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Organizational Choices of Banks and the Effective Supervision of Transnational Financial Institutions

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Abstract: This paper outlines relatively easy to implement reforms for the supervision of transnational banking-groups in the E.U. that should not be primarily based on legal form but on the actual risk structures of the pertinent financial institutions. The proposal also aims at paying close attention to the economics of public administration and international relations in allocating competences among national and supranational supervisory bodies.

Before detailing the own proposition, this paper looks into the relationship between sovereign debt and banking crises that drive regulatory reactions to the financial turmoil in the Euro area. These initiatives *inter alia* affirm effective prudential supervision as a pivotal element of crisis prevention.

In order to arrive at a more informed idea, which determinants apart from a perceived appetite for regulatory arbitrage drive banks' organizational choices, this paper scrutinizes the merits of either a branch or subsidiary structure for the cross-border business of financial institutions. In doing so, it also considers the policy-makers perspective. The analysis shows that no one size fits all organizational structure is available and concludes that banks' choices should generally not be second-guessed, particularly because they are subject to (some) market discipline.

The analysis proceeds with describing and evaluating how competences in prudential supervision are currently allocated among national and supranational supervisory authorities. In order to assess the findings the appraisal adopts insights form the economics of public administration and international relations. It argues that the supervisory architecture has to be more aligned with bureaucrats' incentives and that inefficient requirements to cooperate and share information should be reduced. The evolving Single Supervisory Mechanism for euro area banks with its rather complicated allocation of responsibilities between the ECB and the national supervisors in participating and non-participating Member States will not solve all the problems identified as it is partly in disaccord with bureaucrats' incentives.

The last part of this paper finally sketches an alternative solution that dwells on far-reaching mutual recognition of national supervisory regimes and allocates competences in line with supervisors' incentives and the risk inherent in cross-border banking groups.

JEL classification: G21, G28, H77, K22, K23, L22.

Keywords: cross-border banking, prudential supervision, consolidating supervision, banking union, subsidiaries, branches, Single Supervisory Mechanism, European Central Bank (ECB)

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SUMMARY

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I. TRANSNATIONAL CHALLENGES IN BANKING REGULATION AND SUPERVISION

A. *The Regulatory Challenges Associated with Integrated Cross-Border Banking Groups*

The conventional wisdom in banking theory suggests that allowing financial institutions to provide their services across jurisdictions generates significant benefits for society.[1] Efficiency gains accrue with regard to banks' core function as financial

1. *See, e.g.*, Michael H. Moskow, *Cross-Border Banking: Forces Driving Change and Resulting Regulatory Challenges*, *in* CROSS-BORDER BANKING: REGULATORY CHALLENGES 3, 4–5 (Gerard Caprio, Jr., Douglas D. Evanoff & George G. Kaufman eds., 2006) (discussing the potential benefits of cross-border banking activity including economies of scale and scope, other efficiency gains in the banks' operations, etc.); Jonathan Fiechter et al., *Subsidiaries or Branches: Does One Size Fit All?* 5 (Int'l Monetary Fund, Working Paper SDN/11/04, 2011), *available at* http://www.imf.org/external/pubs/ ft/sdn/2011/sdn1104.pdf (discussing the benefits of cross-border banking including lower operating costs, greater access to credit, and more efficient allocation of global savings, etc.). *But see* GERMAN COUNCIL OF ECONOMIC ADVISORS, ANNUAL REPORT 2011/2012 130 (2011), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_four_ 2011.pdf (pointing to the mid-2011 deposit withdrawal of U.S. banks and money market funds and the resulting liquidity problems of European banks in

intermediaries: economies of scale lower the costs of bringing together capital surpluses with capital needs. The demand-side benefits from improved access to credit where the funds stem from a larger pool of capital under management. The supply-side sees savings allotted to the best investment opportunity picked from those available not only in the domestic market but in many countries. The latter makes banks' portfolios more diverse and hence decreases the dependence of lending on local business cycles. Moreover, local capital markets also receive a boost from the arrival of international actors who bring with them advanced technologies of risk management, payments, and other service offerings as well as methods of information analysis and distribution that local competitors can replicate.[2]

On the other hand, the trade-off associated with the advantages of cross-border banking is also straightforward: financial systems around the world become more and more interconnected, which in turn expands the potential for negative spillover effects in times of crises.[3] Exogenous shocks can affect national economies, which originally did not face any problems in their banking sector. The availability of credit may decline, either because institutions troubled at home (or elsewhere) confine their activities on foreign markets where they formerly played a prominent role in providing finance to local businesses[4] or because international banks cut back on lending in their home country as a consequence of losses incurred abroad.[5] In the

the highly integrated, global financial system).

2. *See* Stijn Claessens, Asli Demirgüç-Kunt & Harry Huizinga, *The Role of Foreign Banks in Domestic Banking Systems*, *in* THE INTERNATIONALIZATION OF FINANCIAL SERVICES: ISSUES AND LESSONS FOR DEVELOPING COUNTRIES 117 (Stijn Claessens & Marion Jansen eds., 2000) (exploring how foreign bank presence has positively impacted domestic banking markets in eighty countries); Stijn Claessens, Asli Demirgüç-Kunt & Harry Huizinga, *How Does Foreign Entry Affect Domestic Banking Markets?*, 25 J. BANKING & FIN. 891 (2001) (showing an increase in technical efficiency at domestic banks subsequent to the arrival of foreign banks in a sample of eighty countries); *see also* Douglas D. Evanoff & Evren Ors, *The Competitive Dynamics of Geographic Deregulation in Banking: The Implications for Productive Efficiency*, 40 J. MONEY FIN. & BANKING 897 (2008) (showing the same effect on incumbent banks following a competitor's out-of-state merger in the U.S. banking sector between 1984 and 1999 using a sample of 2,309 such business combinations).

3. *See* INT'L MONETARY FUND, CROSS-CUTTING THEMES IN ECONOMIES WITH LARGE BANKING SYSTEMS 11–12 (2010), *available at* http://www.imf.org/external/np/pp/eng/2010/041610.pdf (considering economies of various sizes with large banking systems and finding only a low risk of outward spillovers but a rather high risk of inward contagion from abroad).

4. *See, e.g.*, Ralph De Haas & Iman Van Lelyveld, *Multinational Banks and the Global Financial Crisis: Weathering the Perfect Storm?* (European Bank for Reconstruction and Development, Working Paper No. 135, 2011), *available at* http://www.ebrd.com/downloads/research/economics/workingpapers/wp0135.pdf (finding a slowdown in credit growth twice as rapid in a sample of the forty-eight largest multinational banks compared to a control group of 202 purely domestic banks). *But see* John P. Bonin, *From Reputation Amidst Uncertainty to Commitment Under Stress: More than a Decade of Foreign-Owned Banking in Transition Economies*, 52 COMP. ECON. STUDIES 466 (2010) (arguing that foreign banks largely sustained their commitment to the markets of ten European transition economies).

5. *See* Thomas Dietz, Tetiana Protysk & Erich Keller, *Similar but Different? The Financial Crisis in Matured Western and Emerging Eastern European Countries*, 4 BANKS & BANK SYSTEMS 20, 28 (2009) (arguing that Western European banks' significant engagement in Eastern Europe constitutes a potential for relapse in the ongoing financial crisis); Ewald Nowotny, *The Financial Crisis and the Role of Austrian Banks in Central, Eastern and Southeastern Europe*, 17 ECON. & FIN. REV. 3 (2010) (showing that the credit risk provisioning by Austrian banks' Central, Eastern, and Southeastern European subsidiaries rose sharply as a result of the 2008 financial crisis occurring on those foreign markets); *see also* Már Gudmundsson & Thorsteinn Thorgeirsson, *The Fault Lines in Cross-Border Banking: Lessons from the Icelandic Case*, *in* CONTAGION AND SPILLOVERS: NEW INSIGHTS FROM THE CRISIS 141 (Peter Backe, Ernest Gnan & Philipp Hartmann eds., 2010) (describing the events leading to the collapse of the Icelandic banking sector as a result of its disproportionate and mismanaged cross-border activities).

latter case, the magnitude of the shocks originating overseas and the importance of the financial institutions affected may ultimately compel fiscally expensive[6] and politically unpopular government bailouts in order to avoid the disruptive consequences of a pivotal bank's failure.

Public policy hence faces the challenge of minimizing these potential downsides of cross-border banking without impeding its upside. One key element of the institutional framework targeted at this ambitious goal is the prudential supervision of banks.[7] The distinctive feature in the context of cross-border banking is that policymakers and regulators operate in a quintessentially transnational setting where legislative intervention and its enforcement on a national level almost naturally create externalities,[8] e.g., if a country deploys resources to facilitate the adequate micro-prudential[9] supervision of banks incorporated under its jurisdiction this will also benefit all other countries where the respective financial institutions conduct business. Yet, if these other countries engage in supervisory activities themselves, redundancies and frictions in the legal framework, turf-wars among authorities etc. will raise the costs of doing business abroad and may compromise the effectiveness of the regulatory regime to which cross-border banks are subjected.[10]

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6. *But see* Gérard Hertig, *Governments as Investors of Last Resort: Comparative Credit Crisis Case-Studies*, 13 THEORETICAL INQ. L. 385, 391 (2012) (showing positive returns of 2.6%–22.5% on government equity stakes acquired in the bailouts of JP Morgan Chase, Wells Fargo, Goldman Sachs, Crédit Agricole, BNP Paribas, and Société Géneral for the years 2008 and 2009, and thus presenting preliminary evidence that the recent bank bailouts during the financial crisis were not as costly for governments as originally perceived and suggested by the enormous figures used in the recapitalizations).

7. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 756 (Roy Hutcheson Campbell & Andrew S. Skinner eds., Clarendon Press 1976) (1776) (espousing the general rationale of sovereign supervision of banks, which *in grosso modo* aims at minimizing the probability and the impact of financial distress in the sector under the assumption that these goals are inadequately achieved through market discipline alone). For modern economists arguments, compare MILTON FRIEDMAN, A PROGRAM FOR MONETARY STABILITY 4 (1959); MATHIAS DEWATRIPONT & JEAN TIROLE, THE PRUDENTIAL REGULATION OF BANKS (1994); George J. Benston & George G. Kaufman, *Is the Banking and Payments System Fragile?*, 9 J. FIN. SERVICES RES. 209 (1995); PETER D. SPENCER, THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS 193–208 (2000); Charles W. Calomiris, *Blueprints for a New Global Financial Architecture*, *in* INTERNATIONAL FINANCIAL MARKETS 259 (Leonardo Auernheimer ed., 2003); for a critical account of the history of banking regulation see CHARLES W. CALOMIRIS, UNITED STATES BANK DEREGULATION IN HISTORICAL PERSPECTIVE 1–79 (2000); for the libertarian skepticism regarding the legitimacy of any regulatory interference in the banking sector see FRIEDRICH AUGUST HAYEK, DENATIONALIZING MONEY 9 (1976); DAVID GLASNER, FREE BANKING AND MONETARY REFORM (1989); KEVIN DOWD, THE STATE AND THE MONETARY SYSTEM (1989).

8. *See* Maximilian J.B. Hall & George G. Kaufman, *International Banking Regulation*, *in* THE STRUCTURAL FOUNDATIONS OF INTERNATIONAL FINANCE 92 (Pier Carlo Padoan, Paul Brenton & Gavin Boyd eds. 2003) (speaking to the reason banks were traditionally regulated on a national level).

9. This term refers to a regulatory approach that aims at securing individual financial institutions resilience *vis-à-vis* external shocks and diverges in this limited goal from a macro-prudential approach that is targeted towards the soundness and viability of the financial system as a whole and accepts the existence of risk originating within the system. *See, e.g.*, Claudio Borrio, *Towards a Macro-prudential Framework for Financial Supervision and Regulation?* 2–3 (Bank for Int'l Settlements, Working Paper No. 138, 2003) (arguing that the macro-prudential approach can be used naturally to measure rational and compelling situations, whereas applying the micro-prudential approach is impossible under the same circumstances); Samuel G. Hanson, Anil K Kashyap & Jeremy C. Stein, *A Macro-Prudential Approach to Financial Regulation*, 25 J. ECON. PERSP. 3, 4–7 (2011) (demonstrating that the macro-prudential approach aims to counter-balance the actual crisis).

10. For a pre-crisis view on the regulatory challenges that cross-border banking posed to the emerging markets to which banks extend their business, *see* Guillermo Ortiz, *Cross Border Banking and the Challenges Faced by Host-Country Authorities*, *in* CROSS-BORDER BANKING: REGULATORY CHALLENGES, *supra* note 1, at 11, 14–18 (identifying differences in regulation and stakeholder interests, the lack of market discipline, and the

The latter is all the more important as a pivotal determinant of the regulatory framework seems endogenous from the perspective of the supervised financial institutions. As will be discussed in more detail,[11] currently the applicable supervisory regime hinges upon how banks choose to organize their international activities. In principle, a financial institution faces two alternatives if it seeks to establish a continuous and meaningful presence in a foreign market.[12] It can either organize its foreign operations as a subsidiary, a legally independent, yet wholly owned entity incorporated under the laws of the foreign jurisdiction, or it can establish a branch, a legally dependent satellite of its main establishment fully recognized under the laws of the foreign country where the banking services will be provided.[13] Clearly, where the applicable law depends on choices of the regulated entities, concern over potential regulatory arbitrage looms.[14] Recent intra-group restructurings that at least coincided with some tightening in the regulatory regimes applicable to banks operating across borders at first glance seem to corroborate these apprehensions.

B. Intra-Group Restructurings as a Sign of Regulatory Arbitrage?

1. Europe

In Europe, several transactions occurred very recently that followed a common template: In certain jurisdictions, the activities of large cross-border banking groups were transformed from subsidiaries into branches.[15] The transactions were executed

problems of cross-border crisis management as critical aspects).

11. *See infra* Part IV.

12. The additional option to set up a representative office that can provide some auxiliary services abroad to the bank's main operations is also well established under WTO rules. *See* General Agreement on Trade in Services art. XXVIII (g) footnote 12, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183 [hereinafter GATS] ("Where the service is not supplied directly by a juridical person but through other forms of commercial presence such as a branch or a representative office, the service supplier (i.e., the juridical person) shall, nonetheless, through such presence be accorded the treatment provided for service suppliers under the Agreement."). Yet, a representative office may be well-suited to serve niche-markets, but it is practically inapt to establish a presence that broadly competes with domestic firms. This is even more true with regard to providing banking services directly across borders as permitted under The Treaty on the Functioning of the European Union art. 56, Mar. 30, 2010, 2010 O.J. (C 83) 47 [hereinafter TFEU].

13. *See* Eugenio Cerutti, Giovanni Dell'Ariccia & Maria Soledad Martínez Pería, *How Banks Go Abroad: Branches or Subsidiaries*, 31 J. BANKING & FIN. 1669, 1685–91 (2007) (identifying tax rates, regulatory barriers, diverging business models—commercial versus retail banking—and economic and political risks as driving forces behind banks' organizational choices in a sample of the world's 100 largest banks' operations in Latin America and Eastern Europe).

14. On the generally negative connotation of the term that indicates a race for laxity in regulatory standards, see Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 567 (1998) ("Regulatory arbitrage traditionally indicates a phenomenon whereby regulated entities migrate to jurisdictions imposing lower regulatory burdens. By doing so they exert a downward pressure on those jurisdictions that want to retain the regulated activity within their borders."); Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L. L.J. 32, 52 (2007) ("As a consequence [of regulatory arbitrage], issuers and other market participants may be tempted to relocate to jurisdictions with less costly regulation, since the market mechanisms that might normally punish such behavior are suppressed.").

15. *See, e.g.*, Press Release, Deutsche Bank ZRt., Transformation of Deutsche Bank ZRt. into a branch of

through a cross-border merger of the thus far independent foreign subsidiary into the parent corporation[16] that instantaneously assigned the received assets to the newly established foreign branch on its balance sheet. As a consequence, the real-world appearances of the banks' foreign operations were not affected by the legal maneuver. Yet, the regime of prudential bank regulation and supervision of the respective host countries ceased to apply.[17] The restructurings caught the attention of the business press where they were regarded as blatant acts of regulatory arbitrage

> European Banks are restructuring their businesses outside their home countries in ways that mute the impact of tough new regulations that were adopted as a response to the financial crisis. In the U.S., U.K. and Portugal, at least a handful of large European banks have altered their legal structures or shifted assets and business lines between units, partly in an attempt to avoid local rules and oversight, according to bank disclosures and people familiar with the matter.[18]

In stark contrast, the banks involved invoke efficiency considerations as the main motive for converting their subsidiaries into branches when they declare a simplification of the group structure[19] and a more efficient allocation of resources as key objectives of the conversion-schemes.[20]

Deutsche Bank AG (May 31, 2011), *available at* https://www.db.com/hungary/docs/Branch_client_communication_letter.pdf (announcing the conversion of Deutsche Bank in Hungary from a subsidiary to a branch); Lawrence G. Goldberg, Richard J. Sweeney & Clas Wihlborg, *From Subsidiary to Branch Organizations of International Banks: New Challenges and Opportunities for Regulators* 1 (Nov. 14, 2005), *available at* http://openarchive.cbs.dk/bitstream/handle/10398/6783/wplefic042005.pdf? sequence=1 (describing the shift of Nordea from operating in subsidiaries to branches); *see also* FRANKLIN ALLEN ET AL., CENTER FOR ECONOMIC POLICY RESEARCH, CROSS-BORDER BANKING IN EUROPE: IMPLICATIONS FOR FINANCIAL STABILITY AND MACROECONOMIC POLICIES, 26–27 (2011) (showing a general rise in the number of foreign branches in the European Union).

