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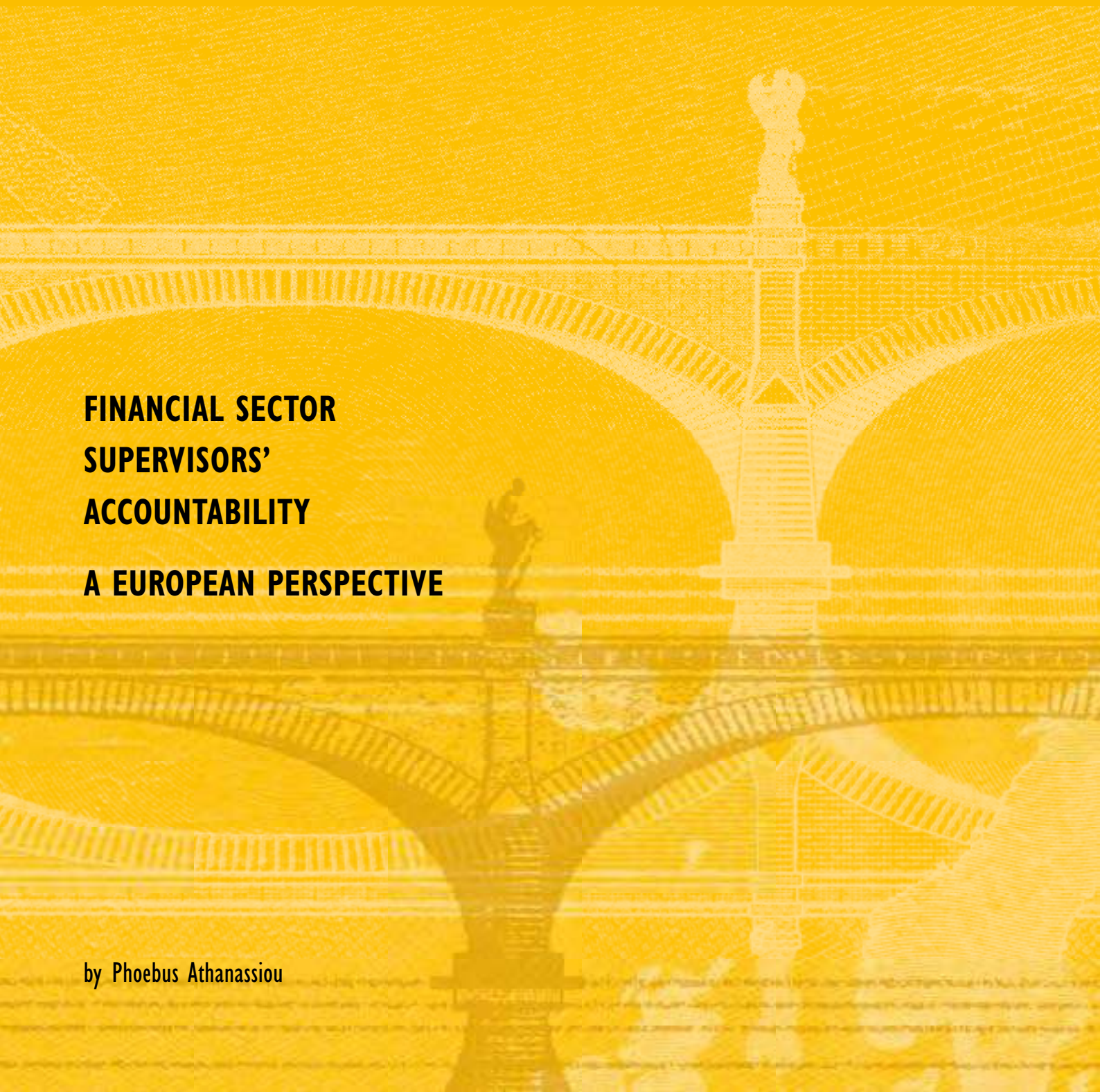

FINANCIAL SECTOR SUPERVISORS' ACCOUNTABILITY

A EUROPEAN PERSPECTIVE

by Phoebus Athanassiou

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1 *Legal Counsel, European Central Bank (ECB). The views expressed in this article are those of the author and do not necessarily represent those of the ECB or the Eurosystem.* *The author is grateful to Rinke Bax and to the paper's referees and reviewers for their helpful comments on earlier drafts of this paper and to Steven Harris, for his editing. The law is stated as it stood on 1 October 2010. The manuscript was finalised on 9 August 2011.*

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CONTENTS

Abstract

Financial sector supervisors' accountability is widely accepted as a sine qua non condition of good governance and as a guarantor of supervisory independence. An arsenal of accountability-inspired control instruments aims to ensure that supervisors are accountable to the legislature, the executive, stakeholders and, last but not least, the judiciary. While the general right to damages for losses arising from civil wrongs is well established, liability for faulty supervisory acts or omissions is, in many respects, limited in scope. This paper examines the conceptual underpinnings of financial sector supervisors' liability and the current legal situation on supervisory liability in the European Union, under both national and Union law. It also inquires into an aspect of the debate that has attracted less attention than it deserves, but which is likely to take on greater importance as the structure of financial supervision undergoes reforms, both at the European Union level and in the Member States: the specificity of the Member States' national central banks as banking supervisors and, in particular, the tension between their independence and their potential third party liability for damages for supervisory faults.

Introduction

Unlike in the field of monetary policy, where the wisdom of delegating the definition and implementation of monetary policy to independent central banks has been widely embraced by national and supranational policy and decision-makers alike[1], in the field of financial sector supervision the case for independent financial sector supervisors has yet to be argued as strongly. The apparent reluctance of policy-makers to grant to financial supervisors the same degree of independence as to central banks (when acting in their monetary policy capacity) is attributable to some well-established concerns, linked to the wider margin for discretion necessary in the field of supervision compared to that of monetary policy, and to the greater degree of contingency inherent in financial supervisory decisions (especially the more complex ones)[2] in conjunction with the individual and socio-economic costs associated with the delegation of wide-ranging decision-making powers over potentially sensitive issues to unelected agencies, acting as the 'fourth branch of government'[3].

Subjecting financial sector supervisors to checks and balances inspired by accountability[4] has long been perceived as a means of reconciling supervisory agency independence (also understood in terms of the degree of operational flexibility necessary for the exercise of supervision) with a measure of external, *public* control, sufficient to prevent abuses and to ensure an objective evaluation of their performance in the discharge of their delegated tasks[5]. While a basic, *quid pro quo* analysis of contemporary supervisory accountability safeguards is apt to portray the latter as the *antithesis* of supervisory independence, accountability and independence are best perceived as 'two sides of the same coin'[6], with accountability serving as a key ingredient of the principal-agent relationship between elected governments and unelected supervisors. Duly considered accountability arrangements can therefore be deemed as 'fully consistent with agency independence', and as capable of contributing to the *effectiveness* of independence, by providing legitimacy to independent agencies entrusted with the exercise of delegated public authority[7].

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[1] In this regard, see the discussion and the sources relevant to footnote 160.
[2] Hüpkes et al., p. 10.
[3] In this regard, see Majone, pp. 14-22.
[4] The plain language definition of accountability is 'the fact or condition of being accountable; responsibility' (Oxford English Dictionary online).
[5] For an insightful discussion of public accountability in democratic societies, the role of bureaucracies in democracies and the downsides of accountability excesses, see Bovens, especially pp. 192-194; Behn, especially pp. 11-13; and Halachmi, especially 233-236.
[6] ECB, Accountability of the ECB, Monthly Bulletin, November 2002, available electronically, p.46.
[7] Hüpkes et al., p. 4.

Acknowledging the pivotal role of supervisory accountability checks and balances in helping to address the 'democratic deficit' concerns arising from the delegation of state prerogatives to unelected supervisory agencies, policy makers, both within and outside the EU, have devised a wide range of institutional mechanisms through which to monitor the manner in which financial sector supervisors exercise their delegated authority. Following the typology proposed by Hüpkes et al. and Black and Jacobzone, the arsenal of accountability-inspired control instruments can be reduced to five main types, most of which are of relevance to both central bank and non-central bank financial sector supervisors, despite the different objectives[8] and the multiple principals environment[9] that sets non-central bank supervisors apart from their central bank counterparts: (i) *parliamentary accountability* instruments, (ii) *ministerial accountability* instruments, (iii) *market-based accountability* instruments, (iv) *financial accountability* instruments and, last but not least, (v) *judicial accountability* instruments[10]. A few words on each of the above types of control are deemed apposite.

Parliamentary accountability typically takes the form of periodic or *ad hoc* contacts between the financial supervisory agency, as the delegatee/agent, and the national legislature, as the democratically elected delegating principal (with the power not only to assess the manner in which the supervisor's mandate is performed but, ultimately, to change it by law or, in extremis, to disband a supervisor, replacing it with another). The submission to Parliament of annual supervisory reports (followed by their publication) as well as appearances by the supervisory authority Head before Parliament or any standing/*ad hoc* Parliamentary committees are amongst the most frequently practiced forms of parliamentary accountability, both within and outside the EU[11].

[8] Goodhart, pp. 156-157.

[9] See Bovens, p. 184 and 189 (referring to an 'accountability forums' confronted with 'multiple potential accountors'); and Behn, Chapter 11 (referring to '360 degree accountability', i.e. complete and full accountability).

[10] For a comparative account of the concrete accountability-inspired control instruments applied to financial sector supervisors in the US, Canada, Australia, the UK and France, see Black and Jacobzone.

[11] For instance, the New York Federal Reserve (Fed) is accountable both to the US Congress and to the House of Representatives. More specifically, the Fed reports annually on its activities to the House of Representatives' Speaker, and biannually on its monetary policy stance to the Congressional banking committee. Fed officials also make *ad hoc* appearance before Congress as and when requested. Similarly, the Bank of England is accountable to Parliament, with its Annual Report being laid before the House of Commons Treasury Committee annually, before being made public, and with Bank of England officials appearing before other select committees, as and when required.

Ministerial accountability caters for the vertical relationship between the supervisory agency and the executive branch, which, depending on the national legal set up and the identity and institutional nature of each financial supervisor, may be responsible for appointing (and dismissing) the supervisory authority's Head and/or other members of its Board. Regular reporting obligations and the exercise, more often than not by the Minister of Finance, of oversight authority over the manner in which delegated supervisory powers are exercised (*inter alia* through the participation of ministerial representatives in the supervisor's Board) are mainstream reflections of this particular type of accountability.

Market-based (or 'stakeholder') accountability stems from the financial sector supervisors' duties vis-à-vis their two main constituencies: supervised institutions – which often bear some, at least, of the costs of financial supervision through the payment of fees, levies or administrative fines – on the one hand, and investors/depositors – that is, the *consumers* of regulated financial services – on the other. Supervisory disclosures (through reports on supervisory practices, general publications hosted by supervisors' websites, press conferences or the publication of the outcomes of regulatory and/or administrative decision-making) and public consultations (often as part of the supervisory regulatory process) are amongst the main stakeholder accountability (and, at the same time, supervisory legitimation) instruments encountered in most of the financially advanced jurisdictions[12].

Financial accountability mainly takes the form of the submission by supervisors of their financial accounts and balance sheets to the review and control of internal audit committees and external, independent auditors. While there is no single set of standards that supervisors apply in preparing their financial statements, the aim of audit-driven financial accountability safeguards is to ascertain that supervisors manage their material resources soundly and efficiently, spending public money in a wise and prudent manner in the pursuit of their respective mandates.

Finally, the aim of judicial accountability is to guarantee the fundamental right of legal redress to those affected by supervisory decisions. Judicial accountability can take one of two main forms, namely *judicial review* (possibly in conjunction with some form of internal or external *administrative review*) and *supervisory liability* for damages caused by a supervisor's acts or omissions in the exercise of its delegated supervisory powers. In a supervisory context, judicial

[12] For instance, in the UK, the Financial Services Authority (FSA) operates a 'Financial Services Consumer Panel', which operated independently from the FSA. The FSA is required to inform the Panel of all policy initiatives and to give public written responses to the Panel's comments on consultation proposals. Similarly, in France, the *Autorité des marchés financiers* operates a 'Retail Investors Consultative Commission'.

review encompasses the set of established administrative law procedures aimed at ensuring that supervisors act within the limits of their delegated powers (that is, *intra vires*), and consistently with basic principles of good administration, to protect the interests of those subject to their supervisory authority.

While the general right to damages for losses arising from civil wrongs is, as a general proposition, no less well established than the right to administrative review, the scope of liability for faulty supervisory acts or omissions is, in many respects, limited. Should financial sector supervisors be liable for damages vis-à-vis third parties for wrongful or faulty acts or omissions in the performance of their public law supervisory tasks and, if so, under what conditions and subject to what limitations? Is it necessary to prove gross negligence in order to establish a supervisor's liability to a third party, or is it sufficient to prove ordinary negligence? Should supervisors enjoy some degree of immunity from suit and would it be desirable to put a cap on their liability for policy reasons? These are by no means novel questions. Scholars, legislators and the judiciary have expended much intellectual energy on them, as they have on the broader issue of the relationship between governmental unlawfulness, in a broad sense, on the one hand, and the availability of *monetary* remedies against public bodies as opposed to remedies via judicial review, on the other[13]. Depending on their legal traditions or their domestic experiences of supervisory failures, different jurisdictions have approached the issue of supervisory liability differently, with 'national solutions ranging from absolute supervisory immunity to proportionate liability'[14]. Some European Union (EU) Member States have statutory protections in place, giving their financial supervisors immunity from third party liability, while others submit them to their regular, civil liability rules.

