EUI Working Papers

LAW 2010/05
DEPARTMENT OF LAW

THE IMPACT OF THE FINANCIAL CRISIS ON THE EUROPEAN ECONOMIC CONSTITUTION

Harold James, Hans-W. Micklitz and Heike Schweitzer (Eds.)

EUROPEAN UNIVERSITY INSTITUTE, FLORENCE
DEPARTMENT OF LAW

The Impact of the Financial Crisis on the European Economic Constitution

HAROLD JAMES, HANS-W. MICKLITZ AND HEIKE SCHWEITZER (EDS.)

EUI Working Paper **LAW** 2010/05

This text may be downloaded for personal research purposes only. Any additional reproduction for other purposes, whether in hard copy or electronically, requires the consent of the author(s), editor(s). If cited or quoted, reference should be made to the full name of the author(s), editor(s), the title, the working paper or other series, the year, and the publisher.

ISSN 1725-6739

© 2010 Harold James, Hans-W. Micklitz and Heike Schweitzer (Eds.)

Printed in Italy
European University Institute
Badia Fiesolana
I – 50014 San Domenico di Fiesole (FI)
Italy
www.eui.eu
cadmus.eui.eu

Editor contact details

Harold James
Email: hjames@princeton.edu

Hans-W. Micklitz
Law Department
European University Institute
Villa Schifanoia
Via Boccaccio, 121
50133 Florence
Italy

Email: hans.micklitz@eui.eu

Heike Schweitzer
Email: heike.schweitzer@eui.eu

Table of Contents

Introduction 1
Hans-W. Micklitz and Harold James

EU-Financial Regulation: From Harmonisation to the Birth of EU Federal Financial Law 3
Takis Tridimas

Procedural Consumer Protection and Financial Market Supervision 19
Susan Emmenegger

Rethinking Competition: State Aids and Competition Rules in the Age of the Financial Crisis 29
Jürgen Keßler

State Aid Control under the Financial Crisis 35
Christophe Giolito

Banks and Competition in the Aftermath of the Financial Crisis 37
Harold James and Chris Kobrak

Abstract

The financial crisis challenges the European Economic Constitution in that the two major pillars, the competition rules and the economic freedoms are put into question. This working paper contains the proceedings of a workshop which was held in Florence on the 4th December 2009. Takis Tridimas traces the development of the current institutional architecture of financial supervision and its possible reforms. Susan Emmenegger brings the consumer protection dimension into focus which has to be taken into account when it comes down to revise the architecture. Jürgen Keßler discusses the impact of the financial crisis on competition rules and state aids. Christophe Giolito comments on the role of the European Commission in the management of state aids granted to rescue banks and to stabilise the economy. Harold James and Chris Kobrak combine a historical perspective with an outlook on the impact of the crisis on banks and on competition. Harold James and Hans-W. Micklitz formulate some tentative options on the management of the financial crisis in a broader perspective.

Keywords

Financial crisis, economic crisis, economic constitution, monetary union, competition, state aids, institutional architecture, financial supervision, consumer protection, regulation, regulatory dilemma, banks

Introduction

Harold James*: The competitive advantage of US banks over EU banks*: A powerful lesson of the financial crisis is that banks have become dependent on governments to bear the potential costs of a rescue. Where very large banks exist in small territories, they are highly vulnerable. Europe has developed large cross-border institutions that exceed the capacity of even large European governments to rescue them in the even of a possible crisis; by contrast, the United States can deal with even such giants as Citigroup or Bank of America. This transatlantic difference has given the U.S. a competitive strength in the post-crisis world, in which banking concentration has increased.

This problem could be solved (1) by a mutual guarantee system of large European banks. The problem with this proposal is that it would require an intensification and coordination of effective supervision at a European level to prevent moral hazard or banks free riding on the mutual guarantee. In the past, in crisis situations banks have been unwilling to take on guarantees for their competitors' positions. Banks would be reluctant to share details of their business models with other banks, so it is improbable that this could really work as self-insurance, and would require official involvement.

Such doubts suggest that (2) a government-run scheme may be a better alternative. Without European federalism, there is no possibility that the cost of such insurance can simply be absorbed on a European level. In addition, it might be argued that the burdens of rescue should not fall on the taxpayer in general, and a tax on banks would be the logical way of funding such a scheme. Such a tax could be linked with disincentives to take on high levels of risk: the tax could be used to attain public policy objectives with regard to capital adequacy (with higher tax levels penalizing low capitalization). But such a tax would also represent a competitive distortion unless the principle was to be agreed on a global level.

Hans-W. Micklitz: *Constraints to solidarity*: For nearly ten years the Euro seemed to be a success story. The Maastricht Treaty, however, introduced a common currency, but not a common European economic policy. The Maastricht Treaty left Member States leeway in the shaping of their economic policy – at least as long they remained within the boundaries set by the Treaty, the 3 % budget threshold and the 60% debt line. These criteria were introduced under pressure from Germany who wanted to make the Euro a hard and stable currency just like the German mark was. A politically independent European Central Bank should guarantee price stability. The European Commission has to survey and monitor compliance with the Treaty requirements. The first asset test for the political independency came in 2003 when Germany challenged the power of the European Commission to initiate an infringement procedure for having passed the 3% threshold. The European Court of Justice allowed for lowering down the legal constraints and enhanced the political leeway in the interpretation of the stability criteria.

There is no direct link to the collapse of the Greek economy and the now widely discussed possibilities of the Member States to 'help' Greece whilst respecting the rules of the Treaty. Indirectly, however, the conflict between Germany and the European Commission demonstrated already that the legal constraints laid down in the Treaty were not as watertight as they seemed to be. In particular in Germany academics and lawyers argue that the Treaty does not allow Member States to demonstrate solidarity with Greece. The political comprise reached between the Member States in March 2010 demonstrates the contrary. The search for a solution was stamped by all sorts of political considerations but to a very limited extent determined by the concern of legal limits enshrined into the Treaty.

What can be learned from the Greek crisis? The establishment of the European Monetary Union bears a dimension which has largely been overlooked when the Treaty of Maastricht was adopted. The Monetary Union yields a constraint to solidarity (Solidaritätszwang). The 'reacher and stronger Member States' cannot let the 'economically weaker Member States' simply go bankrupt. Bankruptcy of the Greek state would endanger the political stability of the EU as a whole. The political solution now reached 'outside the Treaty' might have been facilitated by the simple fact that German banks hold 40% of Greek debts. A state bankruptcy would therefore endanger the German banking system. The current political agreement between the Member States will certainly not be the end of the story, as the crisis is far from being over.

The political options are limited but they all reach beyond the current rules of the Treaty, a) the EU Commission administers the Greek state budget – this would be the first step to turn the European Union into a true state as the European Parliament would then have to be involved, b) the Member States accept a joint supervisory function – which is also not foreseen in the Treaty, c) the European Central Bank issues EU bonds – again beyond the Treaty or d) the IWF accepts a role as mediator - which seems exactly what the Member States seem to prefer

Harold James*: The new institutional architecture*: According to Article 1/14 of the Lisbon Treaty, Article 9 of the Treaty on European Union is amended so as to make the European Central Bank an institution of the European Union, existing in an institutional framework which "shall aim to promote its values, advance its objectives, serve its interests, those of its citizens and those of the Member States, and ensure the consistency, effectiveness and continuity of its policies and actions." It is obliged under this article to practice "mutual sincere cooperation".

This provision appears to modify the strict insistence on the ECB's independence, which is emphasized in its statute, and which was a major source of the argument that its monetary policy independence should not be compromised by requiring it to take over banking supervision and regulation functions (which were also provided for in the ECB Statute). Article 7 of the ECB Statute, referring to the Maastricht Treaty, specifies that:

> "In accordance with Article 107 of this Treaty, when exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and this Statute, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks."

Previous discussions of ECB independence, and demands for more "economic governance" have focused largely on the interest rate policy of the ECB. There is no doubt that the ECB continues to be free of any political control in the setting of monetary policy. But since 2007, another aspect of central bank policy has come to the fore: the extent of quantitative easing, and the kind of collateral on which QE is based. Mutual sincere cooperation might be held to include periodically revising the assessment of what kind of collateral could be used for ECB lending, in line with considerations of the financial stability of the EU and of its financial institutions. To this extent, the Lisbon Treaty holds out a way for the ECB to continue to be active in crisis resolution and in support measures.

EU-Financial Regulation: From Harmonisation to the Birth of EU Federal Financial Law

Takis Tridimas

EU financial law has been the fastest growing area of Community law in the last decade. Since the launching of the Commission's Financial Services Action Plan, the Community has adopted more than 50 measures in the fields of banking, financial services and insurance law. A new wave of measures has begun to emerge in the aftermath of the financial crisis. The Community's presence in the area of financial regulation is not only impressive in quantitative terms but also important as a ground for regulatory experimentation: the Lamfalussy process advanced a new regulatory model which has provided for a higher degree of harmonization and greater Community presence in the field of enforcement. A set of new Commission proposals launched in September 2009 take the process of federalization of financial law a step further. They provide for a new institutional architecture, more Community powers, the introduction of independent Community agencies and the regulation of certain areas hitherto left untouched by Community law. The purpose of this paper is to trace the evolution of financial legislation in EC law, explore its salient features, and examine selectively the Community's response to the financial crisis.

I. The Early Years: Harmonisation of Company and Securities Law

Since the 1970s, the Community has embarked on an ambitious programme to harmonise the corporate and securities laws of the Member States. One may distinguish five phases in the development of this programme.

The first phase, which spanned throughout the 1970s, focused on the harmonization of national company laws. In constitutional terms, it was characterized by the requirement of unanimity in Council decision-making, which contributed significantly to slowing down the harmonisation process. In terms of policy, it was characterized by the strong influence of German corporation law. The First, Second and Third company law directives[1] are prime examples of this phase. At the same time, the Council adopted the first generation of banking and life assurance directives making timid steps towards the liberalization of banking and insurance sectors.[2]T

The second phase began in 1979 and coincided with the birth of Community capital markets law.[3] The Commission focused on the harmonization of securities law on the ground that it was more instrumental than company law in facilitating the integration of national securities markets and thus promoting the efficient allocation of capital within the Community. The shift of focus from corporate to capital markets law was accompanied by a new policy in line with the Commission's White Paper on the Completion of the Internal Market. The emphasis was no longer as much on harmonization as on the principles of mutual recognition and home country control. A distinct feature of this era was the increasing dominance of anglo-saxon regulatory models. Community intervention focused on harmonizing disclosure requirements for the admission of securities to stock exchange listing and making public offers of securities, the regulation of insider trading, and the free movement of investment services and UCITS. During the 1980s, further progress was achieved towards the

[1] First Company Law Directive 68/151, OJ 1968 L 65/8; Second Company Law Directive 77/91, OJ 1977, L 26/1; Third Company Law Directive 78/855, OJ 1978 L 295/36.

[2] See Council Directive 73/189 (1973 OJ L 194/1) and Council Directive 77/780 (OJ 1977 L 322/30) on banking and Council Directive 79/267 on direct life assurance (OJ 1979 L 63/1).

[3] This stage began with the adoption of Council Directive 79/279 on admission of securities to official stock exchange listing, OJ 1979 L 66/21.

harmonization of company law, whilst a second generation of banking and insurance directives provided for the principles of mutual recognition and home country control in those sectors.

The third phase covers the 1990s and may be characterized as one of a "new *lourder*". The harmonization programme somewhat ran out of steam. This was the result of a combination of factors. Political priorities changed as the Community's efforts centred on the introduction of economic and monetary union; the principle of subsidiarity curbed the Commission's harmonization enthusiasm in the wider field of financial law; furthermore, what was left in the negotiation table following the harmonization impetus of the 1980s, were key measures where strong national interests conflicted. As a result, a number of Commission proposals stalled in the light of unbridgeable divergencies in national preferences. This was, for example, the case in relation to the proposed Fifth,[4] Tenth[5] and Thirteenth Company law directives.[6]

II. The Financial Services Action Plan and the Lamfalussy Process

The Financial Services Action Plan (FSAP) in 1999 signaled the advent of a new area of powerful Community presence in the broader field of financial law. In its Communication of 28 October 1998, *Financial Services: Building a Framework for Action*,[7] the Commission identified financial services as a pivotal sector for employment expansion in the EU and the achievement of the Lisbon Strategy objectives. It specified as a key goal the completion of a single market in financial services. This would be based on the establishment of deep and liquid capital markets to serve better the interests of issuers and investors, and the removal of the remaining barriers to cross-border provision of financial services in order to increase consumer choice whilst ensuring a high level of investor protection.[8] The Commission's Communication was followed by the Financial Services Action Plan[9] which laid down a framework for action and a timetable for the adoption of a series of measures to achieve three major objectives: the establishment of a single market in wholesale financial services, increasing investor protection and transparency in retail markets, and strengthening prudential supervision.

The Plan was impressive in its aspirations. Its influence in shaping financial law is as defining as the influence of the Commission's 1985 White Paper in shaping the internal market. It signaled a new era in EU financial law and its significance lies not only in the adoption of Community legislation in substantive areas of law but also in precipitating the introduction of new Community methods and integration disciplines. The FSAP was accompanied by the Lamfalussy Report[10] which introduced a new policy-making framework. The Report provided a strong critique of the existing harmonization attempts and decision-making processes identifying a number of key deficiencies:[11] the absence of clear and unambiguous Europe-wide regulation had impeded the implementation of the mutual recognition principle; the inconsistent implementation of Community directives prevented the

[4] Proposed Fifth Directive on the structure of public limited companies (which governed the structure, powers and obligations of the organs of public companies). See proposal OJ 1972, C/131; amended proposal OJ 1983, C 240/1; new amended proposal OJ 1991, C 7 and C 321. The proposal was subsequently withdrawn.

[5] Tenth Directive on cross-border mergers of public companies. This was subsequently adopted as Directive 2005/65, OJ 2005 L 310/28.

[6] Thirteenth Company Law Directive on Take-over Bids. The Directive was eventually adopted in 2004.

[7] COM(1998) 625, available at http://aei.pitt.edu/3353/01/000529_1.pdf

[8] Op.cit., at p. 1.

[9] Commission Communication of 11 May 1999 "Implementing the framework for financial markets: action plan" COM(1999) 232, available at http://ec.europa.eu/internal_market/finances/docs/actionplan/index/action_en.pdf

[10] Final Report of the Committee of Wise Men on the Regulation of the European Securities Markets (Lamfalussy Report), 15 February 2001, available at http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf

[11] See Lamfalussy Report, op.cit., pp. 10-12.

operation of a level playing field and made for an inefficient regulatory system; furthermore, the lack of comprehensive Community legislation in certain areas (e.g. market abuse and take-overs) created barriers to entry. The Report considered that the existing regulatory system suffered from major shortcomings.[12] It was too slow; it was too rigid and thus incapable of responding speedily to market changes; it produced too much ambiguity; and failed to differentiate "between core, enduring, essential framework principles and practical, day to day, implementing rules."[13]

The Lamfalussy Report suggested a new four-level decision-making process. Under this, Level 1 encompasses primary legislation. It consists of Community measures adopted under the normal EC legislative procedure (i.e. the Council and the Parliament acting on a Commission proposal) which provide for framework principles in specific areas of substantive law. The framework principles laid down in Level 1 are concretised at Level 2 by Commission measures adopted under comitology procedures. This is delegated legislation where the Commission acts with the assistance of two committees, the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). Level 3 provides for the elaboration of common standards for the implementation of Level 1 and 2 measures. The aim here is to achieve consistent and equivalent transposition of Community measures in national law. The Lamfalussy Report elevated this to a key objective as one of its main criticisms of the previous regime was the inconsistent implementation of Community norms at national level. Under the Report, the common implementing standards at Level 3 are to be achieved through enhanced cooperation and networking among national supervisors under the auspices of CESR. Finally, Level 4 envisaged strengthened enforcement of Community law via enhanced cooperation between national supervisory authorities and more vigorous action by the Commission.

A key theme which underlined the Lamfalussy Report was the distinctiveness of financial law. At a time when Member States were calling for greater use of subsidiarity and more national choice, the Report appeared to go against the policy tide advocating the federalization of securities regulation. In that respect, it contrasts sharply with the trend in competition law, an area *par excellence* of Community exclusive competence, where the Commission devolved more powers to national authorities.[14] The expansion of Community powers in the financial field, however, was perceived as justified on functional grounds. A political consensus had emerged that substantial economic benefits would be derived from the integration of the national capital markets. The establishment of a comprehensive Community regulatory regime was seen, in turn, as a *sine qua non* for that integration.