16. Such cross-jurisdictional transactions are facilitated by Directive 2005/56 of the European Parliament and of the Council of 26 October 2005 on Cross-Border Mergers of Limited Liability Companies, 2005 O.J. (L 310) 1 and its implementation in the Member States' merger statutes.

17. Regulatory and supervisory competences in international banking are tied to the legal entities' banking licenses, e.g., where a banking group establishes subsidiaries in a multitude of jurisdictions, its operations will require several banking licenses. Hence, several regulators and supervisors will be tasked with the group's supervision and hence have to cooperate according to the ground rules laid down under the auspices of the Bank for International Settlements (BIS). *See* BASEL COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 40–42 (1997) (discussing cross-border banking and the obligations of home and host country supervisors). For a more detailed account, see *infra* Part IV (discussing the host country's supervisory role depending on whether the bank uses a subsidiary or branch organizational model).

18. Patricia Kowsmann, David Enrich & Laura Stevens, *Banks Find New Wrinkle in Regulatory Arbitrage*, WALL ST. J. (Dec. 2, 2011), *available at* http://online.wsj.com/article/SB40001424052970204397704577072423856961212.html.

19. *See* Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety and Soundness*, *in* THE OXFORD HANDBOOK OF BANKING 197, 214 (Allen N. Berger, Phillip Molyneux & John O. S. Wilson eds., 2012) (showing that the sixteen largest financial institutions in the world have two and a half times more subsidiaries than the sixteen largest non-financial firms).

20. *See, e.g.*, Deutsche Bank, Transformation of Deutsche Bank ZRt. into a branch of Deutsche Bank AG (May 31, 2011), *available at* https://www.db.com/hungary/docs/Branch_client_communication_ letter.pdf (discussing the conversion of the Deutsche Bank ZRt. into a branch of Deutsche Bank AG).

2. United States

Similar concerns were voiced in the aftermath of restructurings that involved the U.S. operations of some global banking groups headquartered in Europe, to wit U.K.'s Barclays and Germany's Deutsche Bank. The criticized transactions sought to avoid the status of a "financial holding company" for the respective groups' top U.S. units under the Bank Holding Company Act of 1956.[21] The critical reform in this regard was promulgated in the course of the Dodd-Frank Act overhaul[22] and invariably requires any bank holding company to be well capitalized itself. In particular, the tightened legislation cancels the prior exemptions granted to large intermediate holding companies of international banking groups[23] which may be backed by a strong financial institution outside the United States and hence do not necessarily depend on their own funds to be sufficiently resilient as a stand-alone U.S. holding company does. Estimates gauged the additional capital requirements one of the intermediate financial holding companies faced under the new regulation at $20 billion.[24] The rather simple move to avoid this massive burden of having to inject new capital into the group's U.S. business was to transfer the shares of the wholly owned U.S. depository bank from the intermediate holding company to the mother company registered outside the United States. As a result, the groups' U.S. intermediate holding companies were left with equity stakes only in subsidiaries that conduct non-depositary financial activities. Hence, they no longer fall under the Bank Holding Company Act's definition of a bank holding company.[25]

Again, the momentous change in the applicable regulatory and supervisory regime could be achieved in an instant without altering the cross-border banking groups' real-world appearances. No wonder that leading business newspapers unanimously regarded the changes in the involved groups' legal structures as aimed at "avoiding" stricter regulation;[26] a reputable German daily even characterized the transaction as "tricking" U.S. supervisors.[27] On the other hand, a spokesman of one of

21. "Financial holding company" is defined as a company that has direct or indirect control over a depository banking subsidiary and meets the mandatory capital requirements. Bank Holding Company Act, 12 U.S.C. § 1841(a)(1), (p) (2011).

22. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. No. 111–203, § 606(a), 124 Stat. 1376, 1607 (2010) (amending the Bank Holding Company Act of 1956 and requiring banks to remain well capitalized).

23. The substantive regulation is contained in the Federal Reserve's amendments to Regulation Y. 12 C.F.R. § 225.8 (2011). The amendments require large bank holding companies to submit capital plans that adhere to rigorous own funds requirements. *Id.*

24. David Enrich & Laura Stevens, *Deutsche Avoids Dodd-Frank Rule*, WALL ST. J., Mar. 22, 2012, at C1 [hereinafter *Deutsche*].

25. *See* David Enrich, Laura Stevens & Alexandra Berzon, *Deutsche Maneuvers Around New Law*, WALL ST. J., Apr. 13, 2012, at C1 (stating that "Deutsche is planning to change the status of Taunus so that it is no longer classified as a bank-holding company," allegedly to avoid compliance with the Dodd-Frank Act).

26. Tom Braithwaite & Shahien Nasiripour, *Deutsche Bank Avoids US Capital Rules*, FINANCIAL TIMES (Mar. 22, 2012), http://www.ft.com/cms/s/0/f2d96462-738e-11e1-94ba-00144feab49a.html#axzz25qXHviPi; *Deutsche*, *supra* note 24.

27. Moritz Koch, *Tricksen mit Taunus* [*Tinkering Around with Taurus*], SÜDDEUTSCHE ZEITUNG, Mar. 23, 2012, at 26. For another harsh critique from the perspective of a U.S. trade union, compare Letter from Marty R. Leary of Unitehere! to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, *available at* http://www.federalreserve.gov/SECRS/2011/August/20110831/R-1425/R-1425_080411_87623_491541684764_1.pdf.

the banks involved justified the changes as a measure to enhance the efficiency of the groups' organizational structure.[28]

C. Misconceptions and the Pivotal Question

Even though the restructurings delineated above seem to be obvious cases of regulatory arbitrage at first glance, a critique focusing mainly on the circumvention of specific substantive rules still deals with rather peripheral aspects and ultimately misses the crucial issue at hand.

Stricter requirements regarding subsidiaries' or the banking groups' own funds and a design of executive compensation packages that rewards sustainable growth have been duly identified as mechanisms that can enhance banks' resilience and do away with detrimental incentives for excessive risk taking.[29] However, it seems implausible that a strategy geared at avoiding particularly austere national regulations promulgated in certain European countries[30] actually motivated the branch conversions described above. When the restructurings were initiated, a general tightening and further harmonization of the pertinent E.U. regimes had already become visible on the international horizon and in critical part even arrived prior to the closing of the restructurings.[31] These restructurings were hence inapt to escape from the regulators' tighter grips in the longer run.

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28. *See Deutsche*, *supra* note 24 ("Action, which does not diminish any of our regulatory oversight, allows us to streamline our organizational structure, strengthening an already strong institution.") (quoting Deutsche Bank spokesman Duncan King).

29. How ill-designed executive pay in banks contributed to the financial crisis has been broadly analyzed, mostly with regard to the short-term orientation of high-powered incentive schemes. For an account of the broad consensus in this respect, see Lucian A. Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1917–19 (2010). With regard to more structural issues in the banking sector, see, e.g., Günther Franke & Jan Pieter Krahnen, *The Future of Securitization*, *in* PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN 105, 126–39 (Yasuyuki Fuchita, Richard Herring & Robert E. Litan eds., 2009) (presenting evidence on how non-negative bonus payments induce high leverage ratios that increase default-risk and potentially threaten financial stability); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, GEO. L.J. 247, 255–74 (2010) (analyzing how equity-based incentive compensation induces a managerial bet on the bank's highly levered assets).

30. *See* Financial Stability Forum, *Principles for Sound Compensation Practices* (Apr. 2, 2009), *available at* http://www.financialstabilityboard.org/publications/r_0904b.pdf (providing an overview of the European reforms implementing the international consensus on sound compensation practices achieved among the G20 nations); *see also* Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks*, 64 VAND. L. REV. 431, 453–54, 483–96 (2011) (providing an overview of the approaches to compensation through the crisis implemented by particular European countries).

31. *See generally* Parliament and Council Directive 2010/76, As Regards Capital Requirements for the Trading Book and for Re-securitizations, and the Supervisory Review of Remuneration Policies, 2010 O.J. (L 329) 3 [hereinafter CRD III] ("In order to address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals, the requirements of Directive 2006/48/EC should be supplemented by an express obligation for credit institutions and investment firms to establish and maintain, for categories of staff whose professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management."). Moreover, as is well known, an even more fundamental reform, aimed at completely leveling the playing field for E.U. banks by basing prudential supervision on a single, harmonized rulebook is also in the making. *See generally Commission Proposal for a Directive of the European Parliament and the Council on the Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms and Amending Directive 2002/87/EC of the European Parliament and of the Council on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms*

Similarly, the efforts to avoid the pertinent Dodd-Frank reforms do not necessarily indicate the affected banks' proclivity to race for laxity at all cost. The pivotal fact under the reform legislation, that some international banks' organizational structure features an intermediate holding corporation that controls the groups' incorporated U.S. depository banking units, ties the massively augmented capital requirements to rather formal aspects. The severely tightened own-funds requisites neither hinge upon the actual risk structure of the group nor upon its supervisory regime. Thus, they outright negate the possibility that the U.S. intermediate holding may benefit from the support of an overseas parent that is itself subject to a rigid regime of consolidated banking supervision which also accounts for the risks that accrue from the U.S. business entity. Seen from this vantage, submitting to the Dodd-Frank reforms could also be regarded as generating a windfall profit for the U.S. banking system as a result of a quasi-protectionist legislation that intentionally disregards the transnational nature of cross-border banking groups.

As a consequence, the reproach that transnational banking groups engaged in regulatory arbitrage when they restructured their organizations should not be based on a narrow analysis that constricts the view on the applicability of specific rules of the supervisory regime prior to and after the restructurings. Regardless of the merits of discrete substantive rules, the more momentous question that should be posed in light of the delineated developments is whether the organizational choices of cross-border banking groups in general are adequately resorbed by the applicable regime of prudential supervision in a transnational context. This implies that the supervisory architecture should neither drive opportunistic choices nor hamper an efficient organization of transnational banking groups.

This Article explores precisely this fundamental question against the background of the ongoing sovereign debt crisis in the euro area. The short sequence of financial disasters that were neither prevented nor mitigated in a meaningful way under the current E.U. regime of shared responsibility among Member States reveals significant shortcomings. Recently promulgated and currently proposed reforms tackle the deficiencies in an insufficient manner. This is all the more worrying as the euro crisis together with the ramifications and sequels of the Lehmann-debacle highlight the importance of effective "normal-times" prudential supervision. The latter is, and will remain, a key determinant when it comes to enhancing the resilience of a transnationally intertwined financial system where market discipline in its most pristine occurrence as the exit of failing participants is partly unavailable.[32]

With this in mind, this Article evaluates the impending European Banking Union[33] and outlines a relatively easy-to-implement reform-alternative for the

in a Financial Conglomerate, COM (2011) 453 final (July 20, 2011) [hereinafter CRD IV Directive] ("For the sake of clarity and in order to ensure a coherent application of those provisions, it would be desirable to merge these provisions into new legislation applicable to both credit institutions and investment firms."); *see generally Commission Proposal for a Regulation of the European Parliament and the Council on Prudential Requirements for Credit Institutions and Investment Firms*, COM (2011) 452 final (July 20, 2011) [hereinafter CRD IV Regulation] (further elaborating on solutions to the regulatory shortcomings).

32. *See infra* Section II.A.2 (describing how neither sovereign debtors nor systematically important financial institutions face the option of resolution or restructuring in bankruptcy).

33. *See* Explanatory Memorandum of the *Commission Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, COM (2012) 511 final (Sept. 12, 2012) [hereinafter *Commission Proposal SSM Regulation*] ("One of the key elements of the banking union should be a Single Supervisory Mechanism (SSM) with direct

supervision of transnational banking groups in the European Union that is no longer based on legal form but more on the actual risk structure of the pertinent financial institutions. It also aims at paying close attention to the economics of public administration and international relations in allocating competences among national and supranational supervisory bodies. Before detailing its own proposition, Part II of this Article looks into the relationship between sovereign debt and banking crises that drive regulatory reactions to the financial turmoil in the euro area that *inter alia* affirm effective prudential supervision as a pivotal element of their implementation. In order to arrive at a more informed idea as to which determinants apart from a perceived appetite for regulatory arbitrage drive banks' organizational choices, Part III scrutinizes the merits of either a branch or subsidiary structure for the cross-border business of financial institutions. In doing so, it also considers the policymaker's perspective. The analysis shows that no one-size-fits-all organizational structure is available and concludes that banks' choices should generally not be second-guessed, particularly because they are subject to at least some market discipline. Part IV describes and evaluates how competences in prudential supervision are currently allocated among national and supranational supervisory authorities. In order to evaluate the findings the appraisal adopts insights from the economics of public administration and international relations. It argues that the supervisory architecture has to be more aligned with bureaucrats' incentives and that inefficient requirements to cooperate and share information should be reduced. Contrary to a widespread perception, shifting responsibility to a supranational authority cannot solve all the problems identified. Resting on these foundations, Part V finally sketches an independent solution that dwells on far-reaching mutual recognition of national supervisory regimes and allocates competences in line with supervisors' incentives and the risk inherent in cross-border banking groups.

II. THE IMPORTANCE OF MICRO-PRUDENTIAL SUPERVISION: LESSONS FROM THE ONGOING SOVEREIGN DEBT AND BANKING CRISES IN THE EURO AREA

Sovereign debt and banking crises frequently correlate in history, a finding that confirms the connections delineated in economic theory. These basic insights serve as a starting point to help understand not only the repercussions that the ongoing euro crisis exerts on the European banking system, but also how the calamities in the financial sector impacted on sovereign debtors. Finally, it provides the necessary background for conceiving the prudential supervision of transnational banking groups as an important component of the European initiatives targeted at long-term hazard control.

A. Sovereign Debt and Banking Crises Through the Ages

1. Historical Anecdotes

The first documented sovereign debt crisis occurred when most of the municipalities of the Attic Maritime Association were unable to repay a loan from the

oversight of banks, to enforce prudential rules in a strict and impartial manner and perform effective oversight of cross border banking markets.").

Delos temple (377−373 B.C.).[34] But as early as in 1343 A.D., shock waves triggered by a sovereign debtor's woes were sent across Europe when King Edward III of England defaulted on his obligations at the largest Florentine banks, sending them into bankruptcy and thus causing the collapse of an entire financial system.[35] The scenario reoccurred in 1557 A.D. when King Philip II of Spain ruined the powerful merchant banks owned by the South German families of the Fuggers and the Welsers.[36] Yet Germans were not always the bereaved but also the bankrupts: During the 19th century German states defaulted five times on their debt jointly with Austria and Portugal, outdistancing Greece, which disappointed its lenders only four times.[37] All these events put severe stress or increased the already existing stress on the banking system, at least in the immediately affected economies.

2. Bailout Rationality and Moral Hazard

At the outset, major banking and sovereign debt crises share a critical common feature, because the option to force a failing debtor's restructuring or resolution in bankruptcy constitutes a credible scenario for neither systemically important financial institutions (SIFIs) nor for sovereign debtors. Moreover, where outside help is foreseeably available, market discipline is dulled and moral hazard occurs.[38]

With regard to sovereign debtors, the probability and magnitude of default in general do not depend critically on their ability to pay but on their willingness to pay; without an executable enforcement mechanism that coerces debt-servicing, sovereign debtors will default once the anticipated costs of doing so have become lower than the costs of redeeming the obligation.[39] Moreover, sovereign debtors, although by their very nature fiscally independent bodies, can rely on outside help where other public

34. MAX WINKLER, FOREIGN BONDS: AN AUTOPSY 22 (1933).

35. Meir Kohn, *Merchant Banking in the Medieval and Early Modern Economy* 20 (Dartmouth College, Dept. of Econ. Working Paper 99–05, 1999), *available at* http://www.dartmouth.edu/~mkohn/ Papers/99-05.pdf.

36. *Id.*

37. Carmen M. Reinhart, Kenneth S. Rogoff & Miguel A. Savastano, *Debt Intolerance* 11 (NBER Working Paper 9908, 2003), *available at* http://www.nber.org/papers/w9908. The last German default occurred during the 1930s. *See* Eduardo Borensztein & Ugo Panizza, *The Costs of Sovereign Default* 44 (IMF Working Paper WP/08/238, 2008), *available at* http://www.imf.org/external/pubs/ft/wp/ 2008/wp08238.pdf (listing the default and rescheduling dates of sovereign debtors all over the world since the early nineteenth century).

38. *See* Jay C. Shambaugh, *The Euro´s Three Crises*, BROOKINGS PAPERS ON ECON. ACTIVITY 32 (2012), *available at* http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2012_spring_bpea_papers/2012_spring_BPEA_shambaugh.pdf (discussing specifically the moral hazard that arose in the euro area when banks and sovereigns were not held responsible for their actions).

39. *See generally* Jonathan Eaton, Mark Gersovitz & Joseph E. Stiglitz, *The Pure Theory of Country Risk*, 30 EUR. ECON. REV. 481 (1986) (explaining the concerns that exist in the relationship between sovereign debtors and their creditors). While the immediate costs of servicing debt simply consist of interest and redemption payments, the pertinent costs of default are more complex. The sovereign debtor will be excluded from international financial markets and will thus be unable to smooth consumption and face impediments to investments for a certain time. The magnitude of these effects depends on the period of exclusion. Yet, even after regaining access to international financial markets, risk premiums will be influenced by the sovereign debtor's prior default. Moreover, further costs are associated with the economic downturn that usually accompanies a sovereign default or trade sanctions in reaction to it.

actors deem their overall economic, social, and political costs of the default of a sovereign as too high, even though legal restrictions on sovereign bailouts may exist.[40]

SIFIs, as private business corporations, on the other hand, are in principle subject to insolvency proceedings. Yet, their market exit, by definition, sends ripples throughout the financial system that create incentives for policymakers to rescue failing banks, even if the handling of a systemic crisis in the banking sector was consciously left unclear to induce caution and discipline among SIFIs in an atmosphere of constructive uncertainty. Even though political decision-makers may have pledged not to bailout SIFIs, they tend to behave inconsistently over time and take rescue measures in order to prevent a chain reaction in the banking sector, which would ultimately lead to its total collapse.[41] The latter would precipitate severe negative consequences for the affected economy's production and employment. That is the case because in a major banking crisis financial institutions either go bankrupt or at least clamp down on loan approvals. Both the losses of assets dealt to institutional and private investors in the former event, as well as the decreased number of loan approvals in the latter, inhibit the propensity to invest and decrease consumer demand. Thus, they hinder macroeconomic output.

