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**Challenging the Prudential Supervisor: Liability  
versus (Regulatory) Immunity**



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**Abstract**

*Over the last decades, bank failures in different EU-countries have increasingly led to liability claims being directed against supervisory authorities for alleged negligence or improper conduct in the course of exercising prudential supervision over banks.*

*The basic assertion of this paper is that integrated markets within the European Union, and in the near future, also including Central and Eastern European countries, should function under more or less similar rules as regards possible supervisory liability.*

*After having analysed the existing legal regime as regards to supervisory liability in different EU-countries, we examine to which extent supervisory liability, as far as it is related to the European banking directives, could be directly based on EU-law. We argue that requirements set by the European Court of Justice in this respect could be met as far as prudential supervision is based on obligations deriving from the EU-banking directives. In our view, this situation does not create negative effects, as the European case law allows to duly take into account the complexity of prudential supervision and the discretion left to supervisory authorities in performing their functions.*

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# Challenging the prudential supervisor: liability versus (regulatory) immunity.

## Lessons from the EU experience for Central and Eastern European countries

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## **Introduction**

Over the last decade, bank failures in different EU-countries have increasingly led to liability claims being directed against supervisory authorities for alleged negligence or improper conduct by these authorities in exercising their supervisory responsibilities over credit institutions. In general, these claims are introduced by depositors with the failed banks who, following the bank failure, have not managed to fully recover their deposits, as the latter are often only partially covered by deposit guarantee schemes. More exceptionally, liability claims originate from shareholders of the bank or the bank management itself, alleging unlawful conduct of the supervisory authority.

Several factors can explain the increasing importance of the supervisory liability issue. First, this evolution goes along with the gradual emergence of prudential regulation as a formal body of law in EU-countries, mainly as a consequence of the adoption of European directives and the need to implement these directive into formal rules at national level. Until hardly more than two decades ago, prudential supervision of banks mainly rested on vague and general rules, the application of which left a large discretion to the authorities responsible for prudential supervision. At present, the supervisory action is much more embedded into formal, often very detailed rules, pertaining to both authorisation requirements and ongoing supervision. The ensuing formalisation of supervision not only substantially reduces the latitude of supervisory authorities, but also makes the supervisory action more open to challenge by different stakeholders. Furthermore, the European directives also stress the need to provide for adequate legal protection to the supervised entities, allowing them to a large extent to challenge decisions of the supervisory bodies in court.

Second, the 'emancipation' of the financial consumer over the last years has increased the risk of litigation against the prudential supervisors, and might increasingly induce depositors with a failed bank to attempt to shift their losses onto the supervisory authorities. This situation might also in part be caused by the (mis)perception of depositors as to the capacity of prudential authorities to avoid banking failures.

The basic assumption of this paper is that integrated markets within the European Union, and in the near future, also including Central and Eastern European countries, should function under more or less similar rules as regards possible supervisory liability. As prudential law in the EU-countries is to a large extent based on European directives, which intend to create a level playing field between EU-member states, there is an argument for promoting more convergence as regards supervisory liability as well. It goes without saying that this issue also bears specific importance for the emerging economies in Central and Eastern European countries, as these countries are also adapting to the *acquis communautaire*

In Part I, we will in general discuss the sources of supervisory liability, and the policy issues involved for the regulators as regards accepting or limiting liability. In Part II, we provide an overview of the present legal situation in the EU-member states, which will show large disparities as regards the legal framework for supervisory liability. We then attempt to provide a cross-country analysis of possible situations where liability may arise, based on cases brought before the courts in the member states examined.



In Part III, we analyse the implications of EU banking integration, and in particular the harmonisation of banking supervisory standards, on supervisory liability. We submit first that home country control in EU banking leads to a shift in liability to the home country supervisor and home country liability laws as well. Further, we will examine how convergence in liability regimes amongst EU member states could be achieved. Specific attention will be devoted to the possible application of the so-called *Francovich*-liability to supervisory liability. Our conclusion will reflect on the prospects for convergence in supervisory liability in the EU and the importance of the issue for the new member states.

### ***1. Causes and risks of supervisory liability: the supervisor's dilemma and policy issues***

In general, liability of the banking supervisor can be conceived in two ways: (A) liability towards third parties, mainly depositors or (B) liability towards the financial institution subject to supervision. This duality in supervisory liability risk will often confront the supervisory authority with a dilemma (C), to the extent the interests of financial institutions and depositors do not necessarily converge. This is in particular the case when a financial institution is in financial distress.

#### **A. Liability towards depositors**

In general, the creditors of a financial institution, in particular depositors, will claim liability of the prudential supervisor following the bankruptcy of the supervised institution, to the extent they have not managed to fully recover their claims out of the bankruptcy or after reimbursement by the deposit guarantee or investor compensation system. The motives underlying their claim against the supervisory authority are alleged shortcomings of the latter in adequately discharging its supervisory responsibilities, thereby causing losses to the depositors. The griefs formulated by the claimants generally are related to negligent passivity or a lack of diligence on the part of the supervisor, faced with indications of financial distress of the supervised institution. For instance, when the supervisor failed to take adequate intervention measures, such as revoking the bank managers or temporarily prohibiting business although it knew or ought to have knowledge of serious dysfunctions (e.g. fraud) or financial difficulties of the supervised bank. Less pronounced are the cases in which the supervisory authorities have failed to closely follow and monitor a financially distressed bank through periodical verifications and assessment of the intervention measures it has taken.

#### **B. Liability towards the supervised financial institutions**

The potential cases of supervisory liability towards the supervised institution itself or its shareholders do not relate to alleged passivity or negligence in exercising prudential supervision, but more to the opposite situation of 'overreaction' by the supervisor or unlawful conduct. Indeed, a financial institution bears primary responsibility for the management of its business, and cannot therefore blame the supervisor for having been negligent or too passive in detecting or reacting to its own shortcomings. By contrast, a financial institution could



suffer damages following a proactive or harsh intervention by the supervisory authority which might affect its reputation and frustrate depositors' confidence. For instance, the supervisor might be blamed for having intervened too severely following indications of financial difficulties of the supervised financial institution (e.g. prohibition of certain activities or revocation of the banking licence in reaction to limited financial difficulties). Furthermore, the supervisor might incur liability for infringing specific prohibitions, such as violation of its professional secrecy obligations.<sup>1</sup>

### C. The supervisor's dilemma

The abovementioned liability risks are illustrative of the delicate situation the prudential supervisor is faced with in exercising its supervisory duties, in particular when confronted to a financially distressed credit institution. In the latter case, the supervisory authority has to find a balance between conflicting interests, which are intrinsically connected with the basic objectives of prudential regulation: on the one hand, maintaining the safety and soundness of financial institutions and the financial system as a whole; on the other hand, protecting the depositors and other creditors of financial institutions. A proactive attitude of the prudential supervisor towards the supervised institution might be beneficial for (prospective) depositors of the individual bank, but may harm the financial institution itself as a consequence of loss of reputation or credibility in the market, and even produce destabilising effects on the financial system as a whole. By contrast, adopting a cautious attitude, though protecting the financial institution, could subsequently expose the supervisory authority to claims from depositors, when it has enabled the financial institution to further accumulate, under an apparent solvency, losses to the detriment of (prospective) depositors and other creditors.<sup>2</sup> The supervisor's dilemma is much similar to the situation of a credit institution in discharging loans to a business enterprise: when the borrower is in financial distress, the creditor has to find a balance between on the one hand the risk of liability towards other creditors of the failing borrower for having created an apparent solvency by maintaining a credit line, and on the other hand the risk of liability towards the borrower itself for abruptly putting an end to the credit relation.<sup>3</sup>

### D. Supervisory liability: policy issues

The issue of supervisory liability, and whether or not or to which extent to accept it as a matter of principle, is essential in the design of banking regulation and policy. Exposing supervisory authorities to large liability risks could in fact lead to shifting to a large extent the costs of banking failures to the State. This would run contrary to the very purpose of

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<sup>1</sup> See, for instance, in England: *Melton Medes v. Securities and Investment Board* [1995] 2 *Weekly Law Reports*, p. 247.

<sup>2</sup> J.-W. VAN DER VOSSEN, "Supervisory Standards and Sanctions", in *Banking and EC Law Commentary*, M. VAN EMPPEL, R. SMITS (eds.), Amsterdam Financial Series, Deventer, Kluwer, looseleaf, (March 1992), at p. 48-49.

<sup>3</sup> There is, however, an important difference between both situations, which makes the supervisor's dilemma even more acute: while the bank-borrower relationship stems from a contract, the prudential supervisor embodies the public interest in discharging its legal duty to supervise. Nevertheless, it should be noted that the existence of lender liability also rests on the assumption that banks are 'special' in relation to other creditors, and sometimes have (wrongfully) been considered exercising a public interest duty in granting loans.



prudential regulation in a market economy: the ultimate objective of prudential regulation should not be to avoid banking failures altogether at any cost, but to leave primary risks for banking failures to the shareholders and creditors of the failed banks. Prudential regulation merely constitutes a specific external monitoring device regarding the financial solidity and integrity of financial institutions, which basically does not modify the allocation of risks in case of a banking failure. Hence, prudential regulation is not a substitute to the normal system of risk allocation within a business enterprise, but merely constitutes an additional external controlling mechanism over a banks' management, the existence of which is motivated by the existence of information asymmetries of (small) depositors entrusting their savings to banks.

The same motives underpin the existence of systems of deposit guarantee and investor compensation, which are to be seen as a limited remedy for market failures resulting from the specific risks banks and other financial institutions generate for (small) depositors and investors.

The foregoing does not imply, however, that supervisory liability should be banned altogether. The rationale for prudential regulation, i.e. maintaining depositor confidence through specific integrity and financial control mechanisms, indeed generates a legitimate expectation from the part of depositors and other bank creditors as to the effectiveness of supervision, i.e. diminishing to some extent the likelihood that bank failures occur, without completely eliminating them. Under this approach, bank supervisors are expected to exercise supervision with reasonable care, taking into account the instruments of supervision at their disposal. Banks cannot, however, be totally prevented to fail, and banking supervisors cannot be expected to prevent fraud or unforeseeable losses within the bank.<sup>4</sup> The supervisor may, however, be expected to react diligently and with reasonable care to problems arising within a supervised financial institution, thereby seeking to conciliate as much as possible the interests of the financial system and those of bank creditors. Submitting prudential supervisors to liability rules therefore is not in itself incompatible with the interests pursued by prudential regulation, as it does not automatically shift the cost of banking failures to the state, but only sanctions negligent or unreasonable behaviour from the part of the supervisory authority.