Among the key measures adopted in implementation of the FSAP are the Market Abuse Directive,[15] the Prospectus Directive,[16] the Transparency Directive 2004/101,[17] and the Directive in Markets in Financial Instruments (MiFiD).[18]

---

12 Op.cit., pp. 14-15.

13 Op.cit., p. 15.

14 See Council Regulation 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, OJ 2003 L 1/1.

15 Directive 2003/6, OJ 2003 L 96/16.

16 Directive 2003/71, OJ 2003 L345/31.

17 Directive 2004/109, OJ 2004, L 390/38.

18 Directive 2004/39, OJ 2004 L 145/1.

In 2005, the Commission issued a White Paper on Financial Services[19] where it outlined its priorities for the period between 2005 and 2010. The leitmotiv of the White Paper was dynamic consolidation. Whilst the removal of remaining barriers to trade via the introduction of Community legislation remained at the top of the agenda, the harmonization model was more nuanced. A key objective was to ensure that Level 1 measures were followed up by Levels 2 and 3 implementation measures and were properly enforced. A second key objective was to provide for enhanced supervisory cooperation and convergence in the EU. The themes of accountability, and better regulation also assumed a higher place in the policy agenda. The Commission identified as a priority to "implement, enforce and continuously evaluate the existing legislation and to apply rigorously the better regulation agenda to future initiatives".[20] It pointed to the need for impact assessments prior to the introduction of Community legislation and also *ex posto* evaluations as means of enhancing the value and functionality of Community intervention. Impact assessments would focus on the "costs and benefits of proposed legislation across the broad economic, social and environmental dimensions, and, where appropriate, the impact on financial stability, proper functioning of markets and consumer protection."[21] Ex-post evaluations would monitor on an annual basis the overall state of financial integration through the Financial Integration Monitor (FIM) report.

The Commission also referred to a series of supervisory challenges.[22] It identified the need to reinforce procedures for cooperation and the exchange of information between supervisors and, ominously, pointed out that "co-operation in crisis situations has to be secure".[23] It also referred, inter alia, to the need to clarify and optimise home-host responsibilities; the need to improve the efficiency of supervision by avoiding duplicative reporting and information requirements; and the need to optimize delegation of responsibilities, enhance cooperation, and develop a pan-EU supervisory culture.

III. Salient Features of the Harmonization Programme

In terms of legislative output, the FSAP has been a great success. All but one[24] measures envisaged in the plan have been adopted leading to the enactment of no fewer than 50 Level 1 and Level 2 measures.[25] In some cases, the targets set can be said to have been exceeded as legislation was adopted in areas where the Plan provided more abstractly for the reaching of political agreement.[26] In some areas, the Plan did not envisage legislation but Community action in the form of non binding measures

[19] A EC Commission, White Paper, Financial Services Policy 2005-2010, available at http://ec.europa.eu/internal_market/finances/docs/white_paper/white_paper_en.pdf

[20] White Paper, p. 3.

[21] Op.cit., p. 5.

[22] Op.cit., p. 9.

[23] Ibid.

[24] The only measure where consensus has not been reached is the proposed Fourteenth Company Law Directive on the cross-border transfer of corporate seat. The Plan had also envisaged the carrying out of a review of taxation of financial services products but no such review was in fact made.

[25] See the Commission's FSAP Evolution Chart available on http://ec.europa.eu/internal_market/finances/docs/actionplan/index/061003_measures_en.pdf

The original Plan provided for 42 measures. The Evolution Chart lists 45 measures but does not include a host of Level 2 measures which bring the overall number to more than 50.

[26] This was, for example, the case in relation to Directive 2004/25 on Take-over Bids, Regulation 2157/2001 on the European Company Statute, Directives 2001/107 and 2001/108 on UCITS, and Directive 2002/65 on Distance Marketing of Financial Services.

such as recommendations or communications.[27] Furthermore, the rate of implementation of the Community measures into national laws was closely monitored by the Commission and has been very high.[28]

The harmonization programme is pursued, first and foremost, through directives. With few exceptions,[29] Level 1 measures have taken the form of directives. By contrast, at Level 2 the Commission has acted either through directives or through regulations depending on the level of uniformity required.[30] The Community regime provides for comprehensive coverage of securities, banking and financial law and regulates, among others, the following key areas: disclosure requirements, the regulation of market abuse, and the regulation of banks, insurance undertakings, UCITS, and financial intermediaries. Both prudential requirements and conduct of business rules are dealt with at Community level. The cornerstone of the harmonization programme is the Market in Financial Instruments Directive (MiFiD)[31] which replaces, and goes much further than, its predecessor, the Investment Services Directive.[32] MiFiD applies to investment firms, regulated markets and multilateral trading facilities. It provides a comprehensive definition of investment services including the provision of investment advice. It introduces the suitability principle[33] and contains detailed requirements governing authorization for investment firms, their operating conditions and conduct of business rules. A major innovation of MiFiD is that it abolishes the concentration rule, i.e. the obligation to execute orders in the stock exchange thus allowing competition through multilateral trading facilities (MTFs) and systematic internalization, i.e. the execution of client orders by a firm against its own books but without prejudice to the best execution principle.[34]

MiFiD establishes the single passport principle in the field of investment firms.[35] An investment firm must receive authorization by its home Member State, i.e. the State where its registered office is located.[36] The conditions for granting authorization are specified in the Directive. Under Article 31, once authorization has been granted by the home State, a firm is free to carry out the investment activities covered by its authorization throughout the Community either by way of provision of services or through the establishment of a branch. The host State may not require the firm to be authorized by its own authorities nor may it impose any additional requirements in respect of the

---

27 See e.g. Commission Communication on E-commerce and financial services (FIN-NET), COM(2001)66 and Commission Report of 20 March 2000 on Retail Financial Services: Overcoming remaining Barriers – A Legal Analysis.

28 See the Lamfalussy League Table, http://ec.europa.eu/internal_market/securities/docs/transposition/table_en.pdf

29 See e.g. Regulation 2157/2001 on the European Company Statute (OJ 2001, L 294/1). The adoption of a regulation in this case was necessary to facilitate the establishment of a new corporate form governed directly by Community law and not based on the law of a Member State.

30 Thus, Level 2 measures implementing the Market in Financial Instruments Directive (MiFiD) include both a Commission directive (Directive 2006/73, OJ 2006 L 241/26) and a Commission regulation (Regulation 1287/2006, OJ 2006 L 241/1).

31 Directive 2004/39, OJ 2004 L 145/1.

32 Directive 93/22, OJ 1993 L 141/27.

33 See MiFiD, Article 19(4). The suitability principle is further concretised by Level 2 measures: see Directive 2006/73 (OJ 2006 L 241/26), Art 35. The principle imposes an obligation on an investment firm, when providing advice, to obtain all information regarding the client's circumstances and preferences to enable it to provide advice which is suitable to the client’s needs. In the absence of such information, the investment firm may not provide advice.

34 See MiFiD, Article 21. A systematic internaliser is defined as an investment firm which, on an organised, frequent and 0systematic basis, deals on own account by executing client orders outside a regulated market or an Multi-Trading Facility; see MiFiD, Article 1(1)(7).

35 The single passport principle is provided also, among others, in relation to banks by Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions, OJ 2006 L 177/1, and in relation to Life assurance institutions by Directive 2002/83 concerning life assurance OJ L 345, 19.12.2002, p. 1, as amended (see consolidated version of the Directive 2002 L 0083 – EN – 10.12.2005 – 003.001 – 1).

36 MiFID, op.cit., Article 5.

matters covered by the Directive.[37] It will be noted, however, that despite the detailed provisions of MiFiD, the division of responsibilities between the home and the host State continues to be problematic.[38]

The FSAP led to the repeal of a number of directives adopted in the 1980s and the adoption of a second generation of directives thus leading to a "second financial law consensus".[39] This is the first example in Community law of a wholesale amendment of a first wave of legislation thus illustrating that the Community legal order has reached a stage of some maturity.

A distinct feature of the harmonization programme is that, unlike a substantial part of national legislation in the financial field, it is not scandal-driven. A common feature of many national statutes in securities law is that they were introduced in the aftermath of fraudulent behaviour or major scandals. Remarkably, this trend of "closing the stable doors after the horses have gone" has been as much a feature of early financial legislation as of more recent legislation in countries with highly sophisticated markets, including the United States. One need go no further than recall the Sarbanes Oxley Act introduced by Congress in 2002 in the aftermath of the Enron and World-Com scandals. In that respect, Community law appears to enjoy a comparative advantage. Being more detached from immediate electoral concerns, which may lead national governments to seek fast remedies in the aftermath of a scandal, the Commission has, or should have, the luxury of contemplation, focusing on long term reform. As we shall see, however, this is not necessarily the case. Following the financial crisis of autumn 2008, the Community has reacted rapidly with a set of legislative proposals, somewhat fusing law reform and crisis management.

In some cases, directives have had an unduly long period of gestation. This has in turn lessened their importance as forces of law reform. The Take-over Bids Directive provides here a prime example. The Commission began work on the harmonization of national take-over laws in 1972 but a directive was not included in the Community statute book until 2004.[40] The same applies to insider trading. When the Commission first considered the introduction of anti-insider dealing legislation in the mid-1970s, Member States, on the whole, lacked specific and coherent regulation in the field. By the time, however, the Insider Dealing Directive was introduced in 1989,[41] a number of Member States had taken further initiatives.[42] The pace of law reform increased spectacularly in the 2000s. As already stated, the Financial Services Action Plan was implemented speedily and it appears that the co-decision procedure has worked well.

In some cases, Community legislation crystallizes regulatory initiatives undertaken at other international or supra-national fora. In that respect, the Community nature of directives may hide their true origins which may lie in supranational professional organizations, such as IOSCO, or other

---

37 MiFID, op.cit., Article 31(1), second sub-paragraph. Free movement may be exercised by the establishment of a branch or the provision of services. By contrast, if a firm wishes to establish a subsidiary in another Member State, the subsidiary is in its own right a corporate entity under the law of the host State and must receive authorization by its competent authorities before being able to carry on any investment activities. The competent authorities of the State where the subsidiary is located must consult the competent authorities of the State of the parent firm before granting authorization to the subsidiary: see Article 60 of MiFiD.

38 See here, among others, the Level 3 recommendation issued by CESR for the implementation of MiFiD, The Passport under MiFiD Ref: CESR/07-337, and Commission, Internal Market and Services DG memorandum, *Supervision of Branches under MiFID*, MARKT/G/3/MV D(2007), Brussels, 18 June 2007, p. 2. Available at

http://ec.europa.eu/internal_market/securities/docs/isd/mifid-branches_en.pdf.

39 E. Avgouleas, The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets, (2004) 23 YEL 321 at 327.

40 Directive on Take-over Bids, op.cit.

41 Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing (OJ 1989 L 334, p. 30).

42 For a discussion, see T. Tridimas, Insider Trading: European Harmonisation and National Law Reform (1991) 40 International and Comparative Law Quarterly pp. 919-937.

international groups.[43] Such "silent" or, in some cases, express following of international initiatives raises issues of accountability and transparency as politicians appear to have little influence over the content of measures.[44]

Perhaps, the most important feature of the evolution of the harmonization programme has been the trend towards centralization and maximum harmonization. In the last decade, this trend has characterized developments especially in the field of securities regulation but has also spilled over in the fields of banking and insurance. Although there are notable exceptions,[45] the maximum harmonization trend represents the prevailing regulatory model and, to a good extent, it corresponds with the wider policy of the Commission in the field of consumer law. The process towards the federalization of securities law was set in motion by the Lamfalussy model and has been further enhanced as a result of the financial crisis. This trend towards federalization occurs at three levels: first, in terms of scope, through the introduction of Community legislation in more areas and the gradual colonization of all aspects of capital markets law; secondly, in terms of intensity, through the establishment of new institutional arrangements and the setting up of a quasi-federal structure; and thirdly, through the gradual introduction by CESR of common implementation standards and the enhancement of Community presence in the field of enforcement.

The last aspect can be seen as part of a wider trend to place emphasis on the uniform implementation of directives and the effective supervision and enforcement of Community rules. The underlying idea here is that it does not suffice for directives to find their way into the national statute book. They must also be applied in the same way by the national financial supervisors and be respected in practice. This ties in with the approach of the ECJ in the wider field of Community law as recent case law stresses the importance of "second level enforcement", namely the need for observance of Community rules not only by the national legislatures but also by the national executive, the administration, and the courts.[46] It also ties in with the findings of various inquiries into the Equitable Life Affair which identified the lax regulatory culture of financial authorities as a key reason behind Equitable's collapse.[47]

A further feature of the harmonization programme is that the directives have generated limited case law. Whilst the Court has had a major impact in articulating the requirements of free movement and facilitating the liberalization of financial services, there have been only few preliminary references on the interpretation of harmonization directives. In this respect, EU financial law contrasts with EU consumer or employment law where harmonization measures are heavily litigated. A number of reasons may account for this. For one thing, wholesale actors in the financial services industry prefer not to litigate. For another thing, where disputes arise between business entities, they tend to be on issues governed by contractual freedom and left untouched by Community harmonization legislation. As far as disputes involving retail investors are concerned, the dearth of litigation before the ECJ mirrors the fact that there is little litigation also at the national level. Consumers prefer to have recourse to alternative dispute resolution systems such as ombudsman services, which provide a speedier and less expensive option, albeit not necessarily one where the chances of success are higher.

---

[43] See e.g. Directive 2002/87 on Financial Conglomerates which represented the first full transposition in the world of the recommendations on the supervision of conglomerates adopted by the G10 Group under the auspices of the Bank for International Settlements. See also Commission Regulation 1606/2002 on the application of international accounting standards.

[44] See G. Bertezzolo, The European Union facing the global arena: standard setting bodies and financial regulation, (2009) 34 ELRev 257.

[45] See especially the Take Over Bids Directive, op.cit., which far from providing a satisfactory harmonization model leaves a wide number of options to the Member States.

[46] See e.g Case C-453/00 *Kühne & Heitz NV v Productschap voor Pluimvee en Eieren*, judgment of 13 January 2004; Case C-129/00 *Commission v Italy* [2003] ECR I-14637.

[47] See e.g. the Penrose and Baird Reports on the Equitable Life collapse.

It is not an accident that the best articulation of the law of misrepresentation in the field of financial law in England is to be found not in court judgments but in decisions of the Financial Services Ombudsman following the Equitable Life Affair.

There is a further reason why litigation is so limited. Community directives rarely give rise rights in favour of investors against issuers, banks or financial intermediaries.[48] The ECJ on its part has not promoted the granting of implied rights of action.[49] A number of judgments have been delivered in enforcement proceedings against Member States but these rarely involve issues of substance. It in notable that, where references are made to the ECJ on the interpretation of EU financial legislation, they tend not to come from States with the most developed financial markets.[50]

There are however reasons to suggest that the ECJ will increase its presence in this area. The sheer volume of legislation is likely to give rise to more problems of interpretation. Furthermore, the establishment of the suitability doctrine by MiFiD and its implementing directives may well give rise to disputes at the retail level. Finally, the increasing use of the copy-out technique whereby Member States incorporate directives verbatim into national law means that the text of the directive itself becomes more determinative of the interpretation of national law and therefore more likely to be material in the event of a dispute.

IV. The Post-Crisis Phase: Panic and Reflection

In the aftermath of the financial crisis of September 2008, the Community has intervened in a number of ways to contain its adverse effects. The action taken by the Community falls broadly into two categories. Urgent relief measures seeking to provide liquidity, avoid a meltdown, and help jump start the economy (crisis management) and changes to the regulation of financial institutions with a view to avoiding a similar crisis from occurring in the future (law reform). Crisis management measures have, in effect, taken the form of rewriting the state aid rulebook. Law reform initiatives have been broad and relate both to substantive regulation and, especially, to reforming the regulatory architecture. They seek to provide for a higher degree of regulation and supervision and a project a Keynesian model of a more cautious capitalism. We will examine briefly each of these categories.

V. Crisis Management

When EU banks were first affected by the sub-prime mortgage lending in the US, the Commission addressed ensuing problems by reference to established rules and methodologies. It relied, in particular, on the Rescuing and Restructuring State Aid Guidelines issued under Article 87(3) (c) of the Treaty.[51] This was the case, for example, in relation to the German IKB and Sashsen LB cases and the UK Government guarantee temporarily granted to Northern Rock until the final restructuring plan was drawn up.[52] After the collapse of Lehman Brothers, however, the crisis unfolded and it became

[48] Even where such rights arise, the lack of horizontal effect would inhibit direct reliance on a directive against a non-state actor.

[49] See Case C-222/02 *Paul and Others v Bundesrepublik Deutschland*, judgment of 12 October 2004.

[50] See e.g. the three references made so far on the interpretation of Directive 89/592 on Insider Trading: Case C-28/99 *Verdonck*, judgment of 3 May 2003 (reference from Belgium); Case C-384/02 *Grøngaard and Bang*, judgment of 22 November 2005 (reference from Denmark); Case C-391/04 *Ipourgos Ikonomikon v Georgakis*, judgment of 10 May 2007 (reference from Greece).

