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Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis

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Abstract

One of the main objectives of transnational banking regulation over the past two decades has been the standardization of regulatory practices and the allocation of regulatory powers to minimize the regulatory burden for banks. The resulting division of labor between home and host country regulators strongly favors Home over Host; And the regulatory scope has continued to focus on entities rather than activities. This paper argues that this has created several blind spots in transnational regulation of finance. First, Home is unlikely to monitor and respond to risks that are unique to Host, even though they might emanate from activities of banks that are subject to their consolidated regulatory supervision. Second, Host, may have regulatory supervision over a subsidiary of Home's parent company, but may rely on Home to exert regulatory controls. Moreover, Host has little regulatory leverage if the parent bank side-steps regulatory restrictions imposed on subsidiaries by engaging in direct lending practices, or by channeling capital through entities that are not subject to similar regulations. Second, the continued focus on entity based regulation ignores the fact that the core function of banks, maturity transformation, is increasingly performed by non-bank institutions that escape the existing transnational regulatory framework. Against this background, this paper proposes effect-based regulation, which gives Host the power to regulate any activity that has a systemic effect on its financial system, irrespective of who undertakes it and where it is carried out. The paper uses the recent example of Central and Eastern Europe during the global financial crisis to illustrate the failure of the existing regime.

Keywords: EU banking regulation, financial crisis, transnational regulation, effect-based regulation, systemic risk, home-host country regulation

JEL Classifications: F34, F55, G21, K2

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1. Introduction

Over the past two decades, the quest for integrating financial markets into a single global marketplace has produced a host of legal and regulatory measures aimed at taming national protectionism, easing access to foreign markets, and lowering the regulatory burden for financial intermediaries that operate trans-nationally. Based on commonly agreed upon prudential standards, home country regulation and supervision has become the core principle in the design of most regulatory structures. This principle, first established as the “Basel Concordat” in a series of reports issued by the Bank of International Settlement in Basel,² has also informed financial regulation in the EU: Indeed, the European passport system—which allows a financial intermediary that has been duly licensed in one member state to offer financial services and establish branch offices in other member states without requiring additional regulatory approval in the host state—can be viewed as a strengthening of the home-host country regulatory principle.

This paper questions the soundness of this principle as the primary means for governing interdependent financial markets; it draws on the lessons from the global financial crisis, which has exposed the vulnerability of *host* countries’ financial system to regulatory abstinence by home countries of trans-nationally operating financial groups. This problem has become

² Note that the first “Report to the Governors on the supervision of banks’ foreign establishments” of 1975 stresses cooperation and makes only general recommendations for the allocation of supervisory authorities between home and host country. However, by 1983 the notion that the parent company’s home regulator would exercise consolidated supervision over the banks’ worldwide operation, became well established. See “Principles for the Supervision of Banks’ Foreign Establishments” (May 1983). Host country regulators retained supervisory control over subsidiaries located in their countries and were encouraged to prohibit the operation of a subsidiary in the event they deemed regulatory oversight by the parent to be inadequate. Nonetheless, as anticipated by the Principles, vesting consolidated supervision over the international banking group with the parent has undermined host country supervision. All BIS documents are available at www.bis.org.

acute due to increasing financial interdependence: As emerging markets in Eastern Europe and Latin America opened their borders to foreign financial investors they have witnessed large parts of their financial systems being taken over by foreign groups and capital channeled across their borders.³ This in turn has exposed these host countries to risks emanating from activities of these foreign financial groups. Even the UK—with its long tradition of financial market development—has found itself at risk from parent banks in Iceland with extensive branch and Internet operations in the UK.⁴ In contrast, existing templates for transnational financial regulation as embodied in EU law or the Basel Concordat are primarily concerned with the opposite scenario—namely risks emanating from a host country's failure to regulate a subsidiary to the parent company and its home market. Moreover, in a world of mobile capital, entity-based regulation captures only a fraction of capital flows—which can just as easily be channeled into direct lending, securities, or through unregulated financial intermediaries as through intra-group relations between parents and subsidiaries.

To address the new risk pattern of interdependent financial markets, this paper advocates existing arrangements with bias in favor of home-country regulators and a strong focus on entity-based regulation be supplemented with *effect-based jurisdiction*. While there is still a need for consolidated regulation of financial intermediaries that operate trans-nationally, the global crisis has demonstrated that there is also a pressing need to

³ To be sure, the fact that liberalization of financial markets exposes the new destination countries of foreign capital flows to the risk of financial crisis has been well established in the literature. See *Graciela L. Kaminsky & Carmen Reinhart* The Twin Crises: The Causes of Banking and Balance-of-Payment Problems, 89 *American Economic Review*, 473 (1999) and more recently *Carmen Reinhart & Kenneth S. Rogoff* Is the 2007 U.S. Sub-Prime Crisis so Different? An International Historical Comparison, Working Paper Harvard Economics Department, (2008).

⁴ For details on this see *The Turner Review: A Regulatory Response to the Global Banking Crisis*. UK Financial Services Authority (2009) at 39.

address the systemic effects the operations of these intermediaries have on markets other than their home country. Effect-based jurisdiction would allow countries to regulate financial intermediaries that have a material effect on their domestic financial markets irrespective of their domicile. I suggest that such an arrangement might also instill the kind of cooperative regulation of global financial markets that has so far eluded a regime that favored home over host country regulators. The intuition for this claim is as follows: Vesting host countries with effect-based regulatory powers changes the balance of power between home- and host-country regulators and increases the likelihood that interests of host countries will be heard and incorporated into the home country regulator's objectives. Effect-based host country regulation therefore does not necessarily multiply regulatory oversight; In contrast, the prevailing home-host country distribution of regulatory powers favors home country regulators and leaves host country regulators without much leverage to ensure that consolidated home regulators adequately account for the risks the growth markets of financial intermediaries subject to their regulation face as a result of their actions. I argue that effect-based regulation is also superior to centralized regulation in the hands of a supranational European regulator not only on grounds of political feasibility, but also as a matter of efficacy; this strategy better aligns regulatory authority with the allocation of costs in the event of regulatory failure. Moreover, it encourages greater attention by global financial groups to the impact their actions may have on the various domestic markets in which they operate: Should they wish to avoid the scrutiny of multiple regulators they will need to stay below the threshold that triggers effect-based regulation or incorporate the concerns of host countries into their actions; Incidentally this can also be viewed as a strategy for addressing the too-big-to-fail syndrome. Within the European Union, such a regime will almost certainly require an amendment of existing banking directives. De lege lata, only in exceptional

circumstances will member states be able to exert effect-based jurisdiction in contravention of established home-host country regulatory structures on grounds of public policy exceptions incorporated in the Treaty and relevant directives (see *infra* Part 4).

The analysis is presented in four parts: Part 2 discusses the limitations of home-host country regulatory divisions of labor in light of the global crisis, Part 3 develops the principles of effect-based regulation and assesses its likely impact on inter-regulatory cooperation drawing from experience with other regulatory regimes that accommodate multiple overlapping jurisdictions,. Part 4 analyzes the scope for effect-based jurisdiction within existing EU law and offers some critique of proposals for reforming the EU financial regulatory regime that are currently under discussion, Part 5 concludes.

2. Host's Dilemma

Host—for the purpose of this paper—is defined as a medium-sized country that has fully liberalized its financial markets. Three banks that are domiciled in the neighboring country Home (thus, they exist as foreign banks) own the majority of bank assets in Host. *Host's* financial system grows rapidly for a while thanks to the strategies pursued by banks from *Home*: *Home's* banks acquired local banks in *Host*, improved management structures, transferred capital and expertise and developed new markets—including consumer lending and corporate lending to firms that hitherto had little access to external sources of finance. Eventually regulators in *Host* suspect that the growth of the financial sector—especially the pace of credit market expansion—might not be sustainable and may well trigger a financial crisis. *Host* therefore attempts to slow the expansion of credit by domestic financial intermediaries by imposing higher reserve requirements and administrative ceilings on the permissible credit volume per bank. To their surprise, they find that these measures

have little impact on the expansion of credits which continues almost unabated; Investigations suggest that domestic banks licensed in *Host* have by and large complied with the new restrictions, however, their parents located in *Home* have chosen to channel new credits not through them—i.e. their foreign subsidiaries—but instead to lend directly to customers in *Host*; in addition, some parents have established leasing companies and other vehicles that are not subject to *Host*'s banking regulations and thus proved unresponsive to the imposed restrictions.