An argument frequently invoked to fend off liability of supervisory authorities is the existence of deposit guarantee systems, which cover the losses incurred by depositors in case of a bank failure. In our view, this argument is flawed. First, deposit guarantee systems generally contain quantitative limits as to coverage, in order to limit moral hazard from the part of depositors and bank management.<sup>5</sup> As a consequence, depositors do not necessarily fully recover their claims from the failed bank. To the extent the bank failure may be (in part) attributed to negligence or shortcomings by the prudential supervisor, there is no reason why the damages suffered by depositors could not be claimed from the authorities which have caused these damages. Second, it is sometimes overseen that deposit protection systems nowadays generally are not funded through government funds, but by the financial community itself, based upon the solidarity principle.<sup>6</sup> Consequently, the assertion that the

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<sup>4</sup> See also R. SMITS, R. LUBERTI, "Supervisory Liability: An Introduction to Several Legal Systems and a case Study", in M. GIOVANOLI, G. HEINRICH (eds.), *International Bank Insolvencies: A Central Bank Perspective*, London, Kluwer Law International, 1999, (363), at p. 367.

<sup>5</sup> In the European Union, the 1994 Deposit Guarantee Directive provides for the creation or recognition by the Member States of deposit guarantee systems which should provide a minimum coverage of at least up to EUR 20,000 in the event of a bank failure. Member States may provide for a higher coverage ceiling.

<sup>6</sup> Indeed, within the European Union, government funding or support to deposit guarantee systems could be considered a state aid contrary to Article 87 EC.



public authorities already offer financial protection through deposit guarantee systems does not hold true.

Finally, submitting prudential authorities to a liability regime might even be regarded as an element of strength of the financial system, as it will have a disciplining effect on the supervisor itself: granting total immunity from liability creates a moral hazard risk on the part of the prudential authorities, as the accountability for their own actions would be reduced. By contrast, a liability regime which takes due account of the nature of prudential supervision and the need for sufficient discretion in taking supervisory measures (see later), will function as a monitoring mechanism with respect to the exercise of supervision, and eventually benefit the financial system as a whole. The assumption that the stringency of financial regulation can be beneficial for the attractiveness of a country's financial system (paradigm of 'competition for excellence'), may also apply as regards the issue of supervisory liability: granting (regulatory) immunity from liability could be seen as an element of weakness of the supervisory system, while applying a well balanced liability regime could be indicative of the accountability of the supervisory authorities. This is not to say that liability is presumed whenever a banking failure occurs: the interested parties claiming liability will have to demonstrate the specific shortcomings in the exercise of prudential supervision, taking into account the (limited) resources of supervision.

## ***II. Overview of liability regimes in different EU countries***

The present legal situation as regards supervisory liability in the EU-Member States is characterised by its large diversity. Different patterns can be identified in this respect. In a first group of countries, no specific liability rules exist with respect to the exercise of prudential supervision, and general tort liability rules apply. Very often, this situation appears not to be the result of a deliberate policy choice, but may be explained by the lack of any precedents in jurisprudence as regards liability claims against supervisory authorities in these countries. By contrast, a second — increasing — group of EU Member States has enacted specific rules as regards the limitation of liability to be possibly incurred by supervisory bodies. Through specific laws, liability is either confined to the situation of gross negligence or bad faith from the part of the supervisory bodies, or even results in total immunity from liability. It is interesting to notice that, very often, the intervention by Parliament to grant (partial) immunity from liability follows specific court decisions where judges have held the supervisory authority liable towards depositors. These immunity regimes therefore are specifically aimed at neutralising possible liability claims in the future. Finally, in a third group of Member States, some limitation of liability stems from the general tort law, which to a certain extent protects state bodies from excessive liability claims.

It should be noted, furthermore, that the diversity of general tort law regimes between EU member states further adds to the fragmentation of supervisory liability regimes. Illustrative in this respect is the concept of 'relativity' or 'proximity' which exists in some countries (e.g. Germany, United Kingdom, Netherlands), but is inexistent in others (e.g. Belgium). According to this concept, the breach of a legal rule will only lead to liability towards persons alleging damages as a consequence of this breach if the said rule is intended to protect the interests of the latter. In the context of supervisory liability, this implies that liability towards depositors will only come into play if prudential regulation is considered to protect the interests of (individual) depositors, and not (only) the interests of the financial institutions or,



more generally, the financial system. We will see that this issue stood at the centre of debates in different jurisdictions.

It goes without saying that prudential supervisors themselves favour some immunity from liability in the exercise of their responsibilities, as appears from the Basle Committee's *Core Principles for Effective Banking Supervision*.<sup>7</sup> Core Principle 1, which lays down the essential preconditions for effective banking supervision, stresses *inter alia* the need to provide for "legal protection for supervisors". The explanatory memorandum to Core Principle 1 further specifies in this regard that supervisors should enjoy "protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties". The Core Principles are not, however, in any respect to be regarded as legally enforceable rules, but are merely recommendations. Moreover, it should be stressed that the *Core Principles* as adopted by the Basle Committee primarily emanate from the supervisory authorities themselves, who have an evident self-interest in promulgating (partial) immunity from liability as a good standard for prudential regulation.

The next sections will give an overview of the main characteristics of the legal regime as regards supervisory liability. A comparative summary is provided in Table 1.

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<sup>7</sup> BASLE COMMITTEE ON BANKING SUPERVISION, *Core Principles for Effective Banking Supervision*, Basle, Sept. 1997, 46 p., <<http://www.bis.org/pub/bcbs30a.pdf>>.



| Country         | Subject of Liability                            | Liability criteria |                  |           | Source   |
|-----------------|---|--------------------|------------------|-----------|--|
|                 |   | Negligence         | Gross Negligence | Bad faith |  |
| Basle Committee | Not specified                                   | N                  | N                | Y         | Core Principle 1   |
| United Kingdom  | Financial Services Authority                    | N                  | N                | Y         | Schedule I, section 19(3) Financial Services and Markets Act |
| Germany         | Bundesanstalt für Finanzdienstleistungsaufsicht | N                  | N                | N         | § 6 III Kreditwesengesetz                                    |
| France          | French state                                    | N                  | Y                | Y         | Case law of Conseil d'Etat                                   |
| Belgium         | Banking and Finance Commission                  | N                  | Y                | Y         | Art. 68 Law 2 August 2002                                    |
| Netherlands     | De Nederlandsche Bank                           | (Y)                | (Y)              | (Y)       | General tort law (subject to relativity requirement)         |
| Luxembourg      | Commission de Surveillance du Secteur Financier | N                  | Y                | Y         | Art. 20 Law of 23 December 1998                              |
| Ireland         | Central Bank of Ireland                         | N                  | N                | Y         | Section 25A Central Bank of Ireland Act 1997                 |

Table 1: Comparative overview of supervisory liability of banking supervisors in different EU Member States, compared to the Basle Committee *Core Principles* recommendation



## A. Country-analysis

### 1. Germany

#### a. The case law

Historically the first EU Member State where, to our knowledge, supervisory liability arose in the courts, was Germany. The German situation is archetypical for the evolution in several Member States, which introduced statutory immunity regimes, as a reaction to case law holding the banking supervisor liable for negligence.

The legal foundation for supervisory liability in German law is § 839 *Bürgerliches Gesetzbuch* (BGB), according to which a public servant can be held liable for damages for breach of a professional duty owed to third parties. According to general tort law, however, only those third parties who establish that the duty which allegedly has been breached was instituted not only to protect the general interest, but also the interests of the claimant, are eligible to claim damages (so-called ‘*Schutznormtheorie*’).<sup>8</sup> Hence, in order to base supervisory liability on § 839 BGB, the plaintiff must first prove that prudential regulation and supervision not only serves the general interest, but also his individual interests.

The case law with respect to the latter issue showed an interesting evolution. Until the late seventies, the case law firmly held that the then applicable banking supervisory law (the *Kreditwesengesetz 1939*) served the public interest only. Private individuals, whether the supervised banks or bank creditors, could therefore not claim damages for alleged deficient prudential supervision.<sup>9</sup> It was commonly accepted that the same conclusion subsequently applied in application of the 1961 Banking Act.<sup>10</sup> The German Supreme Court (*Bundesgerichtshof*) confirmed this point of view with respect to insurance supervision<sup>11</sup>: the Supreme Court held that prudential supervision realised a *collective* protection of the insured, granting only indirectly protection to individual insured persons as part of the group.

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<sup>8</sup> See, *inter alia*, Bundesgerichtshof 31 March 1960, *Neue Juristische Wochenschrift* 1960, p. 1005; Bundesgerichtshof 28 April 1960, *Versicherungsrecht* 1960, p. 979; Bundesgerichtshof 27 May 1963, *Neue Juristische Wochenschrift* 1963, p. 1821; See also K. BENDER, "Die Amtspflichten des Bundesaufsichtsamtes für das Kreditwesen gegenüber einzelnen Gläubigern eines Kreditinstituts", *Neue Juristische Wochenschrift* 1978, p. 622.

<sup>9</sup> Oberlandesgericht Bremen, 13 November 1952, *Neue Juristische Wochenschrift* 1953, p. 585; Oberlandesgericht Hamburg, 28 June 1957, *Betriebs-berater* 1957, p. 950; See also H.CH. KOPF, H. BAÜMLER, "Die neue Rechtsprechung des BGH zur Amtshaftung im Bereich der Bankenaufsicht", *Neue Juristische Wochenschrift* 1979, p. 1871.

<sup>10</sup> See Oberlandesgericht Köln, 19 September 1977, *Neue Juristische Wochenschrift* 1977, p. 2213.

<sup>11</sup> Bundesgerichtshof 24 January 1972, *Neue Juristische Wochenschrift* 1972, 577; Critically: R. SCHOLZ, "Versicherungsaufsicht und Amtshaftung", *Neue Juristische Wochenschrift* 1972, p. 1217-1219. The supreme Court considered in the same judgment that an identical rule applied for banking supervision, although the banking act was not at stake in the case.



Two judgments of the German Supreme Court delivered in 1979<sup>12</sup> fundamentally reversed the traditional opinion. Based on a detailed analysis of the German Banking Law of 1961 and the purposes of banking supervision under this Act, the Supreme Court held that the Banking Act purported to protect individual bank creditors, who could therefore claim damages from the banking supervisory authority for alleged deficient supervision. Considering prudential supervision as a creditor protection device at the same time implied that neither the supervised bank itself or its shareholders<sup>13</sup>, nor competitors of the bank<sup>14</sup> could claim damages from the supervisory authority.

