, or between channels of intra-Community trade.[68]

The importance of the judgment of the ECJ in the so-called *Cassis de Dijon* case dated 1979 is that the ECJ held that in the absence of EC rules, a Member State can create barriers to the import of a product only if this is necessary to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions or the defense of the consumer. Such principle dos not explicitly provided under the Treaty of Rome. Hence, it can be said that this is a concept purely developed by the European Court of Justice.

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[65] Walker, ibid., pg. 110-112.
[66] Wyatt & Dashwood, ibid., pg. 219.
[67] Case 120/78, Rewe [1979] ECR 649.
[68] Wyatt & Dashwood, ibid., pg. 221.

The case involved the intended importation into Germany of a consignment of the alcoholic beverage *Cassis de Dijon*. Under German legislation fruit liqueurs such as Cassis could only be marketed if they contained a minimum alcohol content of 25 percent, whereas the alcohol content of the product in question was between 15 percent and 20 percent. In summary, the ECJ held that:

> *…In the absence of common rules relating to the production and marketing of alcohol… it is for the Member States to regulate all matters relating to the production and marketing of alcohol and alcoholic beverages on their own territory…Obstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognized as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer… It is clear from the foregoing that the requirements relating to the minimum alcohol content of alcoholic beverages do not serve a purpose which is in the general interest and such as to take precedence over the requirements of the free movement of goods, which constitute one of the fundamental rules of the Community.*[69]

The ECJ's decision was significant in confirming the application of the relevant Treaty provisions to indistinctly applicable measures. The decision supported the right of the Member States to impose national regulations in the absence of relevant EC legislation.

The major importance of the *Cassis* decision was that it did not refer to the **recognition** or **mutual recognition**. The ECJ did not refer to mutual recognition in its *Cassis* decision. Nonetheless, the concept was implied in paragraph 14[70] of the judgment but not developed further.[71] Equivalence was only implied and national authorities required to take into account marketing of composition rules already imposed in the country of origin. A more clear and substantial policy was only developed in this regard as part of the EC Commission's subsequent creation of its new approach to technical standards. This would then be further expanded in connection with the EC Commission's White Paper dated 1985

[69] Wyatt & Dashwood, ibid., pg. 222.
[70] Paragraph 14 of the judgement referred to the lawful production and first placement of goods on the market.
[71] Walker, ibid., pg. 302.

has attempted to remove all remaining physical, technical and fiscal barriers to free trade. The White Paper was implemented through various Treaty amendments under the Single European Act in 1986 which provided, in particular, for the inclusion of a new Article 8a (18) on the internal market and for the introduction of qualified majority voting in associated measures.[72] As will be discussed below, this provided, in particular, for the completion of a fully unified internal market by 1992 on the basis of a program and timetable to be produced by the EC Commission. The Principle of **Mutual Recognition** as such would then only more slowly emerge over the five-period between the decision in *Cassis* and the White Paper of 1985.[73]

By 1985, the EC Commission proposed in its White Paper the adoption of a new approach in connection with the removal of technical barriers based on **essential equivalence** and **mutual recognition**. In introducing this new integration approach, the EC Commission was careful not to state that existing EC legislation provided for mutual recognition as such but only that equivalence and recognition should be adopted as a core general principle.[74]

Nevertheless, the ECJ clarified in a number of following cases (e.g. Cinéthéque case – Cases 60&61/84 [1985] ECR 2605) that the *Cassis* formulation is not limited in its application to national measures which are proved to have or assumed to have some discriminatory purpose or effect.[75] On the other hand, it became apparent following the ECJ's *Cassis* decision that there has to be some limits to the findings of the ECJ in *Cassis*. Accordingly, the ECJ has noted in its judgment on *Keck and Mithouard*[76] the purpose of the legislation and accepted that although it may restrict the volume of sales it had to assess whether that possibility was sufficient to characterize the legislation as a measure of equivalent effect.

The European Court of Justice held in Case 33/74, *Van Binsbergen v. Bedriifsvereniging Metaalnijverheid*, a Member State cannot be denied the right to take measures to prevent the exercise by a person providing services whose activity is fully or principally directed towards its territory of the freedom guaranteed by the Treaty of Rome for the purpose of avoiding the professional rules of conduct which would be applicable to him if he were established within that Member State. The ECJ further stated that such a situation may be subject to judicial control under the provisions of the Treaty relating to the right of

[72] Walker, ibid., pg. 306.
[73] Walker, ibid., pg. 122.
[74] Walker, ibid., pg. 122.
[75] Wyatt & Dashwood, ibid., pg. 224.
[76] Cases C-267 and 268/91 Criminal Proceedings Against KEck and Mithouard [1993] ECR I-6097 [1995] 1 CMLR 101.

establishment and not of that on the provision of services. The ECJ concluded that in order to give judgment in the proceedings it is necessary to consider only the provision of services relating to contracts of insurance against risks situated in a Member State concluded by a policy holder established or residing in that Member State and who does not maintain any permanent presence in the first State or direct his business activities entirely or principally towards the territory of that State.

Accordingly, the ECJ seems to be clear in its judgment that an undertaking may be established in a Member State without having a branch there. According to the ECJ, an undertaking will be established if:

- it has an office managed by the undertaking's own staff; or
- it has an office managed by a person who is independent but authorized to act on a permanent basis for the undertaking; or
- where the undertaking directs its activities entirely or particularly towards the territory of another Member State, without having any presence there.

On the other hand, it is important to note that while the general principles developed by the ECJ are capable of equal application in the banking and financial area, it is unfortunate that more finance related decisions, wit a number of exceptions, have not yet been issued.[77]

The initial major analysis of the issues that arise in the financial area was conducted by the ECJ in the *Co-Insurance cases*[78] in December 1986. On the main issue of whether a local authorization and establishment requirement was contrary to the provisions of the Treaty on services, the main judgment was issued in the case *Commission v. Germany*. The ECJ noted that the said provisions of the Treaty had become directly applicable on the expiry of the transitional period and such applicability was not conditional on the further harmonization or coordination of relevant national laws of the Member States. Such provisions of the Treaty accordingly required the removal of any discriminatory provision on the grounds of nationality as well as all restrictions on the freedom to provide services imposed by reason of the fact that a person is established in a Member State other than in which the service is to be provided. The ECJ considered that the requirement of a local permanent establishment and separate authorization constituted restrictions on the freedom to provide services.

[77] Walker, ibid., pg. 153.
[78] Case 220/83 Commission v. French Republic [1986] ECR 3663; Case 252/83 Commission v. Kingdom of Denmark [1976] ECR 3713; Case 205/84 Commission v. Federal Republic of Germany [1986] ECR 3755; and Case 206/84 Commission v. Ireland [1986] ECR 3817.

Nonetheless, having considered that the establishment and authorization requirements were contrary to the freedom to provide services, the ECJ examined possible imperative reasons relating to the public interest that could justify this.[79]

Finally, in the case *CaxiaBank France*[80] *against Ministére de l'Economie, des Finances and de I'Industrie*[81], the EJC held that Article 43 of the EC Treaty precludes legislation of a Member State which prohibits another Member State from remunerating sight accounts in euros opened by residents of the former Member State. Such a prohibition, which constitutes for companies from other Member States a serious obstacle to the pursuit of their activities via a subsidiary, affecting their access to the market, is to be regarded as a restriction within the meaning of Article 43 of the EC Treaty. That restriction cannot be justified by overriding requirements of the public interest, relating to the protection of consumers or the encouragement of medium and long-term saving, since it goes beyond what is necessary to attain those objectives. The ECJ also noted that it is clear from settled case-law that where, as in the case at issue in the main proceedings, such a measure applies to any person or undertaking carrying on an activity in the territory of the host Member State, it may be justified where it serves overriding requirements relating to the public interest, is suitable for securing the attainment of the objective it pursues and does not go beyond what is necessary in order to attain it.

[79] Walker, ibid., pg. 156-159.
[80] From 18 February 2002 Caxia-Bank France, a company governed by French law with its seat in France which is a subsidiary of Caxia Holding, a company governed by Spanish law with its seat in Spain which holds the Caxia group's holdings in the credit institutions established under that name in Spain and in other countries of the EU, marketed in France a sight account remunerated at the rate of 2% per annum on balances of at least EUR 1500.
[81] Case C-442/02 CaxiaBank France v. Ministére de I'Economie, des Finances and de I'Industrie (Reference for a Preliminary Ruling from the Conseil d'Etat [France]).

§ 3. EC BANKING LAW FRAMEWORK

I. General

Financial integration is one of the aspects of the larger integration process within the EC. This relates specifically to the integration of each of the main financial sectors on a European basis as well as the further approximation or harmonization of supporting monetary and economic policies.[82] The EC builds liberalization of trade in financial services on its unique constitutional structure and its powerful administrative, legislative and adjudicative institutions. As will be discussed in this Chapter, the liberalization process has been gradual, starting with the constitutional principles enshrined in the EC Treaty, continuing with the decisions of the European Court of Justice and the commitments of the directives adopted to regulate the banking sector, and strengthening with the European monetary union. In other words, the introduction of the single European currency and the single monetary policy provide basis for the development of an integrated European banking system. Nevertheless, it can be said that the EC has adopted legislation to deal with consolidated supervision banks, financial conglomerates, cross-border banking, investment and insurance groups, and is moving towards more centralized supervision structures.[83]

Realization of the common internal EC banking market requires the elimination of internal barriers to the entry and operations of EC credit institutions (banks) and to the supply of banking services by the banks. The EC banking program is necessarily linked to the EC internal market objectives in other financial services including insurance, securities etc. as well as with the EC program for ensuring the free movement of capital.[84] The freedom to provide financial services usually follows the free movement of capital as already foreseen in the original EC Treaty.[85]

In order to realize its purpose of completing the internal market in banking, the EC has adopted a number of directives pursuant to the general provisions of the Treaty of Rome

[82] Ross Cranston, European Banking Law: The Banker – Customer Relationship, published jointly with the Centre for Commercial Law Studies and the Chartered Institute of Bankers, Lloyd's of London Press Ltd., 1993, London, UK, pg. 1.
[83] Panourgias, ibid., pg. 3.
[84] Norton, ibid., pg. 54.
[85] Dalhuisen, ibid., pg. 279.

governing establishment and services.[86] The Treaty of Rome contains foundations for the European internal banking market by prescribing the freedom of establishment, the freedom to provide services and the free movement of capital. The EC Treaty had only included minimal provision with regard to finance and capital related matters.[87] However, banking industry together with some other services have been included in the General Programs adopted under the Treaty. The general evolution of the EC banking legislation can be understood on the basis of a number of separate historical periods. It can be said in general that the underlying policy adopted has generally moved from being based on an **early approach** dominated by the attempted **full harmonization** of all relevant measures to one **new approach** based on the **mutual recognition of agreed standards within a more limited area of selected key provisions**.[88] This new approach based on essential legislative harmonization and non-essential mutual recognition would be extended in the financial area to include the adoption of the three principles or mutual recognition, minimal legislative harmonization and home country control. In other words, the original principles of mutual recognition and the minimum harmonization subsequently developed following the ECJ's decision in *Cassis* would then be extended in the financial area to include home country control inclusion of which effectively transfers the original market-entry based composition and placement rule into a post-entry continuing compliance condition. Accordingly, the simple pre-entry product rules (lawful production and placement) are converted into a much more substantial continuing post-entry validation system.[89]

Until now, the EC has enacted the following directives, among others, in the area of banking:

- the Council Directive 73/183EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions;
- the First Council Directive (77/780/EEC) of 12 December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (the "First Banking Directive");
- the Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions;

[86] Sooman Park, "Treatment of Non-EC Banks under EC Banking Directives", Journal of International Banking Law (vol.10), 1990, pg. 413.
[87] Walker, ibid., pg. 83.
[88] Walker, ibid., pg. 12.
[89] Walker, ibid., pg. 320.

- the Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (the "Second Banking Directive");
- the Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions;
- the Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis;
- the Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions;
- the Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions; and
- the Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.

These directives have been accompanied with a number of major programs including the White Paper of 1985 under which the so-called New Approach was adopted, and the Financial Services Action Plan of 1998 etc.

According to one commentator, the major policy objective behind the EC banking law approach is that the EC Commission in considering banking law reform started from the assumption that financial products and services are Community products and services which need to be provided and moved freely throughout the Community for the benefit of the European economy and consumers. Accordingly, the liberalization, prudential supervisory and transparency aspects of this regulatory system need to be assessed within the context of the European users of financial products and services and more broadly of a common Community economic market that will increase the standards of living within the Member States.[90]

Nonetheless, the said major policy is now supplemented with various other policies and goals and the main aims of modern financial regulation may include:[91]

- The protection of banking clients against a financial difficulty of the bank and against bad selling or advisory practices often caused by a conflict of interest between bank and client.

[90] Norton, ibid., pg. 56.
[91] Jan H. Dalhuisen, International, Commercial, Financial and Trade Law, Hart Publishing, Oxford, UK, 2000, pg. 720-721.

- The smooth operation of markets, price transparency and proper information supply in the markets and adequate clearing and settlement facilities and especially in the absence of market abuse or manipulation.
- The prevention of risk of monopolization.
- The creation of a proper framework of investments generally in terms of their legal characterization and structure.
- The minimalization of contagion or systemic risk whilst attempting to prevent the collapse of a credit institution affecting others. This is fundamentally important since through the inter-bank market and payment systems, all banks are connected and the failure of one may seriously affect the others.
- The creation of a level playing field so that the more prudent bank is not in the short term punished for its prudence and affected in its competition with other banks. Imposition of similar capital adequacy standards on all is here an important leveler.
- The minimalization of concerns relating to the reputation and soundness of the banking services system.

As will be discussed below, the recent EC directives are mainly based on three major principles, Mutual Recognition, Essential Harmonization and Home Country Supervision. The Principle of Essential (partial or minimum) Harmonization implies a harmonization of only essential standards. These have been included in the national banking legislations of the EC Member States. Since all national banking legislations now embody these essential standards, they can be recognized as equal to each other, which is the Principle of Mutual Recognition. The harmonized essential standards and mutual recognition facilitate the implementation of the Principle of Home Country Supervision which contemplates the home country control and supervision by the Member State in which the bank is based.[92]

[92] Benink & Benston, ibid., pg. 2.

II. The Council Directive 73/183EEC of 28 June 1973

At the end of the 1960s, the EC had completed the customs union ahead of the envisaged schedule and had established a Common Agricultural Policy (or the "CAP"). Nonetheless, from the late 1960s onwards, the attempts at liberalization came to a standstill.[93] The lack of progress during these years can be explained by a number of factors.[94] The first factor may be the recession of the world economy during the oil crisis in the 1970s as a result of which the Member States' economies have faced with high inflation and low growth and employment problems. Consequently, the Member States have followed protectionist policies and they had less concern for the common market. Second factor can be indicated as the decision-making process and procedures set forth under the Treaty of Rome. As known, in most sensitive areas of EC policy, the Treaty required unanimity for decision-making and adoption of secondary legislation. Thus, various attempts to enact secondary legislation regarding matters in which the Member States traditionally have strong interests have not been successful. Thirdly, financial systems, practices and laws of the Member States varied widely across the EC. This has created particular difficulties in integration and harmonization efforts. Accordingly, due to the strong resistance of the Member States to open up their national markets and the significant differences in the national legislations, EC legislation on the financial services sector was absent until the mid-1970s, the adoption of the Banking Directive of 1973 (Directive 73/183/EEC of 28 June 1973).

In this context, the Commission had prepared a proposal for a Directive designed to abolish restrictions on the freedom of establishment in the field of banks and other financial institutions and transmitted the same to the Council in July 1965 which was finally adopted by the Council on 28 June 1973. The Directive does not apply only to banks but also applies to a number of savings and loan institutions and certain insurance syndicates. The undertakings to which the Directive applies are set out in full category of undertaking in an annex to the Directive. The Directive has provided the definitions of various terms including "bank", "banker", "savings bank", and any other term by non-EC undertakings which provide services in a Member State.[95] Those undertakings are permitted to provide services under names which include such terms provided that the names are their original ones and that the

[93] Avgerinos, ibid., pg. 32.
[94] Avgerinos, ibid., pg. 33.
[95] Marc Dassesse & Stuart Isaacs QC & Graham Penn, EC Banking Law, 2nd Edition, Lloyd's of London Press, London, UK, 1994, pg. 18.

undertakings leave no doubt as to their status under the national law to which they are subject. Nonetheless, the Directive excluded from its scope the activities of certain kinds of brokers and financial intermediaries.[96] Hence, the Directive may be considered as a limited endeavour to liberalize certain banking activities in the Community, listing all formal and substantive discriminatory practices that needed to be abolished in the Member States.[97] According to one commentator, although some progress was made in the Directive, which ensured equal treatment of EC entities in respect of entry and conditions of operation in domestic markets, international competition in financial services remained constrained by capital controls, notably in countries such as France, Denmark, Italy and Ireland.[98]

[96] Dassesse & Isaacs & Penn, ibid., pg. 19.
[97] Marc Pearson, "Development of Legislation", published in Amsterdam Financial Series (Banking and EC Law Commentary), edited by Matijn van Empel (General Editor) and Rene Smits (Co-Editor), Kluwer Law and Taxation Publishers, Deventer, the Netherlands, 1992, pg. 7.
[98] E. Phil Davis, "Problems of Banking Regulation – An EC Perspective", Special Paper No.59; LSE Financial Markets Group, Special Paper Series, London, UK, December 1993, pg. 10.

III. The First Banking (Co-ordination) Directive

1. General

Following the Directive 73/183/EEC of 1973, the Council adopted so-called the First Banking Directive (Council Directive 77/780/EEC) on 12 December 1977. Contrary to the 1973 Directive, the First Banking Directive, did not intend to abolish restrictions but to co-ordinate and set forth provisions for the establishment of credit institutions.[99] The purpose of the First Banking Directive was to lay down the common guidelines on various matters relating to the supervision of credit institutions in the EC. The particular importance of the Directive is that in its preamble, the goal of **full coordination** has been provided and the preamble further states that the Directive is only **a step on the road to full-coordination**. The Directive acknowledges the necessity, given the extent of the existing differences between the laws of the Member States as regards the rules to which credit institutions are subject, to proceed by successive stages but with the eventual aim of introducing **uniform authorization requirements** throughout the EC.

The significance of the First Banking Directive is that together with the Second Banking Directive and with the subsequent directives (i.e. the Directive 2000/12EC and the Directive 2006/48/EC), it has established the basic principles on which the integration of the EC banking market is based. According to one commentator, the importance of this Directive should not be underestimated as it was the first attempt to harmonize certain aspects of banking law within the EC and in fact generated a far closer and institutionalized form of cooperation between supervisory authorities than had existed before.[100]

It can be said that the harmonization of the EC banking law has started with the First Banking Coordination Directive, which established a definition of credit institutions, as well as setting forth the general principles of the major **Principle of Home Country Supervision**. The Directive set out general guidelines for deregulation, but also prompted several specific Directives, mentioned above, on i.e. Consolidated Supervision (1983), which required credit institutions to be supervised on a consolidated basis where one holds more than 25% of the other's capital; Accounts (1986), which harmonized accounting rules for financial institutions; and Consumer Protection (1986).

[99] Pearson, ibid, pg. 8.
[100] Pearson, ibid, pg. 8-9.

Under Article 3 of the Directive, Member States were obliged to require credit institutions having their head offices in one Member State to obtain authorization to carry on business before starting their activities even if they do not intend to set up or carry on activities in another Member State. Article 1 of the Directive defines authorization as an instrument issued in any form by the authorities by which the right to carry on the business of a credit institution is granted. This definition of the authorization also kept under the Second Banking Directive.

Another important rule introduced under the First Banking Directive is laid down in its Article 5. As per Article 5, the right of the credit institutions operating in another Member State to preserve its original name is guaranteed.

According to Article 10 of the Directive, credit institutions which were already carrying out business activity in a Member State at the time when the Directive came into force on 15 December 1979 are deemed to have been authorized. Accordingly, the credit institutions already carrying out business activity in a Member State at the time when the Directive came into force remain subject to the Directive and their activities are subject to the supervision of the competent authorities of the Member States in which they have their head offices and they may, under certain circumstances, be prohibited by the competent authority from carrying out their business.

Under Article 4(1) of the Directive, the branches of the credit institutions having their head offices in another Member State may be required to obtain authorization by the Member State where the branches are located to carry on business before starting business. As will be discussed below, such requirement for branches to obtain authorization is removed by the Second Banking Directive.

As per the First Banking Directive, Member States retained full competence to permit or reject the incorporation within their territory of branches of credit institutions having their head offices outside the EC. However, the issue of regulation of branches of banks having their head offices in a non-EC country is not regulated and addressed under the First Banking Directive in details. The only relevant provision of the Directive seems to be Article 9(1) of the Directive which provides that once a Member State has permitted the establishment of a branch, such Member State is under the requirement not to treat such branch of a foreign bank, having its head office outside the EC, more favourable than the branches of credit institutions having their head office in another EC Member State. Accordingly, the Directive has set forth the general rule that a branch that a bank with its head office in another Member

State would be treated in the same way as a new bank being set up for the first time in the host country.

Similar to the Banking Directive of 1973, the First Banking Directive contained mechanisms for co-operation between the various interested bodies set up under the earlier Directive. Nonetheless, different from the Banking Directive of 1973, the First Banking Directive contained also mechanisms for co-operation between the competent authorities of the Member States. Article 7(1) of the First Banking Directive states that the competent authorities of the Member States must cooperate closely in order to supervise the activities of credit institutions operating in one or more Member States other than in which their head offices are located and are obliged to supply each other with all information likely to facilitate the monitoring of such institutions. This is a very important novelty since it may be considered as a first step towards the major **Principle of Home Country Supervision**. Although, the supervisory authority of the host country retains its responsibility with regard to the branch, it has to share this with the authority of the Member State where the head office is located. The cooperation among the competent authorities is particularly important since under Article 8 of the Directive, where the credit institution has its authorization withdrawn by the competent authorities of the country of the head office, the corresponding authorities in the host country must also withdraw the authorization they have issued.

Article 9 of the Directive regarding relations with non-Member States provides significant principles in connection with the branches of credit institutions having their head office in a non-Member State. The first of these principles is that, as mentioned above, in no circumstances can an institution from a non-Member State receive more favourable treatment than an institution from a Member State. If a Member State wishes to apply privileged treatment (i.e. tax treatment, flexible implementation of bank supervision rules etc.) to institutions coming from one or more non-Member States, it must automatically extend such treatment to institutions coming from the other Member States.

The other regulation set forth under the Directive is the recognition of the power of the Community, as an institution with its own independent legal personality, to enter into agreements with states which are not its members non-Member States). Accordingly, if the EC can execute agreements with non-Member States in a particular field, the Member States no more will have the right of entering into bilateral agreements of the same type relating to the same subject matter. The basis for EC competence in entering into international banking

agreements is the coordination carried out in this field. Accordingly, the more coordination is advanced, the greater the EC's competence will be, and the less that of the Member States.[101]

[101] Paolo Clarotti, "Progress and Future Development of Establishment and Services in the EC in Relation to Banking", Journal of Common Market Studies, Volume XXII No.3, Basil Blackwell Oxford, UK, March 1984, pg. 216-217.

2. Analysis

The First Banking Directive is considered to be one of the first regulatory expressions of the initiative to liberalize the European banking system. To address systemic risk implications as well as to promote equal conditions of competition it also provided for minimum prudential standards. Among these were the protection of depositors and the duties of banking supervisors.[102]

The Directive provided for elimination of trade barriers. The Directive also provided for cooperation among the national authorities for supervision. However, the First Banking Directive granted only limited freedoms for branches and only envisaged **further harmonization, mutual recognition and home country control**. Nonetheless, the First Banking Directive may be regarded as a milestone piece of legislation which has lead to various important changes in financial markets, aiding competition and to some extent, integration of EC financial markets, decline in use of structural regulations including interest rate ceilings, development of money, bond and equity markets, and deregulation of fees and commissions in financial services.[103]

Further, Article 13 of the First Banking Directive introduced the novelty of **direct effect** under the EC law. The said Article explicitly provides that *Member States shall ensure that decisions taken in respect of a credit institution in pursuance of laws, regulations and administrative provisions adopted in accordance with this Directive may be subject to the right to apply to the courts. The same shall apply where no decision is taken within 6 months of its submission in respect of an application for authorization which contains all the information required under the provisions is force.*

The number of the specific rules of law in the Directive is few. However, the Directive has laid down a series of principles which the EC has developed following the entry into force of Directive.[104] These principles include, among others, the definition of credit institution. Accordingly, the receipt of funds from the public and the granting of credit must be carried out by the same undertaking. The second principle is that a credit institution must receive prior authorization before starting its operations. The Directive also laid down various requirements for entry into the market, and these (existence of adequate minimum

[102] Panourgias, ibid., pg. 121.
[103] Davis, ibid., pg. 10-11.
[104] Clarotti, ibid., pg. 213.

own funds; the existence of separate own funds; the management of banks must be conducted by persons of good repute and experienced; submission of program of operations etc.) have been made compulsory.

In this respect it may be noted that although a credit institution intending to set up in one country must have one of the legal forms accepted in that country for the pursuit of banking business but if only a branch is involved, the relevant Member State must accept it even if the institution concerned has in the country of origin a legal form which is not allowed in the host country (Member State). The Directive provisions concerning coordination of requirements regarding entry into the market have lead to major amendments in the legislations of the Member States.[105]

The importance of the First Banking Directive can be summarized as follows:[106]

- The Directive has introduced a banking regulation in some Member States where there was no regulation at all or has brought an important reform of the existing regulation of some other Member States.
- It has established an institutional cooperation among the supervisory authorities which has expanded beyond the EC borders.
- It has made compulsory for supervisory authorities of two or more Member States to cooperate in the monitoring of a credit institution having business in two or more Member States.
- It sets out a procedure, which will lead progressively to a degree of approximation which will allow the implementation of the principle of home country control.
- It has established a first step towards common policy *vis-à-vis* the third countries.
- It has given a general broad definition of a "credit institution" submitting all of these to the same regulations and making it more difficult to maintain discriminatory treatment between the different types of credit institutions, and ensuring in that way more equal conditions of competition.
- It has underlined also the principle that all credit institutions should be allowed to carry out all operations related with this industry thus giving support to the trend towards the despecialization of credit institutions, lobbied by many groups.
- It is a positive secondary step in the direction of the economic and monetary union.

[105] Clarotti, ibid., pg. 214-215.
[106] Dassesse & Isaacs & Penn, ibid., pg. 22.

It may be added that Article 7 together with Article 11 of the Directive regarding the Advisory Committee institutionalize and enlarge the framework of the multilateral cooperation between supervisory authorities which already existed on an informal basis.

Nonetheless, the First Banking Directive did not abolish a number of barriers and various barriers to full integration in the sector remained following the entry into force of the Directive. Such barriers included the requirement that branches had to be provided with own capital as if they were subsidiaries and the supply of cross border services was subject to the capital controls, branches of banks whose head office are located in another Member State need to seek authorization from the authorities of the host Member States and the supervision remained largely host Member State based.[107] Accordingly, branches were not able to benefit from any competitive advantage resulting from a more flexible regulatory system applicable to home country. According to one commentator, the result has been that branches opened in one Member State by a bank of another Member State have in general tended towards wholesale banking operations and not the servicing of the local clientele of private individuals and small and medium size enterprises.[108] In addition, the definition of a very significant term "own funds" was not brought under the First Banking Directive.

The level of harmonization achieved with respect to the requirements regarding the pursuit of business by the First Banking Directive is very low. For example, on entering another market, a bank frequently had to comply with a set of rules fairly different from those which it has to abide by in the home country.

Finally, it must be noted that, as will be discussed in details below, since the EC efforts on the full harmonization of the banking sector were not very successful, the First Banking Directive constituted for a long time the only basis for the expansion of the banking activities throughout the EC.

[107] Davis, ibid., pg.11-12.
[108] Dassesse & Isaacs & Penn, ibid., pg. 23-24.

IV. White Paper of 1985 on the Completion of the Internal Market (the "White Paper")

1. General

The EC Commission had originally adopted an integration approach based on **full harmonization** involving adoption of detailed measures regarding all aspects of product and service production or provision. However, the hurdles and problems that occurred in two decades (1960s and 1907s) forced the Commission to attempt to find a **new approach** by the early 1980s.

The efforts in the EC on the full harmonization of the banking sector were not very successful. This can be explained by various differing reasons. This was mainly due to the traditional approach adopted in the EC was to attempt to bring the different sets of legislation in the Member States closer together by way of **complete harmonization of standards** at EC level. This approach, geared as it was towards prior and complete harmonization, had the paradoxical result of leaving the EC market fragmented and with various internal barriers preventing the free movement of goods, persons, services and capital envisaged by the Treaty of Rome.[109] The EC Treaty included various provisions on capital and current payments as well as exchange rate policies, economic policy and balance of payments.[110] The Treaty basis for the free movement of capital was Article 67(1) which provided for the progressive abolition of restrictions but only to the extent necessary to ensure the proper functioning of the common market.[111]

By the mid-1980s, the economic and political climate in the EC and at a global level for financial services in particular had developed in such a manner that steps towards further integration of the market became easier to achieve. The need for further progress in the area of financial policy and financial integration was underlined first by the Commission in a Communication on Financial Integration in 1983. The Commission, being aware of the urgency and importance of the problem as well as the fact that the Member States were recovering very slowly when compared with the United States and Japan from the recessions

[109] Pearson, ibid., pg. 8-9.
[110] Walker, ibid., pg. 84.
[111] Article 67(1) of the EC Treaty provides that *Member States shall to the extent necessary to ensure the proper functioning of the common market progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in the Member States and any discrimination based on the nationality or on the place of residence of the parties or the place where such capital is invested.*

of the late 1970s, highlighted that despite the progress that had been achieved in other trade related areas, little had been possible in the financial area.[112] This was followed by the White Paper having the objective to ensure that all of the measures required for the full free movement of goods and services (a customs union) and factors of production (common market) were adopted. It is important to note that the achievement of capital liberalization is particularly important since full free movement of financial services would not have been possible without the capital liberalization.

The creation of a single market in banking and financial services has generated been dealt with separately from the work undertaken with regard to free movement of capital and financial policy more generally. Nevertheless, it would not have been possible to secure the full free movement of financial services until capital liberalization had been achieved.[113]

Further, it is important to note that these principles relating to the free movement only represent more general precepts or doctrines that have been applied in the construction of the new legislative program adopted. To this extent, rather than treat these principles as fixed legal rules, these principles are best considered as more general strategic, framework or design principles on which the overall integration approach has been constructed.[114]

The aforementioned developments led the EC Commission to prepare a White Paper aiming to achieve further integration and growth in the banking sector. In June 1985, the Commission submitted to the European Council its *White Paper on the Completion of the Internal Market*. The internal market in financial services introduced by the White Paper constitutes part of a wider project to create a single market comprising an area without internal frontiers in which the free movement of goods, services and capital is ensured.[115]

The White Paper providing the basic guideline for the establishment of an Internal Market in the EC, identified 300 pieces of legislation which the EC would have to enact to remove all physical, technical and fiscal barriers in the EC in a wide range of domains, including financial services, public procurement, taxation, free movement of individuals, free movement of capital, monetary policy and etc. The White Paper also established a timetable for each proposal, which was devised to ensure the completion of the program by the end of 1992.

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[112] Walker, ibid., pg. 79.
[113] Walker, ibid., pg. 89.
[114] Walker, ibid., pg. 298-299.
[115] Avgerinos, ibid., pg. 2.

According to one commentator, the idea and concept behind the White Paper was threefold:[116]

- to merge the national markets of the Member States to establish a single enlarged market,
- to form an expanding, dynamic market, and
- to ensure that such a market is flexible enough to channel human, material and financial resources towards the domains where they will be best used.

Within the framework of this **New Approach**, the Commission has attempted to establish a structure to promote EC integration on the basis of mutual recognition, minimum harmonization and home country supervision. The New Approach envisages that the liberalization would involve a much more limited degree of harmonization. Despite the importance of the New Approach advanced under the 1985 White Paper, it was not possible to make any significant progress in this area until substantial free movement of capital had been secured across Europe.[117]

Paragraph 13 of the White Paper states that … *The general thrust of the Commission's approach in this area will be to* ***move away from the concept of harmonization towards that of mutual recognition and equivalence****. However, there will be a continuing role for the* ***approximation*** *of Member States' laws and regulations …*

Under its relevant section, the White Paper further provides that …*Such harmonization, particularly as regards the supervision of ongoing activities, should be guided by the* ***principle of home country control****. This means attributing the primary task of supervising the financial institution to the competent authorities of its Member State of origin, to which would have to be communicated all information necessary for supervision. The authorities of the Member State which is the destination of the service, whilst not deprived of all power, would have a complementary role. There would have to be a* ***minimum harmonization*** *of surveillance standards, through the need to reach agreement on this must not be allowed further to delay the necessary and overdue decisions.*

In its Third Report on the implementation of the White Paper,[118] the Commission summarized its approach to the liberalization of the financial services sector, including it to the below three key elements:[119]

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[116] Avgerinos, ibid., pg. 33-35.
[117] Walker, ibid., pg. 83.
[118] Report on the implementation of the Commission's White Paper on completing the internal market, COM (88) 134 final, 21 March 1988.

- harmonization of essential standards for prudential supervision and for the protection of investors, depositors and consumers;
- mutual recognition of the way in which each Member State applies those standards;
- based on the first two elements, home country control and supervision of financial institutions operating in other Member States.

As will be discussed in the following sections, the subsequent EC banking directives including the Second Banking Directive was intended to set forth the foundation for the implementation of the aforementioned principles in the banking sector.

[119] Robert Strivens, "The Liberalization of Banking Services in the Community", Common Market Law Review 29, Kluwer Academic Publishers, printed in the Netherlands, 1992, pg. 287.

2. Analysis

The White Paper of 1985 was significant in the move towards further liberalization in the services including the banking industry. The freedom of services was treated as an essential element in the construction of the single market. Further harmonization and free movement of capital were envisaged to the benefit of banking services. According to the White Paper, the European Community would promote deregulation through essential harmonization, mutual recognition and home country control. Financial institutions including the banks would be subject to home country jurisdiction in respect of authorization and prudential supervision, after the establishment of minimum common rules throughout the EC and recognition of home country rules by the host country.

The importance of the White Paper is that it announced for the first time a **new approach** or strategy by abandoning the previous unsuccessful **old approach** of the full harmonization of national legislations of the Member States which, for a long time, was regarded as a natural prerequisite for the opening up of the national markets. Accordingly, the White Paper may be considered as an admission and declaration of the failure of the EC to achieve a complete removal of barriers. In lieu of this old approach, the Commission proposed as the new approach to apply to the services sector the same approach as would be followed for the goods sector, namely mutual recognition and equivalence. In other words, following the failure of previous complete harmonization efforts by the EC, this approach has been seen as the most appropriate to achieve a single market and has been subsequently followed by the adoption of the relevant secondary legislation.[120]

This new approach is mainly based on the general principle that goods lawfully produced or marketed in one Member State must be accepted in other Member States, unless rejection to accept the free movement can be justified on legal grounds. In order to achieve this goal the Commission proposed in the White Paper to reach agreement based on minimum coordination and harmonization of essential rules and standards only, since these rules create barriers to trade which can be justified at national level. Implementation of this principle to financial services would then provide the basis for mutual recognition by Member States of what each does to safeguard the interests of the public. Since the goals of national legislations are substantially equivalent among the various countries, **mutual recognition** could represent

[120] Avgerinos, ibid., pg. 35.

an effective strategy in the creation of a common market.[121] The Commission also noted in the White Paper that within the framework of this new approach, the **final objective** would be to secure the free circulation of financial products but that the way to achieve this final purpose was not by preparing specific rules pertaining to the products themselves.

Finally, the strategy adopted under the White Paper combined minimum harmonization, mutual recognition and home country control as the three modules. These modules have been characterized as the cornerstone of the Single Market. It is important to reiterate that these three principles were not derived from the original Treaty provisions. Nonetheless, as discussed above, the origin of these principles can also be traced in the case law of the European Court of Justice.

The major difference between the **old approach** and the **new approach** adopted under the White Paper is that the EC legislation is granted residual role, merely providing minimum guarantee ensuring some measure of equivalence between the different national legal regimes.

As will be discussed later in the study in details, these three fundamental principles complete each other. In particular, minimum harmonization is regarded essential for a number of reasons. Initially, the Principle of Mutual Recognition has caused the elimination of barriers to trade and has ensured the free movement of products and services. Mutual recognition is based on the philosophy that goods and services emanating from one Member State must be freely allowed into other Member States. Accordingly, Member States recognize the equivalence of corresponding measures taken in other Member States even when there are divergences between these measures and its own legislation. However, the mutual recognition principle which does not involve the transfer of regulatory powers to the EC, itself does not by itself establish a sufficiently unified market. This may be achieved with the help of the principle of minimum harmonization.