Regulatory authorities in *Host* inform *Home*'s regulators of these practices invoking a Memorandum of Understanding (MoU) that sets forth principles of home-host regulatory cooperation. Yet regulators in *Home* don't share *Host*'s concerns: They point out that the transnational banks located in *Home* are well diversified with respect to the different markets they serve (i.e. they have operations not only in *Host*, but in numerous other countries throughout the region) and to the products they offer and they therefore see no reason to intervene. Within weeks of this exchange, international lending markets show severe signs of distress triggering a major contraction of credit globally. Banks from *Home* find themselves unable to raise capital on interbank lending markets to continue their expansive strategies in *Host*; indeed, as global financial markets grind to a standstill they cut back their lending activities—especially in foreign markets. *Host* thus experiences substantial outflows of capital, which plunges its economy into severe recession, forcing them to seek help from the IMF.

The above scenario has been couched in hypothetical terms, yet closely resembles the experience of many Central and Eastern European (CEE) countries—including virtually all new member states of the European

Union,⁵ where foreign financial groups dominate the domestic banking systems; their assets comprise between 36 percent (Slovenia) and 97 percent (Estonia) of total bank assets.⁶ Banking systems are also highly concentrated: As of 2005, the top five banks in key CEE countries had a market concentration ratio⁷ ranging from 48 percent in Poland to 99 percent in Estonia:⁸ thus, a few foreign banking groups own most of the banking sector in CEE countries. Even for the largest country among the new member states of the EU—Poland—the importance of foreign owned banks to the domestic economy is far greater than the importance of its subsidiaries to the portfolio of the foreign bank that serves as its parent company.⁹

The presence of foreign banks in Eastern Europe has greatly contributed to the transformation of domestic financial markets and their catch-up with more developed markets in Western Europe. Where as of 1998 financial market development of most countries in CEE still lagged behind countries at similar GDP levels¹⁰, in the early 2000s they reached—and sometimes

⁵ Slovenia and Slovakia have been least affected by the crisis, most likely because they were already part of the Euro zone and therefore escaped the twin crisis syndrome of a concurrent currency and banking crisis. However, it is also worth noting that as discussed below, foreign bank penetration in Slovenia has been substantially lower than elsewhere.

⁶ *Charles Enoch* Credit Growth in Central and Eastern Europe, in *The Causes and Nature of the Rapid Growth of Bank Credit in the Central, Eastern and South-Eastern European Countries*, (Charles Enoch & Inci Ötker-Robe eds., 2007) at 3.

⁷ Calculated as the fraction of assets of the total banking system's assets held by the five largest domestic and foreign banks per country. See *Andre Uhde & Ulrich Heimeshoff* Consolidation in banking and financial stability in Europe: Empirical evidence, 33 *Journal of Banking and Finance*, 1299 (2009). The ECB confirms a high concentration ratio in these countries. See ECB, *Banking Structure in the New Member States* (European Central Bank, 2005).

⁸ *Uhde & Heimeshoff* supra note 7.

⁹ *Piotr Bednarski & Dariusz Starnowski* Home and Host Supervisors' Relations: A Host Supervisor's Perspective, in *Rapid Credit Growth in Central and Eastern Europe: Endless Boom or Early Warning?* (Charles Enoch & Inci Ötker-Robe eds., 2007).

¹⁰ See *Katharina Pistor et al.* Law and Finance in Transition Economies, 8 *The Economics of Transition*, 325 (2000).

exceeded—these comparative benchmarks.¹¹ What was remarkable and yet proved to be unsustainable was the speed with which these changes occurred. Within a period of only 5 years (from 2000 to 2005) the credit to GDP ratio doubled, and even tripled in several countries.¹² According to Backe et al., “at the end of 2006, the annual growth rates of credit to the private sector ranged from 17% to 64%”¹³ in Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.¹⁴ This data almost certainly understates the real growth of credit, as it captures only credit expansion by domestic banks and excludes direct cross-border lending by foreign banks to firms and households in these countries.¹⁵

When finance in CEE countries dried up as a result of the global financial crisis, their governments turned out to be unable to protect their financial systems without outside help. The sudden stop of foreign capital inflows followed by extensive capital outflows in 2008 and 2009¹⁶ left the Host

¹¹ This has been the case in Bosnia-Herzegovina and Croatia – two small countries that are candidates for full members of the EU. See Figure 2.6 in *Calin Arcalean et al. The Causes and Nature of the Rapid Growth of Bank Credit in the Central, Eastern and South-Eastern European Countries*, in *Rapid Credit Growth in Central and Eastern Europe: Endless Boom or Early Warning?* 13), (Charles Enoch & Inci Ötker-Robe eds., 2007) at p. 22.

¹² *Enoch* in, supra note 6.

¹³ *Peter Backe et al. Credit Growth in Central and Eastern Europe Revisited § 2007* (Österreichische Nationalbank 2007).

¹⁴ In the United States, a country with a much larger and deeper financial system, credit extended by commercial banks grew by about 11 percent in 2006. See Board of the Federal Reserves, *Monetary Report to Congress*, 19 June 2006, at p. 22.

¹⁵ The Austrian National Bank published data in July 2009, that suggest that in the years preceding the crisis direct lending as well as lending via unregulated intermediaries, such as leasing companies, increased on average by 20 percent and by over 50 percent in the newest member states of the EU (Bulgaria and Romania). See ONB, *Finanzmarkt-Stabilitätsbericht* (Österreichische Nationalbank (Austrian National Bank) 2009): “... the share of recipient intra-group FIs increased from 65% to more than 70% of total direct credit to FIs. These growth rates are inter alia due to the growing importance of leasing firms affiliated with Austrian firms.”

¹⁶ *Prisoska Nagy* “BIS Data on Cross-Border Flows – A Closer Look”, EBRD blog, 11 May 2009, available at www.ebrdblog.com.

system economies in freefall and brought their currencies under attack,¹⁷ and many countries were forced to turn to multilateral organizations for help. The IMF has entered into emergency loans with Belarus, Bosnia-Herzegovina, Hungary, Latvia and Ukraine and has concluded standby agreements with Poland and Romania. The European Bank for Reconstruction and Development (EBRD) established a joint action program together with the World Bank and the European Investment Bank (EIB) in January 2009, committing €24.5 billion to support the banking sector in the region. Additionally, the European Central Bank (ECB) has reached out to central banks outside the euro area (Sweden, which has become exposed to the downturn in the Baltic states where Swedish banks have a strong presence, but also Poland and Hungary) to provide additional liquidity.

The hypothetical scenario and its application to the countries of Central and Eastern Europe illustrate the shortcomings of the prevailing regime for governing transnational finance both within the EU and globally. First, it suggests that the allocation of regulatory jurisdiction that is tied to a particular form of intermediation—banking—is incomplete. Host-country control over subsidiaries is effectively undermined by the ease with which transnational financial groups can side-step regulatory controls imposed on one vehicle (banks) by channeling capital through other vehicles (leasing companies) or by engaging in direct-lending activities to customers in foreign markets.¹⁸ Second, it ignores the potential for

¹⁷ Except for those countries in CEE that had already introduced the euro, i.e. Slovenia and the Slovak Republic, these countries suffered a classic twin-crisis.

¹⁸ There are obvious parallels to this incompleteness of global financial regulation in national regimes. The general trend for resolving this problem has been to move a way from institution or entity based regulation (i.e. separate regulation for banks, insurance companies, etc.) and to consolidate financial regulation in a single national regulator. See *Heidi Mandanis Schooner & Michael Taylor* United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets, 38 *Texas International Law Journal*, 317 (2003) for a comparison of the UK and the US and

conflicts of interest between host- and home-country regulators as their risk exposure to the activities of these banks diverges. In the above example, *Home's* regulators were concerned primarily with the diversification of their banks, but showed little interest in the systemic effects the activities of these banks might have on the stability of the foreign markets in which they operated. Yet, what might look like a growth market to the parent bank and its regulators can take the form of a credit boom and looming bust for regulators in the destination country of seemingly benign financial flows.¹⁹ Third, the strategy is oblivious to the fact that in a highly inter-dependent financial system contagion can spread from anywhere (i.e. parent or subsidiary, home or host country) throughout the entire system.²⁰ Early detection and prevention should therefore be paramount; however, this is difficult to achieve as host- and home-country regulators have incomplete information²¹ the former because they do not have access to information about activities of the parent bank that might

additional comparative evidence from Germany, Australia and Switzerland. The argument developed in this paper suggests that consolidation may not be the right answer in all cases. Incidentally, countries with consolidated regulators (UK or Switzerland) have not fared much better in the crisis than the US with its byzantine governance structure.

¹⁹ See also *Richard J. Herring* *Conflicts between Home & Host Country Prudential Supervisors* (2007) who illustrates this conflict of interest with the following “nightmare scenarios” in which a foreign entity with a large share of local (i.e. host country) markets becomes “systematically important, while at the same time, being so small relative to the parent group that it is not regarded as significant to the condition of the parent company”; in this case, the home country regulator may not see a case for intervention as it is naturally concerned with the stability of the financial group for its’ own market, not with the stability of the financial system of countries in which that group operates a subsidiary.