These judgments provoked fierce debates amongst scholars.<sup>15</sup> Opponents basically argued that accepting liability would in the end lead to a situation of State guarantee for failed banks.<sup>16</sup> Proponents of the judgments welcomed the individualist approach advocated by the supreme court, as it would respond to creditors' expectation as to the proper functioning of the supervisory authorities.<sup>17</sup>

In further elaborating the conditions of possible liability, the Supreme Court took into account the necessity to leave a sufficient margin of discretion to the supervisory authority, within which it should be able to take account of the interests of both the creditors and the supervised credit institution itself. The judge must refrain from assessing the opportunity of decisions or measures taken by the prudential supervisor, but should only investigate whether the supervisor has made an error in judgment given all the elements of the situation at hand. Liability would then be established, without the victim having to prove that the supervisor behaved arbitrarily or abused its powers. In the end, the discretion left to the prudential supervisor will substantially reduce the risk of liability being actually established. In the *Herstatt*-case, the *Oberlandesgericht* to which the case was redirected after the Supreme Court's judgment, did not hold the supervisory authority liable, as it considered that the latter did not commit any error in judgment of the situation.<sup>18</sup>

## b. The reaction: Statutory immunity

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<sup>12</sup> Bundesgerichtshof 15 February 1979 (*Wetterstein*), *NJW* 1979, 1354; Bundesgerichtshof 12 July 1979 (*Herstatt*), *Neue Juristische Wochenschrift* 1979, 1879, *Juristenzeitung* 1979, p. 683, *Wertpapier-Mitteilungen* 1979, p. 632. The latter case, introduced in the aftermath of the *Herstatt* bankruptcy, annulled the judgment of the *Oberlandesgericht Köln*, 19 September 1977, cited *supra* note 10.

<sup>13</sup> See Bundesgerichtshof 15 March 1984, *Neue Juristische Wochenschrift* 1984, p. 2691; This is similar to the case law under English law: see later.

<sup>14</sup> COMPARE. H.-J. PAPIER, in *Münchener Kommentar zum BGB*, K. REBMANN, F.J. SÄCKER, (eds.), Vol. 3, 2nd ed., München, Beck, 1986, § 839, para 216, p. 1942.

<sup>15</sup> For a general overview, see: E. HABSCHIED, *Staatshaftung für fehlsame Bankenaufsicht?*, Bielefeld, Giese King, 1988, p. 42 et seq. and the references cited in note 1.

<sup>16</sup> See, *inter alia*, E. BLEIBAUM, *Die Rechtsprechung des BGH zur Staatshaftung im Bereich der Bankenaufsicht*, Würzburg, 1982, p. 22 et seq.; H. HAHN, E. BLEIBAUM, "Bankenaufsicht und Staatshaftung", in *Institutionen des Währungswesens*, H. HAHN, (ed.), Baden-Baden, Nomos, 1983, (105), p. 118; T. NIETHAMMER, *Die Ziele der Bankenaufsicht in der Bundesrepublik Deutschland*, Berlin, Duncker & Humblot, 1990, p. 153; G. PÜTTNER, "Von der Bankenaufsicht zur Staatsgarantie für Bankeinlagen?", *Juristenzeitung* 1982, p. 47-50; E. SCHWARK, "Individualansprüche Privater aus wirtschaftsrechtlichen Gesetzen", *Juristenzeitung* 1979, (670), p. 673-674.

<sup>17</sup> H.Ch. KOPF, H. BÄUMLER, *l.c.*, cited *supra* note 9, p. 1872-1873.

<sup>18</sup> A new appeal against this decision before the Supreme Court was unsuccessful: see Bundesgerichtshof 21 October 1982, *Neue Juristische Wochenschrift* 1983, p. 563.



In view of the liability risk generated by the Supreme Court decisions, Parliament amended the *Kreditwesengesetz* in 1984. A new paragraph 3 was added to § 6 of the law, which states that the banking supervisor fulfils its statutory tasks exclusively in the general interest. The objective of the law was clearly to fend off liability claims in the future, by indicating that prudential supervision did not serve the protection of individual creditors.<sup>19</sup> Similar provisions were enacted in the field of investment firm supervision and insurance supervision.<sup>20</sup> They have been maintained after the recent reform of the structures of financial supervision.<sup>21</sup> As a result, the supervisor finds itself totally shielded from civil liability.

The compatibility of this statutory immunity with the German constitution has been questioned by several authors.<sup>22</sup> The (lower) courts which had to judge on liability cases in recent years are not, however, inclined to support this point of view.<sup>23</sup>

## 2. United Kingdom

### a. The case law

The United Kingdom witnesses a roughly similar evolution with respect to supervisory liability as Germany: though only very few cases were brought before the courts and the latter appeared quite reluctant as to accept supervisory liability, Parliament subsequently sought to neutralise a possible liability risk by granting partial immunity of liability through law.

The issue of supervisory liability only appeared in the late eighties in English case law. However, an earlier judgment of the *Privy Council* delivered in a case involving the banking law of Hong-Kong<sup>24</sup> constituted an important precedent. The plaintiffs, who were creditors of a failed bank, alleged that the Hong Kong supervisory authority had negligently granted and maintained a banking licence to the failing bank. The *Privy Council* held that liability could

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<sup>19</sup> W.M. WALDECK, "Die Novellierung des Kreditwesengesetzes", *Neue Juristische Wochenschrift* 1985, (888), p. 892; F. RITTNER, *Wirtschaftsrecht*, 2nd ed., Heidelberg, C.F. Müller, 1987, 583; N. HORN, N., P. BALZER, P., "Germany", in *Banking Supervision in the European Community. Institutional Aspects*, Brussels, Editions de l'ULB, 1995, p. 142; P. CLAUSSEN, *Bank- und Börsenrecht*, München, Beck, 1996, p. 40-41, para 15. See however: M. BRENDLE, *Amtshaftung für fehlsame Bankenaufsicht?*, Darmstadt, S. Toeche-Mittler Verlag, 1987, p. 442 and 565, who considers that § 6 III *Kreditwesengesetz* does not touch upon the individually protective aspect of banking supervision.

<sup>20</sup> Zie § 1, para 4 *Börsengesetz*; § 4, para 2 *WertpapierHandelsGesetz*; § 81, para 1, 3<sup>rd</sup> sentence *Versicherungsaufsichtsgesetz*.

<sup>21</sup> § 4, para 4 of the *Finanzdienstleistungsaufsichtsgesetz* (FinDAG) dated 22 April 2002 (*BGBl* I, 2002, p. 1310) states that the integrated supervisor (Bundesanstalt für Finanzdienstleistungsaufsicht) may exercise its functions and use its powers solely in the general interest.

<sup>22</sup> For an extensive analysis, see: E. HABSCHIED, cited *supra* note 15, p. 85 et seq.; H.-J. PAPIER, cited *supra* note 14, para 215. See also, more recently: M. GRATIAS, *Staatshaftung für fehlerhafte Banken- und Versicherungsaufsicht im Europäischen Binnenmarkt*, Baden-Baden, Nomos, 1999, p. 79-94.

<sup>23</sup> See Oberlandesgericht Köln, 11 January 2001, *ZIP* 2001, p. 645, *Wertpapier-Mitteilungen* 2001, p. 1372, *EwiR* 2001/20, 962, note R. SETHE. An appeal against this judgment has been made before the German Supreme Court (see later), in which the incompatibility of § 6 III *Kreditwesengesetz* with the German constitution has also been invoked. No final judgment has been delivered yet by the Supreme Court.

<sup>24</sup> *Yuen-Kun-yeu and others v Attorney General of Hong-Kong* [*Privy Council*], [1987] 2 *All England Reports*, p. 705



only be conceived when a sufficient *proximity* existed between the supervisory authorities and the bank creditors, such as to legitimate a duty of care of the former towards the latter. The Privy Council held that this condition was not met under Hong Kong law, given the limited instruments of supervision, which did not allow a continuous monitoring over the bank's daily management, and the consideration that supervision did not intend to offer to individual creditors any guarantee as to the bank's creditworthiness.<sup>25</sup>

The English courts proved to be even more stringent as regards the conditions of supervisory liability. In *Minorities Finance Ltd v Arthur Young and Johnson Matthey plc v Arthur Young*<sup>26</sup> the *Queen's Bench Division* added that the existence of a duty of care, the breach of which could give rise to supervisory liability, had to be "fair and reasonable". As a consequence, the court held that no supervisory liability could exist towards the supervised bank itself: accepting liability would entail the possibility for banks to shift the costs of bad management to the supervisory authority. Likewise, the court held that no supervisory liability could exist towards the supervised bank's parent company, as the latter possesses ample means to monitor the management of its subsidiary bank.<sup>27</sup> On the contrary, the court did not make a firm statement as to possible liability of the Bank of England as supervisory authority towards bank creditors. This may explain why Parliament amended the Banking Act in 1997.

#### b. The reaction: Statutory immunity

Parliament reacted to the potential liability risk towards depositors left open by the courts by including in the Banking Act 1987 a provision according to which neither the Bank of England nor any of its staff members or board members could be held liable for any act or negligence in discharging the Bank of England's statutory duties, unless it appears that the act or omission was done in bad faith. A similar limitation of liability was granted to the regulatory bodies instituted under the *Financial Services Act 1986*.<sup>28</sup> At present, the *Financial Services and Markets Act 2000*, which has unified supervision over financial services providers in the hands of the *Financial Services Authority* (FSA), provides for a similar immunity regime, save for one exception: beneath *bad faith*, liability of the FSA can also be based on breach of the Human Rights Act.<sup>29</sup> The immunity regime does not exclude the possibility to challenge supervisory acts through judicial review.<sup>30</sup>

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<sup>25</sup> A similar case was decided with respect to the banking legislation of the Isle of Man: see *Davis v. Ratcliffe*, [1990] 1 *Weekly Law Reports* p. 821.

<sup>26</sup> *Minorities Finance Ltd v Arthur Young (a firm) (Bank of England, third party); Johnson Matthey plc v Arthur Young (a firm) (Bank of England, third party)* [QBD], [1989] 2 *All ER*, 105.

