EUROPEAN FINANCIAL INTEGRATION:

Economic aspects, the existing legal framework and the way ahead[1]

Christos Vl. Gortsos

Associate Professor of International Economic Law,

Panteion University of Athens (*)

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Abstract

The process of European financial integration has been put forward in the European Community mainly during the last three decades, in stages, but at a gradually intensified pace. This process, whose starting point was the complete fragmentation of its member states' financial systems, is constantly evolving and aims at shaping a single financial area within its common market.

In principle, implementation of financial integration is sought either through the regulatory framework established by intergovernmental and/or supranational authorities, or through self-regulation, or, finally, through market-led initiatives. In the Community, implementation of financial integration through the regulatory framework is sought (and achieved) by the adoption of the provisions of the legal acts constituting the sources of European financial law.

The aim of this study is confined to this latter aspect of European financial integration. Accordingly, it is structured in three sections:

(a) Section A contains two sub-sections:

- the first is devoted on the one hand to the definition of the concept, and on the other hand to the two dimensions of financial integration (under 1), while
- the second provides a short overview of financial policy objectives and financial policy instruments in developed market-based economies (under 2).

(b) Section B lays down the stages of development of European financial law, which is then defined in two alternative ways, and concludes with an overview of the fundamentals of European banking law, one (and probably the most significant) of the branches of European financial law.

(c) Section C concludes by shortly exploring the way ahead, with specific emphasis on the most significant new political benchmark which will influence the development of European financial law, notably the 2009 "de Larosière Report".

Keywords: financial integration, financial policy objectives, financial policy instruments, bank safety net, European financial integration, European financial law, European banking law, current financial crisis

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A. Economic aspects

1. The reference framework

1.1 Functions and infrastructures of the financial system

In every economy operating under free market conditions ("market-based economies"), the financial system is the system by which two main economic functions are being performed:

(a) The first function is the channelling of funds from households, firms and governments that have saved surplus funds by spending less than their income (the "positive savers") to those that have a shortage of funds because they want to spend more than their income ("the negative savers").[2] The channelling of funds is performed:

- either indirectly, with the intermediation of specialised financial firms,[3] called "financial intermediaries", mainly banks and insurance firms,[4]
- or directly, through the placement of stocks and bonds to the public in primary money and capital markets, which are then traded in secondary markets[5] (alongside with derivative financial instruments),[6] where certain categories of financial firms provide services (investment services) to both issuers (negative savers) and investors (positive savers).[7]

In this context, the financial system contains three main sectors: the banking sector, the insurance (and reinsurance) sector, and the capital markets sector.

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[2] From the very extensive literature on this function, see indicatively **Mishkin (2007)**, p. 23-25, and **Stillhart (2002)**, p. 8-12.

De Haan, Oosterloo and Schoenmaker (2009), p. 3-4, define this function as the main "task" of the financial system (with reference to **Mishkin (2007)**), considering that its functions are:

- the reduction of information and transaction costs, and
- the facilitation of the trading, diversification and management of risk (*ibid*, p. 6-10).

To the author's opinion, the latter constitute the main objectives of the financial system's first function.

[3] The terms "financial firms" and "financial services providers" are used in this study as synonymous.

[4] See in detail **Stillhart (2002)**, p. 12-121, **Allen and Santomero (1999)**, **Allen (2001)**, **Allen and Gale (2001)**, and **Gorton and Winton (2002)**. See also **Mishkin (2007)**, p. 39-42, and **De Haan, Oosterloo and Schoenmaker (2009)**, p. 5-6, and in particular for banking, p. 205-212.

[5] The distinction between money markets and capital markets relates to the initial duration of the securities issued: money markets trade in short-term corporate and government bonds (with an initial term of up to one year), while capital markets trade in long-term bonds, as well as stocks of listed companies. For the sake of brevity, only the term "capital market" will be used hereinafter, including both money and capital markets.

[6] On these instruments, see **Cox and Rubinstein (1985)**, and **Hull (1997)**.

[7] See **Mishkin (2007)**, p. 25-32, and **De Haan, Oosterloo and Schoenmaker (2009)**, p. 65-72.

(b) The second function of the financial system consists in the issuing and acquiring of payment instruments as well as the provision of other payment services for those agents who wish to make and accept payments without the use of cash (*i.e.*, banknotes and coins, issued by central banks and governments, respectively).[8]

The performance of these functions requires the existence of specific infrastructures. The main infrastructures of the financial system are:

- the systems for the clearing and settlement of payments with regard to the various payment instruments and other payment services, and
- the systems for the settlement of transactions in financial instruments traded in capital markets (stocks, bonds and derivatives) (collectively referred to as "payment and settlement systems").[9]

1.2 Definition of the concept of financial integration

Financial integration between two or more sovereign states is one of the dimensions of their microeconomic integration which, along with the macroeconomic integration, are the two components of economic integration in general.[10] Meanwhile, financial integration falls within the broader process of financial internationalisation,[11] but usually materializes at regional level and has a deeper penetration in the financial system of participating states. According to a recent study of the European Central Bank (hereinafter the "ECB"):

"Taking as a starting point the view that national financial systems have historically been segmented, financial integration is part of the currently heavily emerging process of financial internationalisation. Evidently, however, the process of financial integration aims at deeper results in comparison to that of financial internationalisation, because its ultimate purpose is the establishment and functioning of a single financial area within the context of a common economic area ("microeconomic integration"). It may be even deeper if the states concerned strive also at "macroeconomic integration", as it is the case in the European Community, which has already achieved its monetary unification".[12]

To the extent of the author's knowledge, there is no commonly accepted definition of financial integration in the relevant literature. In view of this, the point of reference used is the following definition, adopted by the ECB:[13]

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[8] See **Stillhart (2002)**, p. 121.

[9] See **De Haan, Oosterloo and Schoenmaker (2009)**, p. 136-151.

On the interdependencies of payment and settlement systems, see the relevant study of the **Committee on Payment and Settlement Systems (2005)** (available at the following internet address: http://www.bis.org/publ/cpss84.htm).

[10] The author defines microeconomic integration as the aggregation of the markets (for the provision of goods and services) of the sovereign states participating in the process, with a view to creating a common economic area. On the other hand, macroeconomic integration is defined as the harmonisation-unification of the instruments for the conduct of the macroeconomic policies of the states participating in the integration process, with a view to implementing single macroeconomic policies.

[11] *See* **Herring and Littan (1995)**, p. 13-48.

[12] **European Central Bank (2007)**.

[13] **European Central Bank (2008a)**, p. 6.

"The ECB (…) considers the market for a given set of financial instruments or services to be fully integrated when all potential market participants in such market are subject to a single set of rules when they decide to deal with those financial instruments or services, have equal access to this set of financial instruments or services, and are treated equally when they operate in the market.

This integration can be achieved through initiatives of the market itself ("market-led process of integration"), through self-regulation, and/or through binding rules stemming from intergovernmental or supranational institutions."

Based on this, for the purpose of this study financial integration is defined to mean the aggregation of the financial systems of two or more sovereign states within the framework of the operation of a common economic area

- aimed at meeting the three (3) aforementioned conditions pertaining to the operation of a single financial area, and
- sought either through the regulatory framework established by intergovernmental and/or supranational institutions, or through self-regulation, or, finally, through market-led initiatives.[14]

International, including European, experience, has demonstrated the difficulties of implementing (and in some cases even approaching) full financial integration.[15] *This is mainly due to two closely linked factors:*

(a) *As a rule, the starting point of the financial integration process is the effort to amalgamate fragmented national financial systems, which present significant differences in many of the components of their structure and their infrastructures, the terms of operation of financial services providers, as well as the objectives for regulatory intervention in the financial system and even more the instruments employed for implementing this intervention.*

(b) *Moving this process forward meets usually with resistance from participating states, which are confronted with the loss of power to exercise autonomous regulatory intervention in the financial system.*

1.3 The two dimensions of financial integration

1.3.1 Negative financial integration

To the extent that financial integration is sought through the regulatory framework, it has two dimensions: the negative and the positive one. The materialisation of negative financial integration requires on the one hand the liberalisation of trade in financial services,[16] and on the other hand, the adoption of rules to ensure free competition in the financial system, a policy objective of primary importance for the entire common economic area (*i.e*., non-specific to the financial system).[17]

[14] For a detailed presentation of these conditions which, when met, signify the achievement of full financial integration, *see* **European Central Bank (2008a)**, p. 64-65.

[15] The result of a successful financial integration process is the creation of a single financial area among participating states, *i.e*., the materialisation of financial integration *per se.*

[16] On this aspect of financial integration in the European Community as applied in the banking sector, see below in Section B of the present study, under 2.2.1.

[17] See **Bellamy & Child (2008)**, p. 40-42.

Implementation of this dimension of financial integration should be considered as constituting the necessary condition to achieve full financial integration.