²⁰ Allen and Gelb use a formal model to suggest that only a fully integrated, or complete, financial system can avoid contagion problems of this kind. See *Franklin Allen & Douglas Gale* *Financial Contagion*, 198 *Journal of Political Economy*, 1 (2000). For empirical evidence compare *Graciela L. Kaminsky et al.* *The Unholy Trinity of Financial Contagion*, 17 *Journal of Economic Perspectives*, 51 (2003).

²¹ Under EU guidelines and Basel equivalents, host country regulators depend on home country regulators for receiving relevant information. See, for example, the CEBS Guidelines for Cooperation between Consolidated Supervisors and Host Supervisors, 25 January 2006, according to which the parent company in charge of consolidated regulator has unfettered access to all relevant information; in contrast, “essential information and, if deemed useful, relevant information is provided to all supervisors at an appropriate level”. *Ibid* at 15.

affect their markets; and the latter because they do not have sufficient information about how the totality of activities of their banks might affect foreign markets.

The described risk properties of inter-dependent financial markets call for an approach to regulation other than the choice between home versus host country regulation on one hand, or national vs. supra-national regulators on the other. The choice between home and host country regulation offers a wrong alternative where in fact both home and host country regulation is required to fully take account of the different risks associated with financial interdependence. Home country regulators will focus on the stability of financial institutions—including financial groups with regional or global reach in light of the repercussion their failure might have on the home market; their interests are primarily entity-focused and based on the assumption that the stability of the financial entity is strongly correlated with the stability of the bank's and the regulator's home market. Even if true, this correlation is not sufficient enough to protect the host country, and it's market may suffer from actions taken by parent banks that may not have any repercussions for the stability of the parent or its home market. Home country regulators have few incentives to fully internalize these host-country specific risks, because they do not bear the costs of a crisis in that country. Rather, a crisis in host countries can be (and as the history of emerging market crises suggests²² typically is being)

²² This is true for the Latin American debt crisis of the 1980s as well as the series of emerging market financial crises of the 1990s from Mexico's tequila crisis in 1994, to the 1997/8 East Asian financial crisis and the related crises in Russia and other former socialist countries; as well as the most recent crisis in Argentina in 2001. These crises were all fueled by foreign financial intermediaries, yet the clean up was left to the IMF and other multinationals. For an overview of the role of multinational organizations in resolving these crises, see *Martin Feldstein* Economic and Financial Crises in Emerging Market Economies: Overview of Prevention and Management, NBER Working Paper 8837, (2002); *Ngairé Woods* Understanding Pathways Through Financial Crises and the Impact of the IMF: An Introduction, 12 *Global Governance*, 373 (2006); *Charlie Calomiris* Capital

sourced out to multilateral lending agencies—such as the IMF or the EBRD—as has proven the case with CEE countries during the global financial crisis.

The standard solution to this misalignment of costs and regulatory jurisdiction is the centralization of regulatory powers. By creating a supra-national regulator that undertakes to supervise financial groups operating in more than one country it is presumed that regulation can be optimized.²³ The tendency to attempt resolving conflicting regulatory objectives by way of vertical integration is pervasive: Even if in general decentralized or local policy spaces are preferred over centralization—as embodied, for example in the subsidiarity principle of the Treaty on European Union— whenever inter-community spillovers occur (that is in the case of externalities) a move upwards in the hierarchy towards a federal or centralized solution is advocated as the natural solution.²⁴ Some properties of cross-border finance are indeed akin to the externality problems associated with environmental regulation: the classic case of externalities in search of central solutions.²⁵ As thus, the excessive ‘emission’ of finance into a previously closed or less developed market can trigger a crisis. Similarly, both parent banks and home regulators may have incentives to externalize the costs of their actions to host countries.

Flows, Financial Crises and Public Policy, in *Globalization, What's New?* , (Michael M. Weinstein ed., 2005).

²³ For a summary of these frameworks and the application to environmental regulation, corporate law, and banking regulation, see *Richard L. Revesz* Federalism and Regulation: Extrapolating from the Analysis of Environmental Regulation in the United States, 3 *Journal of International Economic Law*, 219 (2000).

²⁴ See Robert *P. Inman* & *Daniel L Rubinfeld* Rethinking Federalism, 11 *Journal of Economic Perspectives*, 43 (1997) for a summary and analysis of different federalism theories.

²⁵ See *Revesz* supra note 23.

Still, some important qualifications should be made to the suggestion that centralization is optimal in case of spillovers in the area under investigation: First, unlike victims of polluters, recipients of cross-border financial flows can exclude and regulate financial flows to their territory—capital controls being the obvious solution and regulation a finer tuned version thereof;²⁶ Second, capital flows are in principle benign, thus questioning the efficacy of standardized emission controls for the entire policy space—Indeed, they tend to produce beneficial outcomes in the country of destination if adequately regulated, and only when left unchecked do they destabilize the recipient country’s financial system. Whether or not this negative scenario occurs depends not simply on the volume of capital channeled to a market of destination, the type of investment (whether portfolio investment or foreign direct investment) or the transmission channels used, but also on the effect capital flows will have given pre-existing local conditions in the country of destination, or on its “absorption capacity”²⁷ —This mismatch problem between capital flows and absorption capacity cannot be easily resolved by consolidating regulatory authority with a central federal or global agent, which is unlikely to have access to or be able to process of relevant information to make the relevant judgment calls—Instead, a set of differentiated regulations may be required that are tailored to capture different risks associated with transnational financial intermediation: the risk to the intermediary itself and the risk to the different domestic markets in which they operate;Third, the centralization of regulatory tasks does not eliminate conflicts of interest or

²⁶ There is a substantial literature that questions the efficacy of capital controls, although much of it focuses capital outflows (or flights). However, there is also substantial evidence that capital controls when judiciously applied can have beneficial effects. See only *Barry Eichengreen & David Leblang Capital Account Liberalization and Growth: Was Mr. Mahathir Rights?*, 8 *International Journal of Finance and Economics*, 205 (2003).

²⁷ See *Eswar Prasad et al. Foreign Capital and Economic Growth*, 2007 *Brookings Papers on Economic Activity*, 153 (2007) who develop this concept in trying to explain patterns of global capital flows.

fully internalize the costs of under- or over-regulation of financial markets. Only if markets are fully integrated and the costs of market or regulatory failure are equally distributed will that be the case. Absent such conditions (and even in the relatively highly integrated European financial market they are still absent), conflicts will have to be resolved either within a single agency; or alternatively, among different de-centralized regulators.²⁸

An additional benefit typically associated with centralization is the avoidance of a race-to-the-bottom whereby several host countries in competition with each other seek to attract foreign capital by lowering regulatory standards. The race-to-the-bottom argument is often invoked in policy debates, yet exit is much less common than often assumed and is dependent on industry specifics.²⁹ Races tend to be more common when physical relocation is not required to reap the benefits of a more accommodating regulatory regime and/or when relocation is cheap and the new regulatory regime can be exported to the markets where the company wishes to operate.³⁰ Thus, in the United States federal legislation providing that credit card companies chartered in any state could do business throughout the entire federation under the rules of that state³¹ has triggered a race-to-the-bottom. Several states positioned themselves to attract credit card companies by offering low regulatory standards (in the form of usury laws, low disclosure requirements and the like) in all

²⁸ An example for this is the consumer protection agency advocated by the Obama administration as part of their reform proposal for the financial market. See the proposed "Consumer Financial Protection Agency Act of 2009" available at www.treasury.gov.

²⁹ *Bruce G. Carruthers & Naomi R. Lamoreaux* Regulatory Races: The Effect of Jurisdictional Competition on Regulatory Standards (2009) discussing labor, financial and environmental regulatory races within the United States.

³⁰ *Ibid* at 29.

³¹ *Samuel Isacharoff & Erin F. Delaney* Credit Card Accountability, 73 *The University of Chicago Law Review*, 157 (2006) on the National Bank Act of 1964 (12 USC § 85 (2000)) and subsequent acts of Congress, including the Riegle-Neal Interstate Banking and Branching Efficiency Act (12 USC § 1811 (2000)) and the Gramm-Leach-Bliley Act (Pub L No 106-102, 113 Stat 1338, 1999).

states in which they operated and in doing so have effectively lowered the safeguards for borrowers and consumers nationwide.³² This race-to-the-bottom scenario has the specific feature of allowing parent banks to shop for the state that offers the most convenient regulation and to use this state's set for banking operatives not only within said state, but in its actions nationwide. In other words, it combines regulatory jurisdiction based on domicile with universal jurisdiction. The European passport accomplishes the same feat by allowing banks, insurance companies and other financial intermediaries to operate across the European Union once they have been authorized by a single regulator: The crucial difference that sets the US example apart is that universal scope of a single regulatory regime is conditioned on mutually agreed minimum regulatory requirements. How important this difference is in practice depends on whether the mutually agreed upon minimum regulatory standards adequately address all relevant risks. To the extent they don't, the same regulatory race-to-the-bottom as described in the example of US credit card agencies may ensue.

