The advent and development of the prudential rules and of banking supervision may be attributed to a legitimate reaction of society to negative financial events. When individual insolvencies of credit institutions affect only the institution concerned and its creditors, the social need to prevent the failure of banks is limited. It is when the failure of a financial institution does not only affect its creditors, but instead has contagion or systemic effects leading to large-scale insolvencies, that the public at large is concerned. In a way, prudential rules have a certain reactive character, in that they are often adopted *ex post facto*, that is, as a consequence of problems that have arisen precisely because of the absence of preexisting prudential measures to prevent them.

Some recent examples of such reactive character of prudential rules may include the following examples. The first is the Bank of Credit and Commerce International (BCCI) crisis, which triggered a relevant debate in the regulatory field and eventually led to a set of new prudential rules and a Community Directive at the EU level (commonly referred to as the “post-BCCI Directive”). A second example is the more recent crisis of Barings, which brought some prudential and transparency rules on the risks of derivatives trading as well as prudential rules on banks’ internal control systems. Third, the present debate about the reform of international financial architecture is the consequence of the crises in countries including Thailand, Korea, Malaysia, Brazil, and Russia, and may ultimately involve some new prudential rules as well as an improvement of the supervisory regime. Finally, the case of Long-Term Capital Management—rescued through the intervention of a panel of market participants brokered by the Federal Reserve Bank of New York—has triggered a wide debate on the appropriate regulatory treatment of hedge funds that is still under way.

The recent establishment of the European Economic and Monetary Union (EMU) is expected to affect heavily the environment in which banks operate in terms of increased competition. In this context, the reactive character of prudential rules is likely to become even more evident.

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From the point of view of the institutional framework, the Treaty of Maastricht has not introduced novelties in the specific field of banking supervision. Whereas the responsibility for monetary policy has been shifted to the European System of Central Banks (ESCB), the responsibility for banking supervision has remained at the national level.

Therefore, the treaty retained the status quo of Stage Two with regard to the institutional setup of banking supervision. This, in turn, was roughly similar to the situation in Stage One, when the single market in financial services and the final abolition of exchange controls were deemed to have been achieved.

The drafters of the treaty focused on whether or not banking supervision was a function for central banks, yet were unable to reach any decisions. In the end, the treaty produced little innovation. The ESCB was assigned some functions in the field of banking supervision that closely resemble those carried out by central banks that do not have specific responsibilities in this field. In particular, the ESCB obtained a role of promotion of cooperation among the competent authorities on supervisory policy (article 105(5) of the treaty), whereas the European Central Bank (ECB) received an advisory role in the Community and national rule-making process (article 105(4) of the treaty).

It is interesting to notice that the drafters of the treaty did not follow the initial proposal of the Committee of Governors of the national central banks of the European Community, which had foreseen wider supervisory functions for the ESCB and the ECB in Stage Three. This occurred both when submitting the first draft for the statute of the ESCB to the Intergovernmental Conference, and later, when invited to comment on the final wording proposed for that statute by the Intergovernmental Conference.

The existence of strong controversial opinions in this area explains why the Intergovernmental Conference decided to introduce an article in the treaty (article 105(6)) that enabled the Council, upon a proposal by the Commission and with Parliament's assent by unanimous decision, to vest supervisory powers to the ECB. Incidentally, it should be noted that the wording of article 105(6) excludes supervision of insurance undertakings from any potential supervisory role of the ECB. This is clearly based on the situation in 1991 when supervision of insurance pertained to governmental bodies. In current times, any supervisor would have advised the treaty drafters about the surge of financial conglomerates that perform integrated financial services, including insurance.

To summarize, Europe has started a monetary union, built upon a single market where all basic community freedoms apply, without any noticeable change in terms of allocation of supervisory responsibilities. The euro-wide financial market retains eleven banking supervisory authorities. In my view, monetary union represents such a considerable change in the financial environment that it is likely to trigger some review of the status quo in banking supervision.

I will first address the developments in the banking and financial sector. The basic idea in this context is that the introduction of a single currency acts as a catalyst for trends that are already underway within the single market.