Secondly, general implementation of the Principle of Mutual Recognition without being accompanied with the Principle of Minimum Harmonization may invite competitive deregulation by and among the Member States and may lead to lower standards of protection. Finally, the Principle of Home Country Supervision which constitutes the keystone of the financial services directives with respect to the prudential supervision, allows a service provider authorized in one Member State to conduct its activities in other Member States without needing further authorization. Nonetheless, as will be discussed below, the applicability of the home country supervision is weakened by a provision under which the

[121] Cranston, ibid., pg. 285.

host country also has the right to regulate to the extent necessary to protect the **public interest**.

It is also important to underline that the White Paper makes particular reference to the so-called *Cassis de Dijon* judgment of the European Court of Justice dated 1979 where the ECJ held that in the absence of EC rules, a Member State can create barriers to the import of a product only if this is necessary to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions or the defense of the consumer.

As per the White Paper and the subsequent Single Europe an Act of 1986, amending the Treaty of Rome, the liberalization of the banking services and its implementation is legally connected and is in a parallel manner to the free movement of capital requirements and liberalization of capital within the EC.

Another importance of the Single European Act amending the EC Treaty is that the Single European Act has introduced the qualified majority voting in the Council of Ministers with regard to legislative proposals aimed at harmonizing Member States' laws. Finally, as discussed above, the other significant change post-Single European Act concerned the type of harmonization legislation passed; less detailed framework legislation was adopted at EC level and greater use was made of:

(a) the principle of mutual recognition; and

(b) lower level standardization measures to fill the gaps left by the framework EC legislation.[122]

[122] Karen Connolly, "The Financial Services Action Plan" published in A Practitioner's Guide to EU Financial Services Directives by Freshfields Bruckhaus Deringer, edited by Michael Raffan, City & Financial Publishing, First Edition, Surrey, UK, 2003, pg. 28.

V. The Second Banking (Co-ordination) Directive

1. General

Until the entry into force of the Second Banking Directive which is adopted by the EC Council on 15 December 1989, only some progress has been made towards full freedom of establishment as per the First Banking Directive. However, very little progress has been made towards freedom to provide services. The Second Banking Directive was intended to follow-up and to supplement the First Banking Directive but it adopts a radically different approach. When compared with the prior banking directives, the Second Banking Directive sets forth importantly more specific and immediate methods of implementation related to banking harmonization and takes a flexible and realistic approach to achieving a fully integrated EC banking market. In this regard, the Second Banking Directive may be considered as the cornerstone of all directives relating to the business of the credit institutions in the context of the achievement of the internal banking market.

The Second Banking Directive concerns the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions. The Second Banking Directive is a very significant legal tool in the path towards the single market and contemplates that the integration of the banking sector will be based on the following three fundamental principles:

(i) Single Banking License and Mutual Recognition;
(ii) Home Country Supervision; and
(iii) Common Supervisory Rules for Essential Matters (Essential Harmonization).

The Second Banking Directive forms the cornerstone of all directives for the business of these institutions in the context of the achievement of the single (or internal) banking market. The single license concept constitutes the heart of the Second Banking Directive. The Directive sets forth a requirement of a single license along with an agreed list of banking activities covered by this license. The single license implies that once an institution has obtained a banking license in an EC Member State, it can operate freely in all of the other Member States, both through establishment of a branch and cross-border provision of banking services. The result of this concept is that a host Member State may no longer require

authorization for these banks to operate in its banking market. The national authorities of banks' home states are responsible for their authorization and supervision.

The list of banking activities given under the Directive is subject to the Principle of Mutual Recognition. This Principle implies that a host country must allow non-domestic EC banks free access to its market. The list covers all major and investment banking activities, implicating the endorsement of universal banking. Consequently, apart from traditional commercial banking activities, credit institutions can engage in all forms of transactions in securities, including transactions for their own account or for the account of customers in all types of security.[123]

Supervision by the Home Country and the application of the Principle of Mutual Recognition are enabled by a harmonization of minimum supervisory standards. The Directive harmonizes supervisory requirements related to sound administrative and accounting procedures, the initial capital necessary for authorization and the execution of activities, and the supervision of holdings of banks in sectors outside the banking business.[124]

With the adoption of the Second Banking Directive and by virtue of the above principles, significant progress has been achieved towards the aim of abolishing barriers to the creation of a single market in banking sector within the territories of the Member States. The major reasons or this was the introduction by the Second Banking Directive of the single EC banking license through the Principle of Mutual Recognition, and the Directive aims to control over this new license concept, EC wide bank branching and the standardization of certain prudential and regulatory practices.

As these principles will be discussed in the following chapters in details, the following sections of this chapter focuses briefly on the principles and more generally on general characteristics and analysis of the Directive.

According to its recitals, the objective of the Directive is to achieve only the ***essential harmonization*** *necessary and sufficient to secure the* ***mutual recognition*** *of authorization and of prudential supervision systems, making possible the grant of a* ***single license*** *recognized throughout the Community and the application of the principle of* ***home Member State prudential supervision***.[125] The recitals intend also to avoid the fraud of law and reiterate the various rulings of the European Court of Justice. Recital 8 of the Directive states that *the principles of mutual recognition and of home Member State control require the*

[123] Benink & Benston, ibid., pg. 3.
[124] Benink & Benston, ibid., pg. 4.
[125] Recital 4 of the Directive.

competent authorities of each Member State not to grant authorization or to withdraw it where factors make it quite clear that a ***credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State in which it intends to carry on or carries on the greater part of its activities****…a credit institution shall be deemed to be situated in the Member State in which it has its registered office; Member States must require that the head office be situated in the same Member State as the registered office.*

In recitals 10 and 15 of the Second Banking Directive host Member States are granted with specific roles and authorities. Whereas under recital 10 of the Directive, the host Member State's competent authorities will retain responsibility for the supervision of liquidity and monetary policy, recital 15 of the Directive allows the host Member State to require compliance with specific provisions of its own national laws. Furthermore, recital 18 of the Directive makes it clear that the Directive is **not intended to encourage regulatory arbitrage and an institution is not to be allowed to obtain an authorization in one Member State, where the regulatory requirements are perhaps less strict, when the center of its activities is in another Member State**.

Under Article 5 of the Directive, the shareholders or members of a credit institution are required to inform the competent authorities about their identities and sizes of holding before taking up business. The ownership and control of a credit institution by important shareholders is an issue of supervisory concern. Article 5 also provides that the competent authorities of the Member States shall refuse authorization if they are not satisfied as to the suitability of the shareholders or members of a credit institution.

Under various other provisions of the Second Banking Directive, a bank authorized and supervised by the competent authorities of a Member State which plans to set up a branch or to provide services across the border in the territory of another Member State, no longer requires the authorization of the host country. Pursuant to Article 1 of the Directive, "branch" means a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions. Further, as per Article 24 of the Directive, the endowment capital requirement with respect to establishing a branch shall be abolished by 1 January 1993. In the meantime, the minimum amount of endowment capital shall be reduced by not less than 50 % from 1 January 1990.

Accordingly, a bank having its head office in a Member State must be allowed to carry out banking activities in the territory of another Member State, whether by means of setting

up of a branch or by way of cross border provision of services. This freedom applies regardless of any limitation of the scope of local banks under the law of the host country, provided that authorization has been obtained from the competent authorities of the home country, and provided also that the activities are among the banking activities listed which qualify for mutual recognition.[126]

Under Article 10 of the Directive, a credit institution's own funds may not fall below the amount of initial capital. In order to reinforce the content of this principle, Article 10 also states that when a credit institution is taken by a person other than that who controlled the institution previously, the own funds must attain the level of initial capital. Nonetheless, there is an exception to this provision also under the same Article which provides that where there is a merger of two or more credit institutions, the own funds of the institution resulting from the merger may not fall below the total own funds of the merged institution at the time of the merger.

According to Article 12 of the Second Banking Directive, which is one of the major provisions of the Directive, requires banks to comply with a number of objective criteria if such banks are intending to acquire or maintain participation in non-credit or non-financial institutions.

Under the Directive, **the home Member State control has not been carried to all aspects of banking supervision**. Under Article 14 of the Directive, which states that host Member States shall retain complete responsibility for the measures resulting from the implementation of their monetary policies, supervision necessary to safeguard a Member State's monetary policy rests with the host Member State.

Article 15 of the Directive is another fundamental provision brings the possibility for the home country competent authorities, after first informing the host authorities, to undertake instant verification in branches of their credit institutions which are incorporated in other Member States.

Article 18 of the Directive is the most significant legal device in achieving the principle of mutual recognition of banking activities.[127] Under the said Article, the subsidiaries of credit institutions are allowed to provide the activities listed in the Annex of the Directive throughout the EC territory if they fulfil various conditions set forth thereunder. The Directive specifies certain core activities (listed activities) in the fields of banking and

[126] Park, ibid., pg. 413.
[127] Carlos Javier Moreiro Gonzales, Banking in Europe After 1992, Dartmouth Publishing Company Limited, London, UK, 1993, pg. 21-22.

financial services. It applies the principle of home member state supervision (the Principle of Home Country Supervision) by directing that member states shall permit listed activities to be carried on within their territories by any credit institution authorized and supervised by the competent authority of another member state, provided that such activities are covered by the authorization.

Under Article 19 of the Directive it is secured that the host Member State is not allowed to refuse the establishment in its territory of a branch of a credit institution duly agreed in its home Member State. The procedure for setting-up a branch in another Member State, involves the notification to be submitted to the home state authorities, together with a significant amount of information on the intended business of the branch to be set up. The information to be supplied includes the host Member State where the branch is intended to be established, a program of envisaged operations, the address in the host Member State from which documents may be obtained, and the names of those responsible for the management of the branch. Within two (2) months of their receipt of the information, the host Member State authorities must prepare for the supervision of the credit institution in accordance with the Directive, and if necessary, indicate the conditions under which, in the interest of the general good, those activities must be carried on in the host Member State.

Article 20 of the Directive provides that host Member States are authorized to take appropriate measures when a credit institution continues to breach the legal rules laid down in Article 20 of the Directive. Accordingly, in order to simply provide services for the first time into another Member State, without opening a branch there, a credit institution will, pursuant to Article 20 of the Directive, have to notify the competent authorities in its home state of the activities which it intends to undertake in the host state.[128]

Under Article 21 of the Directive, even in those areas of supervision reserved primarily for host Member State control, **responsibility for enforcement** remains primarily with the Home Member State authorities. The said Article also lays down a procedure for the enforcement in those areas. As per the same Article, it is confirmed that enterprises may advertise their services in host Member State but subject to any rules governing the form and content of such advertising adopted in the interest of the general good. The reference to "the general good" confirms the effect of the EC law that national regulation which restricts the provision of services must be justified in terms of the EC law concept.[129]

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[128] Strivens, ibid., pg. 291.

[129] Eva Lomnicka, "The Home Country Control Principle", published in Services and Free Movement in EU Law, edited by Mads Andenas and Wulf-Henning Roth, Oxford University Press, Oxford, UK, 2002, pg. 299.

Finally, it must be added that the two other major directives introducing amendments to and supplementing the Second Banking Directive are the Directive 89/299 EEC of 17 April 1989 (the "Own Funds Directive") and the Directive 89/647 EEC of 18 December 1989 (the "Solvency Directive"). These two supplemental directives are detailed pieces of legislation. The Directive 89/299 EEC has laid down the common standards for the definition of the "own funds", which Member States are required to use in all their legislation implementing the EC measures on the prudential supervision of credit institutions. The Directive 89/647 has laid down the EC legislation on the capital adequacy of credit institutions and has introduced greater degree of comparability of supervisory standards.[130] The Solvency Directive provides for the methods how the competent authorities are to calculate the weighted risk/asset ratio (solvency ratio) of a credit institution for capital adequacy purposes and stipulates that Member States must require credit institutions authorized by them to maintain a minimum risk/asset ratio of at least 8%. These two Directives largely follow the agreement of the Basle Committee on Banking Regulations and Supervisory Practices on the international convergence of capital measurement and capital standards.[131]

[130] Gonzales, ibid., pg. 25.
[131] Strivens, ibid., pg. 291.

2. Analysis

The Second Banking Directive adopts a radically different approach than the approach adopted under the First Banking Directive. The Directive indicates the **new approach** to supervisory legislation in the field of financial services. It can be said that the liberalization and new approach adopted under the White Paper is now reflected in the Second Banking Directive. The fundamental principles of the EC banking legislation namely essential harmonization, mutual recognition and home country supervision have been inserted in the Second Banking Directive. Together with the concept of consolidated supervision, these principles constitute the foundations for the EC internal banking market.[132]

The Directive has introduced, among others, two limits on banks' holdings in non-banking institutions. First, a credit institution is not allowed to have a qualifying holding (one with at least 10% of the outstanding shares or voting rights in an individual non-bank) exceeding 15% of its equity. Second, the amount of all such holdings may not exceed 60% of credit institution's equity.

It can be said that freedom of establishment and freedom of provision of services have been facilitated by the Second Banking Directive. This removes various national barriers and also coordinates some of the basic prudential regulations with which banks must comply. An important aspect of this liberalization and coordination process is that it is based upon three major principles namely the Essential Harmonization, Mutual Recognition and Home Country Supervision, initially introduced under the White Paper of 1985, on how to set up the regulatory structure.

Under the Second Banking Directive, the **Principle of Mutual Recognition** has replaced the principle of full harmonization. The legal basis of this approach can be found in the earlier milestone decision rendered by the European Court of Justice in *Cassis de Dijon*. Accordingly, it is accepted under the Directive that when a financial product has been manufactured and marketed in accordance with the legislation of a Member State such product may be freely offered for sale throughout the EC regardless of the specifications obtaining in the countries of destination.

The agreed list of banking activities are subject to the Principle of Mutual Recognition and a host country must allow non-domestic EC banks free access to its banking market.

[132] Panourgias, ibid., pg. 139.

However, contrary to the areas of market access and prudential regulation, the regulation of market practices to a large extent is left untouched by the Second Banking Directive, and except with respect to conduct of business rules, substantial harmonization in the said field has not been realized.[133] The list set forth under the Second Banking Directive covers all major commercial and investment banking activities, implicating the endorsement of universal banking. As a result, in addition to the traditional commercial banking activities, credit institutions, as defined under the Directive, can engage in all forms of transactions in securities, including transactions for their own account or for the account of customers in all types of security, participation in share issues and the provision of services related to such issues, and portfolio management and advice.[134] It seems that the so-called German model (universal bank) is being followed. The most characteristic feature of German financial institutions is that they are allowed, by the Act on the Supervision of Financial Institutions dated 1961, and since modern banking started in Germany in the course of the last century have always been allowed, to carry on simultaneously all kinds of financial transactions, thereby being free to operate under the system of "universal banking". In other words, in Germany, there is no legal division between commercial and investment banks.[135] Hence, once a bank has obtained from its home Member State regulator authorization for any of these activities, the host Member State cannot prevent the pursuit of such activities by that bank in its territory even if its own local banks are not permitted to pursue them.[136]

With respect to the **Principle of Essential Harmonization**, the Second Banking Directive envisages a different strategic approach than the earlier legislative efforts. Under the Directive, harmonization would be achieved only in selective essential areas of prudential and regulatory concern. The core issues on which harmonization was judged necessary may be summarized as the following: own funds and solvency ratios, reorganization and winding-up rules, a minimum list of authorized services, and the rules governing supervision.[137] The harmonization of minimum supervisory standards under the Principle of Essential Harmonization enables supervision of the credit institutions by the home country and the implementation of the Principle of Mutual Recognition.

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[133] Tison, ibid., pg. 357.
[134] Benink & Benston, ibid., pg. 3.
[135] Ulrich Koch, "The System of Universal Banking (Germany)", published in European Banking Law: The Banker – Customer Relationship, edited by Ross Cranston, Lloyd's of London Press Ltd., London, UK, 1993, pg. 62.
[136] Lomnicka, ibid., pg. 308.
[137] Geert Wils, "The Concept of Reciprocity in EEC Law", Common Market Law Review 28, 1991, pg. 263-264.

In other words, even after the Second Banking Directive, which does not clarify banking regulation objectives, the EC has still no own regulatory system (in terms of supervisor and prudential rules) or even full harmonization in the domestic supervisory regimes. It proved impossible to achieve the foregoing.[138] EC has in fact only a distribution of powers between home and host regulator operating under their own national legislation, therefore always between domestic regulatory regimes albeit with some harmonization principles through the EC directives. This has nevertheless proved decisive progress and allowed the single license for intermediaries in the financial services industries to emerge largely under their own legislations and own (home) supervisor (with the regulatory competition connected to it), except for the conduct of consumer business with basically remains under host country supervision.[139] Further, the lack of hierarchy and clear allocation of responsibilities between the home and the host country had the potential to create specific problems of regulatory and supervisory management as well as political drift.

Nevertheless, one commentator underlines that, although under Article 52 of the Treaty of Rome it is provided for the abolition of restrictions on the setting up of agencies, branches or subsidiaries, the Second Banking Directive has failed to allow a bank to establish a subsidiary in another Member State without obtaining a separate authorization for that subsidiary.[140] Further, branch of a credit institution may invoke in the host Member State the mutual recognition of the home Member State rules on e.g. distance selling or tied product offers, against the application of the host Member State's rules, unless the latter satisfy the general good test.[141]

Another important point to underline is that the Directive does not provide a reference to and therefore it seems that there is a lack of regulation regarding the content and procedure of the measures that host Member State can take with respect to the credit institutions insisting to violate the provisions of the Directive in particular the rules and principles laid down in Article 21 of the Directive. This may lead breaches to the principle of legal security.[142]

One of the other major issues to be underlined within the context of the analysis of the Second Banking Directive is the "*reciprocity*". To the extent that the subsidiaries of non-EC financial institutions established in one EC country were set to benefit from the new

[138] Dalhuisen, ibid., pg. 285.
[139] Dalhuisen, ibid., pg. 286.
[140] Strivens, ibid., pg. 295.
[141] Tison, ibid., pg. 358.
[142] Gonzales, ibid., pg. 23.

opportunities, a problem of reciprocity was seen as arising.[143] The solution found by the Second Banking Directive guarantees the Principle of Home Country Supervision and thus for some issues there is no equal treatment of financial institutions irrespective of their home base. Similar to the legislation governing the production of goods, the EC reasoning is that the prospect of legislation for supervising only the local producers will deter protectionist overregulation or misplaced administrative enthusiasm.[144]

It is also necessary to underline the concept of general good as reflected under the Second Banking Directive. Although, the Directive does not provide a definition of the concept of general good, it makes reference to the concept of general good in its various articles, i.e. Articles 19 and 21 of the Directive.

In light of the above novelties introduced by the Second Banking Directive, it is clear that the Directive can be interpreted as a very important tool in the direction of internal market in the EC banking sector. Nevertheless, the Directive can be criticized for various reasons. Firstly, under certain provisions of the Directive, it can be argued that the following are still necessary and prerequisite before the single market can be achieved:[145]

- a more substantial convergence of the Member States' monetary policy,
- a precise description of the content of the common monetary policy,
- the continuation of efforts to harmonize national legislations in the key sectors including the rules for calculating and supervising the liquidity of credit institutions, and
- the close and regular cooperation between the competent authorities of the Member States.

Moreover, limited areas of home country rules still remained. Accordingly, the EC approach adopted in the Second Banking Directive can be characterized as an attempt to allow partially for competition between administrative supervision systems.[146] The Second Banking Directive is also criticized for not clarifying the objectives of the banking regulation. The note of confusion on the true objective of modern banking regulation has a major importance. On the other hand, this must be seen within the context of the prime objective of

[143] Geert Wils, The Concept of Reciprocity in EEC Law, Common Market Law Review 28, (1991), pg. 263-264.
[144] Wils, ibid., pg. 265.
[145] Gonzales, ibid., pg. 20.
[146] Norbert Reich, "Competition Between Legal Orders: A New Paradigm of EC Law ?", Common Market Law Review (29), 1992, pg. 868.

the Second Banking Directive namely the dividing the role of home and host country regulators.[147] This final item has lead to regulatory competition under a system of mutual recognition of home country standards of authorization, capital and supervision for cross-border activities within the EC.[148] Consequently, it resulted in the single banking license for financial service providers established in the EC are subject to proper authorization and supervision in their home state. The single license idea with the divided supervision between home and host country regulators is not an illogical system but has some imperfections.[149] Accordingly, it can be said that the Directive does not fully settle the issue of the allocation of the roles between home Member State competent authorities and host Member State competent authorities. The Directive can also be criticized for not tackling with the challenges presented by modern electronic methods of attracting and doing business which require approaches which are not territorially focused.[150]

In light of the foregoing analysis, it may be concluded that the system established by the Second Banking Directive and the other legislative measures in the banking industry forms the basis for more effective exercise by banks of the rights of establishment and the freedom to provide services. The Directive has established the single banking license eliminating barriers, like host country authorization and endowment capital requirements, to cross-border bank branching and provision of financial services. Without creating a European banking license, the Second Banking Directive has allowed credit institutions authorized in a Member State to open branches and to provide cross-border financial services in another Member State by simply complying with a notification requirement while they are subject to home country prudential supervision. A bank is allowed through its branch conduct activities listed in the Annex of the Directive and for which it is licensed in the Member State of the initial authorization. In addition, the powers of the host Member States to impose their general good rules within the general good exception are clarified in the Second Banking Directive and the Directive enables the host Member State to take appropriate measures to prevent or to punish irregularities which are contrary to the general good rules.[151]

Nonetheless, the progress achieved under the Second Banking Directive may be viewed as limited. According to one commentator, after the Second Banking Directive and the subsequent related directives introducing, among others, certain amendments to the

[147] Dalhuisen, ibid., pg. 289.
[148] Dalhuisen, ibid., pg. 818.
[149] Dalhuisen, ibid., pg. 287.
[150] Lomnicka, ibid., pg. 296.
[151] Tison, ibid., pg. 364.

Second Banking Directive, there is no own regulatory system (in terms of supervisor and prudential rules) or even full harmonization in the domestic supervisory regimes. It proved impossible to achieve.[152]

Consequently, it can be said that the Second Banking Directive has provided the powerful legal instruments towards a European banking market without trade barriers, discriminatory or not, on the basis of essential harmonization, mutual recognition and home country supervision. Furthermore, the Second Banking Directive seems to form the cornerstone of all directives for the business of credit institutions in the context achieving a single EC banking market.

Finally the Second Banking Directive does not state clear banking regulation objectives. This must be seen, however, within the context of its prime objective of dividing the role of home and host regulator.[153]

[152] Dalhuisen, ibid., pg. 285.
[153] Dalhuisen, ibid., pg. 289.

VI. Developments Following the Second Banking Directive

As discussed above, the White Paper, the Single European Act and the subsequent directives provided a secure prudential environment for the financial institutions. Although progress towards the completion of the single market following the Single European Act has been most evident in the area of free movement of goods, EC financial markets remain still segmented to a certain extent. The Single European Act addresses the four freedoms set out in the EC Treaty, including the free movement of services. Nonetheless, progress reports prepared by the EC Commission on the internal market since 1992 commented on the lack of a single market in financial services and contemplated measures which now form part of the Financial Services Action Plan ("FSAP").[154]

The introduction of the Euro on 1 January 1999[155] provided support to establish the conditions necessary for the successful completion of the single market in financial services. With this in mind, and in recognition of the changing financial landscape, the Cardiff European Council of June 1998 invited the European Commission to table a framework for action to improve the single market in financial services.[156] This is considered as the political birth of the FSAP. The major motivation behind the FSAP was economic and it was believed that the successful completion of the single market in the field of financial services would bring substantial economic gains to the EC.[157]

The EC Commission responded to the Cardiff Council's invitation by publishing a paper "Financial Services: building a framework for action" (the "Framework Paper") which was intended to act as the basis for establishing a clear set of priorities for future work. Following its discussions and meetings on its Framework Paper, the Financial Services Action Plan is adopted by the European Commission on 11 May 1999 and is endorsed by the European Council in June 1999, March 2000 and March 2001. In its meetings the European Council set 2005 as the deadline for implementation of the FSAP and the integration of the financial markets.

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[154] Karen Connolly, "The Financial Services Action Plan" published in A Practitioner's Guide to EU Financial Services Directives by Freshfields Bruckhaus Deringer, edited by Michael Raffan, City & Financial Publishing, First Edition, Surrey, UK, 2003, pg. 28.

[155] The Euro became the legal means of payment (along with the currencies of the participating Member States during the transitional period) in the Euro countries. It was already, since 1 January 1999, the official book money for the participating countries.

[156] Avgerinos, ibid., pg. 45.

[157] Connolly, ibid., pg. 29.

The FSAP sets out a plan toward a Single Market for financial services. It prescribes measures for **further harmonization and reduction of regulatory barriers**, while it stresses the importance of "state-of-the-art" prudential regulation and supervision.[158]

The FSAP therefore outlined a series of measures aimed at ensuring that the EC's financial services sector realized its full potential against the background of the introduction of the Euro and would be capable of sustaining competitiveness in the long term.

As discussed above, a wide range of legislative tools and procedures is available to the EC institutions for the creation of EC legislation and the Financial Services Action Plan is being instituted by means of a number of these legal instruments. The Financial Services Action Plan contained key measures to deliver an integrated financial market which delivers real benefits to business and consumers.[159] It recommends priorities and timescales for legislative and other measures to address three major strategic objectives:[160]

(a) completing a single market for wholesale financial services;

(b) developing open and secure retail markets; and

(c) Ensuring the continued stability of EC financial markets through adequate prudential rules and supervision.

In relation to the (c) above, the Commission has believed that effective and supervisory regimes are central to the effective functioning of the internal market in financial services. It has emphasized that EC regulatory safeguards need to be flexible to ensure that they can be kept up to date to reflect new sources of risk and take account of market developments. The FSAP has certainly provided support to focus political will and advance reform. A large number of new legislative measures designed to facilitate the creation of a single market in financial services have already been adopted and several existing directives have been amended.[161]

It is important to note that the FSAP has been followed by a number of other action plans, communications and reports prepared by the Commission. For example, the Commission issued a communication on 11 May 1999 entitled "Implementing the Framework for Financial Markets: Action Plan".[162]

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[158] Panourgias, ibid., pg. 38-39.
[159] Chris Bates, "European Regulator: Time to Deliver", Butterworths Journal of International Banking and Financial Law – February 2002, pg. 65.
[160] Connolly, ibid., pg. 33.
[161] Connolly, ibid., pg. 48.
[162] Commission Communication of 11 May 1999 entitled "Implementing the framework for financial markets: action plan" [COM(1999) 232 final - Not published in the Official Journal.

The said action plan follows on from the Communication of 28 October 1998 entitled "Financial services: building a framework for action". It was presented at the request of the European Council, meeting in Vienna in December 1998, which invited the Commission to draw up a programme of urgent work to achieve the objectives set out in the framework for action, on which a consensus had emerged. It is also based on the discussions held within the Financial Services Policy Group (FSPG), composed of personal representatives of the finance ministers and the European Central Bank (ECB).

At its meeting in Cologne on 3 and 4 June 1999, the European Council requested the Commission to continue the work undertaken on the action plan within the FSPG. The action plan for a single financial market puts forward indicative priorities and a timetable for specific measures to achieve three strategic objectives, namely establishing a single market in wholesale financial services, making retail markets open and secure and strengthening the rules on prudential supervision.[163]

Several initiatives related to this action plan but distinct from it are covered by this integrated approach:

- the 1999 Financial Services Action Plan;
- the 2000 financial reporting strategy ;
- the 2002 communication on corporate social responsibility ;
- the communication on industrial policy in an enlarged Europe ;
- the communication on the priorities for the statutory audit in the EC;
- Commission staff working document, of 5 January 2006, "Single Market in Financial Services Progress Report 2004-2005". This report mentions, among others, progress made in adopting:
- the Capital Adequacy Directive;
- the Reinsurance Directive;
- the Fifth Motor Insurance Directive;
- the Directive on cross-border mergers;
- the Eighth Company Law Directive on statutory audit;
- the Third Money Laundering Directive;
- the Green Paper on financial services policy introduced by the EC Commission in May 2005 and the following White Paper issued by the EC Commission in December 2005. Both the Green Paper and the White Paper attempted to develop ideas for the

[163] http://europa.eu/scadplus/leg/en/lvb/l24210.htm (19 February 2009).

further integration of EC financial markets with the focus on consolidation and implementation of the existing rules already under the Financial Services Action Plan and on cooperation rather than proposing new laws as such.[164]

[164] Walker, ibid., pg. 272.

VII. The Directive 2000/12/EC (Banking Consolidation Directive)

1. General

The Second Banking (Coordination) Directive together with the related directives was replaced by the Banking Consolidation Directive of 2000. The Directive 2000/12/EC, relating to the taking up and pursuit of the business of credit institutions, or the so-called **Banking Consolidation Directive** (the "BCD") is the major EC legislation coordinating the banking activities within the Community.[165] The BCD combines the text of a number of earlier banking and capital directives. It is merely consolidatory and did not change the substance of the directives it has replaced.[166]

According to its recitals, the directives consolidated under the Banking Consolidation Directive are as follows:

(i) Banking Directive 73/83/EEC;
(ii) First Banking Directive 77/780/EEC;
(iii) Own Funds Directive 89/299/EEC;
(iv) Second Banking Directive 89/646/EEC;
(v) Solvency Ratio Directive 89/647/EEC;
(vi) Consolidated Supervision Directive 92/30/EEC; and
(vii) Large Exposures Directive 92/121/EEC.

The Banking Consolidation Directive in its recitals[167] states that the scope of the measures for the coordination of credit institutions should be as broad as possible to cover all institutions whose businesses to receive repayable funds from the public and to grant credits for their own account. The BCD' recitals also provide that without prejudice to the application of national laws which provide for special supplementary authorizations permitting credit institutions to carry on specific activities or undertake specific kinds of operations. Furthermore, according to its recitals, the Banking Consolidation Directive has

[165] For the sake of clarity, the Second Banking Directive, as amended, has been codified and combined along with a number of other directives in the Banking Consolidation Directive.
[166] E.P.Ellinger, E.Lomnicka and R.J.A. Hooley, Modern Banking Law, 3rd Edition, Oxford University Press, Oxford, UK, 2002, pg. 52.
[167] 6th Recital of the Directive.

the aim to achieve only the **essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision** systems of credit institutions.

The BCD contains a mutual recognition concept under which a credit institution is entitled in many instances to conduct business throughout the Community without the need to have prior authorization in each Member State. Following being authorized in its home Member State, a credit institution may obtain a passport to provide banking and investment services in other Member States. As will be discussed below, other Member States are defined as host Member States under the Directive. Credit institutions may also establish branches in the host Member States without the need for an additional authorization in either case.

The Home Member State's authorities are responsible for granting the initial authorization for credit institutions and exercising prudential supervision in accordance with the legal requirements. The Banking Consolidation Directive sets forth the minimum prudential requirements which the Home Member State must necessitate in order to protect depositors and investors. Within this framework, a credit institution is required to have authorization in accordance with these minimum standards irrespective of whether it intends to take advantage of the passport to provide services in other Member States.

2. Credit Institutions and Authorization

In **Article 1** of the Banking Consolidation Directive, a credit institution is defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or an electronic money institution within the meaning of the Directive 2000/46/EC.

Article 3 of the BCD requires the Member States to impose a general prohibition on persons or undertakings that are not credit institutions to stop them carrying on the business of taking deposits or other repayable funds from the public. Nonetheless, the said Article also introduces a number of exceptions (i.e. central or local governments' receipt of deposits etc.) to this prohibition.

Starting from its **Article 4**, the Directive lays down the requirements for the taking up and pursuit of the business of credit institutions. The BCD sets forth certain minimum prudential requirements which must be met for initial authorization to be granted. Such minimum prudential requirements can be summarized as follows:[168]

(i) the credit institution must have adequate initial capital – generally at least €5.000.000 (Article 5);

(ii) the direction of the credit institution's business must be in the hands of at least two persons, each of whom satisfies the "good repute and sufficient experience" test (Article 6(1));

(iii) where a credit institution has a registered office, this must be in the same Member State as its head office, and where it does not have a registered office then its head office must be in the Member State which issued its authorization and in which it actually carries on its business (Article 6(2));

(iv) the credit institution must provide to the relevant competent authority information about the identities and holdings of its larger shareholders (Article 7); and

(v) the credit institution must also provide a program of operations covering the business proposed and the organization of the institution (Article 8).

[168] Mac Mackenzie, "The Banking Consolidation Directive" published in "A Practitioner's Guide to EU Financial Services Directives" by Freshfields Bruckhaus Deringer, edited by Michael Raffan, City & Financial Publishing, 1st Edition, Surrey, UK, 2003, pg. 54-55.

The effect of the item (iii) above, regulated under Article 6(2) of the BCD, is that the BCD is applicable only to credit institutions which have their registered and/or head office in the EC. Accordingly, the authorization must be granted by the Member State in which an institution has its registered office (or head office if it has no registered office).

Under the BCD, the "qualifying holdings" is defined as a direct or indirect holding of 10% or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of the institution. In order to be granted authorization, any applicant must disclose in its application to be filed with the relevant authority the qualifying holdings. Article 7 of the BCD also provides that competent authorities must withhold authorization where any close links which an institution has with any person, or the laws and procedures of any non-EC Member State governing such a person, would prevent the effective supervision of the institution.

As per Article 17 of the BCD, Home Member State's competent authorities must also require that every credit institution has sound administrative and accounting procedures and adequate internal control mechanisms.

In Article 14 of the Directive, the circumstances in which competent authorities may withdraw the authorization issued to a credit institution are listed. These circumstances can be summarized as follows:[169]

(i) the institution does not make use of the authorization within 12 months, expressly renounces the authorization or has ceased to engage in business for more than 6 months;
(ii) the institution has obtained the authorization through false statements or any other irregular means;
(iii) the institution no longer performs the conditions under which authorization was granted; or
(iv) the institution falls within one of the other categories where national law provides for withdrawal of authorization.

Finally, pursuant to Article 12 of the BCD, where an institution applying for authorization in a Member State is a part of a group of undertakings which already contains

[169] Mackenzie, ibid., pg. 54-55.

credit institutions authorized in other Member States, then the competent authorities of the Member State which has been requested to grant the authorization must consult with the other Member States concerned.

3. Single License (Passport)

According to Article 18 of the Banking Consolidation Directive, the Member States are required to provide that the activities listed in Annex 1 of the Directive may be carried on within their territorities either by the establishment of a branch or by way of the provision of services, by any credit institution authorized and supervised by the competent authorities of another Member State, provided however that such activities are covered by the authorization.

One may conclude that the foregoing provisions of the BCD reflect the **Principle of Mutual Recognition**. The provisions of the BCD require the host Member States to respect the authorization granted by the Home Member State and the ongoing supervision of the authorities of the Home Member State.

As also repeated in the Directive 2006/48/EC, which will be discussed below, the recitals of the BCD provide that the Member States should ensure that there are no obstacles to carrying on activities receiving **mutual recognition** in the same manner as in the home Member State, as long as the latter do not conflict with legal provisions protecting the general good in the host Member State.[170]

Under Article 19 of the Directive, the scope of this so-called "single banking license" is extended to a subsidiary of a credit institution if the subsidiary is subject to consolidated supervision with the parent and if certain conditions are complied with. A subsidiary is normally fully subject to the host country legislation. This is mainly because the subsidiary is legally separate legal entity having its legal personality and incorporated in the host country. Accordingly, insolvency of the parent bank does not entail insolvency of the subsidiary bank.

Nonetheless, it is noted that the activity of a foreign subsidiary bank raises a number of special concerns, which may justify its discriminatory treatment by the host regulator. Initially, the parent-subsidiary relationship may cause home country regulator deficiencies to be of concern. To the extent that the subsidiary looks at the parent for capital support or that transactions between subsidiary and parent are not always at arm's length, regulation of the parent bank becomes of interest for the host country regulator. Similar concerns arise if problems in the parent bank put the financial health of the subsidiary at risk.[171] Furthermore, there may be problems in the supervision of the subsidiary when the home country authority in charge of consolidated supervision for the parent bank is not the same as the home country

[170] Recital 17 of the Banking Consolidation Directive and Recital 18 of the Directive 2006/48/EC.
[171] Panourgias, ibid., pg. 91.

authority in charge of consolidated supervision for the banking group that owns or controls the parent bank.[172]

The activities listed in Annex I to the BCD are as follows:

(a) Acceptance of deposits and other repayable funds from the public.
(b) Lending, including, consumer credit, mortgage credit, factoring, and financing of commercial transactions.
(c) Financial leasing.
(d) Money transmission services.
(e) Guarantees and commitments.
(f) Trading for own account or for account of customers in money market instruments, money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments and transferable securities.
(g) Participation in share issues and the provision of services related to such issues.
(h) Advice to undertakings on capital structure, industrial strategy, and related questions and advice and services relating to mergers and the purchase of undertakings.
(i) Money broking.
(j) Portfolio management and advice.
(k) Safekeeping and administration of securities.
(l) Credit reference services.
(m) Safe-custody services.

The scope of the license granted by the national authorities of the home Member State is not limited to the activities which define a credit institution. The license is instead available for any of the listed activities, mentioned above, provided that such activities are covered by the authorization of the credit institution. Hence, if a bank is expressly authorized to carry on a listed activity in a Member State, it can rely on the single license to carry on this activity in another Member State. Nonetheless, such bank is not authorized to carry on a listed activity in another Member State for which it is not expressly authorized to carry on in its home Member State under its license granted by its home Member State.