The combination of freedom to choose one's domicile with universal application of that domicile's legal regime which is race-conducive should be distinguished from cases where all competing jurisdictions have to offer is access to their own markets. This makes a race-to-the-bottom scenario much less likely, or at least less likely for bigger states, or states that offer other comparative advantages that make them too big or too important for transnational financial intermediaries to pass on.³³ In contrast, smaller

³² Ibid.

³³ China is the most obvious example. For a discussion of the concession Western banks have been willing to make in order to enter the Chinese financial market, see *Katharina Pistor* Banking Reforms and Bank Bail Outs in the Chinese Mirror, in *China's Transition to a Market Economy*, (Joseph Stiglitz ed., *China's Transition to a Market Economy*, 2010 forthcoming).

countries may lose out in the competition for global capital if they impose host country regulations that are perceived to be overtly costly. Transnational groups may decide to bypass them if they impose regulatory burdens that are not worth the costs in light of the expected benefits these markets have to offer. This, however, does not refute the notion of effect-based host regulation. Effect-based regulation gives host countries an option to exercise regulatory jurisdiction in the event that their financial or economic system might be inadvertently affected by a financial intermediary's actions, which they may choose to exercise or not. They may even commit ex ante not to exercise this option. That act alone should focus their minds on the fact that they are effectively relinquishing the responsibility to safeguard their domestic financial systems and they may therefore ask for some assurance vis-à-vis the intermediary or their home country regulators in return.³⁴ The home-host regulatory regime accomplishes the same outcome, but without the awareness or the political costs associated with an explicit abdication of regulatory power.

This analysis results in two conclusions: . First, centralization or vertical integration is not a panacea for resolving conflicting interests between home and host countries, customers and financial service providers, et cetera. Second, the benefits of centralization do not necessarily outweigh the costs of a decentralized system with partially overlapping jurisdictions that pursue different regulatory goals. While standardization of regulation may reduce the costs for firms ex ante, the total costs of incomplete ex ante regulation and ex post bail out may far exceed these benefits, moreover, such centralization tends to come at the expense of

³⁴ For a more detailed exposition of this point see *Katharina Pistor Into the Void: The Governance of Finance in Central and Eastern Europe* (Gerard Roland ed., Reflections on Transition Twenty Years after the Fall of the Berlin Wall, 2010, forthcoming).

information.³⁵ Regulatory centralization is likely to reduce the collection and processing of localized information thus exposing the system to the vulnerabilities of local and unrecognized crises spreading throughout the system; thus, any compromise between a fully integrated centralized model and a more decentralized regime has to take into account that the need to collect information locally and to assess its local and system-wide implications will entail maintenance and coordination costs. As suggested earlier, effective coordination requires ‘voice’ and this presupposes leverage. The current home-host regulatory regime disarms host country regulators. By contrast, effect-based regulation is meant to level the playing field.

3. Towards Effect-Based Regulation

The deficiencies of the existing regulatory regime for global finance could be counteracted by centralizing regulation at the global level, or, alternatively, by devolving regulatory powers to (multiple) local agents. This paper advocates the latter solution not only for political reasons but also on grounds of efficacy: Within the EU a centralized regulator might be feasible at some point in the future (although, interestingly, the global crisis has not been sufficient to achieve consensus on this³⁶), however, at the global level such an arrangement is unlikely (and given the size and diversity of global financial markets would be impractical). A centralized regulator would face substantial challenges: it would have to regulate and supervise a vast number of highly complex financial intermediaries that offer a range of financial services across multiple and divergent markets. Yet, effective regulation of financial intermediaries requires proximity to the regulated entities and/or activities so as to facilitate the conduct of regular

³⁵ On this point see *James C. Scott Seeing Like a State: How Certain Schemes to Improve the Human Conditions Have Failed* (Yale University Press, 1998).

³⁶ See also the discussion of the new EU reform proposals under 4 below.

audits, to sanction noncompliance, and to resolve looming crises before they spread throughout the system. A centralized regulator would therefore have to rely extensively on regulators in places where these services are rendered. Rather than operating as an autonomous global regulator, such an agency would instead need to coordinate the different regulatory activities of national regulators. This kind of coordination may well be needed, but it does not require shifting the regulatory and supervisory powers to a central agent; to the contrary, such a reallocation of oversight functions may well undermine the vigilance of local agents. Neither could a centralized regulator replace cooperation among domestic regulators. A quick response system is more effective if information is shared directly by agents that have the means and the incentives to respond with the appropriate level of urgency than if information has to travel upwards to a central authority and commands have to be issued by the center to local actors.³⁷

The key challenge for effective regulation of global financial markets is to ensure effective de-centralized regulation where this is possible and to enhance cooperation among multiple regulators. The challenge in designing such a system is the allocation of regulatory powers and responsibilities among regulators in a way that internalizes the costs of potential future financial crises, including crises that might originate within their territory and those that may originate elsewhere. While it may not be possible to fully optimize such a system, it does seem a feasible model for improving upon what we have. An effective governance regime would have to meet at least two conditions: First, it would need to better align

³⁷ This insight is well established in organizational theory. See for example *Yingyi Qian et al.* Coordination and Experimentation in M-Form and U-Form Organizations, 114 *Journal of Political Economy*, 366 (2006), who develop a formal model that suggests that innovation is more likely in M-Form organizations that link decentralized actors directly to one another, than in U-Form organizations, in which information and commands have to be channeled through a centralized authority.

regulatory responsibilities with the allocation of costs associated with regulatory failure; and Second, it should enhance rather than reduce the propensity for cooperation among regulators.

The current regime is deficient on both grounds: The allocation of regulatory responsibilities between home and host country under Basel Concordat and even more so under existing EU regulations largely does not take full of account of the propensity for conflict between home and host country regulators.³⁸ The Basel Concordat—even in its most recent iterations—works from the assumption that the core of financial activities of a given intermediary take place in its home jurisdiction and that foreign activities comprise only a small share of its activities and thus only marginally affect the financial system of host countries. This explains the strong emphasis on home country regulation—which has grown rather than diminished over the past several years. However, the experience of CEE countries (and others) during the credit boom and the subsequent bust demonstrates that foreign markets have become critical growth markets for banks from over-banked countries and that despite regulatory efforts, foreign banks can come to dominate if not control entire domestic financial systems. If anything, the European regulatory regime is even more focused on home country regulation than the Basel Concordat. The European passport system eliminates entry control except for

³⁸ Earlier versions of the Basel Concordat mention the potential for conflict, but over time the role of home country regulators has been strengthened. The 1983 version talks about “complementary and overlapping” regulatory responsibilities between home and host country regulators. The 1992 version places the burden to challenge the proposed division of labor, which favors home country regulation on the host country by stipulating that “Inaction on the part of either authority will be construed as an acceptance of the division of responsibilities established in the Concordat”. Thus, each authority is responsible for making a deliberate choice between accepting its responsibilities under the Concordat or initiating consultations on an alternative allocation of supervisory responsibilities for the case at hand”, section 2 at page 4. The different versions are available at www.bis.org.

subsidiaries,³⁹ which according to the Basel Concordat is a critical juncture at which home and host country regulators can review the viability of a financial intermediary's ambitions for external expansion and establish channels of communication among themselves. European directives even provide for delegated supervision, wherein a host country fully delegates financial supervision over foreign-owned subsidiaries on its territory to the home country regulator of the parent; so far, however, not a single host country has used this provision – much to the dismay of the financial industry.⁴⁰ However, EU hard and soft law emphasizes the lead role of home country regulators in the case of consolidated regulation⁴¹; and the EU home-host guidelines⁴² developed by the Committee of European Bank Supervisors, or CEBS, in consultations with stakeholders from the financial industry leave only a subordinate role for host country regulators.⁴³ Both the Basel Concordat and the relevant EU directives and guidelines emphasize the need for coordination between home- and host-

³⁹ It requires only notification in case of a branch or when a foreign bank from another member states extends financial services within its territory for the first time. See Directive 2006/48/EC Relating to the "Taking up and Pursuit of the Business of Credit Institutions" of 14 June 2006, OJ L177/1, 30.6.1006 (hereinafter Credit Institutions Directive, DCI) Arts. 25.1 and 28.1, respectively.