A recent report of the Banking Supervision Committee, published by the ECB under the title *Possible Effects of EMU on the EU Banking Systems in the Medium to Long Term*, describes, with well-researched data, such trends that can be recalled as follows:

- **Growing internationalization and geographical diversification.** The average domestic market share of foreign branches and subsidiaries in the fifteen EU countries is still relatively low: around eleven percent of the market. However, important qualifi-
cations may be made: Because of their role as international banking centers, the United Kingdom, Luxembourg, and Ireland are well above that average; the branches and subsidiaries abroad of German and French banks already account for one-third of their total assets, and for more than half of those of the Dutch banks; the trend, as shown by the figures for the years 1997 and 1998, already in contemplatione euro, are of a progressive increase in the average foreign market share within the EU, and this progressive growth is expected to continue in 1999 and subsequent years. In addition, the acceptability of the euro as an international currency will reinforce the growing lending activity of European banks outside the EU, which is already at a very high level (European banks' exposure to Asian, Russian, central and eastern European, and Latin American risks are higher than that of the U.S. banks and Japanese institutions). Finally, technological developments, followed by adaptation to the legal environment, will facilitate more and more cross-border financial activity such as links between Securities Settlement Systems (SSSs) and between organized markets, which allow remote access to investment and trading of securities, or the progression of Internet banking and other sorts of "virtual" and "direct" banking. These phenomena will enhance the internationalization of financial services and, because of the lack of currency risks and the proximity of the markets, are likely to occur with a greater intensity within the euro area.

- **Increased conglomeration.** In Europe, unlike the United States, where bank specialization has been the rule up to now and the Glass-Steagall Act has not facilitated conglomeration, the tradition of universal banking has permitted the increase in the phenomenon of financial conglomeration, by which traditional banking business is mixed with securities business, investment fund management, and insurance. In the two most international financial centers, the United Kingdom and Luxembourg, the expansion of these financial conglomerates has triggered the unification of prudential supervision for all financial services in one single agency. This phenomenon of conglomeration is expanding beyond European boundaries, and we have recently seen a great financial conglomerate appearing overseas with the projected merger between Citigroup and Travelers in the United States, where the Glass-Steagall Act is about to disappear.

- **Market consolidation.** Banks have reacted to monetary union with enhanced strategies for mergers and acquisitions. The trend toward consolidation had already been growing since the removal of obstacles to the internal market in financial services; the total number of banks in Europe has been steadily decreasing since the 1980s, mainly through mergers and acquisitions. Compared with the some 11,200 credit institutions in the eleven participating Member States in 1985, today there are only 8,249, which is some 3,000 fewer banks. In the four months since the launch of the euro, no fewer than twelve mergers have been started in Europe, in addition to those initiated in 1998, with a view to benefitting from the new dimension of the market. Still, in all but two cases, these are domestic mergers intended to gain ground in the home market in the context of the greater euro market. In addition, partly because of the regulatory difficulties, which the Commission will try to limit by way of a new 14th Company Directive on the cross-border transfer of headquarters and an amendment to the 10th Company Directive on cross-border mergers, banks are starting to consider alternative formulas to cross-border mergers, such as cross-shareholdings, functional associations, cogovernance agreements, and product-sharing. The new dimension of the euro financial market will lead to participants taking on new dimensions, and this will be achieved.
increasingly on a cross-border basis. Euro area-wide megabanks offering all sorts of financial services are already on the horizon. This trend will continue to accelerate, especially if regulatory barriers to cross-border mergers are duly adapted to the new euro area-wide financial market and competing jurisdictions do not place obstacles in the way of these corporate transactions; the Commission should be active in fighting against the use of national regulatory provisions to protect national banks from foreign takeovers, as such takeovers would contradict the primacy of the basic freedoms on which community law is based, as well as the integrity of the single market.

- Bank profitability is set to be put under pressure because of the confluence of several factors: a more competitive environment leading to a reduction in existing excess capacity inherited from imperfect competition in the domestic markets; some national markets less prepared for foreign competition being exposed to the activities of foreign banks; increased disintermediation and securitization, by which important sections of banks' balance sheets are transferred to investment funds and other capital market intermediaries; increased provisioning of risks related to Asian, Russian, central and eastern European, and Latin American debtors; reduction of income following the disappearance of some business activities as a result of the euro, such as currency trading and correspondent banking activities; increased costs owing to the introduction of the euro; and the increased relative significance of private risks in banks' balance sheets, following the reduction in public debt to conform to the strict convergence criteria and the Stability and Growth Pact.

To summarize, there are important structural changes in the financial services sector motivated by various preexisting trends for which the euro is acting as a catalyst. Such changes will mean more financial conglomerates expanding with a mixture of financial activities both intra-EU and extra-EU, consolidating on an international basis by way of mergers and acquisitions and other techniques with pressure on profit and loss.