At the same time, the economic crunch exacerbates the crisis, as a recession makes it harder for sovereign borrowers to service their debt, which in turn will put banks even deeper into the quagmire. Finally, the political costs are high as well, as basically no elected government will survive the economic downturn, the decline in household income, and the ensuing asset losses.[42] On the other hand, the incentives to "gamble for resurrection"[43] are high for political actors, particularly because there is no external mechanism that can force sovereign debtors to declare insolvency in order, for example, to apply for loans from the International Monetary Fund or other institutions.

The anticipation of such time inconsistencies leads to significant moral hazard and excessive risk-taking *ex ante*. There is an inherent market failure as a consequence of the lack of a predictable insolvency regime, which leads to incorrect debt-pricing.[44] Risk premiums hinge not only on the probability of default but also on

40. The Founding Treaty of the European Union explicitly prohibits a bailout of Member States' central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings. *See* TFEU, *supra* note 12, art. 125(1). However, the massive sovereign bailouts in the euro area were not barred by this constitutional restriction. For a comprehensive discussion of the contested constitutional issue, see Jean-Victor Louis, *The No-Bailout Clause and Rescue Packages*, 47 COMMON MKT. L. REV. 971, 975–86 (2010); for a brief overview, see Bruno de Witte, *The European Treaty Amendment for the Creation of a Financial Stability Mechanism*, EUR. POL'Y ANALYSIS, June 2011, at 5–6 (2011), *available at* http://www.eui.eu/Projects/EUDO-Institutions/Documents/SIEPS20116epa.pdf.

41. *See* Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REG. 121, 123–29 (2012) (describing the economics of bailouts).

42. *See* Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1375–83 (2011) (discussing the reasons why pre-committed politicians will bail out SIFIs they deem too-big-to-fail).

43. For a discussion of the connection between sovereign debt and a "gamble for resurrection," see Anne O. Krueger & Sean Hagan, *Sovereign Workouts: An IMF Perspective*, 6 CHI. J. INT'L L. 203, 207–08 (2005).

44. *See, e.g.*, Organisation for Economic Co-operation and Development [OECD], *The Third Meeting of the Latin American Corporate Governance Roundtable,* at 4, OECD Doc. 8–10 (2002), *available at* http://www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/2085780.pdf
(discussing how the mispricing of debt capital, because of weak insolvency mechanisms, spread the risk of insolvency around the Asian economies in 1998).

the probability of declining a bailout, or at least asking for a private sector contribution to the rescue efforts.[45] Hence, risk premiums are distorted and the pricing mechanism fails to induce adequate risk-taking, such as when sovereign debtors and SIFIs can borrow too cheap as part of their liability is externalized. Moreover, the participation in the losses following the default of a sovereign debtor or a SIFI is attributed on a case-by-case basis that follows the specific political and institutional preconditions prevailing at the time insolvency is declared. Hence, it can hardly be predicted *ex ante*, thus handicapping a stringent ranking among groups of creditors. As an observable consequence, sovereign debtors—and SIFIs—face relatively low risk premiums for a long time, but interest rates spike in the vicinity of insolvency.[46] Hence, a debt crisis exhibits the typical elements of a self-fulfilling prophecy where a sudden change in market participants' expectations generates entirely different results although all other economic determinants remain unchanged;[47] as long as creditors expect other creditors to renew their existing loans or extend even larger ones, they will be willing to do the same. Investor panic may plunge debtors into a liquidity crisis, as long-term claims do not work to cover short-term liabilities. Where unfavorable refinancing conditions persist, a solvency crisis will ensue.

Moreover, bank bailouts put tremendous fiscal burdens on the rescuing country's budget,[48] which in turn may cast doubts on its ability to service its own debt. These doubts will lead to a rise in risk premiums and hence will make the country's future debt service even more burdensome. Once again the overall economic recession may add to the fiscal hassles. Finally, the sovereign debt crisis will backlash on the national banking system insofar as banks will typically be the main holders of a shaky country's bonds.[49] Hence, their financial stability will be severely impacted if a country declares

45. *See* Giovanni Dell'Ariccia, Isabel Schnabel & Jeromin Zettelmeyer, *How Do Official Bailouts Affect the Risk of Investing in Emerging Markets?*, 38 J. MONEY CREDIT & BANKING 1689, 1690–92 (2006) (discussing the effect that the expectation of a bailout has on investors and debt markets).

46. *Id.* at 1699–1700; Mardi Dungey et al., *International Contagion Effects from the Russian Crisis and the LTCM Near-Collapse*, 7–10 (IMF Working Paper No. 02/74, 2002), *available at* http://www.imf.org/external/pubs/ft/wp/2002/wp0274.pdf (illustrating the bond spreads of different countries in which interest rates spike during times of crisis).

47. *See* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 401–04 (1983) (demonstrating an economic model that explains how changed expectations about a bank run can result in a bank run); Jeffrey Sachs, *Theoretical Issues in International Borrowing* 38 (NBER Working Paper No. 1189, 1983), *available at* http://www.nber.org/papers/w1189.pdf ("If all banks suddenly expect all other banks to stop lending to the country, it will be rational for certain parameter values for each bank to stop lending as well on the basis of that expectation, with the result that it becomes self-confirming."); Paul De Grauwe, *The Governance of a Fragile Eurozone* 5 (CEPS Working Document, Working Paper No. 346, 2011), *available at* http://www.ceps.be/ceps/download/5523 (discussing the self-fulfilling prophecy of sovereign debtors becoming insolvent when investors fear insolvency).

48. Between October 2008 and May 2010 the twenty-seven Member States of the European Union spent a total of 236.1 billion euro ($288.6 billion) on bank recapitalizations, issued 957.7 billion euro ($1,175.6 billion) of guarantees for bonds and other debentures, and further asset support to safeguard banks financial stability amounted to an assumption of risk worth 346.5 billion euro ($425.4 billion). The pertinent figures for Eurozone members amounted to 160.1 billion euro ($196.5 billion) of recapitalizations, 735.2 billion euro ($902.5 billion) of guarantees, and 128.7 billion euro ($158 billion) of risk assumptions. Stéphanie Marie Stolz & Michael Wedow, *Extraordinary Measures in Extraordinary Times: Public Measures in Support of the Financial Sector in the EU and the United States*, at 24 tbl. 1 (European Central Bank Occasional Paper Series, No. 117, 2010), *available at* http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp117.pdf. (dollar conversions as of May 31, 2010).

49. *See* Jack Ewing, *Already Holding Junk, Germany Hesitates*, N.Y. TIMES, (Apr. 28, 2010),

its insolvency or restructures its debt. This so impact stands to be even more severe, as sovereign debtors will find it harder, or at least more expensive, to refinance themselves on international financial markets and consequentially will have the sovereign debt-load absorbed mainly by domestic banks. The collapse of a national banking system will affect the international banking system depending on its size and interconnectedness.[50]

B. The Contemporary European Angle and One Regulatory Response

The contemporary European angle of these general relationships between sovereign debt and banking crises followed this general pattern and threatened to spin out of control in July 2011. The events prompted coordinated regulatory reactions that *inter alia* highlight the relevance of effective prudential supervision.

1. Confidence Crisis July 2011

The events that occurred during the summer of 2011 elucidate the interconnection between the banking and the sovereign debt crisis in the euro area.[51] The crisis indicators in the banking sector flashed red alert again when the usually highly liquid interbank markets ran dry;[52] U.S. banks and money-market funds withdrew their deposits;[53] and the stock prices of European banks declined, while credit default swap spreads climbed.[54] The trigger for the resurging banking troubles was pulled when Greece was ostensibly facing the abyss. Rumors had it that the so called *Troika*, consisting of representatives from the European Commission, the European Central Bank (ECB), and the International Monetary Fund (IMF), would assess Greece negatively, thereby calling into question further fiscal aid and making a voluntary write-off of private sector creditors more likely.[55] Credit rating agencies had already announced that they would consider such a voluntary participation in Greece's rescue as a "selective default," which in turn would lead the ECB to no longer accept Greek bonds as collateral for refinancing purposes, sending the largest Greek banks immediately into bankruptcy.[56] Although the severe confidence crisis shaking the

http://www.nytimes.com/2010/04/29/business/global/29banks.html?_r=1 (discussing the large amount of Greek debt held by German banks); Philip Aldrick, *UK Banks Face Huge Losses on Italian Debt*, THE TELEGRAPH, (Nov. 9, 2011), http://www.telegraph.co.uk/finance/financialcrisis/8879927/UK-banks-face-huge-losses-on-Italian-debt.html (discussing the large amount of Italian debt held by U.K. banks).

50. *See* Joseph E. Stiglitz, *Risk and Global Economic Architecture: Why Full Financial Integration May Be Undesirable*, 100 AM. ECON. REV. 1388 (2010) (providing an analytical framework that demonstrates the technological conditions under which financial autarky is preferable to full integration as the associated risk-sharing lowers expected utility).

51. *See* GERMAN COUNCIL OF ECONOMIC ADVISORS, ANNUAL REPORT 2011/2012 130–34 (2011), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_four_ 2011.pdf [hereinafter ANNUAL REPORT] (discussing the entanglement of banking with the sovereign debt crisis). For a general chronology of the main events during the euro crisis, see *id.* at 121–22, *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_three_2011.pdf (the chapters of this report are divided by separate web addresses).

52. *Id.* at 130.

53. *Id.*

54. *Id.*

55. *Id.* at 131.

56. *Id.*

whole European banking system could be countered by short term measures of hazard control, the need for more fundamental reactions to eventually reestablish trust in the financial sector had become undeniable.

2. Micro-Prudential Regulatory Reactions

On October 26, 2011, European politics reacted to the dwindling confidence in the European banking system with far-reaching coordinated measures. *Inter alia*, a recommendation by the European Banking Authority (EBA)[57] sought to tighten relevant micro-prudential regulation to reestablish confidence in SIFIs' resilience.[58] At the time of the writing of this Article, it was thought that a core capital (Tier 1)[59] to risk-weighted assets ratio[60] of 9% should have been reached by June 30, 2012.[61] Furthermore, all banks with a capital shortfall as of September 30, 2011 according to the EBA's capital exercise[62] had to file a steps plan no later than January 20, 2012 that

57. A formal recommendation addressed to Member States' banking supervisors is not legally binding but subject to a comply-or-explain mechanism. Parliament and Council Regulation 1093/2010 (EU) of November 24, 2010, art. 16, 2010 O.J. (L 331) 12, 27 [hereinafter EBA-Regulation]. The national authority has to declare its non-compliance within two months after the issuance of the recommendation and communicate its reasons to the EBA, which has to publish the fact that the national authority deviates from the recommendation and may choose to publish the reasons for doing so. *Id.* art. 16(3).

58. *See generally* EBA, EBA RECOMMENDATION ON THE CREATION AND SUPERVISORY OVERSIGHT OF TEMPORARY CAPITAL BUFFERS TO RESTORE MARKET CONFIDENCE (Dec. 8, 2011), *available at* http://stress-test.eba.europa.eu/capitalexercise/EBA%20BS%202011%20173%20 Recommendation%20FINAL.pdf [hereinafter EBA-RECOMMENDATION] (explaining the formulas banks are supposed to use in order to create capital buffers).

59. *Id.* at 6. The definition of Core Tier 1 is based on existing E.U. legislation in the Capital Requirements Directive. For the E.U. legislation, see *infra* note 162. This definition of capital comprises the highest quality capital instruments (common equity) and hybrid instruments provided by governments. It strips out other hybrid instruments including existing preferred stock.

60. The risk-weighting of assets means that a bank's assets and its off-balance sheet exposure are valued according to the risk of depreciations. Asset classes with lower risk of devaluation can be deducted accordingly, the simplest example being a riskless (0% possibility of depreciation) asset that can be deducted entirely from a bank's risk-weighted assets. *See* David Enrich & Max Colchester, *EU Banks' Risk in Eyes of Beholder*, WALL ST. J. (June 22, 2012), http://online.wsj.com/article/SB10001424052702304441404577480443348931240.html ("Under the risk-weighting systems, banks are permitted to hold less capital against safer assets than they have to hold against riskier ones."); Sonali Das & Amadou N.R. Sy, *How Risky are Banks' Risk Weighted Assets? Evidence from the Financial Crisis* 3 (Int'l Monetary Fund, Working Paper WP/12/36, 2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp1236.pdf (discussing the importance of risk-weighted assets in the context of risk-based capital ratios).

61. EBA-RECOMMENDATION, *supra* note 58, at 6. *See generally* Hal S. Scott, *Reducing Systemic Risk Through the Reform of Capital Regulation*, 13 J. INT'L ECON. L. 763 (2010) (describing the significance of capital requirements in reducing systemic risk).

62. The EBA ultimately calculated the capital shortfall of all relevant European banks in its recapitalization exercise at 114 billion euro ($186 billion). *The EBA Publishes Recommendation and Final Results of Bank Recapitalisation Plan as Part of Coordinated Measures to Restore Confidence in the Banking Sector*, EBA (Dec. 8, 2011), http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-publishes-Recommendation-and-final-results.aspx. However, in June 2012, Spain acquiesced to a bailout package of 100 billion euro ($125 billion) to rescue its banks alone. Charles Forelle & Gabriele Steinhauser, *Latest Europe Rescue Aims to Prop up Spain*, WALL ST. J., June 11, 2012, at A1. The dependence on the methodology was already illustrated by the earlier estimations of the German Council of Economic Experts that based their gauges on the balance sheet positions published by the EBA in July 2011: The capital shortfall of European banks would amount to 106 billion euro ($150 billion) if a write-down of 50% was applied to Greek bonds. ANNUAL REPORT, *supra* note 51, at 132. If a mark-to-market approach was applied to

indicated how they would satisfy their capital needs, primarily by raising new capital in private markets and cutting dividends and bonuses.[63] Finally, an extraordinary buffer for risky sovereign bonds had to be put in place, e.g., the core capital requirement had to be met after the removal of the prudential filter on the sovereign assets in the available-for-sale portfolio and the conservative valuation of sovereign debt exposures in the held-to-maturity and loans and receivables portfolios, reflecting market prices as of September 30, 2011.[64] Banks that could not raise sufficient capital in private markets were to be compulsorily recapitalized with public funds from their home Member States that could borrow funds at the European Financial Stability Facility (EFSF) if they became overstrained or were put under severe pressure by financial markets as a consequence of such recapitalizations.

Even though significant steps to enhance the regulatory framework for SIFIs and reestablish market discipline have been taken in the meantime,[65] micro-prudential regulation will constitute a pivotal building block in the attempts to erect a stable and sustainable structure for the financial sector in the European Union. It is thus of critical importance to ensure an effective administration of these rules. This general assessment is corroborated by the fact that the first step in establishing the E.U. Banking Union will be the setting-up of a Single Supervisory Mechanism (SSM) to buttress the effectiveness of prudential oversight.[66] With the supervisory structure depending on a transnational banking group's legal structure,[67] organizational choices of banks impact the administration of these rules. This is why the next part turns to the basic characteristics of the available alternatives in order to evaluate the driving forces behind banks' pertinent decisions.

III. ORGANIZATIONAL CHOICES OF BANKS

Part III briefly reviews the most important characteristics of the organizational structures prevalent in cross-border banking.[68] Benefits and detriments associated with either the branch or the subsidiary model are rather scattered so that neither structure dominates over the other from the banks' or the policymakers' perspective.

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all sovereign debt-positions, allowing for both depreciations and appreciations, the capital shortfall of European banks would rise to 137 billion euro ($194 billion). *Id.*

63. EBA-RECOMMENDATION, *supra* note 58, at 14.

64. *Id.* at 13.

65. *See, e.g.*, *Commission Proposal for a Directive of the European Parliament and Council Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010*, at 4, COM (2012) 280/3 (June 6, 2012) [hereinafter *Proposal Resolution Directive*] (establishing a cross-border crisis management framework in the banking sector and "equip[ping] authorities with common and effective tools and powers to tackle bank crises pre-emptively, safeguarding financial stability and minimizing taxpayer exposure to losses in insolvency"). This directive aims at establishing a cross-border resolution regime for SIFIs and a viable bail-in mechanism and, thus, goes to the heart of the moral hazard problem in the banking sector. *See supra* Section II.A.2 (discussing the moral hazard problem that occurs when the bailout of SIFIs is foreseeable).

66. *See Commission Proposal SSM Regulation*, *supra* note 33 (showing that the SSM Regulation aims at more effective prudential supervision of transnational financial institutions).

67. For a detailed analysis, see *infra* Part IV (explaining the supervision of cross-border banking groups).

68. *See supra* Section I.A. (explaining that cross-border banking has created an interconnected global financial system in which banks operate through either subsidiaries or branches).