⁴⁰ See the comment by the European Banking Federation (FBE) to the CEBS proposed home-host guidelines laid down in Consultation Paper CP09: "In this context, the delegation of tasks and responsibilities is central to the home/host framework. We appreciate the emphasis on this in CP09. Article 52 (9) of Directive 2000/12/EC (Article 131 in the revised Directive) already provides for the delegation of supervisory responsibilities. We are however concerned that this provision has never been utilised to date. We therefore urge CEBS to explore the use of this provision to the fullest possible extent under the new framework." Available at <http://www.c-eps.org/getdoc/0d883044-b483-4b45-a1f7-76b9e36b8b59/Responses-to-CP09.aspx>.

⁴¹ See Arts. 125, 126 and 129 DCI 2006.

⁴² CEBS Guidelines on Supervisory Cooperation for Cross-Border Banking and Investment Firm Groups, CEBS CP09, 8 July 2005, available at www.c-eps.org

⁴³ Specifically, they are advised to seek other than essential information about foreign subsidiaries operating on their territories primarily from home country supervisor. See CP09 supra note 43 recital 45 at 15.

country regulator of the parent rather than the subsidiary or its parent. See CEBS Home-Host Guidelines supra note 43 recital 45 at 15.

country regulators especially in times of crisis. Nonetheless, the described (mis-)allocation of regulatory responsibilities creates the possibility for two-way free riding: Home country regulators can hope to escape the costs of their regulatory failure if it materializes abroad, and host country regulators have few incentives to invest in adequate regulation if home country regulators are given the lead and are presumed to take it.

To improve on the current regime it is useful to start with an analysis of the costs of regulatory failure that materialize in a financial crisis. These costs are born primarily by three constituencies: By the ordinary people in a country affected by a financial crisis who lose their savings, jobs, etc.; by the taxpayers in countries that have the resources to stabilize their own financial system (and possibly those of other countries that might exert spill-over effects); and by multilateral organizations such as the IMF which help stabilize the financial systems of countries that lack the resources to protect themselves and do not receive sufficient bilateral support.⁴⁴

In light of this distribution of costs the allocation of regulatory jurisdiction should emphasize not entities and their domiciles, but the location where the positive and negative effects of financial services can be felt. Such an approach is also better suited for the mercurial nature of financial services and the risks associated with them. In the past, the failure of deposit taking banks has been the major concern for regulators because of the systemic effect such a failure might have on the market in which that bank is

⁴⁴ Note that the IMF finances itself not only from member contributions in the form of special drawing rights, but also from interests charged on loans. Indeed, in the 1990s, most of the revenue was generated from loans, implying that the countries at the receiving end of IMF funding were financing the organizations. When countries chose to pay back their loans to the IMF early and to avoid the IMF when in need of external finance, the IMF was forced to lay off a significant part of its staff. See *Ngairé Woods & Domenico Lombardi Uneven patterns of governance: how developing countries are represented in the IMF*, 13 *Review of International Political Economy*, 480 (2006) for a review of how developing countries are financing yet remain under-represented at the IMF.

located. However, the maturity transformation function that is at the heart of banks' inherent vulnerability to failure is shared by other entities that face short-term claims but invest in long(er) term assets. The failure of Bear Stearns and Lehmann in 2008 illustrates that non-deposit taking institutions can face a 'bank run,' not only by their depositors but by their short-term lenders-many of them fellow banks that participate in the inter-bank lending market. Fears of illiquidity and doubts about the viability of available collateral can bring down a single participant in this interconnected market and fears about widespread illiquidity can topple the entire system. Thus, risk exposure is determined not primarily by the domicile of an entity but by a system's exposure to systemic risk.⁴⁵ It follows accordingly that the entity-based regulatory model with its strong bias in favor of home country regulation which was the inspiration for the Basel Concordat and the EU regulatory regime is outdated.

The risk assessment and judgment call for an appropriate response to an actual or perceived risk should be left with regulators that are accountable to the constituencies⁴⁶ that will bear the costs when the uncontained risk materializes. While it is true that Iceland's banks collapsed together with their customers in the UK, the Austrian and Swedish banks weathered the downturn of international credit markets by cutting back their exposure to the markets in Central and Eastern Europe.⁴⁷ Cutting their losses and

⁴⁵ Systemic risk refers to the propensity that a local event may trigger a domino-like effect for an entire system. For a comprehensive account of the meaning of systemic risk see *Steven L. Schwarcz Systemic Risk*, 97 *Georgetown Law Journal*, 193 (2008).

⁴⁶ There is an extensive literature questioning the accountability of regulators. See only *George Stigler The Theory of Economic Regulation*, *Bell Journal of Economics*, (1971). Yet, unless one is of the view that this problem is inherent to any form of regulation, it is secondary to the question of who should regulate. This paper focuses on the latter question; the former will be addressed in future research.

⁴⁷ To be fair, they did this only after the true scale of the global economic crisis had been exposed and at least some of them received bailout money from taxpayer with conditions that prevented the use of these resources to stabilize foreign subsidiaries. At the beginning of the unfolding crisis, foreign parent bank cross-subsidized subsidiaries in

consolidating their business was sound business practice from their perspective. Yet, the existence of national borders that separate their policy space and scope of accountability from that of markets that provided their banks with unprecedented growth opportunities allowed the banks to externalize the costs of what proved to be unsustainable expansion strategies. By the same token, their home regulators could pride themselves in stabilizing their own banking system by ensuring that they were adequately capitalized for their activities in the home market, but left the clean-up job in Central and Eastern Europe to multilateral organizations. In the words of the Austrian central bank, “in light of recent rescue measure by the IMF and the EU Commission, extreme scenarios [i.e. those that would have required further intervention by the ONB, *the author*] have become much less likely”.⁴⁸ This quotation illustrates two related key problems in the existing regime: The misallocation of regulatory responsibility and the lack of accountability for failure to regulate in markets beyond the home regulator’s jurisdiction: The regulators in Reykjavik, Stockholm and Vienna concerned themselves primarily with the stability of the banks they regulated, but had little interest in the stability of the markets in which their banks had come to play a dominant role. It was only in response to the crisis that the Austrian Central Bank launched an investigation into the lending practices of Austrian banks in neighboring countries regarding the circumvention of attempts by domestic regulators in those countries to fuel the credit boom. Even then, the primary concern was legality of the banks’ actions (and most were deemed legal, which they probably were) rather than stability concerns with respect to the foreign market affected by the lending

Eastern Europe. See *Ralph De Haas & Iman Van Lelyveld* Internal Capital Markets and Lending by Multinational Bank Subsidiaries, *Journal of Financial Intermediation* 19:1 (2010) 1-25.

⁴⁸ See ONB *supra* note 15 at 9.

boom.⁴⁹ Instead, the countries that were affected by the strategies financial intermediaries from Iceland, Austria or Sweden pursued in their markets should have been responsible for taking actions to mitigate these risks. After all, people in these countries are bearing the ultimate costs of a financial crisis.

This calls for an effect-based allocation of regulatory responsibilities: a domestic regulator should have jurisdiction over practices of financial intermediaries that have a material affect on the stability of their home market irrespective of the nature of the entity that undertakes these actions (a bank or a non-bank); whether or not the entity is domiciled within their jurisdiction; or whether the action is taken domestically or abroad. Effect based jurisdiction should complement—not replace—entity - based home-country regulation.

Two major objections can be raised against effect-based regulation in the area of financial services. First, such a regulatory system would impose excessive regulatory burden on globally active financial intermediaries and thereby undermine the process of financial globalization. Second, it may undermine rather than foster cooperation among regulators from different countries. With respect to the first argument it would seem that the global crisis has shifted the burden of proof to those who continue to advocate the benefits of unfettered global capital flows subject primarily to entity-based self-regulation.⁵⁰ Facing more than one regulator will increase the

⁴⁹ The shift in lending strategy often increased the risk for the recipient markets, as direct loans tended to be denominated in Euros or Swiss francs rather than local currencies.

⁵⁰ This line of argument is most aggressively pursued by the Institute for International Finance, a lobbying organization for multinational financial intermediaries. See IIF, Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations 2008), which advocates self-regulation as the primary response to the global crisis; and IIF, Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search

transaction costs of multinational banks—however from a social welfare perspective, benefits will come alongside these costs. The liberalization of financial markets and the emergence of large, multinational intermediaries in an increasingly competitive financial market where the search for higher yields and thus greater risk has become a major driver of global expansion, has contributed to the destabilization of many domestic financial systems, and by implication to the global system. Increasing the costs of global expansion could mitigate that risk. Moreover, allocating the power to determine the extent to which domestic markets shall be exposed to the risk associated with financial liberalization and greater financial interdependence should be left with those who bear both the costs and benefits of such decisions, i.e. with sovereign nation states. In a world of mobile capital, financial intermediaries have the choice to enter certain markets. Individual countries should have the choice to determine on what grounds they might enter as they bear the costs for these decisions. As noted previously, countries with big and potential growth markets may have greater leverage, whereas countries with smaller markets have less bargaining power. The latter might therefore face greater risks, however, these risks do not translate into greater risk for the entire system so long as their regulatory regime is denied universal jurisdiction.