I now turn to the possible effects of the framework for banking regulation and supervision against the background of the industry scenario set out above. With regard to banking regulation, launching the euro will result in pressure from market participants and organizations to eliminate or reduce the existing differences in the regulatory framework, ultimately leading to effects on costs and profit and loss. Such market pressure is already reflected in the Action Plan for the Single Financial Market announced by the Commission, which reviews the existing body of EU Directives on financial services, all of which predates Stage Three, with most of them also predating the Maastricht Treaty.

The current institutional framework based on the principles of minimum harmonization and mutual recognition was supposed to foster an adequate degree of convergence at the Community level. In particular, with the mutual recognition of national rules, one would expect that further convergence would be the product of competition among national rules. This process is clearly not yet completed, but the introduction of the euro is set to increase the competition among national rules.

In this transitional phase, however, the existence of national regulatory differences may hinder to some extent the further integration of banking and financial markets within the euro area. It may also affect the accomplishment of the basic tasks of the ESCB. First, there is a constant need for the Eurosystem to achieve a 100 percent level playing field in the single monetary policy domain. This could be met through a more harmonious framework throughout the euro area. One concrete example refers to the basic legal concept of "credit
institution," that is, the counterpart of the Eurosystem for monetary policy operations. Although this notion is broadly defined in the First Banking Coordination Directive, the actual implementation still differs substantially between member states, giving rise to differing kinds of entities. The absence of a proper Community definition represents another example of the money market funds, which today administer more than five percent of the M3 aggregate. They exist in a legal vacuum at the Community level, with no euro area-wide harmonization of its legal concept and outside the current scope of the UCITS Directive.¹

Turning to the financial markets, the pace of convergence varies noticeably across the different markets' segments. So far, only the money markets seem to have smoothly integrated within the euro area, thanks to the TARGET system connection and the creation of the EURIBOR as a common interest reference. Other financial markets are still predominantly domestic and this is partly due to the maintenance of legal and administrative differences that, finally, act as a nonquantitative barrier to the integration of markets.

In this situation, competition between financial centers may produce a trend toward deregulation by which the nonharmonized part of the framework may be interpreted and applied by national authorities in a manner purported to better attract or retain financial business, rather than driving toward a stricter regime only acceptable if applied equally throughout the whole euro market. This may occur within a scenario by which, because of the monetary union, the capacity for the propagation of financial instability problems across national borders is likely to increase.

There seems to be a need to further harmonize the regulatory framework for financial services in order to reduce and avoid existing distortions motivated by different approaches to the national implementation of EU Directives. Competition between financial centers to preempt or avoid delocalization of financial services into benign regulatory climates or to attract new business may entail a trend toward a softening of criteria, namely, in that part of the regulatory framework that is not properly harmonized at the Community level. This result should be counteracted partly through the set of new legislation envisaged by the Commission in the context of the Action Plan. Nevertheless, perhaps a less burdensome and more flexible approach would have to be further prepared in order to avoid the long lead-times of the traditional path of Community single market directives, to permit the slimming of the final differences that inevitably result from the national implementation of such directives, and to create a normogenetic framework permitting the smooth adaptation of the regulatory framework to the ever-changing world of finance. Proposals in this respect may fit within the existing provisions of the Community law (i.e., comitology procedures), or may be the subject of specifically tailored provisions to be inserted in the treaty following the forthcoming Intergovernmental Conference.²

An area in which there is a need for change stemming from EMU is the supervision of liquidity of foreign branches. In accordance with the current provisions of the Second Banking Directive (2BCD), where the supervision of the solvency profile of foreign branches lies with the “home” supervisor, the “host” supervisor is responsible for the supervision of liquidity. The rationale for this prior to the monetary union was quite obvious: the liquidity situation of a foreign branch was closely connected to the local money market

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¹ The Commission has, however, prepared a draft directive that will regulate, inter alia, such funds.
² It may be recalled that to achieve the internal market, the revision of the Treaty named the Single Act added new normogenetic provisions to facilitate the adoption of internal market directives.

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and the monetary policy of the host state; to the extent that money markets and monetary policy were "national," liquidity supervision had to be the responsibility of the relevant national authority. This state of affairs has become obsolete for the Member States participating in the monetary union. A revision of the relevant Community Directives is thus warranted in the direction of shifting the responsibility from the host to the home supervisor. With regard to the framework for banking supervision, the main challenge in light of the increasing internationalization of banking activity is strengthening cross-border cooperation among national supervisors.

Community secondary legislation states the principle of cooperation between supervisors by removing the legal obstacles to such cooperation. But there is no obligation on the part of supervisors to cooperate. Particularly relevant in this field are the provisions of the so-called "post-BCCI Directive," which has enhanced the scope of supervisory cooperation. So far, national authorities have developed this cooperation mainly through bilateral agreements, such as the Memoranda of Understanding (MOU). National supervisors have signed nearly eighty MOUs to date at the European Economic Area (EEA) level.