<sup>27</sup> See also *Hall v. Bank of England* [CA], 19 April 1995, cited in Ch. PROCTOR, "Financial regulators – Risks and liabilities", *Butterworths Journal of International Banking and Financial Law* 2002, p. 19, where the shareholders of the deposit-taking company blamed the Bank of England for having instructed the management to proceed to the sale of assets, causing losses to the shareholders.

<sup>28</sup> See s. 187 *Financial Services Act 1986*.

<sup>29</sup> See Schedule I, Section 19(3) *Financial Services and Markets Act 2000*.

<sup>30</sup> See G. PENN, *Banking Supervision. Regulation of the UK banking sector under the Banking Act 1987*, London, Butterworths, 1989, 22.



Since a statutory immunity regime does not necessarily rule out liability based on *common law*, it was not clear how the courts would react to the new statutory regime.<sup>31</sup> In the aftermath of the BCCI failure, a number of depositors claimed damages from the Bank of England for alleged improper supervision.<sup>32</sup> Both the Queen's Bench Division in first instance<sup>33</sup> and the Court of Appeal in appeal<sup>34</sup> held that only the tort of *misfeasance in public office* could give rise to liability under common law. Though the issue was not decided unequivocally, the House of Lords, upon appeal against the judgment of the Court of appeal, decided that *misfeasance in public office* required that the supervisor should have knowledge of the fact that its acts would cause damages to depositors.<sup>35</sup> It is submitted that this requirement is similar to the condition of *bad faith* under statutory law. Hence, the statutory limitation of liability to situations of *bad faith* cannot be circumvented through a liability claim based on common law.<sup>36</sup>

### 3. Ireland

The situation under Irish law is largely similar to the present statutory regime in England. In 1997, the Central Banking Act 1987 was amended by insertion of a new section 25A, which states that: “[t]he [Central] Bank or any employee of the [Central] Bank or any member of its Board or any authorised person or authorised officer appointed by the [Central] Bank for the performance of its statutory functions shall not be liable for damages for anything done or omitted in the discharge or purported discharge of any of its statutory functions under this Act unless it is shown that the act or omission was in bad faith”. The provision seems to be inspired by the English statutory immunity, with a view to anticipating possible future liability cases. No reported cases on liability claims directed against supervisory authorities have been found.

### 4. Luxembourg

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<sup>31</sup> Compare. E.P. ELLINGER, E. LOMNICKA, *Modern Banking Law*, 2<sup>nd</sup> ed., Oxford, Clarendon Press, 1994, p. 32, according to whom the statutory provision has eliminated separate actions under common law.

<sup>32</sup> See about the claims introduced A. JACK, “BCCI depositors sue Bank for failing as regulator”, *Financial Times*, 25 May 1993. It appeared that 6019 depositors introduced the claim against the Bank of England: See *Three Rivers District Council and Others v. Governor and Company of the Bank of England [C.A.]*, [1995] 3 *weekly Law Reports*, p. 650, [1995] 4 *All England Reports*, p. 312.

<sup>33</sup> *Three Rivers District Council and others v Bank of England (No 3)*, [1996] 3 *All England Reports*, p. 558 [QBD].

<sup>34</sup> *Three Rivers District Council and others v Bank of England*, [1999] 4 *All England Reports*, p. 800 [CA].

<sup>35</sup> *Three Rivers District Council and Others (original appellants and cross-respondents) v. Governor and Company of the Bank of England (original respondents and cross-appellants)*, [2000] 2 *Weekly Law Reports*, p. 1220. See also <<http://www.publications.parliament.uk/pa/ld199900/ldjudgmt/jd000518/rivers-1.htm>>. Until now, no final decision has been made on the facts of the case: see Ch. PROCTOR, “BCCI: suing the supervisor”, *The Financial Regulator* 2001, No 6, p. 35 et seq.; Ch. PROCTOR, “Financial regulators...”, cited *supra* note 27, p. 15-19.

<sup>36</sup> See also Ch. PROCTOR, “BCCI: suing the supervisor”, cited *supra* note 35, p. 37, who assimilates *misfeasance in public office* to *bad faith*. Compare *Three Rivers District Council and others v Bank of England (No 3)*, [1996] 3 *All England Reports*, (558), p. 596 j, in which the court decides that the existence of *misfeasance in public office* under *common law* implies the demonstration that the defendant acts in *bad faith* in the sense of section 1(4) Banking Act 1987.



A statutory regime granting partial immunity from liability to the prudential supervisor was introduced in Luxembourg law in the nineties. Until 1993, the law merely stated that the State did not bear liability for the acts of the *Institut Monétaire Luxembourgeois* (IML), which then exercised prudential supervision over banks. The law did not exempt, however, the IML from liability. When implementing the EU Second Banking Directive into national law, Parliament has, probably bearing in mind a liability risk following the BCCI-failure<sup>37</sup>, laid down limitations to possible liability of the banking supervisory authority towards the supervised credit institutions and its creditors. This provision has been subsequently copied into the 1998 law shifting banking supervision to the Commission de Surveillance du Secteur Financier (CSSF).<sup>38</sup>

The Law of 23 December 1998 first clarifies, in a way similar to German law and the earlier German case law, the objectives of prudential supervision: supervision exclusively serves the public interest, and does not purport to protect the individual interests of the institutions subject to supervision, their clients or third parties.<sup>39</sup> Second, the same provision lays down the conditions of possible supervisory liability: the supervisory authority can only be held liable towards either a supervised financial institution, its clients or third parties, when it is established that the damage incurred by the victims is caused by a gross negligence in the choice and use of the methods deployed for the exercise by the supervisory authority of its public duty. It may be submitted that gross negligence does not only encompass bad faith, which constitutes the standard for liability under English and Irish law, but more generally refers to a shortcoming which a normal person placed in the same circumstances would never commit. In this regard, the liability regime is largely similar to the situation which at present prevails in France and Belgium (see later).

However, it should be stressed that, absent any case law, the scope of the statutory liability regime still remains unclear, as the explanatory memorandum of the law underlined that the statutory regime did not preclude the application of the general rules of law as regards liability of public authorities.<sup>40</sup>

## 5. France

The situation in French law as regards supervisory liability is peculiar in several respects. First, contrary to the previous countries analysed, no statutory provision exists as concerns supervisory liability, though there is extensive case-law on the matter. The number of cases which specifically involved supervisory liability over banks and investment firms is substantially higher than in other European countries.<sup>41</sup> This might probably be related to the

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<sup>37</sup> Apparently, a liability claim has also been filed against the banking supervisory authority in the aftermath of the BCCI failure, the holding company of which was established in Luxembourg: see E. DE LHONEUX, M. CROMLIN, "Luxembourg", in *Banking Supervision in the European Community*, Brussel, Editions de l'ULB, 1995, (217), 233. The outcome of that liability claim is unknown.

<sup>38</sup> Law of 23 December 1998 "portant création d'une commission de surveillance du secteur financier", *Mémorial*, A n° 112,, 24 December 1998.

<sup>39</sup> See Art. 20 Law of 23 December 1998.

<sup>40</sup> See A. ELVINGER, "Histoire du droit bancaire et financier luxembourgeois", in *Droit bancaire et financier au Grand-Duché de Luxembourg*, Brussel, Larcier, 1994, vol. 1, (3), p. 44-45, para 144; E. DE LHONEUX, M. CROMLIN, *l.c.*, *supra* note 37, at p. 234.

<sup>41</sup> This has not changed in recent years. For instance, in the aftermath of the BCCI-failure, more than 60 liability claims were brought before the courts in France (see COMMISSION BANCAIRE, *Rapport 1994*, p. 96).



relatively high number of (small) bank failures in France over the last decades compared to its neighbouring countries. By contrast, over more than 40 years of jurisprudence, only 2 cases are known where the courts effectively held the state liable for deficient supervision.<sup>42</sup> Second, contrary to the other jurisdictions examined, liability under French law rests directly on the State, as the authorities responsible for prudential supervision (*Commission Bancaire* for credit institutions and *Commission des Opérations de Bourse* for portfolio managers) are deprived of legal personality.

The principles guiding supervisory liability under French law are to be found in general tort law, as applied by the courts. First, it should be noted that, contrary to German law, French tort law does not apply the ‘relativity’ rule. It is therefore irrelevant to first examine whether or not the prudential rules are intended to protect the (individual) interests of banks or bank creditors, or merely serve the public interest. In contrast with other civil law countries however, the French judiciary has traditionally applied less stringent standards with respect to liability of public authorities when, due to the complexity of their duties, these authorities should not be held liable for normal negligence (*faute légère*).<sup>43</sup> In that case, public authorities can only be held liable for their gross negligence (*faute lourde*) in exercising their duties. The *Conseil d’Etat*, which is in last instance competent to decide on liability claims directed against public authorities<sup>44</sup>, has consistently applied this specific liability standard to prudential authorities, without ever extensively providing motives for its position.<sup>45</sup> This approach did not meet unanimous consent in legal writing.<sup>46</sup> This specific liability regime as applied by the courts probably explains why Parliament has refrained until now from introducing specific legal provisions limiting supervisory liability.

In recent years, some lower administrative courts have taken a different view on the criteria for supervisory liability, accepting liability even in case of normal negligence (*faute légère*).<sup>47</sup>

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The withdrawal of the authorization of ‘United Banking Corporation’ in 1993 provoked more than 80 claims (COMMISSION BANCAIRE, *Rapport* 1993, p. 90), and led to the landmark “Kechichian”-judgment of the *Conseil d’Etat* in 2001 (see footnote 42).

<sup>42</sup> See : *Conseil d’Etat* 24 January 1964, Achard, *Juris-Classeur Périodique*, 1965, édition Générale., II, No 14416, and recently *Conseil d’Etat* 30 November 2001, Kechichian, *Juris-Classeur Périodique* 2002, édition Générale., II, No 10042, note J.-J. MÈNURET, *Petites Affiches* 2002, No 28, p. 7, with opinion of A. SEBAN.

<sup>43</sup> For an overview of the relevant case-law, see: F. MODERNE, note under *Conseil d’Etat* 29 December 1978, *recueil Dalloz* 1979, I.R., p. 155.

<sup>44</sup> See for the first application of this jurisprudence *Tribunal des Conflits*, 8 February 1873, *Recueil Dalloz*, 1873, III, p. 17, which grants to the administrative courts, and not to the civil courts, exclusive competence as regards liability claims directed against public authorities. However, as regards liability of the *Commission des Opérations de Bourse*, not the administrative courts are competent, but the *Cour d’Appel* of Paris.

<sup>45</sup> See for the first case: *Conseil d’Etat* 12 February 1960 (2 cases), *Banque* 1960, p. 320, note X. MARIN.