The findings corroborate the posit that the simple allegation of regulatory arbitrage underestimates the complexity of the choice of organizational form and misdirects the attention away from the central issue of how prudential supervision can best serve its end regardless of the legal structure banks opt for in their cross-border operations.

A. Branches and Subsidiaries: Main Features of Prototypical Organizational Structures

In an ideal world, the branch structure, under which all foreign operations are conducted from within a single legal entity, allows for a centralized organization where capital and liquidity flow freely across business units and across borders.[69] Capital is raised in the market where it is least expensive and deployed where it yields the highest return, thus offering cost-reducing arbitrage options across jurisdictions. In times of crisis, the integrated risk management can move excess capital and liquidity that is available anywhere within the group to the business unit under stress.

On the other hand, opting for an archetypical subsidiary structure under which foreign business units are legally independent, incorporated entities, entails decentralized operations subject to local capital and liquidity requirements. Legal restrictions on the transfer of capital and liquidity hamper respective intra-group transactions,[70] whereas the transfer of knowledge and technology is by and large unimpeded. Parent and subsidiaries are subject to the own funds and liquidity requirements of local jurisdictions.[71] Individual risk-management of the group's entities is required to make them resilient independently, as in times of crisis, financial aid is guaranteed neither from the parent nor from any other group affiliate.[72] In fact, capital maintenance requirements in corporate law serve as a weak form of ring-fencing,[73] which raises the operating costs of the transnational banking group requiring overall higher levels of capital.[74]

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69. The closest real world example of such an idealized branch structure occurs in the European Union. *See infra* Section IV.B.1.b (stating that the regulatory framework "allows credit institutions to 'travel' on their domestic banking authorizations throughout the European Union without significant restrictions").

70. *See* EUR. BANK COORDINATION "VIENNA" INITIATIVE, WORKING GROUP ON BASEL III IMPLEMENTATION IN EMERGING EUROPE, REPORT TO BE SUBMITTED TO THE EBCI FULL FORUM (Mar. 2012) (explaining that restrictions might hamper the functioning of intra-group transfers of funds).

71. *See* Fiechter et al., *supra* note 1, at 7–9 (explaining the pertinent requirements for a subsidiary structure in cross-border banking groups).

72. *Id.* at 9.

73. Usually, the term signifies a separation of business units that aims at limiting the risk of contagion without proscribing their consolidation under the roof of a single financial institution. *See* Julian T.S. Chow & Jay Surti, *Making Banks Safer: Can Volcker and Vickers Do It?* 22–23 (Int'l Monetary Fund, Working Paper WP/11/236, 2011), *available at* http://www.imf.org/external/pubs/ft/wp/2011/wp11236.pdf (describing the objectives of the retail ring-fence). The most prominent proposal in this direction comes from a U.K. commission and seeks to shield domestic retail operations from the risks of international investment banking without prohibiting that these lines of business be organizationally united within a so called universal bank that arguably attains diversification benefits. *See* INDEPENDENT COMM'N ON BANKING, FINAL REPORT RECOMMENDATIONS 35–77, 76–77 (2011), *available at* http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf (describing retail ring-fence and recommending the development of individual retail ring-fence entities).

74. *See* Eugenio Cerutti et al., *Bankers Without Borders? Implications of Ring-Fencing for European Cross-Border Banks* (Int'l Monetary Fund, Working Paper WP/10/247, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1750736 (devising a stylized model that indicates that cross-border banking groups need larger capital buffers at the subsidiary and parent level under ring-

It has to be noted here that for the purpose of analysis simplifications are useful, although reality is significantly more complex. For instance, on a regulatory level, some jurisdictions treat foreign branches and subsidiaries alike when it comes to capital and liquidity requirements for the hosted business unit.[75] As will be discussed in more detail,[76] this is only one example where the legal differences between branch- and subsidiary models that are clear-cut at the outset are significantly mitigated with regard to micro-prudential supervision.

B. The Bank's Perspective

1. General Considerations

The principal characteristics of the organizational options translate into costs and benefits for a banking group that seeks to optimize the legal structure of its cross-border business.[77]

Intuitively, a branch structure entails lower costs of doing business for the banking group compared to operating under a subsidiary structure. Independent legal personality in principle requires subsidiaries to sustain themselves as stand-alone entities and thus leads to a need for higher capital and liquidity buffers.[78] Moreover, the latter have to be filled at higher lending costs for the individual entities.[79] The pertinent restrictions on the transfer of capital and liquidity attenuate opportunities for arbitrage when capital is raised and deployed under a subsidiary structure.

Furthermore, the branch structure can strengthen the banking group's resilience if locally contained, adverse developments occur. Obviously, this constitutes an advantage from the bank's perspective if the banking group's survival in its current structure is deemed desirable.[80] The unimpeded transfer of funds allows the group to overcome country-specific negative shocks, as long as the magnitude of the adverse developments does not consume the group's entire capital and liquidity reserves. On the other hand, legal restrictions that can result from general corporate law (e.g., minimum capital requirements)[81] as well as specific regulations applying to banks,[82] may hamper the quick transfer of much needed funds under a subsidiary structure.[83]

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fencing to survive a credit shock).

75. Fiechter et al., *supra* note 1, at 7 note 4.

76. *Infra* Section III.D.

77. *See* Fiechter et al., *supra* note 1, at 8–9 (explaining the benefits of both branch and subsidiary models for cross-border banks).

78. *Id.* at 8.

79. *See* Ata Can Bertay, Asli Demirguc-Kunt & Harry Huizinga, *Is the Financial Safety Net a Barrier to Cross-Border Banking?* 2 (World Bank Policy Research Working Paper No. 5947, 2012), *available at* http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2012/01/17/000158349_20120117092544/Rendered/PDF/WPS5947.pdf (showing that the "cost of funds raised through a foreign subsidiary is between 1.5% to 2.4% higher than the cost of funds for a domestic bank").

80. *See* Fiechter et al., *supra* note 1, at 8 (explaining that the branch structure allows financial institutions to better withstand an adverse shock of this type).

81. For instance, European legislation prohibits any corporation to distribute funds if its net assets are or would fall—as a result of such distribution—below the amount of the subscribed capital established in the corporate charter. *See* Second Council Directive on the Coordination of Safeguards, Which for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the Treaty, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, with a View to Making such

Conversely, however, the subsidiary structure may facilitate the containment of losses that accrue at a single group unit. The crisis, or even the bankruptcy of a battered, legally independent affiliate or of the parent corporation, as a matter of principle does not affect the ongoing concern of other group entities.[84]

2. Assets and Drawbacks Depending on the Bank's Business Model

Some advantages accrue depending on the business model the banking group intends to pursue in its transnational expansion.[85] The branch structure allows corporate clients to borrow against the entire group's global balance sheet and hence to push large exposure limits[86] and to improve borrowing conditions.

On the other hand, only the subsidiary structure allows access to local deposit insurance schemes[87] and thus appeals to consumer confidence if the latter is rooted in a larger faith in domestic institutions.[88] Moreover, the advantages of a centralized liquidity- and risk-management structure may be smaller if the business model is

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Safeguards Equivalent, art. 15, 1977 O.J. (L 26) 1.

82. *See supra* Section II.B.2 (listing stricter capital requirements applied to banks).

83. A group of experts assigned by the European Commission identified a multitude of restrictions on intra-group transfers that can form an obstacle to containing a banking crisis and thus proposed to lift these barriers under certain conditions. EUROPEAN COMMISSION, STUDY ON THE FEASIBILITY OF REDUCING OBSTACLES TO THE TRANSFER OF ASSETS WITHIN A CROSS BORDER BANKING GROUP DURING A FINANCIAL CRISIS 7 (proposal No. 1), 31–113 (2011), *available at* http://ec.europa.eu/internal_market/bank/docs/windingup/200908/final_report20091218_en.pdf. The Commission intends to follow the expert advice. *See Proposal Resolution Directive*, *supra* note 65, arts. 17–23 (proposing "overcom[ing] current legal restrictions" on intra-group transfers as a way to help "address developing financial problems within individual group members").

84. *See* Bonin, *supra* note 4, (providing a review of the empirical literature to indicate under which conditions banks retain their presence through subsidiaries in transition economies even in times of crisis).

85. *See* Fiechter et al., *supra* note 1, at 9–10 (discussing in more detail "[a] number of . . . benefits of the branch and subsidiary structures accrue only to banking groups following a particular business model").

86. In order to provide for a reasonable degree of diversification, micro-prudential regulation of banks restricts the permissible concentration of credit risk by setting a limit on how much a single counter-party can borrow from the bank, i.e. large exposure limits relate the maximum that is available for lending to a single borrower to the bank's total capital base. Basel Committee on Banking Supervision, *Measuring and Controlling Large Credit Exposures*, para. 17 (1991), *available at* http://www.bis.org/publ/bcbsc121.pdf.

87. For example, under current European legislation, credit institutions, e.g., incorporated entities, are covered by the Member State's guarantee scheme that issued their banking license with the institution's branches included in the pertinent national system. Directive 94/19/EC, of the European Parliament and of the Council of 30 May 1994 on Deposit-Guarantee Schemes, arts. 3(1), 4(1), 1994 O.J. (L 135) 5; *see also* Basel Committee on Banking Supervision & International Association of Deposit Insurers, *Core Principles for Effective Deposit Insurance Systems*, 3, 12 (2009), *available at* http://www.bis.org/publ/bcbs156.pdf (describing responsibilities within compulsory deposit insurance schemes in a cross-border context).

88. The euro crisis serves as a reminder that this need not be the case, with depositors from the troubled Member States at least engaging in a "bank jog" in which they transfer their funds to foreign banks as a consequence of their distrust in local guarantee schemes. *See* Noémie Bisserbe, *Greek Banks Under Pressure*, WALL ST. J., June 14, 2012 at A1 (reporting that Greek depositors have been withdrawing their funds from Greek banks). Note also how the Belgian press responded to Deutsche Bank's branch conversion that pointed to improvements for retail customers that came under the protection of the limitless German depositor guarantee scheme as a consequence of the intra-group restructurings. P.D-D, *Protection Sans Plafond*, LA LIBRE, Oct. 15, 2011, *available at* https://www.deutschebank.be/media/ pdf/presse-libre-protection-sans-plafond-15-10-2011.pdf; F.M., *Les clients belges de Deutsche Bank protégés… en Allemagne* [*Belgian Clients of Deutsche Bank Protected . . . in Germany*], L'ECHO, Oct. 15, 2011, *available at* https://www.deutschebank.be/media/pdf/presse-echo-clients-proteges-15-10-2011.pdf.

focused on retail clients where local fund-raising and a deepened understanding of local markets seem more important.[89]

3. Business Judgment and Market Reactions

The noteworthy aspect of this brief overview—which does not aim at exhausting the subject[90]—lies in the observation that both the subsidiary and the branch-structure support sound business models and thus cannot be regarded as abusive or opportunistic, an observation that becomes even more stringent if the policymaker's perspective is taken into account in more detail.[91] Ultimately, the organizational choices seem to hinge upon the context-dependent business judgment of cross-border banks' decision-makers because no model clearly dominates the other in terms of effectiveness and practicality.[92]

After all, some market discipline can be expected at least with regard to palpably opportunistic choices. Although SIFIs do not face the terminal sanction of a forced market exit in bankruptcy,[93] their creditors face at least uncertainty and potential losses on the nominal value of their claims in the event of financial distress. As a consequence, it is plausible that a bank's choice of an inferior regime of prudential regulation and supervision will have a negative impact on its prospects.[94] The mounting distrust in certain countries' deposit guarantee schemes and the general public alertness *vis-à-vis* the details of such schemes supports this notion.[95] Furthermore, there is robust evidence that markets are sensitive with regard to the effectiveness of public enforcement of the regulatory framework designed to protect their interest.[96] Admittedly, with regard to banking supervision, this can only be extrapolated from certain studies that establish markets' general capacity to assess

89. Fiechter et al., *supra* note 1, at 10; *see id.* at 22 (attributing the organizational structure of Spanish cross-border banking to its retail-customer orientation).

90. An in-depth analysis identifies further determinations that account for the organizational choices in transnational banking and points to (i) the treatment of branches and subsidiaries in tax law in the home as well as in the host jurisdiction, (ii) the development and the structure of the foreign markets which may or may not provide sufficient opportunities to source capital, and (iii) macroeconomic and political risks abroad which may less severely affect branches than locally incorporated subsidiaries. Cerutti, Dell'Ariccia & Martínez Pería, *supra* note 13, at 1685–91 (scrutinizing the world's 100 largest banks' operations in Latin America and Eastern Europe).

91. *Infra* Section III.C.

92. *See* INT'L MONETARY FUND, *supra* note 3, at 9 (concluding that banks chose branches or subsidiaries based on the form of expansion).

93. On the underlying too-big-to-fail or too-interconnected-to-fail dilemma, see *supra* Section II.A.2.

94. *See, e.g.*, Andrea Sironi, *Testing for Market Discipline in the European Banking Industry: Evidence from Subordinated Debt Issues*, 35 J. MONEY CREDIT & BANKING 443, 443–72 (2003) (showing sensitivity to bank-risk among investors in subordinated notes and debentures). *But see* Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293, 311–22 (2012) (explaining the methods and difficulties associated with assessing default risk in loan portfolios).

95. *Supra* note 88; *see also* Maria Soledad Martinez Peria & Sergio L. Schmukler, *Do Depositors Punish Banks for Bad Behavior? Market Discipline, Deposit Insurance, and Banking Crises*, 56 J. FIN. 1029 (2001) (showing how depositors disciplined weak banks by withdrawing deposits and by requiring higher interest rates in Argentina, Chile, and Mexico during the 1980s and 1990s).

96. *See, e.g.*, John S. Jordan, Joe Peek & Eric S. Rosengren, *The Market Reaction to the Disclosure of Supervisory Actions: Implications for Bank Transparency*, 9 J. FIN. INTERMEDIATION 298, 307–17 (2000) (showing how increased disclosure of supervisory actions even during a banking crisis in the United States had no destabilizing effect but contributed to a more effective allocation of resources in the U.S. banking sector).

available information on banks' default risk correctly even in times of crisis.[97] However, if prudential regulation is at least potentially suited to mitigate the risk of bank failure, creditors should be attuned to its quality and enforcement. And it is precisely such awareness of market participants that has been particularly well-documented with regard to the enforcement of investor protecting securities laws.[98] As a consequence, choosing "bad" prudential supervision should be penalized by credit markets, which hence serve as a counterbalance to opportunistic choices.[99] It can be justified on these grounds to accept banks' organizational choices and design the supervisory regime accordingly instead of cramming them into certain structures in cross-border banking by alleging maneuvers of regulatory arbitrage.

C. The Policymaker's Perspective

To have the full picture, the policymaker's view on transnational banks' choices between the branch model and the subsidiary model must be assessed. The critical issues from the vantage of a cross-border bank's home and host country seem to be the relative growth perspectives under either organizational model and their respective impact on financial stability.[100] Once again, however, the findings remain ambiguous.

Intuitively, growth-hungry policymakers should prefer transnational banks branching into their economies, as the branch model potentially grants easier access to credit.[101] Yet, the empirical evidence with very successful transition economies being served through subsidiaries of large international banks casts doubt on the existence of such a clear-cut preference.[102] Moreover, if the subsidiary structure hampers the intra-group transfer of funds and hence compels more reliance on local deposits,[103] it can contribute to the development of credit markets in host countries.

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97. *Id.*

98. *See* John Armour, Colin Mayer & Andrea Polo, *Regulatory Sanctions and Reputational Damage in Financial Markets* (Oxford Legal Studies Res. Paper No. 62/2010, 2010), *available at* http://ssrn.com/abstract=1678028 (finding that fines administered by public enforcement agencies serve as clear signals to the market that subsequently punishes wrongdoers); Howell Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207 (2009) (establishing the correlation between public enforcement of securities laws and market development).

99. *But see* Joel P. Trachtman, *The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation*, 13 J. INT'L ECON. L. 719, 723–25 (2010) (giving a more pessimistic view but underestimating the significance of supervisory deficits and palpable opportunism).

100. *See* Fiechter et al., *supra* note 1, at 15–17 (claiming "key considerations for home or host authorities" are the "implications for growth and financial stability . . . of the two bank structures"); *see also* FRANKLIN ALLEN ET AL., CROSS-BORDER BANKING IN EUROPE: IMPLICATIONS FOR FINANCIAL STABILITY AND MACROECONOMIC POLICIES 47–53 (2011) (reviewing the literature regarding the effect of cross-border banking on financial stability and stating that cross-border banking "reduces the risk of bank failures" but, at the same time, exposes a country to "foreign shocks").

101. For the underlying reasons, see *supra* Sections III.B.1 and III.B.2.

102. *See* Ralph de Haas & Iman van Lelyveld, *Internal Capital Markets and Lending by Multinational Bank Subsidiaries*, 19 J. FIN. INTERMEDIATION 1, 10–16, 21 (2010) (finding evidence for the existence of internal capital markets that allow subsidiaries of financially strong parents to expand their lending faster than domestic competitors, i.e., access to credit is also enhanced significantly even though foreign banks opt for a subsidiary structure). *But see* Bonin, *supra* note 4, at 487 (suggesting policymakers have reason to be skeptical of transnational banks because the "potential for financial contagion from home-country shocks to host countries via the bank-lending channel" can be a major concern).