1.3.2 Positive financial integration

The content of positive financial integration, which constitutes the sufficient condition to achieve full financial integration is, in the author's view, twofold:

(a) Initially, according to a "*stricto sensu* approach", the achievement of positive integration requires the adoption of rules that will enable achieving, within the single financial area, the objectives for regulatory intervention in the financial system, *i.e.*, achieving specific financial policy objectives. These rules must be designed as to ensure conditions of competitive equality among all categories of financial services providers which are operating in the single area, are offering similar services and are exposed to similar risks.

In this context, there are three (3) issues of primary importance that need to be dealt with:[18]

(aa) The first concerns the identification of the necessary financial policy objectives and the appropriate financial policy instruments in order to achieve the former. This aspect will be examined more closely just below (under 2).

(ab) The second issue concerns the level and extent of harmonisation within the single financial area of the rules according to which regulatory intervention should be exercised in order to achieve the identified financial policy objectives.[19]

(ac) The third (related) issue concerns the identification of the administrative authorities (and in certain cases schemes[20]), which should be competent for the exercise of regulatory intervention in the financial system. In this respect, decisions need to be taken with regard to two sub-issues:

- whether these authorities and schemes should remain national or become supranational, and
- in the first case, whose country's authorities and schemes should be competent with respect to the foreign establishments (*i.e.*, branches and subsidiaries) of financial firms operating in several states within the single financial area.[21]

(b) The second (and undoubtedly more ambitious) aspect of positive financial integration consists in the adoption of a single set of rules with respect to the provision of financial services, namely a single "financial contracts and mortgage credit law". Achieving this target as well, according to a "*lato sensu* approach" of positive financial integration, requires the full harmonization of the respective aspects of private law of the states participating in the single financial area.

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[18] See in detail **Gortsos (1996)**, p. 79-89.

[19] On this aspect of financial integration in the European Community as applied in the banking sector, see in Section B of the present study, under 2.2.2.1.

[20] See in more detail just below, under 2.

[21] On this aspect of financial integration in the European Community as applied in the banking sector, see in Section B of the present study, under 2.2.2.2.

2. Financial policy objectives and instruments in developed market-based economies

2.1 Introductory remarks

The financial system is one of the sectors of the economy that are subject, in almost all states in the world, to heavy regulatory intervention.[22] The extent of this intervention is nevertheless graduated and there are significant differences mainly between developed market-based economies, on the one hand, and less developed ones, on the other, mainly because the policy objectives are usually different. While in less developed economies regulatory intervention in the financial system, and notably in the banking sector, aims primarily at meeting specific economic and broad social objectives,[23] in economically developed states:

- the policy objectives for regulatory intervention are primarily linked to the proper functioning of the financial system, and
- their main (even though not single) task is to overcome market failures arising in the financial system.[24]

The main aspects of the latter form of financial regulatory intervention will be discussed in more detail just below (under 2.2-2.6).[25] At this point it should only be mentioned that the financial policy objectives justifying regulatory intervention in the financial system at any time cannot be exhaustive, given that the conditions prevailing in the economy and in society may give rise to additional ones in the future. The dynamics of this variability is clearly demonstrated by the fact that certain policy objectives applying today, did not apply just a few years ago. In particular:

- the rationale for regulatory intervention in the financial system with a view to combat consumers' overindebtness arose in the late 1990s, as a result of the full liberalisation of consumer credit and the subsequent extensive exposure of households to debt,

[22] A bold exception constitute the so-called "offshore financial centres", which are characterised by the existence of a lax regulatory and supervisory regime in their financial system (coupled with favourable tax conditions).

[23] *See* **The World Bank (1989)**, p. 54-69.

[24] On market failures, and in particular on negative externalities and information asymmetries, see **Mercuro and Medema (2006)**, p. 60-67, and in more detail **Ippolito (2005)**, p. 153-379.

For an overall examination of financial policy objectives, see **Herring and Santomero (2000)**, p. 2-11. Even though with differentiations, the author is following closely their analysis.

[25] The following analysis is based on the so-called "public interest approach" of regulatory intervention, according to which financial regulation is intended to promote the public good by requiring individuals and firms to change their preferred behaviour in ways that will benefit others. This is contrasted to:

- the "public choice theory approach", according to which regulation is the outcome of the efforts of interest groups, politicians, and bureaucrats to use the political process for their own personal benefit, and
- the "industrial organisation theory approach", according to which financial regulation exists as a response to the demand of financial firms and their clients for certification of soundness and facilitation of the clearing and settlement of transactions.

See **Herring and Littan (1995)**, p. 79-84.

- the rationale pertaining to the combating of terrorist financing through the financial system arose mostly following the terrorist attacks in the USA on September 11, 2001,

- the rationale to deal with the adverse consequences for public finances arising in connection with banks which are exposed to insolvency, but have grown "too big to be left to fail" (or are "too interconnected to be left to fail"), especially if those are operating internationally, is currently predominant in the financial policy agenda of the recent financial crisis.[26]

2.2 Ensuring the stability of the financial system

The first (and primary) policy objective justifying regulatory intervention in the financial system of economically developed states is ensuring the financial system's stability, which may be threatened by the occurrence of so-called "systemic crises". In this framework, there are five individual, yet closely linked, individual financial policy objectives (based on the distinct sectors and the infrastructures of the financial system):

(a) The first objective is to ensure the stability of the banking sector by preventing the evolution of negative externalities in the form of contagious bank failures (*i.e.*, by preventing bank failure chain reactions).[27] The policy instruments employed to obtain this objective constitute the so-called "bank safety net"[28] and are being materialised by the adoption of rules concerning:

- the licensing of banks by competent (administrative) authorities,

- the micro-prudential supervision of banks by competent (administrative) authorities,[29] and the macro-prudential supervision of banks by central banks (in their capacity as monetary authorities),[30]

[26] This problem, which is closely related to the policy objective of ensuring financial stability (see just below, under 2.2), is definitively not new. On the recent concrete proposals to deal with see **Basel Committee on Banking Supervision (2009)**: *Report and Recommendations of the Cross-border Bank Resolution Group*, Consultative Document (available at the following internet address: http://www.bis.org/publ/ bcbs162.pdf).

[27] From the very extensive literature on this financial policy objective, see **Herring and Litan (1995)**, p. 50-61. Regarding the synergies between the stability and the effectiveness of the financial system, see **Barth, Caprio, Levine (2006)**, p. 307-309.

[28] *See* **Herring and Santomero (2000)**, p. 17-21 (based on **Guttentag and Herring (1988)**). According to the authors, the components of the bank safety net can be viewed as *"a series of circuit breakers designed to prevent a shock to one bank from spreading through the system to damage the rest of the financial grid"* (*ibid*, p. 17).

It is worth mentioning that while the two first components of the bank safety net are preventive in nature, the others should be considered as protective ("crisis management") financial policy instruments.

[29] On the licensing and micro-prudential supervision of banks, see in detail **Barth, Caprio, Levine (2006)**, p. 110-132. On the best international practices with regard to the licensing and micro-prudential supervision of banks, see **Basel Committee on Banking Supervision (2006)**: *Core Principles for Effective Banking Supervision* (available at the following internet address: http://www.bis.org/publ/ bcbs129.pdf).

[30] On the distinction between micro-prudential and macro-prudential supervision of banks and other categories of financial firms and the content of macro-prudential supervision, see **Borio (2003)**.

- the implementation of reorganisation measures and winding-up proceedings to insolvent banks by competent (administrative and/or judicial) authorities,[31] and
- the operation of deposit guarantee schemes.[32]

The operation of the central bank (in its capacity as monetary authority) as a lender of last resort for solvent banks exposed to illiquidity[33] and the neutralisation by the monetary authority of any shift in the public's excessive demand for cash in periods of crisis, in order to protect the cumulative collapse of the financial system,[34] constitute the last components of the bank safety net, resort to which is usually not based on legislative rules but on discretionary decisions of central banks.[35]

(b) The second objective is ensuring capital markets' stability, which may be disrupted, either due to an abrupt and large scale price fluctuation of financial instruments traded therein, or due to the bankruptcy of a financial intermediary offering investment services.[36] The achievement of this objective is sought by the adoption of rules concerning:[37]

- the authorisation, oversight and ongoing regulatory supervision of securities exchanges and other markets for trading in financial instruments by competent (administrative) authorities, and
- the licensing and micro-prudential supervision of financial firms providing on an individual basis investment services in capital markets by competent (administrative) authorities.

(c) The third objective is ensuring stability in the insurance (and re-insurance) sector of the financial system from the risk of bankruptcy of enterprises offering insurance and reinsurance services.[38] Its achievement is sought by the establishment of

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[31] On this component of the bank safety net, see in detail **Santomero and Hoffman (1999)**.

[32] On this component of the bank safety net, see in detail **Carisano (1992)**.

On the best international practices with regard to the operation of deposit guarantee schemes, see **Basel Committee on Banking Supervision and International Association of Deposit Insurers (2009)**: *Core Principles for Deposit Insurance Systems* (available at the following internet address: http://www.bis.org/publ/bcbs156.pdf).

[33] On this component of the bank safety net (in both national and international contexts), see, among others, **Guttentag and Herring (1983)** and **(1987)**.

[34] This circuit breaker is closely linked to the conduct of monetary policy and provides a good manifestation of the close links existing between the monetary and the financial system.