<sup>46</sup> See for instance the criticism voices by J. BECQUÉ, H. CABRILLAC, “Chronique de législation et de jurisprudence françaises”, *Revue trimestrielle de Droit civil* 1960, p. 614. Others found in the approach adopted by the *Conseil d’Etat* a right balance between the duty to supervise on the one hand and the risk of shifting the cost of all bank failures to the State on the other: see, for instance, F. MODERNE, note under *Conseil d’Etat* 29 December 1978, *Recueil Dalloz* 1979, I.R. p. 155; M. WALINE, note under *Conseil d’Etat* 13 June 1964, *Revue de droit public*. 1965, (75), p. 82; R. DENOIX DE SAINT-MARC, “Rapport français”, in *La responsabilité du banquier: aspects nouveaux*, Travaux de l’Association Capitant, Vol. XXXV (1984), Paris, Economica, 1986, (565), at p.573

<sup>47</sup> See for an analysis: D. FAIRGRIEVE, K. BELLOIR, “Liability of the French State for Negligent Supervision of Banks”, *European Business Law Review* 1999, p. 17; M. ANDENAS, D. FAIRGRIEVE, “To Supervise or to Compensate?”, in M. ANDENAS, D. FAIRGRIEVE (eds.), *Liber amicorum Lord Slynn of Hadley: Judicial Review in International Perspective*, London, Kluwer, 2000.



<sup>48</sup> However, in the landmark *Kechichian*-judgment of 30 November 2001<sup>49</sup>, the *Conseil d'Etat* has maintained its traditional jurisprudence, limiting supervisory liability to situations of gross negligence.<sup>50</sup> As far as liability of the Commission des Opérations de Bourse in its prudential supervision over portfolio managers is concerned, the Paris Court of Appeal equally applies the 'gross negligence'-standard.<sup>51</sup>

It is surprising to notice that the *Conseil d'Etat*, though repeatedly referring to 'gross negligence' as standard for supervisory liability, never gave any definition of it or provided any element enabling to distinguish between normal and gross negligence. Several authors see the difference as follows: while a normal negligence corresponds to a shortcoming which would not be committed by a 'normal' supervisor placed in the same circumstances, the gross negligence refers to those situations of such a flagrancy that even a non-professional would not have committed them. It supposes a manifest deficiency in the functioning of the public service which leads to apparent mistakes.<sup>52</sup>

## 6. Belgium

Belgian law did not until 2002 know any specific statutory regime as regards supervisory liability, nor did it face supervisory liability claims brought before the courts in the field of banking supervision.<sup>53</sup> In contrast to the situation under French law, it was generally accepted that under Belgian law the prudential supervisor could be held liable for negligence according to the normal liability standards of general tort law (article 1382-1383 *Code civil*).<sup>54</sup> As a consequence, the supervisor could be held to damages for its normal negligence.

This situation has recently changed: the reform of the supervisory system by Act of 2 August 2002 has led to inclusion in the law of a limitation of liability for the Banking and Finance Commission in the exercise of its statutory tasks. Article 68 Law 2 August 2002 first states, in a way similar to German law, that the Banking and Finance Commission (BFC) fulfils its

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<sup>48</sup> Interesting in this respect are mainly two judgments delivered by the Cour Administrative d'Appel (TAA) of Paris: TAA Paris 30 March 1999, *El Skikh, La Semaine Juridique* 2000, Edition Générale., II, No 10276; TAA Paris 25 January 2000, *Kechichian*. The latter decision was subsequently quashed by the Conseil d'Etat.

<sup>49</sup> Conseil d'Etat 30 November 2001, cited *supra* note 42. The judgment is the more important as it is was decided in full court, and not merely in one of the Conseil's chambers.

<sup>50</sup> Again, the motivation advanced by the court to limit liability to gross negligence was extremely short: the Court merely stressed that supervisory liability could not be a substitute to the primary responsibility of a bank towards its depositors.

<sup>51</sup> Cour d'Appel Paris, 6 April 1994, *Bulletin Joly Bourse*, 1994, 259, note J.-M. DESACHE:

<sup>52</sup> *Zie, inter alia*, opinion of. A. SEBAN in Conseil d'Etat 30 November 2001, *Kechichian, Petites Affiches* 2002, No 28, (7), p. 10-11; J.-J. MÈNURET, note under Conseil d'Etat 30 November 2001, *La Semaine Juridique* 2002, Edition Générale., II, No 10042, p. 502, para 7.

<sup>53</sup> Though one decision been reported with respect to supervision over securities brokers: see Cour de Cassation 9 October 1975, *Revue critique de jurisprudence belge* 1976, p. 165, note A. D'ETEREN and R.O. DALCQ.

<sup>54</sup> Since the landmark judgment of the *Cour de Cassation* in the *Flandria*-case (judgment of 5 November 1920, *Pasicrisie* 1920, I, p. 193) it is clear that public authorities are subject to the same liability standards as private individuals. Different court decisions have referred to possible liability of the prudential supervisor, without ever accepting it in the facts of the case: see Court of First Instance Brussels 28 June 1955, *Journal des Tribunaux* 1956, p. 71; President Commercial Court Bruges 15 January 1982, *Rechtskundig Weekblad* 1982-1983, column 2784; Court of First Instance Brussels, 24 October 1994, *Bank- en Financierwezen*, 1995/4, p. 232



duties in the general interest only, though the legal significance of this provision is not entirely clear<sup>55</sup>. Further, the law states that the BFC, its bodies and personnel are not liable for any decision, act of behaviour in the exercise of their statutory tasks<sup>56</sup>, except in the event of fraud or gross negligence. Government motivated the inclusion of the provision with reference to the Basle Committee's *Core Principles* on the one hand, and the circumstance that prudential supervision under a normal liability regime would entail disproportionate financial risks for the supervisory authority.<sup>57</sup>

Liability in case of fraud or gross negligence will be borne by the Banking and Finance Commission itself, as it is an independent authority with legal personality.<sup>58</sup> This could be potentially problematic, as the BFC is funded through contributions made by the institutions supervised by it. The question then arises what would happen if the BFC's financial resources are insufficient to pay damages once liability is established: it would be difficult to accept for the supervised institutions to ultimately bear the costs of liability through (increased) contributions to the BFC. Therefore, it may be submitted that, to the extent the BFC exercises a task of public interest, a budget deficit of the BFC following an obligation to pay damages in liability, should ultimately be borne by the State.

## **B. Possible cases of liability: a cross-country analysis**

Notwithstanding the differences outlined above between different EU countries as regards the standards for supervisory liability, the situations in which depositors have sought to hold supervisory authorities liable, do not substantially differ in fact. A cross-country analysis of the case law illustrates that liability, when it is not totally excluded by law, can occur under different circumstances. This allows us to further refine the possible situations of potential liability in different aspects of supervision over credit institutions.

### *1. Supervisory action as regards illicit banking activities*

According to the EU Coordinated Banking Directive<sup>59</sup>, all credit institutions should prior to taking up a banking activity obtain an authorisation from the competent authority in their home member state. The directive does not oblige member states to entrust supervisory authorities with investigation powers in order to search for the possible illicit taking-up of banking activities by non-authorised firms. To the extent supervisory authorities only have

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<sup>55</sup> Indeed, under German law, the rule that supervision serves the general interest only is motivated by the existence of a 'relativity'-requirement in liability law. Belgian law does not, however, require 'relativity' as a precondition for establishing liability.

<sup>56</sup> Through the reference to the BFC's statutory tasks in general, the limitation of liability will encompass all functions taken up by the BFC, including its supervision over public offer prospectuses and take-overs. This clearly exceeds the motivation for partial immunity advanced by Government, which referred only to the BFC's prudential functions.

<sup>57</sup> It is submitted, however, that the inclusion of the statutory limitation of liability was at least in part also provoked by the liability claim introduced against the BFC after the failure of Bank Fisher by a number of former depositors.

<sup>58</sup> See Article 44 Act of 2 August 2002.

<sup>59</sup> Article 4 Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126 of 26 May 2000, p. 1.



supervisory powers as regards duly authorised credit institutions, as is the case e.g. in France<sup>60</sup>, they may not be held liable for losses incurred by creditors of non-authorised firms. By contrast, when individual member states have granted investigative powers to supervisory authorities, as is the case in Belgium<sup>61</sup> and Germany<sup>62</sup>, the existence of such powers may be important for possible liability cases, to the extent depositors might suffer damages as a result of illicit deposit-taking business by non-authorised enterprises.<sup>63</sup> The precise scope of such investigative powers should be taken into account when assessing supervisory liability: generally, the investigative powers cannot be analysed as a legal obligation to actually prevent any illicit banking business, but more as a duty to duly monitor possible irregular situations. Liability could then for instance occur when the supervisory authority, after having been informed about possible illicit activities (e.g. advertisements in newspaper, complaints from customers, ...), failed to accurately investigate and follow up the indications it possessed. The supervisor should take all reasonable action in order to put a halt to overt irregular situations, or enquire for situations which cast doubt as to their legality.

## 2. The grant or refusal to grant a banking licence

As a rule, the decision to grant a banking licence is not discretionary for the banking supervisor: the supervisory authority cannot make its decision dependent on the economic needs of the market<sup>64</sup>, and it is normally obliged to grant a licence to every applicant which satisfies the authorisation conditions laid down by law. This is not to say that the banking supervisor has no leeway at all in deciding how to apply the authorisation requirements: many authorisation requirements are very generally worded, and leave room for discretion to the supervisor (e.g. the requirement of adequate internal organization and internal controls within the credit institution). The Coordinated Banking Directive provides for adequate legal remedies for the applicant when the banking supervisor refuses to grant a banking authorization (e.g. judicial review).<sup>65</sup> The possibility for judicial scrutiny also implies that the banking supervisor should indicate the reasons for its refusal to grant a licence.<sup>66</sup> Apart from the possibility to quash the supervisor's refusal through a judicial review, a decision to refuse a licence could lead to supervisory liability towards the applicant, to the extent the latter has been deprived of a commercially profitable opportunity.<sup>67</sup> Equally, the

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<sup>60</sup> See Ch. GAVALDA, J. STOUFFLET, *Droit du crédit*, vol. I: *Les institutions*, Paris, Litec, 1990, p. 253, para 366.

<sup>61</sup> See Article 78 Law of 2 August 2002.