The aim of this paper is not to provide an exhaustive comparative overview of national supervisory liability arrangements in the EU, although an account thereof is necessary for its purposes; rather it is to take a step back from the current state of the law so as to examine critically the conceptual underpinnings of supervisory liability, inquire into the extent to which the conventional justifications for it are also relevant for central bank supervisors, and to apply its findings to an assessment of the ongoing shift, in several Member States, of banking supervision

[13] For a thorough examination of these and other closely related issues see Law Commission, 'Monetary Remedies in Public Law', Discussion Paper, 11 October 2004.
[14] Dragomir, p. 301.

from specialised, dedicated supervisory authorities to central banks[15, 16]. This paper will *not* cover administrative review procedures brought by entities subject to supervision, nor regular judicial review by the courts under the general principles of administrative law, for the assessment of the legality of the acts of supervisory authorities[17].

Before turning to the substance of the analysis, it is useful to define the scope of this paper and to briefly consider terminology, and, more specifically the meanings of certain terms used in this paper.

The scope of this work covers *supervisory* rather than *regulatory* liability[18]. Although the terms 'regulation' and 'supervision' are often used interchangeably (*inter alia*, because 'the very process of supervision … is subject to regulation'[19])[20] the two differ markedly from one another. Unlike 'regulation', which includes both the *process* of rule-making and its concrete *outcome*, 'supervision' refers to the monitoring of compliance with and the enforcement of the rules resulting from the regulatory process. The emphasis of this paper is on micro-prudential

[15] The reference is mainly to the UK, where the operational responsibility for prudential regulation is to be transferred to a new Prudential Regulation Authority (PRA), a subsidiary of the Bank of England; to Ireland, where legislation was enacted in July 2010 to reintegrate financial supervision into the Central Bank of Ireland; and to Belgium, where the supervisory architecture was reorganised from 1 April 2011 with a view to integrating the supervision of financial institutions into the Nationale Bank van België/Banque Nationale de Belgique, with a new supervisory authority, distinct from the central bank, being responsible for the surveillance of the financial markets. This is a reversal of the trend in recent years which saw supervisory powers shift from central banks to single financial sector supervisors. For an overview of the recent changes in the supervisory structures of the EU Member States, see ECB, Recent Developments in Supervisory Structures in the EU Member States (2007-10), October 2010, available electronically.

[16] Despite the particularities of central banks as supervisors, and the tension between their independence and their potential liability to third parties for supervisory failures, the existing literature has rarely addressed the issue of the supervisory liability of central banks, on which this paper is partly focused. For a notable exception, see Doherty and Lenihan, pp. 213-232, where some of the issues discussed in this paper are also addressed.

[17] It is acknowledged that judicial review and the statutory rights of appeal of banks against supervisory failures could be perceived to be adequate remedies for banking supervisory failures, as well as damaging a supervisor's reputation, even though not catering for the award of compensation. This, in turn, raises the thorny issue of the relationship between a claim for damages and alternative, but equally effective, legal means at the disposal of claimants by which they can ensure the judicial protection of their rights.

[18] Establishing liability arising from legislation is a qualitatively different, more demanding exercise. For an account of the conditions for such liability in EU law, see Case 5/71 *Zuckerfabrik Schöppenstedt* v *Council* [1971] ECR 975.

[19] Dempegiotis, p. 132.

[20] Other reasons include the fact that regulatory and supervisory tasks are often, but not invariably, dealt with by the same entity, or because their pursuit serves a higher common goal, namely the preservation of financial stability (House of Lords, 'The future of EU financial regulation and supervision', European Union Committee, Fourteenth Report, 9 June 2009, Chapter 2).

supervision[21], and in particular on the liability of supervisors for the deficient or wrongful performance of their public law supervisory tasks[22].

As used in this paper, the term 'liability' denotes the supervisors' institutional, non-contractual, civil law obligation to make good any financial damage that third parties suffer as a result of the wrongful performance of their public law supervisory tasks, whether due to negligence, recklessness or bad faith and whether by way of an act or omission, where a causal link can be established between the alleged supervisory fault and a claimant's loss. Within the meaning of this paper, supervisory liability can arise with respect to a bank's *depositors, investors* or *shareholders* (although the *nature* of liability towards each of those groups is likely to differ; claims brought by depositors or investors are more likely than not to be based on the supervisor's *negligent failure to act*, whilst claims of shareholders are more likely to be based on supervisory *overreaction*). A typical example of a situation where third party supervisory liability could arise vis-à-vis depositors is where the collapse of a bank is preceded by the supervisor's failure to exercise the degree of care necessary to detect or avert it, resulting in losses for depositors that cannot be recovered under contractual claims against the failed bank or by claims under the relevant deposit guarantee scheme. It is also conceivable that claims for compensation could be brought against supervisors by a financial intermediary's *shareholders*[23]. Indeed, claims brought by shareholders could, in some respects, represent an even graver source of concern for supervisors, as they need not necessarily arise from a financial intermediary's collapse (as in the case of depositor claims) but, also, from lesser evils, such as, for instance, the withdrawal of a credit institution's licence on grounds of prudence, with a knock-on effect on the value of its shares.

As used in this paper, the term 'depositor' excludes banks (except where their deposits are not for own account), other financial sector enterprises, central and local public authorities, and

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[21] Micro-prudential supervision denotes the day-to-day supervision of individual financial institutions, focusing on their soundness and depositor protection, whereas macro-prudential supervision denotes the analysis of trends in the financial system and the detection and prevention of the systemic risks they may pose for the financial system and the economy at large. Dragomir, p. 312, has observed that supervisory liability 'could also refer to macro-prudential functions, provided that damages and a breach of a duty of care can be shown'.

[22] Supervisory tasks typically consist of: (i) authorisation – granting permission for financial institutions to operate within the supervisor's jurisdiction; (ii) oversight – monitoring asset quality, capital adequacy, liquidity, internal controls and earnings; (iii) enforcement – imposing sanctions on institutions that do not adhere to the regulatory regime; and (iv) crisis management – including the institution of deposit insurance schemes, providing lender of last resort assistance, and instituting insolvency proceedings (House of Lords, 'The future of EU financial regulation and supervision', European Union Committee, Fourteenth Report, 9 June 2009, Chapter 2).

[23] In this regard, see Tison (2005), p. 641.

depositors with a special relationship with the bank, such as managers, directors or auditors, who are deemed to be in a position to assess the risks of their operations or those to which the bank is exposed[24]. For the purposes of this paper, the term 'investor' denotes any natural or legal person to whom an investment firm provides investments and/or other ancillary services[25]. Finally, 'shareholder' is used more narrowly than the definition in Article 2 of the Transparency Directive[26], excluding important shareholders, i.e. those in a position to exercise decisive influence on a bank's management or risk-taking (even if they are not majority shareholders).

Finally, 'bank' is used as a generic term for any undertaking (whoever its supervisor may be) covered by the definition in Article 4(1) of the recast Banking Consolidation Directive, the business of which is 'to receive deposits or other repayable funds from the public and to grant credits for its own account'[27], whatever its precise nomenclature under the laws of its place of incorporation or establishment (whether a commercial bank, credit union, *cooperativa de ahorro y crédito*, cooperative credit society, *Raiffeisenbank* etc.), and even if it is exempt from the obligation to hold minimum reserves under the relevant ECB regulation[28].

This paper is divided into *four* parts. The *first* part provides a concise overview of supervisory liability in selected EU Member States and under general Union law; the *second* part examines the conceptual underpinnings of supervisory liability, summarising the legal, public policy and other arguments for and against it; the *third* part examines the application to central banks of the traditional rationales for supervisory liability, taking into account their independence and the tension between the need to reconcile the preservation of their autonomy in carrying out their functions with the need to ensure accountability in the conduct of banking supervision; finally, the *fourth* part draws some conclusions that are relevant to the ongoing reorganisation of

[24] The definition of 'depositor' used here is therefore intended broadly to match the scope of 'eligible deposits' for the purposes of Article 4 ('Eligibility of deposits') in the Commission Proposal of 12 July 2010 for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [recast], Brussels, (COM(2010) 368 final).

[25] Our definition of 'investor' coincides, therefore, with the definition of 'client', under Article 4 (1)(10) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).

[26] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, (OJ L 390, 31.12.2004, p. 38).

[27] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), (OJ L 177, 30.6.2006, p. 1).

[28] Regulation ECB/2003/9 of 12 September 2003 on the application of minimum reserves, (OJ L 250, 2.10.2003, p. 10).

supervision in the EU, with an emphasis on those Member States where banking supervision has recently shifted (or is in the process of shifting) from dedicated authorities to central banks.

1 Supervisory liability: the current situation in the EU

1.1 Domestic financial supervisory liability regimes

There are substantial differences, from one EU Member State to another, regarding the third party liability of financial supervisors for the deficient or wrongful performance of their public law tasks[29]. In some Member States, including France[30], Greece[31], Italy[32] and the Netherlands[33], supervisors are, in principle, bound by the normal civil liability rules and do not enjoy any special statutory immunity. In at least two further Member States, namely Slovakia and Spain, the legislator has taken steps to recognise by law the financial supervisor's liability[34]. In contrast, in several other Member States, such as Belgium[35], Cyprus[36], Estonia[37], Ireland[38], Luxembourg[39],

[29] For a recent overview of the legal status in several of the Member States, see Giesen and others 2009.

[30] For an account of the legal position in France, see Dempegiotis, pp. 140-141; Tison (2005), p. 650; and Andenas and Fairgrieve, pp. 768-771.

[31] The relevant provision is Article 914 of the Greek Civil Code, according to which '[A] person who through his fault has caused in a manner contrary to the law prejudice to another shall be liable for compensation', read in conjunction with Articles 105 and 106 of the Introductory Law (on the third party liability of the State). For an account of the legal position in Greece, specifically with regard to banking supervision, see Karagounidis, pp. 759-760 (in Greek).

[32] For an account of the legal position in Italy, see Rossi (2003), pp. 655 ff.; and Andenas and Fairgrieve, pp. 772-773.

[33] The relevant provision is Article 6:162 of the Dutch Civil Code, which *inter alia* provides that '[A] person who commits an unlawful act against another which is attributable to him, must repair the damage suffered by the other in consequence thereof.' For an account of the legal position in the Netherlands see Giesen and others, (2009) pp. 40-48; and van Dam. At the time of publication, discussions were under way in the Netherlands on draft legislation to limit the liability of its two financial supervisors, De Nederlandsche Bank and the Autoriteit Financiële Markten.

[34] See Article 43.1 of Slovak Law 747/2004 on Supervision of the Financial Market, read in conjunction with Articles 3.1 and 4.1.g of Law No 514/2003 on Liability for Damage Caused During the Exercise of Public Authority; and Article 25.1 of Spain's Resolución de 28 de marzo de 2000, del Consejo de Gobierno del Banco de España, por la que se aprueba el Reglamento Interno del Banco de España.

[35] See Article 68 of Belgium's Loi d'août 2002 relative à la surveillance du secteur financier et aux services financiers, recognising the Belgian Banking, Finance and Insurance Commission's liability, but only in cases of *'dol ou de faute lourde'*.

[36] See Section 32.1 of Cyprus's Banking Business Law 66 (I)/1997, which excludes acts or omissions attributable to bad faith or resulting from gross negligence from the scope of the statutory immunity that it provides for the Central Bank of Cyprus and its staff and/or advisors.

[37] See Article 58.1 of Estonia's Financial Supervision Authority Act 2001, read in conjunction with Article 13.3 of the State Liability Act 2001, whereby public authorities (including Estonia's Finansinspektioon) are relieved of liability for damage caused in the course of performing their public duties if the damage could not have been prevented even if the necessary diligence had been observed.

[38] See Section 33AJ.2 of the Central Bank Act 1942, which excludes acts or omissions attributable to bad faith from the scope of the statutory immunity of the Bank and the persons listed in Section 33AJ.1 thereof.

Poland[40] and the UK[41], statutory immunities protect financial supervisors from liability for damages, with the level of statutory protection varying from Member State to Member State, mostly depending on the subjective element required for supervisory liability. More specifically, while most jurisdictions apply a 'gross negligence' standard of liability to financial supervisors, in other Member States (e.g. Ireland and the UK) nothing short of bad faith will suffice. There are also examples of jurisdictions where supervisory liability appears to be altogether excluded (e.g. Poland and Estonia). In some Member States, the legislature or the courts have explicitly stipulated that supervisors owe their duties to *the public at large* rather than to *individual depositors*[42], so that in the absence of a specific legal obligation to protect individual interests, financial supervisors *cannot* be held liable for any pecuniary losses that depositors (or shareholders) may suffer as a result of the supervisors' deficient performance of their public law tasks[43]. The approaches taken by the national courts and legislatures in the EU have parallels

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[39] See Article 20.2 of Luxembourg's Loi du 23 décembre 1998 portant création d'une commission de surveillance du secteur financier, according to which the civil liability of the Commission de Surveillance du Secteur Financier's (CSSF) for damages vis-à-vis supervised entities and/or their customers or any other third parties requires proof of *'négligence grave'* by the CSSF in the exercise of its public law powers.