[35] On whether the last resort lending function should be explicit or "constructively ambiguous", see **Guttentag and Herring (1987)**, p. 167-172.

[36] See **IOSCO (2008)**: *Objectives and Principles of Securities Regulation*, p. 6-7 (available at the following internet address: http://www.iosco.org/library/ index.cfm?section=pubdocs).

This argument, however, is challenged by authors claiming that the risk of contagious failures of investment firms is limited (*see* **Haberman (1987)**, and **Herring and Litan (1995)**, p. 72-73).

[37] On the best international practices with regard to this aspect, see **IOSCO (2008)**, principles 21-23, 25-26, and 29.

[38] See **Herring and Litan (1995)**, p. 73-74.

rules concerning the licensing and micro-prudential supervision of insurance and reinsurance undertakings by competent (public) authorities.[39]

(d) The fourth objective concerns safeguarding the financial system, as a whole, from the occurrence of widespread financial crises in the economy, resulting from the assumption of excessive risks by the so-called financial conglomerates, comprising banks, insurance companies and investment firms. The achievement of this objective is sought through the adoption of rules concerning the "supplementary" prudential supervision of these groups by competent (administrative) authorities.[40]

(e) Finally, the fifth objective consists in ensuring the normal and smooth operation of payment and settlement systems. The risk to such systems consists in the contagion of liquidity and/or solvency problems from one member of the system to another, with all the adverse systemic consequences this may potentially have for the functioning of the financial system.[41] Control of exposure to this risk is carried out through the proper oversight of payment and settlement systems.[42]

2.3 Other policy objectives relating to capital markets

2.3.1 Safeguarding the protection of investors and capital markets' integrity, efficiency and transparency

The second policy objective for regulatory intervention in the financial system is related to:

- safeguarding the protection of investors that wish to invest, or already invest, in primary and derivative financial instruments, that either will be listed in a regulated market (primary market), or are already being traded therein (secondary market),[43] as well as
- safeguarding capital markets' integrity, efficiency and transparency.[44]

The "close" character of the connection between these two financial policy objectives with regard to capital markets is due to the fact that they share, to a large extent, the same financial policy instruments, making the distinction often difficult.[45]

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[39] On the best international practices with regard to this aspect, see **International Association of Insurance Supervisors (2003)**: *Insurance Core Principles and Methodology* (available at the following internet address: http://www.iaisweb.org/_temp/Insurance_core_principles_and_methodology.pdf), principles 1-23.

[40] The supervision exercised on such conglomerates is supplementary in nature. Namely it is exercised additionally to the supervision exercised on the participating financial firms on an individual basis and on a consolidated basis within homogeneous activity groups. See **Dierick (2004)**, p. 20-26.

[41] See **Committee on Payment and Settlement Systems (2001)**: *Core Principles for Systemically Important Payment Systems*, Bank for International Settlements, January (available at the following internet address: http://www.bis.org/publ/cpss43.htm), section 2.

[42] See **Committee on Payment and Settlement Systems (2005)**: *Central Bank Oversight of payment and settlement systems*, Bank for International Settlements, May (available at the following internet address: http://www.bis.org/publ/cpss68.htm).

[43] See **IOSCO (2008)**, p. 5-6.

[44] *Ibid*, p. 6.

[45] *Ibid*, p. 5.

The achievement of this objective is sought by the adoption and implementation of four (4) sets of rules concerning the following areas:[46]

(a) The first set of rules applies to the issuers of transferable securities in capital markets and refers to:

- the corporate governance (including internal audit mechanisms) of listed companies,
- listing particulars for potential issuers,
- prospectus requirements for potential issuers,
- the periodical dissemination of information by listed companies,
- the protection of rights and interests of minority shareholders in the case of takeover bids, and
- accounting and (external) auditing standards for listed companies.

(b) The second set of rules applies to investment firms and banks providing investment services and refers to:

- the adequate internal organization with regard to the provision of investment services, and
- the *stricto sensu* investor protection.

(c) The third set of rules applies to UCITS management companies and refers to:

- the licensing and supervision of UCITS management companies,
- the segregation and protection of investors' assets,
- the dissemination of information by UCITS management companies, and
- criteria for the evaluation of UCITS assets and redemption of UCITS units.

(c) Finally, the fourth set of rules relates to the proper functioning of secondary markets and refers to:

- the transparency of transactions conducted in secondary markets,
- the combating of market abuse (market manipulation and insider trading), and
- the oversight of systems for the clearing and settlement of transactions in securities and derivative instruments.

2.3.2 Compensation of investors

Related is also the objective for the compensation of investors (usually up to a certain amount) in case of suspension of the operation of a firm providing investment services (bank or investment firm), if such firm is not in a position to return funds or financial instruments belonging to investors. The appropriate policy instrument in this case is the operation of explicit investor compensation schemes.[47]

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[46] On the best international practices with regard to this aspect, see *ibid*, principles 14-20, 27-28, and 30.

[47] On the best international practices with regard to this aspect, see **IOSCO (2008)**, principle 24. The operation of investor compensation schemes is another protective financial policy instrument.

2.4 Safeguarding the efficiency of payment and settlement systems

The fourth policy objective of regulatory intervention in the financial system refers to the safeguarding of the efficiency of payment and settlement systems.[48] The proper oversight of payment and settlement systems is the appropriate policy instrument in this case as well.[49]

2.5 Protection of the economic interests of consumers of financial services

The fifth policy objective for regulatory intervention in the financial system is the protection of the economic interests of consumers of financial services, namely consumers contracting with financial services providers.[50] The policy concern in this case consists both in:

- reducing the information asymmetry that exists between consumers and financial services providers,[51] and
- addressing the problem of consumers' reduced negotiating capacity *vis-à-vis* financial services providers, mainly due to the expanded use of general terms of transactions.[52]

The policy instruments employed for the achievement of this objective include rules pertaining to:

- the provision of adequate information to consumers in connection with the transactions and the content of the contracts they conclude (prior to the contract, at the conclusion of the contract and during its term),
- the prevention of unfair commercial practices,
- the safeguarding of certain consumers' contractual rights (i.e., the right of withdrawal),
- the elimination of abusive terms, and
- the possibility of a recourse either to justice on the part of consumers through collective actions or to out-of-court dispute settlement systems.

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[48] See **Committee on Payment and Settlement Systems (2001)**, section 2.

Regarding the synergies between the stability and efficiency of payment and settlement systems, see *ibid*, para. 7.8.6, and **Committee on Payment and Settlement Systems (2005)**, para. 60.

[49] See **Committee on Payment and Settlement Systems (2005)**.

[50] See **Herring and Litan (1995)**, p. 61-62.

[51] With regard to this form of information asymmetry, see **Cartwright (2004)**, p. 49-84, and **Calais-Aulois and Steinmetz (2006)**, p. 53-67.

[52] With regard to this issue, see **Calais-Aulois and Steinmetz (2006)**, p. 188-203, and **Howells and Weatherill (2005)**, p. 261 ff.

It is noteworthy that especially as regards consumer lending, in recent years the combating (*i.e.*, prevention and containing) of consumers' overindebtness has been elevated to a separate rationale for regulatory intervention, with a view to avoid the negative consequences that excessive exposure of consumers to debt can have from a social and economic viewpoint.[53] The adequate policy instruments for this case are the adoption of rules on "responsible lending", and on consumers' bankruptcy.[54]

2.6 Combating the use of the financial system for the commitment of economic crimes

Finally, the sixth policy objective for regulatory intervention in the financial system consists in combating (*i.e.*, prevention and containing the use of the financial system for the commitment of economic crimes, such as money laundering, terrorist financing, and payment instruments fraud.[55] In order to achieve this policy objective rules are adopted with regard to:

- the prevention and containing of money laundering through the control of transactions carried out (with a view to identifying "suspicious transactions") and the forwarding of information to the competent authorities,[56]
- the prevention and containing of terrorist financing,[57] and
- the prevention and containing of fraud in the use of payment instruments.

[53] See **Finlay (2009)**, p. 73-76, **Rosenthal (2002)**, p. 150 ff., and **Barret-Barney (2002)**.

[54] See **Bouteiller (2004)**, p. 155, **Ramsay (1997)**, and **Piedelièvre (2008)**, p. 475 ff.

The latter is also a protective financial policy instrument.

[55] See **Dupuis-Danon (2005)**, and **Blair, Walker and Purves (2009)**, p. 487-488.

[56] On the best international practices with regard to this aspect, see **Financial Action Task Force (2004)**: *FATF 40 Recommendations* (available at the following internet address: http://www.oecd.org/dataoecd/7/40/34849567.pdf).

[57] On the best international practices with regard to this aspect, see **Financial Action Task Force (2004)**: *Special Recommendations on Terrorist Financing* (available at the following internet address: http://www.oecd.org/dataoecd/8/17/3489466.pdf).

B. Seeking European financial integration through the regulatory framework: European financial law

1. General overview

1.1 Introductory remarks

The process of European financial integration has been put forward in the European Community (hereinafter the "Community") mainly during the last three decades, in stages, but at a gradually intensified pace.[58] This process, whose starting point was the complete fragmentation of its member states' financial systems,[59] is constantly evolving and aims at shaping a single financial area within its common market.