<sup>62</sup> The issue was raised by the plaintiffs before the supreme court in the *Wetterstein*-case (see footnote 12), which involved losses incurred by depositors with a non-authorised financial institution. The supreme court held that § 44 II *Kreditwesengesetz*, which empowers the supervisory authority to investigate whether a person or company qualifies as a credit institution, also serves the interests of the latter's creditors.

<sup>63</sup> According to article 4 of the Coordinated Banking Directive, member states should normally only allow credit institutions to collect deposits or other reimbursable funds from the public or solicit the public with a view to deposit-taking.

<sup>64</sup> See Article 9 Coordinated Banking Directive.

<sup>65</sup> Article 33 Coordinated Banking Directive.

<sup>66</sup> As imposed by Article 10 coordinated Banking directive: "Reasons shall be given whenever an authorisation is refused ...". The same rule applies when an authorisation is subsequently withdrawn: see article 14.2 Coordinated Banking Directive.

<sup>67</sup> Compare, in France, with respect to the control by the *Commission des Opérations de Bourse* on financial information for real estate investment companies: Tribunal d'Arrondissement Paris, 5 April 1979, *Recueil Dalloz*, 1980, I.R. 389.



banking supervisor which does improperly consider a bank manager as being not ‘fit and proper’ (e.g. confusion with other person), runs a liability risk towards the latter.

The reverse situation — the banking supervisor is blamed, mainly by depositors, for having granted a banking licence to a credit institution which did not satisfy the legal requirements for it, also occurs, and has in fact been repeatedly invoked before the courts in different countries.<sup>68</sup> The courts are understandably reluctant to accept liability for these motives<sup>69</sup>, as they have to judge on the facts as they appeared at the moment of granting the authorization, and should avoid the pitfall of an *a posteriori* assessment of the situation. The court should only examine whether, at the time of applying for a banking licence, the applicant satisfied the legal requirements for it, and whether any indications were present which could possibly justify to subject the authorization to certain conditions or even refuse it. If the bank satisfied the legal authorization requirements at the time of granting the licence, the supervisor has not acted improperly. In reality, most difficulties in financial institutions only appear during their existence, and cannot be reduced to unjustified decisions from the part of the supervisor when granting the licence.

### 3. Ongoing prudential supervision and intervention measures

The most frequently occurring cases of supervisory liability are related to the supervisor’s “crisis-management” of financially troubled credit institutions: after occurrence of a banking failure, the supervisor is blamed by third parties, mostly depositors, for not having reacted adequately to indications of financial deterioration or fraud within the supervised financial institution, and consequently to be liable for the accumulation of losses suffered by the plaintiffs. The question whether the supervisory authority has acted with due care and diligence should be assessed by taking account of the factual situation at the time of the difficulties and of the instruments and means the supervisor generally possesses to intervene towards the troubled financial institution.

In all legal systems examined, it is clear that the supervisory instruments and means created by law do not enable to continually exercise supervision through on-site verifications. Supervision is basically exercised on basis of reporting requirements imposed on credit institutions, by means of either periodic reports or specific reports on certain issues commissioned by the supervisory authority to the credit institution itself or to its auditors. On site verifications are mainly intended to verify from time to time the data gathered through the reports. When the reports provided to the supervisory authority contain indications of irregularities, inconsistencies or financial difficulties, it may however reasonably be expected from the supervisory authority to adopt a more proactive attitude towards the supervised financial institution. This might, depending on the circumstances, lead to the request for additional information from the part of the bank or even to an on-site verification.<sup>70</sup> The case

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<sup>68</sup> See in the U.K. the allegations of depositors in the BCCI-case: *Three Rivers District Council and others v Bank of England (No 3)*, [1996] 3 *All England Eeports*, p. 558 [QBD]. Under French law, see: M. WALINE . note under Conseil d’Etat 13 June 1964, *Revue de droit public*, 1965, (75), p. 83.

<sup>69</sup> See, for instance, in France: Conseil d’Etat 12 February 1960, *Banque*, 1960, p. 321, note MARIN; Conseil d’Etat 13 June 1964, *d’André, La Semaine Juridique*, 1965, Edition Générale, II, No. 14416; Conseil d’Etat 19 January 1966, *de Waligorski, La Semaine Juridique*, 1966, Edition Générale, II, No. 14526

<sup>70</sup> See the allegations of the plaintiffs in the German supreme court decision which is currently pending before the European Court of Justice by way of preliminary ruling (see footnote 97): the supervisor is



law indicates that this is considered a critical element in assessing ‘reasonable care’ by the supervisory authority: it is crucial to adequately follow up and monitor problems which the supervisor has discovered through its normal supervisory activity or through information received from third parties<sup>71</sup>, and to take measures which are adequate to the situation. Moreover, in choosing the intervention measures which the law offers to the supervisor, the latter should act proportionately to the gravity of the situation. For instance, in case of indications of serious fraud within the institution, taking measures towards bank management will be more appropriate than in case of a deteriorated financial situation which is caused by inadequate internal controls. As supervisory authorities enjoy a large degree of discretion in the choice and use of intervention measures, the judge should refrain from “taking the supervisor’s seat”, and substitute its judgment to the supervisor’s decision. The judge should merely assess whether the supervisory authority, after having put in balance the interests of both the bank itself and its stakeholders, could reasonably decide as it actually did. This implies, for instance, that the mere fact that the banking supervisor did not react to problems discovered within a financial institution, does not in itself lead to liability.<sup>72</sup> Basically, the courts will have to decide whether, at that time, the supervisor’s action was adequate to deal with the situation, taking account of its seriousness<sup>73</sup>, without being too stringent as to unduly frustrate the depositors’ confidence.

The case law indicates that liability may in these circumstances occur when the supervisor failed to take any action notwithstanding the knowledge of serious difficulties within the financial institution, or when the measures taken were inadequate in view of the seriousness of the problems (e.g. by giving an ‘ultimate warning’ only, without further action, despite the existence of serious irregularities<sup>74</sup>). Equally, the supervisor should be consistent in its action: liability could arise when the supervisor first ordered a credit institution to recapitalize and take other redress action, but subsequently softened its demands without objective justification.<sup>75</sup> Under circumstances, the supervisor might be blamed for not having withdrawn the bank’s authorization when it appeared that the depositors’ interest were seriously threatened.

### **III. Supervisory Liability: The EU context**

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blamed for not having taken adequate measures, such as promulgating a moratorium on deposits, after having discovered serious financial difficulties in a supervised credit institution. Moreover, the plaintiffs consider that the supervisory authority should have taken adequate prudential measures in order to make sure that the supervised bank would join a deposit guarantee scheme.

<sup>71</sup> This was the case in the allegations made by the plaintiffs in the German *Herstatt*-case: the plaintiffs considered that the supervisory authority had been informed by third parties of the disproportionate size of speculative foreign exchange transactions undertaken by Herstatt, but had failed to adequately react to this situation, for instance by making an investigation of Herstatt’s accounts and consequently by not ordering Herstatt to limit its foreign exchange exposure.

<sup>72</sup> Conseil d’Etat 13 June 1964, *d’André, La Semaine Juridique*, 1965, Edition Générale, II, No. 14416, *Revue de droit public*, 1965, p. 84.

<sup>73</sup> See also X., note under Conseil d’Etat 13 June 1964, *d’André, La Semaine Juridique*, 1965, Edition Générale, II, No. 14416.

<sup>74</sup> Conseil d’Etat 24 January 1964, *Achard, La Semaine Juridique*, 1965, Edition Générale, II, No. 14416, *Revue de droit public*, 1965, p.43.

<sup>75</sup> Conseil d’Etat 30 November 2001, *Kechichian*, cited *supra* note 42.



Though supervisory liability is not directly touched upon by the various EU directives aimed at creating an integrated EU banking and financial services market, the ongoing process of financial integration nevertheless indirectly influences the issue of supervisory liability. Two elements deserve further attention: first, the implications of the system of home country control for supervisory liability in terms of identification of the supervisory authority which bears responsibility, for the law applicable to liability claims and for the court competent to decide on such claims. Second, the Europeanization of supervisory law raises the fundamental question whether supervisory liability could be based directly on EU law. This issue is critical in view of the disparities existing between member states as regards supervisory liability. Founding supervisory liability directly on EU law could allow depositors to circumvent immunity regimes existing in their national laws.

## A. Supervisory liability in a home country control paradigm

With the creation of a European passport and home country prudential supervision, the Coordinated Banking Directive not only shifts responsibility for prudential supervision to the country of origin, but also liability: depositors with a branch of a credit institution with its head office in another EU member state will have to direct their liability claims against the home state supervisory authority. This shift in the subject of liability also bears important consequences as for the law applicable to a liability claim and the determination of the competent judge to decide on such claims. The rules of private international law with respect to cross-border liability issues will generally lead to the applicability of the home country law<sup>76</sup>. As regards the determination of the territorially competent judge, depositors could theoretically bring an action against the foreign (home country) supervisory authority before the courts in the host country, by virtue of the applicable European rules.<sup>77</sup> In reality, however, it is most unlikely that a home state public authority would accept the jurisdiction of a host state court. According to a commonly accepted principle in international law, sovereign states normally enjoy immunity before foreign jurisdictions. As prudential supervision directly emanates from public authority, this rule could equally apply to supervisory authorities.<sup>78</sup> As a consequence, depositors might in fact be forced to bring a liability claim against the foreign supervisory authority also before the courts of the home country.

It appears from the foregoing that the legal protection depositors enjoy as regards supervisory action may differ according to the competent supervisory authority in a system of home country control: to the extent the home state supervisor enjoys (partial) immunity from liability, this regime would also affect depositors of foreign EU branches, while depositors with local banks in the host country could possibly be better protected. However, this risk of inequality is not unique, as it also appears in other aspects connected with the home country

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<sup>76</sup> For a detailed analysis, see M. TISON, *De interne markt voor bank- en beleggingsdiensten*, Antwerp, Intersentia, 1999, p. 717-720, para 1414-1420.

<sup>77</sup> Namely the 2001 Brussels II-regulation, which decides *inter alia* on international competence for liability claims. According to the case law of the Court of Justice, an action can be brought before the courts of either the country where the acts were committed or the country where the damage was provoked. The latter would allow the depositors, who allegedly have suffered damages in their country of residence, to bring the liability claims before the courts of their country of residence. See also European Court of Justice. 19 September 1995, *Marinari*, case C-364/93, *European Court Reports* 1995, p. I-2719.