[40] See Article 133.4 of the Polish Banking Act of 29 August 1997, according to which the Polish Financial Supervision Authority, the National Bank of Poland and any persons carrying out banking supervision activities are not liable for damages resulting from legitimate acts or omissions connected with their supervisory tasks.

[41] See Schedule 1, Section 19.1 of the Financial Services and Markets Act (FSMA) 2000, whereby neither the FSA nor any of its officers or members of staff are to be liable for damages for anything done or omitted in the discharge, or purported discharge, of the FSA's functions, unless the act or omission is shown to have been in bad faith or so as to prevent an award of damages made in respect of an act or omission on the ground that the act or omission was unlawful as a result of Section 6.1 of the Human Rights Act 1998.

[42] e.g., that is true in Belgium (see Article 68 of the Loi d'août 2002 relative à la surveillance du secteur financier et aux services financiers, according to which *'La CBF exécute ses missions exclusivement dans l'intérêt général'*); Germany (see Section 4.4 of the Finanzdienstleistungsaufsichtsgesetz, which provides that *'Die Bundesanstalt nimmt ihre Aufgaben und Befugnisse nur im öffentlichen Interesse wahr'*); and Luxembourg (see Article 20.1 of the Loi du 23 décembre 1998 portant création d'une commission de surveillance du secteur financier, according to which *'La surveillance exercée par la Commission n' a pas pour objet de garantir les intérêts individuels des entreprises ou des professionnels surveillés ou de leurs clients ou de tiers, mais elle se fait exclusivement dans l'intérêt public'*). In the absence of a clear statutory provision to this effect, the courts in other Member States have arrived at the same conclusion; see e.g. in Italy (Rossi (2003), p. 659) and Greece (Karagounidis, p. 759).

[43] In its rulings in the *Wetterstein* case, 15 February 1979, BGHZ 74, 144 (148) and the *Herstatt* case, 12 July 1979, BGHZ 75, 120, the German Supreme Court rejected the argument that the objective of banking supervision was to only protect the stability and soundness of the German banking system at large; in the Supreme Court's view, the protection of individual creditors against risks arising from hazardous banking activities was also among the statutory objectives of the Banking Law, as it then was, so the banking supervisory authority could be liable for a breach of its public law duties under the German Civil Code.

elsewhere in the financially sophisticated world, where variations of the patterns of liability applicable within the EU can also be observed[44].

1.1.1 The impact of national legal traditions on domestic supervisory liability regimes

Differences between the Member States' supervisory liability regimes are, to some extent, attributable to differences in their national legal traditions. At the risk of oversimplification, it can be argued that the legal tradition to which a Member State belongs is also relevant to supervisory liability[45]. In several, even if not all, Continental European jurisdictions the principles applicable to supervisory liability appear to reflect those applied to ordinary civil law disputes[46], while in the common law jurisdictions, where there is no general principle of tortious liability for unlawful acts, including administrative acts[47], claimants have to establish a specific private law cause of action if they are to recover damages[48] (as liability is not based on general principles)[49]. However, this is not to say that financial supervisors in Europe's common law jurisdictions can altogether escape liability for the wrongful performance of their supervisory tasks. While common law courts will not apply ordinary tort principles to financial supervisors for third party losses caused by the defective performance of their public law tasks[50], claimants in Europe's common law jurisdictions can invoke the special tort of 'misfeasance in public office' (the only public law-specific tort) against their financial supervisors. This requires proof of the public officer's knowledge of or subjective recklessness with regard to (i) the illegality of their act, and (ii) the

[44] For an account of supervisory liability in some of the more significant non-EU jurisdictions, see Proctor, Part II, p. 71. For an EU-US comparative analysis, with an emphasis on US sovereign immunity as a bar to private tort claims, see Meltzer, p. 39.

[45] For a financial law-specific taxonomy of national legal systems and the criteria for their classification in different families of laws, see Wood (2007), p. 333.

[46] This is without prejudice to the jurisdictional peculiarities of Continental European jurisdictions, i.e. to the division of courts into administrative and other civil courts, a division which does not apply to Member States of the common law tradition.

[47] *Lonhro Ltd* v *Shell Petroleum Co Ltd (No 2)* [1982] AC 173, 187G; *X (Minors)* v *Bedfordshire County Council* [1995] 2 AC 633, 732-735.

[48] *Dunlop* v *Woollahra Municipal Council* [1981] 2 WLR 693, 172.

[49] Cyprus is an exception since, under Section 32.1 of its Banking Business Law 66 (I)/1997, liability can arise not only for acts or omissions attributable to the supervisors' bad faith but also for those attributable to gross negligence.

[50] *Yuen Kun-Yeu* v *Attorney General of Hong Kong* [1988] AC 175 (PC); *Davis* v *Radcliffe* [1990] 1 WLR 821; and *Three Rivers District Council* v *Governor and Company of the Bank of England* [2000] 3 CMLR 205.

probability of that act causing loss to the claimant[51].

Principled objections to supervisory liability, though of a somewhat different nature, have also been expressed outside Europe's common law jurisdictions, more specifically in those Member States where the existence of supervisory liability has been linked to the *Schutznormtheorie*[52]. An obvious example is Germany, where the first sentence of Paragraph 839 of the German Civil Code, in conjunction with Article 34 of the German Constitution, suggests that in order for the State to be liable for any damage caused to third parties by public officials in the performance of their duties, the third party must be capable of being regarded as a beneficiary of an obligation that has been breached. In some of the Member States where the *Schutznormtheorie* applies, statutory provisions have been introduced to avert litigation against financial supervisors[53]. At the same time, to the extent that the tort of misfeasance in public office is based on the premise that the holders of public office are subject to the rule of law and that their powers must be exercised for the public good[54], much the same principled objection to supervisory liability can be said to apply in Europe's common law jurisdictions.

The fact that, in some Continental European jurisdictions, the principles applicable to supervisory liability mirror those applicable to ordinary non-contractual disputes does not mean that proving supervisory liability is more straightforward there than in Europe's common law jurisdictions[55]. For some of the legal and public policy reasons touched on later in this paper[56], the standard of proof has often been onerous and Continental European courts have been resourceful in shielding

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[51] For the most famous illustration, to date, of the application of this tort in the financial supervisory context, see *Three Rivers District Council* v *Governor and Company of the Bank of England* [2000] 3 CMLR 205. On the application of the tort of misfeasance in public office in Ireland, see Doherty and Lenihan. No precedents are known in Cyprus, Europe's third common law jurisdiction (where the House of Lords ruling in the *BCCI* case would, however, be likely to be treated as a persuasive precedent). It follows from *Racz* v *Home Office* [1994] 2 AC 45, that vicarious liability for the unlawful acts of public officers is legally possible.

[52] This refers to the idea that liability is to be denied where a particular claimant (e.g., an aggrieved depositor) is not among those whom a specific legal rule (e.g., a prudential supervision rule) is intended to protect or, *a fortiori*, where the legal rule seeks to protect the interests of the public at large rather than those of any private individual. See Arnull, p. 136.

[53] See, e.g., §4 Abs.4 of the Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht (FinDAG) (Law establishing the Federal Financial Supervisory Authority), according to which *'Die Bundesanstalt nimmt ihre Aufgaben und Befugnisse nur im öffentlichen Interesse wahr'*. For an assessment of the compatibility of §4 Abs.4 of the FinDAG with Union law and the German Constitution, see Jaskulla, p. 231 (in German); and Forkel, pp. 183 and 187 (in German).

[54] Cox, available electronically.

[55] The traditional reluctance of courts to recognise the existence of a private law duty of care owed by supervisors to third parties and the concrete content of the tort of misfeasance in public office suggest that far more claims are likely to fail than to succeed.

[56] See below, Part 2, 'Conceptual underpinnings of supervisory liability'.

supervisors from third party liability. As a result, depositors have rarely been able to recover all or even part of their losses, even where supervisors are subject to the regular liability rules, and even where no statutory immunities apply to financial supervisors[57]. Indeed, what emerges from a cursory examination of the case law in the various Member States is that aggrieved parties often have to overcome substantial hurdles in order to establish the existence of an unlawful act or omission attributable to a supervisor in the performance of their public law supervisory tasks. Moreover, even if such an act or omission *can* be established, considerations of proximity or causation can result in courts rejecting claims for damages, especially where supervisory omissions rather than positive acts are involved[58].

While the many precedents of unsuccessful claims against supervisors say something about the prospects of successful litigation, it would be unwise to deduce from this that supervisory liability is merely an academic concern. Culpability for supervisory faults is decided on a case-by-case basis, and a single successful claim against a supervisor would be sufficient to damage that supervisor's credibility, especially if it were to involve the collapse of a major credit institution. Moreover, EU-level legal developments could increase the probability of successful litigation in the future, circumventing some of the limitations that national legal systems put in the way of supervisory liability claims[59]. Given the high impact of such an eventuality for the financial standing, reputation and authority of the affected supervisor, and its wider socio-economic and political implications, the issue of supervisory liability merits detailed investigation, however low the probability of a financial supervisor being found at fault for the collapse of a bank or another major financial institution[60].

1.1.2 On the national statutory immunities of supervisors

In some European jurisdictions, *statutory immunities* have been shaped as much by actual claims against supervisory authorities as by doctrinal and legal theory-based considerations or other, irreconcilable, cross-jurisdictional differences of perception regarding supervisory liability. In at least some of the Member States where statutory immunities apply, these appear to have been introduced in the aftermath of and as a reaction to specific court rulings, which have recognised

[57] In this regard, see Rossi (2003), p. 663; and Andenas and Fairgrieve, pp. 769-771.
[58] See van Dam, p. 14.
[59] See the discussion later in this paper and, more generally, Rossi (2003), p. 655; and Dragomir, pp. 302-303.
[60] This is all the more so where the supervisor is a Member State NCB, whose participation in the ESCB or the Eurosystem can tarnish their reputation and undermine their authority, or compromise the ambition of the nascent European Systemic Risk Board (ESRB) to project itself as a credible early-warning mechanism for macro-prudential disruptions.

the liability of financial supervisory authorities for the wrongful performance of their public law tasks[61]. Thus, statutory immunities often seem to have been motivated as much by public policy concerns about the implications of the courts' recognition of supervisory liability, as by concerns founded on the need to define the boundaries of financial supervisory liability for unlawful acts or omissions in the interests of legal certainty. With no clear pattern emerging from a comparison of domestic supervisory liability regimes, it is difficult to assess the extent to which the differences in the Member States' supervisory liability arrangements can be explained by reference to other factual or legal considerations including, for instance, the public versus private divide in the financing of supervisory activities[62], or the statutory objectives of national supervisors and, more specifically, whether or not these explicitly include the protection of the interests of depositors or consumers[63].

1.2 Supervisory liability under Union law

This section examines the *EU dimension* of supervisory liability and, in particular, the bearing of specific aspects of Union law on supervisory liability under domestic law.

1.2.1 Introductory remarks: supervisory liability, and the new European supervisory architecture

Unlike European financial *regulation*, where a high degree of harmonisation has been achieved over the years[64], *financial sector supervision* remains fragmented along national lines, with the principles of mutual recognition and home country control to some extent making up for the lack of a single European supervisor to monitor the implementation of the rules adopted by the European Council and the European Parliament in their capacities as the Union's joint financial sector legislators[65]. Despite the many drawbacks of supervisory fragmentation[66], and

[61] See fn 52; and Forkel p. 187 (in German). However, this has not been the case in the Netherlands where, despite three high-profile precedents (*Vie d'Or*, *Befra* and *Van der Hoop*) no statutory immunities have so far been introduced for supervisors (see, however, fn 33).

[62] For an account of the economics of financing banking supervision, the cross-jurisdictional differences and their possible explanations, see Masciandaro and others, p. 303.

[63] One example is that of the UK, where despite the fact that consumer protection was one of its statutory objectives (see section 2(1) of the FSMA 2000), the FSA enjoys statutory immunity.

[64] Harmonisation in the field of banking was to start in the mid-1960s and to culminate over a decade later with the adoption of the First Banking Directive (First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (OJ L 322, 17.12.1977, p. 30)). For a comprehensive account of the chronology of European harmonisation initiatives in the field of banking, see Dragomir, pp. 65-93.

[65] Dempegiotis, p. 136.

notwithstanding the fact that the uniform application of the harmonised Union rules would, in principle, warrant convergence also in terms of the remedies for the faulty implementation, by domestic supervisors, of these rules, the responsibility for supervision remains the preserve of the Member States.