As mentioned in the previous section of this study (under 1), implementation of financial integration is sought either through the regulatory framework established by intergovernmental and/or supranational authorities, or through self-regulation, or, finally, through market-led initiatives.[60] In the Community, implementation of financial integration through the regulatory framework is sought (and achieved) by the adoption of the provisions of the legal acts constituting the sources of European[61] financial law, a subset of European economic law.[62]

The rest of this study is confined to this aspect of European financial integration.

The main political benchmarks which influenced the development of European financial law are the following:[63]

(a) The first was the 1985 White Paper of the European Commission on the internal market, which identified the legislative measures needed to complete the internal market and establish a common market.[64]

(b) This was followed in 1986 by the Single European Act of 1985,[65] which was the first major amendment of the Treaty establishing the European Economic Community. In order to facilitate the establishment of a common market, it introduced the principle of qualified majority voting by the Council, instead of unanimity, for

[58] The annual reports of both the European Commission and the European Central Bank on European financial integration offer a systematic overview of its progress.

[59] The abovementioned problem of fragmented financial systems is intensified in the case of the Community, given, in particular, its constant enlargement, and notably most recently with member states which had adopted market economy institutions as recently as in the 1990s.

[60] On the most recent developments in European financial integration (with emphasis in the euro area) and the impact of the current financial crisis on it, see **European Central Bank (2009)**, p. 11-42, and **European Commission (2009)**.

[61] The term "European", instead of "Community", financial law is used given that this term is adopted in the majority of the relevant literature (see **Sousi-Roubi (1995)**, **Schnyder (2005)**, and **Walker (2007)**). **Dassesse, Isaacs and Penn (1994)** and **Van Empel and Smits (editors)** prefer the term "European Community law".

[62] Regarding the concept and content of European economic law, see **Kellerhals (2006)** and **Schwarze (2007)**.

[63] For a short but very precise overview of these benchmarks before the current financial (and economic) crisis, see **Blair, Walker and Purves (2009)**, p. 98-102. See also **Hadjiemmanuil (2006)**, p. 786-804. See also **Dermine, J. (2003)**, p. 33-50, with respect to banking.

[64] COM(85) 310 final. On the distinction between the terms "common market" and "internal market", the former being broader, see **Ukrow (1999)**, p. 280.

[65] OJ L 169, 29.6.1987, p. 1 ff.

almost all relevant legal acts, paving the way for a higher degree of harmonization of national legislative and administrative measures.

(c) The third benchmark was the 1992 Treaty of Maastricht[66] which, among other major amendments:

- renamed the European Economic Community to European Community,
- introduced the co-decision procedure for the adoption of basic legal acts between the European Parliament and the Council, and
- set as an objective the creation of a monetary (and economic) union and the introduction of the single European currency, the euro, which started in 1999 and, among others, acted as a trigger for the deepening of European financial integration.

(d) The next benchmark was the so-called 1999 Financial Services Action Plan (the "FSAP"), a Communication of the European Commission entitled *"Financial Services: Building a framework for action"*.[67] FSAP laid down all the legislative measures, in the fields of European financial, company and taxation law, needed to accelerate the financial integration process immediately after the introduction of the euro.

(e) This was followed soon, in 2001, by the Lamfalussy Report,[68] which laid down the institutional changes necessary to enhance the legislative process with regard to the adoption of the legal acts constituting the sources of European financial law.[69]

(f) The last benchmark was the 2005 European Commission's White Paper "Financial Services Policy 2005-2010", which outlined the Commission's financial services policy for that period with a view to the further deepening of European financial integration by law.

The progress in the implementation of this policy program was interrupted in 2008, when the current international financial crisis broke, and rendered necessary a more comprehensive re-adjustment of European financial law.[70]

1.2 The two alternative definitions of European financial law

Based on the definition of the concept and the two dimensions of financial integration developed in section A of this study (under 1.2 and 1.3), the author considers that European financial law can be defined in two alternative ways: *stricro sensu* (under a) and *lato sensu* (under b).[71]

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[66] OJ L 191, 29.7.1992, p. 1 ff.

[67] COM(1999) 232 final.

[68] *"Final Report of the Committee of Wise Men on the Regulation of European Securities Markets"*, February 15, 2001, available at the following internet address: http://ec.europa.eu/internal_market/securities/lamfalussy/index_en. htm.

[69] On this, see below in the present section of the study, under 2.1.

[70] On this, see below in section C of this study, under 1.

[71] The first definition is consistent with the abovementioned *stircto sensu* approach of positive financial integration and the second consistent with the abovementioned *lato sensu* approach of positive financial integration.

(a) According to the *stricto sensu* definition, European financial law is defined as:

"the set of provisions of secondary Community law aimed at the achievement of the Community's negative and positive financial integration, with a view to creating a single financial area in the common market, positive financial integration relating to the achievement at Community level of specific financial policy objectives".[72]

Consequently, the concept of the stricto sensu European financial law, based on a functional approach, is demarcated on the basis of legal acts issued by the competent institutions of the Community (hereinafter the "Community institutions") aimed:

- on the one hand, at materializing three of the Community law's basic freedoms (movement of capitals, freedom of establishment and freedom to provide services) in relation to various categories of Community financial services providers, in the context of negative financial integration,[73] and
- on the other hand, at adopting provisions regarding the implementation of the individual rationales for regulatory intervention in the financial system (according to the abovementioned in section A of this study, under 2.2.1), in the context of positive financial integration.[74]

(b) Under the *lato sensu* definition of European financial law, this is defined as:

"the set of provisions of secondary Community law aimed at the achievement of the Community's negative and positive financial integration, with a view to creating a single financial area in the common market, positive financial integration relating in this case both to:

- *the achievement at Community level of specific financial policy objectives, and*
- *the creation of a European financial contract and mortgage credit law".*

The provisions of European financial contract and mortgage law adopted by the time this study was completed are piecemeal and, therefore, adoption of this definition is deemed, at least for the time being, not necessary. The relevant provisions of Community law, based on article 95 of the Treaty,[75] are confined to:

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[72] Even though the provisions in certain articles of the Treaty establishing the European Community (OJ C 321E, 29.12.2006, p. 37-187) form the legal basis for issuing the basic legal acts of secondary Community law that constitute the sources of European financial law, primary Community law contains no European financial law provisions (as opposed to European monetary law).

One could claim that the sole exception constitute the institutional provisions of para. 5 and 6 of article 105 of the Treaty, which are setting the existing (para. 5) and potentially future (para. 6) duty of the ECB and the European System of Central Banks (hereinafter the "ESCB") with respect to prudential supervision of financial services providers, and ensuring the stability of the financial system in the Community.

[73] The legal basis for the relevant legal acts are articles 47, para. 2, and 55 of the Treaty.

It is worth mentioning that the liberalisation in the provision of financial services is closely linked to the liberalisation of capital movements (Treaty, article 51, para. 2). Abolition of restrictions in the free movement of capitals was realised by Directive 88/361/EEC of the Council *"regarding implementation of article 67 of the Treaty"* (OJ L 178, 8.7.1988, p. 5-18).

[74] The legal basis for the relevant legal acts is article 95 of the Treaty.

[75] According to the provisions of articles 94 and 95 of the Treaty, the competent Community institutions are entitled to issue legal acts covering a broad range, in the fields of not only administrative, but also private and criminal law. *See* **Kahl (1999)**, p. 1068.

- consumer protection law, and
- the field of provision of investment services.[76]

Initiatives have also been undertaken for the creation of a European civil law code, including provisions for financial transactions, which, however, are far from being completed.[77]

Nevertheless, the possibility cannot be ruled out that such provisions will become more systematic in the future, if Community institutions deem that the objective of full European financial integration can be better achieved through them.

The vast majority of the legal acts which constitute the sources of the European financial law in force contains provisions consistent with the stricto sensu definition. Accordingly, in the rest of the present study, the analysis will be confined to this definition of European financial law, with specific emphasis on European banking law.

1.3 The branches of European financial law

1.3.1 General overview

Considering the above, and taking into account the financial policy objectives mentioned in section A of this study (under 2), it is the author's position that European financial law contains seven (separate but closely linked) individual branches:

- European banking law (*see* in more detail below, under 1.3.2),
- European capital markets law,
- European insurance law,
- European law on the supplementary supervision of financial conglomerates,
- European law on payment and settlement systems,
- European law on the protection of the economic interests of consumers of financial services, and
- European law on combating the use of the financial system for the conduct of economic crime.[78]

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[76] In this context it is worth mentioning the initiatives undertaken by the European Commission with the Green Paper *"on Retail Financial Services in the Single Market"* (COM(2007) 226 final), and with regard to the European contract law.