Regarding the need to ensure coordination among multiple regulators, vesting multiple de-centralized regulators with regulatory powers and responsibilities is likely to enhance cooperation among them over the current state of affairs. Under the existing regime primary regulatory jurisdiction lies with the regulator in whose jurisdiction a bank is licensed. Both the Basel Concordat and EU directives call for coordination among

for Stability (2009), which takes a more nuanced approach in light of the depth and spread of the crisis.

home and host regulators, while at the same time singling out the home regulator for taking the lead. This is also true for the proposed “colleges of supervisors”⁵¹, which shall include home and host country regulators under the leadership of the home country regulator. As suggested earlier, this dilutes regulatory responsibility and invites free riding on presumed regulatory vigilance by the other side.

In contrast, effect-based regulation recognizes that host and home country regulators may have different, yet partly overlapping, regulatory objectives, and at times conflicting ones. Centralizing regulation is appropriate when multiple regulatory objectives can be aligned, or a social welfare-maximizing outcome can be identified ex ante that justifies giving higher priority to one objective over another. In this case allocating regulatory powers to more than one regulator would indeed lead to inefficient duplications. In contrast, separation of regulatory functions is sensible if and when regulatory objectives are in conflict with each other and it is difficult to determine ex ante, whether pursuing one objective or the other will be welfare-enhancing in the long term. The fact that regulatory objectives may conflict and that it is difficult for lawmakers and regulators to anticipate future contingencies strengthen the case for multiple regulators with overlapping jurisdiction. This will at times entail additional regulatory costs, as it is unlikely that regulators will reallocate regulatory powers among themselves to achieve an efficient outcome. Such a Coasian bargain⁵² faces political and legal constraints; moreover, absent conditions that ensure efficient bargaining such an arrangement will not

⁵¹ Colleges of supervisors are already referred to in Directive 2006/48/EC (see *infra*) and re-appear in the draft Regulation for a European Banking Authority (COM(2009) 499 final); see *ibid* Art. 12.

⁵² See *Ronald H. Coase The Problem of Social Cost*, 3 *Journal of Law and Economics*, 1 (1960).

produce optimal regulation.⁵³ However, this is not the only outcome that is conceivable. Instead, regulators can and do coordinate provided they have the right incentives to do so. Just as in a Coasian bargaining scenario this requires that regulators have something to bargain over, that is, they have both power and responsibility. In addition, a facilitator for regulatory coordination that does not have a direct stake in the outcome may be helpful.

An important example for coordinated regulation can be found in European anti-trust law. European-wide anti-trust matters are vested with the European Commission, however, cases that affect only member states fall within their respective jurisdictions. In this area effect-based jurisdiction is the default allocation of regulatory powers.⁵⁴ Thus, anti-trust authorities assert regulatory authorities that can have an effect on the competitiveness of their respective markets irrespective of where the conduct occurred or where the entity that is engaging in such conduct is located. The German Act against Restraints on Competition specifically provides that it applies to all restraints of competition having an effect within the territorial scope of the Act, even if they occur outside its regulatory scope.⁵⁵ Similarly, the UK Competition Act of 1998 prohibits anticompetitive agreements, decision, and practices that “may affect trade within the United Kingdom...if the agreement, decision or practice is, or is

⁵³ See also *Robert P. Inman & Daniel L. Rubinfeld* Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism, 75 *Texas Law Review*, 1204 (1997) who suggest that economic efficiency cannot be achieved in most cases by bargaining among decentralized regulators, because the conditions – spelled out in Tiebout’s “pure theory of local expenditure” (see *Charles M. Tiebout* A pure Theory of Local Expenditures, 64 *Journal of Political Economy*, 416 (1956)) are in most cases not fulfilled.

⁵⁴ Incidentally, the same is true for the reach of US or European antitrust law, a matter that cannot be further pursued within the confines of this paper.

⁵⁵ See *GWB § 130(2)*: “Dieses Gesetz findet Anwendung auf alle Wettbewerbsbeschränkungen, die sich im Geltungsbereich dieses Gesetzes auswirken, auch wenn sie außerhalb des Geltungsbereichs dieses Gesetzes veranlasst werden.”

intended to be, implemented in the United Kingdom.”⁵⁶ It is easy to envision that a single case of misconduct can trigger regulatory responses by more than one member state, and that such conduct may not only violate the domestic law of individual member states but might also constitute a violation of Arts. 81, 82 of the EU Treaty. In order to ensure effective coordination of member-state conduct in the event that Treaty provisions are violated, the EU has constituted a European Competition Network with the task of coordinating enforcement actions by different member states.⁵⁷ The Council and the Commission that set forth the principles of cooperation among competition authorities have issued a joint statement⁵⁸ acknowledging the co-existence of multiple competition authorities whose autonomy and equal status are explicitly recognized. The joint declaration strives to ensure the allocation of a case to a single regulator that is best capable of dealing with it, but does not allocate jurisdiction *ex ante*; moreover, it also recognizes that such consolidation is not always feasible in which the different regulators commit to cooperate with each other.

An important difference between the mentioned examples is that the issues at hand for the most part are and can be resolved in an *ex post* fashion, (i.e. after a case that might invoke multiple jurisdictions has arisen). In contrast, financial market regulation to be effective needs to be proactive, and when a crisis is imminent regulators need to have measures in place that can be implemented quickly, as they will have little time to coordinate at this stage. This calls for an early response system,

⁵⁶ S. 2(1)(a) and 2(3) UK Competition Act 1998.

⁵⁷ The objectives of the ECN are set forth on its web site. See http://ec.europa.eu/competition/ecn/more_details.html. See also *Eleanor Fox* Competition Law, in *International Economic Law* (418), (Andreas F. Lowenfeld ed., 2008) at 426.

⁵⁸ “Joint statement of the Council and the Commission on the Functioning of the Network of Competition Authorities” available at <http://ec.europa.eu/competition/ecn/>.

one that encourages the sharing of information by multiple regulators and the coordination of measures aimed at preventing a crisis. The questions to be addressed in the following section are whether such a system already exists in the EU *de lege lata*, whether the reform proposals currently under discussion contemplate such a system, and if not, whether such a system anchored in effect-based regulation would be compatible with the Treaty and/or existing secondary EU law.

4. Legality of Effect Based Regulation in the EU

The existing regulatory regime for financial intermediation is rooted in Treaty provisions guaranteeing the free movement of services, including financial services and the free movement of capital. Specifically, Art. 56 (Art. 49 TEC) of the Treaty on the Functioning of the EU⁵⁹ prohibits restrictions on the freedom to provide services within the Community, and Art. 63 (Art. 56 TEC) outlaws all restrictions on the free movement of capital not only among member states of the Community, but also *vis-à-vis* third countries. While the scope of these Treaty provisions is broad, it is not without limits. Member states retain the authority to regulate financial services and capital flows for tax purposes, purposes of prudential regulation, and to protect public policy (or common good) concerns.⁶⁰ As such, the Treaty provisions are therefore compatible with notions of effect-based regulation, as it can be regarded as but one assertion of member state sovereignty to protect its public interests. Nonetheless, the scope of

⁵⁹ OJ C115/1 (2008), at 49.

⁶⁰ Specifically, Art. 58 (2) EU Treaty provides that member states are free “to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.” In addition, Art. 60 opens the possibility that in emergency cases member states may act unilaterally impose capital controls if the Council has not taken relevant actions.

member state regulatory autonomy has been curtailed by two factors: First, the European Court of Justice (ECJ) has over the years heightened the standards for public policy defenses in an attempt to lend greater credence to the principles of economic freedom enshrined in the Treaty of Rome. Second, the EU has established a framework for regulating financial intermediaries that encompasses directives designed to harmonize regulatory standards as well as to coordinate mechanisms at the European level in the form of EU-wide committees for ensuring the specification of such standards for regulatory purposes and their consistent implementation. Both trends effectively curtail member states' abilities to resort to effect-based regulation other than in exceptional circumstances or in areas not specifically covered by existing secondary law. Reform proposals currently under discussion do not seek to reverse these trends; rather, they are aimed at strengthening the centralization of regulatory control at the European level with only nominal participation of affected member states in the colleges of supervisors.