103. *See supra* Section III.B.2 (explaining that only the subsidiary structure allows access to local

Yet, as has already been mentioned, where savings are limited due to market development, large exposure limits may quickly preclude corporate clients from borrowing from local subsidiaries[104] and in turn coerce these actors into bypassing local credit markets, thus handicapping their development.[105]

The competing organizational models' influence on financial stability reveals a dichotomy of interests between the banks' host and home countries. Assuming that the subsidiary model allows containing local crises,[106] greater resilience should result with regard to individual group members, if the shock is external. Conversely, under the branch model the readily available, group-wide support[107] should make it easier to weather the storm if the crisis has a domestic source. However, saving a foreign business unit puts stress on the banking group. As a result, policymakers will be reserved with regard to rescue obligations that originate abroad but weaken the institution and entail the risk of contagion.[108] Policymakers in a banking group's home country will thus prefer a subsidiary structure if the financial crisis arises abroad, and will prefer a branch structure if foreign entities will contribute to averting a crisis in the group's home country. The host country agenda is diametrical.

This contrast of preference only varies in degree if a failing bank has to be rescued with public funds. Absent transnational burden-sharing arrangements,[109] host countries are under no obligation to participate in bailouts under the branch model, whereas home countries do not have to contribute to the rescue of a foreign incorporated affiliate under the subsidiary model.[110]

From the perspective of those responsible for public policy, there is no abstract preference for either organizational structure. This is particularly true once policy considerations are not ruthlessly confined to national interests: Where a polity reaps all the social gains from a branch's successful operations, it seems hard to justify and creates a free-rider problem if it is in fact under no obligation to contribute to alleviating distress originating at that very entity.

deposit insurance schemes).

104. *Id.*

105. *See* Fiechter et al., *supra* note 1, at 15 (explaining how the subsidiary model may hinder development for local markets).

106. *See supra* Section III.B.1 (stating that a "subsidiary structure may facilitate the containment of losses that accrue at a single group unit").

107. *Id.*

108. *See supra* Section I.A ("[T]he magnitude of the shocks originating overseas and the importance of the financial institutions affected may ultimately compel fiscally expensive and politically unpopular government bailouts in order to avoid the disruptive consequences of a pivotal bank's failure.").

109. It is a critical feature of the recent reform initiatives in the European Union that such risk-sharing agreements will be concluded among the Member States involved in a bailout of a transnational financial institution. *See Proposal Resolution Directive*, *supra* note 65, art. 98 (stating that in case of group resolution, the Member States must ensure that the institutions contribute to the financing of the resolution); Charles Goodhart & Dirk Schoenmaker, *Fiscal Burden Sharing in Cross-Border Banking Crises*, 5 INT'L J. CENTRAL BANK 141 (2009) (discussing various models of *ex post* and *ex ante* agreements to achieve the recapitalization of failing banks in a cross-border banking crisis).

110. From the vantage of a small country that is the domicile of large international banking groups but has only confined fiscal firepower, it may be prudent to encourage a subsidiary structure. For a correspondent recommendation, see INT'L MONETARY FUND, *supra* note 3, at 23.

D. The Regulatory Arbitrage Debate Revisited

This brief survey indicates that neither from the banks' nor from the policymakers' perspective does one organizational model dominate the other. Importantly, many effects identified as core features of either organizational model can be molded in practice to a significant degree. For instance, centralized group financing and liquidity management typically involves independently incorporated affiliates, e.g., with qualified corporate and accounting counsel capital flows are largely independent of the group's legal structure.[111] Similarly, group-wide guarantees, or letters of comfort may create liability risks although the originally chosen subsidiary structure created firewalls between business units. The latter can also be undone if looming negative reputational effects of an affiliate's failure *de facto* compel its support.[112] Hence, it is not surprising that, in practice, rather complex organizational hybrids can be observed, mainly as a function of the cross-border banks' business models.[113]

All this affirms the perception that banks' organizational choices in their cross-border business cannot easily be identified as serving or militating against social welfare.[114] In general, they should be accepted, not least because banks will have to live with a variety of consequences other than their choices' impact on the regulatory framework.[115] As a result, the attention of policymakers should be turned to designing a supervisory architecture that achieves its stated goal of minimizing the probability and consequences of financial distress in the banking sector regardless of banks' organizational choices.

With this in mind, an important consequence of the discussion should not go unnoted. As polities are affected in different ways by the financial distress of independently incorporated or legally dependent business units of a transnational bank,[116] their incentives in prudential supervision diverge accordingly. If the failure of an affiliate or branch does not affect supervisors' economies, they will only have low-powered incentives to engage in preventive efforts. On the other hand, if the viability of the respective business units impacts on the economy, public policy has reasons to seek influence in their prudential supervision and execute it adequately. This

111. Fiechter, et al., *supra* note 1, at 5 ("In practice, most cross-border banking groups . . . run operations through a hybrid structure that includes both branches and subsidiaries in different jurisdictions."); *id.* at 15 ("There is no firm evidence that subsidiaries are characterized by more/less stable inter-affiliate cross-border capital flows than branches.").

112. *See* Herring & Carmassi, *supra* note 19, at 206 (discussing the risk of intra-group contagion once a subsidiary is sent into bankruptcy); Thomas C. Baxter, Jr. & Joseph H. Sommer, *Breaking Up Is Hard to Do: An Essay on Cross-Border Challenges in Resolving Financial Groups*, *in* Systemic Financial Crises 175, 187 (Douglas D. Evanoff & George G. Kaufman eds., 2005) (arguing that an affiliate's benefit from limited liability only comes at the expense of other group members).

113. *See* Fiechter, et al., *supra* note 1, at 13–14 (graphing data compiled from central banks, supervisory and regulatory authorities that proves the large nature of subsidiaries of foreign banks all over the world); *see also* Herring & Carmassi, *supra* note 19 (stating that among the sixteen international financial conglomerates identified by regulators as "large complex financial institutions (LCFIs)," each has several hundred majority-owned subsidiaries and half have over one-thousand subsidiaries).

114. *Supra* Section III.B.3.

115. *See* Fiechter et al., *supra* note 1, at 7–10 (describing the different considerations involved in a bank's decision on its organizational model, such as restrictions on asset transfers, risk management, types of services for core clients, and costs of doing business).

116. *Supra* Section III.C.

observation is important, because it indicates that charging authorities with responsibilities creates an externality problem if the benefits from reducing the risk of failure, or the damages from doing so sub-optimally, accrue in foreign economies. These external effects are exacerbated if the allocation of supervisory competence prevents authorities from contributing to prudential efforts even though their economies are massively affected.

Dwelling on these observations, the following part of this Article turns to the supervisory regime for E.U. transnational banking groups. It explains which shortcomings contributed to the current banking crisis and why the attempts to remedy the problems identified may be only a half-hearted step into the right direction.

IV. THE SUPERVISORY REGIME FOR E.U. CROSS-BORDER BANKING GROUPS

Public supervision of banks generally constitutes a reserve of sovereign countries, which requires at least some division of labor once banks expand their business across borders. However, organizational choices affect the institutional setup in a significant manner: Where an international banking group opts for the subsidiary model, host country supervisors get more clout in the cooperative game as the separate legal entity has to be furnished with a domestic license and is thus supervised by host country authorities, whereas under a branch structure host country watchdogs are largely deemed to remain idle.[117]

Tying the whole supervisory regime to the distinction between organizational choices seems somewhat stuck in nineteenth century formalism. Moreover, it stands in stark contrast to the efforts made elsewhere in current banking law to gear micro-prudential supervision towards the actual risk posed by the regulated institution's business.[118] To bolster this argument, the general determinants of the division of competences between the national supervisors involved will be outlined in Section A, before turning to the E.U. regime in more detail in Section B, and evaluating the findings in Section C.

A. General Determinants

A basic concept for the effective supervision of cross-border banking groups was laid out in the Basel Concordat,[119] and later transformed into rather lofty ground rules in the Basel Core Principles (BCP)[120] devised by the Basel Committee on Banking Supervision (BCBS) at the BIS. The BCP have been reviewed repeatedly without

117. *See infra* Section IV.B (discussing the E.U. architecture of banking supervision structured in accordance with international standards).

118. *See infra* Section IV.B.4.a (chronicling the harmonization of European substantive banking and financial laws, including prudential supervision of credit institutions and discussing the overall end of the underlying, so-called Basel I, II, and III Accords).

119. Basel Committee on Banking Supervision & Offshore Group of Banking Supervisors, *The Supervision of Cross-Border Banking* (1996), *available at* http://www.bis.org/publ/bcbs27.pdf.

120. Basel Committee on Banking Supervision & Offshore Group of Banking Supervisors, *Core Principles for Effective Banking Supervision* (1997), *available at* http://www.bis.org/publ/bcbs30a.pdf.

material alteration in pertinent respect, the current version dating to September 2012 (BCP 2012).[121]

BCP 23 obliges home country supervisors of internationally active banking groups to "practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries."[122] Furthermore, BCP 24 underlines that a "key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities."[123] Correspondingly, pursuant to BCP 25 host country supervisors "must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision."[124]

It is worth noting that the pertinent section of the BCP underscores the importance of unconfined cooperation between home and host country authorities and at this juncture does not distinguish between the different organizational structures of cross-border banks.[125]

B. The E.U. Architecture of Micro-Prudential Banking Supervision

The European regulatory framework responds to the BCP and transforms them into supranational law that binds E.U. Member States.[126] To this end, supranational law makes rather detailed prescripts when it comes to delineating national authorities' competences that leave Member States little to no latitude in implementing the pertinent directive. With regard to cross-border banking groups, European law frames an elaborate regime that governs both the monitoring of individual business entities and the consolidated supervision of the whole group. In that, it makes a pivotal distinction between subsidiaries and branches. In general, the supervisory architecture requires a relatively high degree of cooperation and the constant exchange of information between national authorities. The necessary coordination shall generally be facilitated by colleges of supervisors as well as supranational authorities established on the E.U. level where most recently initiated reforms will significantly alter the scenario.

121. Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (2012), *available at* http://www.bis.org/publ/bcbs230.pdf.

122. *Id.* at 40.

123. *Id.*

124. *Id.* at 41.

125. *Id.* at 41–42. An identical cooperative regime is delineated in Principles 12 and 13 of the BCP 2012, Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, 35–37 (2012), *available at* http://www.bis.org/publ/bcbs230.pdf.

126. The relevant European directive prescribes to which ends and to what extent national laws shall be harmonized and obliges Member States to implement the specifications in their domestic legislation. TFEU, *supra* note 12, art. 288.

1. Supervision of Individual Business Entities

The prudential supervision of individual business entities is linked directly to the authorization of the pertinent activities: The competent authority that granted the banking license is responsible for the institution's ongoing supervision, e.g., where cross-border activities require no separate authorization, national banking supervision encompasses permanent activities on foreign markets.

a. Subsidiaries

Independently incorporated business entities of a cross-border banking group constitute "credit institutions" within the scope of the pertinent supranational regulation[127] and hence have to be authorized by the Member State of incorporation.[128] As a consequence, these home Member States assume the primary responsibility for the pertinent institutions' prudential supervision regardless of their group-affiliation.[129]

The necessary coordination and cooperation between multiple supervisory authorities that are simultaneously tasked with controlling the cross-border banking groups' affiliates incorporated in different jurisdictions is supposed to be achieved on a macro-level within the European Financial Supervisory System and, for Europe's largest banks, on the micro-level within Colleges of Supervisors.[130]

This supervision of individual credit institutions, which at the outset considers each independently incorporated deposit institution as a stand-alone, is complemented by the consolidated supervision of the whole group that represents a duty of the competent authority that authorized the parent institution.[131]

b. Branches (E.U. Passport)

Banking Directive Article 40(1) [CRD IV Directive Article 49(1)] refers to Banking Directive Article 23 [CRD IV Directive Article 33], and thus indicates expressly that prudential supervision of a credit institution encompasses the cross-border activities carried out through a branch or the direct provision of services.[132] Correspondingly, Banking Directive Article 16 [CRD IV Directive Article 17] prohibits host Member

127. Directive 2006/48 of the European Parliament and the Council Relating to the Taking Up and Pursuit of the Business of Credit Institutions, arts. 4(1), 4(13), 2006 O.J. (L 177) 1 [hereinafter Banking Directive]. The allocation of competences is supposed to remain untouched in its substance under the Proposed CRD IV legislation, *supra* note 31. Future references to the CRD IV equivalents of the Banking Directive will be placed in brackets.

128. Banking Directive, *supra* note 127, art. 6 et seq.; [CRD IV Directive, *supra* note 31, art. 9 et seq.].

129. *See* Banking Directive, *supra* note 127, arts. 40(1), 4(7) (allocating supervisory competences to the home Member State that issued the banking license for the group member). The system will remain intact under CRD IV Directive, *supra* note 31, arts. 49(1), 4(61).

130. *See infra* Section IV.B.4.b ("Despite . . . advances in the harmonization of the substantive regulations, only consultative and coordinative functions are allocated on the supranational level.").

131. Banking Directive, *supra* note 127, art. 40(2); [CRD IV Directive, *supra* note 31, art. 49(2)]. *Cf. infra* Section IV.B.2 ("[E]ven though the transnational banking group is comprised of legally independent affiliates . . . it represents a business unit that is economically integrated and hence poses a variety of risks . . . .").

132. For a more detailed description on the various forms of cross-border activities, see *supra* note 12.

States from requiring a separate authorization or to prescribe a specific capital endowment for the branches of those credit institutions that received a banking license from their home Member State. This regulatory framework warrants describing the banking license of the incorporated credit institution as a "European passport."[133] In fact, the latter allows credit institutions to "travel" on their domestic banking authorizations throughout the European Union without significant restrictions.[134] Transnational credit institutions merely have to notify host Member States' authorities prior to commencing their cross-border activities, with the depth of required disclosures varying between branch establishment and provision of services.[135]

As home Member States' competent authorities almost completely predominate in the prudential supervision of cross-border activities carried out through branches, host Member States' authorities are confined to providing information to facilitate home Member State supervision, although the duty to cooperate under Banking Directive Article 42 [CRD IV Directive Articles 146, 51(1)] is by design a mutual obligation. The home Member States' competent authorities are even authorized to conduct on-site-examinations, i.e., act in a sovereign capacity on foreign territory in order to obtain information pertinent to their supervisory activities that was not adequately supplied by host Member States' watchdogs.[136]

After all, the competent authority of a branch's host Member State retains the responsibility *inter alia* for the supervision of the branch's liquidity.[137] However, these functions have to be exercised in cooperation with the home Member State's competent authority in accordance with the procedures laid out in Banking Directive Article 30.[138] The host Member State's authority may require a branch to improve on its liquidity endowment, but has to turn to the home Member State's supervisor in case the credit institution does not comply voluntarily. Only if the home Member State's authority fails to put an end to the branch's irregular situation may the host

133. Banking Directive, *supra* note 127, arts. 23 & 25 et seq.; [CRD IV Directive, *supra* note 31, arts. 33, 35 et seq.] (describing the mechanisms by which a credit institution can establish a branch or provide services in a Member State).

134. *See* Commission Staff Working Document: Impact Assessment, Accompanying Document to the Proposal Amending Directives 98/78/EC, 2002/87/EC & 2006/48/EC, n.20, SEC (2010) 979 (Aug. 16, 2010) ("[T]he European passport allows financial institutions to provide financial services throughout the internal [European] market while being authorized in one of its member states.").

135. Banking Directive, *supra* note 127, arts. 25–28; [CRD IV Directive, *supra* note 31, arts. 35–38].

136. *See* Banking Directive, *supra* note 127, art. 43; [CRD IV Directive, *supra* note 31, art. 53] (providing for "on-the-spot verifications" of information by home Member States).

137. Banking Directive, *supra* note 127, art. 41 also grants host Member State's authorities the necessary competences to implement national monetary policy where the latter is independent. Until January 1, 2015, CRD IV Directive Article 145 shall contain an identical rule. According to CRD IV Directive Article 140. Yet, CRD IV Directive Article 145 will be replaced by the more complex regime in CRD IV Directive Articles 41 and 43 that, except for emergency situations, gives host Member States generally less clout in monitoring a branch's liquidity as they can no longer act *vis-à-vis* the foreign branch but only induce the home Member State competent authority to take action or appeal to the EBA to settle a dispute. Under the Markets in Financial Instruments Directive (MiFID) the host Member State's competent authority is also tasked with supervising the proper business conduct of the branch. Directive 2004/39 of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments, art. 32(7), 2004 O.J. (L 145) 1, 26.

138. On January 1, 2015, CRD IV Directive Article 142 will give way to the division of labor outlined in CRD IV Directive Articles 41 and 43 that give home Member States (and the EBA) a stronger position. CRD IV Directive, *supra* note 31, art.140.

Member State's supervisor step in and enforce the required measures directly *vis-à-vis* the foreign credit institution.[139]

2. Consolidated Supervision

As recommended by the BCP,[140] a core feature of the European regulatory framework is consolidated supervision of the group. The prominence of this type of monitoring reflects the accurate perception that even though the transnational banking group is comprised of legally independent affiliates (incorporated parents and subsidiaries), it represents a business unit that is economically integrated and hence poses a variety of risks that warrant a comprehensive micro-prudential view on the group's operations.[141]

According to Banking Directive Article 125(1) [CRD IV Directive Article 106(1)], consolidated supervision is exercised by the competent authority of the Member State that authorized the parent credit institution of a cross-border banking group.[142] Banking Directive Article 126 [CRD IV Directive Article 106(3)–(6)] aims at a similar concentration of competence for consolidated supervision of a group's credit institutions if the head of the banking group itself is not a credit institution, which accepts deposits, but provides any of an array of financial services and is thus deemed to be an E.U. financial holding company.[143] The head of a financial holding company as such may also be included in consolidated supervisory activities pursuant to Banking Directive Article 127 [CRD IV Directive Article 114].