[77] See the Commission's Communication *"The European contract law and the review of the* ***acquis communautaire****: the way forward"* (COM(2004), 651 final) as well as its progress reports on the "Common Frame of Reference". On this, see **Lando and Beale (2000)**, **Lando, Clive, Prüm, and Zimmermann (2003)**, **Hartkamp, Heelnik, Hondius, Joustra, and du Perron (eds.) (1998)**, **Karsten and Petri (2005)**, p. 31 ff., **Hondius (2004)**, p. 245 ff., **Reich (2005)**, p. 383 ff., and **Hesselink (2007)**, p. 323 ff.

[78] For a thorough presentation of the legal acts which constituted the sources of all these branches of European financial law as of 2007 (without following the classification adopted by the author in this study), see the various contributions in **Servais (direction, 2007)**. For an overview of these acts as of 2006, see also the (non academic but complete) work of **Hemetsberger – Schoppman – Schwander – Wengler (2006)**.

The approach adopted for the definition of the individual branches of European financial law, especially as to the dimension of positive financial integration, is in this case functional as well. In the author's opinion, in this case, this approach is not only suitable, but necessary as well, since, if the definition was based on an institutional approach (focusing on the categories of financial services providers coming under the individual scope of the relevant provisions), there would be an extensive overlapping between individual branches.

As an indication, it should be mentioned that the regime governing the operation of Community credit institutions (and partly also the branches of non-Community credit institutions established in the Community) [79] *is also affected by the provisions of almost all the other branches of European financial law (with the exception of European insurance law). If the institutional approach were to be adopted, these provisions would need to be concurrently included in European banking law, alternatively defined in this case also as "European law of credit institutions", as well as in European capital markets law, if they also apply to investment firms.*

Moreover, given that Community credit institutions (and all other categories of Community financial services providers) are also subject to the provisions of several other legal acts constituting the sources of other branches of the European economic law not included in the European financial law, if the functional approach was not pursued, these provisions should also be included, for reasons of consistency, in the European banking law.

1.3.2 In particular: definition of European banking law and field of application of its provisions

European banking law[80] is defined as the set of provisions of European financial law, whereby the following two objectives are sought:

- to materialise the two basic freedoms laid down in the Treaty establishing the European Community,[81] *i.e.*, the freedom of establishment (by branching) and the freedom to provide services, with regard to Community credit institutions,[82] and
- to ensure the stability of the European banking system, which may be disrupted due to the occurrence of contagious credit institutions' failures.[83]

[79] For the definition of the terms "Community credit institution" and "non-Community credit institution, *see* just below, under 1.3.2.

[80] In addition to the references made below on the provisions of European banking law, the reader should also consult the various chapters in the collective work edited by **Van Empel and Smits**, which is in loose-leaf form and is continuously updated.

[81] OJ C 321E, 29.12.2006, p. 37-187 (consolidated version, 2006).

[82] As "Community" is meant in this study a credit institution incorporated under the laws of a member state of the Community.

[83] On this financial policy objective, see above section A of the present study, under 2.2 (a).

The overwhelming majority of the provisions of European banking law apply to Community credit institutions.[84] Credit institution has been defined to mean:

"any undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account".[85]

The definition of credit institutions was broadened in 2000 to include also electronic money institutions.[86]

In the remaining of this study, reference to the term "credit institution" will mean credit institutions according to the initial (stricto sensu) definition, while specific reference will be made (in italics) to the provisions of European banking law applying to electronic money institutions.

This branch of European financial law also contains provisions applying to the branches of non-Community credit institutions established in the Community.[87]

2. Fundamentals of European banking law as in force

2.1. Sources of European banking law and classification of the relevant provisions

The provisions of the European banking law in force (at the time of completion of the present study) are found in three categories of legal acts:

(a) The main source of European banking law (as well as of the other branches of European financial law) are "basic" legal acts,[88] exclusively in the form of Directives,[89] issued by the European Parliament and the Council according to the co-decision procedure laid down in article 251 of the Treaty.

[84] The provisions of European banking law (and in general European financial law) apply also to credit institutions incorporated in other member states of the European Economic Area ("EEA"), notably Norway, Lichtenstein and Iceland. Certain of them apply also to Community financial institutions (*ibid*, article 4, point 5), which are subsidiary companies of Community-based credit institutions. This category comprises mainly finance, leasing and factoring companies.

[85] This definition was firstly adopted in the so-called "First Banking Directive" (**Directive 77/780/EEC**, OJ L 322, 17.1.2.1977, p. 30 ff.) and then continuously adopted in the subsequent Directives, constituting the sources of European banking law, unchanged. On this definition, see **Fernandez-Bollo et Tabourin (2007)**, p. 92-93.

[86] **Directive 2000/28/EC** *"amending Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions"* (OJ L 275, 27.10.2000, p. 37-38), article 1, para. 1, point (b). See on this **Fernandez-Bollo et Tabourin (2007)**, p. 95-96.

[87] As "non-Community" is meant in this study a credit institution incorporated under the laws of a third country, which is not a member state of the Community and, in general, the EEA.

[88] The legal basis of all these acts is para. 2 of article 47 of the Treaty, first and third sentences.

[89] The practice of Community institutions to mainly issue Directives and not Regulations is founded on the provisions of para. 6, Protocol no. 30 *"on the application of the principles of subsidiarity and proportionality"*, annexed to the Treaty. This approach prevailed due to the pressures exerted by member states for the preservation of the principle of subsidiarity and use of that form of legal act that provides them with the greatest possible flexibility during the implementation of European law provisions into their national law, namely Directives.

(b) European banking law provisions are also found, even though to a very limited extent (especially if compared to European capital markets law), in Regulations and Directives of the European Commission. These are containing implementing measures, under powers conferred to the Commission by a basic legal act, which are adopted according to the regulatory comitology procedure,[90] usually (but not exclusively) in the framework of the so-called "level-2" of the Lamfalussy procedure.[91]

(c) Finally, a source of European banking law are also the standards and guidelines issued by the Committee of European Banking Supervisors ("CEBS") in the context of the so-called "level-3" of the Lamfalussy procedure (to the author's opinion, the main *novum* of this procedure),[92] and constituting European soft law.[93] Through its standards and guidelines, CEBS is seeking to specify the provisions of basic legal acts and implementing measures, with a view to achieving their common implementation and consistent application by member states throughout the Community.[94]

From a systematic point of view, the provisions of the basic legal acts and the legal acts containing implementing measures which constitute the sources of European banking law need to be classified in two categories:

- those applying to Community credit institutions (and electronic money institutions) (*see* below, under 2.2), and
- those applying to branches and subsidiary credit institutions of non-Community credit institutions established and incorporated, respectively, in the Community (under 2.3).

The provisions of the first category are classified into two sections:

(a) The first section contains provisions on the materialisation of negative financial integration as applied to credit institutions (and electronic money institutions) (*see* below, under 2.2.1).

(b) The second section contains provisions on positive financial integration as applied to credit institutions (and electronic money institutions), which should be further classified in two groups:

- those pertaining to the rules according to which regulatory intervention is exercised in the banking sector (under 2.2.2.1), and

[90] This procedure is governed by the provisions of **Council Decision 1999/468/EEC** *"laying down the procedures for the exercise of implementing powers conferred on the Commission"* (OJ L 184, 17.07.1999, p. 23-26), as amended by **Council Decision 2006/512/EC** (OJ L 200, 22.07.2006, p. 11-13).

[91] On this procedure, see in detail, among others, **Ferran (2004)**, p. 58-118, **Lastra (2006)**, p. 334-341, **Hadjiemmanuil (2006)**, p. 815-818, and **Sousi (2007)**, p. 24-29.

[92] The operation of CEBS is currently governed by **Commission Decision 2009/78/EC** (OJ L 25, 29.1 2009, p. 23-27), which replaced **Commission Decision 2004/5/EC** (OJ L 3, 7.1 2004, p. 28-29) and its own Charter (available at the following internet address: http://c-ebs.org/Aboutus/CEBS-Charter.aspx).

Apart from its tasks as a "level-3" Committee (**Decision 2009/78/EC**, articles 3-6), CEBS has also the main task to advise the European Commission with regard to draft implementing measures pertaining to the banking sector, according to the abovementioned "level-2" of the Lamfalussy procedure (*ibid*, article 2).

[93] On this concept, see **Chalmers, Hadjiemmanuil, Monti, and Tomkins (2006)**, p. 137-140.

[94] On the work of CEBS see the following internet address: http://c-ebs.org/Publications.aspx.

- those pertaining to the authorities and schemes competent for the exercise of this intervention (under 2.2.2.2).