Although, so far, financial supervision has been left to the national authorities, significant changes are under way at the EU level, which may also have an impact on supervisory liability. Following the recommendations of the de Larosière Report[67], three European Supervisory Authorities (ESAs) have recently been created and become operational. These are the European Banking Authority (EBA), based in London; the European Insurance and Occupational Pensions Authority (EIOPA), based in Frankfurt; and the European Securities and Markets Authority (ESMA), based in Paris. The ESAs are to be entrusted with micro-prudential supervisory tasks. Notwithstanding their separate legal personalities, hinting at their autonomous non-contractual liability in line with Article 340 of the Treaty on the functioning of the European Union (TFEU), the three-pronged mission of the ESAs is not to supplant national supervisors but, rather: (i) to help *coordinate* the supervision of institutions that are active on a cross-border basis by establishing a 'hub and spoke' network consisting of the ESAs and the national supervisors; (ii) to contribute to the promotion of a coherent approach to the application of EU financial markets law; and (iii) to foster the development of consistent supervisory practices at European level. The power of the ESAs to take individual decisions addressed to financial institutions is to be limited to specific cases concerning directly applicable Union law, where the national supervisory authority has consistently failed to act in response to a financial institution's failure to comply with its legal obligations[68]. This suggests that the ESAs are not intended to be a substitute for national supervisors. However, the fact that they have a common Board of Appeal[69] makes it more likely that European financial law will also develop a say on issues of relevance to supervisory liability, influencing the standard of care required of national supervisors in performing their Union law-based tasks. Should that turn out to be the case, the differences in national remedies for the failures of supervisors will no longer subvert the effectiveness of

[66] As this author has observed elsewhere, '[T]he progressive integration of European financial markets and the harmonisation of the rules governing their operation without a parallel integration of supervisory and crisis-management functions is, in this author's view, likely to increase forbearance and decrease the efficiency of cross-border supervision'; Athanassiou (2009), p. 293.
[67] The High Level Group on Financial Supervision in the EU, Report, Brussels, 25 February 2009.
[68] See, e.g., Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p. 12), Article 6(2)(e), read in conjunction with Articles 9(6), 10(3) and 11(4).
[69] Ibid., Articles 44-47.

supervision to the same degree as today. In particular, it is possible that, by contributing to the development of consistent supervisory practices at European level, the ESAs may help shape national attitudes to supervisory liability for the deficient performance, by domestic supervisors, of their public law tasks, contributing to a common perception in this field and indirectly encouraging EU-wide convergence of the national law remedies for supervisory failings. At this stage it is less easy to assess the impact on the supervisory liability debate of the parallel establishment of the European Systemic Risk Board (ESRB), which is to be responsible for macro-prudential oversight, that is for preventing or mitigating systemic risks, and which is to cooperate closely with the ESAs. This is both because of its focus on *macro* rather than *micro* prudential supervision and because of its lack of legal personality, which suggests that it is highly unlikely to be possible to sue the ESRB for damages.

1.2.2 The impact of Union law on domestic supervisory liability

The extent to which Union law is *already* relevant to the issue of supervisory liability under the domestic laws of the Member States is a function of the answers to the following three questions:

1) Does Union financial law confer on individuals rights to compensation for the deficient performance of supervision that depositors or investors can enforce in their national courts?
2) Does the principle of State liability for breaches of Union law establish a right to compensation for the negligent performance, by supervisors, of their tasks, such as to override national immunities?
3) Does the European Convention on Human Rights (ECHR) render inoperative any statutory immunities of supervisors under national law?

The following sub-sections examine each of those questions and their impact on the liability of financial sector supervisors under their national law.

Union law as a source of rights to compensation for the deficient performance of prudential supervision: relevant case law

The landmark ruling of the Court of Justice of the European Union (ECJ) in the *Peter Paul and others*[70] case is directly relevant to answering the first of the three questions above. *Peter Paul* was a reference for a preliminary ruling from the *Bundesgerichtshof* (the German Federal Supreme Court) concerning the interpretation of Articles 3 and 7 of the Deposit Guarantee Schemes Directive[71], arising from a claim for compensation brought by depositors in a bankrupt German bank (BVH Bank) against the former *Bundesaufsichtsamt* (the Federal office for the supervision of credit institutions). The depositors, *inter alia*, claimed that the *Bundesaufsichtsamt* had failed to properly supervise the bankrupt German bank and, for that reason, should bear such pecuniary losses as were not covered under the Deposit Guarantee Schemes Directive[72]. From an EU banking law perspective, the depositors' claim to compensation effectively challenged the legitimacy of former paragraph 6(4) of the *Kreditwesengesetz* (Law on credit institutions), which purported to limit the liability of the *Bundesaufsichtsamt* by only imposing on it supervisory obligations in the *public* interest[73]. While not expressly disputing the claim of supervisory fault, the German government denied liability on the ground that the public interest nature of the functions of the *Bundesaufsichtsamt* precluded individuals from claiming damages against it. The ECJ ruled that the purpose of the Deposit Guarantee Schemes Directive was to ensure that Member States introduced properly functioning deposit guarantee schemes, so as to protect and compensate depositors, but not to confer upon them a right to have the authorities take supervisory measures in their interest[74]. The Court also found that the purpose of the EU banking law directives, taken as a whole, was to 'achieve only the essential harmonisation necessary and sufficient to secure the mutual recognition of authorisations and of prudential supervision systems' and that while the recitals stated 'in a general manner that one of the objectives of the planned harmonisation [was] to protect depositors', it did not follow that the directives conferred

[70] Case C-222/02 *Peter Paul and others* v *Germany* [2002] ECR I-9425. For an account of the facts of the case and of the ECJ ruling in *Paul and others*, see Dempegiotis, pp. 136-138; Doherty and Lenihan, pp. 223-224; Proctor (2005), pp. 74-77; Dragomir, pp. 341-347; and Tison (2005), pp. 662-667.

[71] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.05.1994, p. 5).

[72] Despite the fact that Germany had failed to transpose the Deposit Guarantee Directive, so that, at the time of the collapse of BVH Bank, its depositors did not have the protection of a deposit guarantee scheme, the *Landgericht Bonn* awarded each depositor EUR 20 000, corresponding to the minimum amount they would have had if Germany had transposed the Directive. The claim in *Peter Paul* was for the amount by which the losses of the depositors in BVH Bank exceeded the minimum coverage provided under the Deposit Guarantee Directive.

[73] The claimants' argument, which was resonant of the *effet utile* doctrine, is summarised in para. 22 of the ECJ's judgment in Case C-222/02 *Peter Paul and others* [2002] ECR I-9425.

[74] Case C-222/02 *Peter Paul and others* [2002] ECR I-9425, paras 29-32.

rights to compensation on individual depositors for any damage they might suffer on account of deficient supervision, nor that the coordination of national rules on the liability of national authorities to depositors in the event of deficient supervision was necessary to ensure the directives' objectives[75]. As a result, the banking law *acquis* did not preclude national law rules to the effect that the functions of the national supervisory authority are to be carried out in the public interest, even if their effect was to bar individuals from claiming compensation for damages resulting from deficient supervision[76].

Even though it left 'the issue of compensatory remedies for defective supervision to the discretion of member state laws and regulators'[77], the ECJ's ruling in *Peter Paul* must be approached with caution. The ruling should not be taken out of the context of the Deposit Guarantee Schemes Directive and of the banking law *acquis*, as it stood at the time when the ECJ gave judgment. Specifically, it cannot be excluded that, however indirectly, subsequent and future amendments or additions to the financial law *acquis* (including those inspired by the ongoing crisis) may confer rights to compensation which individual consumers can enforce before their national courts. Commentators have pointed to the recast Banking Consolidation Directive but, also, to the Prospectus Directive[78] as examples of post-*Peter Paul* harmonised rules, which, while not imposing upon Member States the obligation to apply uniform liability standards upon banks, supervisors or underwriters would nevertheless seem to place the emphasis on *consumer protection*.[79] The jury is out on the prospects of future, Union law-based challenges similar to that in *Peter Paul*, and on the Court's assessment of the legal effects of specific prudential supervisory rules for the benefit of individual claimants[80].

Another notable analysis of supervisory liability from the perspective of Union law was that of the House of Lords in the *Three Rivers* case[81], which preceded the ruling of the ECJ in *Peter Paul*. One of the issues addressed in that case was whether the Bank of England could be held liable for damages to the plaintiffs, who had been depositors of the Bank of Credit and Commerce International (BCCI), for breach of the requirements of the First Banking Directive[82]. Resorting to

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[75] Ibid., paras 37-44.
[76] Ibid., para. 47.
[77] Dempegiotis, p. 137.
[78] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345, 31.12.2003, p. 64).
[79] See Dragomir, especially at pp. 348-362; Scarso, p. 113; and Rossi (2005), p. 1533.
[80] In this regard, see also Dragomir, pp. 308-310.
[81] Above, fn 51.
[82] First Council Directive 77/780/EEC; and Dragomir, pp. 65-93.

the *acte claire* doctrine[83], the House of Lords made its own interpretation of the Directive and concluded that it imposed no supervisory duty on the Bank of England, nor did it confer any rights on depositors or any other of BCCI's creditors that they could invoke against the Bank of England. In his speech, Lord Hope of Craighead pointed, *inter alia*, to the First Banking Directive's recitals as evidence that its purpose was 'to take the first step towards the introduction of uniform authorisation requirements for comparable types of credit institution having their head office in one member state and their branches in other member states', and to 'set equivalent financial standards', but not to impose any duty or any minimum standard of supervision[84]. Despite the fact that, for practical purposes, the House of Lords ruling is indistinguishable from that of the ECJ in *Peter Paul*, it would be unwarranted to regard it as conclusive evidence of the non-recognition of supervisory liability under Union law. The fact that their Lordships' analysis was limited to the First Banking Directive, and is thus even narrower in scope than the ECJ's ruling in *Peter Paul*, has led some commentators to conclude that, as wider obligations have subsequently been imposed in Union banking law, the House of Lords decision need not necessarily discourage future litigation being brought under the more intrusive, supervening banking law rules, whether in the UK or elsewhere in the EU[85].

The principle of State liability for damages as a source of a right to compensation for the deficient performance of supervision

The application of the Union law principle of State liability for damages for breaches of Union law is one way in which liability for compensation for financial supervisory failures may conceivably arise in Union law; this is closely linked to the basis for liability examined in the preceding sub-section. Despite the absence of any express provision in the Treaty on European Union (TEU) or the TFEU on the consequences of breaches of Union law by the Member States, the principle of State liability has consistently been recognised by the ECJ since its ruling in *Francovich and others*[86]. The full scope of the principle of State liability, described by one commentator as 'the apotheosis of judicial intervention in the law of remedies'[87], was clarified in another landmark ECJ ruling, *Factortame III*[88] where, *inter alia*, the Court held that, 'the full

[83] The reference is to the principle whereby there is no need for a national court to refer to the ECJ for a preliminary ruling on a point of law which is clear and free from reasonable doubt. The decision of the House of Lords not to seek a preliminary ruling from the ECJ has been criticised in Andenas (2000), pp. 408-409.
[84] Above, fn 51, 209.
[85] Rossi, (2003), p. 655; Andenas (2000), p. 406; and Dragomir, p. 309.
[86] Joined Cases C-6/90 & 9/90 *Francovich and Bonifaci* v *Italy* [1991] ECR I-5357.
[87] Tridimas, *Common Market Law Review*, p. 301.
[88] Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* [1996] ECR I-1029.

effectiveness of EC law would be impaired and the protection of the rights which they grant would be weakened if individuals were unable to obtain redress when their rights are infringed by a breach of Community law for which a Member State can be held responsible'[89]. Noting that it did not matter *which* State organ may have been responsible for the breach[90], the Court set out the following three conditions for conferring a right to reparation where the State is responsible for unlawful acts or omissions: 'the rule of law infringed must be intended to confer rights on individuals; the breach must be sufficiently serious; and there must be a direct causal link between the breach of the obligation resting on the State and the damage sustained by the injured parties.'[91] The ECJ also held that this right to compensation overrides any narrower national law rules, adding that, while the factors connected with the concept of 'fault' under national law may be relevant for determining whether a breach was sufficiently serious, '[t]he obligation to make reparation for loss or damage caused to individuals cannot, however, depend upon a condition based on any concept of fault going beyond that of a sufficiently serious breach of Community law' since, imposing such an additional condition 'would be tantamount to calling in question the right to reparation founded on the Community legal order.'[92] Going a step further, in the *Haim II*[93] case the ECJ clarified that, under Union law, there is no requirement that the State *itself* should make reparation, nor is there any rule to preclude an autonomous public body from being liable for damages, either instead of or in addition to the State, even if it lacks 'the necessary powers, knowledge, means or resources'[94]. The right granted is to reparation for any damage that is causally linked to the breach of an eligible provision of Union law, and it is satisfied if reparation is made by the public body responsible for the breach, with the issue of the *internal* allocation of liability as between the various organs of the State being of no relevance, provided that the right, as such, to reparation is guaranteed[95]. Finally, the *Köbler* case concerned a claim against Austria for damages for the claimant's alleged loss resulting from the non-recognition by the *Verwaltungsgerichtshof* (Supreme Administrative Court) of his purported right to payment of

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[89] Ibid., para. 33.
[90] Ibid., paras 31-32. This was later confirmed in Case C-302/97 *Konle* v *Austria* [1999] ECR I-3099, para. 62; and Case C-424/97 *Haim* v *Kassenzahnärztliche Vereinigung Nordrhein* [2000] ECR I-5123, para. 27.
[91] Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* [1996] ECR I-1029, para. 51. These conditions were, subsequently confirmed, *inter alia* in Joined Cases C-178/94, C-179/94, C-188/94, C-189/94 and C-190/94 *Dillenkofer and Others* v *Germany* [1996] ECR I-4845, paras 20-21; Case C-140/97 *Rechberger and Others* v *Austria* [1999] ECR I-3499, para. 21; and Case C-424/97 *Haim* v *Kassenzahnärztliche Vereinigung Nordrhein* [2000] ECR I-5213, para. 36.
[92] Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur and Factortame* [1996] ECR I-1029, para. 79.
[93] *Haim* v *Kassenzahnärztliche Vereinigung Nordrhein* [2000] ECR I-5123, where an Italian dentist with a Turkish dentistry diploma brought his claim against the Nordrhein Association of Dental Practitioners, an independent public law body, which had refused to enrol him on the register.
[94] Ibid., para. 28.
[95] Ibid., paras 31-32.

a special length-of-service increment payable to academics in Austria. In *Köbler*, the ECJ extended the *Francovich* principle to *judicial* acts, recognising that Member States can be liable for breaches of Union law attributable to their national courts adjudicating as courts of last instance[96]. Read in conjunction with *Haim II*, and in particular with the opinion of the ECJ that State liability cannot be avoided because of the nature and characteristics of the State body responsible for a breach of Union law, the ECJ's ruling in *Köbler* is of special significance for the purposes of this paper, both because it related to the liability of a *par excellence* independent body (i.e. a court or tribunal) against the decisions of which there was no right of appeal under national law[97], and because the ECJ accepted the existence of liability, despite the fact that legal doctrine (including the principle of *res judicata*, the common law doctrine of *stare decisis* and the principle of judicial independence) appeared to militate strongly against liability[98].