Moreover, consolidated supervision also affects the supervision of a cross-border banking group's subsidiaries and restricts the leeway for autonomous decision making of a Member State's supervisor that authorized affiliated credit institutions. The consolidating supervisor shall seek joint decisions with the competent authorities

139. CRD IV Directive, *supra* note 31, art. 142

140. *Supra* Section IV.A.

141. A typical issue is the risk of intra-group contagion, which is not necessarily limited to scenarios where the original shield of limited liability that protects incorporated affiliates from financial distress at other group members has been undone, e.g., by a binding letter of comfort. Intra-group contagion can also occur if, even without direct mutual financial exposure, negative information on specific group members corrupts the confidence of creditors in other affiliates. Similar problems may occur when the group members' respective exposure to certain counterparties accumulates and constitutes a massive concentrated risk, even though individual large exposure limits are observed. *See, e.g.*, Ronald MacDonald, *Consolidated Supervision of Banks*, *in* 15 HANDBOOKS IN CENTRAL BANKING 11–14 (June 1998), *available at* http://www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ ccbshb15.pdf (explaining various supervisory problems with banking groups that operate in subsidiary structures).

142. In a rather nested way, Banking Directive Articles 4(1), (2), (4), (14), and (15) define the parent credit institution of a cross-border banking group as the legal entity at the top of the cross-border banking group within the European Union. Thus, the top E.U. subsidiary of an international banking group where the global parent is domiciled outside the European Union is subject to E.U. consolidated supervision. In fact, this approach is pretty similar to that under the U.S. Bank Holding Company Act. *Cf. supra* Section I.B.2 (explaining intra-group restructurings in the United States and defining a financial holding company under the U.S. Bank Holding Company Act as a company that has either indirect or direct control over a depository banking subsidiary).

143. Whereas a "credit institution," as defined by Banking Directive Article 4(1), engages in classical banking business such as deposit and credit transactions, a "financial institution," within the scope of Banking Directive Article 4(5), provides any service from a broader array of financial activities listed in Banking Directive Annex I Numbers 2 through 12 and 15, ranging from consumer credit provision to investment banking and portfolio management. The same can be said for CRD IV Regulation Article 4(1), (3).

supervising the group's subsidiaries on key aspects of prudential group supervision, particularly the specifications on sufficient own-funds on both the consolidated as well as the entity level with regard to the application of Banking Directive Articles 123, 124, and 136(2) [CRD IV Directive Articles 72, 92(1)–(2), and 100].[144] The EBA may be consulted to reach a settlement if differences between the responsible authorities occur.[145] Yet, ultimately, the decision of the consolidating supervisor prevails.[146] Furthermore, competent authorities responsible for the supervision of controlled credit institutions are under the obligation to contact the consolidating supervisor prior to implementing approaches and methodologies in order to obtain pertinent information available at the top level.[147] Finally, competent authorities shall consult each other prior to taking any action with regard to certain critical issues at the supervised banks, in particular structural changes concerning a member of the banking group that require approval, major sanctions, and exceptional supervisory measures.[148]

	Home Member State	Host Member State
Subsidiary Structure	Authorization and supervision of parent; Consolidating supervision of group	Authorization and supervision of legally independent subsidiaries in cooperation with consolidating supervisor (home Member State authority); Participation in consolidating supervision
Branch Structure	Authorization and supervision of bank, including Foreign activities (on-site investigations, etc.)	No authorization (E.U. passport); Supervision of liquidity endowment in cooperation with Home Member State authority

Table 1: Home-/Host-Member State competence and cooperation in micro-prudential bank supervision according to the Banking Directive.

144. Banking Directive, *supra* note 127, art. 129(2), para. 1; [CRD IV Directive, *supra* note 31, art. 108(1)(a)].

145. Banking Directive, *supra* note 127, art. 129(2), para. 2; [CRD IV Directive, *supra* note 31, art. 108(2)].

146. Banking Directive, *supra* note 127, art. 129(2), para. 5; [CRD Directive, *supra* note 31, art. 108(3)].

147. Banking Directive, *supra* note 127, art. 132(2); [CRD IV Directive, *supra* note 31, art. 112(3)].

148. Banking Directive, *supra* note 127, art. 132(3); [CRD IV Directive, *supra* note 31, art. 112(4)].

3. Colleges of Supervisors

Both the supervision of business entities and consolidated supervision of transnational banking groups require a good deal of cooperation or at least information exchange. European law mandates permanent bodies that constitute an institutional framework, which seeks to streamline and intensify but also keep flexible the procedures national supervisors follow in discharging their cooperative obligations.[149]

Colleges of Supervisors provide the framework that facilitates the exchange of information and coordination among the consolidating supervisors and the other competent authorities involved in the supervision of a cross-border banking group.[150] However, supervisors in host Member States where the group carries out its activities through branches are usually not members of these Colleges. Banking Directive Article 42a(3) [CRD IV Directive Article 52 (3)] provides a notable exception if a branch is deemed systemically important ("significant") from the perspective of its host Member State.[151] The critical determination whether a branch is significant is initiated by its host Member State and should be reached in consensus with the consolidating or home Member State supervisor. However, ultimately the assessment of the host Member State's competent authority prevails.[152]

Even where Colleges of Supervisors are established, they merely provide a forum for exchange between national authorities; that is, they have no power to interfere with a Member State's supervisory authority.[153]

4. Supranational Competences as an Insufficient Remedy

Obviously, where a cumbersome division of labor between national authorities potentially inhibits effective prudential supervision, elevating competences on a supranational level becomes appealing.[154] It is no wonder that U.S. fiscal federalism,

149. Originally, the European Union advocated plans to establish global Colleges of Supervisors with a detailed proposal to the G20 Washington Summit in November 2008. *See* Tony Barber, *EU Calls for Tighter Financial Controls*, FIN. TIMES, Nov. 5, 2008, at 8 (reporting broad support among E.U. Member States for robust reform proposals in advance of the 2008 G20 summit in Washington). The idea also plays a prominent role in the envisioned regime for the resolution of cross-border banking groups where the Proposal Resolution Directive Article 81 mandates the establishment of European resolution colleges.

150. Banking Directive, *supra* note 127, art. 131a; [CRD IV Directive, *supra* note 31, art. 111]; *see also* Banking Directive, *supra* note 127, art. 131a(1)(a)-(f) (explaining the particular tasks of a College); Committee of European Banking Supervisors (CEBS), Guidelines for the Operational Functioning of Supervisory Colleges (GL 34) (2010), http://www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Colleges/CollegeGuidelines.aspx (detailing guidelines on carrying out the relevant duties and responsibilities).

151. Banking Directive, *supra* note 127, art. 42a(3); [CRD IV Directive, *supra* note 31, art. 52(3)]; Banking Directive Article 42a(1)(a)–(c) gives particular weight in determining the significance of a bank's foreign branch to a three-factor test and looks at (a) the branch's share in the deposit market (greater than 2%), (b) its relevance for market liquidity and the payment and clearing and settlement system, and (c) the number of clients it serves.

152. Banking Directive, *supra* note 127, art. 42a(1), para. 4.

153. *See id.* art. 131a(1) (stipulating that "[t]he establishment of and functioning of colleges of supervisors shall not affect the rights and responsibilities of the competent authorities under this Directive").

154. *See also* Jean Dermine, *European Banking Integration: Don't Put the Cart Before the Horse*, 15 FIN. MARKETS INSTITUTIONS & INSTRUMENTS 57, 97–98 (2006) (pointing to the shortcomings of the home country

starting with the reforms initiated by Alexander Hamilton, is analyzed as a template for Europe today.[155] Clearly, the European Union, with its long-standing history of ever closer economic integration and legal harmonization, provides an institutional framework that is, in theory, suitable in an unrivalled manner to follow down this road. However, until the very recent past, efforts to harmonize the regulatory framework of prudential bank supervision were largely limited to substantive law and established only marginal supranational competences in the pertinent laws' administration and enforcement. Bolder steps, taken just recently as a reaction to the still lingering crisis in the euro area's banking sector, aspire to establish a stronger supranational institution as a building block of a more closely integrated European fiscal union. Yet, the emerging structure of the supranational supervisor seems to have become only a somewhat half-hearted remedy for the shortcomings and pitfalls identified.

a. Harmonization of Substantive Law

The critical importance of financial institutions for Europe's developed economies and the perceived need to foster competition by creating a level playing field accounted for an early start in a far reaching harmonization of substantive laws. The First Coordination Directive that harmonized the prerequisites for authorization was promulgated in 1977.[156] It was followed by a series of smaller legislative advances[157] until a Second Coordination Directive in 1989 was promulgated that facilitated cross-border banking through subsidiaries and branches in a meaningful way.[158] Prudential supervision of European credit institutions became early attuned to the recommendations of the BCBS with the transposition of the Basel I-Accord[159] in 1989.[160] This policy was maintained with the Basel II-Accord[161] becoming binding

rule in bailout situations).

155. For an astute and differentiating essay that concludes *inter alia* with the recommendation to harmonize banking regulation, see C. RANDALL HENNING & MARTIN KESSLER, FISCAL FEDERALISM: U.S. HISTORY FOR ARCHITECTS OF EUROPE'S FISCAL UNION 31 (2012), *available at* http://www.bruegel.org/download/parent/669-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/file/1537-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/. For a macroeconomic analysis of the much broader topic of U.S. fiscal policy in general and its influence on Europe, see generally the Nobel lecture of 2011's laureate, Thomas J. Sargent, *United States Then, Europe Now* (New York University & Hoover Inst., Working Paper, 2011), *available at* https://files.nyu.edu/ts43/public/research/Sargent_Sweden_final.pdf.

156. First Council Directive 77/780 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30.

157. *See* Peter O. Mülbert & Alexander Wilhelm, *Reforms of EU Banking and Securities Regulation After the Financial Crisis*, 26 BANKING & FIN. L. REV. 187, 194 (2011) (providing a brief account of the subsequent legislative directives).

158. Second Council Directive 89/646 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1–2.

159. *See generally* BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (July 1988), *available at* http://www.bis.org/publ/bcbs04a.pdf (setting out the content of the Basel I-Accord and reporting that the Accord had received widespread endorsement of the national supervisory authorities).

160. Council Directive 89/299/EEC of 17 April 1989 on the Own Funds of Credit Institutions, 1989 O.J. (L 124) 16.

161. BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (June 2004),

European law with the promulgation of the CRD in 2006.[162] These Directives were subsequently amended by the CRD II[163] and CRD III[164] reform packages that responded to lessons derived from the financial crisis.[165] Similarly, the most recent, profound overhaul of the BCBS recommendations in reaction to the financial crisis (the Basel III-Accord[166]) will most likely make its way into ambitious European legislation that aspires to base prudential supervision on a single comprehensively harmonized and binding rule book.[167]

b. Current Supranational Competences in Micro-Prudential Supervision

Despite these long-standing and significant advances in the harmonization of the substantive regulations, only consultative and coordinative functions were allocated on the supranational level. In 2003 the Commission appointed the European Banking Committee (EBC)[168] and the Committee of European Banking Supervisors (CEBS)[169] to give expert advice to rule-makers and to coordinate the administration of the promulgated regulatory framework.

Following a proposal from an expert group headed by Jacques de Larosière,[170] the new European System of Financial Supervision (ESFS) was created.[171] With regard to

available at http://www.bis.org/publ/bcbs107.pdf; *see also* BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (2006), *available at* http://www.bis.org/publ/bcbs128.pdf (incorporating the 2004 report into a more comprehensive version reflecting further amendments to the 1988 recommendations).

162. The Basel II-Accord and Its Implementation in the Banking Directive and the Parliament and Council Directive 2006/49 on the Capital Adequacy of Investment Firms and Credit Institutions, 2006 O.J. (L 177) 201 [hereinafter CRD]—jointly referred to as Capital Requirements Directive—aimed at improving the own-funds requirements by providing for a more accurate calculation of the risk actually inherent in a bank's business. Moreover, the new rules introduced two new pillars in prudential supervision, to wit ongoing supervision of internal procedures and disclosure to foster market discipline. *See generally, e.g.*, Jan H. Dalhuisen, *Financial Services, Products, Risks and Regulation in Europe After the EU 1988 Action Plan and Basel II*, 18 EUR. BUS. L. REV. 819, 1032–39, 1081–82 (2007); Razeen Sappideen, *The Regulation of Credit, Market and Operational Risk Management Under the Basel Accords*, 2004 J. BUS. L. 59, 90 (discussing the evolution of the Basel Accords up to the 2003 amendments, in an attempt "to transfer responsibility for risk management to banks and hold them accountable through the transparency of their actions").

163. Parliament and Council Directive 2009/111 Amending Directives 2006/48/EC, 2006/49/EC & 2007/64/EC as Regards Banks Affiliated to Central Institutions, Certain Own Funds Items, Large Exposures, Supervisory Arrangements, and Crisis Management, 2009 O.J. (L 302) 97.

164. Parliament and Council Directive 2010/76/EU of 24 November 2010 Amending Directives 2006/48/EC and 2006/49/EC as Regards Capital Requirements for the Trading Book and for Re-securitizations, and the Supervisory Review of Remuneration Policies, 2010 O.J. (L 329) 3.

165. *See generally* Mülbert & Wilhelm, *supra* note 157 at 202–07 (discussing the lessons learned by the E.U. banking regulators and supervisors as a result of the financial crisis and the regulatory response).

166. BCBS, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING (2010), *available at* http://www.bis.org/publ/bcbs188.pdf.

167. *Supra* note 31.

168. Commission Decision of 5 November 2003 Establishing the European Banking Committee 2004/10/EC, 2004 O.J. (L 3) 36.

169. *Id.* at 28.

170. THE DE LAROSIÈRE GRP., HIGH LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU (Feb. 25, 2009), *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

171. *See* Eddy Wymeersch, *The Reforms of the European Financial Supervisory System*, 7 EUR. COMPANY & FIN. L. REV. 240, 252–64 (2010) (providing a detailed description and assessment of the ESFS); Niamh Moloney, *EU Financial Market Regulation After the Global Financial Crisis: 'More Europe' or More Risk?* 47 COMMON MKT. L. REV. 1317, 1332–35, 1365–72 (2010) (describing the formation of the ESFS and its impact

the supervision of transnational credit institutions[172] the new architecture created several bodies at the European level, but without conferring sweeping competences in the ongoing supervision of banks to them. The EBA, based in London, became tasked with duties in micro-prudential supervision of individual financial institutions in January 2011.[173] A non-trivial function of the EBA lies in its power to draft both regulatory and technical implementing standards.[174] Still, to become binding, these standards require the formal endorsement of the Commission, which has the power to reject standards in part or amend them,[175] thereby depriving the EBA of its already limited ability for independent rulemaking.[176]

The EBA may further issue guidelines and recommendations addressed to Member States' supervisors to achieve a homogenous supervisory practice. Yet, to realize this goal, the EBA has to rely on a comply-or-explain mechanism and the pressure that emanates from publishing the mere fact of non-compliance by a Member State's competent authority.[177] Where disputes among Member States' competent authorities that supervise a transnational banking group arise, the EBA, at the request of a national authority or on its own initiative, serves primarily as a mediator. But it can ultimately, albeit after a lengthy "conciliation phase," settle the controversy and issue a binding decision that requires national authorities to take or refrain from action.[178] Only where the EBA acts to stabilize financial markets after the Council has determined that an emergency situation exists, may it bypass national supervisors who do not comply with binding emergency orders and take action directly *vis-à-vis* financial institutions.[179]

Finally, in order to improve macro-prudential supervision, another new body, the European Systemic Risk Board (ESRB) was established and charged with monitoring and assessing the systemic risks threatening financial stability thereby cooperating and coordinating with international and non-E.U. institutions.[180] The ESRB's main

on the preceding infrastructure); Marco Lamandini, *When More Is Needed: The European Financial Supervisory Reform and Its Legal Basis*, 6 EUR. COMPANY L. 197, 199–202 (2009) (discussing the establishment of the ESFS and its salient features).

172. Identical structures were established for the supervision of securities markets, insurances, and occupational pension schemes. *See generally* Parliament and Council Regulation 1095/2010 (EU) of 24 November 2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331) 84 (establishing a supervisory authority to oversee securities markets in Europe); Parliament and Council Regulation 1094/2010 (EU) of 24 November 2010 Establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), 2010 O.J. (L 331) 48 (establishing a supervisory authority for insurance and occupational pensions in Europe).

173. Parliament and Council Regulation 1093/2010 (EU) of 24 November 2010 Establishing a European Supervisory Authority (European Banking Authority), 2010 O.J. (L 331) 12 [hereinafter EBA Regulation].

174. *Id.* arts. 8(1)(a), 10, 15. The former standards seek to ensure the consistent harmonization of national laws where E.U. Directives have been promulgated. TFEU, *supra* note 12, art. 290(1). The latter standards aim at a uniform application of E.U. Regulations. *Id.* art. 291(2).

175. EBA Regulation, *supra* note 173, art. 10(1), sub-para. 5.

176. Niamh Moloney, *The Financial Crisis and EU Securities Law-Making: A Challenge Met? in* FESTSCHRIFT FÜR KLAUS J. HOPT 2265, 2273 (Stefan Grundmann et al., eds., 2010).

177. EBA Regulation, *supra* note 173, art. 16(3).

178. *Id.* art. 19.

179. *Id.* art. 18.