[51] See Guidelines on State Aid for rescuing and restructuring firms in difficulty, OJ 2004, C-241/2 Article 87(3)(c) empowers the Commission authorize aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

[52] See Commission Report, State Aid Scoreboard – Spring 2009 Update – Special Edition on State Aid Interventions in the Current Financial and Economic Crisis, Brussels 8 April 2009, COM (2009) 164, p. 6.

clear that there was a need for drastic action. Community intervention was precipitated by the unilateral guarantee of bank deposits announced by the Irish Government on 30 September 2008. The guarantee was initially applicable only to six Irish banks and their subsidiaries located abroad but not to other EU banks operating in Ireland. This was clearly discriminatory and in patent infringement of the state aid rules of the Treaty. Following the Commission's intervention, the guarantee was extended to all EU banks with subsidiaries or branches in Ireland. The Commission noted that it was due to it its "rapid intervention, that securing financial stability was achieved and the integrity of the Internal Market maintained at the same time".[53] Although the Commission acted promptly and decisively, it turned necessity into virtue. The unilateral intervention by the Irish Government showed that in times of crisis Member States may react somewhat atavistically reverting to sovereignism. The truth is that the EU, as a constitutional arrangement of nation States, is better equipped to contribute to law reform than crisis management. The latter requires clear competence, wide executive discretion and high expertise. In the field of financial regulation, however, the Community lacks at least the first two elements. As a result, in the aftermath of the crisis, the Commission had to fight to establish its own constitutional space.

In October 2008, the Governments of the Member States agreed to implement national rescue packages for the banking sector with a view to restoring liquidity and safeguarding stability. As a result, the Commission offered guidance on the implementation of the national schemes under the state aid rules of the Treaty so as to avoid undue distortions of competition. Guidance was offered in successive documents, namely, the Banking Communication of 13 October 2008,[54] the Recapitalisation Communication of 5 December 2008,[55]and the Impaired Assets Communication of 25 February 2009.[56] Furthermore, Member States sought and obtained authorization to subsidise financial institutions in *ad hoc* cases. The detailed examination of these measures is beyond the scope of this paper. Suffice it here to discuss the salient features of the Banking Communication of October 2008.[57] This Communication broke with tradition as it is the first time that the Commission authorized aid on the basis of Article 87(3)(b) which enables the granting of aid "to remedy serious disturbance in the economy of a Member State".[58] Recourse to Article 87(3)(b) was justifiable in the circumstances

---

53 Commission Report, op.cit., p. 18.

54 OJ 2008 C 270/8.

55 OJ 2009 C 10/2.

56 OJ 2009 C 72/1.

57 The Recapitalisation Communication of 5 December 2008 provided detailed guidance on the conditions under which specific forms of bank recapitalisation would be considered acceptable. It laid emphasis on avoiding distortions in the conditions of competition and was based on two principles: first, remuneration for state support must remain as closely as possible to market prices; secondly, state support must remain temporary with incentives for State capital redemption favouring an early return to normal functioning of the market. The Impaired Assets Communication of 25 February 2008 provided for a number of principles governing the assets relief measures. These were summarized by the Commission as follows (see Commission Report, State Aid Scoreboard – Spring 2009 Update, p. 13): full transparency and disclosure of impairments, which has to be done prior to government intervention; coordinated approach to the identification of assets eligible for asset relief measures through development of eligible categories of assets ("baskets"); coordinated approach to valuation of assets ex-ante, based on common principles such as valuation based on real economic value (rather than market value), certified by independent experts and validated by banking supervisory authorities; validation by the Commission of the valuation of the assets, in the framework of the State aid procedures on the basis of uniform assessment criteria; adequate burden-sharing of the costs related to impaired asset between the shareholders, the creditors and the State; adequate remuneration for the State, at least equivalent to the remuneration of State capital; coverage of the losses incurred from the valuation of the assets at real-economic-value by the bank benefiting from the scheme; aligning incentives for banks to participate in asset relief with public policy objectives, through an enrolment window limited to six months during which the banks would be able to come forward with impaired assets; management of assets subject to relief so as to avoid conflicts of interests; appropriate restructuring including measures to remedy competition distortion, following a case by case assessment and taking into account the total aid received through recapitalisation, guarantees or asset relief, with a view to the long-term viability and normal functioning of the European banking industry."

58 Article 87(3)(b) had been used only once in the 1908s in an isolated case relating to Greece.

although it is subject to a strict proportionality requirement.[59] The financial crisis posed a systemic risk to national economies. Invoking that legal basis enabled the Member States to adopt structural measures and also to extend schemes to the entire banking sector without restricting them to banks that were in immediate financial difficulties.[60]

The Communication authorizes three kinds of State intervention in the banking sector: bank guarantee schemes, recapitalization schemes and the controlled winding up of credit institutions.

The aid could be granted subject to compliance with a number of principles. First, eligibility for the aid must be based on objective criteria and must not be discriminatory on grounds of nationality. (*non-discrimination).* All institutions incorporated in the State granting the aid, including subsidiaries of banks from other Member States, must in principle be eligible for the aid.[61] Secondly, the aid must be limited in time (*temporal scope).* This derives from the principle of proportionality: state commitments are viewed as an aberration to ordinary free market rules and must be restricted to what is necessary in order to cope with the financial turmoil. Member States must review aid schemes on a six-month basis and submit the results of their review to the Commission. Provided that such regular review takes place, the approval of the scheme may cover a period of up to two years.[62] This condition may well provide the litmus test of the Commission's scheme. At the present stage, it is too early to assess compliance with that condition. It is however important to monitor the implementation and operation of the various national schemes in practice with a view to ensuring the orderly and transparent withdrawal of the state as the credit markets return to normality. One suspects that withdrawal of state support will prove a challenge at least in some Member States or, at least, in relation to certain institutions. Thirdly, State intervention must be limited in scope and clearly defined (*proportionality requirement*). The aid must be well-targeted and limited to the strict minimum so as to exclude unjustified benefits for shareholders at the expense of the taxpayer and minimize negative spill-over effects for competitors.[63] Fourthly, the aid must be subject to an appropriate contribution by the beneficiary undertaking (*private sector contribution*). The *quid pro quo* for receiving a state guarantee, and thus substantially reducing market risk, is that the beneficiary institution must pay a fee to the State.[64] The difficulty here is how to determine what is appropriate remuneration for a State guarantee in circumstances where there are no comparable market benchmarks. In practice, many national aid schemes have incorporated a clawback mechanism whereby beneficiary undertakings will have to reimburse the State for the subsidies that they have received as soon as they are able to do so. Fifthly, the aid must be accompanied by behavioural rules for the beneficiaries to ensure that they do not misuse state resources to engage in aggressive market practices (*avoidance of undue distortions in competition*).[65] Such conduct of business constraints are aimed to avoid moral hazard, i.e. banks taking undue risks with a view to maximizing profits on the back of a State guarantee of any potential losses. Such constraints may take the form of restrictions on advertising, or even pricing and business expansion. They may also take the form of limitations on the size of the balance-sheet of the

---

59 The provision can only be used to counteract a disturbance in the entire economy of a Member State: see Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, para. 167; and Commission Decision in Case C 47/1996, *Crédit Lyonnais*, OJ 1998 L 221/28, point 10.1, Commission Decision in Case C28/2002 *Bankgesellschaft Berlin*, OJ 2005 L 116, page 1, points 153 *et seq.*

60 See Commission Report, State Aid Scoreboard – Spring 2009 Update, op.cit., p. 10.

61 The Communication states that the aid must be open to foreign subsidiaries "with significant activities in that Member State": see para 18. This would permit the exclusion of a foreign subsidiary on objective grounds. Thus an aid scheme may be restricted to certain types of credit institutions or banks operating in certain sectors or subject to certain thresholds etc.

62 See para 24. The Commission may approve the extension of an aid scheme beyond the two year period if it is necessary to cope with the crisis.

63 See para 15.

64 See para 26.

65 See para 27.

beneficiary institutions, e.g. by reference to gross domestic product.[66] Finally, aid schemes must be accompanied by structural adjustment measures for the beneficiary sector as a whole (*structural readjustment*).[67] The underlying idea here is that government subsidies are only allowed on an exceptional basis to counteract the symptoms of the crisis and must be accompanied by long-term measures to address structural shortcomings in the organization of financial markets.

In general, the rescue packages adopted by the various Member States appear to have had the desired effect. Although both retail and wholesale financial markets have moved very slowly since autumn 2008, a complete meltdown was avoided and state guarantees were crucial in providing a safety net and thus a minimum level of confidence for depositors. The national rescue measures were adopted in haste and, inevitably, they pursue a mix of economic and political objectives set by the incumbent governments. In the longer term, if the integrity of the internal market is to be safeguarded, it is imperative that the national schemes remain under close scrutiny by the Commission and that any "spill over" effects, i.e. their extension to other sectors of the economy, is avoided.

VI. Law Reform

In addition to rewriting the state aid rulebook, the Commission spearheaded an ambitious programme of law reform. In November 2008, it appointed a High Level Group, chaired by Mr Jacques de Larosière, to make recommendations on how to strengthen financial markets regulation at EU level. In launching its reform programme, the Commission took a global view. On the one hand, it sought to put in place an effective regulatory regime with a view to preventing a similar crisis from occurring in the future and, on the other hand, it saw this as an opportunity to play a leading role beyond Europe's borders by promoting global financial stability and security.[68] The final Report of the de Larosière Group was presented on 25 February 2009.[69] On the basis of the Report, the Commission set out an action plan in its Communication on Driving European Recovery presented on 4 March 2009.[70] This was subsequently followed by more detailed policy plans laid down in its Communication on European Financial Supervision of 27 May 2009,[71] and an extensive and fully developed package of reform proposals presented in September 2009.[72]

The Commission's proposals fall essentially into two categories. First, a number of proposed measures seek to regulate substantive areas of law. There is a new regulation on credit rating agencies,[73] proposed rules for hedge funds and private equity,[74] amendments to accounting rules,[75] new capital requirements,[76] and initiatives on executive pay.[77] Secondly, the Commission proposes to overhaul the

---

66 See para 27.

67 See paras 28-29.

68 See Commission Communication on European Financial Supervision, Brussels, 27 May 2009, COM (2009) 252 final, p. 2.

69 Available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

70 COM(2009) 114 available at http://ec.europa.eu/commission_barroso/president/pdf/press_20090304_en.pdf

71 See Commission Communication on European Financial Supervision, Brussels, 27 May 2009, COM (2009) 252 final.

72 See below, n… 00

73 Proposal for a Regulation on Credit Rating Agencies, COM(2008) 704 final, Brussels, 12 November 2008. The Regulation was adopted by the Council on 27 July 2009 but has not yet been published or entered into force: http://www.se2009.eu/polopoly_fs/1.10617!menu/standard/file/109349.pdf

74 Proposal for a Directive on Alternative Investment Fund Managers, COM(2009) 207 final, Brussels, 30 April 2009.

75 For an overview, see http://ec.europa.eu/internal_market/accounting/news/index_en.htm

76 Proposal for a Directive amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, COM(2009) 362 final, Brussels 13 July 2009.

financial supervisory architecture by establishing a new pan European regulatory framework. The detailed examination of these proposals is beyond the scope of this paper. Suffice it here to refer briefly to selected aspects of the new financial architecture.

The Commission proposes the establishment of an enhanced European financial supervisory framework based on two pillars, a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS).[78] The ESRB focuses on macro-prudential supervision. Its role is to monitor and assess potential threats to financial stability that arise from macro-economic developments and trends within the financial system as a whole.[79] The ESRB will provide early warning of emerging systemic risks and have power to issue recommendations to deal with such risks. It will analyse trends, identify imbalances in the financial system as a whole and detect systemic risks. The ESFS, by contrast, will focus on micro-prudential supervision and its role will be to enhance the day-to-day supervision of the financial industry. It will be based on a network of national financial supervisors working together with three newly established EU authorities. This “network approach” is intended to provide a pragmatic solution. On the one hand, it recognizes that authority for the day-to-day supervision of financial institutions lies with the national authorities since, ultimately, it is the Member States which have responsibility to fund any necessary rescue plans. On the other hand, the reform package recognizes the need for coordination and for ensuring “a balanced flow of information between home and host authorities”.[80]

In fact, the September proposals go well beyond facilitating coordination. The most prominent features of the new structure are more centralization of tasks at EU level, greater harmonization of rules, and more coordination of supervisory practices and enforcement. At the heart of the new regulatory architecture is the replacement of the existing Level 3 committees of supervisors[81] with three new fully-fledged European Supervisory Authorities, namely, a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). Each of these authorities will have independent legal personality. They will take on the tasks currently performed by the level 3 committees and, in addition, they will be allocated important decision-making, monitoring and even quasi-regulatory functions. The objectives of the new committees will be to contribute to (a) improving the functioning of the internal market, (b) protecting depositors, (c) ensuring the integrity, efficiency and orderly functioning of financial

(Contd.)

77 Those initiatives are mostly soft law measures in the form of recommendations and communications: see Commission Recommendation on remuneration policies in the financial services sector, COM(2009) 211 final, Brussels 30 April 2009; Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, C(2009) 3177, Brussels, 30 April 2009; and Communication from the Commission accompanying the above Recommendations, COM(2009) 211 final, Brussels, 30 April 2009; all available at http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm. Note also that the proposed amendments to the Capital Adequacy Directive require credit institutions to establish remuneration policies that do not reward excessive risk-taking by executives and traders.

78 These proposals were introduced in the Commission’s May 2009 Communication: see above. On 24 September 2009, the Commission presented the following detailed proposals: available at

http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package

Proposal for a regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB); Proposal for a decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board; Proposal for a regulation establishing a European Banking Authority (EBA); Proposal for a regulation establishing a European Insurance and Occupational Pensions Authority (EIOPA); Proposal for a regulation establishing a European Securities and Markets Authority (ESMA).

79 May communication p. 3.

80 See May Communication, op.cit., p. 9.

81 Currently, there are three committees operating at Level 3 of the Lamfalussy structure. These are the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR).

markets, (d) safeguarding the stability of the financial system, and (e) strengthening international supervisory coordination.[82]

The tasks of the proposed agencies are to develop technical standards, ensure consistent application of Community rules, take action in emergency situations, settle disputes between national supervisors, promote the smooth functioning of colleges of supervisors, promote a common supervisory culture, assess market developments, collect information, and undertake an international and advisory role.[83] Suffice it to examine here briefly the first two of the above powers by reference to the proposed Regulation establishing ESMA.[84]

ESMA is intended to play a quasi-regulatory role by promoting a higher level of harmonization. It has, in particular, the power to develop "technical standards". In view of the limitations on the powers of Community agencies deriving from the case law of the ECJ,[85] those technical standards do not acquire binding force unless they are adopted by the Commission. The proposed regulation, however, operates a system of reverse accountability which brings the powers of ESMA very close to a regulatory competence: where the Commission decides not to endorse the standards submitted by ESMA or decides to amend them, it must provide reasons for its decision.[86] The term "technical standards" is in itself open to interpretation. The proposals envisage that the powers of ESMA are confined to "issues of a highly technical nature" which do not involve policy decisions and whose content is tightly framed by the Community acts adopted at Level 1.[87] Drawing, however, the boundaries between technical and policy matters, especially in an area as complex as financial regulation, is notoriously difficult.

One of the key new functions vested to ESMA is to ensure the consistent application of Community rules. To this end, the proposed regulation provides for an elaborate enforcement procedure which will exist alongside the Commission's enforcement powers under Article 226 of the Treaty. The enforcement procedure has three steps.[88] Where ESMA considers that a national supervisor does not comply with the applicable Community rules, it may investigate the matter and, if necessary, adopt a recommendation addressed to the national authority in question. Such investigations may take place either at the initiative of ESMA or upon the request of a national supervisory authority or the Commission. If the national supervisory authority does not comply with ESMAs recommendation, the Commission may adopt a decision requiring it to take specific action or abstain from an action. The national authority must then within a strict time-limit inform the Commission and ESMA of the steps that it has taken to comply with that decision. Finally, in the third stage, if the national supervisory authority fails to comply with the Commission's decision, ESMA may adopt an individual decision addressed to a specific financial institution or market participant requiring it to take the necessary action to comply with Community law. The power of ESMA is here extensive and includes the power to require the entity in question to cease business.[89] The striking feature of this provision is that, in extreme cases, it enables a Community agency to bypass the national supervisor and command a

---

[82] Commission Proposal for a Regulation establishing a European Securities and Markets Authority, COM(2009) 503 final, Brussels, 23 September 2009, p. 4.

[83] Op.cit., pp. 5 et seq.

[84] See above, n 00.

[85] Case 9/56 *Meroni v High Authority* [1957-1958] ECR 133. For an assessment of *Meroni* especially in the field of financial law, see Tridimas, Community Agencies, Competition Law and ECB Initiatives on Securities Settlement 28 (2009) Yearbook of European Law.

[86] See Article 7(1), sub paragraph 4.

[87] See proposed regulation on ESMA, p. 5.

[88] See Article 9.

[89] Article 9(6).

specific market actor. The exercise of such powers is subject to a number of elaborate and strict conditions which give rise to many issues of interpretation.