It follows that, as a basis for establishing supervisory liability, especially where such liability is not recognised under national law, Union law should not be underestimated. This is not least because, pursuant to the case law of the ECJ, neither the precise basis of the obligation (i.e. whether it is derived from primary or secondary Union law) nor the identity of the body incurring liability (i.e. whether the State, an autonomous public body, or the courts) is relevant for establishing State liability for damages. This follows from the universality of the Union law right to reparation, evidenced in the Court's unequivocal statement in *Francovich* that, 'the principle … is inherent in the system of the Treaty'[99]. Establishing State liability is further facilitated by the

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[96] Case C-224/01 *Köbler* v *Austria* [2003] ECR I-10239. To reach that result, the Court *inter alia* invoked the principle of 'state unity', according to which the State is viewed as a single entity for the purposes of liability, as a result of a breach of an international commitment caused by the legislature which, as the ECJ stated, plays an even more vital within the EU where all state organs are involved in the implementation and application of Union legal rules, including those which directly govern the circumstances of individuals (para. 32). National courts, and especially courts of last instance, play a crucial role, since they constitute the last judicial body before which individuals may assert their Union law rights (paras 33-34).

[97] As Tridimas has noted, in his analysis of the pre-*Köbler* case law of the Court; '[T]he dictum that a Member State may not avoid liability by claiming that the body responsible for the breach of Community law did not have the necessary power, knowledge, means of resources is of considerable importance…The issue may be crucial in relation to independent public bodies which enjoy budgetary autonomy'; Tridimas, *Common Market Law Review*, p. 318. His observation is of even greater relevance post-*Köbler*.

[98] The ECJ rejected the idea that the principle of *res judicata* was an obstacle to liability, arguing that although considerations that are relevant to the principle had caused national legal systems to impose restrictions on State liability for judicial decisions, these were not absolute, and most Member States recognise some form of liability for the decisions of their courts (Case C-224/01 *Köbler* v *Austria* [2003] ECR I-10239, para. 48). For an intellectually convincing defence of the ECJ ruling in *Köbler*, *inter alia* touching on judicial independence and the *res judicata* objections to State liability for judicial acts, see Anagnostaras, *European Public Law*, at pp. 287-291.

[99] Case C-224/01 *Köbler* v *Austria* [2003] ECR I-10239, para. 35; also, Tridimas, *The Cambridge Law Journal*, p. 412.

fact that the Court's case law does not formally make the operation of the *Francovich* principle conditional on the Union law rules in question having direct effect[100], nor does it subordinate the award of damages to the content of any competing domestic law provisions. In order for there to be State liability, it is sufficient for the Court to find that the rules in question are intended to protect the private interests of individuals. Finally, it would appear plausible that, '[S]ince 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 States for the acts or omissions of their supervisory authorities'[101].

Whether or not the liability of a Member State for supervisory failures under Union law will be established in a concrete case will ultimately depend on whether the prudential supervision rules that are alleged to have been misapplied by a supervisor establish rights for bank depositors, investors or shareholders that are capable of being breached. It is only then that deficient supervision could be deemed to be tantamount to a Member State's failure to fulfil its Union law obligations, and that third party liability could be based directly on Union law[102]. In *Peter Paul*, the ECJ was of the opinion that the *Factortame* 'conferral of rights' condition was not fulfilled vis-à-vis the Deposit Guarantee Schemes Directive[103]. In the *Three Rivers* case, the House of Lords was of the same opinion regarding the First Banking Directive[104]. However, it remains to be seen how domestic courts or the ECJ will approach other post-*Peter Paul* examples of Union

[100] This is inherent in *Francovich*, concerned with a non-directly effective directive (see para. 34 of the *Francovich* ruling). However, considering that: 'a certain degree of clarity and precision as concerns the subject matter of the infringed provision and the identity of the intended beneficiaries thereof is always required for the imposition of governmental liability', it is a matter of debate 'whether this degree is the same as the one required for the operation of the direct effect principle'; Anagnostaras, *Yearbook of European Law*, at pp. 359-360. In an incisive analysis, Anagnostaras reaches the conclusion that: 'the extent to which identifiable legal rights for the purposes of governmental liability can ever arise from provisions that do not meet the direct effect test is still uncertain', and that '[a] limited direct effect is thus required, in order for an infringed provision to be amenable to judicial review under Francovich' (p. 381).

[101] Tison (2003), p. 23.

[102] Tison (2002), pp. 53-54.

[103] For a critical assessment of the ECJ's decision to deny the existence of *Francovich* liability in *Paul and others*, see Tison (2005), pp. 667-673.

[104] Interestingly, the Court of Appeal reached a different conclusion; see *Three Rivers District Council* v *Governor and Company of the Bank of England* [2000] 2 W.L.R. 15.

financial law provisions where the consumer protection dimension may be stronger,[105] and how they will apply the *Factortame* conditions if confronted with supervisory liability claims brought under the Union's revamped financial regulatory framework.

1.2.3 The ECHR as a source of rights to compensation for the deficient performance of financial supervision

The ECHR could also be relevant to the liability of domestic financial sector supervisors, especially where immunity clauses are at stake. The following examines the ECHR's potential impact on the validity of national supervisory immunity clauses from a human rights law perspective.

One situation where the ECHR may be relevant for establishing the liability of financial sector supervisors is where an aggrieved depositor, investor and/or shareholder challenges a statutory immunity clause, alleging that it deprives them of a right to bring proceedings against the supervisor[106], in contravention of Article 6(1) of the ECHR (right to a fair hearing)[107]. This scenario is by no means fanciful given that, as the ECJ concluded in *Internationale Handelsgesellschaft*, 'respect for fundamental rights forms an integral part of the general principles of law protected by the Court of Justice'[108], and that the rights arising from the ECHR

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[105] In its recommendations to the other EU Institutions, in the matter of the collapse of Equitable Life Assurance Society, the European Parliament's Committee of Inquiry 'strongly' recommended that: 'Parliament, the Council and the Commission, when legislating in the financial services area, bear in mind the need to draft legislation in a comprehensive and comprehensible way which grants the individual consumer clearly defined rights which can be relied upon before national courts. This would improve consumer protection whilst at the same time creating strong incentives for Member States to transpose and apply such EC legislation correctly and on time. In turn, this will make more readily achievable a genuine internal market in financial services based on the country of origin principle and the home/host regulator method of supervision' (European Parliament, Report on the Crisis of the Equitable Life Assurance Society, 2006/2199 (INI), 4.6.2007, 362).

[106] Proctor (2005), p. 85. In this regard, see *X (Minors)* v *Bedfordshire CC*; and *X (A Minor)* v *Newham Borough Council*, [1995] 3 All ER 353 where this argument was raised. For an analysis of these cases, see Wright.

[107] Article 6 of the ECHR *inter alia* provides: 'In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law'.

[108] Case 11/70 *Internationale Handelsgesellschaft mbH* v *Einfuhr und Vorratsstelle für Getreide und Futtermittel* [1970] ECR 1125, para. 4.

are binding on the Member States and their courts[109]. At the time of writing, there is at least one Member State whose legislation on the immunity of national financial supervisors explicitly refers to Article 6(1) of the ECHR[110], possibly in an attempt to avert challenges based on human rights law. Article 41 of the ECHR, whereby the European Court of Human Rights (ECtHR) can order States responsible for breaching a fundamental right to provide reparation to injured parties, may also be relevant, though invoking it in a supervisory liability context would necessitate identifying a concrete legal right, the breach of which entitles a plaintiff to reparation. This may well be the right to a fair hearing guaranteed under Article 6(1) of the ECHR.

Although the implications of successfully invoking the ECHR against supervisory immunity would no doubt be significant, the risk of a fundamental erosion of immunities on account of their conflict with European human rights law is perhaps limited, mainly on account of the case law of the ECtHR and, in particular, its traditional interpretation of the concept of 'rights' in Article 6(1) of the ECHR. More specifically, the ECtHR has accepted that, even if the meaning of 'rights' cannot be determined exclusively by reference to domestic law (i.e. the provisions of the national legal system of the relevant Contracting State)[111], Article 6(1) targets *substantive* as opposed to *procedural* rights, the existence and scope of which are matters of domestic law[112]. It follows that where the national law-makers or courts have *not* recognised a civil law right to a claim for damages for supervisory negligence, Article 6(1) cannot be used to create one[113]. Moreover, given that the Article 6(1) right to due process is not absolute, and that restrictions on access to

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[109] The development of the case law on the concept of human rights under Community law is now encapsulated in Article 6(3) TEU which states: 'Fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms and as they result from the constitutional traditions common to the Member States, shall constitute general principles of the Union's law.' The key role played by the ECHR and the increasing prominence of human rights within the EU have repeatedly been emphasised by the ECJ in its post-*Internationale Handelsgesellschaft* decisions, e.g., in Case C-274/99 *Connolly* v *Commission* [2001] ECR I-1611, para. 37; and Case C-94/00 *Roquette Frères SA* v *Directeur général de la concurrence, de la consommation et de la répression des fraudes* [2002] ECR I-9011, para. 25.

[110] The reference is to the UK and to Schedule 1, section 19.1 of the Financial Services and Markets Act (FSMA) 2000.

[111] The concept of rights has been deemed to have an 'autonomous' meaning, at least to some degree; see e.g., *Kaplan* v *United Kingdom* (1980) 4 EHRR 64.

[112] At one time this orthodox approach to the interpretation of the concept of 'rights' was challenged by the ECtHR itself in *Osman* v *United Kingdom* [1998] ECHR 101, a precedent which the ECtHR has since departed from in *Z and Others* v *United Kingdom* [2001] ECHR 333. For an account of the ECtHR's *volte face*, and the resulting legal uncertainty in this area of the law, see Kingscote, p. 844; and English, p. 973.

[113] See *Powell and Rayner* v *UK* [1990] ECHR 9310/81, which concerned a statutory bar to bringing an action for nuisance in respect of aircraft noise; *Agee* v *United Kingdom* (1976) 7 D & R 164, concerning parliamentary immunity; and Proctor (2005), p. 86.

the courts can be permissible[114], it would only be in the face of an absolute or a very far-reaching supervisory immunity that such a right might take effect, assuming such immunity to qualify as a *procedural* bar to access to judicial relief[115]. But, even where a challenge might be possible on the basis of the ECHR, its outcome would be far from certain.

Ultimately, given that their *practical* effects are indistinguishable, differentiating between 'procedural' and 'substantive' bars to litigation would be unduly legalistic[116]. It would be more helpful to make a distinction between a situation where the courts would at least *examine* a claim, even if they were ultimately to decide that no supervisory obligation is owed to an individual claimant (in which case the requirements of Article 6(1) would be exhausted), and a situation where access to a court is altogether denied or plaintiffs are allowed to bring a claim only to have it summarily rejected on the ground of an immunity (in which case the requirements of Article 6(1) of the ECHR would not be exhausted). As a general proposition, it is difficult to believe that domestic courts would be sympathetic to the creation of a parallel system of remedies under the ECHR, resulting in claims having a higher probability of success under the ECHR than under national law.

1.3 Conclusions on supervisory liability under domestic and Union law

Supervisory liability standards are currently a matter of national law, with the different national approaches to the third party liability of financial supervisors running the gamut from blanket supervisory immunity to partial liability. As a general proposition, only in the most flagrant cases of deficient supervision can claimants hope to establish supervisory liability under *domestic* law[117]. It is clear that the existing differences between jurisdictions operate as an obstacle to the creation of a genuine single market in financial services. The home-host country allocation of supervisory powers built into the current financial law *acquis* is bound to amplify the impact of this divergence, giving rise to discrimination in cases where, for instance, the rights of depositors to claim damages from supervisors for the failure of a bank in their home jurisdiction depend on whether the defaulting bank's home or host supervisors (as the case may be) are liable for

[114] The conditions are that: i) it must pursue a permissible aim; and ii) it is not manifestly disproportionate for achieving those aims; see *Ashingdane* v *UK* (1985) 7 EHRR 528, paras 57-60.
[115] The argument is that, in the absence of an opportunity for the exercise of discretion, so as to ensure that meritorious claims can be brought before the courts, this type of immunity would fall foul of Article 6(1) ECHR, as an absolute procedural obstacle to litigation; Proctor, Part I, p. 26; Dempegiotis, pp. 143-144; and Scarso, p. 111.
[116] Proctor (2005), p. 87.
[117] Rossi (2003), p. 644; and Dragomir, p. 302.

damages for their acts or omissions under their national law[118]. Even if falling short of actual harmonisation, a gradual convergence of national supervisory arrangements would be desirable, not only for reasons of equity or due to the risk of regulatory competition between the different national supervisory liability regimes[119], but ultimately because a common or coordinated approach to sanctions for supervisory failures would be the logical conclusion of a harmonised, cross-border financial market. Turning to the issue of the impact of Union law on the third party liability of financial supervisors, the conclusion reached above is that, to the extent that prudential supervisory standards are derived from obligations enshrined in Union law, deficient supervision could in principle provide a basis for claims for damages based on Union law. To date, there has been no successful claim against financial supervisors brought on the basis of the *Francovich* doctrine. However, the *Francovich* line of cases allows wide scope for successful claims against negligent supervisors, whatever their identity and institutional features and whatever the degree of their autonomy, which is why it should not be disregarded. Finally, for the reasons explained in sub-section 1.2.3, the conclusion reached above is that the implications of successfully invoking the ECHR against the immunities of national supervisors could be significant in theory; however, in practice, the risk of a lasting erosion of national law immunities because of their potential conflict with European human rights law appears to be limited, except where there are blanket or very far-reaching immunities shielding supervisors from litigation.