A commentator summarizes the situation for UK banks as follows. A UK bank is deemed to be authorized in the UK to provide (and therefore able to passport out of the UK)

[172] Panourgias, ibid., pg. 92.

any listed service which it is lawful for it to carry on in the UK and this could cover the listed services which do not themselves require authorization in the UK (i.e. non-consumer lending). Nonetheless, where in contrast a bank's authorization does not cover a listed activity for which authorization is required in the home Member State, then the bank could not carry out that activity in another Member State in reliance on the single license. For example, if a UK bank's license under the relevant legislation does not include dealing in i.e. derivatives, then that bank could not passport activities under the Annex I of the BCD namely derivatives. Further, the license would also not be available in respect of activities for which a credit institution is authorized in its home Member State but which are not listed in Annex I of the BCD.[173]

On the other hand, the foregoing does not restrict the rights of the credit institutions arising from the EC Treaty regarding basic freedoms of establishment and to provide services even these rights are not regulated under the BCD. This is also restated under the BCD in its recital 14 which provides that the carrying on of the activities which are not listed in the Annex I of the BCD enjoys the right of establishment and the freedom to provide services under the general provisions of the EC Treaty.

In addition to the above, recital 16 of the BCD provides that a host Member State may require compliance with specific provisions of its own national laws or regulations (i) by institutions not authorized as credit institutions in their home Member States; and (ii) for activities not listed in Annex I of the BCD provided that (i) such provisions are compatible with the EC law and are intended to protect the general good; and (ii) such institutions or such activities are not subject to equivalent rules under the relevant legislation of their home Member States.

It is important to add that the single license concept does not introduce single European license concept. In other words, the authorization for starting-up business rests with the relevant home country.

[173] Mackenzie, ibid., pg. 58-59.

4. Branch and Cross Border Services and Supervision

A credit institution of a Member State faces a complex decision of whether to conduct full service banking operations in another Member State through an unrestricted branch or branches, through a bank subsidiary, or through both.[174] The decision would depend principally on the bank's business objectives. Nonetheless, bank regulatory and other legal considerations also are important. In the absence of compelling business reasons, the net effect of bank regulatory considerations still leads most foreign banks to conduct their full service banking operations in another Member State. Nonetheless, the choice between an unrestricted branch and a bank subsidiary is not exclusive. According commentators, in the United States of America, it is indeed, by using both a branch and a bank subsidiary; a foreign bank could operate more effectively in both the wholesale and the retail banking markets.[175]

The EC Treaty contains various provisions concerning one of the major freedoms regulated under the Treaty namely right of establishment. The right of establishment as regulated under the EC Treaty is based on the assumption that presence is a **non-temporary (or permanent)** presence in the host Member State. Under the EC Treaty, where a credit institution maintains a permanent presence in another EC Member State in which it provides services, it comes, in principle, under the right of establishment. This is the case where a person pursues a professional activity on a stable and continuous basis in another Member State from an established professional base.[176]

The BCD defines "**branch**" as *a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions*. Article 20 of the BCD lays down the procedure for the establishment of a branch. A credit institution wishing to establish a branch in another Member State must provide certain information to the relevant national authority in its home Member State. The competent national authority then has a period of 3 months in which to do either (a) to notify the relevant competent authority of the host Member State of the institution's intention to establish a branch presence; or (b) to refuse to submit that

[174] There are various cross-border banking groups within the EU including, among others, Banco Santander Central Hispano, BNP Paribas, Commerzbank, Crédit Agricole, Deutsche Bank, Dexia, Erste Bank, Fortis, ING, Intesa Sanpaolo Group, KBC, National Bank of Greece, Nordea, Raiffeisen Zentralbank, SEB, Societé Générale, Unicredit etc. (Annual Report 2007 of the Committee of European Banking Supervisors).
[175] Michael Gruson and Ralph Reisner, Regulation of Foreign Banks, Butterworth Legal Publishers, Washington DC, USA, 1991, pg. 1-16.
[176] Mackenzie, ibid., pg. 61.

notification if it doubts the adequacy of the institution's administrative structure or its financial situation, having regard to the activities envisaged. A refusal must be subject to a right of appeal to the courts of the home Member State. It must be noted that as per Recital 9 of the BCD Member States' competent authorities should not grant or should withdraw authorization where factors such as content of the activities programs, the geographical distribution or the activities actually carried on indicate clearly that a credit institution has opted for the legal system of a Member State for the purpose of evading the stricter standards in force in another Member State within those territory it carries on or intends to carry on the greater part of its activities. Accordingly, the BCD does **not prohibit the so-called forum shopping**.

On receipt of the notification, the competent authority of the host Member State then has 2 months in which to prepare for the supervision of the new branch. At the expiry of that two-month period (or earlier, if the host authority makes early notification to the credit institution), the credit institution is entitled to commence its listed activities from its new branch presence.

The powers of the host Member State are limited to impose regulation on the institution's business conducted through the branch. Under Article 20(4) of the BCD, host Member States may specify in relation to a proposal to carry on activities in that state through a branch, the conditions under which, in the interest of the general good, those activities must be carried on in the host Member State.

As per Article 22 of the BCD, **host Member States** also have certain additional powers. These powers include the authority to require that all credit institutions having branches within a host Member State's territory **report periodically** for statistical purposes on their activities in that Member State. Article 22 of the BCD further provides that the provisions of Article 22 shall not prevent credit institutions with head offices in other Member States from advertising their services through all available means of communication in the host Member State, subject to any rules governing the form and the content of such advertising adopted in the interest of the general good. On the other hand, Article generally deals with the mechanisms by which a host Member State can enforce the rules which, under the Directive, it is able to impose on credit institutions with branches in or providing services in its territory.

Host Member States have limited power to make rules which are not subject to the general good constraint. The rules of the host Member State may be characterized as being

made for the general good under the EC legislation, the rules allegedly in the **general good** must:[177]

- be non-discriminatory;
- be justified by imperative requirements in the general interest (and must not go beyond the harmonized areas of the BCD);
- be suitable for securing the attainment of the objective which they pursue;
- be non-duplicative of measures in the home Member State; and
- not go beyond what is necessary to achieve the objective pursued.

The European Court of Justice has so far recognized the following objectives as being imperative reasons in the general good:[178]

- protection of the recipient of services;
- protection of workers, including social protection;
- consumer protection;
- preservation of the good reputation of the national financial sector;
- prevention of fraud;
- social order;
- protection of intellectual property;
- cultural policy;
- preservation of the national historical and artistic heritage;
- cohesion of the tax system;
- road safety;
- protection of creditors; and
- protection of the proper administration of justice.

On the other hand, the freedom to provide cross-border services can also be exercised where a credit institution "**temporarily pursues**" its activities in another Member State. The

[177] Mackenzie, ibid., pg. 64.
[178] Mackenzie, ibid, pg. 64.

European Court of Justice has held that the temporary nature of a supply of services is to be determined in the light of its duration, regularity, periodicity and continuity.[179]

Article 21 of the BCD lays down the provision of cross-border services. The procedure requires is summarized as follows:

(i) the credit institution must notify the competent authority of its home Member State of its desire to initiate the provision of any listed activity;

(ii) the home Member State's competent authority has maximum 1 month after that in which to forward the notification to the relevant authorities in the EC Member States in which the credit institution proposes to carry on listed activities on a cross-border basis (the host Member State).

As mentioned above, the prudential supervision of a credit institution including any passported branches is the responsibility of the competent authorities of the home Member State. Nonetheless, certain powers relating to the supervision are reserved to the host Member States' competent authorities and to the operation of the consolidated supervision provisions of the BCD. The host Member States' competent authorities continue to hold the power to supervise the liquidity of branches of credit institutions (albeit in cooperation with the competent authorities of the home Member State) and for measures resulting from the implementation of monetary policy.

The BCD also requires the competent authorities of the Member States to collaborate closely in order to supervise the activities of credit institutions operating in one or more Member States other than that in which their head offices are situated. They must supply each other with information likely to facilitate their supervision and the examination of the conditions for their authorization and the monitoring of such institutions. The duty of confidence does not prevent competent authorities from exchanging information with the competent authorities of other Member States. Nonetheless, information received by a competent authority can, broadly, only be used in the performance of supervisory duties or in connection with civil proceedings arising under the BCD.

Subject to informing the host Member State authorities, the competent authorities of the home Member States are allowed to conduct on-the-spot verifications of branches for the purpose of verifying supervisory information. According to Articles 29(2) and 56(7) of the

[179] Mackenzie, ibid., pg. 60-61.

BCD, the home Member State authority also has the ability to request a host Member State to verify branch information and that authority must then either do so or allow the home Member State authority or an expert to do so.

The BCD also contains provisions covering the technical instruments of prudential supervision and consolidated supervision and relate in essence to the capital adequacy requirements of a credit institution. Article 51 of the BCD provides that a credit institution may not have:

(a) a qualifying holding the amount of which exceeds the 15% of its own funds in a single undertaking which is not a credit institution, or a financial institution, or an undertaking the activities of which are a direct extension of banking or concern services ancillary to banking; and
(b) the total amount of a credit institution's qualifying holdings in such undertakings may not exceed 60% of its own funds.

Articles 34 to 38 of the BCD lay down requirements in relation to the amount and type of capital that an EC credit institution must have. The rules require a minimum amount of capital to be held, but do not restrict a credit institution from holding additional capital. The level of an institution's capital which is permitted to be counted for regulatory purposes is determined by reference to an institution's core capital (known as "tier one capital") and supplementary capital (known as "tier two capital").[180] The issue important for the purposes of this study is that the capital requirements laid down under the BCD are minimum requirements and the competent authorities may choose to impose higher requirements.

The situations for further disclosure are summarized under Article 30 of the BCD as follows:

(i) exchanges of information between the banking supervisor and certain other financial authorities of regardless whether the same or other Member States;
(ii) exchanges of information between the competent authorities and the authorities or bodies responsible under the law for the detection and investigation of breaches of company law;

[180] Melanie Fitzsimons, "Directives Governing the Capital Framework for Banks and Investment Firms" published in A Practitioner's Guide to EU Financial Services Directives by Freshfields Bruckhaus Deringer, edited by Michael Raffan, City & Financial Publishing, 1st Edition, Surrey, UK, 2003, pg. 268.

(iii) disclosure to a clearing house or other similar body recognized under national law for the provision of clearing or settlement services for one of their Member States' markets if this is considered necessary to ensure the proper functioning of those bodies in relation to defaults or potential defaults by market participants; and

(iv) the disclosure of certain information to government departments responsible for legislation on the supervision of financial services institutions and to inspectors acting on behalf of those departments, provided that such disclosures are made only where necessary for reasons of prudential control.

Finally, it is worth mentioning that in the Case C-442/02 *CaxiaBank France against Ministére de I'Economie, des Finances and de I'Industrie*, the ECJ has held that the Directive 2000/12/EC does not refer to restrictions on the establishment of companies which make use of freedom of establishment in a Member State as subsidiaries of credit institutions established in other Member States.

5. Relations with Third Countries

The BCD also contains provisions (Articles 23-25) concerning relations with third countries and these relations are essentially on the basis of reciprocity. As per Article 23 of the Directive, the Member States are required to inform the EC Commission:

(a) of any authorization of a subsidiary which has a parent undertaking governed by the laws of a third country (and whenever a third country undertaking acquires a holding in an EC credit institution such that the latter would become its subsidiary); and
(b) of any general difficulties encountered by their credit institutions in establishing themselves or carrying on banking activities in a third country.[181]

Article 23 of the BCD requires the Commission to periodically prepare a report examining the treatment accorded to EC credit institutions in third countries. The said Article also provides for certain procedures where the Commission has the view that:

(i) a third country is not granting the EC credit institutions effective market access comparable to that granted by the EC to credit institutions from that third country; or
(ii) EC credit institutions in a third country do not receive national treatment offering the same competitive opportunities as are available to domestic credit institutions.

Although the aforementioned terms "effective market access" ((i) above) and "national treatment" ((ii) above) are not defined in the BCD, the term seems to imply the existence of problems of access to the market of the country concerned by EC credit institutions and the existence of discrimination between local and foreign credit institutions respectively. The Commission submits proposals to the Council to enter into negotiations with that country if the country concerned does not provide effective market access. Nonetheless, in case of existence of national treatment, the Commission itself can initiate the negotiations and the

[181] Article 38 of the Directive 2006/48/EC which contains a similar provision states that *the competent authorities shall notify the Commission and the European Banking Committee of all authorizations for branches granted to credit institutions having their head office outside the Community*.

Member States may be required to limit or suspend their decisions regarding pending or future requests for authorizations and the acquisition of holdings by parent undertakings governed by the laws of the third country concerned.

Article 24 of the BCD states that the Member States may not apply to branches of non-EC credit institutions, when commencing or carrying on their business, provisions which result in more favourable treatment than that accorded to branches of EC credit institutions. Under the said Article 24 of the BCD, the EC may agree with a third country to apply provisions which, on the basis of the **principle of reciprocity**, accord to branches of a credit institution having its head office in that country identical treatment throughout the territory of the EC.

Article 25 of the BCD contains similar provision concerning the cooperation with third countries' competent authorities in relation to the supervision on consolidated basis.

It is also important to add that although the Banking Consolidation Directive addresses the establishment by non-EC undertakings of subsidiaries or branches in the EC, it does not address the provision of cross-border services by non-EC credit institutions. Such credit institutions clearly do not have a right to provide services into the EC, but where Member States allow the provision of cross-border services by third country credit institutions this would presumably also be subject to the provision that such institutions could not be given more favourable treatment than EC credit institutions providing cross-border services notwithstanding that the BCD does not state this explicitly.

6. Analysis

The Banking Coordination Directive has not introduced many novelties. On the other hand, it has consolidated and simplified a number of directives formerly adopted by the EC institutions in relation to the banking and financial services field. On the other hand, the Directive reflects the major principles of the EC Banking Law namely Home Country Control (Supervision), Mutual Recognition and Essential Harmonization.

Initially, it is clear that the Banking Consolidation Directive is a minimum harmonization directive. The BCD does not attempt to harmonize the banking legislations of the Member States but rather attempts to lay down the minimum standards and rules for, among others, authorization, licensing, operation and supervision of credit institutions. The national authorities of the Member States are required to comply and use their authority in accordance with these rules and standards set forth by the BCD.

Since the Directive lays down the minimum standards and rules for the regulation of credit institutions, Member States are free to impose such additional authorization requirements on the credit institutions of which they are the home Member State as they think appropriate. Nevertheless, the additional requirements to be imposed by the Member States will still be subject to the general principles of the EC law, i.e. non-discrimination etc.[182]

The other major principles namely the home country supervision and the mutual recognition are also embodied in the Directive through in a number of its provisions governing license and supervision.

Accordingly, it can be concluded that the single license concept, which is the basis of the EC approach to the harmonization of regulatory measures in the financial services sphere, has certain interrelated characteristics. The first characteristic is that an authorization (or license or passport) to carry on certain activities from their home state regulator, enables defined enterprises either to establish a branch or to provide cross-border services in the host Member State, in relation to the listed activities, without the need for further authorization. Secondly, the EC Member States have harmonized certain minimum or key standards, the implementation of which (both initially on authorization and subsequently through supervision and monitoring) they agree are the province of the home Member State.

[182] Mackenzie, ibid., pg. 56.

The Directive harmonizes minimum standards, for example, as to capital adequacy and fitness of directors, but expressly permits a Member State to impose tougher standards on its home-authorized and regulated enterprises. However, as that Member State will have to permit firms established and authorized in other Member States complying with those minimum standards to operate within its territory.[183]

The other development is achieved in relation to the setting up of new committees, namely the European Banking Committee and the Committee of European Banking Supervisors. According to the Commission, achievement of the single market in financial services has required the establishment of at two levels of advisory committees that can support and advise the Commission in connection with market regulation.[184] Hence, the European Commission has set up new banking committees at the EC level in order to improve regulation and supervision of cross-border banking in the EC. These recently established financial services committees follow the adoption of the *Lamfalussy* regulatory model[185] in EC securities regulation under which a legislative role is given to EC committees, namely the European Securities Committee, and supervisory cooperation and implementation are facilitated by a new committee of EC supervisors, the Committee of European Securities Supervisors. This model has been extended to banking (and insurance and investment funds).[186]

In the field of banking, the **European Banking Committee** (EBC) with advisory and regulatory capacity replacing the **Banking Advisory Committee**, has been set up and is attached directly to the Commission. The EBC is a legislative advisory body. There is also a new **Committee of European Banking Supervisors** which will provide advice to the Commission on technical implementing measures and will assist with supervisory cooperation and implementation. The Committee of European Banking Supervisors (CEBS) is an interface between the Commission and the national public authorities that is also responsible for the proper and uniform application of Community measures.[187] The purpose of these new banking committees is to allow EC banking regulation to respond more efficiently to theory and market developments as well as to improve implementation and supervision.[188]

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[183] http://europa.eu/scadplus/leg/en/lvb/l22025.htm (3 January 2009).
[184] http://europa.eu/scadplus/leg/en/lvb/l22025.htm (3 Januaru 2009).
[185] The Report of the Committee of Wise Men on the Regulation of European Securities Market dated 15 February 2001 is called as Lamfalussy Report.
[186] http://europa.eu/scadplus/leg/en/lvb/l22025.htm (3 January 2009).
[187] http://europa.eu/scadplus/leg/en/lvb/l22025.htm (15 November 2008).
[188] Panourgias, ibid., pg. 8-9.

Accordingly, credit institutions authorized in a Member State can set up branches and/or provide services in another Member State subject only to home country prudential supervision. Host Member States must rely on minimum prudential regulation enacted by the home country authorities after harmonization and must rely on home country authorities' prudential supervision. Further, the national supervisory authorities are expected to cooperate with each other through exchanging information and providing enforcement assistance.[189]

[189] Panourgias, ibid., pg. 141.

VIII. Directive 2006/48/EC and Analysis

1. General

In general, the directives are minimum standards directives, including the Directive 2006/48/EC, which allow Member States to impose more onerous regulatory requirements on their home undertakings, although there may be difficulties in doing this under the EC law or national law. It can be said that the Commission's White Paper of 1 December 2005 on Financial Services Policy 2005-2010 is another development in the field of banking sector until the adoption of the Directive 2006/48/EC.[190] The Paper envisaging the dynamic consolidation of financial services provided for the completion of the single market in financial services is a crucial part of the Lisbon economic reform process. In the White Paper, the Commission lays down the main aims of its policy for the next five years:

- consolidation of the progress achieved;
- completion of current measures;
- enhancement of supervisory cooperation and convergence;
- removal of the remaining barriers to integration.

The said Paper thus identifies a number of priorities, in particular the increased efficiency of the pan-European markets for long-term savings products, the completion of the internal market for retail services and a more efficient venture capital market. The Commission considered it important to strengthen the control mechanisms for the **effective application** of the Community legislation. In order to achieve this purpose, the increased cooperation between the Member States is considered necessary and to facilitate the effective monitoring of progress:

- the annual Progress Report on financial services will give an account of the overall rate of transposition and the online FSAP transposition matrix will be updated regularly;

[190] http://europa.eu/scadplus/leg/en/lvb/l33225.htm (20 September 2008).

- the transposition workshops with Member States and European regulators will continue to play a central role in the implementation of particular provisions of EC legislation;
- check sectoral consistency in the securities field;
- detect, through a study to be carried out in 2008, any inconsistencies in the information supplied in response to the requirements in the existing EC rules;
- publish a Communication/Recommendation in 2006 concerning collective investments in order to resolve uncertainties from an information angle;
- codify sixteen insurance Directives concerning the framework for the Solvency II project into a single directive;
- where any incorrect implementation of Community law is found, take appropriate action, including the opening of infringement proceedings.

Furthermore, the EC Commission considered that it is necessary to improve the transparency and comparability of financial products and to help consumers understand them better. The Community policy on the regulation and supervision of financial services is based on the four levels of the **Lamfalussy process** and the Commission has the intention to develop this process over the next five years. The key regulatory policy issues are:

- to continue the debate on comitology reform;
- to improve the system of accountability and transparency;
- to develop cross-sectoral regulatory cooperation;
- to ensure that the four levels of the Lamfalussy process respect the Better Lawmaking agenda;
- to contribute to the global convergence of standards.

In this context, it is extremely important for the supervisory authorities to cooperate and exchange information, and the Commission wishes to encourage this by:

- clarifying and optimising the responsibilities incumbent upon, respectively, the Member State of origin and the host Member State;
- exploring the possibility of delegating certain types of tasks and responsibilities;
- improving the efficiency of supervision, without increasing obligations and, consequently, reporting and information costs;

- ensuring faster and more consistent cooperation, and contributing to the development of a European supervisory culture.

2. Analysis

Following the aforementioned developments, the Banking Consolidation Directive was replaced by the Directive 2006/48/EC of the European Parliament and of the Council dated 14 June 2006 relating to the taking up and pursuit of the business of credit institutions. According to the recitals of the Directive 2006/48/EC, the adoption of the Directive was mainly due to the reason that the BCD relating to the taking up and pursuit of the business of credit institutions has been significantly amended on several occasions and now that new amendments are being made to the said Directive, it is desirable, in order to clarify matters.

The recitals of the Directive 2006/48/EC which refer to the Commission Communication of 11 May 1999 entitled "Implementing the framework for financial markets: Action Plan" and the Lisbon European Council of 23 and 24 March 2000, also state that in order to make it easier to take up and pursue the business of credit institutions, it is necessary to eliminate the most obstructive differences between the laws of the Member States as regards the rules to which these institutions are subject. The Directive constitutes the essential instrument for the achievement of the internal market from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions.

Further, there are clear references to the major principles of the EC Banking Law in the recitals of the Directive i.e. Recital 7 of the Directive states that it is appropriate It is appropriate to effect only the **essential harmonisation** necessary and sufficient to secure the **mutual recognition** of authorisation and of prudential supervision systems, making possible the granting of a **single license** recognised throughout the Community and the application of the principle of **home Member State prudential supervision**. The Recitals also state that the requirement that a program of operations be produced should be seen merely as a factor enabling the competent authorities to decide on the basis of more precise information using objective criteria. A measure of flexibility should nonetheless be possible as regards the requirements on the legal form of credit institutions concerning the protection of banking names.

In addition, the objectives of the Directive, namely the introduction of rules concerning the taking up and pursuit of the business of credit institutions, and their prudential supervision, cannot be sufficiently achieved by the Member States and can

therefore, by reason of the scale and the effects of the proposed action, be better achieved at Community level, the Community may adopt measures, in accordance with the **principle of subsidiarity** as set out in Article 5 of the Treaty. The European Council had ruled out that compliance with the principle of subsidiarity has a direct effect and national courts cannot apply the Article 5 test in the case of a national institution's or individual's complaint that a piece of EC legislation contradicts with the principle of subsidiarity.[191] The ECJ has the power to interpret the principle of subsidiarity and examine the EC institutions' compliance with the requirements of Article 5. In accordance with the **principle of proportionality**, as set out in that Article, the Directive does not go beyond what is necessary in order to achieve those objectives.

The Recitals of the Directive further provide that the **principles of Mutual Recognition** and **Home Member State Supervision** require that Member States' competent authorities must not grant or should withdraw an authorisation where factors such as the content of the activities programs, the geographical distribution of activities or the activities actually carried on indicate clearly that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within whose territory it carries on or intends to carry on the greater Part of its activities. Where there is no such clear indication, but the majority of the total assets of the entities in a banking group are located in another Member State the competent authorities of which are responsible for exercising supervision on a consolidated basis, in the context of Articles 125 and 126 responsibility for exercising supervision on a consolidated basis should be changed only with the agreement of those competent authorities. A credit institution which is a legal person should be authorised in the Member State in which it has its registered office. In addition, Member States should require that a credit institution's head office always be situated in its home Member State and that it actually operates there.

Nonetheless, the Member States may also establish stricter rules than those laid down in Article 9(1), first subparagraph, Article 9(2) and Articles 12, 19 to 21, 44 to 52, 75 and 120 to 122 of the Directive for credit institutions authorised by their competent authorities. The Member States may also require that Article 123 be complied with on an individual or other basis, and that the sub-consolidation described in Article 73(2) be applied to other levels within a group. Nonetheless, the Member States should ensure that there are no obstacles to

[191] Emilios Avgouleas, "The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection", European Law Journal, Vol.6, Blackwell Publishers, Oxford, UK, March 2000, pg. 85.

carrying on activities receiving mutual recognition in the same manner as in the home Member State, as long as the latter do not conflict with legal provisions protecting the **general good** in the host Member State.[192] Further, the Member States must ensure that there are no obstacles to carrying on activities received **mutual recognition** in the same manner as in the host Member State, as long as the latter do not conflict with legal provisions protecting the **general good** in the host Member State. The general good justification cannot be used if the particular service is subject to harmonization.[193]

The Directive also contains important provisions for **branches of credit institutions having their head office outside the EC**. According to the Directive, the rules governing branches of credit institutions having their head office outside the Community should be analogous in all Member States. It is important to provide that such rules may not be more favourable than those for branches of institutions from another Member State. The Community should be able to conclude agreements with third countries providing for the application of rules which accord such branches the same treatment throughout its territory. The branches of credit institutions authorised in third countries are not allowed to enjoy the freedom to provide services or the freedom of establishment in Member States other than those in which they are established. Accordingly, an agreement must be concluded, on the basis of reciprocity, between the Community and third countries with a view to allowing the practical exercise of consolidated supervision over the largest possible geographical area.

[192] The other important reference to the general good concept is laid down in Recital 17 of the Directive. The said Recital provides that *...the host Member State should be able, in connection with the exercise of the right of establishment and the freedom to provide services, to require compliance with specific provisions of its own national laws or regulations on the part of institutions not authorized as credit institutions in their home Member States and with regard to activities not listed in Annex I provided that, on the one hand, such provisions are compatible with Community law and are intended to protect the **general good** and that, on the other hand, such institutions or such activities are not subject to equivalent provisions under this legislation or regulations of their home Member States.*

[193] Charles Abrams, "The Investment Services Directive – who should be the principal regulator of cross-border services?" European Financial Services Law, Volume 2, Kluwer Law International, London, UK, December 1995, pg. 251.

§ 4. PRINCIPLE OF MUTUAL RECOGNITION

I. General

It is argued that the principle of Mutual Recognition has been the dominant doctrine referred to in any discussion of European integration more generally and financial integration specifically.[194] The general purpose of the Principle of Mutual Recognition is to promote market access.[195] Nonetheless, the Principle of Mutual Recognition has only some limited base in the EC Treaty. However, this gap seems to be filled by the European Court of Justice starting from its major decision in the leading case *Cassis de Dijon*. Mutual Recognition was then first expressly referred to by the Commission in its 1985 White Paper. In addition, the directives adopted within the framework of the EC Treaty following the ECJ's decision in the *Cassis de Dijon* case and the White Paper of 1985 make clear references to this major Principle which can be considered as the key doctrine within the EC integration.

The Principle of Mutual Recognition is based on the principle that goods and services emanating from one Member State should be freely allowed into other Member States. In other words, the Principle of Mutual Recognition allows products and services legally circulated in one Member State to be admitted to other Member States without being required to meet additional regulatory requirements. By virtue of the mutual recognition, not all sectors of the EC internal market needed to be harmonized, or harmonization has been restricted to the essential requirements.[196] The current underlying policy has generally moved from being based on an early approach dominated by the attempted full harmonization of all relevant measures to one based on the Mutual Recognition of agreed standards within a more limited area of selected or listed key provisions. Following the difficulties that arose in attempting to provide complete sets of common standards (full harmonization) in all of the areas set out in the earlier general programs, work has since focused on the production of more limited framework measures that only contain common minimum agreed standards in essential technical, regulatory and other public interest areas under the Mutual Recognition approach aimed to achieve European integration.[197]

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[194] Walker, ibid., pg. xi.
[195] Walker, ibid., pg. 312.
[196] Avgerinos, ibid., pg. 4.
[197] Walker, ibid., pg. 12.

Accordingly, each Member State must recognize the equivalence of corresponding measures adopted by other Member States, even when there are divergences between the measures adopted by the other Member States and its own legislation. The advantage of the Principle is that it allows the variety of products and services within the EC to be maintained, while ensuring their free movement. By applying mutual recognition, economic operators are not forced to adapt their production to the technical specifications of the host Member State. They are able to continue to provide their product or service according to the technical specifications of the home country and use mutual recognition to market their product in – potentially – all Member States of the EC.[198]

Unlike harmonization, the Principle of Mutual Recognition does not involve the transfer of regulatory powers from Member States to the EC. Instead, at least in theory, it stimulates competition among national regulators, which should provide sufficient and efficient way of assessing the costs and benefits of different methods of regulation – and thus improving them. Such assessment would also increase the range of choice for consumers.

In general, the Principle of Mutual Recognition guarantees free movement of goods and services without the need to harmonize Member States' national legislation. Goods which are lawfully produced in one Member State cannot be banned from sale on the territory of another Member State, even if they are produced to technical or quality specifications different from those applied to its own products. The only exception allowed – overriding general interest such as health, consumer or environment protection – is subject to strict conditions. The same principle applies to services.[199] Nonetheless, the "essential" (sufficient) minimum harmonization is different from the partial minimum harmonization effected by other directives enacted in the first half of the 1980s, *inter alia* in the field of misleading advertising or consumer credit. Such directives do not aim at exhaustively harmonizing what otherwise would fall under the general good powers of the Member States, but clearly only intended to achieve a partial harmonization of specific issues, leaving room for the Member States to introduce or maintain more restrictive standards.[200] In other words, the main implication of the "perfect" mutual recognition principle with respect to the market access and prudential supervision is the impossibility for the host Member State to interfere in any way in the home Member State's exclusive competence, not even on basis of the residual general good clause of the EC banking directives. However, when a credit institution wishes to act as

[198] Avgerinos, ibid., pg. 36.
[199] htttp://www.eu.int (5 February 2009).
[200] Tison, ibid., pg. 337.

an insurance intermediary in another Member State – an activity which is not included in the list of banking activities enjoying mutual recognition – the host Member State could impose its own requirements justified by the general good (e.g. rules on specific professional skills and experience with respect to insurance products).[201]

Mutual recognition can only be applied in full provided that the most essential rules are harmonized. If a product or service meets the legal requirements of any Member State, then, subject only to those requirements meeting certain EC-wide minimum standards, there should be no restriction on that product or service being sold, distributed or provided throughout the EC. There is therefore a crucial link between harmonization on the one hand and liberalization on the other. If harmonization is not established at a minimum level, then the mutual recognition principle does not work in practice. Accordingly, the thorough implementation of the Principle of Mutual Recognition is crucial in both essential and non-essential areas. This is particularly relevant in financial services. As known, financial services sector is deeply dependent upon reliability and stability for the sake and protection of both consumers and the financial system as a whole.

In general, the Principle of Mutual Recognition is against anti-competitive effects of the Member States' regulatory regimes and provides the impetus for further harmonization. As an example, a credit institution that is licensed in a Member State with a universal banking regime can conduct most of the activities listed in the Annex of the Second Banking Directive in another Member State that may not allow its credit institutions to carry out all such activities. This can have a negative effect on the competitiveness of the host country credit institutions, as they are not able to engage in activities permitted to their foreign competitors. The remedy is expected to be further harmonization through the host country allowing its credit institutions to carry on most, if not all, of the activities listed in the said Annex.[202]

This Principle of Mutual Recognition has been the main operational or policy solution adopted with regard to various difficulties.[203] It may also be argued that by virtue of the Principle of Mutual Recognition, EC policy and law making remains sensible to local and regional interests, while the maintenance of specific national characteristics is ensured.[204] Nonetheless, it is important to note that despite the importance of this major Principle, it suffers from a number of inherent policy and technical limitations. The origin, meaning and legal validity as well as content and operation of this Principle are still far from clear.

[201] Tison, ibid., pg. 355.
[202] Panourgias, ibid., pg. 37.
[203] Walker, ibid., Introduction Page.
[204] Avgerinos, ibid., pg. 4.

According to one commentator, a major element for the effective application of the Principle of Mutual Recognition is the mutual trust and commitment between Member States and national authorities, which is a crucial, and advocates of mutual recognition often do not seem to realize how demanding the principle is. It could thus, be concluded that mutual recognition is not based on any consideration of the requirements of the financial markets and as the Commission's White Paper has clarified, was considered a substandard integration mechanism required by the Council in the Commission's pursuit of common rules.[205]

[205] Avgerinos, ibid., pg. 36-37.

II. Mutual Recognition and Single Banking License

An appropriate banking and financial policy must accordingly be adopted within any regional trading system to secure proper market access, market efficiency and market stability.[206] As discussed above, the White Paper of 1985 has also announced a "new approach" by abandoning the previous, unsatisfying approach of harmonizing national laws and regulations. Instead, the EC Commission has proposed to apply to the services sector (particularly the financial services) the same approach as would be adopted for the goods sector, namely "mutual recognition and equivalence".[207]

This approach is based on the broad principle that goods lawfully produced or marketed in one Member State must be accepted in all other Member States, unless refusal to do so can be justified on grounds recognized by EC law. In order to achieve this it was proposed to reach agreement based on minimum coordination and harmonization of essential rules and standards only, because precisely these rules create barriers to trade which can be justified at national level.

Implementing this to financial services would then provide the basis for mutual recognition by Member States of what each does to safeguard the interests of the public. In developing this approach in the White Paper, the Commission has noted that its final objective is the free circulation of financial products, but that the way to attain that objective was not by drafting specific rules pertaining to the products themselves. Instead, the emphasis was laid down on minimum coordination and mutual recognition of rules for the financial institutions that generate and market those products.[208] Accordingly, in carrying out its role in the banking and financial area, mutual recognition operates by validating the effectiveness of the authorization[209] (license) held by the incoming bank or financial firm and supporting supervisory system.[210]

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[206] Walker, ibid., pg. 297.
[207] Pearson in Matijn van Empel (General Editor) René Smits (Co-Editor) Amsterdam Financial Series, Banking and EC Law Commentary (Kluwer), Kluwer Law and Taxation Publishers, Deventer, the Netherlands (1994), pg. 9.
[208] Pearson, ibid., pg. 10.
[209] Directive 2006/48/EC defines "**authorization**" as an instrument issued in any form by the authorities by which the right to carry on the business of a credit institution is granted.
[210] Walker, ibid., pg. 312.

Mutual recognition means that this authorization enables the credit institution to establish branches[211] and to provide services on a cross-border basis in any other Member State, the so-called Host Member State, without any additional authorization by the Host Member State.[212] In other words, once undertakings obtain an authorization to carry on certain listed activities from their home state regulator, the EC banking legislation state that the host Member State must allow them either to establish a branch or to provide cross-border services, in relation to the listed activities, without the need for further authorization.[213] The EC-wide effectiveness of the authorization of a credit institution[214] is commonly known as the single license. The single license reflects two of the fundamental freedoms of the Treaty of Rome – the right of establishment and the free movement of services.[215]

The "single license concept" can be considered as the concept constituting the basis of the EC approach to the harmonization of regulatory measures in the financial services sphere. The concept has **three interrelated characteristics**.[216]

First characteristic is that an authorization (or license or passport) to carry on certain activities from their home state regulator, enables defined enterprises either to establish a branch or to provide cross-border services in the host Member State, in relation to the listed activities, without the need for further authorization from any other authority of any other Member State.[217] Hence, the passport or license does not extend to permitting the establishment of subsidiaries. The subsidiaries are required to obtain their own local authorization. Nonetheless, subject to the notification requirements, once a branch has been established in a host Member State it may provide services, under the passport, within a third Member State. The exercise of the passport is subject to the notification procedures. The undertaking concerned is required to notify its home Member State regulator that it intends to exercise the passport and the home Member State regulator must then notify the host Member

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[211] Directive 2006/48/EC defines "**branch**" as a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions.

[212] Article 23 of the Directive 2006/48/EC provides that *...the Member States shall provide that the activities listed in Annex I may be carried on within their territories, in accordance with Articles ... either by the establishment of a branch or by way of the provision of services, by any credit institution authorized and supervised by the competent authorities of another Member State, provided that such activities are covered by the authorization...*

[213] Lomnicka, ibid., pg. 300.

[214] Directive 2006/48/EC defines "**credit institution**" as (i) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or (ii) an electronic money institution within the meaning of Directive 2000/46/EC.

[215] Gruson and Reisner, ibid., pg. 475.

[216] E.P.Ellinger, E.Lomnicka, R.J.A. Hooley, Modern Banking Law 3rd Edition, Oxford University Press, Oxford, UK, 2002, pg. 55.

[217] Ellinger, Lomnicka and Holley, ibid., pg. 55.