<sup>78</sup> See also CH. PROCTOR, "Financial regulators ...", cited *supra* note 27, p. 78.



rule and mutual recognition, such as deposit guarantee.<sup>79</sup> Contrary to the latter situation, which is clearly enacted in the EU directives and about which banks should inform their depositors, the implications of home country control on supervisory liability have hardly been explored until now. Nevertheless, further convergence as regards responsibility for supervision in a home country control paradigm and the legal effects of it as regards liability, with respect to both applicable law and international jurisdiction, should be welcomed, as they increase, at least from the perspective of the supervisory authority, legal certainty as to the legal framework of supervisory action.

On the other hand, further cross-country convergence as regards supervisory liability would be more consistent with the aim of an integrated market, where decisions to allocate deposits should not be influenced by possibly diverging liability regimes.<sup>80</sup> In this regard, it is of critical importance to find the right balance between the legitimate expectations of depositors as to the quality of prudential supervision, and the need to allocate primary responsibility for bank failures to the banks themselves and their stakeholders. As we already indicated, we believe that systems which generally eliminate liability or limit it to bad faith from the part of the supervisor, do not strike a fair balance between the interests at stake, and might fail to sufficiently discipline supervisory authorities to exercise due care in their tasks. On the other hand, courts should take into account the nature and complexity of prudential supervision in assessing possible liability.

Should further convergence as regards supervisory liability be achieved through European regulation? This would not be necessary to the extent other means can achieve the same objective. In the next section, we argue that the doctrine of state liability for non compliance with EU law, as developed by the European Court of Justice, can lead to the desired convergence, and at the same time avoids excesses in the assessment of supervisory liability.

## **B. Founding supervisory liability on EU law**

### *1. The jurisprudential context: Francovich liability*

Since its landmark *Francovich*-judgment<sup>81</sup> the European Court of Justice has consistently held that a member state could be held liable for non fulfilment of its obligations under EU law,

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<sup>79</sup> Indeed, the 1994 Deposit Guarantee Directive also imposes a system of mutual recognition of guarantee systems. As a consequence, depositors of a foreign branch will be protected by the home state guarantee system, though it may provide for a lower level of coverage than the deposit guarantee system which has been put in place in the country where the branch is established. It should be noted, however, that the risk of 'reverse discriminations' in this context can be eliminated through the 'top up-option', which allows the credit institution to 'top up' the level of deposit guarantee to the (higher) level which exists in the member state of its foreign branch.

<sup>80</sup> A similar concern exists as regards deposit guarantee systems: depositors should make their choice as to where to deposit their savings not dependent on the amount of deposit protection, but principally on the financial soundness of the bank and the financial return on their deposits. This explains why the EU Deposit Guarantee Directive limits the possibility for banks to use better deposit guarantee coverage as a competitive device in advertisement or otherwise.

<sup>81</sup> European Court of Justice 19 November 1991, *Francovich and Bonifaci*, cases C-6/90 en 9/90, *European Court Reports* 1991, p. I-5357.



and that this liability could be legally based on EU law, not on the law of individual member states. The Court considers that the legal protection of individuals against member states could not differ from the protection which is granted to them under Article 228, para 2 EC against the institutions of the European Union.<sup>82</sup>

Since the obligation to exercise prudential supervision and the minimum requirements attached to it are determined by the various EU banking directives, it could be argued that shortcomings in the exercise of prudential supervision constitute a breach of the member states' obligations under the EU directives, and therefore could form the legal foundation for a liability claim directed against the member state for the acts or omissions of its supervisory authority. However, according to the Court's case law, a number of conditions must be satisfied in order to establish *Francovich*-liability, namely:

- (1) There should be a breach by the member state of its obligations under EU law
- (2) The allegedly breached rule is intended to grant rights to private individuals
- (3) There must be a serious breach of Community law
- (4) There is a direct causal link between the breach of Community law and the damages suffered by the victims

These conditions will be further examined in the context of supervisory liability.

## 2. Application of *Francovich*-liability to deficient prudential supervision ?

### a. Breach of an obligation imposed by EU law

The Court's case law witnesses a flexible approach as regards the first condition for member state liability: both the source of the breached rule (EC Treaty or provision of secondary legislation, such as directives) and the originator of the breach (executive power, independent agency, Parliament or judiciary) are irrelevant in order to establish member state liability. Furthermore, recent case law suggests that liability could arise out of both a normative breach of European law, and individual breaches, for instance in the application of rules of European origin in individual cases.

This leads to a further refinement as regards possible liability cases: on the one hand, state liability could arise when a member state has failed to duly implement EU banking directives into national law, and thus has caused damage to private individuals. This situation is generally considered *per se* as a serious breach of EU law. An interesting application in the sphere of banking can be found in two German court decisions, which held the German state liable for not having implemented on time the 1994 Deposit Guarantee Directive. The plaintiffs, who were depositors with a German based bank which went bankrupt, successfully invoked *Francovich*-liability against the German state, which was held to indemnify the depositors for the losses they had incurred as a consequence of the non-existence of a deposit guarantee system in compliance with the directive. Every depositor was awarded an

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<sup>82</sup> European Court of Justice 5 March 1996, *Brasserie du pêcheur/Factortame III*, cases C-46/93 en 48/93, *European Court Reports* 1996, p. I-1029.



indemnity of up to EUR 20,000, corresponding to the minimum coverage level to be offered by each deposit guarantee system to be instituted under the 1994 directive.<sup>83</sup>

By contrast, supervisory liability is not related to a normative incompatibility of national law with EU law, but concerns the alleged improper application of obligations under national law, which originates in EU law, where the former is compatible with the latter. Though the case law of the European Court of Justice with respect to *Francovich*-liability principally concerned issues of normative breach of EU law, at least one case accepted *Francovich*-liability in a situation of non-normative breach of EU law.<sup>84</sup> As a consequence, the circumstance that supervisory liability is not concerned with a normative breach of EU law does not preclude the application of the *Francovich*-doctrine.<sup>85</sup>

#### b. Breach of a rule which is intended to grant rights to private individuals

Critical in applying *Francovich*-liability is the condition that the breached rule, in particular the prudential requirements imposed by the EU directives, are intended to confer rights to private individuals. This requirement in fact incorporates the 'relativity'-rule in the *Francovich*-doctrine: an analysis of the objectives of the EU prudential rules must indicate their purpose to protect private individuals. The case law of the European Court of Justice however witnesses a quite flexible approach as to this requirement: it is not required that the EU rules satisfy the conditions of direct applicability, i.e. worded in a precise and unconditional way such as to allow private individuals to invoke them directly before the courts. The Court is satisfied with the demonstration that the EU rules are intended to protect the *interests* of private individuals.<sup>86</sup>

It is submitted that the prudential rules imposed by the EU banking directives effectively satisfy this condition. It appears clearly from both the preamble to the Coordinated Banking Directive and from its provisions, which embody the core of prudential rules and the obligation to organise prudential supervision, that the directives aim at protecting both the interests of credit institutions and depositors. It is clear that the prudential rules, which constitute the harmonization deemed necessary to realize an integrated market<sup>87</sup> intends to create a climate of confidence amongst member states and for depositors and other bank customers which is an necessary precondition for allowing cross-border banking business. Moreover, the case law of the European Court of Justice in the area of banking has repeatedly stressed the importance of the provisions on banking authorization and prudential rules in

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<sup>83</sup> Landesgericht Bonn, 16 April 1999, ZIP 1999, p. 959, *Entscheidungen im Wirtschaftsrecht* 2000/5, p. 233. See also Landesgericht Bonn, 31 March 2000, *not reported* (cited by R. SETHE in *Entscheidungen im Wirtschaftsrecht* 2001/20, p. 861).

<sup>84</sup> European Court of Justice 23 May 1996, *Hedley Lomas*, case C-5/94, *European Court Reports* 1996, p. I-2604 (the case concerned the refusal by UK authorities to grant an export licence for the export of sheep to Spain).

<sup>85</sup> Compare also M.H. WISSINK, "Staatsaansprakelijkheid voor falend banktoezicht; het oordeel van de House of Lords in de Three Rivers-zaak", *Sociaal-Economische Wetgeving* 2002, (93), p. 97.

<sup>86</sup> Zie T. TRIDIMAS, "Liability for breach of community law: growing up or mellowing down?", *Common Market Law Review* 2001, p. 328. See also M.H. WISSINK, "Staatsaansprakelijkheid ...", cited *supra* note 85, p. 95.

<sup>87</sup> And thus realize the fundamental freedoms of services and establishment, as commanded by Article 47.2 EC.



terms of protection of the consumer.<sup>88</sup> The objective of creditor and depositor protection is finally also embodied in Article 4 of the Coordinated Banking Directive, which as a rule allows only credit institutions subject to prudential supervision to accept deposits from the public.<sup>89</sup>

Recently, a few cases were decided in national courts, both in England and in Germany, where the plaintiffs invoked *Francovich*-liability for alleged deficient prudential supervision over a troubled bank. First, in the *BCCI* liability claim introduced against the Bank of England, the Court of Appeal, and subsequently the House of Lords examined whether all requirements for establishing *Francovich*-liability were met. In the Court of Appeal, two out of the three judges considered that EU prudential regulation was not intended to grant rights to private individuals<sup>90</sup>, but the third judge expressed a thoroughly motivated dissenting opinion.<sup>91</sup> Upon appeal, the House of Lords confirmed the Court of Appeal's decision, following the opinion expressed by Lord Hope of Craighead<sup>92</sup>: the latter strongly advocated that the EU directives<sup>93</sup> were intended primarily to harmonize prudential regulation with a view to creating a single banking market, without imposing a general obligation to exercise prudential supervision or conferring rights in this respect to individuals.<sup>94</sup> In his Lordship's view, the protection of depositors was just one element which had been taken into account in the harmonization process amongst others, such as the establishment of competitive equality between credit institutions. Surprisingly, however, the House of Lords did not deem it necessary to refer this important issue related to the interpretation of the banking directives to the European Court of Justice for a preliminary ruling, arguing that the directives were not open for diverging interpretation (so-called *acte clair*-doctrine). As a consequence, the House of Lord's decision barred the attempt made by the plaintiffs to circumvent the statutory limitation of supervisory liability as contained in the 1987 Banking Act. It may be submitted that the fierce opposition to submit the issue to the Court of Justice might in part be inspired

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<sup>88</sup> See, in particular, European Court of Justice 12 March 1996, *Panagis Pafitis*, case C-441/93, *European Court Reports* 1996, p. I-1347, para 49; European Court of Justice 9 July 1997, *Parodi*, case C-222/95, *European Court Reports* 1997, p. I-3899, para 22; European Court of Justice 11 February 1999, *Romanelli*, case C-366/97, *European Court Reports*. 1999, p. I-862.