Despite their powers to make binding decisions in specific cases, it is unlikely that the recently established ESAs will change much to the above conclusions. Having said that, it would be premature to conclude that the existing national divergences on the third party liability of financial sector supervisors will survive unchanged for very long[120]. It is possible that, by contributing to the development of consistent supervisory practices across the EU, the ESAs will help steer national approaches to liability for the deficient performance of their public law tasks by domestic financial supervisors towards common standards of liability. In the medium to long term this may result in a convergence of the national law remedies for the deficient performance by domestic supervisors of their public law tasks.

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[118] On the jurisdictional angle to the home-host country allocation of supervisory powers that is built into the contemporary banking law *acquis* (i.e. which court is competent to hear a dispute with a cross border element and which law that court would apply), see Tison (2003), p. 21.

[119] The perpetuation of cross-jurisdictional differences in supervisory liability might prompt depositors to choose their bank also on the basis of whether its banking supervisor can be liable for damages for supervisory failures under its national law. Disparities in the national supervisory liability regimes could put certain banks at a competitive disadvantage.

[120] See Dragomir, pp. 367-368.

2 Conceptual underpinnings of financial sector supervisors' liability

Having examined the state of third party liability of financial supervisors in the EU, we now consider, *de lege ferenda*, the arguments for and against such liability. Should supervisors be liable vis-à-vis third parties, either as a matter of legal principle or public policy and, if so, why and subject to what limitations? The answers to these questions can help provide insights into why national rules on the third party liability of financial supervisors differ so markedly from one Member State to another, why the convergence of standards of supervisory liability appears to be unlikely without external intervention, and why it is necessary to rethink the issue of supervisory liability, especially in the aftermath of the financial crisis. As a prelude to discussing the conceptual underpinnings of financial supervisors' liability, it is appropriate to examine a few ideas about the purpose of financial sector supervision.

2.1 The purpose of financial sector supervision

To accept that supervisors can incur third party liability for the deficient performance of their public tasks is to acknowledge that financial sector supervision encompasses the defence of individuals' interests, and that a supervisor's aim should not merely be to protect the public interest in the financial soundness of supervised institutions or in the preservation of systemic stability, but also to safeguard the interests of bank depositors and shareholders. Despite the obvious appeal of its simplicity, the 'public interest' argument against the recognition of supervisory liability appears to be unduly formalistic. To the extent that 'public interest' is little more than the sum total of the interests of depositors, shareholders or other third party stakeholders, it is only by protecting the stakeholders' *individual* (including *financial*) interests that the rules of prudential supervision can serve their purported public interest aims. The German court decisions referred to above, where the public interest argument was emphatically dismissed as a bar to claims for damages against supervisors, were inspired by this argument[121].

The realisation that financial sector supervision serves a plurality of sometimes conflicting interests is inextricably linked to the 'public interest' argument. For instance, the interests of banks or their depositors, on the one hand, can conflict with those of the public at large, on the other hand[122]. The *Icesave* saga is a first-class illustration of the types of conflicts of interest at stake. According to a report from the European Consumers' Organisation, the prudential

[121] See fn 52.
[122] See Tison (2003), p. 4; Lenihan and Doherty, p. 224, referring to the ECJ's decision in *Peter Paul*; Proctor (2005), p. 110; and Tison (2005), p. 642.

supervisor was already aware in August 2008 that the Icelandic savings bank Landsbanki was facing difficulties. The supervisor justified their decision to take no action until October 2008, when Icesave went bankrupt, by invoking their concern for the preservation of the stability of the financial system. What was a legitimate decision, had significant adverse effects for depositors[123]. To accept that supervisors can incur third party liability for the deficient performance of their public tasks entails striking a balance between their tortious liability towards individuals on the one hand, and the effective performance of their duties in the public interest on the other hand. It must be ensured that their margin of appreciation is not fettered to such an extent that they can no longer discharge their duties effectively, through fear of third party liability[124]. This is one of the main reasons why a partial immunity, one that makes allowance for ordinary negligence, would be both desirable as a matter of policy and acceptable as a matter of law[125].

Ultimately, the purpose of financial supervision is not to eradicate financial institution failures, any more than the purpose of criminal law enforcement is to eliminate the commission of criminal acts. Rather, it is to minimise the risk of failures through the exercise of preventive care[126]. To impose *full* liability on financial supervisors would, therefore, be inconsistent with the rationale of prudential supervision, which is not to eliminate the risk of financial intermediaries' failures but rather to mitigate the risk of their occurrence through the constant monitoring of the supervised entities and the *opportunity* (rather than the guarantee) that this provides for the early detection of fault lines, with an emphasis on those capable of bringing down supervised entities or threatening systemic stability[127]. Properly speaking, this is not an argument *against* supervisory liability, but rather an argument against *unlimited* supervisory liability and in favour of a partial immunity, leaving room for errors of judgment that are not attributable to gross negligence or worse.

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[123] See European Consumers' Organisation, Financial Supervision in Europe: Consumer perspective, Ref.: X/054/2009 - 16/07/09 BEUC, available electronically.

[124] As the UK Government argued in Case C-224/01 *Köbler* v *Austria* [2003] ECR I-10239, accepting that they will sometimes make errors that cannot be appealed against or corrected by compensation is inherent in the freedom granted to financial supervisors to decide on matters of prudential supervision. That has always been considered acceptable and is inherent in the allocation of supervisory tasks in a State.

[125] See Scarso, p. 114.

[126] The point was made in *Hill* v *Chief Constable of West Yorkshire* [1989] 1 AC 53, where it was held that, for reasons of public policy (i.e. the fear of defensive conduct and a variation of the 'floodgates' argument), the police were under no general duty of care to individual members of the public for their activities in the investigation and prevention of crime, and that only in exceptional circumstances would the police assume such a responsibility, giving rise to a duty of care to an individual. For a thoughtful account of this and other recent English cases involving remedies for police inaction, see Burton, pp. 272-295.

[127] The same point was made, specifically in connection with central banks, in Smits, p. 322.

2.2 Arguments for supervisory liability

The most commonly invoked arguments in favour of supervisory liability revolve around the idea that there is a need to keep supervisors accountable for their acts or omissions, and to give them incentives to act in the public interest.

According to the advocates of the third party liability of financial supervisors, immunity from liability can take away supervisors' incentives to perform their tasks diligently. Third party liability, so the argument runs, is a legitimate means of keeping financial supervisors 'on their toes', with tort law providing a first-class deterrent against complacency[128] or deficiencies in the performance of their duties[129]. For all its attraction, the 'incentives argument' overlooks the fact that there is no conclusive evidence that tort law has any deterrent effect on supervisors[130] or that third party liability is the only incentive for supervisors to perform their tasks properly. There can be other, non-legal but no less powerful incentives, including the supervisors' sense of duty and their concern to safeguard their authority and reputation against supervisory errors[131]. Moreover, to make a supervisor's success in the exercise of its tasks conditional on its record for avoiding failures – the main type of event capable of triggering third party liability in damages – is to opt for an unduly restrictive test of adequacy in the exercise by supervisors of their day-to-day tasks.[132] The deterrent element of this argument is, similarly, not fool-proof, as the possibility for depositors or the shareholders of supervisees to obtain damages from supervisors can be a source of moral hazards, prompting depositors, investors or shareholders to exercise less care than they otherwise would or to take risks they would normally not take[133].

[128] See Dijkstra (2009), pp. 269-284, who explains why Dutch tort law leads to under-deterrence; Giesen (2006), pp. 14-16; and Tison (2005), p. 672.
[129] Tison (2003), p. 6. The crux of this argument is the idea that to exclude supervisory liability is to convey the impression that supervision is to be conducted on a 'best efforts basis', sending the wrong signal to those exercising supervisory powers.
[130] Giesen (2006), p. 15, with an emphasis on First Council Directive 77/780/EEC; and Dragomir, pp. 65 - 93. The author is not aware that, despite the parallel existence, within the EU, of Member States where restrictions on supervisory liability apply alongside others where banking supervisors are subject to the regular liability regime, any comparative study has been conducted in terms of the effectiveness of supervision.
[131] On avoiding damage to reputation as a supervisory incentive, see Dijkstra (2010), p. 122; and Giesen (2006), p. 15.
[132] See Goodhart, especially p. 162-163.
[133] See, e.g., Scarso, p. 115; Giesen (2006), p. 15; and Rossi, (2003), p. 670.

Arguments in favour of supervisory liability could also be drawn from the concept of supervisory accountability[134]. Power goes hand in hand with responsibility. Unless supervisors are accountable for shortcomings in the performance of their duties, there is a risk they might ignore warning signals or otherwise fail to devote sufficient resources to their monitoring. The Madoff scandal, the run on Northern Rock and the collapse of Lehman Brothers, to cite but some of the recent situations in which financial supervisors may have fallen short of the standard of care expected of them, would appear to militate against supervisory immunity from third party claims (even if one were to accept that those failures were not the product of supervisory errors)[135]. While it is true that those endowed with public powers must be accountable for the exercise of their powers if investors are not to be deterred in their investment decisions for fear of supervisory incompetence or unfairness, it is not clear why supervisory accountability should take the form of subjecting supervisors to private law sanctions for breaches of their obligations vis-à-vis private individuals. In other words, it is not clear why tort law and its *private law* remedies are the right tools for sanctioning the deficient performance by supervisors of their *public law* tasks. There are, surely, several other ways of making supervisors accountable for their failures[136].

An 'equal treatment' argument might also be made in support of subjecting financial supervisors to third party liability. It is unclear why regulators governed by public law should enjoy immunity from tort claims (even if only enjoying partial immunity) when, quite apart from any criminal liability they may incur, the officers and directors of private companies can be held *individually* liable for negligence in the performance of their fiduciary or statutory duties vis-à-vis their shareholders and other creditors, especially in cases where they have failed to forestall a corporate insolvency[137]. Should not the legal and public policy arguments in favour of protecting

[134] Lastra (2001), p. 70, has defined accountability as 'an obligation owed by one person (the accountable) to another (the accountee) according to which the former must give account of, explain and justify his actions or decisions against criteria of some kind, and take responsibility for any fault or damage'.

[135] See Athanassiou (2009), pp. 504-505.

[136] A recent example is that of the FSA's break-up in the aftermath of the collapse of *Northern Rock*, through the transfer of the operational responsibility for prudential regulation to a new Prudential Regulation Authority (PRA), a subsidiary of the Bank of England, and the creation of a dedicated Consumer Protection and Markets Authority (CPMA) with a primary statutory responsibility to promote confidence in financial services and markets (for details of the Treasury's plans see HM Treasury, 'A New Approach to Financial Regulation: Judgement, Focus and Stability', July 2010, available electronically).

[137] Sections 171 to 177 of the UK Companies Act 2006, for instance, impose on company directors the duty to exercise reasonable skill and care and to promote the success of their company. By providing that members of the company can take action against a director personally for an actual or proposed act or omission which involves breach of these duties, whether or not the director benefits personally from that breach, the Act increases the risk of claims against them as individuals. For an account of the situation under German law, see Casper, pp. 1137-1138.

supervisors from liability, and the wider margin of appreciation that supervisors have in the exercise of 'business judgment', also apply to the commercial sphere? How can a double standard and the preferential treatment of supervisors be justified[138]? The 'equal treatment' argument harks back to the debate about whether the fact that *private* individuals and *public* bodies move in different spheres can justify fundamental differences in the way they are treated under the law when they perform their tasks. However, to the extent that it glosses over the fiduciary nature of the duties which the officers and directors of private companies owe to their shareholders, the 'equal treatment' argument is to some extent misconceived and its egalitarian attraction is misleading.