State regulator. The procedures vary depending on whether the undertaking intends to establish a branch or to provide cross-border services and there are different waiting periods.[218]

The Mutual Recognition involves the bank supervisors of the various Member States being required to consider that their respective national regulations, although not identical, offer equivalent guarantees for the supervision of banks. The principle is based on the notion of a sufficient level of minimum coordination having by then been achieved, in particular by the relevant directives (i.e. the Own Funds Directive and the Solvency Ratio Directive). The consequence of the Principle of Mutual Recognition is that the supervisors refrain from applying their own regulations to banks from other Member States operating within their territory, whether through branches or the provision of cross-border services. In effect, such banks are subjected for all their activities throughout the EC to the control of the supervisory authorities of their own Member State.[219]

On the other hand, it is clear that, in order for the Principle of Mutual Recognition to be workable, there must be cooperation between the supervisory authorities of the bank's country of origin (Home Country) and those of the other Member States where it operates, whether through branches or the provision of cross-border services.[220] Accordingly, it is this continuing element of both regulatory and supervisory compliance that mutual recognition provides basis to validate the effectiveness of both initial (authorization) and ongoing regulatory compliance within the host Member State's territory.[221]

Second characteristic is that the EC Member States must have harmonized certain minimum or key standards (Principle of Essential Harmonization), the application of which (both initially on authorization and subsequently through supervision and monitoring) they agree are the province of the home Member State. The directives in the field of banking harmonizes the minimum standards, for example, as to capital adequacy and fitness of directors, but expressly permits a Member State to impose tougher standards on its home-authorized and regulated enterprises.

However, as that state will have to permit firms established and authorized in other EC Member States complying with those minimum standards to operate within its territory, the disincentives to apply higher standards to its home enterprises are obvious. In so far as

[218] Lomnicka, ibid., pg. 300.
[219] Dassesse & Isaacs & Penn, ibid., pg. 25.
[220] Dassesse & Isaacs & Penn, ibid., pg. 26.
[221] Walker, ibid., pg. 314.

regulation inevitably imposes costs and restraints, those home enterprises will be placed at a competitive disadvantage.[222]

The **third** characteristic is that the sole competence of the home Member State to authorize its home enterprises and to exercise supervisory control over them in any EC Member State in which they operate is recognized. The host Member State has merely a complementary role in relation to liquidity and conduct of business. Accordingly, host Member States cannot impose any additional prudential obligation upon the credit institution duly authorized in another Member State (e.g. own funds requirement of any kind, fit and proper-test for managers)[223]. However, problems have arisen concerning the extent to which the host Member State can regulate activity within its borders. Thus, as will be discussed below, the drawing of the separation line between the matters which are within the competence of the home Member State and those within the competence of the host Member State is potentially a very difficult task.[224]

The aim of the EC banking legislation is to create one market in banking services, with no internal barriers to EC banks establishing branches in other parts of the EC, or in providing services cross-border. This aim is to be achieved through the Principle of Mutual Recognition. A bank established in one EC Member State has a "passport" by virtue of the EC banking legislation to establish branches, or to provide services listed in Annex I of the Directive 2006/48/EC, in other Member States. A "single license" is required, rather than licensing in each Member State. Nonetheless, it must be noted that the provisions of the Directive 2006/48/EC have the effect of excluding from the benefit of mutual recognition of authorization activities not listed in the Annex of the Directive 2006/48/EC. Therefore, in case of activities carried on by a credit institution which are not included in the Annex I, the host Member State retains the right to prohibit the exercise of such activities by the foreign bank in the interest of the general good, even if the foreign bank is validly authorized to carry on such activities in its home Member State. Nonetheless, the discretion retained by the host Member State is subject to the limitations imposed by the general rules of the EC Treaty, for example the prohibition of discrimination on grounds of nationality or place of residence and of restrictions which are disproportionate to the purpose which they seek to achieve. In such respects, the host Member State's discretion is subject to the control of the ECJ.[225]

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[222] Ellinger, Lomnicka, and Holley, ibid., pg. 56.
[223] Tison, ibid., pg. 355.
[224] Ellinger, Lomnicka and Holley, ibid., pg. 57.
[225] Dassesse & Isaacs & Penn, ibid., pg. 37.

The single banking license does not apply to a branch of a bank established outside the EC. Any bank of a third country which is not a EC Member State must incorporate a subsidiary in the EC and be licensed in at least one Member State.[226] As mentioned above, the principle of Mutual Recognition is coupled with the harmonization of certain basic prudential standards.

Under the Directive 2006/48/EC, a credit institution wishing to establish a branch in another Member State has to inform the competent authorities of its Home Member State of its intention to set up a branch in the Host Member State. This notification must be accompanied by certain information concerning the applicant, the branch, its management and in particular the program of operation of the branch. The competent authorities of the Home Member State must communicate this information and certain additional information specific to the type of institution in question to the competent authorities of the prospective Host Member State within three (3) months of receipt of the information and inform the applicant accordingly. The competent authorities of a Home Member State shall require a branch of a credit institution to have sound administrative and accounting procedures and adequate internal control mechanisms.[227]

The Home Member State may refuse to communicate such information submitted by the applicant to the Host Member State, if the competent authorities of the Home Member State have a reason to doubt the adequacy of the applicant's organizational structure or its financial situation. This is the *only measure* that can be enforced against the establishment of the branch. The Home Member State must give the applicant reasons for such refusal within three (3) months of its receipt of all information. [228] Under the Directive, such refusal of the Home Member State is subject to a right of appeal to the courts of the Home Member State.

After having received the information from the competent authorities of the Home Member State, the competent authorities of the Host Member State has a period of two (2) months to prepare for the limited Host Member State supervision. If necessary, the conditions under which, in the interest of the general good, the activities of a credit institution must be carried out in the Host Member State may be specified to credit institutions. [229]

On receipt of a communication from the Host Member State competent authorities, or in the event of expiry of the above-mentioned two (2) months period without any

[226] Ross Cranston, Principles of Banking Law (2nd Edition), Oxford University Press, Oxford, UK, 2002, pg. 433.
[227] Michael Gruson and Ralph Reisner, Regulation of Foreing Banks, Banking Laws of Major Countries and the EU, ibid., pg. 574.
[228] Gruson and Reisner, ibid., pg. 575.
[229] Gruson and Reisner, ibid., pg. 576.

communication from the Host Member State, the branch may be established and begin its activities. In the event of a change of certain information that was provided by the institution to the competent authorities of the Home Member State in connection with the notification to establish a branch, the credit institution shall notify the competent authorities of the Home Member State and of the Host Member State at least one (1) month before the institution implementing this change.[230]

It is argued that although the Principle of Mutual Recognition has proved a useful tool for the legislative process, but the technique of mutual recognition is second best when compared to coordination of national provisions. The concept also gives rise to the danger that the interest of consumer since it may be subordinated to the policy of speedy completion of the internal market and may encourage the Member States to accept the lowest common denominator in fixing the EC standard.

Further, the approach based on the principle of equivalence, as proposed in the Commission's White Paper of 1985 also raises concern. Both freedom of services and consumer protection at a high level would be served by imposing the standards of the country of origin in all countries where the services are marketed. All services would thereby be able to circulate freely within the internal market and be supervised by the authorities of the country of origin under certain standard conditions applicable, but necessarily harmonized, Community wide.[231]

The other criticism is that prudential controls established on banking institutions in every Member State, and supervised by the home country authorities, will not be adequate to protect efficiently the consumer funds deposited in a credit institution against fraud and bankruptcy. Positive integration is required to provide for such assistance as Community-wide obligatory guarantee-fund system. An approach to prudential regulations, which relies on balance-sheet ratios, particularly if such regulations are uniform across whole groups of institutions of different sizes and specialization, is a dead end. In fast changing financial system, the essential feature of an effective system of prudential regulation is a concentration on the risk exposure of individual institutions, which cannot be achieved by detailed regulation. It demands a high degree of competence among the supervisors, whose attention should be concentrated on the doubtful cases.[232]

[230] Gruson and Reisner, ibid., pg. 577.
[231] Gonzales, ibid., pg. 29.
[232] Gonzales, ibid., pg. 30.

III. Concept of Reciprocity

Reciprocity is a concept with a potential for limiting the number of foreign banks in a jurisdiction. Former Article 238 of the EC Treaty provides rules relating to the concept of reciprocity. Accordingly, the Community may conclude with a third State, a union of States or an international organization, agreements establishing an association involving reciprocal rights and obligations, common action and special procedures. Current Article 300 of the EC Treaty, as amended, deals with the conclusion of agreements between the EC and one or more states or international organizations. According to the said Article 300, agreements concluded under the conditions set out in Article 300 shall be binding on the institutions of the EC and on Member States. The reciprocity provision in the EC Banking Consolidation Directive of 2000 is an example. It was inserted because of the concerns which the Member States had about access for their banks to the United States and Japan. There were, and are, domestic reciprocity provisions, but it was thought that a uniform European response was desirable.[233]

In Article 23(5) of the Directive 2000/12, there is a minimum standard of national treatment of EC banks by third countries, i.e. they must treat EC banks the same as domestic banks. Violation of this may lead the EC Commission to open negotiations with the third country so that EC banks receive national treatment, but it may also lead to Member States being required to prevent entry to third-country banks. Restrictions on the entry to the market cannot, however, be retrospective. Accordingly, third-country banks which gained access before 1 January 1993 are not subject to this sanction.[234] The aim of the reciprocity procedure is to encourage third countries to come closer to the operating conditions of the EC.[235] Hence, the idea underlying the insertion of a reciprocity clause into the EC banking directives is that the internal market for financial services, which will benefit all credit institutions whether or not they are in the EC, is difficult to conceive of unless EC institutions experience a sufficient improvement in their possibilities of access to the markets of third countries.[236]

Currently, the Banking Law No. 5411, the main piece of legislation governing the banking sector in Turkey, does not provide any reference to the so-called Principle of Reciprocity. Nevertheless, as will be discussed in the below chapters, the draft proposal

[233] Cranston, ibid., pg. 429.
[234] Cranston, ibid., pg. 430.
[235] Philippe Vigneron and Aubry Smith, "The Concept of Reciprocity in Community Legislation: The Example of Second Banking Directive", Journal of International Banking Law, (1990) Vol.5, pg. 183.
[236] Vigneron and Smith, ibid., pg. 184.

posted in the official web site of the Turkish Banking Regulatory and Supervision Authority which aims to amend the Banking Law No. 5411 provides a legal ground for the Principle of Reciprocity to a certain extent. The draft proposal aiming to amend the Law No. 5411 has the purpose to grant the Banking Regulatory and Supervision Authority the authority to examine the foreign banks' application to open a bank in Turkey on the basis of reciprocity. This will be further discussed in the below chapters.

IV. Analysis

As discussed above, banks perform three key functions: (i) channeling funds from savers to investors; (ii) providing a payment system for transactions; and (iii) distributing risks across space and time to those best able to bear them. While the first two continue to remain pivotal for the functioning of the real economy, the risk distribution function has become increasingly important as the financial instruments have become more complex.[237] Hence, with respect to the regulation of the functions of the banks, it is crucial to find the appropriate level of the regulation of the banking activities (appropriate level of standards).

This is enormously important within the EC context particularly due to the Principle of Mutual Recognition and the single licensing concept. The inadequate resolution of the regulation of the banking activities has the potential to create the wrong incentives and lead to banking fragility. On the other hand, overregulation may cause delaying the development of national financial systems, hindering the best use of available domestic savings, preventing countries from accessing international capital, and ultimately lead to slower growth.[238]

In general, the advantages of the implementation of mutual recognition are obvious. It allows products and services legally circulated in one Member State to be admitted to other Member States without being required to meet additional regulatory requirements. In addition, costly duplications are theoretically avoided without the need for complete harmonization of national legislation at EC level. By virtue of mutual recognition, not all sectors needed to be harmonized, or harmonization has been restricted to the essential requirements. Hence, minimum harmonization of basic standards allows a certain degree of regulatory competition between Member States and accommodates flexibility, innovation, simplification and experimentation. In addition, EC policy and law making remains sensible to local and regional interests, while the maintenance of specific national characteristics is ensured.[239]

It can be argued that the EC banking legislation have extended the rights of establishment and to provide cross-border services which were already enjoyed under the

[237] International Monetary Fund Working Paper, Emerging Issues in Banking Regulation prepared by Ralph Chami, Mohsin S. Khan, and Sunil Sharma, May 2003, Available at http: www.imf.org (10 December 2008), pg. 3.
[238] International Monetary Fund Working Paper, Emerging Issues in Banking Regulation prepared by Ralph Chami, Mohsin S. Khan, and Sunil Sharma, May 2003, Available at http: www.imf.org (10 December 2008), pg.s 3 & 4.
[239] Avgerinos, ibid., pg. 4.

Treaty of Rome to a certain extent. Even if this were the case as a matter of strict law, the EC banking directives have given certainty to these rights of banks to move across borders, without the need to wring them from the decisions of the European Court of Justice.

If a bank is to take advantage of the single license to establish branches or provide services on the territory of another Member State, it must notify its intention to the home Member State regulator. The relevant regulator/authority will in turn inform the relevant regulator/authority in the host Member State. Accordingly, a banking service is treated as being provided within the territory of another Member State only if the bank is located there. This so-called characteristic performance test means, as the Banking Communication states, that banking services provided *via* the internet are not within the territory of the Member State which is the residence of the customer, but rather within that where the **bank is located**. The result is that the occasions on which a bank must notify under the EC banking legislation are much reduced.[240]

Nonetheless, it is clear that, for the Principle of Mutual Recognition to be actually workable in practice, there must be sufficient cooperation between the supervisory authorities of the Home Member State and those of the Host Member State in relation to the branches or the provision of cross-border services. As discussed above, such cooperation is provided for in the relevant EC banking directives.

As discussed above, the so-called New Approach has brought dynamic impetus to the EC financial market regulation and supervision. The centerpieces of the New Approach, which has replaced the Old Approach of full harmonization strategies, have been the principles of Home Country Supervision and Mutual Recognition.

In light of the foregoing, one may conclude that the EC has achieved substantial progress in the integration of the EC banking market. One of the major reasons for such integration is the concept of the principle of mutual recognition and the concept of single banking license (passport). Nonetheless, despite the introduction of the single banking license and the substantial reduction of the local regulatory barriers introduced by the Member States, the European banking market does not seem to be extensively integrated. It is noted that the banking business is primarily local and has not yet realized the benefits of an integrated internal banking market. This can be seen from the Report on Financial Stability of the Economic and Financial Committee using four criteria – cross-border establishment, mergers and acquisitions, geographical distribution of earnings and inter-bank claims – to assess the

[240] Cranston, ibid., pg. 434.

degree of Europeanization, concluded that European banking activity remains primarily local:[241]

> *The market share of foreign branches and subsidiaries established by credit institutions domiciled in other EC countries is currently relatively small, with the exception of Belgium, Ireland and Luxembourg …Cross border mergers and acquisitions – another measure of penetration in foreign markets – have thus far not taken place in the EC on a large scale although there exist some regional differences…Most of the income of the largest EC banks is generated in the home country (home country 67%, EC/EC 15%, non-Europe/EC 18%) …*

Nonetheless, it must be noted that the EC banking legislation including its major principles providing for the single license concept does not provide for a **European banking license** and covers cross-border banking only through branches and cross-border provision of services. This analysis derives from the fact that banks are required to comply with host country regulations in areas not covered by EC legislation. As discussed above, host country regulations addressing legitimate regulatory considerations can be maintained, even when such regulations restrict trade within the EC. Hence, the host country can still implement its own conduct of business rules provided however that such rules are in the "general good" interest.[242]

[241] Panourgias, ibid., pg. 148-149.
[242] Panourgias, ibid., pg. 149.

§ 5. ESSENTIAL (MINIMUM) HARMONISATION

I. General - Evolution

The approximation of national laws by the EC is often described in terms of a model of "total harmonization" (**old approach**). Within the total harmonization framework, the Community exhaustively regulates a given field, thereby pre-empting national competence to take independent action therein. The total harmonization presents few problems such as this approach prevents the Member States from introducing any further requirements in respect of the relevant matter. According to Walker, in terms of historical development, the original draft directive produced by the Committee of Experts in July 1972 was based on the *principle of full harmonization*.[243]

As discussed above, the priority of the EC until the White Paper was the liberalization of its markets. What was then aimed was no more than the conditions, which were indispensable for that purpose, ensuring only the harmonization of essential legislative measures. The principal difference between the new strategy (new approach) and the old strategy (old approach) was that EC legislation is granted only a residual role, merely providing minimum guarantees ensuring some measure of equivalence between the different national legal regimes. Minimum harmonization was regarded as fundamental for a number of reasons:

(a) whilst the effect of mutual recognition may be the elimination of barriers to trade, it does not by itself create a sufficient unified market,

(b) general application of the mutual recognition principle with no attempt to harmonize may invite competitive deregulation and may lead to lower standards of protection, which would not be acceptable by Member States' authorities,

(c) the imposition of minimum harmonization might be seen as a result of the EC Commission's belief in the benefits of competition between regulatory frameworks.[244]

Nonetheless, the implementation of the Principle of Minimum Harmonization is more complicated. Whereas within the framework of the minimum harmonization, the Member

[243] Walker, ibid., pg. 318.
[244] Avgerinos, ibid., pg. 35.

States are permitted to maintain and often to introduce more stringent regulatory standards than those contemplated by the EC legislation for the purposes of advancing a particular social or welfare interest, and provided that such additional requirements are compatible with the Treaty. On the other hand, the minimum harmonization does not mean merely minimalist such as would reserve to the national authorities the predominance of regulatory competence.[245]

Minimum harmonization has become a significant characteristic of the EC legislation. The minimum harmonization has become a standard quality of directives on a range of environmental, consumer and employee protection matters since the early 1970s. Nonetheless, the minimum harmonization does not provide a full solution to the hurdles and issues surrounding the evolution of the EC from a solely economic community to a union with social, political and economic perspectives and goals namely the balance between the competing economic and social objectives of the Treaty, and between the competing roles of the Community and domestic authorities of the Member States in their achievement.

This is mainly because the Treaty failed to address several major questions about the permissible scope of more stringent national measures; the European Court of Justice is yet to offer a systematic solution to help in their resolution and thus the character of minimum harmonization is to some extent difficult to describe with precision. There are two other aspects to explain the foregoing. Firstly, the Community's horizontal expansion namely the growth in the EC's powers to legislate in different policy sectors. Secondly, the Community's development namely the presence of countries with very different and often conflicting cultural and political visions is the opposition between uniformity and differentiation in the normative elaboration of the Treaty's expanding policy objectives.[246]

There has been a shift in the character of the EC, away from the domination of the internal market and its ideal of a uniform legal regime embracing all the Member States, and in favour of a broader range of potentially conflicting economic and social-welfare policy agendas with the obligation to accept a greater degree of legal diversity if each is to be addressed successfully within a more challenging political and institutional environment. Consequently, the full potential of minimum harmonization to consolidate the EC's commitment to citizens' welfare even at the expense of the economic integration remains unresolved. Analysing from a wider context, it may be argued that the minimum

[245] Michael Dougan, Minimum Harmonization and the Internal Market, Common Market Law Review 37 (2000), Kluwer Law International, printed in the Netherlands, pg. 855.
[246] Dougan, ibid., pg. 857.

harmonization is just one aspect of the trend towards increased regulatory differentiation and the "closer cooperation".[247] Hence, it may be argued that while both mutual recognition and regulatory cooperation can in principle be conducted in an intergovernmental style, harmonization obviously moves further into the direction of establishing supranational structures, which may be one of the reasons why some governments are reluctant about this happening.[248]

As it is one of the traditionally most strictly regulated sectors of the economy, the harmonization of the banking sector at the EC level has presented considerable problems.[249] However, at present, attempts at harmonization of European financial markets have been achieved, in theory, by implementing the EC banking directives. The standards defined under these directives establish a minimum regulatory foundation necessary for the correct operation of the markets and for the protection of investors.[250] Finally, the EC Treaty has proved to be a remarkably flexible and open-ended instrument, capable of accommodating diverse, and perhaps even contradictory interpretations by the different EC institutions, including the ECJ.[251]

II. Minimum (Essential) Harmonization Principle in Banking Sector

It is important to note that the EC, as discussed above, did not create a uniform banking law which would replace the banking legislations of the Member States. The EC directives enacted in relation to the banking area aim to coordinate the banking laws of the Member States by developing minimum standards of harmonization, in particular with respect to the authorization and supervision of the banks. Accordingly, minimum harmonization can generally either be used to refer to the selection of core areas for legislative intervention (harmonization or approximation) or the fixed minimum level of protection set under any particular directive adopted.[252]

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[247] Dougan, ibid., pg. 885.
[248] Avgerions, ibid., pg. 242.
[249] Dassesse & Isaacs & Penn, ibid., pg. 17.
[250] Rahul Dhumale, Incentive v. Rule-Based Financial Regulation: A Role for Market Disciple in Regulating Financial Services and Markets in the Twenty First Century, edited by Eılis Ferran and Charles A E Goodhart, Oxford – Portland Oregon, 2001, pg. 215.
[251] Geoffrey Fitchew, "Political Hoices" in European Business Law, edited by Richard M. Buxbaum, Gerard Hertig, Alain Hirsch and Klaus J. Hopt – Associate Editor Marina Hertig, Walter de Gruyter, 1991, New York, USA, pg. 3.

[252] Walker, ibid., pg. 316.

In order to achieve the overall objectives of the EC Treaty, in particular the fundamental freedoms of establishment and of provision of services, the EC decision-making bodies were concerned to create a financial services environment, in which all credit and investment institutions within the EC should be able to freely offer their services on the same or similar regulatory and supervisory grounds. Accordingly, without vesting all supervisory power in a pan-European regulator, what could be required was either (a) full harmonization of the supervisory rules of all Member States, or (b) minimum harmonization of essential authorization and supervisory standards, accompanied with recognition by each Member State of the adequacy of the rules of the others, insofar as the authorization and supervision of financial institutions is concerned.

The approach of full harmonization of the supervisory rules of all Member States would eliminate any differences between national rules and the possibility of regulatory arbitrage. As discussed above, the new approach based on the mutual recognition of national laws and regulations was derived from the decision of the ECJ in *Cassis de Dijon* in 1979. As held by the European Court of Justice in its below cited decision, the First Banking Directive is the first step in the **full harmonization** of the banking legislation of the Member States. The ECJ in its judgment in the cases *Commission v. Italy*[253] and *Commission v. Belgium*[254] held that:

> *Council Directive 77/780 constitutes the first step in the harmonization of banking structures and the supervision thereof. The purpose of such harmonization is to permit the **gradual** attainment of freedom of establishment for credit institutions and the liberalization of banking services. In that respect, the Directive introduces certain minimum conditions for the authorization of credit institutions which all Member States must observe. In order to facilitate the taking up and pursuit of business as a credit institution the Directive aims in particular to reduce the discretion enjoyed by certain supervisory authorities in authorizing institutions.*

Hence, this approach would ensure that competition between financial institutions is carried out on a common EC foundation. On other hand, the approach of minimum harmonization of essential authorization and supervisory standards, accompanied with recognition by each Member State of the adequacy of the rules of the others, does not entirely exclude the potential for distorting regulatory competition. Nevertheless, this minimum

[253] [1983] ECR 449, 455.
[254] [1983] ECR 467, 476.

harmonization regime is more perceptive and takes account of the Member States' national concerns and serves the principle of subsidiarity.[255]

The European Commission has chosen to follow the more pragmatic and flexible solution of this minimum harmonization approach of certain standards and mutual recognition. This has confined legal requirements to broad regulatory objectives, which may be met by compliance with the technical specifications formulated by the specialized standards-setting institutions, thus enabling the EC to recognize multiple standards as equivalent. As a supplement and medium to tackle the problems and to facilitate cross-border investment business transactions, EC law has introduced the principle of Home Country Supervision.[256]

This so-called Minimum (Essential) Harmonization Principle in general intends to align the standards of protection of customers of credit institutions, to establish fair conditions of competition among credit institutions and to create and maintain a functional European financial market. By implementing the directives, Member States must meet these minimum standards in their banking law. The Member States are not allowed to fall below the standards set forth under the directives but they may establish more stringent standards in their domestic law.[257] However, it is important to note that minimum regulation does not mean regulation at the level of lowest denominator but minimum regulation does mean that each Member State can apply tougher standards, but only to their own domestic enterprises.[258]

In the EC, there has been essential harmonization, which allows the implementation of the principle of Home Member State prudential Supervision.[259] This is mainly because an integration strategy based purely on mutual recognition would not be sufficient to build an expanding market based on competitiveness. It is argued that the Principle of Essential Harmonization combined with the Principle of Mutual Recognition entails the risk for the quality of banking regulation, as it may trigger a regulatory "race for the bottom". The repackaging of risks has benefited enormously from the development of new financial instruments, such as derivative markets, which are now an important part of the international financial markets.[260] Accordingly, a major concern is that, as banks are able to carry on EC wide business on the basis of home country prudential regulation and supervision, they may

[255] Avgerinos, ibid., pg. 52.
[256] Avgerinos, ibid., pg. 53.
[257] Cranston, ibid., pg. 474-475.
[258] Geoffrey Fitchew, "Political Choices", published in European Business Law – Legal and Economic Analyses on Integration and Harmonization, edited by M. Buxbaum, Gerard Hertig, Alain Hirsch, Klaus J. Hopt, and Walter de Gruyter, 1991, New Yok, USA, pg. 10.
[259] Panourgias, ibid., pg. 9.
[260] International Monetary Fund Working Paper, ibid., pg. 6.

opt for the jurisdictions with less rigid and less costly regulation and supervision. Hence, Member States may relax their standards in order both to attract banks and to protect the competitiveness of banks already incorporated in those Member States. Nonetheless, it is likely that "race for the bottom" will not be the case. Requiring that a bank has its head office in its home Member State and that it actually operates there already discourages "forum shopping".[261]

[261] Panourgias, ibid., pg. 37.

III. Old Approach (Full Harmonization) vs. New Approach

The EC Commission had originally followed a full harmonization approach to European integration more generally. According to one commentator, experience in bringing about close operation between the national supervisory authorities of the Member States and between Member States and the EC Commission, has indicated that it is often preferable to rely more on a realistic but modest degree of harmonization, rather than try to approximate all detailed aspects. The efficient coordination of administrative practices could go a long way towards producing the same effects as harmonization of all statutory regulations.[262] The records of the EC on harmonization in the banking sector indicate that the EC efforts on full harmonization of the banking sector were unsuccessful.

With the proposal for the **First Banking Directive (77/70/EEC)** in 1974, almost all of the financial policy bases or components were identified and the main policy shift from the original draft 1972 Directive to the proposal for the First Banking Directive in 1974 was to move from a fully comprehensive or consolidated single measure to a framework approach in which the necessary common standards would be constructed through a number of separate functionally specific directives. The 1974 proposal refers to it being necessary to proceed by successive stages rather than within a single Directive. The proposal continues that the result of this process should be to provide for the overall supervision of a credit institution operating in several Member States by the competent authorities in the territory where it has its head office in consultation as appropriate with the authorities of the other Member State concerned. This clearly anticipates the operation of a full home country control rule although not referred to in these terms at that stage. The proposal did anticipate the adoption of uniform authorization requirements across the Community although at that stage it was only necessary to specify certain minimum requirements. This would appear to have assumed that full harmonization would be possible although through a number of measures rather than with a single Directive.[263] It is argued that harmonization may be difficult to achieve in the area of banking for various reasons, including, (i) banks enjoy a crucial position in national economy and as a consequence closely relates to issues of sovereignty, (ii) because of differences in economic, political and legal development, national approaches to harmonization efforts vary

[262] Clarotti, ibid., pg. 221-222.
[263] Walker, ibid., pg. 319.

greatly, and (iii) the procedure for decision-making within the EC requiring unanimity in the Council constituted an obstacle to harmonization.[264]

As seen above, the harmonization in the banking sector has been, and is envisaged to be extensive. It is questioned that whether the amount of harmonization that has already taken place could properly be described as minimum, certainly when taken together with the harmonization which is proposed for the future. Despite this extensive harmonization, there are a number of aspects in which the banking regulation and supervision will continue to differ from one Member State to another. This leads to the question that to what extent will these differences will create obstacles to the right of establishment and free movement of services. The response would depend on the kind of differences involved.[265]

The Second Banking Directive reduced regulatory barriers to EC financial services trade and lays the foundations for a single banking system on the basis of harmonization of prudential standards. The Second Banking Directive also provided for a more sophisticated division of responsibility between the home and host authorities. These provisions have since been restated within the May 2000 Banking Consolidation Directive.

Accordingly, the EC's new policy in the banking and financial area has moved from a full harmonization approach (based on a single measure) to one relying on a number of separate functionally specific directives. This original and framework harmonization approach then anticipated authorized institutions being exempt from the equivalent supervisory and regulatory systems applicable in other territories having complied with the provisions of their country of origin. This procures subsequent mutual recognition and the underlying principle of home country control which was clearly considered necessary from an early stage in the financial area. It is this need for subsequent continuing review and oversight through the supervisory process that principally distinguishes financial services from many other products or activities subject to free movement. Almost all of the financial policy components were accordingly anticipated by 1972 except for minimum harmonization which would replace full coordination of all relevant provisions as a form of politically acceptable compromise policy under the 1985 White Paper and 1986 Single Act.[266] It was intended that, following the adoption of some commonly accepted minimum standards by the

[264] Anna Mörner, "Banking Law Reform in Central and Eastern Europe – The Influence of European Union Banking Legislation", Essays in International Financial & Economy Law, No. 11, 1997, pg. 10.
[265] Strivens, ibid., pg. 302.
[266] Walker, ibid., pg. 320.

Member States regulatory competition would fill the possible gaps and further the approximation of national laws.[267]

The significance of the New Approach must be well noted. The original integration mechanism adopted in the goods area in 1979 was Cassis free circulation based on initial lawful production and first market placement. The original principles of Mutual Recognition and the Minimum Harmonization subsequently developed would then be extended in the financial area to include Home Country Supervision. [268] The New Approach is an exercise in deregulation at two levels. First, it involves the establishment of a single EC rule to replace various national rules. The range of diverse national legislation which tends to partition the market is thereby reduced. Second, although the purpose of the rule, safety, remains applicable equally throughout the EC, the rule itself is couched in sufficiently broad terms to permit a choice of methods selected according to national and local taste. Accordingly, it seems that the New Approach is based on the principle that the government must only regulate that which falls under its responsibility and the New Approach shifts the focus to a concept of mutual recognition.[269]

It is argued that a Community institution with prudential rule making power at the EC level would further harmonize supervisory rules and procedures and would thus allow banks to expand their Community-wide business. It will save them unnecessary duplicatory efforts to conform to different rules and supervisory practices. In addition, it will be difficult to justify national restrictions on cross-border banking as prudential. Furthermore, a common supervisory framework developed and administered by a body at the EC level would reduce the anti-competitive effects of divergent regulatory systems. Banks from systems less stringent standards will no longer enjoy a competitive advantage. Banks from systems with high reputation and stringent standards will not have easier access to capital and business markets. Hence, banks will be able to expand across Europe without fearing non-tariff barriers due to unfavorable regulation.[270]

[267] Avgouleas, ibid., pg. 75.
[268] Walker, ibid., pg. 320.
[269] McGee & Weatherill, ibid., pg. 584.
[270] Panourgias, ibid., pg. 151.

IV. Analysis

As discussed above, the mutual recognition is based on the identification of a number of core aspects of control within which certain minimum common standards are established. This approach would be based on selective harmonization in essential areas and the development of appropriate technical standards by relevant standardization bodies. The new technical specifications produced would not be mandatory although the sufficiency of local requirements would have to be recognized as per the Principle of Mutual Recognition where these conformed to the harmonized standards set. Accordingly, relevant minimum standards were set out in a number of framework directives in various areas.[271]

In the banking and financial area the additional principle of home country control also allows for supervisory allocation or division of key functions between the home and host country territories. The Principle of Mutual Recognition then requires each set of national authorities to recognize the validity of the license provided by the home country (single license concept). This includes both the authenticity and sufficiency of the original license and its operational effectiveness within the jurisdiction of the host territory.[272] As discussed above, as per the Principle of Home Country Supervision, the simple pre-entry product rules (lawful production and placement) are converted into a much more substantial continuing post-entry validation system. Mutual recognition is then almost replaced rather than supplemented by a new doctrine of **license recognition**.[273] Accordingly, the Principle of Home Country Control (Supervision) amends the mutual recognition concept to include also license recognition.

Harmonization of national legislations in general may be introduced to replace divergent national rules which act as trade barriers with a single EC rule. Nonetheless, harmonization does not mean uniformity, nor the elimination of all trade barriers, since the implementation of a common EC principle may differ from one state to another.[274]

The difference between mutual recognition and full harmonization is that mutual recognition is not based on the establishment of a complete set of common standards but only a minimum level of protection on selected pre-agreed issues. It is generally accepted that the instruments and requirements of bank regulation include, among others, capital requirement,

[271] Walker, ibid., pg. 309.
[272] Walker, ibid., pg. 240.
[273] Walker, ibid., pg. 320.
[274] McGee & Weatherill, ibid., pg. 581.

reserve requirement, corporate governance, financial reporting and disclosure requirements, credit rating requirement, large exposures restrictions, related party exposure restrictions, activity and affiliation restrictions, payments systems requirements etc. Accordingly, the new integration approach adopted is based on the principle of minimum harmonization in essential areas with mutual recognition being applied and enforced in connection with all other non-essential aspects of standards application and compliance.[275]

Nevertheless, it is noted that according to the EC Commission while pure mutual recognition could remove barriers to trade, it would be inadequate for the purpose of constructing an expanding and competitive European market by itself. Further, a harmonization policy on its own would be over-regulatory, take a significant amount of time to implement and be inflexible and constrain innovation. Hence, the new approach to be adopted would proceed on the basis of the mutual recognition of non-essential standards and with legislative harmonization through directives under Article 100 of the EC Treaty being restricted to core health and safety requirements that would be obligatory in all Member States.[276] Hence, minimum harmonization should be seen today as a transitory stage on the way towards European legal unity.[277]

Whereas the **capital requirement** sets a framework on how banks must handle their capital in relation to their assets, the **reserve requirement** sets the minimum reserves a bank must hold to demand deposits and banknotes. It can be said that the major purpose of the minimum reserve ratios is liquidity rather than safety. **Corporate governance** requirements are intended to encourage the bank to be well managed, and is an indirect way of achieving other objectives. With respect to **financial reporting and disclosure requirements**, banks must (a) prepare annual financial statements according to a financial reporting standard, have them audited, and to register or publish them; (b) prepare more frequent financial disclosures; (c) prepare prospectuses detailing the terms of securities it issues, and the relevant facts that will enable investors to better assess the level and type of financial risks in investing in those securities; and (d) have directors of the bank attest to the accuracy of such financial disclosures. Banks may be required to obtain and maintain a current **credit rating** from an approved credit rating agency, and to disclose it to investors and prospective investors. Banks may be restricted from having imprudently **large exposures** to individual counterparties or groups of connected counterparties. Banks may be restricted from incurring **exposures to**

[275] Walker, ibid., pg. 310.
[276] Walker, ibid., pg. 307.
[277] Avgerinos, ibid., pg. 157.

related parties such as the bank's parent company or directors which may typically include the restrictions such as exposures to related parties must be in the normal course of business and on normal terms and conditions, exposures to related parties must be in the best interests of the bank, exposures to related parties must be not more than limited amounts or proportions of the bank's assets or equity.