It should be mentioned in this context that neither European banking nor European monetary law contain any rules on the lender of last resort function either of national central banks or of the European Central Bank.[95]

2.2 Provisions applying to Community credit institutions

2.2.1 Provisions on negative financial integration

The first concern of Community legislators in order to establish a single banking market was to ensure that Community credit institutions are granted the freedom of establishment, by branching, and the freedom to provide services in other member states (the "host member states") than that in which they are incorporated and have been authorised (the "home member state"). These freedoms have materialised by application of the principle of mutual recognition of the authorisation provided by the competent authorities of the home member state of these credit institutions, by virtue of which the relevant national legislative and/or administrative restrictions were lifted.[96]

Accordingly, as of January 1st, 1993, any credit institution authorised by the competent authorities of the home member state, where its registered office and its head office are located, are allowed, according to a specific procedure controlled by the competent supervisory authorities of the home member state, to conduct activities and provide financial services in host member states either by branching out or by way of providing services without being subject:

- either to the requirement to obtain authorisation by the competent authorities of the host member state, which are also not allowed to examine the conditions of the authorisation of the credit institution concerned by the competent authorities of the home member state,
- or, in the case of branching out, to the requirement to submit an endowment capital.[97]

The principle of mutual recognition applies to banking and payment services provided by credit institutions,[98] as well as investment services (including ancillary ones) and investment activities provided and conducted, respectively, by them.[99]

[95] On this, see the various contributions in **Goodhart (editor, 2000)**, and **Lastra (2006)**, p. 303-307.

[96] On the concept of mutual recognition, see **Walker (2007)**, p. 301-316.

[97] **Directive 2006/48/EC** *"relating to the taking up and pursuit of the business of credit institutions"* (OJ L 177, 30.6.2006, p. 1-200), articles 16 and 23-28, with reference to Annex I thereof, and **Directive 2004/39/EC** *"on markets of financial instruments(...)"* (OJ L 145, 30.4.2004, p. 1-44), articles 31-35 (except article 31, paras. 2-4, and article 32, paras. 2-6 and 8-9 which are covered by Directive 2006/4/8EC), with reference to Annex I, Sections A and B, thereof.

See, indicatively, **Fernandez-Bollo et Tabourin (2007)**, p. 102-105, **Sousi-Roubi (1995)**, p. 120-157, and **Staikouras and Gabrielides (2008)**, p. 55-70.

[98] **Directive 2006/48/EC**, Annex I. See **Fernandez-Bollo et Tabourin (2007)**, p. 94-95.

[99] **Directive 2004/39/EC**, Annex I, Sections A and B.

For electronic money institutions the principle of mutual recognition applies only to the issuing of electronic money.[100]

2.2.2 Provisions on positive financial integration

2.2.2.1 Provisions on the rules according to which regulatory intervention is exercised

In order to contribute to the preservation of the European banking system's stability, European banking law contains provisions pertaining to the harmonisation of the member states' national laws with regard to the authorisation and micro-prudential supervision of credit institutions (and electronic money institutions), as well as the operation of deposit guarantee schemes. On the contrary, there is still no harmonisation at Community level of the rules pertaining to the reorganisation measures and winding-up proceedings of credit institutions, mainly because the differences in the judicial systems of member stets are still significant.[101]

In particular:

(a) Specific conditions are laid down for the granting and withdrawal of authorisation of credit institutions, as well as the pursuit of their business.[102] The relevant provisions are based on the principles of minimum (as to the level) and full (as to the extent) harmonisation.

The same applies to electronic money institutions.[103]

(b) The micro-prudential supervision of credit institutions is based on provisions concerning:

- capital adequacy requirements against exposure to credit, market and operational risks,
- the reporting and quantitative limitation of large exposures,
- the quantitative limitation of qualified holdings held outside the financial sector, and
- assessment processes with regard to internal capital.[104]

[100] **Directive 2000/46/EC** *"on the taking up, pursuit of and prudential supervision of the business of electronic money institutions"* (OJ L 275, 27.10.2000, p. 39-43), article 2, para. 2, second sentence. See **Fernandez-Bollo et Tabourin (2007)**, p. 96-98.

[101] The relevant **Directive 2001/24/EC** *"on the reorganisation and winding- up of credit institutions»* (O.J. L 125, 5.5.2001, p. 15-23) contains, in this respect, only provisions of private international law (articles 20-32). See **Wessels (2006)**, p. 82-102.

[102] **Directive 2006/48/EC**, articles 6-15 and 17-22, and **Directive 2004/39/EC**, articles 11, 13 and 14. See **Sousi-Roubi (1995)**, p. 100-120, **Staikouras and Gabrielides (2008)**, p. 41-54, and **Fernandez-Bollo et Tabourin (2007)**, p. 96-98.

[103] **Directive 2000/46/EC**, articles, 2, para. 2, first sentence, and 4, para. 1. See **Fernandez-Bollo et Tabourin (2007)**, p. 96-98.

[104] **Directive 2006/48/EC**, articles 56-123, and **Directive 2006/49/EC** *"on the capital adequacy of investment firms and credit institutions (recast)"* (OJ L 177, 30.6.2006, p. 201-255), articles 12-21 and 28-34. See **Fernandez-Bollo et Tabourin (2007)**, p. 107-123, and 123-125, respectively.

These provisions are also based on the principle of minimum harmonisation, while the extent of harmonisation is limited, since member states have the discretion to adopt additional micro-prudential measures (*e.g*., liquidity requirements) on which European banking law is still silent.

It is this minimum harmonisation of European banking law's provisions on micro-prudential supervision that has rendered necessary the involvement of CEBS as a "level-3" Committee, in order to achieve their common implementation and consistent application by member states and avoid competitive distortions within the single financial market.[105] *In addition, since CEBS has also been assigned the task to promote the convergence of banking supervisory practices of member states, it can deal with the distortions arising from the limited-extent harmonisation of the provisions of Community legislation in the field of banking micro-prudential supervision.*

On the contrary, the European banking law in force does not contain any provisions on the macro-prudential supervision of credit institutions. On the current proposals to adopt such provisions, see below in section C of this study (under 2.2.2.2).

The micro-prudential supervision of electronic money institutions is narrower in extent.[106]

(c) The operation of deposit guarantee schemes is governed by provisions pertaining to:

- the extent and level of coverage of deposits,
- the persons entitled to compensation if a credit institution's deposits were to become "unavailable",
- the procedure for paying compensation, and
- the information to be provided to depositors on the scheme's operation.[107]

The level of harmonisation is minimum in this case as well, and its extent limited, since certain aspects of the schemes' operation, such as their funding and administration, are left to the discretion of member states.

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[105] See above in the present section of the study, under 2.1. Consistent implementation of European banking law by member states is also pursued by CEBS through initiatives for the consistent use of the national discretions contained in provisions of basic legal acts and legal acts containing implementing measures.

[106] **Directive 2000/46/EC**, articles 4, paras. 2-3, 5 and 7. See **Fernandez-Bollo et Tabourin (2007)**, p. 107-123.

[107] The relevant provisions are laid down in articles 2, 3, 5 and 7-11 of **Directive 94/19/EC** *"on deposit guarantee schemes"* (OJ L 135, 31.5.94, p. 5-14). See **Sousi-Roubi (2005)**, p. 231-234.

This Directive was amended in 2009 by **Directive 2009/14/EC** (OJ L 68, 13.3.2009, p. 3-7), mainly in order to increase immediately the level of coverage from 20.000 euros to 50.000 euros and, then, by 2011, to 100.000 euros.

2.2.2.2 Provisions on the authorities and schemes competent for the exercise of regulatory intervention

2.2.2.2.1 The decision not to create supranational authorities and deposit guarantee schemes

In order to contribute to the preservation of the European banking system's stability, European banking law contains also provisions on the authorities (and in the case of deposit guarantee, the schemes), which are responsible for the exercise of regulatory intervention. In this respect, it is, firstly, worth mentioning that the main political decision taken was not to establish, up to now at least, one or more supranational bodies competent for the exercise of regulatory intervention in the European banking (and in general financial) sector. In particular:

(a) Competent both for the authorisation of Community credit institutions and for their micro-prudential supervision are the authorities designated as such by the member states[108] (hereinafter the "supervisory authorities").[109] Accordingly, in contrast to the monetary and foreign-exchange policies, which have been "communitised" with the creation of the European monetary union, that started operating on January 1st 1999, the ECB, the single European monetary authority, has not become a single European supervisory authority as well, either for the entire European financial system or for any of its sectors. This is based on the provision of para. 5, article 105 of the Treaty, which is repeated *verbatim* in article 3.3 of the Statutes of the ESCB and of the ECB,[110] according to which:

"the ESCB shall contribute to the smooth conduct of policies ***pursued by the competent authorities*** *relating to the prudential supervision of credit institutions and the stability of the financial system".*[111]

In this context, the ECB has the right, among others, based on article 25.1 of the Statutes, to issue (legally non binding) opinions.[112]

(b) National are also the supervisory and/or judicial authorities which are competent for the adoption of reorganisation measures and the opening of winding-up proceedings of credit institutions.[113]

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[108] **Directive 2006/48/EC**, article 4, point 4. See **Lastra (2006)**, p. 298-300. For a summary of the different proposals with regard to the creation of one or more supranational financial supervisory authorities in the Community, see *ibid*, p. 324-328, and **Hadjiemmanuil (2006)**, p. 818-828.

[109] These supervisory authorities have also (extensive or limited, as the case may be) regulatory powers, as well the power to impose sanctions. Accordingly, it would not be inappropriate to refer to them as supervisory *and* regulatory authorities.

[110] On the historical evolution of these provisions, which do not apply neither to the member states with derogation (Treaty, article 122, para. 3, Statutes, article 43.1) nor to the United Kingdom (Protocol No. 25, paras. 5 και 8), see **Smits (1997)**, p. 334-338.