180. Parliament and Council Regulation 1092/2010 (EU) of 24 November 2010 on European Union Macro-prudential Oversight of the Financial System and Establishing a European Systemic Risk Board, arts. 3 & 15, 2010 O.J. (L 331) 1 [hereinafter ESRB Regulation]; *see also* Mülbert & Wilhelm, *supra* note 157, at

instrument to counter detected systemic risks in the financial system consists of warnings and recommendations addressed at either the European Union, the EBA, individual Member States, or the Member States' banking authorities that are subject to a largely confidential comply-or-explain mechanism.[181] Quite importantly, the ESRB receives its information within the network of the ESFS, which is supposed to link national and supranational authorities, making the ESRB dependent on the exchange of information and cooperation among these agents.

c. Banking Union 2012

In the wake of the once again flaring and more and more deteriorating banking crisis in Spain,[182] it became obvious that the counter measures taken so far were insufficient to break the vicious cycle between the sovereign debt crisis in the euro area and the distress in the European financial sector.[183] As already hinted by observers of the European developments,[184] the way forward was seen in a further integration that included as a critical component establishing a single European banking supervisor involving the ECB.[185] This is in line with the economic theory that relates the existence of international organizations to the desire to eliminate the risk of opportunism *ex post*[186]—a specter dreaded by Member States that effectively provide the bailout funds for other E.U. members with troubled and arguably insufficiently overseen banking sectors.[187] Moreover, it can be seen as a "regional

200 (providing a critical assessment of the ESRB effectiveness); Giovanna De Mincio, *Regulators and Rules—President Obama's Reforms vs. Europe's Reforms*, 21 EUR. BUS. L. REV. 451, 454–57 (2010) (comparing the then proposed U.S. Financial Services Oversight Council with the ESRB).

181. ESRB Regulation, *supra* note 180, arts. 16–18.

182. *See* Forelle & Steinhauser, *supra* note 62 (explaining Spain's economic woes and its banking crisis).

183. *See supra* Section II.A.2. (explaining the interconnection between the problems of sovereigns and financial institutions who are facing severe financial strains and the role of the bailout process in creating moral hazard).

184. *See* Dermine, *supra* note 154, at 32–33 ("An alternative development, which we favor, would be to take anticipatory action, that is, to transfer the supervision of international banks to a European regulatory agency.").

185. This political determination manifested for the first time at the Euro Area Summit on June 29, 2012. Press Release, Euro Area Summit Statement (June 29, 2012), *available at* http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf. Earlier, the Commission had expressed the top E.U. administration's conviction that a single financial supervisor was of critical importance in establishing an ultimately comprehensive Economic and Monetary Union. *See Commission Communication, Action for Stability, Growth and Jobs*, at 5, COM (2012) 299 final (May 30, 2012) (suggesting that "moving towards a banking union including an integrated financial supervision and a single deposit guarantee scheme" will facilitate the increased confidence necessary for the future of the E.U.'s economic and monetary union).

186. JOEL P. TRACHTMAN, THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW 150–95 (2008) (analyzing international organizations in line with the Coasean theory of the firm in institutional economics); Barbara Koremos, Charles Lipson & Duncan Snidal, *The Rational Design of International Institutions*, 55 INT'L ORG. 761, 762 (2001) (understanding international organizations as a network of contracts between sovereign agents); s*ee generally* Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 21 (1985) (suggesting the formation of a union, or integration, as a means to reduce the potential for opportunism in an anarchy).

187. S*ee* Francesco Guerrera, *A Fix for Europe Banks*, WALL ST. J., July 3, 2012, at C1 (explaining the package deal that couples further injection of funds into troubled Member States' banks with establishing a supranational supervisor).

version" that follows suggestions from commentators[188] and prominent transnational bodies.[189]

The Commission made detailed proposals on such a single supervisory mechanism in September 2012[190] that the Council—which generally endorsed the project of creating a Single Supervisory Mechanism (SSM)[191]—considered as a matter of urgency at the end of the year, and the Council proposed its own draft for a Regulation.[192] This proposal served as the basis for the political compromise that was reached in a trialogue between the Commission, the Parliament and the Council Presidency on March 19, 2013.[193] As observers had predicted earlier,[194] the cumbersome quest for a politically viable common position leaves significant reservations of Member States' competence intact despite the creation of a supranational watchdog. The SSM will indeed only cover Europe's largest banks, leaving the oversight of mid-sized banking groups, despite their considerable cross-border operations, in the national domains.

Initially, the Commission sought to establish the ECB[195] as an omnipotent supranational authority in charge of all relevant tasks in the prudential supervision of credit institutions established in the euro area[196] and equip the ECB with the pervasive power to issue instructions *vis-à-vis* national competent authorities who were

188. *See, e.g.*, Henry Kaufman, *Structural Changes in the Financial Markets: Economic and Policy Significance*, 79 FED. RES. BANK OF KAN. CITY ECON. REV. 5, 13 (1994) (explaining that a new international institution is needed to establish uniform standards and to monitor the performance of institutions and markets); Brian Strawbridge, *A Ship Without a Captain at the Helm: The Need for the Development and Implementation of a Supra-national Prudential Supervisor to Oversee the European Union Financial Sector*, 20 IND. INT'L & COMP. L. REV. 111, 112 (2011) (arguing that a single, intra-E.U. regulatory body is necessary because financial supervision at exclusively a national level is no longer tenable).

189. *See* FINANCIAL STABILITY FORUM, REPORT ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 52 (2008), *available at* http://www.financialstabilityboard.org/publications/r_0804.pdf ("Authorities should build on the existing sharing of information, in both regional and wider international fora, to extract such good practices. Individual countries should then review how to incorporate these lessons so as to enhance their existing planning."); Press Release, European Council, 2901st Council Meeting Economic and Financial Affairs 7 (Nov. 4, 2008), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/103804.pdf.

190. *Commission Proposal SSM Regulation*, *supra* note 33.

191. Press Release, European Council, 3181st Council Meeting Economic and Financial Affairs 8 (July 10, 2012), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131686.pdf.

192. *Council Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, 2012/242 (CNS) (Dec. 14, 2012) *available at* http://register.consilium.europa.eu/pdf/en/12/st17/st17812.en12.pdf [hereinafter *Council Proposal SSM Regulation*].

193. Press Release, European Parliament, Banking Supervision Deal Struck by EP Negotiators and Irish Presidency (March 19, 2013), *available at* http://www.europarl.europa.eu/news/en/pressroom/content/20130318IPR06653/pdf.

194. *See* Matina Stevis & Stephen Fidler, *Tighter Control for Euro Banks*, WALL ST. J. (July 9, 2012), http://online.wsj.com/article/SB10001424052702303292204577514811150107308.html (explaining senior Eurozone officials' creation of a new agency to police the largest banks in the currency union).

195. *See* Rishi Goyal et al., *A Banking Union for the Euro Area* 14 (Int'l Monetary Fund, Working Paper SDN/13/01, 2012), *available at* http://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf (describing the advantages of ECB involvement that stem from the synergies with its mandate for monetary policy and lender of last resort duties).

196. *See Commission Proposal SSM Regulation*, *supra* note 33, art. 4(1) (providing for the exclusive ECB competence in licensing and authorizing credit institutions, ensuring compliance with own funds requirements, monitoring internal capital adequacy assessment processes etc.).

basically relegated to providing auxiliary assistance.[197] Yet, even this sweeping centralization would have retained the system of shared responsibilities in prudential supervision[198] in important respect even within the European Union. In anticipation of massive political headwind mainly from the United Kingdom,[199] the proposal intended to cover only banks established in the euro area[200] or in a non-participating Member State that expressly opted in to the SSM.[201] In fact, in relation to non-participating Member States (and third countries) the ECB should only assume the role of host/home authority for branches and subsidiaries in the (consolidated) supervision of transnational banks under the Banking Directive.[202]

During the legislative process the ECB's role was further weakened. Its overriding competence was ultimately confined to the supervision of the euro area's most important institutions while a stronger role of participating Member States' competent authorities within the SSM was maintained.[203] For all less significant banks, the system of shared responsibility between national competent authorities as established by the Banking Directive in principle remains in force, although ECB-coordination and oversight is supposed to ensure enhanced consistency and integration of actual supervisory practices.[204] It is noteworthy, however, that the ECB will not only be exclusively competent to supervise each participating Member State's three largest credit institutions[205] or those that received public financial assistance from supranational coffers[206] but can also assume, on its own initiative, such competence from the outset with regard to institutions that have significant cross-border activities.[207] Moreover, the ECB may at any time, on its own initiative, take over the supervisory responsibility for less significant institutions to ensure consistent

197. *See id.*, art. 5(4) (compelling national competent authorities to follow ECB instructions). Within the SSM national supervisors autonomous responsibility would have been confined to protecting consumers and fighting money laundering. *But see id.* ("The proposal recognises that within the SSM national supervisors are in many cases best placed to carry out such activities, due to their knowledge of national, regional and local banking markets, their significant existing resources and to locational and language considerations, and therefore enables the ECB to rely on national authorities to a significant extent.").

198. *See supra* Section IV.B.1 & 2 (describing the current supervisory regime for E.U. transnational financial institutions that is characterized by far reaching cooperative element under either a subsidiary or branch structure).

199. *See also* Goyal et al., *supra* note 195, at 12 (describing functional reasons for an initial limitation of the SSM to the euro area).

200. *See Commission Proposal SSM Regulation*, *supra* note 33, art. 2(1) (defining a participating Member State as one whose currency is the euro).

201. *See id.*, art. 6 (describing the preconditions under which "close cooperation between the ECB and the national competent authority" can be established in order to vest the competence for prudential supervision in the ECB).

202. *See id.*, art. 4(1)(i), (2) (describing the ECB's the role vis-à-vis consolidating and home supervisors where banks established in non-participating Member States have subsidiaries or branches in the euro are).

203. *See Council Proposal SSM Regulation*, *supra* note 192, arts. 4(1), 5(4)–(6) (ascribing the competences for prudential supervision according to the banking group's significance defined by (a) its size, (b) its importance for the economy of the European Union or any participating Member State, and (c) its cross-border activities).

204. *See id.*, art. 4(5)(a), (c), (e) (empowering the ECB to issue regulations, guidelines, or general instructions to national competent authorities, monitor the functioning of the SSM, and request information from national competent authorities on the performance of their supervisory tasks).

205. *See id.*, art. 5(4) ("[T]he ECB shall carry out the tasks conferred upon it by this regulation in respect of the three most significant institutions in each participating Member State.").

206. *Id.*, art. 5(4)(b).

207. *See id.*, art. 5(4)(a) (empowering the ECB to declare an institution to be significant if it has subsidiaries in at least two participating Member States and these subsidiaries have assets or liabilities in significant proportion to the banks total assets or liabilities).

supervision,[208] thus permitting ad hoc interventions particularly when conflicts or disagreements among national competent authorities hamper effective supervision of transnational banking groups. Yet, the most important characteristic of the SSM with regard to this Article's focus is that the ECB, even where it will have sweeping competences in prudential supervision, will depend on the assistance and support of national competent authorities,[209] although it can compel their cooperation via direct instructions.[210]

However, the successful political maneuver to couple further state aid for the banking sector with a groundbreaking reform to achieve its more rigid supervision exhibits a seemingly justified deep mistrust in the existing supervisory architecture.

C. Evaluation

In order to assess if the current or evolving European supervisory architecture provides or will provide an effective tool for micro-prudential supervision in light of banks' organizational choices, agencies should not be treated as black boxes. Instead, incentives of agents who actually discharge the duties of the supervisory authorities, who either offer or refuse to exchange information and collaborate with due diligence, have to be examined closely. To this end, general considerations on the political economics of both public administration and international relations prove helpful and can serve as an analytical basis to reach a final evaluation of the E.U. supervisory architecture.

1. Political Economics of Both Public Administration and International Relations

If the success of the supervisory architecture depends on incentives of public officers (bureaucrats) in charge at the competent authorities, it is important to remember the motivating forces identified in the line of research that applies methodologies from organizational theory to the political and administrative process.[211] The line-up under scrutiny can be framed using the analytical inventory of

208. *See id.*, art. 5(4)(b) (granting the ECB the right to exercise direct supervisory power with regard to less significant banks if the consistent application of high supervisory standards so requires).

209. *See Council Proposal SSM Regulation*, *supra* note 192, art. 5(7), (9) (obliging the ECB to delineate the framework for its interplay with national competent authorities and admonishing all parties to cooperate closely); *see also* Commission Proposal SSM Regulation, *supra* note 33 ("[E]ven for the tasks conferred on the ECB, most day-to-day verifications and other supervisory activities necessary to prepare and implement the ECB's acts could be exercised by national supervisors operating as an integral part of the SSM.").

210. *See Council Proposal SSM Regulation*, *supra* note 192, art. 8(1) sub-para. 3 (allowing the ECB to issue instructions to force national competent authorities to use their powers in national law).

211. For programmatic articles, see generally Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress*, 96 J. POL. ECON. 132 (1988) (providing a theory of legislative institutions that parallels the theory of the firm and the theory of contractual institutions); Terry M. Moe, *Politics and the Theory of Organization*, 7 J. L. ECON. & ORG. 106, 127 (1991) (arguing that the "task is to transform the economic theory into a political theory" since the "basic aspects of politics . . . promote a very different perspective on organization than the one economists now embrace"); Gordon Tullock, *The Politics of Bureaucracy*, 11 ADMIN. SCIENCE Q. 488, 488 (1966) (illustrating how a bureaucrat's desire for advancement "requires actions contrary to the attainment of the objectives of the organization").

agency-theory: Bureaucrats constitute agents who not only have some discretion that allows them to adapt the political system to unforeseen contingencies,[212] but also grants them leeway to take hidden action and pursue their own interest instead of that of their ultimate principals, the citizens.[213] The intrinsic motives that are commonly identified as driving agency personnel in their exercise of office account for actions that serve the principals' interest only sub-optimally.[214]

Importantly, another source of departure from the social goal of effective supervision of cross-border banking groups typical in the transnational context results from the observation that the obligations of national authorities to share information and to cooperate in micro-prudential supervision can, by and large, only be enforced through informal institutions that sanction non-cooperative behavior.[215] If these insights are related to the prior findings on the political economics of bureaucracies, it can be concluded that reputational losses,[216] the threat of reciprocity in case of breach,[217] and further retaliation[218] will only serve as a motivation if these sanctions not only exist in the relation between authorities, but also translate into concurrent incentives of individual personnel.

According to standard analysis[219] bureaucrats are driven by a desire to increase their personal power and to augment their prestige. They thus seek to enlarge their agency's size, competence, and right to intervene in the affairs of those falling within the scope of its mandate. They will discharge their duties in a way that allows them to acquire a favorable reputation among their peers, in the general public, and in the media. Moreover, opportunities to advance their future career in administration, politics, or the private sector motivate their behavior, which makes them prone to promoting the interests of those who offer the most desirable job opportunities in the

212. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 80–81 (1990) (explaining how "adaptive efficiency . . . provides the incentives to encourage a development of decentralized decision-making processes that will allow societies to maximize the efforts required to explore alternative ways of solving problems").

213. *See* TIMOTHY BESLY, PRINCIPLED AGENTS? 98–172 (2006) (providing an overview of various political agency models). Bounded rationality of principals—ultimate (citizens) or intermediate (legislators)—who cannot devise complete contingent constitutions and laws to secure the proper pursuit of the common good, plays a prominent role in all these models. *Id.*

214. *See generally* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (describing how small groups of people influence regulation for their own benefit); Canice Prendergast, *The Motivation and Bias of Bureaucrats*, 97 AM. ECON. REV. 180 (2007) (analyzing how bureaucrats biases does not necessarily serve their principals). For the role of cognitive biases that tend to aggravate the deviation from desirable outcomes, see Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 2 (2003). For an analysis with a particular view to the governance of financial supervisors, see Luca Enriques & Gérard Hertig, *Improving the Governance of Financial Supervisors*, 12 EUR. BUS. ORG. L. REV. 357, 362–63 (2011).

215. *See* ANDREW T. GUZMAN, HOW INTERNATIONAL LAW WORKS: A RATIONAL CHOICE THEORY 33–48 (2008) (providing a general analysis of the self-enforcing mechanisms in international law from an economist's perspective).

216. *See* Lester G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27, 29 (1980) (discussing parties' interest in protecting the appearance of honesty).

217. GUZMAN, *supra* note 215, at 45.

218. *Id.* at 48; *see also* ROBERT AXELROD, THE EVOLUTION OF COOPERATION 13–14 (1984) (describing a tit-for-tat game where agents behave cooperatively in the first round and act in the second round as the counterparty did in the first).

219. *See* WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 36–42 (1971) (describing bureaucrats' ultimate goal as maximizing their bureau's budget in order to maximize prestige and power).

long term and can result in regulatory capture.[220] Finally, agency personnel seek to avoid liability for false actions or forbearance and will consequentially have a proclivity to follow approved practices that can be verified in any review, even if new developments occur.

To be sure, the identified incentives do not necessarily warrant a pessimistic perception of bureaucrats' effectiveness[221] (e.g., their desire for prestige can constitute a powerful incentive to do a good job), but it may also revert to a less desirable eagerness for media presence.[222] These observations only highlight the fact that these individuals are not robots that are automatically programmed to serve the public interest by quasi-mechanically enforcing regulation free of self-interest.

2. Supervision of Cross-Border Banking Groups in Particular

The convoluted hierarchies and the necessary exchange of information and cooperation that the current E.U. supervisory architecture mandates[223] create particularly suboptimal incentives for decision-makers of the authorities involved and are prone for "turf wars" among supervisors with diverging preferences. This can be illustrated with regard to those cross-border banking groups that have organized according to the subsidiary model, but it also holds—albeit to a lesser degree—with respect to transnational branch-structures. Currently evolving supranational institutions may provide some improvement but no ultimate cure to the problems identified.

a. Subsidiaries

An extraordinary dedication to performing supervisory functions that at least in part contribute to the benefit of foreign economies does not yield immediate gains in power or prestige for the bureaucrats of the competent authority, particularly when compared to similar efforts in purely domestic line-ups. This is not only true with regard to a (subordinate) competent authority that is supposed to contribute to effective consolidated supervision but also with respect to consolidating supervisors.