The European Court of Justice's case law has long asserted that the four freedoms embodied in the Treaty of Rome are directly applicable and do not require the enactment of secondary legislation to be enforceable. A requirement by a member state that a provider of financial services - in this case an insurance provider - has to create an establishment in a member state before being allowed to offer services there amounts, according to the ECJ, to a violation of the free movement of services and capital and can be justified only on grounds of common good.⁶¹ The Court acknowledged that the growth of the insurance market, the mass selling of products, and the difficulties customers encounter in deciphering products and assessing their costs can justify regulatory interventions by host

⁶¹ See *Commission v. Germany*, Case 205/84 of 4 December 1986, European Court Reports 1986 page 03755, recitals 28, 29.

states. However, such interventions must be proportionate—that is—the host state must show that the rules of protection in the home state of the insurance provider are not adequate and that the host country regulations imposed are necessary in that respect.⁶² In assessing the level protection provided in a given host state, the ECJ takes into account secondary Community law aimed at standardizing minimum protection throughout the Community. In 1984 the ECJ ruled with respect to the insurance sector, that critical aspects of regulating the insurance sector, including technical reserve requirements, were not yet harmonized, and that a case could be made that such standards are critical for protecting consumers. A host country may therefore fill this void and establish such requirements if it can show that the insurance provider is not subject to similar requirements in its home country.⁶³ In the end, the court held that the requirement to establish a full presence in a host state was not shown to have been necessary to achieve these goals, but that the host country had less onerous means at its disposal. By implication, the Court confirmed the right of a member state to impose regulations if they can be justified on common good grounds, particularly in cases where community law remains incomplete.

In a more recent case, the ECJ had to rule on the legality of Germany prohibiting a Swiss financial intermediary from offering Internet loans to German customers.⁶⁴ The Court first affirmed that such host country restrictions on foreign financial intermediaries restrict the free movement of capital and services. In the words of the ECJ:

⁶² Ibid, recital 35.

⁶³ Ibid, recital 47.

⁶⁴ Fidium Finanz, Judgment of the ECJ in C-452/04, OJ C294/9, 2.12.2006.

“It is settled case-law that all measures which prohibit, impede or render less attractive the exercise of the freedom to provide services must be regarded as restrictions of that freedom (...). If the requirement of authorization constitutes a restriction on the freedom to provide services, the requirement of a permanent establishment is the very negation of that freedom. For such a requirement to be accepted, it must be shown that it constitutes a condition which is indispensable for attaining the objective pursued.”⁶⁵

In the end, the ECJ did not decide the question that would have been critical for “Host’s Dilemma”, which is, whether a member state may invoke the common good principle to constrain capital flows against the background of secondary community legislation that has greatly expanded in scope and level of protection. It argued that a Swiss firm could not invoke the principle of free movement of services, as Switzerland is not a member of the EU. While member states are obliged under the Treaty to eliminate all constraints on the free movement of capital even vis-à-vis third states (Art. 56) that provision did not help the Swiss firm, because the Court argued that credit provisioning was at its core a financial service and that any restriction on the free movement of capital was incidental to regulating financial services.⁶⁶ Nonetheless, the case is relevant in that it affirms that regulations of financial intermediation by member states are construed as a per se violation of the freedom of services. Member states must show that such restrictions are indispensable for protecting the common good.

Existing community law in the area of financial services affirms these principles. Thus, the revised Directive on Credit Institutions (DCI 2006)

⁶⁵ Ibid, recital 46.

⁶⁶ Ibid, recital 49.

obliges member states to ensure that the activities covered by the directive “may be carried on within their territories (...) either by the establishment of a branch or by way of 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” (Art. 23). This and other directives⁶⁷ that establish common standards for the regulation and supervision of credit institutions form the backdrop for this commitment. An entity that is properly authorized by its home regulator based on the harmonized standards can freely operate within the common economic space without facing additional regulatory requirements by host countries. The scope of financial services covered by this commitment is expansive. It covers financial services offered by credit institutions, i.e. “undertakings whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account”.⁶⁸ Appendix I to the DCI 2006 lists 14 types of activities from deposit taking over lending and financial leasing to custody services. By implication, the regulatory regime, including the allocation of regulatory powers between home and host country regulators set forth in the directive is deemed applicable to credit institutions that provide these services as long as they have been duly authorized by a regulator in one of the member states in accordance with this and related directives irrespective of where the actual services are rendered.

The directive allocates regulatory powers between home and host countries as suggested by the hypothetical above: Credit institutions that have been duly authorized by their home regulatory can open branches or offer financial services to customers in other member states upon notifying

⁶⁷ In particular the Directive “On the capital adequacy of investment firms and credit institutions”, of 14 June 2006 (recast) OJ L 177/201, 30 June 2006 (hereinafter Capital Adequacy Directive).

⁶⁸ Art. 4 (1)(a) DCI (2006).

host country regulators; they do not need approval from the host regulatory. Host countries can seek to enforce violations of home country regulation by reprimanding a financial intermediary and informing home country regulators about any violations (Art. 30 (1) and (2)). In the event that the home country regulator proves unresponsive, the host country may take “appropriate measures to prevent or to punish further irregularities and, in so far as is necessary, to prevent that credit institution from initiating further transactions within its territory” (Art. 30 (3)). Furthermore, the host country may “prevent or punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interests of the general good” (Art. 31). These provisions recognize in principle that host countries can impose regulatory supervision based on effect. However, the conditions triggering host country regulation are limited to illegal acts of the financial intermediary and do not include the power to counter activities that are legal but may put the host country’s financial system at risk – such as the simple expansion of credit that may, in the eyes of domestic regulators, fuel an asset bubble. There is only one carve-out: host regulators retain “in cooperation with the competent authorities of the home Member State for the supervision of liquidity of the branches of credit institutions”.⁶⁹ This has made it possible for the UK Financial Service Authority (FSA) to announce its intention to impose new liquidity standards on UK parents, UK subsidiaries of foreign banks as well as foreign bank branches operating in the UK.⁷⁰ While this may open the way for other member state to follow suit, this carve-out does not address cases of direct lending or other activities not channeled through a branch or subsidiary. As noted above, this entity-based approach fails to respond to changes in financial

⁶⁹ Art. 41 DCI (2006).

⁷⁰ See FSA proposed rules on strengthening liquidity standards available at www.fsa.gov.uk.

intermediation—in particular the increasing marketization of financial services—which side-steps entities whether they be branches or subsidiaries. Indeed, as it currently stands, the directive read in conjunction with the freedom of services and capital flows appears to preempt a more aggressive application of effect-based regulation. The recitals to the directive emphasize that in the interest of developing common standards for an integrated financial place the scope of the directive should be broadly interpreted. Only specific activities or specific kinds of operations not covered in the list of financial services covered in the annex to the directive should be subject to supplementary national legislation.⁷¹ In other words, DCI is the reference for EU-wide common regulatory and supervisory standards: member states cannot simply invoke their own prudential standards. The DCI even anticipates cases of emergency, and in the event of the crisis calls for enhanced cooperation between host and home country regulators,⁷² thus leaving little room for argument that deviance from the established allocation of regulatory responsibilities on public policy grounds should be possible in times of crisis or in order to prevent one. The scope for effect-based extraterritorial jurisdiction under existing EU law is therefore limited to financial intermediaries and/or services not covered by DCI 2006 (or similar directives on other financial services, such as insurance or securities).⁷³ Since regulatory interventions against foreign financial intermediaries by

⁷¹ See recital (6) in conjunction with recitals (4) and (5) to the DCI (2006).

⁷² See Art. 130 DCI (2006): “When an emergency situation arises within a banking group which potentially jeopardizes the stability of the financial system in any of the Member States where entities of a group have been authorized, the competent authority responsible for the exercise of supervision on a consolidated basis [i.e. the home country regulator] shall alert as soon as practicable (...) the [home country] authorities.”

⁷³ Existing case law that endorses the public policy exception for imposing national standards on services conducted elsewhere predates the DCI (2000 and 2006). See, for example, *Alpine Invest*, Case C-384/93 (ECJ reports 1995 I-01141), which was decided solely on the basis of the Treaty provisions as the relevant actions predated EU directives that might otherwise have been applicable. See *ibid*, recital 14.

definition restrict access to the domestic markets any such measures would have to be justified on public policy grounds and, as the case law of the ECJ suggests, the threshold for such interventions is high.

Ongoing reforms of the European governance regime for financial services do not follow the effect-based advocated here. Instead, they embrace the increased centralization of regulatory functions in the hands of European-wide regulatory agents. A host of new draft regulation seek to establish a “European System of Financial Supervisors” (ESFS) comprising of several EU-level supervisors for different types of financial service, such as banking, securities, insurance, etc. As part of this scheme, a new “European Banking Authority” (EBA)⁷⁴ will succeed the Committee of European Bank Supervisors (CEBS). CEBS was established in 2004 as part of the “Lamfalussy Process” for European financial services.⁷⁵ The basic idea of this process named after the chair of the “Committee of Wise Men” that authored the report is that EU directives or regulation (level 1) shall set forth the general framework for financial market governance. Their implementation and enforcement by domestic legislatures and regulators shall be guided by complementary guidelines developed by two committees. At level 2, the European Banking Committee (EBC), and any body run by the European Commission, shall facilitate the implementation of directives by addressing political issues as well as design problems. At level 3, CEBS brings together regulators from the member states involved in the regulation of banks. CEBS was charged with providing technical advice and ensuring the consistent implementation of the directive by

⁷⁴ See Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority, COM(2009) 499 final, Brussels, 23 September 2009 (hereinafter EBA regulation).