Ultimately, the main justifications for supervisory liability (or, at least, for *some* measure of it) are to be drawn from considerations of fairness, 'natural justice' and the rule of law. It is difficult to accept that private individuals can be denied the right to recover compensation for their financial losses from those who are deemed to have caused them through their wrongful acts, or to have failed to avert them through their negligent omissions, even though in most cases supervisors will be no more than *secondary* tortfeasors. Thus, to bar claims of liability towards third parties for any of the public policy reasons cited above would appear to fly in the face of the basic right to judicial redress for losses suffered through the wrongful acts or omissions of another, especially where such loss cannot be recovered from another source[139]. This would also run counter to the legitimate expectations of third parties that supervision is conducted effectively, so that harm or damage to third parties is avoided[140]. However, the natural justice argument does not say anything about the *extent* of a supervisor's liability, or whether it is compatible with natural justice for a regime only to accept *partial* rather than unlimited supervisory liability. Finally, a 'marketing argument' may be added to the 'natural justice' argument. As one commentator has argued, 'submitting prudential authorities to a liability regime might even be regarded as an element of strength in a financial system', given that 'the assumption that the stringency of financial regulation can be beneficial for the attractiveness of a country's financial system … may also apply as regards the issue of supervisory liability'[141]. At a

[138] See Wood (2006), p. 3.
[139] For a similar argument but in a somewhat different context, see Anagnostaras, *European Public Law*, p. 289.
[140] On legitimate expectation as a ground for supervisory liability, see Giesen (2006), p. 16; and Tison (2003), p. 5. Needless to say, the 'fairness' argument is more relevant to compensation claims brought by depositors than to claims brought by the shareholders of a failed supervised bank. This is because shareholders' losses are more akin to those of parties involved in a business venture than to the losses of savings (which, by definition, makes for a more 'acceptable' justiciable interest).
[141] Tison (2003), p. 6.

time of fierce regulatory competition in the field of financial law, even within the Union, the potency of this argument should not be underestimated.

2.3 Arguments against supervisory liability and in favour of immunity

Immunity from liability is consistent with the Basel Committee's Core Principles for Effective Banking Supervision[142,143]. As stated earlier in this paper, statutory immunities protecting supervisors from liability apply in a number of Member States. There are many arguments against supervisory liability, on which these immunities are premised. These arguments are presented and critically assessed below.

Of the many arguments in support of the immunity of supervisors from third party liability, the 'inhibition argument' is perhaps the strongest. This refers to the idea that, far from encouraging supervisors to perform their tasks properly, the threat of liability can *inhibit* them from freely exercising their discretionary powers and discourage them from taking prompt and decisive action for fear of the possible consequences. The argument is that liability can prompt supervisors to curtail their activities or to adopt overly defensive practices[144]. For example, supervisors may refrain from suspending a bank's licence, even where they have reason to believe that its activities pose an imminent risk to systemic stability, if they fear that they may face shareholder or depositor claims in damages for doing so. In the same vein, the risk of liability can inhibit transparency, in the sense of making supervisors less candid about past failures for fear that their readiness to admit them might result in future claims. For all its merit, the inhibition argument does not apply to supervisory bad faith or gross negligence, but only to less egregious forms of nonfeasance as well as to errors of appreciation in the *positive* performance by supervisors of their public law supervisory tasks. Perhaps more crucially, the argument that the threat of supervisory liability might fetter a supervisor's margin of discretion exaggerates the potential influence of third party liability to push supervisors into adopting defensive tactics, as the threat of liability may not be more of a supervisory incentive than reputational concerns, or outweigh

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[142] See Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, Basel, September 1997 (as revised in October 2006). Principle 1 ('Objectives, independence, powers, transparency and cooperation') *inter alia* provides that '[A] suitable legal framework for banking supervision is also necessary, including…legal protection for supervisors'.

[143] Tison has argued that the Committee's preference for supervisory immunity may be self-interested, at least to some extent; Tison (2005), p. 644.

[144] See, e.g., Rossi (2003), p. 669; Scarso, p. 114; Dragomir, p. 320; Wright, p. 10; and Quintyn et al. (2007), p. 10. Also, *Barrett* v *London Borough of Enfield* [1993] 3 All ER 193 at 199; *Yuen Kun-Yeu* v *Attorney General of Hong Kong* [1988] AC 175 (PC) at 198, where the point is eloquently argued by Lord Keith; and *Three Rivers District Council* v *Governor and Company of the Bank of England* [2000] 3 CMLR, 205, at 1265d, per Lord Hutton.

deposit/investor guarantee schemes or safeguard clauses[145]. Moreover, the 'inhibition argument' attributes to supervisors concerns and preoccupations that are more appropriate to ordinary human beings than to agencies pursuing a public interest agenda. At least indirectly, the inhibition argument puts emphasis on the discretionary, and hence on the *non-justiciable* nature of supervisory decisions, and on the need to safeguard the *efficiency* of supervision[146] which is inherent in the 'public interest argument' referred to above[147].

There are other arguments against supervisory liability that are more 'constitutional' in nature. For instance, it is not immediately obvious *how* a civil liability regime for supervisors can be appropriate if it is effectively to run in parallel with and, through the interposition of the judicial system, to challenge the wisdom of a political decision to choose a specific national supervisory structure that does not provide a role for the judiciary in assessing substantive prudential supervisory issues or the business case behind specific supervisory decisions. It could be argued that supervisory failures that are not attributable to misfeasance or bad faith should only have *political* consequences for the responsible government minister or for the head of the supervisory authority involved. These would lead to a loss of career opportunities for them and, *in extremis*, to the re-organisation or dissolution of the supervisory body. However they should not necessarily lead to liability for damages, which effectively makes the courts the final arbiter of the correctness of supervisory decisions, *post facto* and with the benefit of hindsight. In other words, it is difficult to accept that the courts should be allowed to substitute their judgment for that of supervisors, not least because to grant the courts the power to adjudicate on supervisory errors of judgment is to create an additional layer of supervision, and in respect of the more controversial decisions at that. This would be contrary to the allocation of supervisory tasks decided, for better or worse, by the legislative and the executive branches of the State. While these are, no doubt, strong arguments, they cannot entirely overcome the objections to supervisory immunity based on the principle of fairness, referred to above. This suggests that there is a need for a compromise between absolute immunity and strict liability.

Another frequently invoked argument against supervisory tortious liability is that it is irreconcilable with the existence of deposit/investor guarantee schemes. By exhausting the claims of depositors or investors vis-à-vis supervisors, deposit/investor guarantee schemes would appear to be incompatible with any *parallel* compensation scheme, whether or not derived from the law

[145] See Dijkstra (2009), p. 282, who concludes, on the basis of a law and economics analysis of supervisory incentives, that given the impact of reputational concerns, deposit guarantee schemes and safeguard clauses, supervisors are unlikely to act too defensively.
[146] On the idea of efficiency as an argument against supervisory liability, see Hadjiemmanuil, p. 384.
[147] See the account of the status and the decisions of the courts in Germany, Greece and Italy above.

of tort[148]. On closer scrutiny, the 'deposit/investor guarantee' argument is misconceived: *first*, such schemes only apply to depositors or investors but not to other stakeholders; *second*, as these schemes rarely provide unlimited coverage, it would not be unreasonable for aggrieved depositors or investors to try to recover from supervisors losses caused by supervisory negligence that are not covered by a deposit/investor guarantee scheme; *third*, the rationale of such schemes is to 'ensure the immediate partial recuperation of deposits entrusted to the failing bank' rather than 'protecting supervisory authorities from pressure arising from potential liability claims'; and *fourth*, such schemes are financed through the mandatory contributions of all banks and investment firms, rather than from the State budget[149], so they cannot be diverted into compensating third-party claims against supervisors[150].

A 'reverse fairness argument' might also be made against supervisory liability. As, more often than not, supervisory liability is for nonfeasance rather than malfeasance, in the sense that the supervisor's fault is failure to prevent another from causing harm to a third party, supervisors are at best peripheral or secondary tortfeasors[151]. There is an element of unfairness in allowing claims to be made against secondary tortfeasors as 'defendants of last resort'[152], simply because they have deeper pockets. On reflection, this variation of the fairness argument is unconvincing. *First*, it ignores the fact that financial supervision is also about prevention, so that a supervisor who has failed to stop another from causing harm has failed in its task of anticipating dangers, and should be liable for its lack of vigilance. *Second*, to exclude the liability of supervisors, possibly leaving an aggrieved party without any redress, on the ground that it is only secondary to the liability of the primary tortfeasor, is to ignore that the harm caused by supervisory failures can be just as serious as that caused by the primary tortfeasors' acts or omissions. Finally, the 'reverse fairness argument' is at best only valid against an assertion that supervisors should be the *sole* party responsible for any financial losses of depositors or other stakeholders resulting from a financial intermediary's failure, but it is not an argument in favour of total immunity for supervisors from tortious liability.

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[148] That was the conclusion of Advocate General Stix-Hackl in her opinion in Case C-222/02 *Peter Paul and others* v *Germany* [2002] ECR I-9425, as well as of the ECJ itself (see, in particular, the Court's reference to recital 24 of the Deposit Guarantee Directive, in its judgment).

[149] Dragomir, pp. 316-317; and Tison (2003), pp. 5-6.

[150] An overview of the status of the financing of national deposit guarantee schemes in the EU suggests that at the time of writing only in Belgium, Bulgaria and Slovakia has the State participated in the funding of the national deposit guarantee scheme, contributing funds *ex ante* on a statutory basis, and not related to emergency situations.

[151] See Giesen (2006), pp. 13 and 17-19.

[152] Scarso, p. 113.

Perhaps the most frequently used argument against the idea of supervisory liability is the 'floodgates argument'[153]. The risk of opening the floodgates to litigation by subjecting supervisors to tortious liability is, however, exaggerated. As argued above, by and large courts are reluctant to allow claims for damages against supervisors, even where their tortious liability is not restricted by any special immunity. It follows that it is unlikely that the courts would be flooded with claims against supervisors, or that such claims would result in massive awards. It is no doubt true that supervisory liability for damages might impose pecuniary burdens on the State, and indirectly operate as an undesirable transfer of wealth[154]. If there is to be supervisory liability for damages paid out of State funds, it is not obvious why taxpayers should bear the full brunt of the aggrieved parties' losses. These arguments do not necessarily militate against the idea of liability, however valid. They could, however, provide arguments in favour of its *limitation*, both by excluding strict liability for failures of supervision and by introducing a reasonable cap, so as to avoid the risk of liability 'in an indeterminate amount for an indeterminate time to an indeterminate class'[155]. The risk, however, is that granting *some* supervisors (but not others) the benefit of an immunity means that those who have been excluded might lobby to become subject to the same, more advantageous treatment in what would, effectively, represent a variation of the classical floodgates argument. The aforementioned risk would nevertheless not militate against supervisory immunities but, rather, against the granting of indiscriminate immunities that do not reflect the specificities of the mission and tasks of different supervisors and of the inherent litigation risks.

2.4 Conclusions

This examination of the arguments for and against supervisory liability suggests that there are as many sound arguments in favour of liability, at least in cases of bad faith or gross negligence, as there are against it. This suggests that there is a need for a balanced and dispassionate approach to the issue of liability, accepting it in principle but subjecting it to reasonable limits. It is desirable to avoid interfering with the margin of discretion necessary for the performance of supervision and to avert unlimited pecuniary loss to the State, while guaranteeing a minimum level of protection for the right of individuals to obtain judicial redress and some compensation for losses they may have suffered. Do the above conclusions also apply to central banks in their supervisory capacity and, if so, to what extent? Can the independence of central banks distinguish their

[153] For an application of the floodgates argument to supervisory liability, see Giesen (2006), pp. 13-14 and 21-22; Scarso, p. 114; and Rossi (2003), p. 671.
[154] It is likely that some of the recipients will be sophisticated investors, including hedge funds, or the majority shareholders of failed banks.
[155] *Ultramares Corp.* v *Touche* (1931) 255 N.Y. 170, 174 N.E. 441, at 444 per Cardozo J, as he then was.

liability for supervisory failures from that of non-central bank supervisors? These and other related questions are addressed in the following section.

3 Third party liability in the case of central banks: some reflections

No discussion of supervisory liability would be complete without inquiring into its interplay with the concept of *central bank independence* (CBI). This is because CBI can provide arguments both for and against the recognition of immunity from supervisory liability for central banks when exercising supervisory powers.