In addition to the above tasks, ESMA will have the power to take action in emergency situations and settle disagreements between national supervisors.[90] In both cases, these powers include the power to issue individual decisions addressed to specific market participants. These powers however are subject to a so-called fiscal responsibility safeguard clause, under which decisions adopted by ESMA may not impinge on the fiscal responsibilities of the Member States.[91]

VII. Conclusion

The most striking feature in the development of EC financial law has been the trend towards federalization. Following the financial crisis, the Commission has put forward a "keynesian model" of financial regulation. This is based on the twin pillars of reform of financial architecture and the adoption of Community legislation in specific areas. The emphasis lies, perhaps, more in the first than in the second. There is no intention to provide for wholesale reform in substantive areas of law but to intervene selectively in areas where the normative framework proved inadequate in the light of the financial crisis. By contrast, the reform of the institutional and regulatory framework is far-reaching. The new model is based on four components: the introduction of supervisory agencies at Community level; a higher degree of harmonization through the introduction of a pan-European rulebook; greater consistency in the application of Community rules; and, finally, the transfer of direct supervisory powers over market participants to Community agencies although such transfer is limited, hesitant and heavily conditioned. The Commission's response to the financial crisis was fast. A broad consensus on the need for reform emerged quickly and detailed proposals were put forward within a tight timetable. This is mostly because financial reform in the light of the crisis became a top political priority. Governments, EU policy-makers and, albeit less enthusiastically, the financial services industry converged on the need for urgent action. This provided policy makers with an opportune moment to introduce proposals for legislation in areas in which they had been working for some time (e.g. hedge funds) but where they had found it difficult to build consensus. The proposed changes transfer more powers to the Community and enhance the process towards the federalization of financial law. It remains to be seen whether they will prove effective.

---

[90] See Articles 10 and 11.

[91] Article 23.

Bibliography

E. Avgouleas, The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets, (2004) 23 YEL, p. 321

G. Bertezzolo, The European Union facing the global arena: standard setting bodies and financial regulation, (2009) 34 ELRev, p. 257

T. Tridimas, Insider Trading: European Harmonisation and National Law Reform (1991) 40 International and Comparative Law Quarterly, p. 919

T. Tridimas, Community Agencies, Competition Law and ECB Initiatives on Securities Settlement 28 (2009) Yearbook of European Law

Procedural Consumer Protection and Financial Market Supervision

Susan Emmenegger

In the aftermath of the financial meltdown, the consensus was that regulation had failed. On the institutional side, the regulators throughout the world were taken by surprise, especially regarding the dimension of the crisis and its spill-over effect. On the substantive law side, the laws which were in place obviously didn't prevent the crisis; indeed, the centerpiece of global bank regulation – the capital adequacy rules – turned out to act as a downward catalyst. As in every financial crises in the past, the primary response of the policy makers was to call for more regulators and more regulation. Some voices also argued for stronger consumer protection mechanisms.[1] In Europe, the new financial architecture, encompassing both new regulatory bodies and regulatory law, is bound to become reality: On December 2, 2009, the EU finance ministers agreed to go forward with the Commission's proposal to overhaul the financial market legislation and to create a new governance structure for the regulation and supervision of the financial markets. Whatever the final agreement of the Member States may look like, there is little doubt that the EU is taking a monumental step towards further federalization.[2] This paper will focus on the question whether the new institutional design has an impact on consumer protection issues. It will do so by tracing the different steps of the institutional developments under a consumer protection perspective.

I. Instruments of Procedural Consumer Protection

Over the years, the European Union has developed a broad set of measures which can be categorized procedural consumer protection instruments. For the purpose of this paper, these instruments will be divided into three categories.

A first category regards *Voice*. It encompasses instruments which are designed to formally integrate consumer interests in the regulatory process by granting them direct representation at the level of policy-making and decision-making. A second category regards *Action.* This category regroups instruments which offer judicial remedies to the consumers or their representatives. Traditionally, the remedy has been to grant legal rights which translated into legal action by consumers in private courts. However, the remedy can also translate into claims against the regulatory agencies for proper implementation of EU law, or in actions against the regulatory agencies for damages suffered from failed supervision. The third and last category of consumer protection instruments regards *Consideration*. It means that issues of consumer protection are a general principle to be taken into account by regulators and legislators.

II. Bank Supervision and Financial Market Supervision

Before analyzing the institutional framework of the EU financial market legislation in the light of procedural consumer protection instruments, it is important to understand the specific regulatory background of this type of legislation – and the mind frame of the people and institutions which are in charge of implementing it.

---

[1] See, e.g., OECD Strategic Response to the Financial and Economic Crises, 2009, available at <www.oecd.org/-dataoecd/33/57/42061463.pdf>), at 11.

[2] For a more detailed account of the development see the contribution of Takis Tridimas.

Historically, supervision in the financial world meant prudential bank supervision by national bank supervisors. With few exceptions, prudential bank supervision was not about consumer protection.[3] It was about functional protection (to ensure that the markets were functioning) and about investor protection, understood as the protection of the depositors.[4]

Financial market supervision is a relatively new concept. Although it had forerunners in the 1970s, it owes its development to the growth of the financial markets, which, in turn, was due to the new technologies of the 1990s. At that time, John Doe the depositor became John Doe the investor, more specifically: the small scale investor. As a consequence, consumer protection issues in the area of financial services started to emerge in an amplified manner.[5] The supervisory authority, however, remained the same. It had a larger portfolio, but in essence it still perceived itself as a bank supervisor, and not as a general guardian of consumer issues. This mind-frame has to be taken into account when analyzing the question of institutional consumer protection.

III. Development of the Institutional Framework

1. Duty of Coordination between the Member States

The EU has a long history of taking a centralized approach to the (material) regulation of financial market activities: the first Banking Directive dates from 1977. In contrast, the supervisory structure has traditionally been decentralized – a notable exception being the principle of the home country control. Supervision has been a matter for the Member States, who are also free to choose their proper institutional design. This has the advantage of empowering the supervisors closest to the individual bank. However, since many banks had pan-European activities, cooperation among national supervisors has always been essential. Therefore, Community law requires the Member States to enter into written coordination and collaboration agreements in view of achieving an integrated financial market. As a result, a substantial number of bilateral Memoranda of Understanding (MoU) have come into existence. Quite recently, the EU banking supervisors have agreed on three multilateral MoU on financial crisis management.[6]

2. The Lamfalussy Framework

a. General remarks

An important development in the design of the institutional framework came with the Financial Services Action Plan (1999) and the Lamfalussy framework (2002), also called Lamfalussy process, which followed it. The FSAP was a blueprint of the issues that needed to be harmonized in order to complete the single market in financial services. The Lamfalussy framework was designed to structure the coordination between the Member States and their connection to the legislative process on the EU level by introducing a four-level decision-making process which relied heavily on comitology

---

[3] Notable exceptions are Sweden and the UK. See the overview by Jürgen Keßler/Hans-W. Micklitz, Rechtsvergleichende Zusammenfassung, in: Hans-W. Micklitz et al. (eds.), Institutionelle Finanzmarktaufsicht und Verbraucherschutz, 2010, pp. 247-267, at 251 ss.

[4] See Wernhard Möschel, Eine Systematik von Bankregulierungszielen, in: Marcus Lutter et al. (ed.), Festschrift für Walter Stimpel, 1985, 1065-1085.

[5] For a general overview see Thomas Taylor, The impact of consumer protection on banking legislation in the European Community and the effect of the recent consumer protection proposals, Fordham Int'l L.J. 28 (2005), 1216-1256.

[6] See Gerard Hertig/Ruben Lee/Joseph A. McCahery, Empowering the ECB to Supervise Banks: A Choice-Based Approach, TILEC Discussion Paper No. 2009-001, available at SSRN: <http://ssrn.com/abstract=1460527>, at 7 s.

procedures. Level one consists of the standard procedure of Commission proposals for framework principles. Usually, these will be directives, although they may also take the form of regulation. Level two operates on the basis of the combined knowledge and interests of the governments of the Member States, embodied in Committees: The European Banking Committee (EBC), the European Insurance and Occupational Pensions Committee (EIPOC), and the European Securities Committee (ESC). These committees give feedback and propose concretization of the level one principles. The measures have taken the form of directives or regulations. Level three consists of the representatives of the national supervisory authorities, which are again formed as committees: the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The three committees advise the Commission on the preparation of measures in their respective area of expertise, they work to enhance the coordination between the national authorities and, above all, they design the standards to ensure that there is a consistent implementation of the measures in the Member States. Level four is operated by the Commission which is in charge of the monitoring and enforcement in order to ensure that the measures decided at levels one and two are effectively implemented.

The process was a success and gained momentum in the new millennium, as important legislation came through: The Market Abuse Directive (2003), the Prospectus Directive (2003), the Transparency Directive (2004) and especially the Directive in Markets in Financial Services, MiFID (2004) with its goal to provide systemic investor protection.7 Through those key directives, a considerable degree of harmonization has been achieved. However, this regards only the substantive law. Neither the FSAP nor the Lamfalussy framework really changed the decentralized approach of the governance structure for financial regulation in Europe. For some, the FSAP and the Lamfalussy process, by increasing the level of legal harmonization and supervisory cooperation, actually enhanced the decentralized prudential arrangements.[8]

b. Consumer protection

Consumer protection groups are not a formal part of the decision-making process in the Lamfalussy process. This is not to say that consumers have no formal forum to communicate their views. One such platform is the Forum of User Experts in the Area of Financial Services (FIN-USE) which was created by the Commission in 2004 with the goal to integrate the views of consumers and small businesses in the EU policy-making.[9] FIN-USE has been actively promoting consumer interests in its communication with the various EU bodies, especially the level three committee CERS.[10] Also, in 2006, the Commission established a Financial Services Consumer Group.[11] More recently, the level three committees have begun to include representatives of FIN-USE in their consultative panels.[12] It

---

7 On MiFID see Kwangwook Lee, Investor Protection in European Union: Post FSAP Directives and MiFID, SSRN Working Paper, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1339305>.

8 Fabio Recine/Gustavo Pedro Teixeira, The new financial stability architecture in the EU, Paolo Baffi Centre Research Paper No. 2009-62, p. 1, available at SSRN: <http://ssrn.com/abstract=1509304>.

9 See <http://ec.europa.eu/internal_market/fin-use_forum/index_en.htm>.

10 See the various statements and letters of FIN-USE, available at <http://ec.europa.eu/internal_market/fin-use_forum/index_en.htm>, Link: Opinions.

11 For a more detailed account see Caroline Bradeley, Consumers of Financial Services and the multi-level regulation in the European Union, 31 Fordham Int'l. Law Journ., 1212 1234, at 1229.

12 This is the case for the Committee of European Banking Supervisors (CEBS), see Bradeley, supra note 11, at 1232. In fact, the CEBS, the CERS and the CEIOPS are charged, by the Commission, to include consumer groups in the consultation process. See Kai P. Purnhagen/Paul Verbruggen, Europäische Gemeinschaft, in: H.-W. Micklitz et. al (eds.), supra note 3, 173-245, at 231.

has to be pointed out, however, that the representation in a consultative panel of a Committee does not, by far, yield the same influence as being part of its governing body.

As to the question whether private actions can be brought for failure to implement the laws passed at levels two and three (protection category „action“), there seems to be a consensus that this is perceivable for very few EU laws only (notably: the directive on MiFID) and is, in any event, a very difficult task.[13]

The Lamfalussy framework did, however, stress in an unprecedented way the crucial importance of integrating consumer groups and consumer issues in the regulatory process. This is consistent with the Financial Services Action Plan, which marked the issue of consumer protection as a high priority.[14] In its final report, the Committee of Wise Men stressed the need for cooperation and partnership among all stakeholders, explicitly including the consumer groups.[15] Also, it proposed consultation procedures at all levels of the decision-making process.[16] As has been pointed out above, consumer groups have indeed received more attention in the Lamfalussy framework than in the previous law-making process of the EU.

IV. Post-Crisis Proposals for a New Regulatory Architecture

1. The Big Picture

The recent financial meltdown created resulted in a global regulatory empowerment: Everywhere in the world there was the political momentum to fundamentally rethink the structure of financial supervision. The Commission, besides engaging in crises management, also saw a clear need for a new EU financial architecture. It instituted a high-level group on financial supervision in the EU, chaired by M. Larosière. The task of the high-level group was to issue recommendations on the reform of the system of financial supervision within the EU. The group released its report on February 2009.

On the basis of the report, the Commission issued two Communications on the new regulatory framework (in March and in May 2009). In September 2009, it presented a comprehensive package of reform proposals.[17] The proposals consist of new substantive regulation (capital requirements, deposit guarantee schemes, credit rating agencies and alternative investment funds). On the institutional side, it proposes a new pan European regulatory framework. The framework establishes new regulatory bodies.

a. The European Systemic Risk Board

The European Systemic Risk Board will be in charge of the macro-prudential supervision of the financial sector in Europe.[18] The Commission proposal[19] stipulates that the ESRB will be chaired by the president of the European Central Bank; the members will mainly be the governors of the twenty-

---

[13] Purnhagen/Verbruggen, supra note 12, at 201 ss. and 234 ss.

[14] Financial Services Action Plan (10.11.1999), at 9 ss. See also the Commission’s Framework for Action (28.10.1998), available at <http://ec.europa.eu/internal_market/finances/docs/actionplan/index/fs_en.pdf>, at 3.

[15] Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, available at <http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf>.

[16] See, e.g., the Final Report of the Committee of Wise Men, supra note 15, at 25, 32, 36, 42.

[17] All documents available at <http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package>.

[18] For an overview see Recine/Teixeira, supra note 8, at 15 ss.

[19] For the Commission proposal see

<http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_499_en.pdf>.

seven national central banks. Its core mandate is to monitor and analyze imbalances in the financial system and, especially, to detect „systemic risks". In other words: The ESRB is supposed to recognize a bubble and act before it bursts. It is an extremely difficult task, as there is no generally accepted definition of the term „systemic risk".[20] It has rightfully been pointed out that „if a problem cannot be defined, it cannot be solved."[21] The task is complicated further because it requires to transpose an already „fuzzy" economic concept into a clear cut legal regulation.[22] In the banking community, there is a widespread skepticism as to how the macro-prudential approach will work in practice. One newspaper cited a banker saying that „not only is macro-prudential regulation rubbish, but it gives rubbish a bad name."[23]

The ESRB will have the power to issue recommendations to deal with systemic risks. However, the proposal changes the mechanism for recommendation by using a regulatory tool which is well know in the prudential supervision of banks: It is the concept of „comply or explain." In other words: If the Commission doesn't follow the recommendation, it has to explain itself. This changes the quality of a recommendation. And it also changes the status of the body that issues a recommendation. It may or may not be on purpose, but it reflects in the language. This body is not called a Committee, but a Board.

In spite of the skepticism regarding the workability of the ESRB, this part of the Commission proposal seems to have passed the deliberation by the EU finance ministers with little modifications.[24]

b. European Supervisory Authorities

In addition to the macro-prudential supervision, the Commission proposes a new system of micro-prudential supervision. In micro-prudential supervision, the focus lies on the safety and soundness of individual institutions – as well as *consumer protection.*[25] The micro-prudential supervision is to be carried out by new European supervisory authorities: The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). These authorities will replace the level three committees of supervisors of the Lamfalussy procedure. According to the Commission proposal, each of these authorities will have independent legal personality. They will take on the tasks currently performed by the level three committees and, in addition, they will be allocated important decision-making, monitoring and even quasi-regulatory functions. As their level three predecessors, these new authorities will be based in Frankfurt, London and Paris.

The Commission presents the new framework differently. The proposal talks of two pillars, the maco-economic pillar with the European Systemic Risk Board and the micro-economic pillar with a body called the System of Financial Supervisors (ESFS). In the proposal, the second pillar is called „a network of national supervisors". However, there is little doubt that it is not the network which is new and which will be the main pillar of the supervisory framework. The pillar – or rather the pillars – will

---

[20] See, e.g., Stephan L. Schwarzc, Systemic risk, GEOLJ 97 (2008), 193 - 249, at 198 ss. For different definitions see also Silvester C.W. Eijffinger, Defining and Measuring Systemic Risk, Brussels 2009, IP/A/ECON/FWC/2009-040/C4, available at: <http://www.europarl.europa.eu/document/activities/cont/200911/20091119ATT64822/20091119ATT6482-2EN.pdf>. For a view on the measurement difficulties *see* Claudio Borio/Matthias Drehmann, Towards an operational framework for financial stability: "fuzzy" measurement, BIS Working Paper No. 284, available at SSRN: <http://ssrn.com/abstract=1330309>.

[21] See Schwarzc, supra note 20, at 197.

[22] For a contribution of the legal scholarship on systemic risk see Schwarzc, supra note 20, passim.

[23] Financial Times [online edition], June 21, 2009 (Respinning the web).

[24] Financial Times Deutschand, December 8, 2009, at 15.

[25] See House of Lords, The future of EU financial regulation and supervision, Volume I: Report, published in June 2009, at N. 28, available at: <http://www.publications.parliament.uk/pa/ld200809/ldselect/ldeucom/106/106i.pdf>.

be the new European Banking Authority, the new European Insurance and Occupational Pensions Authority, and in the new European Securities Authority.

c. Timetable

The ministers of finance agreed, on December 2, 2009, to go forward with a „revised version“ of the Commission proposal.[26] The Council has charged the EU Presidency to start negotiations with the EU Parliament regarding the Commission proposal. The first reading is scheduled for April 4, 2010. The plenary session is scheduled for June 15, 2010.