According to one commentator, in the banking, security may be given as an example where a common EC principle may differ from one state to another. Security is one of the area of the law where the EC countries is considerable, yet banks typically wish to take security, even if only personal security by way of guarantee. There are however exceptions, such as international banking, where security is unusual either because banks have been confident of repayment and of their assessment of creditworthiness, or were prevented by the nature of the borrower from taking it. Because of the differences between EC Member States' laws on security, it is an area where harmonization is likely to proceed at a snail's pace[278]

It is noted that on the safety and soundness front, a major issue of concern is regulating a system of banks that, in the face of increasing competition, may be tempted to take imprudent risks in existing or new lines of business. Essentially, it is always necessary to design the regulation in particular with respect to the following challenges:

- There is a need to redefine risk-based capital standards to more accurately reflect the risks that are actually being borne, particularly when operating with some of the new financial instruments.
- The complexity and rapidity with which the balance sheet of financial intermediaries can change has made the traditional capital standards less appropriate as a regulatory tool. This has resulted in a shift in regulatory emphasis away from capital standards and toward assessing incentive mechanisms, the risk management processes in institutions, and market discipline.
- The blurring distinctions across instruments and across institutions may create a greater need for defining a level playing field to prevent regulatory arbitrage.
- Consolidation is creating more institutions that may be "too big to fail". It is therefore imperative that the regulatory framework and supervision be designed to

[278] Cranston, ibid., Pg. 8-10.

prevent moral hazard on the part of large intermediaries, and regulators explore new ways to provide a safety net for financial institutions.[279]

In fact, the term "exhaustive regulation" refers to the replacement of divergent national systems by an EC rule, where that EC rule becomes the sole regulation governing the area and the Member States' competence in such area is excluded. As a result of a comprehensive reassessment of its regulatory policy, the EC has since 1985 followed the "New Approach". The Old Approach which had tried to create uniform, mandatory rules for the EC stand discredited. Under the New Approach shifts the focus to a concept of mutual recognition. Accordingly, a product lawfully manufactured in a Member State should be taken in principle to be of sufficient quality to be sold throughout the EC. Harmonizatiıon will be limited to aspects of health and safety, where a Community notion of essential safety requirements will be set out in the harmonization measure. These essential requirements indicate the performance standard which must be attained by a product in order to secure the right of free movement throughout the EC and they will be given shape by a supporting body of standards.[280] In other words, the New Approach allows free movement of financial services without the need for harmonization of national legislation at the EC level. Accordingly, for the first time, credit institutions were permitted to operate throughout the EC under the same rules and conditions as in their home Member State that is under one single set of regulations. Under this framework, the host Member State may oppose the lawful provision of a service by a provider established in another country only under extremely restrictive conditions that involve reasons of public interest.[281]

Harmonization of the banking sector should not be seen as an objective in itself for the EC, but it should be considered as a tool for achieving a large objective. In fact, the EC legislation has created a complex web of harmonized EC rules and unharmonized national regimes while many exceptions apply to home country control. Even in certain fields where harmonization has been achieved, this should not be seen as an attempt to implement uniformity of laws and regulations throughout the EC. There remain differences in national laws implementing secondary legislation.[282] Further, there is a widespread perception that notwithstanding the huge effort in harmonization, common rules have often been

[279] International Monetary Fund Working Paper, Emerging Issues in Banking Regulation, prepared by Ralph Chami, Mohsin S. Khan, and Sunil Sharma, May 2003, Available at (20 November 2008) http: www.imf.org, pg. 8.
[280] McGee & Weatherill, ibid., pg. 583.
[281] Avgerinos, ibid., pg. 103.
[282] Avgerinos, ibid., pg. 4.

implemented in slightly different ways in national rulebooks and this may have prevented the common market to deliver its full benefits. Institutions operating on a cross-border basis have to comply with a set of slightly different requirements on supposedly harmonized supervisory tools, with the result that compliance costs increase.[283]

Following the adoption of the so-called New Approach, banks are now permitted to carry out the banking services listed in Annex I of the Directive 2006/48/EC throughout the EC under the same rules and conditions as in their home Member State that is under one single set of regulations. Within this framework, the host Member State may oppose the lawful provision of a service by a provider established in another country only under extremely restrictive conditions that involve reasons of public interest, such as consumer protection. Accordingly, the foregoing discussions indicate that there are limits to a decentralized framework as currently within the EC. With the avoidance of the drafting of detailed harmonized rules at EC level, this approach ensures more careful observance of local, regional and national needs and traditions, providing thus a pragmatic and powerful tool for economic integration.[284]

It is noted that even in the case of the EC, with the integrated operation of the legislative mechanisms for the reduction of trade barriers and development of prudential standards, the existence of advanced cooperation arrangements and the certainty of a coordinated macroeconomic environment, further centralization of prudential regulation and supervision appears necessary for a full and safe internal market within the EC.[285] Furthermore, it may be argued that the supervision by the home country and the application of the principle of mutual recognition are enabled by a harmonization of minimum supervisory standards.

[283] Available at http://www.c-ebs.org (16 September 2008).
[284] Avgerinos, ibid., pg. 104.
[285] Panourgias, ibid., pg. 6.

§ 6. HOME COUNTRY SUPERVISION

I. General - Need for Supervision

Financial institutions perform a highly distinctive role in ensuring the smooth functioning of the economies. By acting as transformers of liquidity intermediating between liquid and illiquid assets, they are able to ensure that resources are allocated in an efficient manner. The classical economic justification for the state interference in a market is that the market fails to allocate resources fairly and efficiently. Hence, as will be discussed herein below, the importance of banks and the role the banks play in an economy (the conduct of monetary policy, the financing of the economy, the conduct of payments, credit allocation and power allocation, and negative externalities to the rest of the economy) provide solid basis for the public regulation and supervision.

In supervision, the supervisor must question which financial services' function is to be regulated or supervised, what the precise concerns are, what risks can be protected against. The three major goals of the supervision may be summarized as follows: (i) to strengthen the macroeconomic and microeconomic stability of the financial system as a whole; (ii) to ensure consumer protection and transparency in the market and credit institutions; and (iii) to safeguard and promote competition in the sector.[286]

In addition, banks engage in information-intensive activities and their profitability also hinges on keeping that information private. Such informational asymmetry, however, between banks and other economic agents, such as borrowers, lenders, and regulators, can lead to various problems. As examples, informational asymmetry between the bank on the one side and the borrowers and lenders, on the other side, can cause bank runs and subject banks to contagion type problems[287]

According to one commentator, although the protection of depositors has been and is an important reason for regulating banks, if it were only small depositors for whom there was concern, banks could be required to offer deposit insurance limited to the balances usually maintained by unsophisticated people. Further, banks are not regulated because they provide loans to businesses and individuals. In the EC, similar loans are offered by many non-bank

[286] Avgerinos, ibid., pg.s 14-18.
[287] International Monetary Fund Working Paper, Emerging Issues in Banking Regulation prepared by Ralph Chami, Mohsin S. Khan, and Sunil Sharma, May 2003, Available at http: www.imf.org (10 October 2008), pg. 14.

organizations, including commercial lenders, securities brokers and underwriters, mortgage companies, consumer-loan companies, automobile finance companies, and businesses which are not regulated.[288]

The banking system has special features which justify special regulation. It is argued that the importance of banks for the conduct of monetary policy, the financing of the economy, the conduct of payments and credit allocation, as well as concerns regarding depositor protection, undue concentration of power and negative externalities to the rest of the economy, justify special rules for the regulation of banking:[289]

(a) Protection of Depositors: Depositors lack the information and sophistication needed in assessing the financial condition of the account holding bank. Economies of scale can also be achieved by assigning monitoring and assessment to regulation instead of every individual depositor spending separate resources for this. Benink and Benston argue that three aspects of deposits that lead governments to protect depositors from loss should be distinguished. The first aspect is that the banking practice of fractional reserves, wherein removal by depositors or central banks of reserves from the banking system can result in a multiple contraction of the money supply and systemic collapse of banking and, often, of the economy. The second is the role of demand deposits as money, the principal means of payment for goods and services. The third is the political reality that almost no government will permit depositors to absorb losses should their banks fail.[290]

(b) Monetary Policy: The commercial banks supply the mechanism for transmission of monetary policy decisions to the rest of the economy.

(c) Economy Financing: The banks play a significant role in the financing of the economy by intermediating between depositors' savings and borrowers' financing needs.

(d) Payments: It is through the banking system that payments are effected.

(e) Credit Allocation: Rules on credit allocation are often necessary for the financing of economic agents who would not otherwise be able to obtain credit due to lack of financial means that can serve as collateral or due to lack of credit history.

(f) Undue Concentration of Power: Anti-competitive practices and concentration of power in a few banks are of considerable concern for the governments, as they can lead to excess profits, distortionary credit policies and undue influence on the political system.

[288] Benink & Benston, ibid., pg. 7.
[289] Panourgias, ibid., pg. 18.
[290] Benink & Benston, ibid., pg. 8.

(g) Negative Externalities: Bank failures can have a disproportionately negative effect on the rest of the economy through disturbing the monetary policy, impairing the financial operation of other industries and affecting the psychology of the economic agents. The negative effect of the systemic risk and the failure of banks which may lead to subsequent failures of other banks exceed the cost of the bank failure itself. Hence, the proportionality of the measures chosen to achieve the legitimate objective pursued is a matter for the Member States, who must themselves ensure that their choices are not disproportionate.[291]

(h) National Control: National ownership of banks is sometimes favoured so that their role in the national economy is controlled.

(i) Fraud and Money-Laundering: Fraud and money-laundering constitute significant risks to the reputation and financial health of individual banks and of the banking system.

Changes in bank regulation in the 1970s and 1980s came about as a response to three factors. Initially, the deregulation of interest rates and exchange rates occurred at the time when the macroeconomic environment changed. Second, advances in information and communications technology began breaking down what at that time was considered a natural segmentation of the financial industry into banks and nonbanks. Third, the globalization of banking made domestic banks compete with foreign ones, and initiated a global debate on comparing the efficacy of regulatory frameworks.[292] Further, a key aspect of the regulations or legislative instruments is the refinement of the risk weights assigned to different assets to more accurately reflect the risks in the banking and trading book.[293]

Accordingly, one commentator notes that banking regulation should take the form of government intervention, government regulation and supervision, on the following grounds. First, the contribution of the banking system to the monetary policy, the conduct of payments, and the financing of the economy have the character of a public good, which should be provided by the state. Second, the information asymmetry between banks and depositors and between banks and potential buyers of banks' assets can lead to costs to the depositors or to the overall economy for which the market remedies are not adequate.

It follows that public regulation of banking should be mainly about market imperfections relating to depositor protection and systemic stability and implications for the rest of the economy. This approach to government and market involvement in banking

[291] Siofra O'Leary and José M. Fernandez-Martin, "Judicially-Created Exceptions to Free Provision of Srvices", in Services and Free Movement in EU Law edited by Mads Andenas and Wulf-Henning Roth, 2002, Oxford University Press, Oxford, UK, pg. 182.
[292] International Monetary Fund Working Paper, ibid., pg. 9.
[293] International Monetary Fund Working Paper, ibid., pg. 10.

regulation is also confirmed by the debate on the new Basel capital adequacy arrangements. The new Basel Capital Accord (Basel II) of the Basel Committee on Banking Supervision reserves a discretionary role for the supervisor while envisaging extensive reliance on market discipline and on use of internal control mechanisms by sophisticated banks. On the other hand, due to the operation of depositor protection and systemic stability at the foundation of banking regulation that financial services trade liberalization and its deregulation effects become of a special concern.[294]

Benink and Benston note that until the early 1980s, banks in many EC countries operated in markets that were protected from competition. This was mainly because the entrance to the national banking markets was restricted. As a result, banks tended to be profitable and could operate with low levels of capital and, until the early 1980s, very few banks failed. Losses were not imposed on depositors or taxpayers, because other banks were willing to absorb the costs, in part maybe because they wanted to avoid government action that might reduce their cartel profits. Benink and Benston further argue that the situation has changed and the solvency of banks in the EC is likely to be threatened, because of three factors. These factors are that there is greater competition among EC banks; competition from non-banks enabled by electronics; and losses to no-longer-protected undiversified banks. Due to the increasing importance of these three factors, there is a serious doubt that banks in the EC hold sufficient levels of capital to absorb the losses they might incur.[295]

It is proposed that the supervision of credit institutions would be restructured. The first element of the proposal is that governments publicly acknowledge that all depositors are fully (100%) guaranteed. At the same time, the scope of the guarantee would be narrowed by explicitly defining a deposit as an account that must be repaid at par and must offer explicit payments explicit interest payments not exceeding a relatively small amount above the comparable Treasury rate. The second element of the proposal is to secure deposits against loss to the deposit insurance fund or to taxpayers by requiring firms that offer deposit services to over-collateralize the deposits they hold or to hold a high level, relative to on-and-off balance sheet assets, of capital. The third element applied to depository institutions would be as banks' capital/asset ratios decline, this system of predetermined capital/asset zones or tripwires first permits and then requires the government banking authorities to take actions to redress the capital decrease and to take over the bank while its economic capital is positive. A

[294] Panourgias, ibid., pg. 19-21.
[295] Benink & Benston, ibid., pg. 10.

final point is that relatively large banks must be required to meet a portion of their capital requirement with debt capital that must be refinanced quarterly.[296]

It must be noted that the Principle of Home Country Supervision is not a principle laid down in the EC Treaty. This is also confirmed by the European Court of Justice in the case *Germany v. Parliament and Council*.[297] The ECJ has explicitly held that, since the Home Country Supervision is not a principle laid down in the EC Treaty, the Community legislature is entitled to depart from the principle of home country supervision, provided that it did not infringe the legitimate expectations of the individuals concerned.[298] The core principles of mutual recognition, minimum harmonization and home country control are not EC Treaty or case law derived legal principles. These major principles do have some EC Treaty precedence and are implied in certain judicial decisions. These principles, are not however, separate, autonomous, self-validating legal rules or principles as such.[299]

[296] Benink & Benston, ibid., pg. 22.
[297] Case 233/94 *Federal Republic of Germany v European Parliament and Council of the European Union,* 1997 ECR I-2045.
[298] Avgerinos, ibid., pg. 61.
[299] Walker, ibid., pg 298.

II. Conceptual Background

As discussed above, given the problems of measuring risk embodied in complex balance sheets, the supervision of banking activities seeks to ensure that banks have sound internal procedures to assess the risk and calculate the required amount of capital to hold. It provides incentives for banks to develop their own internal models for risk evaluation. The role of the supervisor is seen as making sure the systems in place and the capital held are appropriate for the banks' balance sheet and environment. It also envisages a continuing dialogue between banks and their supervisors, with the supervisors having the authority to analysis and to intervene when necessary.[300]

The EC Treaty, without making any reference to the Principle of Home Country Supervision, has laid the foundations for the European internal banking market by prescribing the freedom of establishment, the freedom to provide services and the free movement of capital. In theory, it can be said that three models of regulation and supervision of banks which provide services beyond their home borders: (a) completely harmonized framework of standards between the domestic and the host country; (b) supervision by the host country; and (c) supervision by the home country. It was argued that the establishment of an EC regulator will lead to further erosion of Member State sovereignty in a very sensitive area.[301] Accordingly, the EC seems to have chosen not to create a single pan-European supervisor but the EC has preferred to follow essential harmonization approach and to secure the mutual recognition of authorization and prudential supervision systems. Consequently, the sole major responsibility to authorize and prudentially supervise banks lies in the hands of the home country supervisors.[302]

When one country, the home[303] or the host[304], imposes its own control on entities, the issue is not about the content of rules but rather the conflict of rules, which country's regulation will prevail and which country's regulator will ultimately have the power of supervision. As discussed, the cooperative agreements between supervisory authorities are

[300] International Monetary Fund Working Paper, ibid., pg. 11.
[301] Avgouleas, ibid., pg. 84.
[302] Avgerinos, ibid., pg. 63.
[303] Directive 2006/48/EC defines "**Home Country**" as the Member State in which a credit institution has been authorized in accordance with the Directive 2006/48/EC.
[304] Directive 2006/48/EC defines "**Host Country**" as the Member State in which a credit institution has a branch or in which it provides services.

likely to provide solutions to these problems supplemented by essential harmonization. Nonetheless, the power of the host country to impose justified or unjustified restrictions may weaken the sufficiency of cooperation. Then, an increased level of harmonization becomes necessary.[305]

The concept of home country control is not new. The Treaty of Rome recognizes the principle itself. For example, Article 57 of the Treaty provides for the issue of directives for the mutual recognition of diplomas, certificates and other evidence of formal qualifications. The general philosophy behind the concept is that in a common market a qualification gained in one Member State must be valid in all other Member States. As discussed above, the definition and birth of the home country control principle lies in the White Paper of 1985. Since the White Paper, the principle has been explicitly adopted by the banking directives, which have used the principle as a vehicle to facilitate the internal banking market. In other words, the principle of Home Country Supervision was introduced for the first time by the European Commission's White Paper of 1985, as a basic pillar of the 1992 Internal Market Program. It took many years for the Member States and the EC decision-making bodies to agree on what the appropriate level of regulation and supervision should be. Hence, the White Paper seems to have marked a dramatic change of approach in the way in which liberalization across Member States' frontiers was to be achieved.[306]

It can also be said that the First Banking Directive has clarified some decades ago that home country control as regards both authorization and supervision was the ultimate objective of the EC banking legislation. The principle of home country supervision in the banking sector has been announced as an objective in the Preamble to the First Banking Directive. At the international level, the Basel Committee[307] has set out a set of principles[308], which were adopted by the countries represented in the Committee.[309]

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[305] Avgerinos, ibid., pg. 53.
[306] Avgerinos, ibid., pg. 53.
[307] The Basel Accord(s) or Basle Accord(s) (see spelling section below) refers to the banking supervision Accords (recommendations on banking laws and regulations), Basel I and Basel II issued by the Basel Committee on Banking Supervision (BCBS). They are called the Basel Accords as the BCBS maintains its secretariat at the Bank of International Settlements in Basel, Switzerland and the committee normally meets there.
Basel I is the round of deliberations by central bankers from around the world, and in 1988, the Basel Committee (BCBS) in Basel, Switzerland, published a set of minimal capital requirements for banks. This is also known as **the 1988 Basel Accord**, and was enforced by law in **the Group of Ten (G-10) countries in 1992**, with Japanese banks permitted an extended transition period. **Basel I is now widely viewed as outmoded**, and a more comprehensive set of guidelines, known as **Basel II** are in the process of implementation by several countries.
Basel I, that is, the 1988 Basel Accord, primarily focused on credit risk. Assets of banks were classified and grouped in five categories according to credit risk, carrying risk weights of zero (for example home country

The cross-border provision of services necessarily entails the potential application of more than one legal system namely the legal system of the home country where the undertaking providing the services originates and the legal system of the host country where the provision of services occurs. In certain fields including crime, the law of the host country plays the dominant role. However, the position is more complex with respect to commercial activity. Hence under the Rome Convention[310], in the absence of a choice of law by the parties, the law of the home country of the service provider is generally given the dominant role unless performance is effected through a branch when the law of the host country applies.[311]

The establishment of the EC Common Market under the Treaty of Rome aiming to achieve the purpose of the full free movement of goods, services, workers and capital, introduced the possibility of other approaches to the distribution of legal competences as well as the theoretical possibility of a completely harmonized, centralized system which would make such allocation of competence between the legal systems of Member States theoretically unnecessary.[312] Detailed harmonization has occurred in various discrete areas where a relatively high level of consensus is possible but it proved impractical more generally in the financial services field. Due to the foregoing and in line with the principle of subsidiarity, the focus has been on determining the respective roles of the EC law-making institutions on the one hand and the roles of the Member States on the other hand. In addition to this, an equally significant issue is the respective roles of the home and host countries.[313]

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sovereign debt), ten, twenty, fifty, and up to one hundred percent (this category has, as an example, most corporate debt). Banks with international presence are required to hold capital equal to 8 % of the risk-weighted assets.

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published **in June 2004**, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

[308] Available (17 February 2009) at www.bis.org.

[309] Avgerinos, ibid., pg. 56.

[310] Law Applicable to Contractual Obligations OJ 1980 L226/1.

[311] Lomnicka, ibid., pg. 295.

[312] Article 2 of the EC Treaty.

[313] Lomnicka, ibid., pg. 296.

Responsibility for supervising the financial soundness of a credit institution and its solvency should lay with its home Member State. Article 40 of the Directive 2006/48/EC clearly provides that the prudential supervision of a credit institution shall be the responsibility of the competent authorities of the home Member State. The host Member States' competent authorities must be responsible for the supervision of the liquidity of the branches and monetary policies.[314] Further, host Member States shall retain complete responsibility for the measures resulting from the implementation of their monetary policies.[315]

Following identification of the principle of the Home Country Supervision by the EC Commission in the White Paper, the program envisaged under the White Paper resulted in various directives in the field of the financial services including the Second Banking Coordination Directive, the Insurance Directives (92/49, OJ 1992, L228/1; as amended, and 92/96 OJ, 1992 L360/1, as amended) and the Investment Services Directives (93/22 OJ 1993 L141/27, as amended). In general, the main strategy adopted under the said Directives is that the Member States are given the task of authorizing and prudentially regulating their home financial services undertakings. Such home Member State authorization must then be recognized throughout the rest of the single market without more, thus conferring a single banking license on the undertaking. For this approach to be acceptable to all Member States there has to be level of harmonization of national standards.[316] The other significance of the White Paper is that banking and financial services were considered under the White Paper to amount to financial products which were comparable with the treatment of industrial and agricultural products under the decision of the European Court of Justice in the *Dassonville* case.[317]

[314] Recital 21 of the Directive 2006/48/EC.
[315] Article 41 of the Directive 2006/48/EC.
[316] Lomnicka, ibid., pg. 298.
[317] Walker, ibid., pg. 317.

The legal methodology of the Principle of Home Country Supervision involves the horizontal imposition of three supervisory rules:[318]

(a) **The Harmonized Community Rules:** The EC banking directives have introduced and established common minimum standards for banks, allowing thus, mutual recognition of the regulatory standards between Member States. The minimum standards have largely reflected a reaction against too detailed harmonization attempts of the past and a desire to establish common rules and competitive equality insofar as regulatory requirements were concerned. The regulatory requirements include standards which are believed to be very important to be drafted and supervised by national rules and the national competent authorities.

(b) **The Home Country Rules:** The major purpose and meaning of the home country control principle is that the home Member State is conceded the primary role of authorizing and regulating its own providers of banking services and supervising its own regulated markets. Under the banking directives, the home country is the Member State, in which a credit institution is incorporated and authorized. The rational behind the supremacy of the home Member State's control is its special relationship, which it enjoys with the credit institution incorporated within its borders.

(c) **The Host Country Rules:** Despite the primary role of the home Member State, the banking services directives seem to depart from the originally envisaged scope of the principle and hardly allow the home country to enjoy an exclusive power of control on credit institutions and investment undertakings. Under the banking directives, the host country is a Member State, other than the home Member State in which a bank operates. Certain less significant supervisory powers are conceded to the host Member State, for it is that the Member State's market, in which foreign banks operate, and that market's rules should commonly apply to all banking services providers, domestic and foreign. Nevertheless, the host country's power to impose supervisory rules, which may hinder the freedom of cross-border services, is not without limits. In its famous *Dassonville* decision, the ECJ tried to place host

[318] Avgerinos, ibid., pg. 54-55.

country's rules under scrutiny and establish a criterion in order to examine their lawfulness and compatibility with the provisions of the EC Treaty.

III. Home Country Supervision in the Banking Sector

As discussed above, the EC has opted to retain the full operation of all of the differing systems of national supervision and domestic supervisory agencies in place rather than attempt to establish any central EC authority or control procedure. Thus, it can be concluded that a control gap exists in financial supervision and control within the EC. In the absence of any central control system, considerable inconsistencies would inevitably arise in the operation of national systems. According to Walker, this problem will be particularly severe if large amounts of discretion are left to the Member States and national agencies in implementing relevant EC legislation in this area.[319]

If there is any cross border activity, there is the question what regulator and regulatory regime will be followed in the authorization and supervision and subsequently in the conduct of business and product control. This leads to a choice between the regulator of the service provider (or the home country regulator) and the regulator in the country of activity (or the host country regulator).[320]

The fundamental characteristic of a common market in banking is the opportunity it would provide for banks to operate freely at any given place within the EC. Such opportunity may be benefited by the banks either by establishing branches or by providing services across frontiers. Apparently, such concept would have three aspects: (i) standardized licensing procedures for new banks; (ii) free branching both domestically and across the borders; and (iii) home country control. The last item namely the Home Country Supervision is closely related with all stages of coordination since many of the envisaged measures depend on the principle of Home Country Supervision.

The embryo of the principle of Home Country Supervision was created under the First Banking Directive.[321] The principle has been announced as an objective in the Preamble of the First Banking Directive. Under the First Banking Directive the concept of Home Country Supervision meant that the supervisors of the country of origin will monitor banks which have their head office in their territory, as well as branch operations in other countries. Accordingly, the principle of home country control denotes that a bank authorized by a

[319] Walker, ibid., pg. 18.
[320] Dalhuisen, ibid., pg. 726.
[321] Third Recital of the Directive states that *...whereas the result of this [coordination] process should be to provide for overall supervision of a credit institution operating in severalMember States by the competent authorities in the Member State where it has its head office, in consultation, as apprpriate, with the competent authorities of the other Member States concerned.*

Member State will be subject to the supervision of the competent authorities of its home country even if it carries out its activities on the territory of another Member State.

In other words, Home Country Control means attributing primary authority for the supervision of a financial institution to the competent authorities of the Member State of origin with the territory of destination having a more limited but still complementary role. Home country control was accordingly allocatory in function and corresponded with the division of power or authority within a mixed supervisory system such as that set up within a regional trading block.[322]

According to Walker, while it could be argued that the new allocation provision separately introduced in the financial area was directly in the decision of the European Court of Justice in the case *Cassis de Dijon*, this is not correct to the extent that *Cassis* was only concerned with initial production and first placement. Home country control is necessary to provide for the continuing supervision of financial institutions in addition to their initial authorization which is itself a considerably more complex process than setting or imposing minimum product (content) rules. This then constitutes a new supplementary rule developed for use in the financial area.[323]

The principle of Home Country Control applies whether the business is carried out through branches established in the other Member State or by way of providing cross-border services. The competent authorities of home Member State have the rule-making and supervisory authorities regarding matters relating to the prerequisites for authorization of a bank, the acquisition of shares in a bank, the capital investment by a bank in non-financial area, the solvency ratio, the reorganization and winding-up of a bank, and the performance of banking activities unless the applicable EC legislation specifically provides for supervision by the host Member State.[324]

The Home Country Supervision principle effectively transfers the original market-entry based composition and placement rule into a post-entry continuing compliance condition. Rather than simply add a new compliance element, this changes the nature of the relationship between the firm concerned and the home and host territory and between the home and host territories themselves. The simple pre-entry product rules (lawful production

[322] Walker, ibid., pg. 318.
[323] Walker, ibid., pg. 318.
[324] Park, ibid., pg. 413.

and placement) are converted into a much more substantial continuing post-entry validation system.[325]

This has created important advantages for both the national competent supervisory authorities and the banks. By virtue of this principle, competent supervisors would be able to survey and monitor the global standing of a bank operating internationally. Otherwise, the powers of the competent authorities would end at the national frontiers. The advantage of this principle for the banks is that banks, instead of having to split up into virtually separate units in order to operate in different countries and having separate own funds, facing with different solvency standards etc., may be able to keep a single system of book-keeping and reporting, a single ratio system and a single endowment with own funds. Nonetheless, the competent authorities of the host Member State may, in emergencies, take any precautionary measures necessary to protect the interests of depositors, investors and others whom services are provided.[326]

Accordingly, the sole competence to authorize and prudentially supervise a financial services undertaking is conferred on its home Member State wherever it operates. The "home" State is essentially the State where the undertaking's true head office is. The "host" Member State is defined as the State in which the undertaking concerned establishes a branch or provides services and host Member State is also given a role, but such role is complementary.

It is important also to note that as accepted generally, the major duty of supervisory authorities is to monitor the solvency and the liquidity of a bank. As the more common instruments in this are the so-called prudential ratios, one can infer that the harmonization exercise, which will allow the implementation of the principle of home country control, will be completed only with the harmonization of the different prudential ratios in force in the various Member States. This general idea has lead to a number of initiatives:

- Consolidated Supervision
- Banks Accounts
- Prudential Returns
- Credit Information Exchange
- Crisis Management and Winding Up
- Mortgage Credit.

[325] Walker, ibid., pg. 320.
[326] Article 33 of the Directive 2006/48/EC.

According to one commentator, in regulating the market risk exposure of financial institutions, the approach taken to date has most often been a rule-based regime which sets a relationship between exposure and capital requirements exogenously.[327]

In practice, the EC still has a long way to go to achieve real convergence among national supervisors. Throughout the EC, banks are subject to a high level of regulation in the pursuit of their business activities.[328] Before granting a banking authorization, the competent regulatory authority will have to be satisfied that the applicant meets a number of criteria laid down in the relevant legislation including i.e. initial capital, suitability of directors and major shareholders, business plans, prudential controls and methods of risk management and assessment etc. Once authorized, a bank will continue to be subject to detailed continuous regulation and supervision. The level of its capital and liquidity in relation to its liabilities, the level of exposure to a single customer or class of customers and various other kinds of risk associated with its business will be subject to strict control. A bank may also be subject to detailed rules regarding the manner in which specific kinds of transactions can be entered into.[329]

In general there are four stages of the bank supervision namely, licensing, supervision, sanctioning and crisis management.[330] The degree of regulation differs from one Member State to another and leads to various obstacles in effective exercise in the banking sector. In addition, the powers and resources of national authorities differ widely from one member state to the other and national regulators also approach supervision with widely different philosophies. Whereas some national regulators place a greater emphasis on rules to protect consumers in the market, others emphasize the need to stimulate competition. Accordingly, there can be as many supervisory practices as there are supervisors in the EC. Consequently, national regulators find it difficult to coordinate their actions and monitor the activities of financial companies effectively.[331]

Starting with the White Paper, the EC has changed its approach and instead of attempting to harmonize every aspect of banking regulation, only the minimum necessary to ensure the proper regulation of financial services in the EC would be harmonized. Member States are allowed to adopt stricter rules than the Community rules and to regulate areas not

[327] Rahul Dhumale, Incentive v. Rule-Based Financial Regulation: A Role for Market Disciple, in Regulating Financial Services and Markets in the Twenty First Century, edited by Eılis Ferran and Charles A E Goodhart, 2001, Oxford – Portland Oregon, pg. 59.
[328] Strivens, ibid., pg. 283.
[329] Strivens, ibid., pg. 284.
[330] Panourgias, ibid., pg. 14.
[331] Alasdair Murray & Aurore Wanlin, The EU's New Financial Services Agenda, Center for European Reform, Working Paper, 2006, London, UK, pg. 28.

covered by the EC legislation. Nonetheless, under this so-called New Approach, Member States must accept that, once minimum harmonization had taken place, the regulatory systems of other Member States were intended to protect the same interests as their own systems of regulation and that an undertaking which satisfied the regulatory requirements of one Member State must not be required to satisfy the requirements of another Member State where for its activities in that Member State. Accordingly, in principle and subject to certain exceptions laid down in the relevant legislation, an undertaking would be able to operate throughout the Community subject primarily to the regulation system of only one Member State.[332]

Under this approach, the role of the host Member State is only complementary. In other words, only in exceptional circumstances, the competent authorities of the host country have the power (either exclusively or in cooperation with the authorities of the home county) to control certain aspects of operation within its territory of a bank whose head office is situated in another Member State. There are few instances which can be indicated as examples for the authority of host Member State. Among others, firstly, the host Member State regulator may prevent or punish irregularities within its territory which are contrary to the rules adopted in the interest of the general good. Secondly, with respect to the establishment of branches, the host Member State is to prepare for the supervision of that branch and if necessary indicate the conditions under which in the interest of the **general good** the business must be carried on in the territory of the host Member State. These confirm that the host Member State regulation, if justifiable on the basis of the general good, applies to the conduct of business in the host Member State.[333] Further, matters relating to the monetary policy, the liquidity ratio, the market (or position) risk and public interest considerations of the host country fall under the complementary role of the host Member State authorities.

The Second Banking Directive established the single banking license eliminating the barriers, like host country authorization and endowment capital requirements, to cross-border bank branching and provision of financial services. Without creating a single European banking license, the Second Banking Directive has allowed credit institutions authorized in a Member State to open branches or to provide cross-border financial services in another Member State by simply complying with a notification requirement while they are subject to home country prudential supervision. Accordingly, a credit institution can through its branch

[332] Strivens, ibid., pg. 292.
[333] Lomnicka, ibid., pg. 299.

carry out activities, which are listed in the Annex to the Second Banking Directive and for which it is licensed in the Member State of the initial authorization.[334]

As mentioned above, credit institutions have the right to provide their services in a Member State other than the Member State in which they are authorized without setting up a subsidiary or branch and without being required to apply for a further authorization. Nonetheless, before conducting business within the territory of another Member State for the first time, the credit institution must notify the competent authorities of the Home Member State of the envisaged activities.

Article 19 of the Second Banking Directive may be seen as a striking example of the principle of the Home Country Supervision in respect of authorizations. All control over the establishment of branches in the other Member States rests with the competent authorities of the home state. The competent Home Member State authorities are obliged to examine the application for the cross-border expansion and they are the decision makers. The host Member State authorities have no control at all over the decision of the home Member State to allow a branch to be established in their territory.[335]

Nonetheless, it is argued that the Second Banking Directive has gone too far in relation to the enforcement procedures envisaged under its Article 21.[336] In those areas where because of insufficient harmonization or for other reasons, host Member State authorities retain some degree of responsibility for supervision and those authorities should also be able to take enforcement action, without the need to look to action on part of the home Member State authorities first. In those areas, such as the supervision of liquidity and market risk, which have not been harmonized, there seems to be no justification for extending the home Member State control principle to enforcement action.[337] A specific example may be that a Member State-based banking supervision system lacks the necessary information and resources to assess the EC wide implications of illiquid but solvent pan-European banks or those whose solvency is in doubt.[338]

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[334] Panourgias, pg. 35-36.
[335] Strivens, ibid., pg. 293.
[336] Article 21 of the Directive states as follows:
Exercise of the freedom to provide services
1. Any credit institution wishing to exercise the freedom to provide services by carrying on its activities within the territory of anoher Member State for the first time shall notify the competent authorities of the home Member State, of the activities on the list in Annex I which it intends to carry on.
2. The competent authorities of the home Member State shall, within one month of receipt of the notification ..., send that notification to the competent authorities of the host Member State.
[337] Strivens, ibid., pg. 298.
[338] Panourgias, ibid., pg. 158.

Moreover, it is argued the home country control principle itself does not clearly mark the limits of the host country jurisdiction, as it does not constitute a principle embodied in the EC Treaty.[339] Article 58 of the EC Treaty explicitly provides for the competence of the Member States for the prudential supervision of financial institutions and so allows derogation from the free movement of capital. Further, banks established in a Member State as subsidiaries of a bank from another Member State are not covered by the EC banking directives and so additional restrictions may apply. Accordingly and more importantly, Member States may hinder cross-border banking mergers and acquisitions by relying on the provisions of the banking directives allowing for the national supervisors to oppose the acquisition of a "qualifying" holding in a bank if they are concerned about its effects on the "sound and prudent management" of the target bank.[340]

[339] Case 233/94 *Federal REpublic of Germany v European Parlimanet and Council of the European Union*, 1997 ECR I-2405.
[340] Panourgias, ibid., pg. 150.

IV. European Central Bank[341] - Committee of European Banking Supervisors - Cooperation

The principle of cooperation forms an important element of the principle of home country supervision. Coordination between banking supervisors and other regulators has nevertheless become increasingly important both nationally and internationally. One way to deal with various problems in the banking area is to reduce the number of regulators.[342] On the other hand, cooperation, bilateral or through various EC committees, is an important instrument for dealing with financial stability risks from Europeanization of the banking systems.[343] Accordingly, the relevant competent authorities of the Member States are expected to cooperate in the execution of their supervision tasks and exchange information regarding the management and ownership of banks, as well as banks' authorization, liquidity and solvency. Achievement of the single market in financial services necessitates the setting up at two levels of advisory committees that can support and advise the Commission in connection with market regulation. In the banking field, the European Banking Committee (EBC), which had replaced the Banking Advisory Committee that was established under the First Banking Directive, is attached directly to the Commission as a legislative advisory body, while the Committee of European Banking Supervisors (CEBS) is an interface between the Commission and the national public authorities that is also responsible for the proper and uniform application of Community measures.[344]

Within this framework, the Commission has noted in its Commission Communication of 28 October 1998 entitled "Financial Services: Building a Framework for Action", that there is a need for developing **structured cooperation between national supervisory authorities**. In this connection, it would be desirable to draw up a supervisor's cooperation charter which would assign responsibilities for different tasks and establish machinery for coordination between the different authorities responsible for prudential supervision. In the said Communication, there is also call for international cooperation on regulatory and supervisory matters, as well as review and updating of the existing rules on prudential supervision.[345]

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[341] The European Central Bank was established in the year 1998 in Frankfurt am Main (Germany).
[342] Peter D. Spencer, The Structure and Regulation of Financial Markets, 2000, Oxford University Press, Oxford, UK, pg. 242.
[343] Panourgias, ibid., pg. 142.
[344] Available at (11 December 2008) http://europa.eu/scadplus/leg/en/lvb/l22025.htm.
[345] Available at (4 January 2009) http://europa.eu/scadplus/leg/en/lvb/l24050.htm.

According to the said Communication, the Commission has also noted that the general conditions for a fully integrated European financial market require coordinated action by the public authorities responsible for regulation, supervision and competition. This should result in an integrated infrastructure enabling cross-border transactions to be settled as smoothly and efficiently as those within national borders. The Commission's Communication goes on to state that, it is also necessary to close legal loopholes in payment and securities settlement systems and in retail payment systems (in the case of the latter, by scaling back the obstacles that arise from statistical reporting).

The purpose of setting up the supervisory and regulatory committees is to give greater substance to the moves to achieve the single market in financial services in accordance with the framework mapped out by the Financial Services Action Programme (FSAP). The EBC and the CEBS must contribute to improving banking regulation and supervision of the application of European legislation in this field. They have been set up in response to the need to extend beyond securities markets the four-level approach to the regulation of financial services endorsed by the Committee of Wise Men, (the so-called Lamfalussy Committee in 2001. As advisory bodies, the two committees participate in the formulation and application of measures implementing the framework principles laid down by directives and regulations.[346]

Therefore, the committees are in a position to contribute greater flexibility to attainment of the FSAP and its follow-up by enhancing the adaptability of regulation to market circumstances. Accordingly, a set of six decisions and Directive 2005/1/EC have been adopted in order to extend this principle of regulation and supervision to banks, insurance companies and investment funds. At the same time, the committees that already existed are to be either reformed or abolished. Thus, the EBC replaces the Banking Advisory Committee, set up back in 1979 by the First Banking Coordination Directive 77/780/EEC.[347]

As guardians of activity in the banking field, these two advisory committees help to formulate banking legislation, with each having a specific role to play. The EBC is responsible mainly for advising the Commission on all banking legislation and on legislation relating to credit institutions and investment firms, regardless of whether the legislation exists already or is at the drafting stage. It contributes to discussions on policy issues relating to banking activities. It is also a regulatory committee empowered to give a formal opinion on draft measures implementing the EC directives.