220. *See* Jean-Jacque Laffont & Jean Tirole, *The Politics of Government Decision Making: A Theory of Regulatory Capture*, 106 Q.J. ECON. 1089, 1089 (1991) (explaining a general theory of how and when interest groups dominate regulatory decision processes); Daniel C. Hardy, *Regulatory Capture in Banking* (Int'l Monetary Fund, Working Paper WP/06/34, 2006), *available at* http://www.imf.org/external/pubs/ft/wp/2006/wp0634.pdf (describing regulatory capture as resulting in regulatory fragmentation across jurisdictions as each promulgates prudential standards that best serve its incumbent financial institutions).

221. For at least ambiguous assessments of the complex web of incentives and its inherent trade-offs, see Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest and the Public Agenda: Toward a Synthesis*, 6 J. L. ECON. & ORG. 167, 167–68 (1990) (discussing the goals of regulation and regulators' motivations and incentives in the context of different policy theories); Gordon Tullock, *A (Partial) Rehabilitation of the Public Interest Theory*, 42 PUBL. CHOICE 89, 89 (1984) (examining the public interest as an aspect of democratic politics).

222. *Cf.* Luca Enriques, *Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View*, 30 U. PA. J. INT'L L. 1147, 1149–50 (2009) (showing the ambivalence of regulators' intelligence).

223. *Supra* Section IV.B.

To some extent, their duties also ensure the viability of group affiliates abroad.[224] Obviously, the benefits to foreign economies[225] accrue as a consequence of the operations of for-profit organizations whose success at least in part redounds to the incentives of bureaucrats at the consolidating supervisor: The growth of the supervised transnational financial institution can be associated with an increase in the regulator's importance and reputation, and therefore its bureaucrats' prestige. Yet, the bulk of the advantages connected to a bank's transnational activities constitutes positive externalities (growth perspectives, market development, etc.) and is thus neither fully reproduced in the bank's yields nor in the incentives that the consolidating supervisor and its officers incur. To a similar effect, good practices that are at least in part of an auxiliary character and mainly happen in the background do not naturally boost careers.

Furthermore, incentives to cooperate and share information with other competent authorities are also suboptimal because lapses *mutatis mutandis* create negative external effects for the foreign economy where the group affiliate does business. Legal consequences are not a credible threat in the transnational context—even within the rather tightly integrated E.U. supervisory regime no liability is attached to a breach of a competent authority's duties. Moreover, it cannot be expected that reputational mechanisms or the threat of reciprocity make authorities and bureaucrats internalize errors automatically or exhaustively. Importantly, where financial difficulties occur, and hence information sharing and cooperation become pivotal, bureaucrats face strong motives not to reveal their private knowledge—which would amount to a confession of shortcomings in their own realm—but to exploit informational asymmetries instead.[226]

To be clear, the incentive problem identified is not that of an outright blockade between Member States' supervisors or even of mutual sabotage. Yet, the lack of motivation to go the extra mile in order to facilitate the socially optimal outcome should worry policymakers enough if it is recalled what is at stake.[227]

b. Branches

The E.U. supervisory regime applicable under a branch structure[228] exhibits some of the problematic characteristics discussed for transnational banks that adhere to a subsidiary organization. This is particularly true with regard to the suboptimal incentives to cooperate and share information as a result of positive and negative externalities: The home Member State supervises the whole entity and thereby generates benefits and costs for the host Member State whereas the host Member

224. *See supra* Sections IV.B.1.a and IV.B.3 (discussing how subsidiary-structure supervision and colleges of supervisors facilitate supervision of a cross-border banking group).

225. On the benefits of cross-border banking for market development, access to credit, etc., see generally *supra* Sections I.A and III.C.

226. Gérard Hertig, Ruben Lee & Joseph A. McCahery, *Empowering the ECB to Supervise Banks: A Choice-Based Approach*, 7 EUR. COMPANY & FIN. L. REV. 171, 178 (2010); *see also* Cornelia Holthausen & Thomas Rønde, *Cooperation in International Banking Supervision* 16–22 (ECB Working Paper No. 316, 2004), *available at* http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp316.pdf (showing that host country supervisors have incentives to misreport private information if their preference for liquidating a bank's operations diverge from those of the home country supervisor responsible for the decision).

227. *Supra* Section II.

228. *Supra* Section IV.B.1.b.

State's limited power and information sharing obligations have the same effect *vice versa*. Yet, it should not be overlooked that under the branch structure a clearer allocation of responsibilities occurs as a result of the E.U. passport making the home Member State's competent authority a stronger player that is less dependent on cooperation than the consolidating supervisor under a subsidiary structure.

Another core feature of the supervisory regime covering branch structures deserves attention. It appropriately augments the participation rights, where the branch's operations are significant from the host Member State's perspective, that is, where the externalities of exclusive home Member State supervision become large and the host Member State's bureaucrats have better incentives to participate (e.g., by communicating macro-economic threats unforeseen by remote home Member State supervisors), as their efforts to protect their national economy from the failure of a systemically important branch are likely to be honored more adequately. Hence, the criteria set out in Banking Directive Article 42a that warrant a stronger involvement of host Member States' competent authorities are more attuned to the actual risk and incentive structures than those under the subsidiary model where the momentous host Member State participation is indiscriminately linked merely to the authorization of the affiliates.

c. Supranational Cure

The reforms promulgated thus far remedy the shortcomings of the current E.U. supervisory regime only insufficiently, as they leave the competences in micro-prudential supervision by and large vested with Member State's authorities.[229] As a result, the need for extensive cooperation and information sharing persists and the incentives of bureaucrats remain substantially unaltered. Supervisory Colleges may in fact have some impact in this respect as personal acquaintance among the responsible bureaucrats adds a stronger relational element to their interaction and makes the adherence to cooperative strategies more likely at the margin.[230] Yet, the effect can cut both ways and should not be overestimated anyway—the Colleges of Supervisors are no country clubs!

In principle, the evolving European SSM[231] could avoid many of the incentive deficits identified in respect of the current regime of micro-prudential supervision if, and to the extent its competence in fact makes cooperation with national authorities superfluous. Yet, the brief analysis of the forthcoming SSM Regulation indicated that the ECB as the designated supranational supervisor will have to rely on a good share of cooperation and information sharing with national supervisors, ESFS authorities, etc.[232] It is a problematic feature of the SSM that national competent authorities have an indispensable role in the regime's daily operation but are relegated to auxiliary

229. *Supra* Section IV.B.4.b.

230. For more on relational elements as a core characteristic of self-enforcing (contractual) relationships, *see generally* Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976); Oliver E. Williamson, *Franchise Bidding for Natural Monopolies—in General and With Respect to CATV*, 7 BELL J. ECON. 73 (1976).

231. *Supra* Section IV.B.4.c.

232. *See id.* (discussing the competences of the ECB and national competent authorities on participating and non-participating Member States); *see also Council Proposal SSM Regulation*, *supra* note 192, art. 3(1) (requiring the ECB to "cooperate closely" with the ESFS authorities).

functions where its bureaucrats would arguably have the strongest incentives to engage in expedient supervision: it is precisely the participating Member States largest, most-visible banks where the ECB is in full command, relegating national competent authorities to second-rate functions in preparing and implementing ECB decisions.[233] In fact, removing supervisory responsibility from the national realm largely destroys the incentives of bureaucrats in national competent authorities to cooperate. Hence, centralization as a means to achieve higher standards in supervision should be comprehensive and unconditional, whereas piecemeal supranationalization creates a severe trade-off that potentially calls the overall efficiency of the regime into question.[234] If, however, for political reasons, a sharing of responsibilities is inevitable, its design should be as closely aligned with bureaucrats' motivations as possible, making the allocation of power to implement macro-prudential tools an interesting case in point: according to Council Proposal SSM Regulation Article 4a(1), national competent authorities have the autonomous competence to address systemic risks a bank poses for their economy, e.g., by requiring countercyclical capital buffers. The ECB still has the right to assume such competence, particularly when systemic risks overshoot a single participating Member State's economy.[235] Yet, national competent authorities can address local problems directly and hence their bureaucrats retain the incentives to do their job well.[236] At large, it is questionable, whether the backslide into the thickets of inter-agency cooperation under the SSM will prove temporary. The legislative process has indicated that the political will does not suffice to create an omnibus supranational agency.[237] Moreover, the SSM Regulation will not provide for an opt-in solution for individual banks established in non-participating Member States that some commentators have advocated as a generally desirable regime.[238] As a consequence, the sharing of responsibilities between euro area and other E.U. Member States' supervisors will be maintained to a significant extent.[239]

233. *See supra* Section B.4.c. (highlighting the ECB's exclusive competence for the euro area's largest banks and its dependence on national competent authorities in discharging its duties).

234. *See* Goyal et al., *supra* note 195, at 14 (describing the advantages of a more systemic, macro-prudential, coordinated, and consistent application of supervisory standards and the reduced risk of regulatory capture under an optimally designed SSM and pointing to the perils of an ill-designed allocation of tasks and competences).

235. *See Council Proposal SSM Regulation*, *supra* note 192, art. 4a(2) (giving the ECB the right to apply higher capital buffers than participating Member States' supervisors).

236. *See supra* Section IV.C.1 (arguing that bureaucrats are driven by the desire to acquire a favorable reputation among their peers, in the general public, and in the media, which depends on the visibility and relevance of their activities).

237. *See id.* (pointing to the watering down of the far more ambitious Commission proposal in the Council); *see also* Stevis & Fidler, *supra* note 194 (reporting political concerns about a conflict of interests should the ECB's role extend).

238. *See* Ivan Mortimer-Schutts, *EU Regulatory and Supervisory Convergence: The Case for a Dual System with Choice* (Am. Enter. Inst. Working Paper No. 39, 2005), *available at* http://www.gem.sciences-po.fr/content/publications/pdf/IMS_1205_Dual_EU_Reg_Struct.pdf (discussing a dual system and the choice financial institutions would face under it between national and European regulation and supervision); Martin Čihák & Jörg Decressin, *The Case for a European Banking Charter* 12–15 (Int'l Monetary Fund, Working Paper No. WP/07/173, 2007), *available at* http://www.imf.org/external/pubs/ft/wp/2007/wp07173.pdf (arguing for an optional European Banking Charter that "would be equivalent to a 28th regime for the operation of financial institutions in Europe"); Hertig, Lee & McCahery, *supra* note 226, at 181–89, 194–210 (favoring a solution that allows only individual jurisdictions to opt into supranational supervision).

239. *See supra* Section B.4.c (describing the distribution of competences between SSM-authorities and non-participating Member States' supervisors).

All in all, it seems warranted to still think about improvements of the existing framework that will in any case remain applicable to those transnational banks that will not fall within the ambit of E.U. supervision. Such alternative solutions are all the more relevant as the option of supranational concentration is not readily available on a global level. Hence, cooperation and exchange between national or—for that purpose—supranational authorities remains the only viable road to pursue.[240] As a consequence, the Financial Stability Board recommends with a view to global SIFIs that "[j]urisdictions should provide for a national supervisory framework that enables effective consolidated supervision by addressing ambiguities of responsibilities, impairments related to information gathering and assessment when multiple supervisors are overseeing the institution and its affiliates."[241] The institutional framework for such cooperative supervisions should be designed as efficiently as possible.

V. SKETCHING AN ALTERNATIVE APPROACH TO TRANSNATIONAL BANKING SUPERVISION

In light of the aforesaid, attempts to improve prudential supervision through law reform that compels closer cooperation and improved exchange of information between national and supranational supervisors will only be successful if the pertinent formal institutions are basically in line with the acting bureaucrats' incentives and minimize inefficient cooperative elements.[242]

At the outset, competences in micro-prudential supervision should be allocated to one national or supranational competent authority as unambiguously as possible to capitalize on the expertise of established supervisors.[243] In fact, it is structurally possible to establish precisely the strong authority that is arguably required to break through the vicious cycle of banking and sovereign debt crises[244] on the national level, if the effective powers of such a single authority are mutually recognized,[245] at least

240. *See* Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257, 312–15 (2011) (noting the implausibility of a global financial regulator, and *mutatis mutandis* supervisor). *But see* Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243, 273–83 (2010) (advocating an international administrative law agency for financial supervision).

241. Fin. Stability Bd., *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions*, *Recommendation No. 33* (Oct. 20, 2010), *available at* http://www.financialstabilityboard.org/publications/r_101111a.pdf. For the various institutions facilitating global coordination of financial regulators, see Pan, *supra* note 240, at 246–64 (discussing the various institutions facilitating global coordination of financial regulators).

242. *See Katharina Pistor*, *Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis* (Eur. Corp. Gov. Institute - Finance Working Paper No. 286/2010, 2010) *available at* http://ssrn.com/abstract=1631940 (proposing an "effect based" regime of supervision where competences correspond with the systemic relevance of financial institutions).

243. *See Proposal Resolution Directive*, *supra* note 65, at 169–71 (stating the Commission's estimation that the very limited task of drawing-up new standards and guidelines to coordinate the administration of the European framework for the recovery and resolution of financial institutions—not the administration itself that would be left to the Member States—would require hiring sixteen new employees, costing a total of 5.2 million euro ($6.5 million) in 2014 and 2015 alone).

244. Press Release, Euro Area Summit Statement (June 29, 2012), *available at* http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

245. *See* Pierre-Hugues Verdier, *Mutual Recognition in International Finance*, 52 HARV. INT'L L.J. 55, 60–

between E.U. Member States. As a consequence, national authorities that are the home of a transnational banking group can function as de facto pan-European supervisors.[246] If the group is domiciled within the euro area the ECB can assume this role. Importantly, the sole competence of such a pan-European supervisor should, in principle, be independent from the cross-border banking group's legal structure. Hence, subjecting the supervision of independently incorporated subsidiaries to the consolidating supervisor's authority[247] deserves approval; yet it does not go far enough in this subordination. It is preferable to generally follow the branch model when it comes to defining the competences in prudential supervision which gives host Member State authorities only very limited scope in monitoring ongoing operations.

As an exception, additional competences should be given to host Member States where the banking group's activities are deemed significant from the perspective of the foreign economy. Once again, the branch model can serve as the principal template where host Member States' authorities are granted an additional right to participate in Colleges of Supervisors if the branch is deemed significant.[248] However, in the latter case—and only in that case—host Member State authorities should receive competences like those that currently accrue generally with regard to subsidiaries. Moreover, the binding determination, if the group's activities on the pertinent market are in fact significant, should be made by a supranational authority like the EBA or—with regard to euro area banks—the ECB as the evolving predominant European supervisor for this subset of transnational financial institutions.

In the context of the evolving resolution regime for transnational banking groups, the Commission basically accepts the fundamental need for a strong (national) lead authority when it explicitly posits in its explanatory memorandum that it is of critical importance that ultimately a single decision prevails.[249] Of course, it strictly clings to the problematic distinction between a bank's subsidiaries and branches. Within the SSM the distinction is *de facto* mute with regard to the most significant banks and their euro area affiliates and branches because the ECB is both the home/consolidating supervisor and the host supervisor for all business entities involved.[250] Yet, this outcome is more of a coincidence than the result of an elaborate regulatory plan. It is thus no wonder that outside the euro area the regime of shared competences between national and—as the case may be—one supranational supervisor will be conserved without any improvement.[251]

The paradigm shift advocated here retraces the developments in the substantive law of prudential supervision that also went from a relatively inflexible approach to a

71 (2011) (addressing the theoretical foundations of the concept).

246. The home Member State can be determined along the criteria that are relevant in assigning the consolidating supervisor. *See* Banking Directive, *supra* note 127, arts. 125 & 126 (discussing how to determine competent authorities for consolidated supervision); *supra* Section IV.B.2 (discussing various articles of the Banking Directive that aim at concentration of competence for consolidated supervision).

247. *Supra* Section IV.B.2.

248. *Supra* Section IV.B.3.

249. *Proposal Resolution Directive*, *supra* note 65, at 6.

250. *Council Proposal SSM Regulation*, *supra* note 192, art. 4(1)(a)(aa)(i) (describing the ECB competences in authorization and supervision of credit institutions including their subsidiaries and branches).

251. *Supra* Section IV.B.1.–3. (describing the—in pertinent part—identical distribution of competences under the Banking Directive, *supra* note 127 and the Proposed CRD IV legislation, *supra* note 31).

set of rules that aims at capturing actual risks in banks.[252] It also suggests that, whether within the European Union or not, any potential for regulatory arbitrage by switching from one organizational model to the other is unwarranted. Furthermore, as banking supervision forces competent authorities to employ highly skilled personnel and compete with the private sector, it is doubtful that each and every Member State's agency can retain a sufficient number of qualified specialists. It may thus be a welcome side effect of the proposed regime that it also avoids redundancies and requires host Member States only to monitor significant activities more closely. Of course, the suggested architecture—like any regulatory and supervisory regime that relies on public agencies—assumes that national authorities have efficient governance structures that ensure a socially beneficial administration.[253]

252. *Supra* Section IV.B.4.a.

253. *See* Enriques & Hertig, *supra* note 214, at 365–73 (proposing that financial supervisory agencies should be treated more like professional firms with monitoring boards, a strong CEO, and a flattened hierarchy); *see also* Anita Anand & Andrew Green, *Regulating Financial Institutions: The Value of Opacity*, 57 MCGILL L.J. 399, 408–22 (2012) (arguing for an opaque and insulated design of financial supervisors).