2. The Fine Print

The fundamental changes in the regulatory structure are brought to light if one looks beyond the broad descriptions of the tasks (and powers) of the new prudential watchdogs. The European Securities and Markets Authority (ESMA) may serve as an example.

Among other things, ESMA will be in charge of the development of technical standards.[27] The Commission staff working document provides an overview of the key areas which could be subject to the development of such standards.[28] They include areas where detailed methodological or quantative standards are required (*e.g.,* internal models of capitalization of banks), areas where uniform reporting is deemed beneficial (*e.g.,* uniform reporting format for banks), and areas such as rsik assessment and information sharing.[29] Generally speaking, technical standards do not involve policy decisions. Even if this were true, one should not underestimate their impact. By way of example: The numerial sequence of the international bank account number (IBAN) is a technical standard. This technical standard has ensured that the payment systems become interoperable, thus creating a level playing field among them.[30]

So far, technical standards have not been a binding instrument of law-making at the EU level. The present proposal, however, states that where the Commission decides not to endorse the standards submitted by ESMA or decides to amend them, it must provide reasons for its decision.[31] The fact that ESMA will develop the standards using better regulation principles,[32] including appropriate consultation, does not eliminate the risk of quasi legislation under the guise of technical standards – a risk which is even more serious in view of the “comply or explain” situation of the Commission. The Commission draft emphasizes that the technical standards will be limited to matters of highly technical nature.[33] However, once ESMA is operative, there is no procedural safeguard to limit the technical standards to matters of highly technical nature – with the exception of the “veto” by the Commission.

Another task of ESMA is to ensure the consistent application of Community rules. The draft foresees a three-step enforcement procedure: (1) Where ESMA considers that a national supervisor does not

---

26 See Council of the EU, 2981st Council meeting, Press Release 352, 2.12.2009; available at <http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/111706.pdf.>; Financial Times [London Edition], 3.12.2009, at 8.

27 For the term „standard“ see art. 1.6 of 98/34/EC, as amended by 98/48/EC.

28 Commission Staff Working Document, Annex I, available at supra note 17.

29 Commission Staff Working Document, supra note 29, at 8.

30 See Eddy Wymeersch, Standardisation by law and markets especially in financial services, Financial Law Institute Working Paper Series No. 2008-02, available at SSRN: <http://ssrn.com/abstract=1089037N 24>, at N 24.

31 See Commission proposal, supra note 33, Art. 7 (1) subparagraph 4.

32 See 98/34/EC.

33 Commission Proposal 6.2.2.1. at 6, available at <http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package>.

comply with the applicable Community rules, it may investigate the matter, and, if necessary, adopt a recommendation addressed to the national authority in question. (2) If the national supervisor does not comply, the Commission will step in. The national supervisor has then strict time limit to inform the Commission and ESMA of the steps that it has taken to comply with that decision. (3) Finally, if the national supervisor does not comply, ESMA can address the financial market participant individually requiring it to take the necessary action to comply with Community Law. The power of ESMA is extensive and it includes the power to require the entity in question to cease business. In other words, it can sidestep the national supervisor.

This part of the proposal has been revised in the course of the deliberation of the finance ministers. Notably Germany and France had been opposed to granting strong enforcement powers to the new authorities.[34]

3. *Institutionalized Consumer Protection*

The preliminary statement of the proposal to establish a European Securities and Markets Authority states that the Authority „should act with a view to improving the functioning of the internal market ... to protect investors ... to strengthen international supervisory coordination, for the benefit of the economy at large, including financial market participants and other stakeholders, *consumers* and employees. ...“ In view of the different consumer protection categories outlined above, this falls under the category „consideration“: Consumer issues are to be taken into account in the rulemaking on a general level.

The new framework does not explicitly contain provisions regarding possible claims of private persons or consumer groups with regard to the implementation of EU law by the Member States. However, it is conceivable that with the increasing volume and scope of EU legislation and also the increasing tendency of this regulation to set maximal standards instead of minimal standards,[35] law suits for failure to implement EU law are more likely to succeed.

The truly new point of the proposed prudential framework is that, for the first time, consumer groups are *formally* included in the decision-making process. In the drawing of technical standards and in the design of a common rulebook, ESMA is supposed to consult with interested parties. The proposal includes the creation of a Securities and Markets Stakeholder Group (art. 22). In its present version, it reads as follows: „(1) For the purpose of consultation with stakeholders in areas relevant to the tasks of the Authority, a Securities and Markets Stakeholder Group shall be established. (2) The Securities and Markets Stakeholder Group shall be composed of 30 members, representing in balanced proportions Community financial market participants, their employees as well as *consumers*, investors and users of financial services.“ The proposal regarding the European Banking Authority (EBA) and the proposal regarding European Insurance and Occupational Pensions Authority (EIOPA) each include a parallel provision.[36]

The Stakeholder Groups may, at a first glance, be somewhat similar to the present consultative panels of the level three committees of the Lamfalussy framework.[37] The difference, however, lies in the fact that the Stakeholder Groups are formally given a place at the level of the legislation establishing the three supervisory authorities, thereby giving them a more important role in the future governing process. Being part of those Stakeholder Groups means that consumer interests now have a platform

---

[34] Financial Times Deutschland, December 8, 2008, at 15.

[35] A prominent an consumer-relevant example is MiFID, which is seen, at least by some authors, as maximum standard regulation. See Peter O. Mülbert, Auswirkungen der MiFID-Rechtsakte für Vertriebsvergütungen im Effektengeschäft der Kreditinstitute, ZHR 172 (2008), 170 - 209, at 177.

[36] Both at art. 22. For the full text see: <http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package>.

[37] See supra at 21 (Consumer protection).

which is more visible and which cannot easily be sidestepped. This, in turn, enhances its overall position in the policy and decision-making. On the other hand, it has been rightfully pointed out that this does not change the imbalance between industry and consumers with regard to resources. In its response to the proposed new system of governance, FIN-USE has suggested that the proposal should include wording which defines as a key objective of the Stakeholder Groups that they should provide insight to the authorities regarding the impact of consultations and initiatives on consumers and users, and ensure that the decision-making process takes those interests into account.[38] Another issue, according to FIN-USE, concerns the „balanced proportion" of interests which are represented in the Stakeholder Groups. In order to ensure that consumer interests are adequately represented, a quota of one third should be reserved to the consumer representatives on the Group level, whereas no more than one third of the members should be from the financial services industry on the Board level.[39] Also, on very practical terms and in view of the unequal resources, the Stakeholder Groups should be given secretarial support and their members should be compensated for the attendance of Group meetings.[40]

V. Conclusion

The recent development in the prudential supervision of the financial services sector reflects a fundamental change in the role of consumers and consumer interest groups. For the first time, consumer interests are a formal part of the decision-making process. This does not transform the new institutional framework into a consumer protection platform. Indeed, the impact of the formal inclusion of consumer interests within the wide group of stakeholder interests should not be overestimated. This is even more so if one considers that the Stakeholder Group, as designed in the proposal, only has a consultative role. On the other hand, it does give consumer protection issues an institutionalized voice. Considering the fact that other interest groups, namely the professional service providers, have levels of resources available that clearly favors them in terms of informal agenda-setting and decision-making, this is an important first step. It must be hoped that the final version of the new institutional framework does not downgrade or water down this element of representation. In terms of power, agenda-setting and decision-making, consumers are certainly not the main players in the EU. Yet they are at the heart of the concept of an internal market. Accordingly, they should be among its primary beneficiaries.

---

[38] FIN-USE Response on Stakeholder Groups of the European Supervisory Authorities, November 2009, available at <http://ec.europa.eu/internal_market/fin-use_forum/docs/stakeholder_groups_en.pdf>.

[39] FIN-USE, supra note 38.

[40] FIN-USE, supra note 38.

Bibliography

Caroline Bradeley, Consumers of Financial Services and the multi-level regulation in the European Union, 31 Fordham Int'l. Law Journ., pp. 1212-1234.

Jürgen Keßler/Hans-W. Micklitz, Rechtsvergleichende Zusammenfassung, in Hans-W. Micklitz et al. (eds.), Institutionelle Finanzmarktaufsicht und Verbraucherschutz, Band 31, VIEW Schriftenreihe, 2010, pp. 247-267.

Wernhard Möschel, Eine Systematik von Bankregulierungszielen, in Marcus Lutter et al. (ed.), Festschrift für Walter Stimpel zum 68. Geburtstag am 29. November 1985, 1985, pp. 1065-1085.

Peter O. Mülbert, Auswirkungen der MiFID-Rechtsakte für Vertriebsvergütungen im Effektengeschäft der Kreditinstitute, ZHR 172 (2008), pp. 170-209.

Kai Purnhagen/Paul Verbruggen, Europäische Gemeinschaft, in H.-W. Micklitz et. al (eds.), Institutionelle Finanzmarktaufsicht und Verbraucherschutz, Band 31, VIEW Schriftenreihe, 2010, pp. 173-245.

Stephan L. Schwarzc, Systemic risk, GEOLJ 97 (2008), pp. 193-249.

Thomas Taylor, The impact of consumer protection on banking legislation in the European Community and the effect of the recent consumer protection proposals, Fordham Int'l L.J. 28 (2005), pp. 1216-1256.

Rethinking Competition: State Aids and Competition Rules in the Age of the Financial Crisis

Jürgen Keßler

I. Introduction

The ongoing financial crisis has raised a lot of still unanswered questions not only in respect of the logic and rationality of marked related processes in general and the rough and irresponsible behaviour of some market participants especially in the financial and banking sector in particular.[1] Above all the findings of economic theory, especially of competition theory,2 seem to be more and more questionable. So far as the underlying legal structures of the financial markets are concerned among consumers and politicians there are significant and wide spread irritation, whether the existing legal rules are suitable to protect the private and public interests involved.3 Far more by applying the provisions of common market competition law, last but never ever the least the rules relating state aids, among Member States too, it seems to be a firm belief that national egoism prevails over the obligations based upon the Treaty.4

So no wonder that in autumn 2008, at the beginning of the financial crisis, Member States entered into competition with each other to provide their industries with subsidies and to give way for co-operations among enterprises more or less regardless the common market rules of competition as laid down in the Treaty.5 At the first glance the initial reaction of the Commission to the decline of the common market order and its legal framework was not convincing and partly helpless.6

So for some analysts of the policy of the European Commission it seems to be nearly a clear case that European Competition policy and its legal base may only functioning under "good weather conditions" but reaches its limits under the circumstances of a global crisis, which not only hurts the financial markets.7 European and harmonized national competition policy aimed to secure the autonomous self-regulation of the internal market by the invisible hand of competition and "*allowing consumers a faire share of the resulting benefit*" in the age of the financial crisis ended in a race between Member States to correct the results of failing markets and to rescue systemic relevant banks with the monetary help of apparently systemic irrelevant tax payers and consumers.8

For that reason it seems to be as fruitful as intellectual stimulating to try once again some kind of critical analysis of the structure and underlying philosophy of the EC competition rules and the way they are related to each other. I'm not sure whether the financial crisis and the measures taken by

---

1 See Pohl, Krisenbewältigung und Krisenvermeidung: Lehren aus der Finanzkrise, ORDO, (2009), pp. 289 ff., 305 ff.

2 See Ingo Schmidt, Wettbewerbspolitik und Kartellrecht, 8. ed. 2005.

3 See Schüller, Krisenprävention als ordnungspolitische Aufgabe, ORDO (2009) Band 60, pp. 355-388; Jestaedt/Wiemann, Anwendung des EU-Beihilfenrechts in der Finanzmarktkrise – Wettbewerbspolitisches Regulativ, Hemmschuh oder Feigenblatt?, WuW 2009, pp. 606-619.

4 See Jestaedt/Wiemann, WuW 2009, p. 609; MEMO/08/795, State aid: Commission adopts temporary framework for Member States to tackle effects of credit squeeze on real economy – frequently asked questions, 17.12.2008, p. 3.

5 See Keßler/Dahlke, Die Auswirkungen der Finanzkrise auf das europäische Beihilfenrecht, EWS, pp. 79-81; Zimmer/Blaschczok, Die Banken-Beihilfenkontrolle der Europäischen Kommission: Wettbewerbsschutz oder Marktdesign? WuW 2010, pp. 142-157.

6 For the beginning of the crisis Jestaedt/Wiemann, WuW 2009, pp. 606 ff., p. 619.

7 Jestaedt/Wiemann, WuW 2009, pp. 606 ff.; 618 f.; Pohl, Krisenbewältigung und Krisenvermeidung: Lehren aus der Finanzkrise, ORDO 2009, Band 60, pp. 289 ff.; to some extent Zimmer/Blaschczok, WuW 2010, pp. 142 ff.

8 See Schüller, Krisenprävention als ordnungspolitische Aufgabe, ORDO (2009) Band 60, pp. 355 ff.

Member States or the European Commission in order to get over will provide us with the solution in respect of our unanswered questions.9 Among lawyers it is a well known and common saying, that hard cases make bad law. In respect of the ongoing crisis there are some indications that hard facts and bad circumstances are doing also.

II. The EC Competition Rules

According to article 3 § 1 lit. b of the Treaty on the functioning of the European Union, the Union shall have "exclusive competence in respect of the establishing of the competition rules necessary for the functioning of the internal market." In so far the competition rules are part of a legal based system with the aim of establishing or ensuring the functioning of the internal market, in accordance with the relevant provisions of the Treaties (article 26 1.).

Usually in respect of the common rules of competition we distinguish to separate pillars on which the legal system securing competition in the internal market is based upon, but which are nevertheless close connected to each other in a complementary way. On the one hand the rules applying to undertakings, e.g. the prohibition of concerted practices (article 101, former article 81) and the prohibition of any abuse by one ore more undertakings of a dominant market position within the internal market (article 102, former article 82) which together with the Council Regulation on the control of concentration between undertakings are creating the heart of the EU anti cartel and anti trust policy. On the other hand EU competition policy as a "*system ensuring that competition in the internal market is not distorted*" – so former article 3 I lit. g – is also shouldered by the provision of article 107 (former article 87) of the Treaty, prohibiting "*any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods in so far as it affects trade between Member States.*"

If we try to look for some common principles or some kind of underlying philosophy in respect of the anti cartel provisions of articles 101 and 102 of the Treaty on the one hand and the state aid rules on the other, there are significant clues that the concept of autonomy builds the dogmatic fundament the EC competition rules are based upon. Nevertheless in the context of the EC competition rules, the concept of autonomy shows in some respect a double-bind, dualistic structure with institutional and individual dimensions. As far as the institutional dimension is concerned, autonomy means autonomy of the market itself.[10]

In this respect it is up to the staid aid rules to protect markets against intervening subsidies granted by the Member States which distort the integration and the functioning of the internal market. Relating to the individualistic dimension of the autonomy concept it falls in the range of application of the anti cartel provisions of articles 101 and 102 of the Treaty to protect market participants, especially competitors and consumers, against concerted actions of undertakings aimed directly or indirectly to fixe purchase or selling prices or any other trading conditions as well as against any abuse of a dominant position within the common market or in a substantial part of it. In other words: it is up to articles 101 and 102 of the Treaty to ensure that undertakings acting as market participants make up their market related decisions in an autonomous way without to get or to keep in contact with their competitors and not forced by the dominant market position of any relevant competitor.

If we try to analyse the preconditions of the autonomy concept outlined above not only as far as undertakings are concerned but also including private consumers in their role as market participants, it turns the attention to some significant shortcomings which make it clear that the conditions of autonomous behaviour of consumers are different from those of enterprises. To articulate their voice in

---

9 Keßler/Dahlke, EWS 2009. pp. 79 ff.

10 See Schüller, Krisenprävention als ordnungspolitische Aufgabe, ORDO (2009) Band 60, pp. 355 ff.

the market and to gain some kind of nearly equal bargaining power compared to the supply side it seems to be not sufficient to protect private consumers against cartels and misuse of power. Far more it seems to be inevitable to provide consumers with the information they need to make an informed and reasonable choice.[11]

Beside the aspect of consumer related market information scrutinizing the structure of competition processes and the legal framework they are based upon, reveals reasonable doubts whether the abstention of market interventions by the Member States and the European Commission are sufficient to secure the autonomous functioning of the markets and its participants.[12]

If the real life is able to teach us lessons in the light of the financial crisis regarding its origins and its consequences, one conclusion seems to be convincing: liberalized and deregulated markets do not in a compelling way produce the results predicted and promised by the representatives of a neo-liberal market philosophy.[13] Far more and with deep reaching consequences in respect of the legal framework and the role States have to play in order to enable and secure competitive processes, if we want competition not only l'art pour l'art for itself or wishful thinking, if we are more interested in competition in a realistic way, as an useful and effective instrument to produce and enforce consumer welfare, competition should not be left to the pleasure of competitors only.[14]

Rethinking competition in the light of the financial crisis means more or less to revive and reinforce the legal framework governing market related processes and under some circumstances, especially in respect of markets dealing with products of high complexity, like in the financial sector, the legal framework of competition rules needs a complementary concept of regulative state based interventions, not for the sake of failing industries or enterprises but for the sake of market performance and market results and last but never the least for the sake of private consumers. For my opinion it seems to be one of the most remarkable shortcomings by analysing the financial crisis and controlling its consequences that economists and lawyers are focussing the traditional instruments of anti cartel and state aids law only. No doubt, in some cases it may turn out to be fruitful or maybe necessary to implement state subsidies in order to stabilize failing regions.