<sup>89</sup> And if a member state would allow other actors to collect deposits from the public, Article 4 requires them to provide for adequate rules for the protection of depositors.

<sup>90</sup> The judges thereby confirmed the decision delivered in first instance by the Queen's Bench division: see *Three Rivers District Council and others v Bank of England (No 3)*, [1996] 3 *All England Reports*, (558), p. 607-608 and 612-615.

<sup>91</sup> See the opinion of Lord Justice Auld in *Three Rivers District Council and others v Bank of England*, [1999] 4 *All England REports*, p. 800 [CA].

<sup>92</sup> *Three Rivers District Council and Others (original appellants and cross-respondents) v. Governor and Company of the Bank of England (original respondents and cross-appellants)*, [2000] 2 *Weekly Law Reports*, 1220 (opinion of Lord Hope of Craighead).

<sup>93</sup> It should be noted, however, that the facts of the case were prior to the entry into force of the 1989 Second Banking Directive, several provisions of which are more clearly oriented towards depositor protection than the provisions of the 1977 First Banking Directive.

<sup>94</sup> Lord Hope adopted a very narrow approach in this respect, which in fact came down to requiring that a provision of EU law only conferred rights upon individuals when the conditions for direct applicability were met. See also critically: M. ANDENAS, "Liability for Supervisors and Depositors' Rights – The BCCI and the Bank of England in the House of Lords", *Euredia* 2000/3, (388), p. 407; H.M. WISSINK, "Staatsaansprakelijkheid ...", cited *supra* note 85, p. 94.



by a desire to keep control over the case in 'national' hands and to preserve the statutory protection against liability granted to the Bank of England.<sup>95</sup>

A similar reluctance as to incorporation of *Francovich*-liability in prudential supervision appeared in a recent German court of appeal decision<sup>96</sup>, where the plaintiffs argued that the immunity from supervisory liability existing in German law was incompatible with the European banking directives, to the extent the latter granted rights to individuals. The court of appeal dismissed the argument, without extensively motivating it. However, the plaintiffs appealed against the judgment before the German supreme court (*Bundesgerichtshof*), and again alleged that the conditions for *Francovich*-liability were met with regard to different EU banking directives which oblige the member states to exercise prudential supervision over credit institutions. The German supreme court, in contrast to the English House of Lords, admitted that this raised questions as to the interpretation of the banking directives which were far from clear. As a consequence, the Supreme court made an interim judgment<sup>97</sup>, in which it submitted a series of preliminary questions to the European Court of Justice, which essentially concern the issue whether various EU banking directives<sup>98</sup> can form the basis for *Francovich*-liability of the German state for alleged deficient prudential supervision. The case is currently pending before the European Court of Justice. Ultimately, a positive answer by the European court of Justice would lead to incompatibility of the German statutory immunity from liability, or at least enable its circumvention as far as the application of EU originated prudential rules is concerned. The open attitude from the part of the German supreme court should be welcomed. Submitting the issue to the European Court of Justice will contribute to more uniformity in the interpretation of the banking directives as regards *Francovich*-liability.

### c. Serious breach of EU law

The requirement of a serious breach of Community law<sup>99</sup>, has important implications in the context of supervisory liability: as already indicated, member states enjoy a certain discretion in applying the often generally worded provisions of EU banking law in day-to-day supervision, both as regards authorization requirements<sup>100</sup> and for ongoing prudential requirements<sup>101</sup>. This leads to the conclusion that *Francovich*-liability allows to counter the risk of excessive liability claims: it appears from the case law of the European court of Justice

<sup>95</sup> This attitude of 'legal protectionism' has been highly highly criticized : see X., "European banking law as applied by the House of Lords: Overshadowing the *acte clair* doctrine", *Euredia* 2000/3, p. 305-306; M.H. Wissink, "Staatsaansprakelijkheid ...", cited *supra* note 85, p. 96.

<sup>96</sup> Oberlandesgericht Köln 11 January 2001, *ZIP* 2001, p. 645, *Wertpapier-Mitteilungen* 2001, p. 1372, *Entscheidungen in Wirtschaftsrecht* 2001/20, p. 962, note R. SETHE.

<sup>97</sup> Bundesgerichtshof 16 May 2002, III ZR 48/01, *ZIP* 2002, p. 1136.

<sup>98</sup> The questions submitted to the Court of Justice are deliberately broadly worded, and concern not only the core prudential directives, but also the 1994 Deposit Guarantee Directive and the 1989 Solvency Ratio Directive.

<sup>99</sup> See European Court of Justice 8 October 1996, *Dillenkofer*, cases C-178-179/94, C-188-190/94, *European Court Reports* 1996, p. I-4867.

<sup>100</sup> E.g. the requirement of a sound administrative organization of the credit institution and adequate internal controls.

<sup>101</sup> E.g. the obligation to take adequate measures with regard to irregularities, without specifying the means or instruments to take action.



that a “serious” breach will only occur when the supervisory authority has manifestly and gravely disregarded the limits on the exercise of its discretionary powers.<sup>102</sup> In other words, the concerns which have led some national courts to incorporate the complexity and limited means of supervision into their liability assessment, can be equally met when founding liability on *Francovich*. Where, by contrast, prudential requirements in the banking directives prescribe a clear obligation, a “serious” breach will follow from the mere non compliance with the obligation (e.g. authorization of a credit institution which does not satisfy the initial capital requirement of EUR 5 million).

#### d. Causation

A member state will only be held for damages when there is a direct link of causation between the serious breach of EU law and the damage suffered by private individuals. Applied to the situation of deficiencies in prudential supervision, the requirement of a *direct* causal link can constitute a further buffer to effectively holding a member state to compensate depositors for deficient prudential supervision: the member state will only be held to compensate the victims for those damages which are directly connected to an alleged shortcoming in exercising prudential supervision.

### 3. Conclusion on Francovich-type liability and prudential supervision

The analysis of the conditions attached to *Francovich*-type liability as applied to supervisory liability has showed that accepting a basis for liability in EU law should not necessarily lead to excessive liability claims. In fact, the corrective techniques used in different countries aimed at incorporating into the liability decision the complexities of supervision and the primary responsibility of the supervised institution, can also be applied under *Francovich*-liability: not only does *Francovich*-type liability allow to fully take account of the circumstances of fact in which the supervisor’s behaviour should be assessed, avoiding thereby a *a posteriori* assessment.<sup>103</sup> Moreover, the leeway left to supervisory authorities in the actual exercise of prudential supervision, and the arbitrage to be made between different, sometimes conflicting interests, will also in *Francovich*-liability influence the role of the judge: it is not up to the judge to substitute itself to a banking supervisor, but merely to assess whether the supervisory authority, in the given circumstances of time and facts, could reasonably have acted as it has done.

In the end, the conditions attached to *Francovich*-liability are largely similar to the way the courts in different member states have approached supervisory liability under general tort law.<sup>104</sup> However, accepting *Francovich*-liability as regards deficient prudential supervision would offer a substantial additional protection to depositors in those member states which at present apply a full or partial immunity from liability. We believe that accepting a

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<sup>102</sup> See *Brasserie du pêcheur/Factortame III*, cited *supra* at footnote 82, p. I-1029, para 55.

<sup>103</sup> Compare J.-V. LOUIS, G. VANDERSANDEN, D. WAELBROECK, M. WAELBROECK, *Commentaire Mégret. Le droit de la CEE*, vol. 10: *La Cour de Justice. Les actes des institutions*, 2nd ed., Brussels, Editions de l’ULB, 1995, para 11, p. 295.

<sup>104</sup> See, for instance, the situation in Germany prior to the statutory immunity, and the case law in France and in Belgium (the latter prior to the 2002 law).



*Francovich*-type of supervisory liability would be beneficial in two respects: first, given the disciplining effects on the banking supervisor's behaviour, accepting liability would increase the reputation of the system in an international perspective (*competition for excellence*). Second, applying a similar liability regime in a single European market would eliminate potential competitive distortions between member states, and create a level playing field between member states. This is the more important in view of the system of home country control, which also shifts liability to the home country supervisor.

### **General conclusion**

Though supervisory liability has been discussed in several EU member states for quite some time, recent cases show that it appears under a new dimension in the context of the Europeanization of supervisory law. We have tried to demonstrate that there should be no *a priori* reluctance to allowing EU law to serve as a legal basis for supervisory liability, as it contains all elements to achieve a well-balanced liability regime which takes duly account of the complexities of prudential supervision. It will then be up to the courts not to over-protect depositors and to avoid the temptation of the 'deep pocket-syndrome' in allocating liability for bank failures to the state.

However, in a EU perspective the issue of supervisory liability still is "under construction" and different orientations have been identified: on the one hand, individual member states increasingly tend to limit supervisory liability through statutory immunity regimes, thereby supported by the Basle Committee's *Core Principles*. On the other hand, depositors more and more put pressure on national courts by relying on EU law as legal foundation for supervisory liability in order to circumvent limitations originating in member states' law. We have argued that allowing *Francovich*-liability in the field of prudential supervision allows to strike a fair balance between the legitimate expectations form depositors in the quality of supervision and the risk of systematically shifting the cost of banking failures to government.

With the prospect of accession in 2004, the discussions about supervisory liability will increasingly influence most of the Central and Eastern European Countries (CEECs) as well. As CEECs have incorporated the *acquis communautaire* into their national laws, or are in the process of doing so, most of them already at present operate under similar prudential standards as the EU member states. However, building a stable and sound banking system requires more than simply "transplanting" the legal rules.<sup>105</sup> It also requires the setting up of well staffed supervisory agencies which can effectively ensure high quality supervision. Supervisory liability could also in this context serve as a disciplining factor. If the outcome of the German case currently pending before the Court of Justice leads to accepting *Francovich*-liability in the field of banking supervision, policy makers both in the EU and the CEECs should be aware of the imperative need to ensure at all times high standards not only in regulation, but also in day-to-day supervision.

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<sup>105</sup> See for a previous study, focused on deposit guarantee: M. TISON, "Harmonisation and Legal Transplantation of EU Banking Supervisory Rules to Transitional Economies: A Legal Approach", in D. GREEN, K. PETRICK (eds.), *Banking and Financial Stability in Central Europe. Integrating Transition Economies into the European Union*, Cheltenham, Edward Elgar, 2002, p. 37-71.



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