[346] Available at (4 January 2009) http://europa.eu/scadplus/leg/en/lvb/l22025.htm.
[347] Available at (4 January 2009) http://europa.eu/scadplus/leg/en/lvb/l22025.htm.

According to the Commission's Decision dated 5 November 2003[348], the CEBS is an independent body providing advice on banking supervision.[349] It contributes to the consistent application of European banking legislation and to the convergence of supervisory practices. It is also a forum for cooperation and information exchange between European banking supervisors. As an advisory body, it submits opinions to the Commission on measures implementing the framework principles, whether acting on its own initiative or at the request of the Commission. In this connection, it has to hold wide-ranging consultations with market participants, consumers and end-users. It thus acts as an interface between the Commission and the national supervisory authorities. Accordingly, the nature of the roles and powers of each of these two committees reflects their respective composition.

The EBC is composed of high-level representatives of the Member States and is chaired by a representative of the Commission. It may invite experts and observers to attend its meetings.[350] The roles and duties of the EBC include, among others, consultancy. National authorities of all EC Member States (except the United Kingdom) have a duty to consult the EBC about draft legislation falling within its fields of competence, and the EBC delivers opinions in reply. EC institutions also consult the EBC about relevant draft Community legislation.[351]

Article 3 of the Commission's Decision dated 5 November 2003 states that the CEBS[352] shall be composed of high-level representatives from the national public authorities competent for banking supervision, representatives of the central banks and a representative of the European Central Bank.[353] Its composition must reflect the rights of each category represented and must comply with the principle of confidentiality. Each Member State designates two high-level representatives to participate in the meetings of the Committee. In particular, it may invite to its meetings observers from the other committees in the banking and financial sectors. However, only the representatives of the supervisory authorities have voting rights. Moreover, the two committees work closely together. The President of the

[348] Commission Decision of 5 November 2003 establishing the Committee of European Banking Supervisors (2004/5/EC) published in the Official Journal of the European Union dated 7.1.2004.
[349] The CEBS has started operating in January 2004 and the operational structures have been fully up and running since October 2004.
[350] Available at (4 January 2009) http://europa.eu/scadplus/leg/en/lvb/l22025.htm.
[351] Available at (22 December 2008) http://www.ecb.eu/ecb/legal/html/index.en.html.
[352] The CEBS publishes consultation papers on consultation practices, outsourcing, supervisory review process, common reporting, supervisory disclosure and financial reporting.
[353] Interestingly, Article 5 makes a clear distinction between (i) the central banks entrusted with specific operational responsibilities for the supervision of individual credit institutions alongside a competent supervisory authority; and (ii) the central banks which are not directly involved in the supervision of individual credit institutions, including the European Central Bank.

CEBS attends EBC meetings as an observer; the European Central Bank is also represented. The Commission too attends CEBS meetings.[354]

There are various challenges CEBS is facing in its work on the implementation of the EC legislation. These include, among others, ensuring the consistency in the implementation of the new framework in Member States, pursuing the convergence in supervisory practices, shaping cooperation between home and host Member State authorities in such a way as to streamline the supervisory process for cross-border groups, and shaping effective consultations, able to enhance the quality of the supervisory standards.[355] It is noted that the supervision cooperation may not deal effectively with the need for real-time information sharing and action in case of liquidity problems at pan-European banks.[356]

There is no provision, however, for a centralized banking supervisory institution at the EC level. Host Member States can rely only on minimum prudential regulation adopted by the home authorities after harmonization, and can only on home Member State's authorities' prudential supervision. Further, the national supervisory authorities of the Member States are expected to cooperate with each other through exchanging information and providing enforcement assistance. Cooperation, bilateral or through various Community committees, is a significant vehicle for dealing with financial stability risks from the establishment of the EC internal banking market. The national competent authorities are expected to cooperate with each other in carrying out their supervision tasks and exchange information concerning the management ownership of banks, their authorization and their liquidity and solvency.

Whereas bilateral cooperation has generally taken the form of the Memoranda of Understanding, which lay down detailed provisions of on information sharing and supervision coordination, cooperation at the EC level takes place in the context of the Banking Supervision Committee, the Banking Advisory Committee, as replaced by the European Banking Committee, and the Contact Group.[357] Currently, the decision-making bodies of the ECB are supported by the ESCB Committees.[358]

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[354] Available at (14 December 2008) http://europa.eu/scadplus/leg/en/lvb/l22025.htm.
[355] Available at (14 December 2008) http://www.ecb.eu/ecb/legal/html/index.en.html.
[356] Panourgias, ibid., pg. 6.
[357] Panourgias, ibid., pg. 142.
[358] At present, the Committees are as follows: the Accounting and Monetary Income Committee, the Banking Supervision Committee, the Banknote Committee, the Committee on Cost Methodology, the Eurosystem/ESCBCommunications Committee, the Eurosystem IT Steering Committee, the Information Technology Committee, the Internal Auditors Committee, the International Relations Committee, the Legal Committee, the Market Operations Committee, the Monetary Policy Committee, the Payment and Settlement Systems Committee, and the Statistics Committee.

It is also important to note that the EC Treaty, as amended, in its Article 105(6)[359], which is described as "enabling clause",[360] now states that [361]

…The Council may, acting unanimously on a proposal from the Commission and after consulting the European Central Bank and after receiving the assent of the European Parliament, confer upon the European Central Bank ***specific tasks concerning policies relating to the prudential supervision of credit institutions*** *and other financial institutions with the exception of insurance undertakings.*

Accordingly, Article 105 lays down the primary and secondary objectives of the ESCB. In addition, Article 105 indicates the ESCB's main tasks, which are normally associated with the activities of central banks.[362] The *de facto* independence of the ESCB is an important goal the guarantee of which will require a legal or statutory framework which protects, through specific legislation or regulations, that desirable room for manoeuvre.[363] The objectives and tasks of the ESCB are instrumental to the objectives of the EC as regulated under Articles 2 and 4 of the EC Treaty. As per Article 8 of the EC Treaty[364] the principle of subsidiarity laid down in Article 5 of the EC Treaty applies also to ESCB and ECB.

Pursuant to Article 105 of the EC Treaty, the ESCB's major objective is to maintain price stability. Furthermore, in addition to the objective regarding price stability, the ESCB's other objective is to contribute to the general economic policies in the EC with a view to contributing to the achievement of the objectives of the EC as laid down in Article 2 of the EC Treaty. Accordingly, prudential supervision is not among the basic tasks of the ESCB. It is argued that safeguarding financial stability and promoting European financial integration are often presented as other ESCB objectives. Although, no general financial stability

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[359] Article 105 was introduced by the Maastricht Treaty.

[360] Hanspeter K. Scheller, The European Central Bank – History, Role and Functions, Second Reivsed Edition (2006), available at (11 January 2009) http://www.ecb.int, pg. 112.

[361] Article 105(6) of the EC Treaty envisaged to be amended by the Treaty of Lisbon amending the Treaty on European Union and the Treaty Establishing the European Community (2007/C 306/01) will provide:

... The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings...

[362] Arda, Atilla, "Objectives and Tasks of the European System of Central Banks and the European Central Bank: A Commentary on Article 105 TEC", in Christian Campbell, Peter Herzog and Gudrun Zage, Smit & Herzog on the Law of the European Union (2005, loose-leaf), available at (12 November 2008) http://ssrn.com/abstract=928148, pg. 5.

[363] Lastra, Rosa Maria, "The Independence of the European System of Central Banks", Harvard International Law Journal, Volume 33, Number 2, Spring 1992, Harvard University Press, USA, pg. 519.

[364] Article 8 of the EC Treaty provides as follows:

A European system of central banks and a European Central Bank shall be established in accordance with the procedures laid down in this [EC] Treaty; they shall act within the limits of the powers conferred upon them by this [EC] Treaty and by the Statute of the ESCB and of the ECB annexed thereto.

objective can be derived from the Treaty, since monetary policy and financial stability are linked, and financial markets and infrastructures play a key role in the transmission of monetary policy, the ECB has a legitimate interest in and is committed to financial stability and financial integration.[365]

Whereas some of the tasks of the ESCB and ECB are basic tasks some others are described as other tasks. The basic tasks of the ESCB include (a) to define and implement the monetary policy of the EC; (b) to conduct foreign-exchange operations; (c) to hold and manage the official foreign reserves of the Member States; and (d) to promote the smooth operation of payment systems.

The Treaty lays down the consultative tasks of the ECB. In addition to the ECB's such consultative tasks which ensure that the ECB is involved in all matters relating to its field of activity, the Treaty also provides for the ECB's powers concerning prudential supervision. Such powers of the ECB are limited. Initially, the ECB has no operational tasks with regard to prudential supervision of the financial sector. More importantly, although under Article 105(6) of the EC Treaty, the ECB can be given specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings such provision has not yet been used.

The ECB merely contributes to the smooth conduct of policies pursued by the competent authorities and may offer advice to and be consulted by the Council, the Commission, and the competent authorities of the Member States on the scope and implementation of the EC legislation relating to the prudential supervision of credit institutions and the stability of the financial system. Accordingly, it is argued that the ECB's involvement with supervisory activities is limited to (a) contributing to national policies relating to prudential supervision, (b) contributing to the drafting of EC and national legislative provisions materially influencing financial stability; and (c) specific supervisory tasks to be given to the ECB in the future.[366]

Hence, the direct responsibility for banking supervision and financial stability remains with the competent authorities in each Member State, but the EC Treaty has assigned to the ESCB the task of contributing to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the

[365] Arda, ibid., pg. 8-9.

[366] Arda, ibid., pg. 18.

financial system.[367] Hence, the objective of the ESCB is to produce more harmonized regulation and improve supervisory cooperation and implementation, which will in turn contribute to more and stable cross-border financial services trade.[368] It seems that the institutional framework for banking supervision established by the EC legislation seems to rely on two pillars:

- National competence based on the principles of Home Country Control, Essential Harmonization and Mutual Recognition; and
- cooperation among the competent authorities.

The Treaty (as also reflected in the Statute of the European Central Bank) now expressly provides for expansion of the prudential supervision competence of the European Central Bank. According to one commentator, it allows centralization of prudential supervision at the ECB level even without activation of the so-called enabling clause. In addition, further responsibility could include "prudential rule making" with positive impact on the European banking market.[369] It is also argued that although the EC Treaty makes reference only to prudential supervisory policies, the EC Treaty does not seem to employ a systematic distinction between prudential regulation and supervision, however, in light of the major goals of the Treaty, tasks regarding prudential supervision policies can be interpreted to include rule making power. Such argument can be further supported by the softness of the expression of Article 105(6) which provides for the possibility of greater formal centralization of banking supervision throughout the ECB.[370]

The ECB's contribution **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** consists:

(i) to promote cooperation among central banks and supervisory authorities on policy issues of common interest in the field of prudential supervision and financial stability;

[367] "The European Central Bank – the Eurosystem; The European System of Central Banks", Available at (5 September 2008) http://www.ecb.int.
[368] Avgerinos, ibid., pg. 153.
[369] Panourgias, ibid., pg. 171.
[370] *(…) of specific tasks concerning policies relating to the prudential supervision of credit and other financial institutions with the exception of insurance undertakings …*

(ii) to perform its advisory function under Articles 4 and 25.1 of the Statute of the ESCB and ECB; and

(iii) to cooperate with other relevant authorities.

Accordingly, by virtue of (ii) above,[371] prudential supervision is among the subject of prior consultation of the ECB. Taken together, these provisions entitle ECB with a consultative and coordinating role in prudential supervision. However, the so-called enabling clause has not been activated yet. Accordingly, the ECB promotes the cooperation among central banks and supervisory authorities by hosting and supporting the Banking Supervision Committee.[372] In addition, the ESCB monitors and assesses the financial stability at the Euro-zone/EC level. Such activity complements and supports the corresponding activity at the national level, carried out by the national central banks and supervisory authorities in order to maintain financial stability in their respective country. The ESCB also gives advice on the design and review of regulatory and supervisory requirements for financial institutions. Much of this advice is provided through the ECB's participation in the relevant international and European regulatory and supervisory bodies.[373]

In this respect, the principle of subsidiarity would not be a major concern and have applicability to prevent the activation of the enabling clause. The "implied doctrine" provides that the EC has not only competence which is expressly prescribed by specific EC Treaty provisions but also competence that is implied from them. Thus, the ECB can exercise powers, which are conferred upon it by the EC Treaty.[374] Further, since the EC enjoys exclusive competence in reforming the prudential supervision arrangements. Moreover, Article 105(5) of the Treaty and the monetary policy and implied powers doctrine adopted thereunder offer an additional legal basis for the expansion of the prudential supervision powers of the European Central Bank.[375]

[371] Articles 4 and 25.1 of the Statute of the ESCB and ECB.
[372] Scheller, ibid., pg. 113.
[373] Available at (22 December 2008) http://www.ecb.int.
[374] Panourgias; ibid., pg. 176.
[375] Panourgias, ibid., pg. 172.

The need to establish a European regulator (i.e. EC Banking Authority) or to activate the so-called enabling clause derives also from EC principles other than the principle of subsidiarity. It is suggested that there are a number of areas of bank regulation where discretion is particularly important, and that should have been centralized even before the monetary union, once there is sufficient integration of financial markets to imply a significant degree of risk of cross-border contagion. These discretionary functions are authorization, illiquidity, closure and administration of deposit insurance.[376] As discussed above, the EC Banking directives confirmed the ability of the host Member State regulator to maintain banking rules in the interest of the **general good**.[377] The recital of the subsequent Directives provides that the Member States must ensure that there are no obstacles to carrying on activities receiving mutual recognition in the same manner as in the home Member State, as long as the latter do not conflict with legal provisions protecting the general good in the host Member State. Accordingly, host country prudential arrangements can be maintained if they meet the criteria of the general good principle. The host Member State can apply prudential measures, which are equally applicable to national and non-national banks, to the extent that minimum common prudential standards and home country supervision on a consolidated basis are not adequate to address risks for financial stability and depositor protection.

In light of the foregoing, it may be concluded that the Home Country Supervision may not be sufficient for financial stability if the EC internal banking market is to be realized. The Principle of Home Country Control may have reached its limits. It seems difficult to argue that there is too much point in having a common monetary policy and aiming at a single financial market, while keeping different financial regulation and supervision in each Member State. Regulatory arbitrage, implementation divergence and issues of supervisors' liability indicate the shortcomings. Cooperation among the supervisory authorities of the Member States may not deal effectively with the need for real-time information sharing and action in case of liquidity problems at pan-European banks.[378] Further, a single supervisory authority

[376] Davis, ibid., pg. 21.
[377] Article 31 of the Directive 2006/48/EC provides that *Articles 29 and 30 shall not affect the power of host Member States to take appropriate measures to prevent or to punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interests of the **general good.***
[378] Panourgias, ibid., pg. 6.

could render the system more credible than the current multiple and overlapping national regulatory and supervisory authorities.[379]

[379] Avgerinos, ibid., pg. xiv.

V. Analysis

As discussed above, the situation in the EC has been changing and the solvency of the EC banks is likely to be threatened, because of three factors: greater competition among EC banks, competition from non-banks enabled by electronics, and losses to no-longer-protected undiversified banks.

There is no centralized prudential mechanism at the EC level. All Euro-zone national central banks enjoy financial autonomy and generally perform Eurosystem[380] tasks at their own cost and risk. Nonetheless, intra-system financial relationships exist in two respects:

(i) the Euro-zone national central banks have paid up their shares in the capital of the ECB, have endowed the ECB with foreign reserve assets and share the ECB's financial results;[381] and

(ii) the Euro-zone national central banks share out among themselves the "monetary income", i.e. the income that accrues to the national central banks in performing the Eurosystem's monetary policy function.

Home country control seems to be necessary to provide for the continuing supervision of banks in addition to their initial authorization (licensing) which is itself a considerably more complex process than setting or imposing minimum product rules.[382] So far, minimum standards and cooperation frameworks constitute the prudential institutional foundation of the EC internal banking market. Supervisory responsibilities are therefore carried out at the national level and are allocated according to institutional arrangements specific to each Member State. Whereas in some countries, the respective national central bank is given the task to supervise banks either extensively or even exclusively, in some other Member States, separate authorities perform banking supervision, but cooperate with the respective central bank.[383] Accordingly, the institutional structure for financial services supervision differs in Member States. While, some of the Member States, such as the United Kingdom, Denmark and Luxembourg have a single regulator for their financial sector, different structures are in place in other Member States, some within finance ministries, some outside.[384] In the UK, the

[380] The word "Eurosystem" is used to describe the entity composed of the ECB and the national central banks of those Member States that have adopted the euro, currently 15.
[381] The Eurosystem national central banks have transferred foreign reserve assets to the ECB totalling to some € 40billion.
[382] Walker, ibid., pg. 318.
[383] Scheller, ibid., pg. 111.
[384] Avgerinos, ibid., pg. 186.

first-line prudential supervision has been transferred to the Financial Services Authority (micro-prudential supervision), while the Bank of England remains the primary macro-prudential supervision. The novelties introduced in the UK legislation include the move to a single regulator, a simpler framework for rule-making including clear objectives, a more prominent role for cost-benefit analysis and a more consistent approach to individual responsibility for compliance.[385] Germany and Austria have also adopted the single financial regulator model but these two Member States have provided for extensive macro-prudential functions of the respective central banks and this on a statutory basis.[386]

Nonetheless, this idea can be criticized by a number of reasons. It is claimed that the major argument for the separation of bank supervisory services from the monetary authority is that the combination of functions might lead to a conflict of interests. The implied concern is that, as the central banks lends to a troubled credit institution in its role, this loan will increase the net inflow of reserves to the banking system and thus undermine monetary policy. Also, it would not be very compatible with basic democratic principles to entrust too much power to a single institution. Also, the main argument against separation of functions is systemic stability and consistency between monetary policy and financial supervision. Further, a pan-European supervisor could do more harm than good, if such an institution were overly politicized like other regulators.[387]

On the other hand, a flexible, independent and accountable central pan-European regulator would stand away from national, political and socio-economic interests which would address the need for the resolution of the inevitable national conflicts and to provide the natural shield to prevent problems.[388] Prudential supervision by the home country authorities, supported by essential harmonization of banking regulation and mutual recognition, provides the basis for both the reduction of national barriers to financial services and the supervision of cross-border banking activity.[389] As discussed above, the EC Commission recognized that increased cooperation between supervisory authorities was of crucial importance to the management of institutional and prudential risk. While the effective supervision of financial institutions on a cross-border and increasingly cross-sector basis had to be ensured, the EC Commission considered that this was best achieved through increased cooperation between national authorities rather than the creation of any new pan-European

[385] Iain MacNeil, "The Future for Financial Regulation: The Financial Services and Markets Bill", The Modern Law Review, Vol.62 (1999), Blackwell Publishers, Oxford, UK, pg. 743.
[386] Panourgias, ibid., pg. 189.
[387] Avgerinos, ibid., pg. 233.
[388] Avgerinos, ibid., pg. 245.
[389] Panaourigias, ibid., pg. 136.

arrangements at this stage. Many cross-border mergers and acquisitions have taken place during the past few years, both in Europe and elsewhere, and both domestically and cross-border. In EC, there have been more than 1200 deals with an aggregate value of €250 billion between June 1999 and June 2000.[390] Within the EC, some 45 large cross-border institutions account for 70% of total bank assets.[391] To this end, increased cooperation was would be promoted between supervisory authorities and between supervisory and monetary authorities.[392]

With respect to the importance of national banks in relation to the supervision of financial institutions, it is significant to note that the ECB itself has stated in its Opinion[393] that also the EC Treaty contains a provision relying on the central bank to address supervisory issues which may arise in increasingly integrated financial markets.[394] Further, with respect to the establishment of a public entity to established in Austria under a draft Law shared with the ECB for its opinion, the ECB had stated that the objective of achieving more effective coordination between the conduct of supervisory functions in all segments of financial activity could be pursued also with means that do not imply a reduced role of the central bank (Austrian Central Bank). The ECB also opined that in support of a continued and even reinforced involvement of the Austrian Central Bank (OeNB) in prudential supervision, it may be argued that also the EC Treaty contains a provision relying on the central bank to address supervisory issues which may arise in increasingly integrated financial markets. According to the ECB, in fact, Article 105(6) of the EC Treaty envisages a simplified procedure to confer upon the ECB specific tasks in the context of supervision of credit institutions and other financial institutions with the exception of insurance firms.[395]

Central banks are in general in an advantageous position to fulfil the responsibility for financial stability, given their insight into money and financial market developments and involvement in payment systems and monetary policy operations.[396] It is argued that neither institutional nor geographical separation of monetary policy and bank supervision means no prudential supervision power for the central bank. The central bank always retains a

[390] Avgerinos, ibid., pg. 225.
[391] Interviews with Lucas Papademos (ECB vice-president) and Jean-Claude Trichet (ECB president) published in the cover page of the daily newspaper, Financial Times Newspaper, 5 January 2009.
[392] Walker, ibid., pg. 258-259.
[393] Opinion of the European Central Bank dated 25 May 2001 issued at the request of the Austrian Ministry of Finance on a draft Article of the Federal Law.
[394] The ECB's competence to deliver an opinion is based on Article 105(4) of the EC Treaty, Article 3.1 of the Statute of the European System of Central Banks and of the European Central Bank, and Article 2(1) of the Council Decision 98/415/EC dated 29 June 1998.
[395] Paragraph 4 of the Opinion.
[396] Paragraph 7 of the Opinion.

significant, in the worst case residual, bank supervision responsibility. Even when a separate agency is in charge of bank supervision, the central bank can undertake prudential supervision functions, as these are indispensable to its monetary policy power.[397]

There are various views that the current decentralized supervisory framework is inadequate and supervision must be further centralized. Despite the establishment of the single banking license and the substantial reduction of regulatory barriers, the EC banking market remains largely fragmented and banking business is primarily local and has not yet realized the benefits of an integrated European banking market. It is therefore argued that centralization of the European supervisory framework will contribute to integration of the currently fragmented European banking systems and will effectively deal with subsequent EC-wide systemic stability risks. In the EC, banks still have to comply with the Host Member State's regulations in areas not covered by the EC legislation and the Home Country Supervision Principle itself does not determine the limits of the Host Member State jurisdiction.[398] In addition, it is clear that some subjects can be more effectively handled by host country supervisors; and cooperation between supervisors both bilaterally and multilaterally will be essential.

On the other hand, according to one commentator, there had to be a pressing, imperative and obvious need for host country restrictions, which therefore could not be justified on the mere ground of reasonableness. Even after the liberalization a contemplated in the EC liberalization directives, the general good concept still remains of considerable importance in the area of conduct of business and product control.[399] The analysis of the general good in the ECJ's case law and in the EC banking directives indicates that there is much scope for the implementation of the general good exception in the context of financial services.[400] Accordingly, it can be argued that the Principle of Home Country Supervision applies only with respect to the harmonized prudential rules for example own funds, solvency ratios, capital requirements etc. The Member States can still adopt non-discriminatory restrictions with respect to prudential rules that have not been harmonized or with respect to rules that address prudential concerns not sufficiently deal with by the harmonized prudential standards. Directly discriminatory measures may be sustained only under the "public policy" exception of Article 46 of the Treaty of Rome. However, implementation of Article 46 of the Treaty to banking regulation is difficult since the ECJ has excluded economic considerations

[397] Panaourgias, ibid., pg. 163.
[398] Panaourgias, ibid., pg. 148-150.
[399] Dalhuisen, ibid., pg. 727.
[400] Tison, ibid., pg. 377.

from the ambit of "public policy" under Article 46.[401] Discrimination seems to remain relevant only with respect to the type of regulatory considerations which can justify exemption of trade-restrictive regulation. Different Member States have used the general good clauses for attributing specific residual powers to their prudential authorities towards foreign financial institutions and the lists of general good rules established by some Member States are moreover illustrative of the sometimes very extensive concept of the general good by the host Member States.[402] Hence, directly discriminatory measures can be exempted only for the very limited reasons of public policy, public security, and public health laid down in the EC Treaty.[403]

Further, it is essential to tackle with the issues presented by modern electronic methods of attracting and doing business which require approaches which are not territorially focused.[404] In other words, the close link between the national financial systems leads to links for the transmission of deficiencies among each other.

According to Avgerinos, despite their initial aim, practice has shown that the twin principles of Home Country Supervision and Mutual Recognition, as implemented by EC secondary legislation, have not been supplemented by a clear allocation of responsibilities in times of crisis and a mechanism to ensure that all banks operating in EC have an effective supervisory authority. The existing regime has indicated a legal, structural and practical lacuna in times of crisis, as in a number of cases. Further, the grey responsibilities between the home and the host Member State have resulted in the duplication of control in many cases, which significantly hinders the cross-border services rendered by banks. This has an especially negative effect in a new European market with a single currency, a major change of asset allocation patterns and an increasing demand for Euro-wide investment products.[405]

The elements of the effective supervision are of significant nature. These elements consist, among others, the following: (a) identifying the appropriate supervisory objectives; (b) establishing mechanisms that will achieve those objectives; (c) monitoring whether the objectives are being achieved; and (d) enforcing or taking other corrective action when there is a violation or lack of compliance with requirements.[406] The appropriate supervisory objectives include (i) to strengthen the macroeconomic and microeconomic stability of the financial system as a whole, (ii) transparency in the market and in financial undertakings and

[401] Panaourigias, ibid., pg. 46-47.
[402] Tison, ibid., pg. 377.
[403] Panaourgias, ibid., pg. 96.
[404] Lomnicka, ibid., pg. 296.
[405] Avgerinos, ibid., pg. 55.
[406] Avgerinos, ibid., pg. 5.

consumer protection, and (iii) the safeguarding and promotion of competition in the financial undertakings' sector.[407]

The following seems to have the potential to prevent the occurrence of forum shopping. Firstly, the requirement that a bank has its head office in its home Member State and that it actually operates there discourages forum shopping. Secondly, the home Member State regulator's responsibility for depositors' insurance suggests that retention of strict requirements is in the interest of the home Member State regulator. Thirdly, the ability of the host Member State to retain regulation in the interest of the general good stands as a barrier to a harmful regulatory competition allowing for forum shopping. Fourthly, banking systems with higher standards and reputation must contribute to their institutions' better access to capital and business markets and thus should be more attractive to banking business.[408]

EC favours the home country control and mutual recognition principles over harmonization and centralization. A decentralized system consisting of national structures and international cooperation may not be adequate for the regulation and supervision of a bank that is active in various jurisdictions. The existing domestic regulatory structures, even if strengthened, may not deal effectively with problems in the payment and settlement systems and interbank complications in a more global banking system.[409] It is also beyond any doubt that there might be case in which the home and host Member State authorities maintain different views particularly relating to the distribution of capital within a group of companies. In addition, the difference in the views of the home and host Member States may emerge also in crisis situations, in which the distribution of responsibilities could be less precisely defined.

As discussed above, the Mutual Recognition can be achieved on the basis of the minimum coordination or essential harmonization of certain core rules in the banking and financial area. And, such harmonization may be completed and achieved by a separate principle of home country supervision.

To the extent that the principle of Home Country Supervision effectively converts the principle of Mutual Recognition into a new doctrine (of license recognition or license or systems validation), it can be considered to be separate and independent. The principle of Home Country Supervision would then imply both the Mutual Recognition (through the cross-validation of the license or authorization provided within each territory) and minimum harmonization (being the defined basis on which the reciprocal recognition would be

[407] Avgerinos, ibid., pg. 18.
[408] Panaourigias, ibid., pg. 38.
[409] Panaourigias, ibid., pg. 55.

provided). Mutual Recognition can only suggest rather than fully imply Home Country Control to the extent that its pre-market entry product composition and marketing conditions cannot be naturally extended to include full post-entry supervision and continuing regulation. A full doctrine of Home Country Control would still imply underlying mutual recognition.[410]

Nonetheless, derogation from the principle of home country supervision is possible. This is mainly because the said principle does not constitute a constitutional EC law principle, and therefore, the regulatory jurisdiction of the host country may always be brought back. This has been stated by the ECJ in one of its decisions where the ECJ has held in the Case 352/85, *Bond van Adverteerders and others v The Netherlands State*, 1988 ECR 2085 that:[411]

> *The Court finds, first, that it has not been proved that the Community legislature laid down the principle of home State supervision in the sphere of banking law with the intention of systematically subordinating all other rules in that sphere to that principle. Second, since it is not a principle laid down by the Treaty, the Community legislature could depart from it, provided that it did not infringe the legitimate expectations of the persons concerned.*

The regulatory and supervisory machinery of the EC internal banking market is further enhanced through the EC institutions. The Banking Advisory Committee, as replaced by the European Banking Committee (or the "EBC"), and the Banking Supervision Committee contribute to effective supervision by performing an advisory and coordinating role. The European Central Bank having a coordinating role and responsibility for the smooth conduct of national policies towards financial stability, also stands as the ultimate guarantor of financial stability. Further, the national central banks or authorities are primarily responsible for banking supervision. The European Commission has established two new banking committees at the EC level in order to improve regulation and supervision of cross-border banking in the Community. A new European Banking Committee has replaced the Banking Advisory Committee and a new Committee of European Banking Supervisors, comprised of national supervisory authorities, is established in order to advise the Commission on technical implementing measures and assist with supervisory cooperation and implementation.

It is argued however that the Home Country Supervision model may not be the most efficient solution either for the realization of the EC internal banking market or for the safety

[410] Walker, ibid., pg. 321.
[411] Panaourigias, ibid., pg. 47.

and soundness of a Europeanized banking system. Host country rules, even when non-discriminatory, have proved to be barriers to EC-wide financial services trade. Arguably, these host country rules are allowed to stay or even grow, as the home country control system is not a fundamental EC law principle that cannot be departed from. The general good exception provides further justifications for host country regulation. The home country control model may not be adequate for financial stability in the context of a further Europeanized banking market. The current banking supervision framework fails to address issues for banks operating in various EC Member States and cooperation may not ensure the necessary real-time information sharing and real-time action.

The analysis of the banking supervision in the EC is undertaken in order to identify the limits of a decentralized supervisory framework as the foundation for a sustainable liberalization of trade in financial services. Even in the EC, with the integrated operation of legislative mechanisms for the reduction of trade barriers and development of prudential standards, the existence of advanced cooperation arrangements, and the certainty of a monetary union and a coordinated macroeconomic environment, centralization of prudential institutions appears necessary for a complete and safe internal banking market. Otherwise, there is considerable room for trade-restrictive domestic measures, and in any case there are weaknesses in maintaining the stability of the integrated banking systems.[412]

The main purpose of setting up the supervisory and regulatory committees is to give greater substance to the moves to achieve the single market in financial services in accordance with the framework envisaged under the Financial Services Action Programme. The committees must contribute to improving banking regulation and supervision of the application of EC legislation in this field. They have been set up in response to the need to extend beyond securities markets the four-level approach to the regulation of financial services endorsed by the Committee of Wise Men, (the so-called Lamfalussy Committee in 2001. As advisory bodies, the two committees participate in the formulation and application of measures implementing the framework principles laid down by directives and regulations. The committees are thus in a position to contribute greater flexibility to attainment of the FSAP and its follow-up by enhancing the adaptability of regulation to market circumstances. Accordingly, a set of six decisions and Directive 2005/1/EC have been adopted in order to extend this principle of regulation and supervision to banks, insurance companies and investment funds. At the same time, the committees that already existed are to be either

[412] Panourgias, ibid., pg. 138.

reformed or abolished. Thus, the EBC replaces the Banking Advisory Committee, set up back in 1979 by the First Banking Coordination Directive 77/780/EEC.

As guardians of activity in the banking field, these two advisory committees help to formulate banking legislation, with each having a specific role to play. The EBC is responsible mainly for advising the Commission on all banking legislation and on legislation relating to credit institutions and investment firms, regardless of whether the legislation exists already or is at the drafting stage. It contributes to discussions on policy issues relating to banking activities. It is also a regulatory committee empowered to give a formal opinion on draft measures implementing the Consolidated Banking Directive 2000/12/EC.

The Central European Banks System is an independent body providing advice on banking supervision and contributes to the consistent application of the EC banking legislation and to the convergence of supervisory practices. The Central European Banks System is also a forum for cooperation and information exchange between European banking supervisors. As an advisory body, it submits opinions to the Commission on measures implementing the framework principles, whether acting on its own initiative or at the request of the Commission. In this connection, it has to hold wide-ranging consultations with market participants, consumers and end-users. It thus acts as an interface between the Commission and the national supervisory authorities.

Accordingly, the nature of the roles and powers of each of these two committees reflects their respective composition. The ECB is composed of high-level representatives of the Member States and is chaired by a representative of the Commission. It may invite experts and observers to attend its meetings.

Given the tasks assigned to it, the Central European Banks System is composed of high-level representatives from the national public authorities competent for banking supervision, representatives of the central banks and a representative of the European Central Bank. Its composition must reflect the rights of each category represented and must comply with the principle of confidentiality. Each Member State designates two high-level representatives to participate in the meetings of the Committee. In particular, it may invite to its meetings observers from the other committees in the banking and financial sectors. However, only the representatives of the supervisory authorities have voting rights.

Moreover, the two committees work closely together. The President of the Central European Banks System attends EBC meetings as an observer; the European Central Bank is also represented. The Commission too attends Central European Banks System meetings.[413]

The Principle of Home Country Supervision does not itself clearly indicate the limits of the host country jurisdiction. Article 58 (former Article 73) of the EC Treaty explicitly acknowledges competence of the Member States for prudential supervision of financial institutions and thus allows derogation from the free movement of capital. Further, banks established in a Member State as subsidiaries of a bank from another Member State are not covered by the EC Directive and so additional restrictions may apply. Overlaps in the responsibilities of the home and host supervisor of a banking group and divergence in their respective supervisory practices become of increased concern, as banking groups tend more and more to manage their business and risk centrally.[414] According to the Directive 2006/48/EC of the European Parliament and of the Council, whereas responsibility for supervising the financial soundness of a credit institution, and in particular its solvency, should lay with its home Member State, the host Member State's competent authorities should be responsible for the supervision of the liquidity of the branches and monetary policies. The supervision of market risk should be the subject of close cooperation between the competent authorities of the home and host Member States.

This chapter provided a discussion of the main characteristics of the Principle of Home Country Supervision. Following the failure of initial harmonization efforts, the EC policy-makers have opted to follow home country control and mutual recognition of minimum standards. This regime was believed to constitute the best means of liberalization of European banking market and the free provision of banking services on the one hand, and to take more account of national concerns and to serve the principle of subsidiarity on the other.

In light of the foregoing, one may conclude that the principle of supervision by the competent authorities of the home Member State refers to prudential supervision of banks and is in principle the exclusive competence of the home country and the rules of the home Member State apply. Further, in the absence of centralized mechanisms, prudential concerns allow trade-restrictive host country rules to be retained to the extent that harmonization of prudential regulation has not covered them and besides the problems for the internal market, the home country supervision model may not be adequate for financial stability if the EC

[413] Available at (10 January 2009) http://europa.eu/scadplus/leg/en/lvb/l22025.htm.
[414] Panourgias, ibid., pg. 150.

internal banking market is to be realized.[415] Regulatory arbitrage, implementation divergence, and issues of supervisors' liability indicate the shortcomings. Although certain aspects of cross-border banking services are harmonized by EC law, other areas of competent authorities' responsibility are not clearly separated between the home Member State and host Member State.

This leads to unanswered various questions including what would be the best way to deal with the imperfections of the home country control and does the home Member State supervision of banks have negative effects for the efficient and truly free provision of banking services as contemplated under the EC Treaty. Meanwhile, a number of financial authorities, and in particular the ECB, have some concerns that the complexity of the EC's regulatory system would make it difficult for the EC to react efficiently and quickly to a Europe-wide financial crisis. The fear is that the lack of effective supervisory coordination could result in poor scrutiny of cross-border firms, and hamper an effective pan-European response to any crisis.[416] Finally, the EC legislation does not contain any restriction to endeavour to find a new structure for bank supervision. In other words, if the developing and restructuring of European financial services sector requires a new and more challenging approach by EC regulatory and supervisory authorities, there is no legal obstacle hindering the abandonment of the existing home country control regime and the adoption of better solutions.[417] Such difficulties and ambiguities have led some businesses to propose the formation of a more centralized regulatory system within the EC. For example, in the year 2004, the European Financial Services Roundtable suggested establishing not a "single" but a "lead supervisor" to address these problems.[418]

[415] Panourgias, ibid., pg. 6.
[416] Murray & Wanlin, ibid., pg. 29.
[417] Avgerinos, ibid., pg. 82.
[418] Murray & Wanlin, ibid., pg. 29.

§ 7. EFFECTS OF TURKEY'S EU MEMBERSHIP ON TURKISH BANKING LEGISLATION

I. General – Existing Legislation

Until the adoption of the Banking Law No. 5411 in the year 2005, various banking laws were enacted to regulate the banking sector in Turkey. It can be said that following the establishment of the Republic of Turkey the first piece of legislation adopted with the purpose to regulate the banking sector was the Law on Protection of Savings No. 2243 dated 30 May 1933 which stayed in force only for a very short term.