[111] This is not one of the basic tasks of the ESCB, which are listed exclusively in para. 2, article 105 of the Treaty. On this article, see **Smits (1997)**, p. 193-221, **Lastra (2006)**, p. 216-222, and **Louis (2009)**, p. 162-166 (with specific reference to the powers of the ESCB during the current financial crisis).

[112] On other means for achieving the task established in article 105 (para. 5) of the Treaty, *see* **Smits (1997),** p. 339-343.

[113] **Directive 2001/24/EC**, article 2, sixth indent.

(c) In addition, the deposit guarantee schemes are national as well.[114]

2.2.2.2.2 Competent authorities and deposit guarantee schemes for foreign establishments of Community credit institutions in other member states

(a) Branches of Community credit institutions established in other member states

European banking law contains detailed provisions applying to the branches of Community credit institutions established in other member states, whose content derives from the application of the principle of mutual recognition of credit institutions' authorisations, according to the abovementioned with regard to negative financial integration.[115] In particular:

(i) The micro-prudential supervision of these branches is exercised:

- with regard to solvency, by the competent supervisory authorities of their home member state (*i.e.*, those who have granted them the authorisation to branch out in the host member state), according to the principle of mutual recognition of micro-prudential regulations,[116] and
- with regard to liquidity, by the competent supervisory authorities of the host member state.[117]

The obligation has also been established for close cooperation between the competent authorities of home and host member states of such credit institutions.[118]

(ii) The reorganisation measures adopted and the winding-up procedures opened by the competent supervisory and/or judicial authorities of Community credit institutions are also effective in the member states where their foreign branches are established and operating.[119]

(iii) The deposits of branches of Community-based credit institutions established in host member states are covered by the deposit guarantee scheme of the home member state.[120] However, these branches may voluntarily join also the deposit guarantee scheme of the host member state, if the level and extent of cover offered by the latter are exceeding those of the home member state's scheme, in order to supplement the guarantee (the so-called "topping-up" option).[121] In such a case, the deposit guarantee schemes concerned, must establish on a bilateral basis appropriate rules and procedures for paying compensation to the depositors of those foreign branches.[122]

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[114] **Directive 94/19/EC**, article 3, para. 1, first sentence. Each member state may have one or more such explicit schemes.

[115] See above in the present section of the study, under 2.2.1.

[116] **Directive 2006/48/EC**, articles 40 and 43. See **Sousi-Roubi (1995)**, p. 198-206.

[117] *Ibid*, article 41.

[118] **Directive 2006/48/EC**, article 42. See **Sousi-Roubi (1995)**, p. 206-210, and **Fernandez-Bollo et Tabourin (2007)**, p. 133-135.

[119] **Directive 2001/24/EC**, articles 3-7 and 9-18. See in details **Wessels (2006)**, p. 55-81.

[120] **Directive 94/19/EC**, article 4, para. 1. See **Sousi-Roubi (1995)**, p. 229-231.

[121] **Directive 94/19/EC**, article 4, para. 2.

[122] *Ibid*, Annex II.

(b) Subsidiaries of Community credit institutions incorporated in other member states

Credit institutions which are subsidiaries of Community credit institutions are incorporated and authorised according to the laws of the member state where their registered office and their head office are located. Their "home member state" is that of their authorisation, and the abovementioned provisions of European banking law apply to them accordingly.

European banking law contains some specific provisions on these subsidiaries, which refer to their authorisation and micro-prudential supervision. In particular:

(i) Before granting authorisation to such a subsidiary, the competent supervisory authorities must consult with the competent supervisory authorities of the member state where its parent undertaking is operating, and exchange information with regard to the suitability of shareholders as well as the reputation and experience of directors.[123]

(ii) In addition to their micro-prudential supervision on a solo basis by the competent supervisory authorities of their home member state, these subsidiaries are also subject to micro-prudential supervision on a consolidated basis by the competent authorities of the member state where the parent credit institution is incorporated.[124]

2.3 Provisions applying to branches and subsidiaries of non-Community credit institutions

2.3.1 Branches of non-Community credit institutions

European banking law also contains specific provisions applying to the branches of non-Community credit institutions established in the Community. These provisions concern:

- the requirement imposed on member states not to apply on such branches provisions which would result in a treatment more favourable than that accorded to branches of credit institutions from other member states,[125]
- the possibility of the Community to conclude arrangements with third countries according to which these branches would be treated identically throughout the Community,[126]
- specific arrangements related to the reorganization measures and the winding-up proceedings for these branches,[127] and
- the regime governing these branches in relation to their participation in the deposit guarantee scheme of the member state where they are established.[128]

[123] **Directive 2006/48/EC**, article15, paras. 1 and 3.

[124] **Directive 2006/48/EC**, articles 125-143. See **Fernandez-Bollo et Tabourin (2007)**, p. 128-132.

These provisions as well as those of **Directive 2006/49/EC**, articles 22-27, do not only apply to "pure" banking groups, but also to other categories of "homogeneous" financial groups, financial conglomerates excluded. On this distinction, see **Dierick (2004)**.

[125] **Directive 2006/48/EC**, article 38, para. 1.

[126] *Ibid*, article 38, para. 3.

[127] **Directive 2001/24/EC**, articles 8 (for reorganisation) and 19 (for winding-up).

[128] **Directive 94/19/EC**, article 6.

In general, with regard to the authorisation requirements for and the micro-prudential supervision of these branches applicable are the provisions of the General Agreement on Trade in Services (the "GATS") of the World Trade Organisation,[129] *including the Fifth Protocol concerning financial services.*[130] *These are based on:*

- *the principle of most-favoured-nation as a general obligation, and*
- *the principles of national treatment and market access as specific commitments.*[131]

2.3.1 Subsidiaries of non-Community credit institutions

Similarly to credit institutions which are subsidiaries of Community credit institutions,[132] credit institutions which are subsidiaries of non-Community credit institutions are incorporated according to the laws of the member state where their registered office and their head office are located. Thus, they are governed by the entire set of provisions of European banking law, according to the abovementioned, treated as Community credit institutions. Specific provisions on these credit institutions apply only with regard to their consolidated micro-prudential supervision.[133]

On the contrary, the adoption of the abovementioned **Directive 2006/48/EC** brought about the abolition of specific provisions of European banking law with regard to the conditions for the authorisation of these subsidiaries, based on the principle of reciprocity.[134]

[129] The GATS was approved on behalf of the Community by **Council Decision 94/800/EC** (OJ L 336, 23.12.1994, p. 1 ff.).

[130] This Protocol was approved on behalf of the Community by **Council Decision 1999/61/EC** (OJ L 20, 27.1.1999, p. 38-39).

[131] On the provisions of GATS in general, see **Wolfrum, R., Stoll, P.T., and C. Feinäugle (editors, 2008)**. On the Annexes of GATS on financial services and on the Fifth Protocol, see **von Bogdandy and Windsor (2008)**, p. 618-640 and 643-646, respectively.

[132] See above in the present section of the study, under 2.2.2.2.2 (b).

[133] **Directive 2006/48/EC**, articles 39 and 143.

[134] **Directive 2001/12/EC** (OJ L 126, 26.5.200, p. 1-59), article 23. On these provisions, which were firstly adopted in 1989 in **Directive 89/646/EC**, the so-called "Second Banking Directive" (OJ L 386, 30.12.1989, p. 1 ff.), and then maintained *verbatim* in **Directive 2000/12/EC**, see **Vigneron and Smith (1990)**.

TABLE 1

EUROPEAN BANKING LAW

Provisions for Community credit institutions within the single financial area

A. Provisions on the rules according to which regulatory intervention is exercised

Financial policy instruments	Extent and level of harmonisation
Authorisation of credit institutions	• full-extent harmonisation • minimum harmonisation
Micro-prudential supervision of credit institutions	• limited-extent harmonization • minimum harmonization smoothed by "level 3" legal acts adopted by CEBS
Reorganisation and winding-up of credit institutions	no harmonization
Operation of deposit guarantee schemes	• limited-extent harmonisation • minimum harmonization

TABLE 2

EUROPEAN BANKING LAW

Provisions for Community credit institutions within the single financial area

B. Provisions on the authorities and schemes competent for the exercise of regulatory intervention

Financial policy instruments	**National vs. supranational competent authorities and schemes**	**Competent authorities and schemes for foreign establishments of Community credit institutions in other member states**	
		Competent authorities and schemes for foreign branches	**Competent authorities and schemes for foreign subsidiaries**
Authorisation of credit institutions	National supervisory authorities	home member state supervisory authorities	• supervisory authorities of subsidiary's home member state • consultation and exchange of information between supervisory authorities of parent and subsidiary credit institutions
Micro-prudential supervision of credit institutions	National supervisory authorities	• home member state supervisory authorities (for solvency) • host member state supervisory authorities (for liquidity)	• on a solo basis: supervisory authorities of subsidiary's home member state • on a consolidated basis: supervisory authorities of parent credit institution
Reorganisation and winding-up of credit institutions	National supervisory and/or judicial authorities	home member state competent authorities	competent authorities of the subsidiary's home member state
Operation of deposit guarantee schemes	National deposit guarantee schemes	• home member state scheme • host member state scheme (in case of "topping-up") • cooperation between home and host member state schemes (in case of "topping-up")	scheme of the subsidiary's home member state

C. The way ahead

1. General overview

1.1 Introductory remarks

The international financial crisis which started in 2007 and is still affecting the operation of the financial system and the real-sector economy worldwide,[135] has revealed weaknesses in the framework pertaining to regulatory intervention in the financial system. This happens, of course, every time when a financial crisis breaks up, no matter whether this is a banking crisis, a foreign-exchange crisis or a twin crisis.[136]

Accordingly, and even though the European Financial System cannot by any means be characterised as "unregulated", both the extent and the intensity of the current international financial crisis have made it imperative to review the provisions of European financial law, a major parameter, as analysed, contributing to European financial integration. The initiatives already undertaken and the proposals expected to be submitted in the near future with regard to the "re-adjustment" of the European financial law, concern both the rules according to which regulatory intervention is exercised in the financial system, and the authorities and schemes competent for the exercise of this intervention.