The objective of structuring and reinforcing the multilateral mode (i.e., not the bilateral mode already provided for by the MOUs) of cross-border cooperation of banking supervisors can be regarded as the main reason for the Eurosystem’s establishment of its Banking Supervision Committee in 1998. The multilateral mode of this cooperation should achieve the final target that the current multijurisdictional supervisory framework is as effective as that of a single euro-wide supervisor. Furthermore, it should serve the objective that national supervisory bodies may never be in competition between themselves, and worse, be used to create barriers for cross-border financial activities. This committee is composed of representatives of banking supervisory authorities (central banks and separate bodies) of the participating Member States. It also normally includes the supervisors of the nonparticipating Member States and the Commission.

There are no reasons to believe that the envisaged enhancement of the multilateral mode of cooperation among supervisors should not work effectively in practice. To the extent that this event should occur, however, alternative institutional solutions would have to be sought and then a range of options would be available. I would like to focus on one particular option, notably the possibility of vesting the ESCB (not the ECB) with supervisory responsibility, which would not call for the establishment of a new European institution. First, in order to enhance the cooperation between supervisors (as mentioned above), the Banking Supervision Committee is a comprehensive structure that may serve as the proper forum to take initiatives on one side and to organize the cooperation of supervisors, inclusive by the adoption of transparent rules, on the other.

Second, the ESCB comprises both the ECB and the national central banks (NCBs), and this multijurisdictional system, well organized under a common decision-making structure, may perhaps effectively accommodate the coordination of the banking supervisory task to be performed within the euro zone; supervision requires close relationship with market participants, and a "federal" structure like the ESCB may be well tailored for that purpose. The Federal Reserve can be recalled as an example of effective "federal" supervisory authority.

In this context, it should be recalled that six of the eleven euro area NCBs perform banking supervisory functions and in some of them prudential supervision extends to other financial market intermediaries. In two other cases, namely Germany and France, the respective NCBs are very heavily involved in supervisory tasks. In one other case, that of Austria, the prudential supervision function is being transferred from the domain of the
government to that of the respective NCB, by way of new legislation. Therefore, prudential supervision is fully outside the scope of activities of NCBs in only two countries in the euro area—Belgium and Luxembourg.

Finally, it should be noted that the credit institutions and other financial intermediaries to be supervised issue around ninety percent of the total M3 monetary aggregate of the euro area (the remaining ten percent being central bank and governmental money), and therefore are closely connected with monetary policy and the transmission of monetary impulses.

Different tools exist to manage banking crises, including: (i) liquidity injection by a public authority, funded by taxpayers’ money, to insolvent institutions, subject, of course, to controls on competition by the Commission and national authorities; or (ii) the liquidity assistance by financial market participants using schemes aimed at self-protection by avoiding systemic effects, either on an ad hoc basis, such as in the case of LTCM, or in a structured manner, such as for the German “Liko” bank or the Spanish FGD. In some other cases—and this has happened often in the past in all member states—however, such assistance may have to come from the central bank in the form of providing central bank money (emergency liquidity assistance). A long debate has taken place at the beginning of EMU on how the provision of emergency liquidity assistance works within the Eurosystem. Following a decision of the governing bodies of the ECB in February of 1999, it has been made clear that the responsibility for providing this assistance remains with national central banks, which bear the relative risks and costs and should decide the kind of adequate collateral needed for the liquidity assistance. Given the possible implications of these operations for the single monetary policy, the governing bodies of the ECB are always informed and, under certain circumstances, may even deny the undertaking of the projected rescue operation.

The factors I have described mean that the current status quo of prudential regulations and supervision need to be revised if the desired integration of the financial markets following the launch of the euro is to be achieved. Monetary union sets a new dimension of the market that requires a reconsideration of the preexisting supervisory framework, which is necessary to reap all the advantages of monetary union. Decision-makers should prove, in this case, that the reasoning at the beginning of this essay that prudential supervision is a reactive science is wrong. I would personally wish that such revision takes place as the result of policy considerations rather than as a reaction to any negative financial event or to any jurisdictional dispute between national supervisors. Europe would benefit from such exercise.

3. But, however, in close relation with the respective NCB in both cases.
4. The Banque Centrale du Luxembourg was created in June 1999 and has no supervisory tradition.
5. Liquiditäts Konsortialbank GmbH.