Nevertheless in the past 50 years implementing the EC competition rules we learned that state subsidies and cartels do not work in order to manage structure crisis.[15] To disentangle and solve complex and complicated dogmatic problems it doesn't seem to be the right way to cure the symptoms. If it is in public interest that competition is able to produce consumer welfare, it is in public interest too, that Member States and the EU take the responsibility to design the legal framework governing and regulating competition in a way that competition is able to fulfil its tasks. If the invisible hand of autonomous market related actions of competing enterprises produces results harming consumer welfare it is a matter of public policy to regulate the market performance and the behaviour of market participants in a way to guarantee the public interest involved.[16] For that reason

---

[11] In respect of the role of consumers as market participants see Keßler, Schadensersatz und Verbandsklagerecht im Deutschen und Europäischen Kartellrecht, 2009.

[12] Keßler, Schadensersatz und Verbandsklagerecht im Deutschen und Europäischen Kartellrecht, 2009.

[13] See Weede, Die Finanzmarktkrise als Legitimitätskrise des Kapitalismus: Überlegungen zu (allzu) menschlichem Handeln in Wirtschaft und Politik, ORDO (2009), Band 60, pp. 267 ff.; Meyer, Finanzmarktinnovationen und Finanzkrisen: Historische Perspektive, ORDO (2009), Band 60, pp. 325 ff.; Schwarz, Über die Not-Wendigkeit von Nothilfe. Eine Handvoll ordnungspolitischer Betrachtungen angesichts der neuen Staatsgläubigkeit, ORDO 2009 (Band 60), pp. 169 ff.; Keßler/Dahlke, EWS 2009, pp. 79 ff.

[14] Keßler/Dahlke, EWS 2009, pp. 79 ff.

[15] Jestaedt/Wiemann, WuW 2009, pp. 606 ff.; 618 f.; Pohl, Krisenbewältigung und Krisenvermeidung: Lehren aus der Finanzkrise, ORDO 2009, Band 60, pp. 289 ff.; to some extent Zimmer/Blaschczok, WuW 2010, pp. 142 ff.

[16] Schüller, Krisenprävention als ordnungspolitische Aufgabe, ORDO (2009), Band 60, pp. 355 ff.

rethinking competition means more than to improve the effectiveness and the functioning of anti cartel and state aid rules.

Rethinking competition should be enshrined in a renewed concept of market philosophy able to accept consumers as equal market participants and not afraid of complementary regulating interventions where competition for itself produces harming effects. If we actually need some kind of competition theory we need a concept which mirrors market processes in a realistic way, realizing that market related power and market transparency are unequal distributed. Complementary we need competition rules not neglecting the shortcomings of market processes but based upon a concept of complementing provisions and intervening regulations.

Rethinking competition means to abstain from wishful thinking and the naïve expectations that real life and the behaviour of market participants are following the doubtful predictions of speculative competition theory.

Rethinking competition means to understand competition as a political task and not as a concept behind politics. Rethinking competition means rethinking the conditions of human beings.

Bibliography

Thomas Jestaedt/Joachim Wiemann, Anwendung des EU-Beihilfenrechts in der Finanzmarktkrise – Wettbewerbspolitisches Regulativ, Hemmschuh oder Feigenblatt?, WuW 2009, pp. 606-619.

Jürgen Keßler, Schadensersatz und Verbandsklagerecht im Deutschen und Europäischen Kartellrecht, 2009.

Jürgen Keßler/Jürgen Dahlke, Die Auswirkungen der Finanzkrise auf das europäische Beihilfenrecht, EWS, pp. 79-81.

Wilhelm Meyer, Finanzmarktinnovationen und Finanzkrisen: Historische Perspektive, ORDO (2009), Band 60, pp. 325.

Rüdiger Pohl, Krisenbewältigung und Krisenvermeidung: Lehren aus der Finanzkrise, ORDO (2009), pp. 289-316.

Ingo Schmidt, Wettbewerbspolitik und Kartellrecht, 8. ed. 2005.

Alfred Schüller, Krisenprävention als ordnungspolitische Aufgabe, ORDO (2009) Band 60, pp. 355-388.

Gerhard Schwarz, Über die Not-Wendigkeit von Nothilfe. Eine Handvoll ordnungspolitischer Betrachtungen angesichts der neuen Staatsgläubigkeit, ORDO 2009 (Band 60), pp. 169.

Erich Weede, Die Finanzmarktkrise als Legitimitätskrise des Kapitalismus: Überlegungen zu (allzu) menschlichem Handeln in Wirtschaft und Politik, ORDO (2009), Band 60, pp. 267.

Daniel Zimmer/Martin Blaschczok, Die Banken-Beihilfenkontrolle der Europäischen Kommission: Wettbewerbsschutz oder Marktdesign? WuW 2010, pp. 142-157.

State Aid Control under the Financial Crisis

Christophe Giolito*

As a result of the 2008 financial crisis, European Banks in 18 Member States were given almost EUR 3 trillion in State guarantee schemes. In addition, the Member States' governments granted more than EUR 300 billion of capital injections. The European Commission approved all of these measures sometimes subject to commitments and/or conditions.

The 2008 financial crisis has raised many comments and questions, not only about the behaviour of market participants in the financial and banking sectors, but also regarding the Member States and the EU Commission as a regulator. It has given an unprecedented public attention to the existence of EU State aid rules as a tool for restoring financial stability as well as preserving the internal market. State aid rules, as enacted in 1957 by the founding fathers of the EEC Treaty, already provided the possibility "to remedy a serious disturbance in the economy of a Member State" (Article 107(3)(b)). This possibility has – in the recent debate – been said to create precisely the opposite effect. I will briefly comment and try to rebut two lines of criticism concerning the way the EU Commission carries out its monitoring powers as well as the temporal nature of the applicable State aid rules to banks.

First, some authors have criticized the way the Commission uses its State aid control prerogatives. These authors claim that the Commission de facto **regulates** the European banking system, in particular when it imposes structural and behavioral commitments on restructured banks, such as the reduction of a bank's balance sheet, divestiture obligations, or "non-price-leadership commitment". In short, these authors claim that such commitments make it more difficult for the banks to return to viability and to remain competitive.

Personally, I find this criticism wrong and unjust.

The Commission's control of such economic aids is meant to ensure that the measures do not damage the level playing field between aid recipients and their competitors in the EU. By exercising State aid control, the Commission tries to reconcile two objectives: (i) to restore and preserve financial stability, (ii) to preserve competition in the internal market.

The role of public financial support may very well be important, but it is still limited when compared with financial regulation. Although the Commission's role in State aid control should be that of a pro-active and involved player, it is a different one than the role of the regulator. To regulate is to subject an activity to laws and regulations. To control or to monitor a business sector or an activity can have the same aim but involves other tools.

The aim of State aid in crisis management is, first, to address systemic risks and prevent their further aggravation by means of a rescue aid, and second, to address a long-term problem of financial stability through the examination of restructuring plans. Such control gives little scope for regulation. Each bank has its own structure, including its businesses and form of ownership. A German Sparkasse savings bank owned by public authorities may not be treated the same as a conglomerate, listed on the stock exchange such as the Belgian bank ING.

To further emphasize the difference between regulation and monitoring or control, let me also remind you of some basic principle of State aid control in the field of rescue and restructuring applied in the banking sector. For an aid to be justified and hence declared compatible, the aid must enable its beneficiary to restore its viability in the long-term. Second, in order to limit the anticompetitive effects of the aid, the amount of aid must be limited to the minimum and the beneficiary must internalize the restructuring costs to the greatest extent possible (burden sharing). Finally, the distortions of

* Any opinions expressed are personal and do not necessarily reflect the views of the European Commission.

competition in the banking sector especially vis-à-vis banks that are not receiving State aid and that have remained fundamentally sound must of course be minimized as far as it is possible. To that effect, the Commission has a particularly important role in ensuring this through an active approach, not excluding imposing conditions and/or commitments. Such conditions are meant to compensate the competitors that managed to remain viable without aid and that have to face competitors that would have exited the market in the normal course of event but that remain active thanks to public intervention.

Finally, let me comment on the authors that consider that the Commission has been rewriting the State aid rulebook following the latest financial crisis. It is true that there was a need to draft certain specific State aid rules after September 2008 and the collapse of Lehman Brothers. However, it is important to remember that this set of rule is based on a temporal condition: the existence of a serious disturbance in the economy of a Member State. In other words, when such systemic risks no longer exist, these ad hoc rules should cease to apply. The current financial crisis rules apply until the end of 2010. The crisis exit strategy is a crucial issue that the Commission currently has to deal with. For the time being, it is interesting to note that the EU Commission still has some 40 bank restructuring cases to decide in the aftermath of the financial crisis. The Commission services publicly announced their intention to hopefully finalize all those files before the end of 2010.

Banks and Competition in the Aftermath of the Financial Crisis

Harold James / Chris Kobrak

Introduction

Severe banking crises bring painful and long-lasting disruptions. But they also lead to surprises. The lessons learnt in the immediate aftermath of the crisis bear little relationship to the eventual outcome. There are immediate and obvious answers to the question of who was to blame for the banking crisis, but they rarely correspond with the new shape of the financial landscape that emerges from the crisis.

First, the crisis of 2007-8 originated from banks that were "too big to fail" and "too inter-connected to fail". But some banks, including some of the most notoriously weak banks, will (in the absence of new policy responses) get bigger as a result of the crisis.

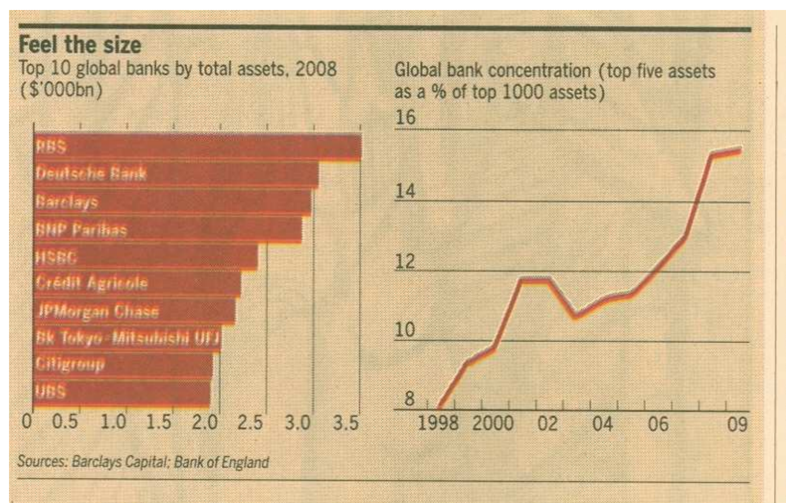
Second, the problems began in the United States, from the sub-prime mortgage sector. Many observers at the outset of the crisis were very happy to predict the end of American financial capitalism. But the banks that were most affected were elsewhere, and until recently it seemed as if the long-term winners will be a few American banks. Fueled by the injection of taxpayers' money, American financial capitalism is back in force. By contrast, and perhaps surprisingly, the financial crisis has posed bigger challenges for Europe and its conception of bank organization.

I. The Lure of Bigness

The explanation of the puzzle of why the obvious lessons are not drawn lies in the curious character of financial activity. Banking is inherently competitive; but at the same time, it is not an industry where competition ever worked very well. Banks essentially depend on information (about the quality of their lending) that is not available to their depositors.

The core of financial activity depends on reputation, networks of information, and the ability to make markets as well as simply trade on them. The result is that there are indisputable advantages to being big, as well as the disadvantages that have become obvious over the past two years. The market tends to be dominated by a relatively small number of firms, and have continued (for reasons that will be outlined below) even through the financial crisis after 2007.

FIGURE 1 (*Financial Times*, February 3, 2009)



In the old days, when banking was stable and regulated securely in a national setting, three or four leading banks tended to form an oligopoly in each country: Barclays, Lloyds, Midland and National Westminster in the UK, Bayerische Vereinsbank, Commerzbank, Deutsche and Dresdner Bank in Germany; Credit Suisse, SBC, and UBS in Switzerland. There were always suspicions of either a formal or an informal cartel of banks, which would agree on conditions and interest rates. But regulators generally turned a blind eye to these suspicions.

In the 1990s and 2000s, internationalization promised to produce a new landscape, in which once again a small handful of banks would divide up not national markets but a single global market. Banks maneuvered to get the best position to take advantage of the new financial globalization. That usually meant locating themselves and their activities via subsidiaries (that were regulated locally) in the most lax and least restrictive regulatory regime.

Today, in a world with seemingly limitless access to information – permitting a great deal of disintermediation and reduction in physical presence in many sectors – why do many banks seem compelled to become multi-poled, international matrix organizations (transnational institutions)? Whereas in 1900 huge amounts of cross-border transfers and investment were arranged, monitored and even distributed by private (mostly family) banks and funneled through correspondent networks, today huge joint-stock companies dominate international finance.[148] These megabanks have internalized activities that were once performed by individuals and institutions in large part legally independent of one another, or of public markets. Nearly all of these new mega-institutions are public companies which – with greater capacity for internalization of transactions **to exploit** new regulation and technology – are better placed than separate institutions, especially those conducting business on public markets, to keep their transactions off the radar screens of regulators. The story of this transition is a complex mixture of technological, economic and political changes, with a little path dependency thrown in for good measure.

The megabanks raise many broad and interrelated issues in the management of the global economy. They entail management problems over a huge geographic area and among very disparate, complicated businesses. They have not only been beset by pure fraud, they also seem at times to have lost control of even legal transactions, many of whose valuations can no longer rely on easily acquired market quotations. Conflicts of interest can easily arise between dealmakers and management, with no ready mechanism for adjudication. Hundreds of separate (and in some cases incompatible) software systems are required to manage these diverse activities, with the result that it is impossible for senior management to track the precise extent of risk exposure. Working across many national borders with integrated affiliates has intensified potential cultural conflicts. As financial institutions lose much of their own national character, regulators have had a difficult time defining the span of their authority**.** Not only is much of international business conducted in self-regulated offshore (Euro) markets**,** many institutions conduct all or most of their activities outside the jurisdictions in which they are incorporated. Along these lines, the very size of these institutions raises questions about how effective a counterweight regulators can be. Many institutions control complex assets and transactions that dwarf the size of the national economies in which they are ostensibly based, posing system risk. They are, therefore, deemed by many too big to fail, adding additional moral hazard to a system already fraught with hazards.

It has long been argued that firms grow and internationalize as the costs and benefits of internalizing market transactions become more favorable for the diversified, hierarchical firm. Could the same logic apply to financial institutions?[149] Whereas manufacturing firms usually diversify into new aspects of

---

[148] Christopher Kobrak, "Family Finance: Value Creation and the democratization of cross-border governance," Enterprise and Society, March 2009.

[149] For the seminal work on internalization see R.H. Coase, The Nature of the Firm, Economica, 1937, Vol. IV, no. 4. In the work of those who followed Coase or introduced new approaches to explaining internalization and foreign investment, there is little discussion of whether finance indeed should be treated as a special case apart from manufacturing, for

the value chain without conflict with formal, regulated markets, banks and other financial institutions d*o*. The banking evolution over the past 50 years was a complex process that at once was allowed by regulation and which continues to help shape regulation: an international, dialectic process that since World War II has included the explosion of offshore banking, derivatives trading, the steady erosion of Glass-Steagall limits on banks acting as investors (holding securities) and lenders, and the exemption of many financial transactions from securities exchange scrutiny.

It is a regulatory and institutional story whose costs and benefits, for institutions and society at large, are insufficiently understood. Although even cost savings are sometimes hard to prove, perhaps more importantly, the risks of internalization are almost never treated until the system implodes or nearly implodes.

From the 1990s, two powerful innovations drove the push to financial bigness: the development of securitized products, and the develop of insurance for financial products, in particular credit default swaps. Securitization produced increasingly complicated financial instruments, that were intrinsically difficult to value. Large banks could offer their customers trading platforms for these illiquid securities, an apparently continuously available "market" on which complex financial products could be priced and traded.

The pace of cross-border bank mergers and other forms of direct investment picked up over the last 20 years. The most active modern investment banks have reassumed a broad range of activities and have internationalized them, effectively internalizing what were cross-border and cross-firm exchanges. *The Economist* reported in 2006 that major banks were tripping over themselves to increase their global reach and product offerings by acquisitions and other means.[150] Greater increases in market activity and lowering of transaction costs have led to greater investments to handle them, which in turn put pressure on participants for more activity to lower unit costs.