⁷⁵ See also Commission adopted Decision 2004/5/EC of 5 November 2003 establishing the Committee of European Banking Supervisors (1) as amended of 23 January 2009, (2009/78/EC), OJ L 25/23, 29 January 2009.

dispersed national regulators. During the first years of its existence CEBS has devoted most attention to implementing the second Basel Accord (Basel II), which is enshrined in the capital adequacy directive.⁷⁶ In addition to collecting information, conducting peer review, and involving the financial industry through consultation processes, CEBS also functions as a mediator in disputes between home and host country regulators; The complexity of the process and the sheer size of the new committees (51 regulators from 27 countries are currently represented in CEBS) as well as the lack of actual enforcement powers in the hands of CEBS leaves key decision-making in the hands of domestic regulators: the regulator in the jurisdiction where a credit institution has been authorized (licensed), i.e. the home country regulator. A 2009 amendment of the Council decision seeks to clarify the objectives of CEBS emphasizing once more its role in ensuring cooperation among member state supervisors, facilitating the exchange of information among them and operating as mediator in the event of disputes.⁷⁷ CEBS shall be governed by consensus, but if a consensus cannot be reached decisions shall be taken by majority vote with votes weighted according to relevant Treaty provisions.⁷⁸ This implies that large countries have more votes, which by definition puts most of the new member states in CEE (with the exception of Poland) into minority position, not only individually but also collectively. The specifics for the relation between home and host country supervisors were established in guidelines that CEBS adopted in 2005.⁷⁹ The guidelines were open for consultation, which are available from CEBS web page. The responses came exclusively from banks and banking associations in old member

⁷⁶ Supra note 69.

⁷⁷ Ibid, Arts. 5 and 6.

⁷⁸ Ibid, Art. 14 (1). See Art. 205 (2) and (4) EU Treaty, which allocates weights roughly in accordance with population size.

⁷⁹ CEBS Home-Host Guidelines, CP09 supra note 43.

states whose members include important trans-European financial conglomerates.⁸⁰ Not a single organization from the new member states submitted a response – perhaps not surprisingly, because in 2005 most of the new member states were relatively new, or in the case of Bulgaria and Romania had not even become members. ~~Nonetheless~~, The timing and process of the adoption of these guidelines is indicative of the lack of real voice of countries, which had already turned themselves into major destinations of credit expansion from banking groups with seats in other EU member states.⁸¹ While one might argue that most of these countries would be unlikely to effectuate effect-based regulation should they receive such powers, the existing governance structure gives them neither powers nor responsibilities to participate in the allegedly coordinative governance structure. Such an allocation of powers might be appropriate if the home countries of parent banks commit to bail out financial systems of voiceless host states in the event of a crisis – a commitment that home country regulatory are unlikely to make.

The reforms triggered by the global financial crisis seek to strengthen EU level supervisory bodies rather than national regulators in host countries. According to the proposal CEBS will be re-named the “European Banking Authority”⁸² and receive management structure more akin to a full blown

⁸⁰ Specifically, the following organizations commented on the guidelines: Association of Foreign Banks in Germany, ING Group, Wirtschaftskammer Österreich - Bundessparte Bank und Versicherung, Institute of International Finance (IIF), Belgian Bankers' & Stockbroking Firms' Association (ABB-BVB), Bundesverband der Deutschen Volksbanken und Raiffeisenbanken e.V. (BVR), Bundesverband Öffentlicher Banken Deutschlands e.V. (VÖB) and Deutsche Sparkassen- und Giroverband e.V. (DSGV), Netherlands Bankers' Association (NVB), British Bankers' Association (BBA), London Investment Bankers' Association (Liba) and the International Swaps and Derivatives Association (ISDA), Eurofinas, European Banking Federation (EBF), French Banking Federation (FBF), HVB Group. See <http://www.c-eps.org/getdoc/0d883044-b483-4b45-a1f7-76b9e36b8b59/Responses-to-CP09.aspx>.

⁸¹ See supra the discussion in part 2.

⁸² Art. 1 EBA Regulation.

regulatory agency with a supervisory board, a management board, a fulltime chairperson, and a fulltime executive.⁸³ The board of supervisors consists of the chairperson (appointed by it), the head of national supervisors of credit institutions, and one representative each of the Commission, the European Central Banks (ECB), a newly created European Systemic Risk Board (ESRB), and non-voting representatives from each of the other two European Supervisory Authorities for securities and insurance (Art. 25). The supervisory board is charged with realizing the EBA's mission, including the establishment of regulatory standards, the development of guidelines and recommendations for their implementation, the consistent application of Community legislation, the prevention of regulatory arbitrage, the coordination of tasks among different regulators and the mediation of conflicts between them (Art. 6). It decides with qualified majority applying weighted voting rights in accordance with the EU Treaty. The management board has four members in addition to the chairperson, all of whom are selected by the board of supervisors. The management board is charged with implementing the policies set forth by the supervisory board and meets at least bi-annually and decides with simple majority of the members present. Its two fulltime executives manage everyday affairs of the EBA – the chairperson of the supervisory board who officially represents the EBA, and the executive who performs day-to-day managerial functions.

A major function of the EBA is to ensure the consistent application of Community law by national regulators.⁸⁴ In particular, it may take direct actions vis-à-vis national supervisors, but also vis-à-vis credit institutions

⁸³ See Arts. 25-29 (board of supervisors); Arts. 30-32 (management board); and Arts. 33-35 on the chairperson.

⁸⁴ Art. 9 EBA Regulation.

in the event that Community law is not or inconsistently enforced.⁸⁵ While these measures create the impression that the EBA in conjunction with the Commission might function as a supranational regulator, the new regulatory structure is only as good as existing community law - including the guidelines developed by the EBA, and its ability to keep pace with market developments.

While the EBA now has the powers to step into the void should national regulators neglect to regulate credit institutions within their jurisdiction, their task is limited to enforcing existing Community law, determining whether a crisis has arisen and directing national supervisors to take actions in accordance with such law. Even in the event of a crisis the EBA it is explicitly prevented from taking decisions that “impinge in any way on the fiscal responsibility of Member States”.⁸⁶ Given that emergencies typically require bailouts of one sort or another that affect a country’s fiscal responsibility, this is a substantial carve out. Last but not least, the efficacy of this new agency will depend largely on its resources. According to the EBA Regulation, the budget shall comprise of obligatory contributions from national financial regulators, a subsidy from the Community, as well as fees paid to the Authority.⁸⁷

In sum, the EBA is more akin to a supranational regulator than CEBS. In fact, the proposed regulation envisions that the EBA might be entrusted with “exclusive supervisory powers” over entities and/or activities with Community-wide reach.⁸⁸ Yet, it falls short of the powers, including enforcement powers, needed to effectively implement these tasks. Moreover, its governance structure arguable entrenches existing

⁸⁵ Art. 6 (2) (d) (e) EBA Regulation.

⁸⁶ Ibid, Art. 23.

⁸⁷ Art. 48 EBA Regulation.

⁸⁸ Art. 6 (3) EBA Regulation.

imbalances between large and small countries, home and host countries of financial intermediaries. While the chairperson and executives shall be independent professionals, they too are appointed by the supervisory board, where decision-making power is geared towards de facto home countries. Last, but not least, the EBA Regulation further entrenches entity based regulation and the system of home-host country division of regulatory powers, which has been weakened by the greater marketization of financial services. This structure does not bode well for resolving Host's Dilemma.

5. Concluding Comments

The existing framework in Europe for governing transnational finance is insufficient for addressing the risks countries face that function as destinations for expanding multinational financial groups-specifically the kind of risks that have materialized in the global financial crisis. There is remarkably little evidence that the crisis was caused or deepened because of inconsistent application of community legislation. The key problem with the existing regime is the misallocation of regulatory powers given the distribution of risk and ultimately costs. Instead of addressing these problems the reform proposals further entrench the 'voice'⁸⁹ of home country regulators in EU institutions. What remains for host countries is 'loyalty' and the hope that their interests will be considered more carefully in the future in light of the harm a systemic failure of their markets can inflict on other member states and the Union.

⁸⁹ As Hirschman has argued, in integrated organizations members have only three options: voice, exit or loyalty. When voice is denied and exit is not an option all that remains is loyalty. See *Albert O. Hirschman* Exit, Voice, and Loyalty; Responses to Decline in Firms, Organizations, and States (1970).

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