Any substantial approach with regard to the extent of this re-adjustment must, to the author's opinion, start from a thorough analysis of the causes of the crisis[137] and be guided by the "appropriateness test". The current crisis has specific causes and the measures to be adopted should be appropriate in order to eliminate them.[138] In any case, it has to be kept in attention, that even within this period of crisis, European law continues to be guided by the principle of an open market with free competition.[139]

It goes beyond the scope of this study to lay down the entire (extensive) range of current regulatory developments, which will lead to the re-adjustment of European financial and in particular European banking law, some of which are based on international initiatives.[140] Instead we will concentrate shortly on the most significant

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[135] See **European Central Bank (2008b)**: *Financial Stability Review*, December, European Central Bank, p. 17-60 και 61-117, αντίστοιχα.

[136] On this distinction see **Brakman, Garretsen, van Marrenwijk, and Van Witteloostuijn (2006)**. See also **Leaven and Valencia (2008)** for an overview of all "systemically important" banking crises all over the world since 1970.

[137] On the causes of the crisis see, among others, **Kiff and Mills (2007)**, **Borio (2008)**, **European Central Bank (2008c)**, **Eichengreen (2008)**, and **Swoboda (2008)**.

[138] This study is not referring to the operations conducted by the European System of Central Banks, as monetary authority, to respond to the financial crisis. On this, see **Committee on the Global Financial System (2008)**.

[139] This remark is being made because during the crisis all Governments have adopted rescue packages and recovery plans for the banking sector. These packages and plans, approved by the European Commission as compatible with European competition law are of a temporary nature (up to five (5) years). On these, see **Petrovic and Tutsch (2009)**, and **Gortsos (2009)**.

[140] See **Financial Stability Forum (2009b)**: *"Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, Update on Implementation"*, April (available at the following internet address: http://www.fsforum.org/publications/r_0904d.pdf).

new political benchmark which will influence the development of European financial law, notably the "de Larosière Report".[141]

2. The two proposals of the "de Larosière Report" on the re-adjustment of the supervisory framework in the European financial system

2.1 Introductory remarks

The European Commission assigned the task of investigating the appropriate means to satisfy the objective for a re-adjustment of the provisions of the currently existing European financial law pertaining to the supervision of financial firms established in the Community to a special, high-level, experts group, chaired by the French national and former central banker Jacques de Larosière ("High-Level Group on Financial Supervision in the EU", hereinafter the "de Larosière Group").

The de Larosière Group submitted its report (hereinafter the "Report" or the "de Larosière Report"),[142] on February 25, 2009. The Report is structured in four (4) chapters, of which Chapter three identifies and analyses the weaknesses that the current financial crisis has revealed with regard to the supervision of the European financial system.[143] Within this framework the report then makes reference to the adjustments that need to take place in the relevant provisions of the European financial law in force. In relation to this, the Report states that *"this chapter (…) proposes both short term and long term changes"*.[144]

2.2 The short term proposal

2.2.1 Towards a "European System of Supervision and Crisis Management"

The first proposal, at the core of Chapter III of the de Larosière Report, is the result of the option not to establish, at least under the current circumstances, any supranational supervisory authorities of the financial system in the Community.[145] It consists of two components:

(a) The first component is the strengthening of the quality of the supervision exercised at European level, by setting up a "European System of Supervision and Crisis Management" of the financial system.[146] Regarding the "European system of supervision", the proposal suggests concretely the establishment of two (2) new bodies at European level, and allocating thereto distinct (but closely linked) tasks:

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[141] For an analytical presentation of the proposals of this Report, see **Gortsos (2010**, forthcoming), on which the rest of this section of the study is based.

[142] The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosière, *Report*, Brussels, 25 February 2009 (available at the following internet address: http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf.

[143] De Larosière Report, chapter III, section II ("Lessons from the crisis: what went wrong?"), paras. 152-162.

[144] *Ibid*, para. 144, second sentence.

[145] *Ibid*, para. 218.

[146] *Ibid*, chapter III, section III ("What to do? Building a European System of Supervision and Crisis Management"), paras. 167-189.

- the first body should be responsible for the macro-prudential supervision of the financial system (*see* below, under 2.2.2), and
- the second should be responsible for its micro-prudential supervision (under 2.2.3).

(b) The second component of the "short term" proposal for strengthening supervision in the European financial system is the concurrent strengthening of the quality of supervision exercised by national supervisory authorities, for which the proposals suggest that they should continue to exist.

2.2.2. The competent body on macro-prudential supervision: the European Systemic Risk Council

According to the Report, the first body to be established should be responsible for the macro-prudential supervision of the European financial system, the area in which the Report finds that the supervisory framework in force has revealed the most significant weaknesses: *"A key lesson to be drawn from the crisis (...) is the urgent need to upgrade macro-prudential supervision in the EU for all financial activities"*.[147]

This body is called the **"European Systemic Risk Council"** (hereinafter the "ESRC") and it is proposed to operate within the ESCB, substitute for the work of the ESCB's Banking Supervision Committee, and receive administrative support by the ECB.

2.2.3 The competent body on micro-prudential supervision: the European System of Financial Supervision

The second body proposed to be established should be responsible in the area of micro-prudential financial supervision, a field which is in need of significant strengthening, according to the Report. This body is called the **"European System of Financial Supervision"**, hereinafter "ESFS". The system should operate outside of the ECB,[148] be decentralised, and consist of three (3) new Authorities that will gradually be established at European level, as follows:

- the **European Banking Authority,** as successor to CEBS,
- the **European Securities Authority,** as successor to CESR, and
- the **European Insurance Authority,** as successor to CEIOPS.

2.2.4 Implementing the proposals of the Report

On September 23 (at the very closing of this study), the European Commission submitted the following five proposals for basic legal acts, which are expected to lead to the implementation of the proposals of the de Larosière Report by the end of 2010:[149]

[147] *See* para. 153 of the Report.

[148] According to the Report, contrary to macro-prudential supervision, micro-prudential supervision of the European financial system should not be assigned to the ECB (para. 146).

[149] It is evident that the provisions of these proposals could not be elaborated. According to a first reading they are in principle fully compatible with the proposals of the de Larosière Report, and they specify their concrete implementation.

- **Proposal for a Regulation of the European Parliament and of the Council** "*on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board*",[150]
- **Proposal for a Council Decision** "*entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board*",[151]
- **Proposal for a Regulation of the European Parliament and of the Council** "*establishing a European Banking Authority*",[152]
- **Proposal for a Regulation of the European Parliament and of the Council** "*establishing a European Securities and Markets Authority*",[153] and
- **Proposal for a Regulation of the European Parliament and of the Council** "*establishing a European Insurance and Occupational Pensions Authority*".[154]

2.3 The long term proposal

The second, equally important and much more radical (if fully implemented) proposal of the Report,[155] consists of exploring the possibility of transformation of the ESFS into a system which could rely only on two European Authorities, according to the "functional approach" of the institutional structure of financial supervision.[156] The proposal suggests that this test should be performed by reviewing the *modus operandi* of the ESFS no later than three (3) years after its entry into force.[157]

In essence, this proposal paves the way for establishing supranational supervisory authorities of the financial system in the Community. In any event, in its Report, the de Larosière Group underlines the implementation difficulties of such an endeavour.[158]

[150] COM(2009) 499 final, 23.3.2009.

[151] COM(2009) 500 final, 23.3.2009.

[152] COM(2009) 501 final, 23.3.2009.

[153] COM(2009) 503 final, 23.3.2009.

[154] COM(2009) 502 final, 23.3.2009.

[155] De Larosière Report, chapter III, section V ("Reviewing and possibly strengthening the European System of Financial Supervision"), paras. 215-218.

[156] Regarding this approach and its alternatives ("sectoral approach" and "full integration approach" of the financial system's supervisory authorities), see **Group of Thirty (2008)**.

[157] De Larosière Report, para. 215.

[158] *Ibid*, para. 218, first and second sentences.

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