The shift in financial activity was reflected in banks' results and their investment needs. While the advising, underwriting and trading revenue (once the highest component of revenues) of the top 10 investment banks as a percentage of capitalization have all dropped as a percentage of investment bank capitalization since 1980, trading revenue in 2000 was nearly half of advisory revenue and nearly five times that of underwriting revenue.

Employment in investment banking has increased dramatically since 1979 (by some measures fourfold), but increases in capital formation have been even more pronounced. Since 1990, they have climbed by a factor of six. Mean capitalization per employee for the five largest investment banks has grown from $200,000 in 1990 to approximately $1,000,000 in 2000. Revenue income per producing employee for the same period jumped $0.4 to $1.0.[151]

In the last decade of the 20th century, bank market capitalizations of equity as a percentage of GDP doubled in Germany (to 60%) and tripled in the United States (160%).[152] In the period of financial globalization that lasted until 2007, financial institutions were perceived by the market as building more value than non-financial corporations, and financial stocks outperformed general market indices.

(Contd.)

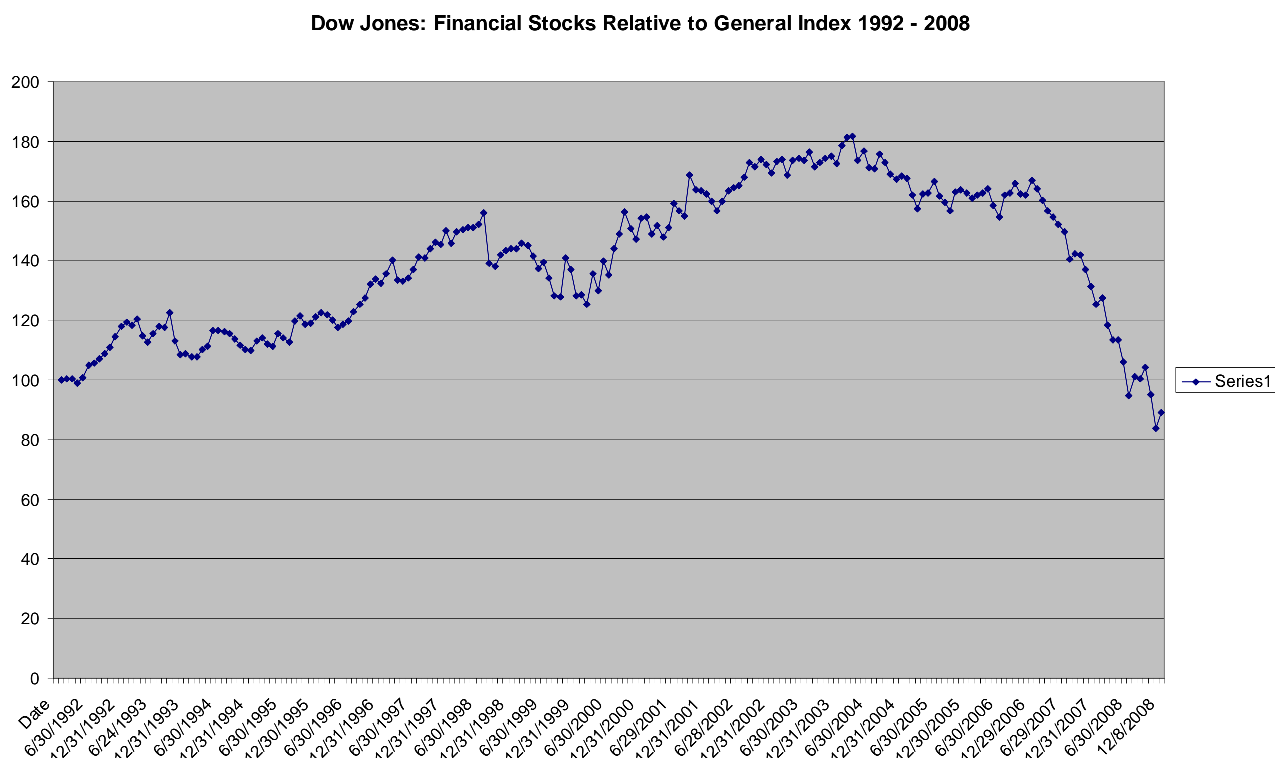
example, and whether financial internalization pose special risks. See Oliver E. Williamson, The Economic Institutions of Capitalism, 1985; Edith Penrose, The Theory of the Growth of the Firm, 1959; J. H. Dunning, Multinational enterprises and the growth of services: some conceptual and theoretical issues, Service Industry Journal, 1989, Vol. 9, pp. 5-39, and Christos N. Pitelis/Roger Sugden (eds.), The Transnational Firm, 1991. One of the few exceptions to this tendency is Geoffrey Jones, ed. Multinational and International Banking (Aldershot: Elgar, 1992), which includes several essays that develop a distinct view of multinational banking, many reprinted from other sources.

150 Thinking Big, The Economist, May 20, 2006, pp. 4-23.

151 Alan D. Morrison/William J. Wilhelm, Jr., Investment Banking: Institutions, Politics, and Law, 2007, pp.8-15.

152 Morrison/Wilhelm, Politics, and Law, 2007, p. 2.

FIGURE 2 (Source: Global Financial Data)



By the millennium, commercial banks had created a huge network of branches and subsidiaries all over the world. Most developed countries had accepted that foreign banks could do outside of their own country whatever they did inside. In the United States alone, foreign banks operate 300 branches – that is, entities that are not legally or financially distinct from their parents – and nearly 100 subsidiaries, mostly for making wholesale rather than retail loans. From 1975 to 2000, total assets by foreign banks grew in the United States from approximately $50 billion to $1.2 trillion, which by then accounted for approximately 20% of all banking assets in the United States.[153] In 2000 after its acquisition of Bankers Trust, Deutsche Bank, at that time briefly the largest bank in the world, headed the list of foreign banks in the United States with nearly $113 billion in assets.[154]

According to Citigroup, offering customers the ability to trade with the group to satisfy their customers' liquidity needs was a key strategic goal. Not only does the bank provide advice clients on new derivative instruments, it has to allow them an opportunity to trade them. For many of the derivative products especially, there would be no market if the bank did not provide one. This is especially important for most hedge funds, whose business model is highly dependent upon quickly exploiting asset price anomalies with ever increasingly refined derivatives for which there is no public market. The bank has invested huge resources in creating an internal market, in essence warehousing securities and derivatives to build hedged positions and for future sale. As of December 31, 2007, 25% of Citigroup's over $2 trillion in assets were being held for trading, up $145 billion from the year before, and nearly five times its equity capital. Trading liabilities amounted to nearly $200 billion. The bank's approximately $800 billion in investments were drawn from its affiliates all over the world. But

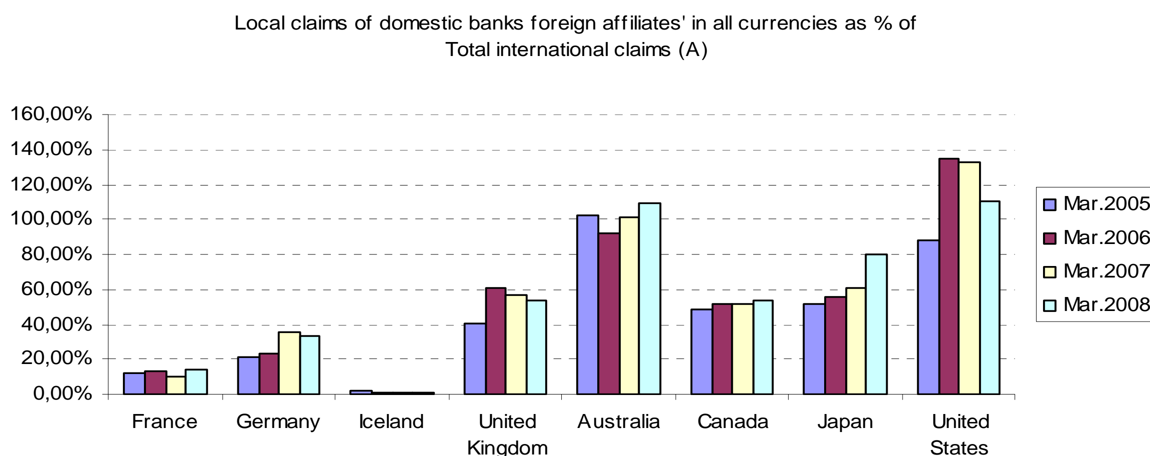
[153] Jane E. Hughes/Scott B. MacDonald, International Banking, 2002), pp. 27, 90-101, 149. By the early 90s, 280 foreign banks from 65 countries with 1,000 offices operated in the United States.

[154] Hughes/MacDonald, pp. 27, 90-101, 149.

investment activities were concentrated in the U.S. and U.K. markets.[155] Trading included fixed income, credit products, collateralized debt obligations (CDOs), equities, foreign exchange, and commodities. While the other trading revenues were smaller but consistently profitable, credit products lost money in 2005-6, and a huge $22 billion in 2007.[156] Overall, the trading of derivatives was approximately 35 times greater in 2000 than in 1988; by then, 90% of the total $109 trillion in transactions are over-the-counter private transactions (OTCs), mainly by banks, and not on organized exchanges.[157] Six years later, total derivatives trading had jumped by a factor of nearly five (to just under $500 trillion), with non-exchange contracts still accounting for the lion's share. Much of the growth came in interest rate contracts, but whole new segments like credit default swaps (CDS) sprung into existence. By 2008, just ten years after their invention, the notional value of CDS contracts measured approximately $60 trillion.[158] Like foreign exchange trading, a great many of these transactions are not driven by commercial transactions but rather are arbitrage-related.

Financial transactions are thus increasingly confined to transactions outside of public markets. Large transnational banks have effectively internalized many international capital flows, whose importance has grown with greater imbalances between savings and borrowing nations. The financial system began to act as a transmission mechanism for what Ben Bernanke called "the global savings glut." The increase in areas with excess cash and their greater distance from cash users has led to an expanded role and need for intermediaries and risk management outside of capital markets, adding, however, many other risks and complexities. The greater relative size of financial transactions and new financial instruments coupled with a great ability of these banks to tap into one national source of funds and pass them on to users of capital in other nations has all contributed to a much more "frictionless" global financial system, with more rapid and more complex worldwide impact, than fifty years ago. Given new regulations and the multinational structure of these institutions, banks have even been able to use cheap sources of funds, including the discount window at a large number of central banks, and to distribute the funds to their international units, in many cases with foreign exchange and other risks.

FIGURE 3 (Source: BIS)



(International claims are cross-border claims plus local claims of foreign affiliates in foreign currency. The numerator in this ratio is domestic banks claims in foreign and local currency, hence the ratio in some cases exceeds one.)

---

[155] Citigroup's 2007 Annual Report on Form 10-K, p. 66.

[156] Citigroup's 2007 Annual Report on Form 10-K, p. 129.

[157] Morrison7Wilhelm, p. 10.

[158] Ismail Erturk et al, Financialization at Work, 2008, pp. 4-9.

The international internalization of banking is even better seen in the activities of domestic affiliates of foreign banks, statistics that the BIS began to track only recently. For all countries, from June 2005 to March 2008, local claims of domestic banks foreign affiliates in all currencies grew by approximately 35%. As indicated by Figure 3, the growth rate of claims in host-country by affiliates of banks from developed home countries exceeded 35%, a little less than the rate for all countries, but far short of the nearly 50% rate of developing countries. All the countries in our sample had growth rates in the foreign bank portion of domestic (host country) claims of around or exceeding 30%. Moreover, on an ultimate risk basis (including guarantees), the domestic claims of foreign banks' affiliates make up a huge percentage of total international claims (cross-border and domestic of foreign-owned entities). In March 2008 in the United States, for example, they amounted to 110% of total international claims excluding the guarantees. As noted, for many years this aspect of global banking was off the radar screen or regulators.

FIGURE 4 (Source BIS)

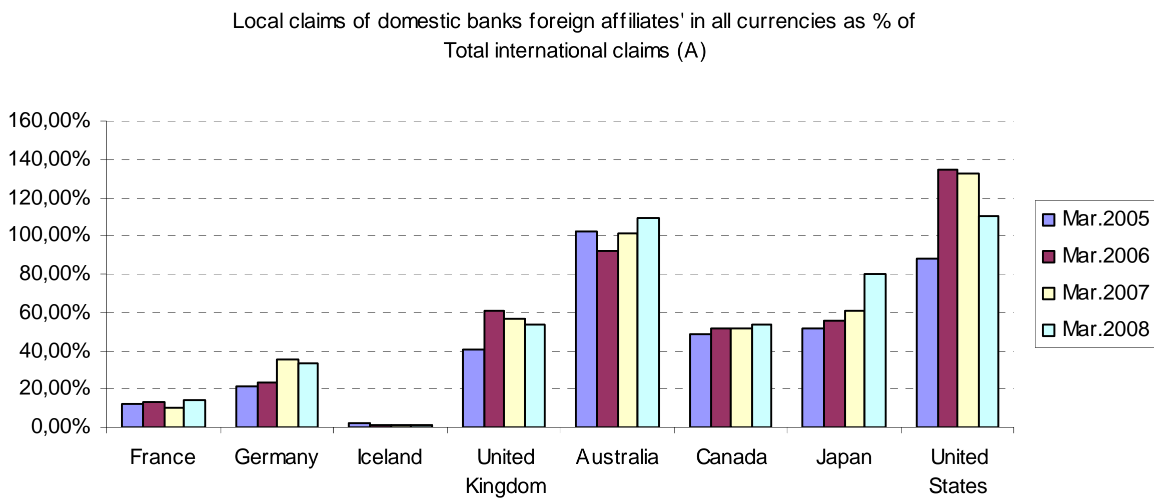


FIGURE 5 (Source BIS)

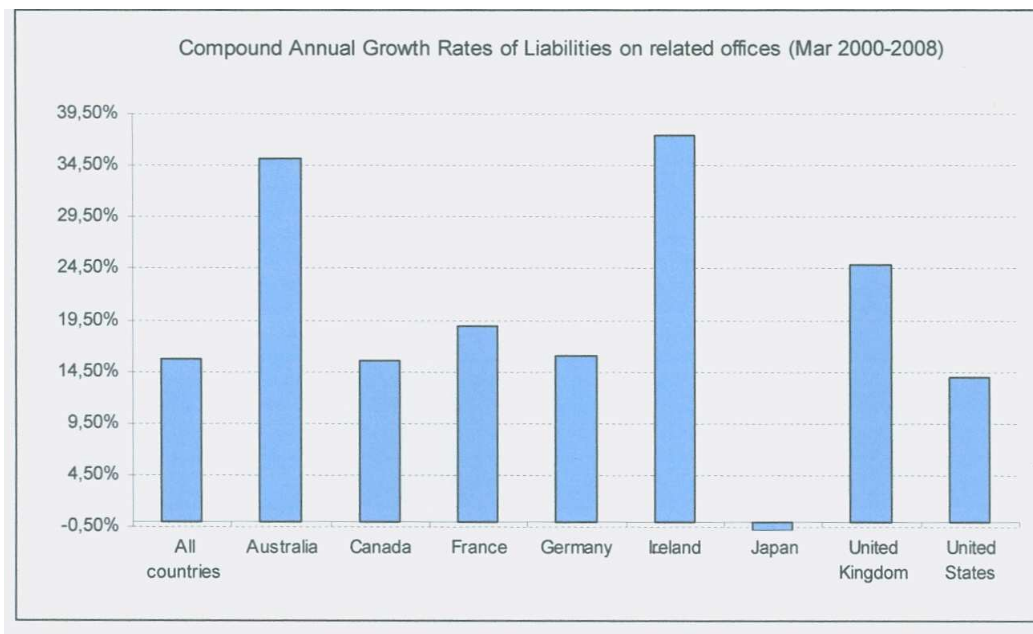
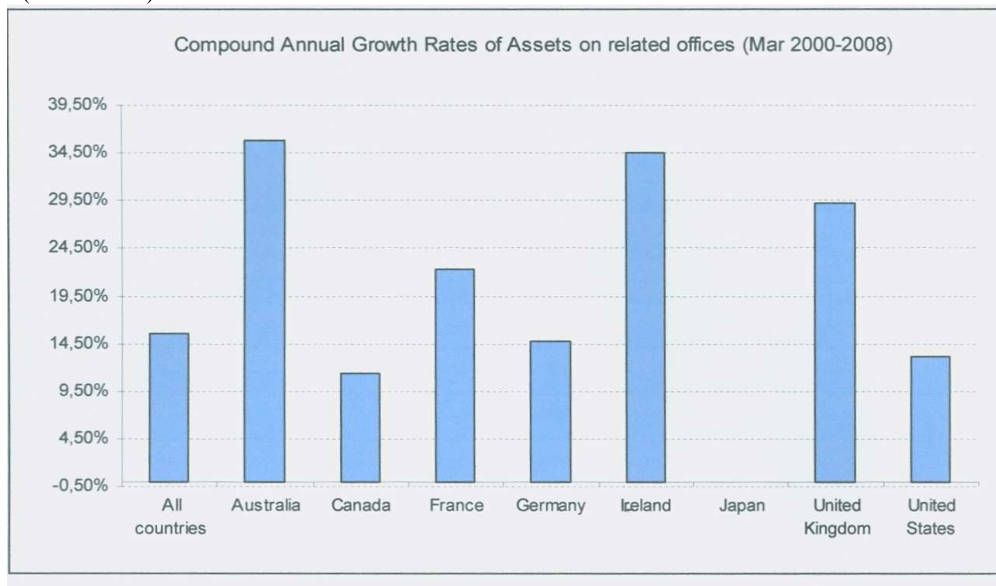


FIGURE 6 (Source: BIS)



From 2000 to 2008, intra-bank assets grew in all countries by approximately 14.5% per annum. In Iceland and Australia, they grew by around 35% per year and the United Kingdom was not far behind with 80%, followed by France, Germany and the United States with around 20, 15, and 13% respectively. For obvious reasons, the story with liabilities is similar (Figures 4 and 5).