The Law was replaced by the Banks Law No. 2999 which was adopted by the Turkish Grand National Assembly on 1 June 1936. The Law No. 2999 stayed in force for a long term (more than 22 years).

Due to the developments and new needs of the sector, the Banks Law No. 2999 was replaced on 2 July 1958 by the enactment of the Law No. 7129 dated 23 June 1958, as amended various times. The Law No. 7129, which was amended various times, had stayed in force around 25 years.[419]

By virtue of the Law on Authorization for the Regulation of Money and Capital Markets No. 2810 dated 5 April 1983 the government was granted the authority to regulate the money and capital markets. As per the authority granted by the Law No. 2810 and within the framework of the Law, the Government had enacted the Decree with the Force of Law No. 70 which had become a law in the year 1985 (Law No. 3182). The Banks Law No. 4389 was enacted by the Turkish Grand National Assembly on 18 June 1999 to replace the legislation which was than in force.[420]

Finally, the Banking Law No. 5411 was adopted by the Turkish Parliament in the year 2005. As will be discussed below, the Banking Regulation and Supervision Agency ("BRSA") has then enacted various pieces of secondary legislation in different forms (e.g. regulation, communiqué etc.) regulating different banking matters with the aim to implement and interpret the provisions of the Law No. 5411.

[419] Servet Taşdelen, Bankacılık Kanunu Şerhi, 2006, Turhan Kitabevi Yayınları, Ankara, pg. 5-25.
[420] Taşdelen, ibid., pg. 5-25.

II. Banking Law No. 5411

At present, the main piece of legislation governing the banking sector in Turkey is the Banking Law No. 5411. The Law No. 5411 was adopted by the Turkish Parliament on 19 October 2005 and was announced in the Official Gazette dated 1 November 2005. The Law consists of 171 Articles and 23 Temporary Articles laid down under 15 sections and has introduced a number of novelties including, among others, providing a clear list of so-called banking activities. The BRSA has enacted various secondary piece of legislation within the framework of the Law. Starting from the general reasoning of the Law, the reasoning of the provisions of the Law includes various references to the EC banking legislation.

The purpose of the Law is stated in its Article 1. According to the said Article, the objective of the Law is to regulate the principles and procedures of ensuring confidence and stability in financial markets, the efficient functioning of the credit system and the protection of the rights and interests of depositors. The deposit banks[421], participation banks[422], development and investment banks, the branches in Turkey of such institutions established abroad, financial holding companies, Turkish Banks' Association, Turkish Participation Banks' Association, BRSA, Savings Deposit Insurance Fund and their activities shall be subject to the provisions of the Law.[423]

Section 1 (*Permissions for Establishment or Opening Branches and Representative Offices in Turkey*) of Part II (*Transactions Subject to Permission*) of the Law governs permission for establishment or opening branches and representative offices in Turkey. Under the Law, "**branch**" is defined as any work place like stationary or mobile bureau, which constitutes a legally bound part of banks and which partly or entirely performs the activities of these institutions, excluding units solely composed of electronic devices. On the other hand, "**central branch**" is defined as the branch established in Turkey by a bank established abroad, or in the case of branches more than one in Turkey, the branch which has been notified to the BRSA and approved by the BRSA Board. Although, the local banks do not need to notify BRSA about their central branch, and even if there is such notification,

[421] The Law defines "**deposit banks**" as the institutions operating primarily for the purpose of accepting deposit and granting loan in their own names and for their own accounts as per the provisions of the Law and the branches in Turkey of such institutions established abroad.
[422] The Law defines "**participation banks**" as the institutions operating primarily for the purposes of collecting fund through special current accounts and participation accounts.
[423] Article 2 of the Law.

central branches and other branches are not subject to any different provisions under the Law, foreign banks operating through branches in Turkey must notify their central branch to the BRSA Board. Accordingly, foreign banks' central branch offices in Turkey will have parallel functions and roles to those of the general directorate of banks established in Turkey.[424]

According to Article 6 of the Law, the establishment of a bank in Turkey or the opening up of the first branch in Turkey by a bank established abroad shall be permitted upon affirmative votes of at least five members of the BRSA Board provided that the conditions for the establishment laid down in the Law have been fully satisfied. Article 6 states that the principles and procedures for permission applications and granting permissions shall be determined by a regulation to be issued by the BRSA Board. Further, BRSA Board shall also determine the details concerning the establishment of a bank to be engaged exclusively in offshore banking or the opening of a branch in Turkey by such banks established abroad for such purposes, and their fields of activity and financial reporting and audit procedures as well as the details concerning the temporary suspension or revocation of their activities. It is important to note that the BRSA has prepared a proposal for the amendment of the Banking Law.[425] The amendments to be introduced by the draft law (or BRSA proposal published in the BRSA's official web site) in the Law includes, among others, Article 2 of the Law. BRSA proposes the amendment of current Article 2 of the Law to include the following provision:

> *In case the legal entities or individuals settled abroad intend to establish bank in Turkey [and made an application to the BRSA for such purpose], the (BRSA) Board has the authority to evaluate the applicant's such request in light of the regulations of the country where the applicant is settled regarding bank establishment on the basis* ***reciprocity*** *in addition to the conditions envisaged under the Law.*

This draft proposal is very important from various aspects. Currently, the Law does not explicitly grant any authority to BRSA to examine any application of a foreign person or entity on the ground of reciprocity. If the current proposal prepared by the BRSA will be accepted and adopted by the Turkish Grand National Assembly as is, the BRSA's authority to evaluate any foreign applicant's request for establishment in Turkey will also include the authority to assess such application in light of the so-called **Principle of Reciprocity**.

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[424] Seza Reisoğlu, Bankacılık Kanunu Şerhi, Yaklaşım Yayıncılık, Ankara, 2007, pg. 106.
[425] Available at (5 October 2008) http://www.bddk.org.tr/turkce/Mevzuat/Duzenleme_Taslaklari.

As per the draft proposal, the BRSA will have the authority to examine the applicable legislation in the applicant's country concerning the bank establishment. In other words, under the Principle of Reciprocity embodied in the draft proposal, the BRSA will be entitled to accept or refuse a foreign bank's application to establish a bank in Turkey on the grounds of the reciprocity. In order to make such analysis, BRSA would need first to examine the applicable legislation in the country concerned and to make a legal analysis about the general legal framework applicable to an applicant to establish a bank in the country concerned. Accordingly, the BRSA will take into account the hurdles that a Turkish person or entity may face with in order to establish a bank in such country, in making its own evaluation for an application to be made to the BRSA by any entity or person from such foreign country for the establishment of a bank in Turkey. Apparently, this will be a very significant novelty in case the Banking Law No. 5411 will be amended as per the draft proposal.

The Law, at present, does not make any explicit distinction between Turkish banks and foreign banks. Further, the Law does not provide any foreign shareholding restriction. This may be criticized from different aspects. However, if the Law will be amended as per the draft proposal, the BRSA Board will have the authority to examine a foreign entity's application to open a bank in Turkey on the basis of reciprocity. Although, the draft proposal is yet be adopted and the implementation and interpretation of the draft proposal by the BRSA Board is yet be tested, it can be assumed that the BRSA Board may use this new legal ground to reject applications of foreign entities from different countries to open a bank in Turkey on the ground of the legislation applicable in such countries regarding establishment of a bank by a Turkish person or entity.

The other novelty introduced by the Law No. 5411 is embodied in Article 4 (Fields of Activity) of the Law. Article 4 for the first time has laid down clearly and in details the activities that can be carried out by banks. This is in parallel with the philosophy of and methodology followed by the EC banking directives.[426]

Under Article 6 of the Law, the banks established abroad may establish representative offices in Turkey with the permission of the BRSA Board provided that they do not accept deposits or participation funds and those they operate within the framework of the principles to be set by the BRSA Board.

[426] Reisoğlu, ibid., pg. 131.

Article 9 of the Law lays down the requirements for the opening of branches in Turkey by banks with headquarters abroad. The said Article of the Law provides that any bank established abroad that will operate in Turkey by opening branch within the framework of the principles and procedures set by the BRSA Board should meet the following conditions:

(a) Its primary activities must not have been prohibited in the country where they are headquartered;

(b) The supervisory authority in the country, wherein the headquarters of the bank is located should not have negative views concerning its operation in Turkey;

(c) The paid-in capital reserved for Turkey should not be less than the amount set forth under the Law;[427]

(d) The members of the board of directors should have adequate professional experience to be able to satisfy the requirement laid down in the corporate governance provisions and to perform the planned activities;

(e) It must submit an activity program indicating work plans for the fields of activity covered by the permission, the budgetary plan for the first three years as well as its structural organization;

(f) The group including the bank must have a transparent shareholding structure.

An application for operating permission cannot be granted for the activities prohibited due to the violation of the local legislation in the country where such institutions are headquartered.

Accordingly, requirements that are parallel to the requirements to establish a bank in Turkey must be complied with in order to establish a branch office in Turkey. Hence, for example, any foreign bank intending establish branch office(s) in Turkey must allocate capital which must at least be equal to the minimum paid-in capital of a bank set forth under the Law. Moreover, according to the Law, the activities of a foreign bank that is intending to establish a branch office in Turkey must not have been prohibited in the country where its headquarters is located. In addition, the supervisory authority wherein the foreign bank's headquarters is located must not have any negative views about the foreign bank's establishment of a branch office in Turkey.

[427] According to Article 7 of the Law, the paid-in share capital amount of a bank must be at least 30.000.000YTL.

Hence, it seems that in order to adopt an approach parallel with that of the EC banking directives, it is now easier for foreign banks to establish branch offices in Turkey. In this respect, it is no longer necessary for a foreign bank, for example, to have been incorporated in the form of a joint stock corporation or a similar/equivalent form in its country of origin, or not to contain in its Articles of Association any provision contrary to the Banking Law, or to appoint a Turkish citizen as the manager of the branch office in Turkey.[428]

It is important also to note that Law No. 4389 had different provisions to regulate the same subject matter. Under the former Banks Law No. 4389, in order to establish a branch in Turkey, the bank concerned must not have been prohibited from carrying out banking activities in any country where such banks has been carrying out banking activity. Therefore, in order to carry out banking activities in Turkey through a branch office, a foreign bank carrying out banking activities in various countries must not have been prohibited from carrying out banking activities in any of these countries. Nonetheless, the Law No. 5411 has limited the country/countries where the foreign bank's activities must not have been prohibited to only the country where the bank's headquarter is located. One can argue that this is also in parallel with the provisions of the relevant EC directives.

The foregoing provisions of the Law No. 5411 may be considered to be parallel with one of the major EC banking law principles namely the Home Country Supervision. Since Turkey is not a member of the EC, it is not required to comply with the major EC banking law principles, e.g. the Home Country Supervision. On the other hand, the foregoing provisions of the Banks Law No. 5411 indicate that the Turkish authorities namely BRSA will cooperate with the authorities of the country wherein the headquarters of a foreign bank intending establish a branch office is located. The BRSA will seek for an affirmative opinion from the official authorities concerned in that respect. As mentioned in the reasoning of Article 7 of the Law, the foregoing is parallel to the requirements sought under the EC Banking directives.

Further, as per Article 10 of the Law concerning operating permission, the banks that are permitted to be established in Turkey or permitted to open up branches in Turkey within the framework of the provisions of Article 6 of the Law are required to receive permission for operation from the BRSA Board. The permission to be given shall be issued in the Official Gazette. The decision regarding the permission shall be made within 3 months following the submission of the application at the latest. The banks that have received establishment

[428] Reisoğlu, ibid., pg. 234.

permission shall be required to meet the following criteria in order to commence their operations:

(1) their capital should have been paid in cash and must be at a level that enables the execution of planned activities,

(2) minimum one fourth of the system entrance fee, equivalent to ten percent of the minimum capital requirements set forth in Article 7 of the Law, should have been paid to the account of the Savings Deposit Insurance Fund (SDIF), and the related document submitted to the BRSA by the founders,

(3) their activities must be in compliance with corporate governance regulations and should have the required personnel and technical infrastructure,

(4) their managers should bear the qualifications set out in the corporate governance regulations,

(5) the BRSA Board must comment that they bear the qualifications required for executing the activities.

Subject to certain conditions set forth under Article 13 (*Opening Domestic Branches*) of the Law, banks may freely open branches within Turkey. The conditions that banks are required to comply include the banks' compliance with the principles to be determined by the BRSA Board. In order to establish branches, banks also required to comply with the corporate governance and protective provisions laid down in the Law. Further, the BRSA must be notified about the establishment of the branch. Whereas, banks do not need to obtain the permission of the BRSA Board in order to establish a branch in Turkey, they need to obtain the permission of the BRSA Board in order to establish a branch or a representative office abroad as per Article 14 (*Cross Border Activities*) of the Law.

According to Article 14 of the Law, banks established in Turkey may open branches or representative offices abroad, including off-shore banking regions, on the condition to set up undertakings or participate in existing undertakings comply with the corporate governance and protective regulations set forth under the Law and to comply with the principles to be established by the BRSA Board. Corporate governance of the banks is regulated under Part III of the Law. The rationale behind the provision is that the country where a Turkish bank intends to carry out banking activities may not have adequate level of regulatory monitoring and supervision. Hence, the Law requires Turkish banks to obtain the permission of the

BRSA before carrying out any banking activity outside of Turkey. This is also parallel with the requirements set forth under the EC banking directives.

Within this perspective, it is important to note that the EC Commission notes in the Turkey 2008 Progress Report that with a view to strengthening the liquidity position in the banking system, the BRSA has introduced additional liquidity requirements.[429] The BRSA also advised private banks to build up a solid capital stock in response to the recent financial crisis.[430] Moreover, the prudential and supervisory standards have been tightened up. The BRSA imposed marked-to-market valuation for the derivative instruments recorded on bank balance sheets.[431] Furthermore, the BRSA has introduced additional reporting requirements for the representative offices of foreign banks.[432].[433]

Under the Turkish Commercial Code as well as the foreign investment legislation in Turkey, liaison offices of entities with legal personalities do not have legal personality. Hence, liaison offices are not allowed to enter into any contract or carry out transaction binding the liaison offices. As mentioned above, a liaison office is referred to as a *"representative office"* under Turkish banking legislation.

The main piece of legislation regulating the operations of a representative office in Turkey is the Communiqué on Principles and Procedures on the Operations of Representative Office in Turkey (the "**Communiqué**"). Under the Communiqué, it is granted a transition period of six months for existing representative offices to comply with the Communiqué, *e.g.* until 1 October 2008. However, representative offices that are established after 1 April 2008 must comply with the provisions of the Communiqué. The failure to comply with the provisions of the Communiqué will result to the penalties prescribed under Article 150 of the Banking Law, *e.g.* imprisonment from three to five years and a judicial fine up to 5,000 days.

The Law sets forth that banks established abroad may open representative offices in Turkey with the permission of the BRSA provided that they do not engage in the business of

[429] The Regulation amending the Regulation concerning the measurement and assessment of the Banks' Liquidity Requirements published in the Official Gazette dated 5 April 2008 and numbered 26838.
[430] The BRSA has advised the Union of Turkish Banks and Participation Banks with a latter dated 3 November 2008 about the same.
[431] The Regulation amending the Regulation concerning measurement and assessment of the capital requirement of banks published in the Official Gazette dated 22 March 2008 and numbered 26824.
[432] The Regulation amending the Regulation on the Activities of the Banks which are subject to permission and indirect ownership published in the Official Gazette dated 5 April 2008 and numbered 26838.
[433] The Commission Staff Working Document (Turkey 2008 Progress Report) accompanying the Communication from the Commission to the European Parliament and the Council (Enlargement Strategy and Main Challenges 2008-2009) prepared by the Commission of the European Communities; Brussels; 5.11.2008; SEC (2008)2699; pg.48-50; Available at (14 Februrary 2009) http//www.eu.int.

accepting deposits or participation funds and, moreover, operate within the framework of the principles to be set forth by the BRSA. Pursuant to the Communiqué, a representative office may only be established (i) to provide services and maintenance to Turkish customers and suppliers of the parent bank, (ii) to conduct market research, (iii) to advertise and promote the parent bank's business and (iv) to include report on information collected from Turkish market to the parent bank. Pursuant to the Communiqué, a representative office cannot engage in activities that generate expenses, except income or inevitable expenses and donations.

In every six month, representative offices must inform the BRSA of their activities. In their information, representative offices must also include list of persons that visited the relevant representative office and the basis of their visit. And in any event, if a representative office has drafted a report to those visitors or *vice-versa* (the "Report"), the representative office must inform the BRSA of the content of this report.

The personnel that will be employed by a representative office must be Turkish resident. Additionally, the representative office must submit identification details, including the résumés and domiciliation of the personnel, excluding cleaning and security staff, to the BRSA within fifteen days starting from their employment. In the event that employment of any of the previously mentioned staff is terminated, the representative office must also notify the BRSA of this event.

Operational expenses of a representative office will be borne by its parent bank. Moreover, a representative office can only have one bank account, and that, a representative office can, in no event, execute a bank transfer from this account to its parent bank. A representative office must keep the details and excerpts related to this bank account for a minimum of ten years.

Pursuant to the Communiqué, representative offices are not allowed to carry out the following activities: (i) to approve money transfers from the parent bank, any other bank or financial institution, (ii) extend credits or loans, (iii) to involve in any other banking activities as prescribed under Article 4 of the Law No. 5411, (iv) to employ any personnel for the purposes of the same, and (v) to extend credits and loans on behalf of the parent bank or financial institution.

III. Turkish Banks under EC Directives

It is important to note at the outset that the Law No. 5411 does not contain any provision regarding the legislation that a Turkish bank's branch office established abroad shall be subject to. The provisions of the Law No. 5411 shall be applicable only to the Turkish banks' branch offices in Turkey.[434] It will be very unfair to argue that a Turkish bank's branch office established abroad shall be subject to the provisions of the Law No. 5411 in addition to those of the legislation of the country concerned.[435]

Since Turkey is not a member of the European Union, the position of the Turkish banks is closely related with the position of non-EC banks under the EC Banking Directives. In order to benefit from the EC Treaty rules on the right of establishment and the right to provide services, it is necessary to be a national of a Member State. The EC Treaty also provides that companies or firms formed in accordance with the law of a Member State and having their registered offices, central administrations or principal places of business within the EC are to be treated, for the purposes of the chapter on the right of establishment, in the same way as natural persons who are nationals of the EC Member States. Hence, any Turkish national including entities namely Turkish banks will not be allowed to benefit from the Treaty provisions on the right of establishment. However, the subsidiaries of Turkish banks established in the EC, are subject to and benefit from the rules relating to the single banking market. The supervisory authority of the Member State concerned which authorized the establishment of the subsidiary of a Turkish bank must have to satisfy itself as to the quality of information received, if requested, from the parent Turkish bank's supervisory authority namely BRSA.

Under the Directive 2006/48/EC, branches of a non-EC bank may continue to carry on their business in the Member State where they have been established. Nonetheless, as per Article 38[436] of the Directive 2006/48, the principles of European banking passport (single banking license) and mutual recognition do not apply to them and they should obtain appropriate authorization from the competent authorities of the host Member State in order to establish a branch or to provide cross-border services in the territory of other Member States.

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[434] Reisoğlu, ibid., pg. 279.
[435] Reisoğlu, ibid., pg. 280.
[436] Article 38 provides that ...*Member States shall not apply to branches of credit institutions having their head office outside the Community, when commencing or carrying on their business, provisions which result in more favourable treatment than that accorded to branches of credit institutions having their head office in the Community.*

Although host Member States are not allowed to require branches of banks authorized by another Member State to provide endowment capital, this does not apply to branches of non-EC banks.[437]

The foregoing is also repeated under the Directive 2006/48/EC. Recital 19 of the Directive 2006/48/EC provides that the rules governing branches of credit institutions having their head office in **third countries** should be analogous in all Member States. It is important to provide that such rules may not be more favourable than those for branches of credit institutions from another Member State. The EC must be able to conclude agreements[438] with third countries providing for the application of rules which accord such branches the same treatment throughout its territory. The branches of credit institutions authorized in **third countries** must not enjoy the freedom to provide services under Article 49 of the EC Treaty or the freedom of establishment in Member States other than those in which they are established.

With respect to the cooperation with third countries, Article 39 of the Directive 2006/48 provides that the EC Commission may submit proposals to the Council, either at the request of a Member State or on its own initiative, for the negotiation of **agreements with one or more third countries** regarding the means of exercising supervision on a consolidated basis over the following: (a) credit institutions the parent undertakings of which have their head offices in a third country; or (b) credit institutions situated in third countries the parent undertakings of which, whether credit institutions or financial holding companies, have their head offices in the EC. The agreements to be concluded with third countries shall ensure that (i) the competent authorities of the Member States are able to obtain the information necessary for the supervision, on the basis of their consolidated financial situations, of credit institutions situated in the Community and which have as subsidiaries credit institutions situated outside the Community or holding participation in such institutions; and (ii) the competent authorities third countries are able to obtain the information necessary for the supervision of parent undertakings the head offices of which are situated within their territories and which have as subsidiaries credit institutions situated in Member States or holding participation in such institutions.[439]

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[437] Park, ibid., pg. 414.
[438] Under the Directive 2006/48/EC, the agreement to be concluded with a non-EC state should be on the basis of reciprocity, between the Community and third countries with a view to allowing the practical exercise of consolidated supervision over the largest possible geographical area.
[439] Article 39(2) of the Directive 2006/48/EC.

It is important to note that a bank authorized by a Member State and which is a subsidiary of a non-EC entity also benefits from the single passport and the principle of mutual recognition. This is irrespective of the situation whether the requirement of reciprocity is satisfied between the EC and the parent entity's country. Within the same context, when the same subsidiary of a non-EC undertaking authorized by a Member State establishes a branch in another Member State or acquires a majority holding in another bank authorized by another Member State, such establishment of branch or acquisition of bank will not be disallowed even if there is no reciprocity.

Nonetheless, the status of a bank authorized by a Member State and established in the territory of such Member State which is a subsidiary of a non-EC entity may be questioned if its center of management is situated outside the territory of the EC. In certain circumstances, a bank being a non-EC entity's subsidiary may be considered to have its center of management outside the EC as its shareholders are resident in countries which are not EC Member States. In such a situation, the 1968 Convention on the Mutual Recognition of Companies and Legal Persons provides that a Member State may refuse to recognize such subsidiary as an EC company, unless that subsidiary has a genuine link with the economy of one of the Member States.[440] Further, the General Programs for the Abolition of Restrictions on Freedom of Establishment and on Freedom to Provide Services gives Member States the right to question the status of the subsidiary of a third country bank: the subsidiary would only be deemed established in a Member State, if its activities reveal a real and continuous link with the economy of a Member State.[441]

The absence of reciprocal treatment of a bank authorized by an EC Member State by a third country does not necessarily prevent a Member State from granting authorization to a branch of non-EC bank. Nonetheless, as per the First Banking Directive, a Member State must not grant more favourable treatment to branches of a non-EC bank than to branches of banks authorized by a Member State.

On the other hand, under recital 19 of the Second Banking Directive, (i) the establishment by a non-EC entity of a bank subsidiary, or (ii) acquisition of a stake in an EC bank by a non-EC entity may be prevented or adversely affected if the requirement of reciprocity is not fulfilled between the EC and the country of the non-EC undertaking.

Article 9 of the Second Banking Directive deals with the authorities of the Commission with respect to two circumstances (a) the third country does not grant banks

[440] Park, ibid., pg. 414.
[441] Park, ibid., pg. 414.

which are authorized by an EC Member State(s) effective market access comparable to that granted to those third country banks by the EC, and (b) the third country is not offering the same competitive opportunities to EC banks (i.e. banks from all Member States) as compared to domestic banks and the conditions of effective market access are not fulfilled. In the cases (a) and (b), the Commission may request the Member States to inform the Commission of any application for authorization of a direct or indirect subsidiary bank of a non-EC undertaking or of any proposal by a non-EC undertaking to acquire a holding in an EC bank such that the latter would become its subsidiary. In the case (a), the Commission is also authorized to submit proposals to the Council of Ministers for the appropriate mandate and may, upon obtaining mandate from the Council of Ministers, initiate negotiations with that third country with the purpose of obtaining comparable competitive opportunities for EC banks. In the case (b), the Commission may initiate negotiations with the relevant third country in order to remedy the situation and for this initiation of negotiations, no mandate is required to be obtained from the Council of Ministers; and most importantly, the Commission, may with the authorization of a committee of representatives of Member States require that the competent authorities of the Member State limit or suspend their decisions about the establishment of an EC bank subsidiary or acquisition of an existing EC bank by a non-EC undertaking. The initial period of such limitation may not exceed three months however the period may be extended by a decision of the Council of Ministers with a qualified majority's consent.[442]

The foregoing leads to the discussions relating to the principle of "reciprocity". The principle of reciprocity established under the Second Banking Directive involves two elements: (i) mirror-image reciprocity, and (ii) national treatment. Whereas the former element involves the question of whether a third country is granting EC banks effective market access comparable to that granted by EC to the third country banks, the latter element is the question of whether a third country offers the same competitive opportunities to EC banks as are available to domestic banks and whether the conditions of effective market access are fulfilled. It is hoped that the reciprocity principle contained in the Second Banking Directive may change the negative attitude of certain Member States in respect of the recognition of EC subsidiaries of non-EC undertakings as an EC entity.[443]

In light of the foregoing, a recent example of the treatment of the Turkish banks under the EC legislation by EC Member States is the case of the state owned Ziraat Bank which had

[442] Park, ibid., pg. 415.
[443] Park, ibid., pg. 415.

problems and which had to go through a very lengthy process in order to establish a branch in an EC Member State, namely Greece.

IV. Analysis

The Principle of Home Country Control and the Principle of Mutual Recognition do not allow non-EC financial firms to establish branches or offer services throughout the EC on the basis of one authorization given by a Member State. Therefore, non-EC financial institutions are at a competitive disadvantage. Accordingly, any Turkish banks are at a completive disadvantage and are not allowed to incorporate branches or offer services throughout the EC on the basis of a license issued by a Member State.

Following Turkey's EC membership, the Turkish legislation must be fully re-visited and revised to fully comply with the EC legislation, including the banking legislation namely Directive 2006/48/EC. The Turkish banking legislation must be amended to reflect the major EC banking law principles of essential harmonization, home country control and mutual recognition on which the EC banking directives have been based. For example, as per Article 9 of the Directive 2006/48/EC, the Turkish authorities shall not grant authorization when the credit institution does not possess separate own funds or in cases where initial capital is less than EUR 5 million. In this respect, it will first of all be necessary to completely harmonize the terms used in the EC directives.

The relevant Turkish banking authorities namely the BRSA will be given new duties and responsibilities. The BRSA will be required to notify the EC Commission about every authorization to be granted by the BRSA.[444] The Commission will publish in the Official Journal of the European Union the list in which the name of the credit institutions granted authorizations are indicated. As per Article 15 of the Directive 2006/48/EC, the BRSA will be required to consult the competent authorities of the Member States involved in the following cases, before granting authorization to a credit institution: (a) the credit institution concerned is a subsidiary of a credit institution authorized in another Member State; (b) the credit institution concerned is a subsidiary of the parent undertaking of a credit institution authorized in another Member State; or (c) the credit institution concerned is controlled by the same persons, whether natural or legal as, as control a credit institution authorized in another Member State. The BRSA will not be able to require authorization or endowment capital for branches of credit institutions authorized in other Member States.[445] In other words, in the interest of applying the principle of free provision of banking services, the principle of control

[444] Article 14 of the Directive 2006/48/EC.
[445] Article 16 of the Directive 2006/48/EC.

by the home member state will have to be introduced into the Turkish legal order before accession to the EC.

Accordingly, Turkish banks will enjoy the freedom to provide services within the EC and the freedom of establishment. However, such enjoyment of the said rights will be subject to the fundamental principles of EC banking law. Hence, once a bank is authorized by the relevant governmental authority in Turkey namely the Banking Regulation and Supervision Agency, such a bank will be allowed to establish branches and provide services in the EC Member States without being required to obtain another license or authorization in such Member States.

On the other hand, once Turkey has become a Member State of the EC, the credit institutions having their head office in other Member States will enjoy the same rights and such credit institutions will not be required to obtain any license or authorization issued by the relevant Turkish authorities in order to establish branches or provide services in the Turkish territory.

Further, Turkey will be required to conclude the same agreements with third countries that the EC and its Member States have previously concluded under the so-called Principle of Reciprocity.[446]

As a final point to note, Turkey will not be in a position to existing EC banking legislation. It is noted that this is ironic since while membership is made conditional upon the creation of stable institutions guaranteeing democracy, no democratic process whereby prospective members may influence present, or indeed future, legislation has been contemplated.[447]

[446] As mentioned above, under the Directive 2006/48/EC, such agreement will be concluded with a view to allowing the practical exercise of consolidated supervision over the largest possible geographical area.
[447] Mörner, ibid., pg. 17.

§ 8. DECENTRALIZATION MODEL

I. Decentralization and ECB

Initially, under the so-called New Approach, discussed above, the EC banking law principles of Essential Harmonization, Mutual Recognition and Home Country Control are the foundations of the EC internal banking market. Accordingly, under the so-called New Approach, the chosen strategy would be based on three principles: (i) a distinction would be drawn between essential internal market initiatives that had to be harmonized and those that may be left to mutual recognition of national regulations and standards; (ii) legislative harmonization would be restricted to laying down essential health and safety requirements which would be obligatory in all Member states; and (iii) where harmonization had not been achieved, mutual recognition would still be applied subject to agreed procedures to prevent unnecessary barriers to trade being maintained.[448] In other words, the centerpieces of the New Approach have been the home country control and mutual recognition principles, which have replaced previous full harmonization strategies.[449]

Credit institutions are allowed to incorporate branches and provide cross-border services in another Member State. Such provision of cross-border services and establishment of branches are subject to the foregoing principles of the EC banking law. This may also be described as the "**Decentralization Model**".

As discussed above, the applicable EC banking directives provides for a single banking license on the basis of mutual recognition and home country supervision that allows for broad access to national markets, as only limited host regulations remain intact. Within this framework, the host Member States can rely on minimum prudential regulations enacted by the home Member States after harmonization, and can rely on Home Member States' prudential supervision. Accordingly, a division of powers between the home and the host Member State and supports a predominant power of the former although the latter preserves important tasks especially in the area of conduct of business rules.[450] Recognition of home country supervision is further mandated through the application by the ECJ of the proportionality test on national barriers to the internal market freedoms, which in turn produces more market access. Prudential implications from these trade benefits are addressed

[448] Walker, ibid., pg. 123.
[449] Avgerinos, ibid., pg. 102.
[450] Avgerinos, ibid., pg. 103.

through harmonization of legislation and through home country supervision on a consolidated basis.

Moreover, the national supervisory authorities are expected to cooperate with each other through exchanging information and providing enforcement assistance. The authorities of the Member States are expected to cooperate in the execution of their supervision tasks and exchange information concerning the management and ownership of banks, and the authorization and liquidity as well as the solvency of the banks. There are also a number of committees namely the Banking Supervision Committee, the European Banking Committee etc. dealing with the financial stability risks.

However, the EC legislation does not contain any provision regarding the centralized banking supervisory authority at the EC level. During the early stages of the EC following the entry into force of the Treaty of Rome, little progress was achievable. This was also reflected in a Commission Communication dated October 1983. The need for some progress in the area of financial policy and financial integration was highlighted by the EC Commission in a Communication on Financial Integration in 1983 (Communication of the European Communities, *Financial Integration* COM (83) 207 final). The EC Commission noted that despite the progress that had been achieved in other trade relate areas little had been possible in the financial area.[451]

Despite the importance of the banking system, a major policy vacuum and control gap remains within the EC. The meanings, relationship and relevance of the aforementioned fundamental principles of the EC Banking Law are still far from clear. Fundamental difficulties also remain in connection with a number of key aspects of the underlying jurisprudence of the ECJ from these new integration devices are derived. Major problems also remain with regard to the structure and content of the supporting secondary program constructed. According to various views, the current decentralized supervisory framework is inadequate and supervision should be further centralized.[452] According to Walker, in the absence of any central control function or mechanism, considerable inconsistencies will inevitably arise in the operation of national systems. This problem is particularly severe if

[451] Walker, ibid., pg. 79.

[452] The European Shadow Financial Regulatory Committee believes that the existing framework is inadequate to handle potential risks: Within a European context, monetary union is prompting a quantum leap in interpenetration of financial institutions and markets. These developments generate a new potential for European-wide instability while also reducing the capacity of individual Member States to handle crisis. Against this background, it is necessary to reassess the adequacy of home country control and existing provisions for the lender-of-last-resort. The Committee proposes as a first step a more institutionalized coordination of supervisory authorities by the European Central Bank. (cited from George Alexander Walker, ibid., pg. 146 - footnotes 59 and 60).

large amounts of discretion are left to Member States and national agencies in implementing relevant EC legislation in this area. To the extent that regulatory provisions are generally enforced at the national level through local or domestic rather than regional agencies, a further control gap is created.[453]

In fact, reference to a European Community banking law model or paradigm presents a basic paradox. This is mainly due to the aforementioned principles of the European banking law and the EC approach. While on the one hand, the bank regulatory and supervisory systems of each of the 27 Member States continue to exist, on the other hand, certain prudential supervisory standards have been imposed through out the whole EC. Further, the efforts for the harmonization of the banking legislation are generally indirect as the strategy is based on the concept of mutual recognition of banks duly incorporated in another Member State. In other words, the EC law does not contemplate the direct harmonization of the national banking systems in all material respects.

Under the principle of mutual recognition, a Member State is required to recognize within its territory, the banking institutions incorporated in other Member States. In addition, under the minimum or essential harmonization principle, the substantive laws of each Member State can remain fundamentally different from other Member States provided however that the minimum standards set forth under the EC legislation are complied with. Consequently, one may conclude that in that respect today an identical EC banking law does not exist.

On the other hand, within the framework of the principles of mutual recognition of banking licenses and minimum prudential supervisory standards, and given the strong competitive dimensions of the EC common market crated under the Treaty of Rome, the secondary EC legislation and the case law of the European Court of Justice, it may be expected that the banking legislations of the Member States even cannot be fully harmonized or completely harmonized would come closer in the near future.

As per the EC Treaty, the European Central Bank has an advisory and coordinating role with respect to the prudential supervision of the banks. Nonetheless, it is argued that the adding the ECB's extended competence for prudential regulation and supervision, a full internal market can be achieved.[454]

There are limits of a decentralized framework as the foundation for a sustainable liberalization of trade in financial services. According to Lazaros, the EC has integrated

[453] Walker, ibid., pg. 18.
[454] Panourigas, ibid., pg. 94 – 95.

operation of legislative mechanisms for the reduction of trade barriers and development of prudential standards, and there is a certain level of advanced cooperation arrangements and the certainty of a coordinated macroeconomic environment. Nonetheless, further centralization of prudential regulation and supervision is still necessary for a full and safe internal banking market. In the absence of such centralized mechanisms, prudential concerns allow trade-restrictive host country rules to be retained to the extent that harmonization of prudential regulation has not covered them.[455]

The EC Treaty's language is general in its description of the European System of Central Banks' role in prudential regulation and supervision. Article 105(5) of the Treaty states that *the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions*. Further, it is set out that the ESBC's coordinating role shall also relate to the stability of the financial system. Article 105(6) envisages that the Council may entrust the ECB with tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. Furthermore, Article 25(1) of the ESBC Statute[456] gives the ECB an advisory role with regard to the scope and implementation of EC legislation relating to the prudential supervision of credit institutions and to the stability of financial system.[457]

It is argued that increased cross-border activity is expected to create additional prudential supervision problems, outside the operation of the payment systems, whereby the decentralized supervision system may not be adequate. The Principle of Home Country Supervision may encourage banks to seek jurisdiction more favorable to risk-taking. In addition, a Member State-based banking control system lacks the necessary information and resources to assess the Community implications of illiquid but solvent pan-European banks or those whose solvency is in doubt. Although supervision by national authorities ensures accurate information and has the advantage of perception of local market conditions, it may not be able to deal with Euro-wide systemic problems. Bilateral cooperation through memoranda of understanding, combined with the generally prescribed ECB coordinating role, do not provide the real-time information and coordination needed to detect and provide a timely response to systemic crises. Centralization of supervision appears to be a more

[455] Panourigas, ibid., pg. 6.
[456] Article 25.1. of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank states that ... *The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system...*
[457] Panourigas, ibid., pg. 15-16.

suitable solution toward the stability of the EC internal banking market. A centralized banking supervision system would also avoid discrepancies in the implementation of the EC directives and their implications for depositors' protection and financial stability.[458]

The European Monetary Union introduces a geographical separation of monetary policy and bank supervision. The European Central Bank defines and implements the single monetary policy as one of its basic tasks while national authorities are responsible for bank supervision. The foregoing indicates the institutional separation of monetary policy and banking supervision in several national jurisdictions.[459]

According to one commentator, the centralization of bank supervision in the EC is possible under the EC Treaty, with no further legal process being necessary. The European Central Bank can undertake supervisory functions on the basis of its monetary policy responsibility and its strict mandate for price stability. The interdependence of the objective of price stability with banking stability and the commonality of the tools used for exercising monetary policy and bank supervision functions do allow extension of the ECB's competences to prudential supervision.[460]

It may be concluded that the EC Treaty envisages the model of institutional separation of monetary policy and bank supervision at a geographical level. Further, the EC financial services legislation follows a sectoral approach. Different sets of rules exist for banks, investment firms and insurance companies. The ECB is now the single monetary authority, and the national authorities of the Member States are responsible for prudential supervision of banks. This arrangement does not envisage the facilitation of further integration. It is neither adequate for the stability of an integrated banking system. Accordingly, further institutionalization of supervision coordination of with more clear allocation of responsibilities can be proposed as a centralization model. Further substantive institutional revision such as through the assumption of more formal responsibility by a single authority i.e. ECB or a new European banking or financial authority may correct some of the more operational difficulties referred to.[461] Such revision may also improve legislative adoption at the European level and possibly allow some further coordination of activity at the national level.[462]

[458] Panourigas, ibid., pg. 157-159.
[459] Panourigas, ibid., pg. 160.
[460] Panourigas, ibid., pg. 160.
[461] Walker, ibid., pg. 285.
[462] Walker, ibid., pg. 286.