The ability of large banks to access central bank liquidity in a variety of markets proved critical during the financial crisis. In 2007, when the Bank of England was pursuing a restrictive policy in order to limit moral hazard, large British institutions refinanced themselves through the ECB via their foreign branches. Smaller and more British institutions, such as Northern Rock, could not do that. Immediately after the Lehman collapse in September 2008, a major part of the Federal Reserve's liquidity went via foreign central banks to support major foreign institutions, to the dismay of the Fed's congressional critics.

II. Regulatory Dilemmas

Bigness has repeatedly brought problems for financial institutions: perhaps this might be seen as a financial equivalent to imperial overstretch. Almost inevitably, biggest bank in the world got into trouble. In the 1990s, the largest globally active banks of the world were mostly Japanese. Who now remembers Daiichi Kangyo?

The crisis of 2007-8 has produced a new answer to where the greatest competitive advantages lie. It is no longer best to be in the lightest regulatory regime, but where the state has the deepest pockets.

The most obvious lesson of the crisis was that a bank needed a strong national government to bear the potential costs of a rescue. Where very large banks exist in small territories with small-scale governments, the banks are vulnerable. Appropriate control is, however, both an economic and political issue. Big countries have the economic clout, but this does not necessarily give them the political will to act. The United States is big enough to handle behemoths such as Bank of America or Citigroup. China can handle its large banks, even if they have very large portfolios of poor credits.

European banks are in a more precarious situation. Small countries that evolved into major financial centers are especially vulnerable. Ireland, as well as Iceland, have become notorious cases of a financial sector that metastasized so as to destroy the host country. But even in the big and strong European countries, France and Germany, large banks and internationally active banks potentially exceed the government's capacity to mount a rescue. In addition, there is the complexity of disentangling which country is responsible for what part of a rescue, when for instance central European banks are controlled by an Austrian bank that is bought by a German bank that is then bought by an Italian bank.

Politically, the easiest way out often lies in blaming the foreign commitments of financial institutions. Gordon Brown complained about the international activities of failed banks such as Royal Bank of Scotland: "Almost all their losses are in subprime mortgages in America and related to the acquisition of ABN Amro. These are irresponsible risks taken by the bank with people's money in the UK." He added that the decision to buy ABN "was wrong".[159] An important part of the rescue operation of RBS was the selling off of foreign branches and activities. Elsewhere there are similar patterns, where governments which have taken stakes in banks demand a refocusing of business. Italian and Austrian banks had few domestic problems, but massive losses as a consequence of earlier large-scale purchases of banks in Central Europe. They will be pressed to retrench. UBS has sold its Brazilian operations, Commerzbank its Swiss business. The American giant Citigroup, which had established a presence in over a hundred countries, will also be slimmed down and its foreign exposure reduced, even though the large losses stemmed primarily from its U.S. business.

Consumers of financial products are likely to become more cautious about entrusting their assets to institutions in far away countries of whose regulatory regimes they known nothing. Only a few years ago, the endless corridors of Heathrow airport were decorated with advertisements for the services of

[159] Financial Times, January 21, 2008, p. 10, "Brown's misplaced financial patriotism." See also John Gapper's blog: http://blogs.ft.com/gapperblog/2009/01/gordon-browns-misplaced-financial-patriotism/ (accessed February 5 2009).

Icelandic and Nigerian banks. It is difficult to imagine that such institutions will continue to be attractive. Campaigns by the big industrial countries against tax havens will also have an effect on deterring foreign banking.

As a result, the big transnational institutions are lobbying hard for a European-wide approach to banking supervision and regulation (and implicitly for fiscal bailouts should that supervision and regulation fail).

Politicians also inevitably worry about big institutions, and about their potential instability. One obvious answer is to try to make them smaller, perhaps by legal limits, or more effectively and justly by the escalation of capital adequacy requirements. In the case of the banks that required state rescues, European competition rules are requiring divestment and downsizing. Institutions such as RBS, which for a time in 2009 headed the list of the world's largest international banks, are being pruned down by the interventions of the European Union's Directorate General for Competition.

Even the stronger European banks are being pressed to improve their capital ratios. This means in most cases that they will continue to cut back on lending. Such measures worsen the impact of the financial crisis on the rest of the economy. By contrast, in the United States, the government pushed big banks into buying up smaller and vulnerable banks, and is now doing everything it can to push banks to lend more.

Government reactions are full of paradoxes. The more we insist that a banking system should be competitive, the greater the risks that individual banks will take. The more governments are prepared to step in, and the greater the resources of those governments, the more the big banks and the big countries will be favored. The surprise announcement by President Obama on January 21 indicates just how worried the U.S. administration is about the political consequences of bigness as well as the degree to which it may have perceived added political gain in attacking plutocrats. Governments all over the world need to be seen to be doing something about the problem of big banks.

The last twenty years of globalization saw the emergence of small open economies as global leaders. The next twenty years will see a different globalization, in which the winners are large powerful countries that will mobilize government resources in the interest of creating winners in the race for financial supremacy.

III. Geopolitical Change and Economic Crisis

Very large financial crises have often accompanied geo-political shifts. One possible scenario is that this crisis will produce a new geography of power, as a consequence of the renationalization of finance, and of the new popularity of fiscal Keynesianism.

One of the hallmarks of eras of financial globalization is that they permit large movements of capital that are used to finance big current account imbalances, in other words very different levels of savings and investment in different national contexts. Before the First World War, a very vigorous and dynamic era of globalization pushed European capital, mostly from Britain and France, to the rest of the world, especially North and South America. As in previous periods, fiscal stimuli involving deficit finance today involve large inflows of foreign capital, which then as now are to a substantial extent channeled through the financial system. Since the 1980s, a new wave of financial globalization saw a different kind of movement: capital flowed largely out from many developing countries, as well as from Japan and Germany, and into the United States. Many commentators now see that those capital flows fueled a bubble in the United States that was bound to burst. Though by far the largest case, the United States is not alone in its dependence on foreign capital, which was a characteristic shared by many so-called Anglo-Saxon economies, notably the UK, Ireland and Australia, as well as Spain, and many smaller central and east European economies. The current crisis has called into question the sustainability of massive imbalances and the mechanisms used to achieve them.

The regulatory response confronts a choice between national versus international approaches to adapting the financial architecture. The level of cross-border flows has already shrunk dramatically since the outbreak of the crisis. It is likely to shrink still further if regulatory intervention reflects and adds to a new financial nationalism.

A national approach will try to stop many kinds of cross-border flows and scale down the activities of supranational banks' ability to operate in many different jurisdictions. This would mean a return to simpler finance – and less international financial intermediation. Eisuke Sakakibara recently made a plea for old-style local lending and borrowing: "That was what pre-Meiji Japan was like. We should go back to that." Amar Bhide has called this idea "retro finance". There are various possibilities – splitting banks up regionally, progressive taxing of banks to penalize large institutions, or the progressive increase of capital requirements.[160]

Multiple and contrasting national answers make international responses harder. Dominique Strauss-Kahn, the Managing Director of the International Monetary Fund, has correctly emphasized that

> "national mechanisms are part of a larger global network. While there is a process of collaboration to bridge the problem of local regulators dealing with global banks, many countries are approaching bigger-picture reforms from different directions and at different speeds. In the process, a central lesson of this crisis is being forgotten: that co-ordination works better than unilateralism."[161]

An international approach might involve an agreement on several points:

1. Whether and how much of an international tax (insurance payment) should be made and by whom it should be collected and distributed to cover the cost future financial bailouts.
2. The degree to which banks can privately transact non-traded securities (not proprietary trading, but rather all transactions), probably as some agreed proportion of capital.
3. Lastly, and perhaps most importantly, that the major economic powers acknowledge their respective international responsibility in fiscal as well as in regulatory issues. In addition to the regulatory issues mentioned above, China, the United States, and the European Union especially have important fiscal responsibilities that must be respected.

Where this agreement is made will be crucial. It cannot be made bilaterally, between the United States and China; the G-20 is too small a forum and is not really representative of the whole international community; and the IMF appears to many to be too US-dominated. An IMF with a more balanced distribution of power may be the answer, but such an institutional reform presents major difficulties.[162]

The crisis has also revived an older approach to fiscal issues. As financial systems appear unstable, as lending is cut back, and as output plummets, there emerged an increasingly strong case that the cut in demand should be compensated by fiscal action**.** Keynes and Keynesianism were back in fashion. China's 4 trillion RMB stimulus appears to be highly successful, but it may well herald an excessive concentration on prestige projects and expensive infrastructure; and it has not yet triggered the growth in consumer spending that would be needed to tackle the imbalances (surplus) problem. The U.S.'s $787 billion stimulus package was immediately effective in preventing a worse slide into high levels of unemployment in the immediate aftermath of the financial crisis, but it does little to address long-term problems of U.S. competitiveness. The heated rhetoric and pork barrel division of spoils that were required in order to insure passage of the bill and to extract the maximum political gain have undermined its beneficial impact on investor and consumer confidence. In addition, "once-off"

[160] Financial Times, March 5, 2009, p. 15, David Pilling, "Japan harks back to an age of innocence." Amar Bhide, "In praise of more primitive finance," Berkeley Electronic Press: Economists' Voice, February 2009.

[161] Financial Times, February 17, 2010.

[162] For a suggestion on how this might be achieved, see Michael Bordo/Harold James, The Past and Future of IMF Reform, in Charles Wyplosz (ed.), Festschrift for Alexandre Swoboda, Geneva, 2010.

stimulus packages have also led to calls for the continuation and extension of such injections of demand. Like many medicines, stimulus packages may conceal real sources of pain and become addictive. Japan, despite its high debt level, may well work out a big stimulus package, but prior attempts to spend its way out of the economic doldrums have had little impact, and is already in the position of having to borrow in order simply to service its debts. Such a position makes for great vulnerability in the face of a likely increase in the cost of financing debt.

For the moment, however, there is little doubt that the United States or China, or some of the large European states, can afford an immediate stimulus.

By contrast some small countries, like Greece or Latvia Ireland, have already reached or exceeded the limits for fiscal activism; and there is – as in the 1930s – a threat of countries going bankrupt. Europe has recently been mesmerized by the Greek trauma, and Greeks are reminding their fellow Europeans of the ancient Greek reform under Solon of the *Seisachteia* or unburdening of debt. The fiscal problems of the some Mediterranean countries provide a reminder that the Eurozone has not yet adequately addressed the fiscal side of becoming a currency zone. In the early 2002, the fiscal restrictions of the Growth and Stability Pact were progressively watered down. In smaller countries, and in most of Europe, Keynesianism does not work as well. The divergent fiscal stances means that Keynesian–style answers are only possible in a limited number of nation-states. France and Germany could afford them, while Greece, Italy and Portugal could not. In between these extremes lay countries such as Spain and Ireland, where the fiscal performance before the outbreak of the crisis had been quite solid, but where a fiscal solution to bank and indebtedness problems made for a sudden spike in public sector deficits. When Ireland started to rescue banks, the cost drove its fiscal balance from a surplus of almost 3 percent of GDP in 2006 to a projected deficit of over 11 percent for 2009. Outside the Eurozone, the same arithmetic concerning the public assumption of previously privately held debt also hit the U.K. Furthermore, Europeans are worried that the effects of stimulus measures would simply spill over to other countries, leaving simply increased long-term burdens for the taxpayer. The decision-making of European states is paralyzed in the face of alternatives that do not look practicable: either concentrating more on a European-level fiscal stimulus (for which there is no political will); or taking measures to ensure that fiscal stimuli benefit national economies (which would be counter to the fundamental orientation of the EU as an integrated market).

The argument thus far can be summarized as follows. Finance will come under increasing political pressure to turn in a national direction. Only big states can really do Keyensianism well, but they may find it addictive. But a third consideration enters here. Only big states with high savings ratios (in other words, the large Asian surplus countries, notably China) are likely to be able to support the new state-centered Keynesian approach. The U.S. National Intelligence Council is already talking about China leading a resurgence of what it terms "state capitalism."[163]

One of the most obvious indicators of globalization was the measurement of the size of current account imbalances. Reducing current account imbalances is the hallmark of deglobalization. Retrospectively, we may wonder whether al our catastrophe might not have been avoided if Chinese or Korean investors had – as they almost did – bought Lehman in the summer of 2008. But they did not, and Asian investors are likely to be cautious about foreign financial institutions for a long time. As credit disintermediation sets in, savers are likely to want to place their money in institutions nearer home, that they can have more confidence in, rather than in obscure banks on the other side of the world. The move to a simplified financial system will also in consequence strengthen Chinese financial institutions, and make them more important players in the world economy. The three largest banks by market capitalization are Chinese: Industrial and Commercial Bank of China, China Construction Bank, the Bank of China.

---

[163] National Intelligence Council, Global Trends 2025: A Transformed World (Washington D.C., 2008), p. 8.

Traumatic financial crises usually also involve a new geography of power. One of the most pervasive and persuasive interpretations of the interwar Great Depression was that offered by Charles Kindleberger, who presented the political paralysis as a concomitant of a shift in power from Britain to the United states, from the *pax Britannica* of the late nineteenth century to the *pax Americana* of the late twentieth century.[164] In the 1930s, he argued, Britain was willing to promote international action to stabilize the world, but was ruined by the First World War and thus unable to undertake the stabilization. By contrast, the United States, which had emerged from the World War as the largest creditor nation, was not politically mature enough to undertake the rescue of the international system. At the time, there were all kinds of convincing reasons why Americans should not want to take on the burden of a worldwide rescue: sending more money to Europe might be seen as pouring money down a drain; had not the Europeans fought a World War that had been the fount and origin of the financial mess? Economically such action would have made a great deal of sense from a long-term perspective; but politically it was a non-starter with no short-term payoff at all.

Kindleberger's interpretation of the Great Depression sheds light on our responses to the events of 2007-9: a deep financial crisis that emanated in the United States, and which seemed the result of specifically American ways of doing business, must surely be the twenty-first century equivalent of the British malaise**.** It is consequently easy to imagine that it marks the beginning of a new and fundamental power shift. The German Finance Minister at an early stage of the development spoke of the 2008 crisis as marking "the end of the American era of global finance."

As a provider of funds, China is the America of this century. But in the interwar period, the United States was by far the world's largest and richest economy, as well as being the major provider of funds in the international capital market. China's relative economic weight is much smaller, and its population is much poorer**.** Such a constellation is likely to produce a political demand for the greater use of resources in a domestic setting. The initial stages of the credit crunch in 2007 were managed so apparently painlessly because sovereign wealth funds from the Middle East, but above all from China, were willing to step in and recapitalize the debt of American and European institutions. The future will depend on the extent to which surplus countries will be willing to finance not only problematical financial institutions, but also highly indebted governments – American and European. The financial crisis raises not just issues of competition between and among financial institutions, but also geo-political challenges.

---

[164] Charles Kindleberger, The World in Depression, Berkeley: University of California Press, 1973.

Bibliography

Amar Bhide, In praise of more primitive finance, Berkeley Electronic Press: Economists' Voice, February 2009

Michael Bordo/Harold James, The Past and Future of IMF Reform, in Charles Wyplosz (ed.), Festschrift for Alexandre Swoboda, 2010

R.H. Coase, The Nature of the Firm, Economica, Vol. IV, No. 4, 1937

J. H. Dunning, Multinational enterprises and the growth of services: some conceptual and theoretical issues, Service Industry Journal, Vol. 9, pp. 5-39, 1989

Ismail Erturk, et al, Financialization at Work, 2008

Jane E. Hughes/Scott B. MacDonald, International Banking, 2002

Geoffrey Jones (ed.), Multinational and International Banking, 1992

Charles Kindleberger, The World in Depression, 1973

Christopher Kobrak, Family Finance: Value Creation and the democratization of cross-border governance, Enterprise and Society, March 2009

Alan D. Morrison/William J. Wilhelm, Jr., Investment Banking: Institutions, Politics and Law, 2007

Edith Penrose, The Theory of the Growth of the Firm, 1959

Christos N. Pitelis/Roger Sugden (eds.), The Transnational Firm, 1991

Oliver E. Williamson, The Economic Institutions of Capitalism, 1985

European
University
Institute
European University Press