On the other hand, in light of a close examination of the EC Treaty, it may be argued that the Treaty already contains sufficient measures for the sound and stable integrated banking system and that no major reform is needed. The so-called enabling clause of the EC Treaty, namely Article 105(6), allows the needed centralized supervision mechanism to develop at the ECB level. According to Panourgias, the enabling clause, the interdependence of price stability and banking soundness, the commonality of monetary policy and bank supervision instruments, and the ambiguity of the Treaty language allow the ECB to undertake certain, macro-prudential, supervisory functions.[463]

The ECB's competence for monetary policy could encompass functions incident to monetary arrangement, and this would include prudential supervision functions. The analysis of prudential supervision in the EC internal banking market indicates some interesting issues. A system of decentralized supervision based on harmonization and home country control leaves room for trade barriers and stability risks. Accordingly, there is a worldwide trend in financial services towards diversification and conglomeration. These trends include the combination of supervisory functions to single or at least fewer regulatory authorities.[464] Hence, the certainty that would arise from a centralized supervision structure appears necessary. It will effectively address prudential risks and thus reduce the scope for domestic prudential structures that are trade restrictive. In the absence of centralized arrangements, integration must rely on a continuous balancing of trade benefits and domestic regulatory considerations.

This does happen in the EC despite the extensive harmonization and the operation of the Home Country Supervision Principle.[465] Further, irrespective of the national banking regulation preserved, the decentralized system may fail to deal with financial stability risks from EC-wide banking activity.[466] In the absence of EC legislation, host country measures addressing legitimate regulatory considerations can be maintained even if they hinder EC-wide trade. The host country can still apply its own conduct of business rules on the condition that they are in the "general good" interest. Prudential regulation also remains available for the host country to the extent not harmonized and justified by "general good" considerations.

Accordingly, the Principle of Home Country Supervision is not a fundamental EC law principle and valid deviations from it are possible. Although national supervision ensures

[463] Panourigas, ibid., pg. 147.
[464] Avgerinos, ibid., pg. 226.
[465] Panourigas, ibid., pg. 210-211.
[466] Panourigas, ibid., pg. 223.

accurate information and has the advantage of perception of local market conditions, it cannot cover EC-wide liquidity problems of individual banks and bilateral cooperation structure combined with the ECB coordinating role does not ensure the real-time information and coordination needed for detecting and responding to systemic crises.[467] In other words, a decentralized system, as the current one in the EC, comprising of national structures and international cooperation may not be adequate for the regulation and supervision of a bank that is active in various Member States. A pan-European banking authority with prudential supervision responsibilities will be able to deal with potential EC wide systemic risks and would also avoid the discrepancies in the implementation of the EC legislation and its implications. It is also argued that clear delineation of a central bank's supervision responsibilities contributes to the efficiency of bank supervision. This would also contribute to reduction of regulatory divergence.[468]

Interestingly, this argument is recently becoming announced by the officials of the ECB itself:[469]

> *The ECB could be given significant extra powers as part of measures to boost Euro-zone bank supervision and a re-think of regulation is urgently needed. The ECB could take the responsibility for policing large banks operating across borders in the 16-country eurozone, working in conjunction with national central banks. Proposals to strengthen the ECB's role at the expense of domestic regulators would run into heavy opposition in national capitals. The ECB would play a particular role in this domain for the coordination of surveillance for cross-border institutions – a little bit like in the United States. EU plans to strengthen cooperation between supervisors within the existing institutional framework could work* ***over the medium term,*** *but it is not likely to be the best solution in the* ***long run****. The current economic situation is a great opportunity for moving forward towards convergence in banking supervision and regulation in the European Union, which is important for averting similar crisis in the future...*

According to Walker, even if any new formal institutional structures cannot be agreed or are considered to be unnecessary or inappropriate indefinitely, closer cooperation and

[467] Panourigas, ibid., pg. 224.
[468] Panourigas, ibid., pg. 177.
[469] Interviews with Lucas Papademos (ECB vice-president) and Jean-Claude Trichet (ECB president) published in the cover page of the daily newspaper, Financial Times Newspaper, 5 January 2009.

coordination of activity at all operational levels must be ensured.[470] This proposal needs to be analysed closely in light of the fact that increased cross-border activity is expected to create additional prudential supervision problems, outside the operation of payment systems, whereby the decentralized supervision system may not be adequate. Finally, as any other EC institution, the legality of the acts of the proposed pan-European banking authority will be subject to the review of the European Court of Justice. In addition, any legal and natural persons will be able to challenge the decisions of the pan-European banking authority having direct effect and claim for damages before a national court.

[470] Walker, ibid., pg. 287.

II. Fragmentation *vs.* Combination of Central Banking (Monetary Policy) and Bank Supervision

As discussed above, whereas in some countries central banks also act as the bank supervision authority, in other countries, bank supervision authority is granted to a special banking supervision authority. In addition, whereas in some countries there is a single authority for the supervision of the financial sector, in other countries there are various independent regulatory authorities regulating the financial sector e.g. banks, securities and investment banks, insurance companies etc. Accordingly, whereas there are various arguments supporting the combination of monetary policy and bank supervision, there are other arguments supporting the fragmentation of central banking and bank supervision.

Before focusing on such arguments supporting the fragmentation or combination of central banking and bank supervision, it is also important to underline at the outset the distinction between financial "regulation" and "supervision" as well as "macro-prudential" and "micro-prudential" supervision. Whereas **regulation** is the set of rules and standards that govern financial institutions aiming to foster financial stability and to protect the customers of financial services, **supervision** is the process aimed to monitor financial institutions in order to ensure that rules and standards are fully complied with.[471] An efficient single market should have a harmonized set of core rules since:[472]

- A single financial market – which is one of the key-features of the Union – cannot function properly if national rules and regulations are significantly different from one country to the other;
- Such a diversity is bound to lead to competitive distortions among financial institutions and encourage regulatory arbitrage;
- For cross-border groups, regulatory diversity goes against efficiency and the normal group approaches to risk management and capital allocation;
- In cases of institutional failures, the management of crises in case of cross-border institutions is made all the more difficult.

[471] The High Level Group of Financial Supervision chaired by Jacques de Larosiére, ("The Report of the High Level Group of Financial Supervision") Brussels, 25 February 2009, pg. 13.
[472] The Report of the High Level Group of Financial Supervision, ibid., pg. 27.

According to a report prepared by the so-called High-Level Group on Supervision chaired by Jacques de Larosiére (the "Larosiére Report"), the experience of the past few years has brought to the fore the significant difference between **micro-prudential** and **macro-prudential supervision**. Micro-prudential supervision has traditionally been the center of the attention of supervisors around the world. The major objective of the micro-prudential supervision is to supervise and limit the distress of individual financial institutions, thus protecting the customers of the institution in question. By preventing the failure of individual financial institutions, micro-prudential supervision attempts to prevent (at least mitigate) the risk of contagion and the subsequent negative externalities in terms of confidence in the overall financial system.[473]

The objective of macro-prudential supervision is to limit the distress of the financial system as a whole in order to protect the overall economy from major losses in real output. While risks to the financial system can in principle arise from the failure of one financial institution alone if it is large enough in relation to the country concerned and/or with multiple branches/subsidiaries in other countries, the much more important global systemic risk arises from a common exposure of many financial institutions to the global systemic arises from a common exposure of many financial institutions to the same risk factors.[474] Within this framework, the specific roles and responsibilities of central banks vary widely, even among developed nations.[475]

At present, various different authorities are involved in macro-prudential analysis in the EU: the Economic and Financial Committee, the Joint Committee on Financial Conglomerates, the European System of Central Banks, the ECB, and the Banking Supervision Committee. According to an assessment by the Commission, the specific problems for the safeguard of financial stability can be summarized as follows:[476]

- Lack of appropriate analysis of macro-prudential risks at EU level, including risks stemming from macro-economic imbalances;

[473] The Report of the High Level Group of Financial Supervision, ibid., pg.s 38-40.
[474] The Report of the High Level Group of Financial Supervision, ibid., pg.s 38-40.
[475] Joseph G. Haubrich and James B. Thomson, "Umbrella Supervision and the Role of the Central Bank, Federal Reserve Bank of Cleveland, Policy Discussion Papers", 11 December 2005, pg. 3.
[476] Commission of the European Communities, The Commission Staff Working Document, pg. 12, Available at (20 June 2009) www.eu.int.

- Lack of interaction between micro – and macro – prudential analysis. The soundness of individual firms' was often supervised in isolation and there was little or no awareness of the degree of interdependence or interconnectedness; and
- Lack of adequate corrective action, cooperation and co-ordination by competent authorities during the building up and in the course of financial crisis.

The EC Treaty has established the ECB as the central bank for the countries that adopted the Euro. The European System of Central Banks is composed of the ECB and the central banks of the Member States. As per the applicable EU legislation, the major objective of the ECB is the maintenance of the price stability. Although the EC Treaty contains a so-called Enabling Clause, the ECB currently does not have any role on the prudential supervision of the bank supervision. This fragmented approach (central banking *vs.* bank supervision) to macro-prudential supervision aiming to identify risks in the economy and in the financial system is subject to criticisms.

Nonetheless, according to a report by the ECB, in ten of the Euro-zone countries, national central banks are either directly responsible for prudential supervision or strongly involved in this activity.[477] In the EU, the ECB and the ESCB have three tasks in the field of financial stability: (i) financial stability monitoring; (ii) provision of advice; and (iii) promotion of co-operation.

According to a research in one-third of OECD countries, the central banks possess primary responsibility for bank supervision. In addition, in some countries like France, Poland, and Finland, the supervisory agencies are separate but have strong ties to the central bank. Thus, if France, Poland, and Finland are included as countries whose central banks are primary bank supervisors, then 43% of OECD countries task their central banks with primary bank supervision.[478]

Despite differences in institutional structure and in formal responsibilities, central banks share three common objectives: (a) to ensure that the conduct of monetary policy is consistent with maximizing social welfare; (b) to maximize social welfare by promoting financial-system stability; and (c) to provide for and foster efficient and stable payments systems. Hence, in the USA, there are three sets of arguments that attempt to justify a bank

[477] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 1.
[478] Heidi Mandanis Schooner, Central Banks' Role in Bank Supervision in the United States and United Kingdom, Brooklyn Law Journal, 2003, Available at (20 June 2009) http://papers.ssrn.com, pg. 10.

supervisory role for a central bank. The first is that reserve banks' exposure to loss through their discount-window operations and payments-system guarantees. The second is related to financial system stability and the potential for systemic banking problems. Third is related to the role of banks in the payments system. Clearing and settlement services provided by depository institutions are crucial part of the payments system, and accordingly central banks have a vested interest in banking-system stability as a means for promoting an efficient and stable payments system.[479]

It follows that historically, the two main objectives of central banks relate to the maintenance of monetary and financial stability which are closely linked to each other. In the UK, as per the Bank of England Act of 1998, duty to regulate depository institutions was transferred from the Bank of England (Central Bank) to the FSA which was established as regulator for banking, securities and insurance firms. Despite the separation of the Bank of England from formal supervision of banks, the Bank of England is still entitled to play an important role in bank supervision.[480] The Bank of England has three core purposes, two of which have strong ties with bank supervision: (i) the Bank of England has the duty to maintain the integrity and value of the currency; (ii) the Bank of England must promote the stability of the financial system; and (iii) the Bank of England must promote the effectiveness of the financial system. The duty of the Bank of England to promote the stability of the financial system relates directly to bank supervision and contains (a) analyzing, and promoting initiatives to strengthen the financial system's capacity to withstand shocks, (b) surveillance, that is monitoring developments in the financial system to try to identify potential threats to financial stability at an early stage, and (c) reinforcing arrangements for handling financial crises should they occur. Nonetheless, little experience has thus far been gained with the performance of the FSA.

Accordingly, there are various arguments in **favour of combining** prudential supervision with central banking including **information-related synergies** between supervision and core central banking functions, **focus on systemic risk**, and **independence** and **technical expertise**.

The argument concerning **information-related synergies** underlines that the importance that the confidential information collected for supervisory purposes may have in the oversight of payment systems and other market infrastructures, which are essential for the

[479] Joseph G. Haubrich and James B. Thomson, ibid., pg. 3
[480] Heidi Mandanis Schooner, ibid., pg .14.

smooth conduct of monetary policy. Central banks' access to prudential information, in particular on systemically relevant intermediaries, is essential also for the conduct of macro-prudential monitoring. In addition, in case of a financial crisis, the central bank would be inevitably involved.[481]

In other words, the central bank monitors the reserve and settlement accounts of banks, central banks get a real-time view of their liquidity position and it is very difficult for a central bank to be an effective lender of last resort without significant knowledge of the current and prospective value of assets and liabilities within financial institutions.[482] Like any counterparty, a central bank acting as a lender needs to be able to evaluate the solvency and liquidity of a borrowing institution.[483] Central banks with potential counterparty risk as a lender of last resort need to have sufficient information to assess the solvency of their counterparty and the liquidity of its collateral.[484] It is also argued that central banks play a major role in a sound macro-prudential system. Within the EU, the ECB is uniquely placed for performing this task and therefore the ECB should be able to require from national supervisors all the information necessary for the discharge of this responsibility.[485]

The argument relating to the **focus on systemic risk** relies on the close relationship between prudential controls of individual intermediaries and the assessment of risks for the financial system as a whole. Central banks' focus on systemic stability puts them in a position to better assess not only the likelihood and the potential impact of macro-shocks or disturbances in domestic and international capital markets, but also the operation of common factors affecting the stability of groups of intermediaries.[486]

The argument regarding independence and expertise underlines the quality of the contribution central banks can make to financial stability. It may be argued that central banks may have better information about the conditions of banks and also may have better human capital. **Independence** of supervisory authority from political interference is significant for effective supervision. In other words, any prudent supervisory authority must be independent

[481] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 4.
[482] Joseph G. Haubrich and James B. Thomson, ibid., pg. 9.
[483] Eric S. Rosengren, "Bank Supervision and Central Banking: Understanding Credit During a Time of Financial Turmoil", 28 March 2008, pg. 10.
[484] Eric S. Rosengren, ibid., pg. 12.
[485] The Report of the High Level Group of Financial Supervision, ibid., pg. 44.
[486] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 4.

from partisan politics.[487] This is particularly true in some emerging countries. Furthermore, central banks are generally recognized as sources of excellent research and analysis on the banking and financial system. Central banks have a wealth of knowledge on the structure and performance of the domestic financial system over time, which is continually renewed through their active presence in financial markets.[488] Nevertheless, failure in bank supervision may adversely affect the central bank's reputation.

A number of people, including representatives of the ECB, have suggested that the ECB could play a major role in a new European supervisory system in two respects: a role in macro-prudential supervision and a role in micro-prudential supervision.[489] According to the Larosiére Report, in the area of **macro-prudential supervision**, the suggested responsibilities could include financial stability analysis; the development of early warning systems to signal the emergence of risks and vulnerabilities in the financial system; macro-stress testing exercises to confirm the degree of resilience of the financial sector to specific shocks and propagation mechanisms with cross-border and cross-sector dimensions; as well as the definition of reporting and disclosure requirements relevant from a macro-prudential standpoint.[490]

In the area of **micro-prudential supervision**, it is argued that the ECB could become responsible for the direct supervision of cross-border banks in the EU or only in the Euro-zone. This could cover all cross-border banks or only the systemically significant ones. In such a scenario, the competences, currently assigned to national supervisory authorities, would be transferred to the ECB which would, *inter alia*, license the institutions concerned, enforce capital requirements and carry-out on-site inspections. Alternatively, the ECB could be granted a leading oversight and coordination function in the micro-supervision of cross-border banks in the EU. While the supervisory authorities of the Member States would continue to directly supervise cross-border banks, the ECB could play a binding mediation role to resolve conflicts between national supervisors, define supervisory practices and

[487] Joseph G. Haubrich and James B. Thomson, ibid., pg. 7.
[488] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 5.
[489] ECB Executive Board Member Lorenzo Bini Smaghi argued that it was the ECB itself should take on the supervisory role. *Coordination in Europe is credible only if it is based on an institution which offers and ensures confidentiality, independence and efficient decision making ... There is such an institution today. It performs this role in monetary policy and has performed it in areas associated with financial stability. It is the ECB and the Eurosystem, for the euro area ...* (Available at (20 June 2009) http://www.europarl.europa.eu).
[490] The Report of the High-Level Group on Financial Supervision, ibid., pg. 42.

arrangements to promote supervisory convergence and become responsible for regulation related to issues such as procyclicality, leverage, risk concentration or liquidity mismatch.[491]

On the other hand, since the major objective of supervision is to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability and thereby to ensure confidence in the financial system as a whole, there are various arguments that **central banking and bank supervision must not be combined**. These arguments mainly relate to the tasks of bank supervision. The tasks of bank supervision can be grouped into three groups: (i) investor protection activities, which are focused mainly on the issuance and enforcement of rules on the conduct of business and disclosure of information; (ii) micro-prudential supervision, which includes all on and off-site surveillance of the safety and soundness of individual institutions, aiming – in particular – at the protection of depositors and other retail creditors; and (iii) macro-prudential analysis, which encompasses all activities aimed at monitoring the exposure to systemic risk and at identifying potential threats to stability arising from macroeconomic or financial market developments, and from market infrastructures.[492]

Accordingly, there are various arguments supporting the **fragmentation of central banking** and **bank supervision** including arguments like the potential for **conflicts of interest** between supervision and monetary policy, and **moral hazard**, the tendency towards **conglomeration** and the blurring of the distinctions between financial products and intermediaries, and the need to avoid an **excessive concentration of power** in the central banking.

The arguments regarding the **conflict of interest** (competing objectives) is based on the possibility that supervisory concern about the fragility of the banking system might lead to the central bank to pursue a more accommodating monetary policy than warranted for the pursuance of price stability. The basic argument is that, by maintaining price stability, the central bank will in fact automatically promote financial stability and should only focus on the objective of price stability. In other words, giving a central bank supervisory power(s) could make it reluctant to raise interest rates and stem inflation whenever such actions would harm the banks and the central bank might view its major duty as protecting banks, not the public

[491] The Report of the High-Level Group on Financial Supervision, ibid., pg. 43.
[492] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 3.

interest.[493] By doing so, it would take account of financial instability only to the extent that the latter is relevant for the prospects of inflation. In the strongest form of this argument, any explicit consideration of financial instability by the central bank would only destabilize the economy because of moral hazard.[494] Accordingly, the central bank, conscious of its reputation, might then refrain from monetary policy that would stress certain banks or lower the industry's profits.[495]

The argument concerning **moral hazard** is closely connected to the role of central banks in crisis management stemming from their supervisory duties. It is argued that this can create the moral hazard of excessive risk-taking by the supervised entities, since the central bank would come to the rescue of the banks via emergency liquidity assistance (or by manipulating interest rates), possibly also seeking to cover up a failure in the supervisory function. Moreover, a potentially more significant source of moral hazard is related to the way winding-down and liquidation measures are carried out which are not usually under the responsibility of central banks.[496]

The other set of argument relates to **conglomeration**. The argument rests on the evidence that closer linkages are gradually developing between banks, securities companies, asset managers, and insurance companies, while the traditional distinction between different financial contracts is blurring, so that different types of intermediaries actually compete in the same markets. Under these conditions, sectoral supervisors might be less effective in monitoring overall risk exposures in large and complex financial groups. The trend towards conglomeration and cross-sector competition is admittedly the strongest argument in favour of a single supervisory authority.[497]

Another argument of **excessive concentration of power** argument is closely connected to the above mentioned arguments. Attributing to an independent central bank both regulatory and supervisory tasks, especially if extended to the whole financial sector,

[493] Joseph G. Haubrich, "Combing Bank Supervision and Monetary Policy", November 1996, Available at (20 June 2009) http://www.cleveland .org, pg. 3.
[494] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 6.
[495] Joseph G. Haubrich, ibid., pg. 4.
[496] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 6.
[497] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 7.

might be considered detrimental to the basis on which democracies rely in order to avoid potential abuse in the performance of public functions.[498]

The foregoing arguments seem to be upheld by the reports prepared by different commissions. According to a working document of the EU Commission, three arguments can be presented against the attribution of macro-prudential supervision to the ECB/ESCB. First, there may be a conflict of interest between financial and monetary stability, in connection with concerns that the ECB/ESCB for reasons of financial stability would pursue a more accommodating monetary policy that warranted for the pursuance of price stability. Second, there would be a reputational risk linked to the conduct of macro-prudential supervision. A perceived failure in fulfilling the task of early warning or in advising on the most effective measures to react to risks identified might prove detrimental to the reputation of the ECB/ESCB, thereby jeopardizing their credibility as a monetary authority as well. Third, the concentration of power argument namely, attributing to the ESCB/ECB the powers linked to macro-prudential supervision might be considered detrimental to the system of checks and balances within the framework for managing the EU economy and financial sector, could also be underlined.[499]

In addition, it is noted in the "Larosiére Report that there seems to be various reasons for not to support any role for the ECB for micro-prudential supervision. These include:[500]

- The ECB is primarily responsible for monetary stability. Adding micro-supervisory duties could impinge on its major mandate;
- In case of a crisis, the supervisor will be heavily involved with the providers of financial support (e.g. Ministry of Finance) given the likelihood that tax-payers money may be called upon. This could result in political pressure and interference, thereby jeopardizing the ECB's independence;
- Giving a micro-prudential role to the ECB would be extremely complex because in the case of a crisis the ECB would have to deal with a municipality of Member States Treasuries and supervisors;

[498] European Central Bank, The Role of Central Banks in Prudential Supervision, Available at (20 June 2009) http://www.ecb.eu, pg. 7.
[499] Commission of the European Communities, The Commission Staff Working Document, pg.s 34-35, Available at (20 June 2009) www.eu.int.
[500] The Report of the High-Level Group on Financial Supervision, ibid., pg. 44.

- Conferring micro-prudential duties to the ECB would be particularly difficult given the fact that a number of ECB/ESCB members have no competence in terms of supervision;
- Conferring responsibilities to the ECB/Eurosystem which is not responsible for the monetary policy of a number of European countries, would not resolve the issue of the need for a comprehensive, integrated system of supervision;
- Finally, the ECB is not entitled by the EC Treaty to deal with insurance companies. In a financial sector where transactions in banking and insurance activities can have very comparable economic effects, a system of micro-prudential supervision which was excluded from considering insurance activities would run severe risks of fragmented supervision.

§ 9. CONCLUSION

The establishment of a common market is the cornerstone of the EC which has been established by 6 Member States under the Treaty of Rome of 1957. For this purpose, the activities of the EC are to include the abolition of obstacles between the Member States to the free movement of goods, persons, services and capital as well as the approximation of the laws of the Member States to the extent required for the functioning of the common market.

More than half a century following its inception, the EC has now 27 Member States with differing economical, historical, political, legal and regulatory systems which are not identical. Hence, there are various historical, political and technical difficulties which may be considered as insurmountable to implement a new integration strategy and legal framework particularly in the existence of a basic vacuum which had been left in the Treaty of Rome and earlier problems that arose in trying to implement a full harmonization approach. The so-called Old Approach aiming to harmonize the legislations of the Member States was not successful due to various reasons and the EC banking legislation attempts to harmonize the prudential supervision of banks and banking services subject to home country control.

Nonetheless, the EC is still the most substantial and complex system of regional trading, financial and legal integration attempted until today. This has, in particular, included the provision of a full right of market access in all areas of goods and services including the field of banking.

Needless to say, by virtue of the EC legislation and the major principles of the EC law, the markets of the Member Sates of the EC have become increasingly integrated and can be regarded as almost one economic and financial unit. The framework and conditions of these markets are being determined increasingly at the EC level, with significant implications for the independence with which the Member States can conduct and rule their own economies and their relations with third countries. In this regard, it must be noted that the establishment of a single financial market place constitutes only one part of the larger European integration process which is still under construction.

Banking and financial services area is a very sensitive area. Because of their special nature, banks are heavily regulated than other financial institutions. The sensitiveness of the banking sector has increased in parallel with the increase in international banking activity which has increased substantially over the last several decades. This can also be noted from in recent and ongoing international banking and financial crisis. In this regard, it is beyond

any doubt that, the regulation and supervision of the field of banking is a very ambitious attempt to establish an integrated system of market access and regulation.

The original and subsequent aim of the EC is to establish a single market throughout the EC by introducing minimum harmonization of the national laws of each Member State insofar as they are concerned with the establishment of banks and the cross-border provision of services and the setting of common standards of prudential supervision. In order to achieve the overall objectives of the EC Treaty, in particular the fundamental freedoms of establishment and of provision of services, the EC decision-making bodies were concerned to create a financial services environment, in which all credit and investment institutions within the EC should be able to freely offer their services on the same or similar regulatory and supervisory grounds.

It took many years for the Member States and the EC decision-making bodies to agree on what the appropriate level of regulation and supervision should be. One of the reasons for this may be that the EC Member States may hinder cross-border banking mergers and acquisitions under the EC banking directives, e.i. Article 16 of the Banking Consolidation Directive. It seems like the EC had, among others, three options to follow: (i) vesting all supervisory power in a pan-European regulator; or (ii) without vesting all supervisory power in a pan-European regulator, full harmonization of the supervisory rules of all Member States; or (iii) without vesting all supervisory power in a pan-European regulator, minimum harmonization of essential authorization and supervisory standards, accompanied with recognition by each Member State of the adequacy of the rules of the others, insofar as the authorization and supervision of financial institutions is concerned. The EC has opted to follow the third option namely without vesting all supervisory power in a pan-European regulator, minimum harmonization of essential authorization and supervisory standards, accompanied with recognition by each Member State of the adequacy of the rules of the others.

The EC did not create a uniform banking law which would replace the banking legislations of the Member States. The EC banking law is currently based on three major principles namely mutual recognition, essential harmonization and home country supervision. The EC banking directives based on these major principles have reduced regulatory barriers to the cross-border banking services. The EC banking directives which aim to create an integrated European banking system, aim to coordinate the banking laws of the Member States by developing minimum standards of harmonization, in particular with respect to the authorization and supervision of the banks. An examination of the concepts of monetary

policy and prudential regulation and supervision and of their use in the EC Treaty indicates the close relationship of the said concepts. Besides the inseparability of the objectives of banking supervision and monetary policy, commonality of tools is also observed and the monetary policy tools of the ECB allow it to develop prudential supervision functions.

It can be concluded in light of the foregoing analysis and subject to the concerns outlined below that in the EC there is a well-defined legislative process for the operation of the concept of single banking license and the principles of mutual recognition and home country control principle on the basis of essential harmonization, while the ECJ is accountable. It is clear that a substantial legal framework has since been constructed on the basis of these principles. Further, this takes place in the context of the European Central Bank supervision and of the European monetary union macroeconomic environment. Accordingly, it can be argued that the current institutional framework seems to be sufficient to deal with prudential concerns arising from the integration of the European banking systems. The adoption of minimum rules through harmonization and the home country supervision principle combined with cooperation arrangements, together with the role of the ECB as guardian of the system, constitute effective prudential safeguards against a still nation-based European banking system. In addition, the directives contain provisions, among others, regarding prudential regulations aiming to resolve the problems relating to the existence of foreign banks and provision of cross-border services.

On the other hand, a general review of the EC banking law framework indicates much about prudential institution building in the context of interconnected national banking systems. Initially, the lack of hierarchy and clear allocation of responsibilities between the home and the host country creates specific problems of regulatory and supervisory management. The home country supervision on the basis of essential harmonization of prudential rules has certain limits in respect of both full trade integration and financial stability in an integrated market, and particularly in light of the ongoing recent international banking crisis that centralization of prudential supervision should take place. Second, monetary policy mechanisms and the operation of a single monetary authority have significant implications not only for the stability of the banking system but also for the structure of the banking supervision. In other words, it seems contradictory from certain aspects to have a common monetary policy and to aim to create a single financial market on one hand, and to keep different financial regulation and supervision rules in Member States on the other hand. Third, sustainable macroeconomic arrangements of intertwined national

banking systems depend upon price stability, banking stability and representation, and they should aim towards their optimum mix.

Further, the concepts of prudential supervision and monetary policy have a critical and dynamic effect in the shaping of a supervisory framework and thus need to be clearly defined if legal engineering is to employ them. In addition, the smooth operation of the internal banking market requires not only legal rules but also close and regular cooperation between the national authorities of the Member States. In this respect, without any prejudice to their own powers of control, the competent authorities of the Member States must be able on their own initiative, in particular in an emergency situation, to verify that the activities of a credit institution established within their territories comply with the relevant laws and the principles of sound administrative and accounting procedures and adequate internal control.

The need for centralized banking supervision is in line with the proposition for more prudential arrangements at the international level. A decentralized existing EC system which is based on a number of major principles is consisting of national structures and cooperation among the national authorities of the Member States may not be sufficient enough for the regulation and supervision of a bank that is active in various Member States.

In the absence of a centralized banking supervision, if there is any cross border activity, there is the question what regulator and regulatory regime will be followed in the authorization and supervision and subsequently in the conduct of business and product control. This of course leads to a choice between the regulator of the service provider (or the home country regulator) and the regulator in the country of activity (or the host country regulator).

The major characteristic of the EC banking directives is that the sole competence of the home Member State to authorize its home enterprises and to exercise supervisory control over them in any EC Member State in which they operate is recognized. The host Member State has merely a complementary role in relation to liquidity and conduct of business. However, problems have arisen concerning the extent to which the host Member State can regulate activity within its borders. Thus, the drawing of the separation line between the matters which are within the competence of the home Member State and those within the competence of the host Member State is potentially a very difficult task.

In light of the historical, economical and legal development or progress of the EC, it would be possible to initiate a new integration strategy and legal framework in the banking area, which is politically a very sensitive area, aimed to balance the conflicting interests and

issues and is depending on more substantial and effective degree of underlying regulatory and technical convergence.

Initially, there is no legal impediment to prudential supervision by the ECB. A formal and express legal competence for the ECB to exercise supervision powers can be provided by the activation of the enabling clause of the EC Treaty. The Council has the authority to decide to confer respective competences on the ECB. The EC Treaty expressly provides that the ECB shall contribute to the smooth conduct of national policies relating to the prudential supervision and financial stability. Although, the said wording of the EC Treaty's provision seems to give the ECB only a coordinating responsibility, it is definitely vague. The interdependence of banking soundness and price stability can provide the basis for prudential supervision by the ECB. The intertwining of the two objectives empowers the ECB to exercise prudential supervision as a function incident to monetary policy. Contrary to the principle of subsidiarity, the "implied powers doctrine" which allows for EC competence to extend to powers not only expressly conferred but also implied from the EC Treaty, provides support for this argument. In the case of the ECB, supervision powers can be implied as incident to monetary policy. The centralized supervision structure offered by the ECB is essential for financial stability and in turn for more and sustainable integration of the banking systems. This is why the cooperation between the Committee of European Securities Regulators, the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors is essentially significant.

The Principle of Home Country Supervision which constitutes the keystone of the financial services directives with respect to the prudential supervision, allows a service provider authorized in one Member State to conduct its activities in other Member States without needing further authorization. Nonetheless, the applicability of the home country supervision is weakened by a provision under which the host country also has the right to regulate to the extent necessary to protect the **public interest** and **general good**.

As discussed above, I t is also noted that there are arguments that prudential measures have been subject to essential (and sufficient) harmonization, in which case there should be no room for the application of the general good exception by the home authorities. Nonetheless, this argument seems to ignore the fact that prudential regulation and supervision are not defined in the EC banking directives while the "prudential" concept is very broad and the EC legislation does not employ a clear and systematic distinction between prudential and non-prudential measures.

Nonetheless, certain powers relating to the supervision are reserved to the host Member States' competent authorities and to the operation of the consolidated supervision provisions of the EC banking directives. The host Member States' competent authorities continue to hold the power to supervise the liquidity of branches of credit institutions (albeit in cooperation with the competent authorities of the home Member State) and for measures resulting from the implementation of monetary policy.

It is also noted that there are arguments that prudential measures have been subject to essential (and sufficient) harmonization, in which case there should be no room for the application of the general good exception by the home authorities. Nonetheless, this argument seems to ignore the fact that prudential regulation and supervision are not defined in the EC banking directives while the "prudential" concept is very broad and the EC legislation does not employ a clear and systematic distinction between prudential and non-prudential measures.

The EC banking legislation lays down the minimum standards and rules for the regulation of credit institutions, for example the EC banking directives set minimum standards of prudential supervision in three areas: (i) minimum capital for authorization of credit institutions; (ii) control of major shareholders in credit institutions; and (iii) participations by credit institutions in the non-bank sector. Member States are free to impose such additional authorization requirements on the credit institutions of which they are the home Member State as they think appropriate. Nevertheless, the additional requirements to be imposed by the Member States will still be subject to the general principles of the EC law, i.e. non-discrimination etc.

With respect to the other major principle called mutual recognition, it can be argued that although the Principle of Mutual Recognition has proved a useful tool for the legislative process, but the technique of mutual recognition is second best when compared to coordination of national provisions. The concept also gives rise to the danger that the interest of consumer since it may be subordinated to the policy of speedy completion of the internal market and may encourage the Member States to accept the lowest common denominator in fixing the EC standard. Further, the approach based on the principle of equivalence, as proposed in the Commission's White Paper of 1985 also raises concern. Both freedom of services and consumer protection at a high level would be served by imposing the standards of the country of origin in all countries where the services are marketed. All services would thereby be able to circulate freely within the internal market and be supervised by the

authorities of the country of origin under certain standard conditions applicable, but necessarily harmonized, Community wide.

In general, the principle of mutual recognition is against anti-competitive effects of the Member States' regulatory regimes and provides the impetus for further harmonization. As an example, a credit institution that is licensed in a Member State with a universal banking regime can conduct most of the activities listed in the Annex I of the Directive 2006/48/EC in another Member State that may not allow its credit institutions to carry out all such activities. In other words, the passported activities are listed in the EC banking directives and they are not limited to the core activities, which characterize banking namely the taking of deposits, the granting of loans and money transmission services. This can have a negative effect on the competitiveness of the host country credit institutions, as they are not able to engage in activities permitted to their foreign competitors. In other words, as a consequence of the design of the EC banking directives, universal banks enjoy comparative advantage within the EC. The remedy is expected to be further harmonization through the host country allowing its credit institutions to carry on most, if not all, of the activities listed in the said Annex.

However, the mutual recognition principle which does not involve the transfer of regulatory powers to the EC, itself does not by itself establish a sufficiently unified market. This may be achieved with the help of the principle of minimum harmonization. Secondly, general implementation of the Principle of Mutual Recognition without being accompanied with the Principle of Minimum Harmonization may invite competitive deregulation by and among the Member States. Although the Directive clarifies that *it is not intended to encourage regulatory arbitrage and an institution is not to be allowed to obtain an authorization in one Member State, where the regulatory requirements are perhaps less strict, when the center of its activities is in another Member State*, the Principle of Minimum Harmonization may lead to lower standards of protection.

Finally, as seen in other fields of EC legislation, securing the political will is the most major issue to introduce the aforementioned suggestions. While two of the major banking principles, Mutual Recognition and Home Country Supervision can in general be conducted in an intergovernmental style, the third principle namely Essential (Minimum) Harmonization is seen as a move towards federalization. This is mainly because harmonization as a concept requires transfer of policy and legislative powers to the EC institutions.

Turkey has established various governmental authorities to supervise the insurance, investment bank and banking sectors. Within the existing legal framework, while the UT

regulates and monitors the insurance sector, BRSA and CMB regulate and monitor the banking and the investment banking sectors, respectively.

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Name : Mustafa Kemal Mamak

Address : Süleyman Seba Cad. No.55 Akaretler Sıraevler
Beşiktaş İstanbul

Place of Birth : Adana

Date of Birth : 6 December 1973

Education : University of Marmara, Ph.D. candidate in EC Law; 2003-present
University of Essex; LL.M in EC Law; 1998
University of Ankara; Faculty of Law; 1995
Tarsus American High School; 1991

Job : Hergüner Bilgen Özeke Law Office; Partner

Publications : Article titled Financial Holding Companies published in the Journal of Institute of Banking and Commercial Law (Ankara Law Faculty)