3.1 Introductory remarks: CBI and its link to banking supervision

The fundamental tenet of CBI is that an autonomous NCB will 'favour the long term over the short term in its monetary policy decisions'[156], thereby mitigating the 'inflation risk' endemic in discretionary decision-making. Legal and economic literature traditionally divides CBI into four elements: *institutional*, *personal*, *financial* and *functional* (or operational) independence. *Institutional independence* essentially means that an NCB's decision-making bodies should neither seek nor take instructions from third parties, and that third parties should abstain from seeking to influence central banks in the performance of their tasks or in the pursuit of their objectives[157]. Since institutional independence is a necessary but not sufficient condition for autonomy, safeguards for personal, functional and financial independence have also been built into the central banks' statutes. *Personal independence* is enshrined in guarantees on the security of tenure of NCB governors and board members, to prevent their arbitrary dismissal[158]. *Financial independence* is typically achieved through provisions to ensure that central banks are not dependent on their national administrations for their budget and resources. Finally, *functional independence* has been entrenched through legal guarantees of the central banks' ability to avail themselves of all means and instruments necessary for the achievement of their objectives and the performance of their tasks, independently of any external influence. The institutional framework in each Member State has undergone (or is in the process of undergoing) the adjustments necessary to cater for each of the aspects of CBI, elevated to the status of key legal convergence

[156] Randzio-Plath and Padoa-Schioppa, p. 4.
[157] See Article 130 TFEU.
[158] In the case of the ESCB, personal independence is guaranteed by Articles 14.2, 11.3 and 11.4 of the Statute of the ESCB, which safeguard the security of tenure and minimum term of office of NCB governors and of ECB Executive Board members respectively.

criteria for a Member State's admission to Stage Three of Economic and Monetary Union (EMU)[159]

There is a substantial body of empirical research, mainly in the fields of law and economics, on the instrumentality of CBI for the conduct of monetary policy (and, secondarily, for the preservation of financial stability)[160]. However, partly because banking supervision has not traditionally been a core central banking task[161], less attention has so far been paid to the instrumentality of CBI for the performance of banking supervision[162], and even less to whether making central banks subject to non-contractual liability for supervisory faults could be problematic from a CBI perspective, or whether it can be treated as *correlative* to CBI, justified by the concern to balance supervisory accountability with CBI. It is tempting to associate the non-universality, within the EU, of the attribution to the national central banks of responsibility for banking supervision (that was the case in 14 Member States at the time of writing)[163] and the fact that banking supervision is no more than a *contributory* task of the European System of Central Banks (ESCB)[164], with the lack of a clear consensus as to the public policy benefits of the central banks' involvement in banking supervision. The ECB has nevertheless strongly supported the 'preservation of a fundamental role for central banks in prudential supervision in euro area countries', pointing to the information-related synergies between banking supervision and the core central banking tasks, to the close relationship between the prudential supervision of individual market intermediaries and the assessment of the risks they pose for the financial system as a whole and, last but not least, to the independence and expertise that central banks can

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[159] 'Old' Member States were required to ensure that, at the beginning of Stage Three of Economic and Monetary Union (EMU), their national legislation, including NCB statutes, guaranteed CBI (see EMI, Convergence Report 1998 (EMI, 1998), p. 12 et seq. Member States with a derogation are required to adapt their national legislation to guarantee CBI as a legal convergence condition for their accession to Stage Three of EMU (see ECB, Convergence Report 2004 (ECB, 2004), p. 25 et seq). Different considerations apply to the UK and Denmark, which have opt-outs with the right to choose whether or not to participate in the Third Stage of EMU (ibid., pp. 23-24).

[160] See, e.g., Padoa-Schioppa (2002), pp. 160-175; Eijffinger and De Haan; Posen; Alesina and Summers, p. 151; Cukierman; and Rogoff.

[161] This is despite the fact that some commentators have pointed to the complementarity of supervisory responsibilities and monetary policy and to the interplay between the quality of financial supervision and financial stability; see, e.g., Peek et al., p. 629; and Das et al.

[162] Some of the literature suggests that responsibility for banking supervision has a significant bearing on CBI, with the assumption of supervisory tasks by an NCB being apt to prejudice its independence in other fields; see, e.g., Heller; Goodhart and Schoenmaker, at p. 555; and Di Noia and Di Giorgio. Based on the finding that countries with an institutional separation between the banking supervision and monetary policy functions exhibit lower levels of inflation than those where these are combined in the NCB, some of these authors conclude that such a separation is advisable, *inter alia* as a means of enhancing CBI.

[163] See Hardy, p. 76.

[164] See Articles 127(5) and 127(6) TFEU as well as Articles 3.3 and 25 of the Statute of the ESCB.

bring to prudential supervision as a key element for monitoring financial stability[165]. Leaving aside, for a moment, the issue of the separation of banking supervision from central banking, the link between CBI and an NCB's liability for the performance of banking supervision is highly topical, at a time when some Member States are in the process of transferring the banking supervisory function from specialised agencies to central banks, a development that other Member States may decide to emulate[166]. While the central banks' non-contractual liability *is* touched on in the Statute of the European System of Central Banks and of the European Central Bank (the 'Statute of the ESCB'), all that primary Union law has to say about it is that functions other than those specified in the Statute of the ESCB are to be performed 'on the responsibility and liability of national central banks', referring the matter to their respective national laws[167]. Interestingly, the Statute of the ESCB does the same with regard to the central banks' non-contractual liability for the performance of their ESCB-related tasks[168].

The last decade has seen a steadily growing body of academic literature on the issue of *supervisory independence*, which is not without parallels to and has no doubt been inspired by the literature on CBI[169]. There has also been a focus on the interplay between the principles of *supervisory independence* and *supervisory accountability*, of which supervisory liability is a part. One of the conclusions of this literature is that, while supervisory independence is necessary for the credibility of the supervisory function, independence safeguards need to be complemented by provisions for accountability[170]. Another conclusion is that supervisory accountability is an

[165] ECB, The Role of Central Banks in Prudential Supervision, 2001, available electronically.

[166] Apinis et al. show that the trend towards consolidation of supervisory authorities is not always linked to a diminution of NCB powers in the field of banking supervision. In three of the eight countries reviewed in their work, the central banks have sole competence for banking supervision, while in two more integrated supervision has been placed within the NCB.

[167] See Article 14.4 of the Statute of the ESCB. For a discussion of the liability regime of the ECB and the national central banks in connection with their supervisory tasks, see Dragomir, pp. 363-366.

[168] See Article 35.3 of the Statute of the ESCB. It follows that the Statute of the ESCB does not differentiate, in terms of liability, between the national (i.e. the non-Eurosystem) tasks of an NCB and its Eurosystem tasks: in both cases, an NCB is to be liable (or not, as the case may be, depending on what immunities it may enjoy under national law), in accordance with its relevant national law provisions. In the author's view, this opens the door for the introduction, by the Member States, of immunities that cover both the national central banks' *national* and *Eurosystem* tasks.

[169] See, e.g., Lastra, (1996), p. 392 et seq.; Goodhart (1998); and Quintyn and Taylor (2003), p. 259. Supervisory independence has since received the support from the Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, Basel, September 1997 (as revised in October 2006).

[170] See Ponce, who finds that the probability of bank failures is significantly lower in countries with independent but *accountable* supervisors.

affirmation of supervisory independence rather than its antithesis[171].

An obvious difficulty with applying this 'traditional' analysis of supervisory accountability to the performance of banking supervision by central banks is closely linked to the *sui generis* nature of their independence, especially for the Eurosystem central banks. The independence of the central banks that also act as banking supervisors tends to be more firmly entrenched than that of non-central bank supervisors, despite their parallel competences for monetary policy and, in many cases, for financial stability. The extant literature ascribes a special premium to CBI and to the protection it gives from outside interference for both of these core central banking tasks[172]. This *plurality* of NCB competences suggests that the natural tension between supervisory independence and supervisory accountability is stronger in the case of central banks that also act as banking supervisors than in the case of dedicated, non-central bank supervisors. This is both because of the greater complexity of banking supervision compared with the conduct of monetary policy (at least under normal conditions)[173], and because of the obvious *reputational* implications for central banks of supervisory failures, which can have a more far-reaching impact on central banks than on specialised, non-central bank supervisors. It is argued that an NCB's reputation for the conduct of monetary policy and/or for the monitoring of financial stability is bound to suffer in the event of a supervisory failing for which it is found liable[174]. Even if they do not in themselves militate against the imposition of supervisory liability on central banks and do not provide conclusive arguments in favour of separating banking supervision from the conduct of monetary policy[175], the heightened risks to which central banks are exposed as supervisors, compared to non-central bank supervisors, makes the problem of deciding the boundaries of their supervisory liability more intractable if the central banks' credibility in pursuing their monetary policy and financial stability objectives is not to suffer as a result of successful claims against

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[171] As observed in Lastra (2001), p. 75: '[I]ndependence and accountability can be seen as the opposite ends of a continuum. While too much independence may lead to the creation of a democratically unacceptable "state within the state", too much accountability threatens the effectiveness of independence, and in some instances … may actually nullify independence. The debate about independence and accountability resembles the philosophical debate about freedom and responsibility: independence without accountability would be like freedom without responsibility'. The idea that accountability and independence are complementary is supported by Hüpkes et al.

[172] In this regard, see Hüpkes et al., referring to Lastra's observation that several central banks were granted a higher degree of independence for attaining their monetary policy objectives than for their banking supervisory tasks; and Quintyn and Taylor (2003), who have explained why the level of independence of banking supervisory agencies is lower than that of monetary policy agencies and why supervisory independence remains more controversial.

[173] See Hüpkes et al., p. 10, drawing attention to the 'greater range of contingencies that can occur in regulation and supervision than in the conduct of monetary policy'.

[174] Quintyn and Taylor (2004), p. 8.

[175] On the pros and cons of separating banking supervision from the conduct of monetary policy see, e.g., Padoa-Schioppa (2004), pp. 71-72; Llewelyn, pp. 28-33; and Quintyn and Taylor (2004), pp. 7-9.

them for supervisory errors, and if their independence in relation to their non-supervisory tasks is not to be compromised.

3.2 Other objections to the supervisory liability of central banks

There are a number of other substantive objections to the supervisory liability of central banks, all of which have a bearing on their independence. One of the strongest objections is that to make an NCB liable for damages for supervisory faults would be to expose specific aspects of its independence to varying degrees of risk, depending on the gravity of the supervisory faults and the attendant compensatory obligations. Starting with the *financial* aspect of CBI, if an NCB were to have to pay out substantial amounts in compensation to satisfy third party claims, this could deplete its statutory capital, possibly putting at risk its financial independence. In the event of the depletion of an NCB's statutory capital arising from its liability to pay damages for the negligent performance of its supervisory tasks, it would arguably be for the State treasury to step in and recapitalise the NCB, in accordance with the implicit Treaty obligation of Member States to guarantee that their NCB has, at all times, the capital necessary to continue to perform its tasks in full autonomy[176]. While a State guarantee to cover any substantial losses of an NCB in the performance of its banking supervision would *prima facie* be both helpful and defensible (and not only legally)[177], the publicly funded recapitalisation of an NCB[178] could raise CBI concerns if a State guarantee were to be conditional on the recipient NCB accepting instructions on the performance of its supervisory tasks. In that case, government involvement could also risk encroaching on an NCB's *operational* independence[179]. Finally, serious supervisory failures attributable to an NCB's negligence could also be expected to have an impact on the *personal* independence of its governor and board members[180]. Even if the personal independence aspect of

[176] The Member States' obligation to recapitalise their central banks follows, by necessary implication, from the principle of CBI enshrined in Article 130 TFEU, read in conjunction with Article 127 TFEU, and Article 7 of the Statute of the ESCB. The principle of CBI, which has been consistently upheld in the ECB's Convergence Reports, requires the central banks to have sufficient financial resources to continue to autonomously fulfil their mandates and perform their statutory tasks.

[177] A State guarantee could also be justified by the argument that the decision to appoint an NCB as a banking supervisor is a State decision rather than the choice of the NCB, and that as supervision is not a core central banking task, central banks conducting it by delegation from the government should be indemnified for any pecuniary loss they suffer from successful liability claims.

[178] Different considerations would apply in the case of central banks that are public companies, where recapitalisation may also be possible in the capital markets. This is the case, for instance, with the Bank of Greece and the Nationale Bank van België/Banque Nationale de Belgique.

[179] The relevant NCB's government may subsequently closely monitor the NCB's exercise of its supervisory tasks, to ensure that its own liability for damages is not engaged.

[180] The issue of personal liability, and of its limits, is particularly difficult to resolve in the case of Eurosystem central banks, since the Statute of the ESCB stipulates restrictively the grounds for dismissal of an NCB governor or board member.

supervisory liability does not necessarily militate against the acceptance of supervisory liability for central banks (indeed, the opposite may be the case)[181], it certainly represents a challenge that cannot be tackled without reference to CBI and to the need to reconcile supervisory accountability with the protection of CBI.

There are further CBI-related arguments against the imposition of supervisory liability on central bank supervisors. One of the most important is the 'reputational argument', referred to earlier. Based on the preceding analysis, it is concluded that the reputational argument is, at best, an argument against *unlimited* supervisory liability, but not in favour of its wholesale exclusion. Another argument against the imposition of supervisory liability can be linked to the observation that the assumption of supervisory tasks by a central bank can prejudice its independence in the conduct of monetary policy by exposing it to conflicts of interest[182]. Based on that observation (which could help explain the current practice, in many jurisdictions, of institutionally separating the responsibility for monetary policy from the responsibility for banking supervision, as a means of enhancing CBI) the argument can be made that, to add to the problem of limited independence for central bank supervisors by burdening them with supervisory liability may be to further undermine their independence. This argument is, however, exaggerated, viewed in the context of the institutional realities created since the introduction of the single currency as, '[c]onflict of interest concerns have been alleviated in the euro area by the transfer of monetary jurisdiction from NCBs to the ECB'[183]. Ultimately, how one assesses that argument is a function of one's understanding of supervisory liability, either as a negation of supervisory independence or as its guardian, and of how high a premium one places on accountability as a means of boosting the credibility of the supervisory function and of those who perform it.

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[181] Dijkstra (2010), p.124, advances an argument which, applied to an independent supervisor such as an NCB, could be understood as follows. There are two ways to keep an independent supervisor on its toes: one is through supervisory liability for damages; the other is through other, non-pecuniary forms of accountability (e.g. in the form of dismissal). In the case of an NCB, accountability in the form of dismissal is effectively out of the question, since an NCB is independent; that leaves supervisory liability for damages as the only means of incentivising an NCB to do its job properly.

[182] See Goodhart and Schoenmaker; and Di Noia and Di Giorgio. The first argument in favour of separating financial supervision from the conduct of monetary policy is the possibility of a conflict of interest in having a single institution manage both activities. An NCB that is vested with both responsibilities might be tempted to rectify financial sector failures by allowing lower interest rates or higher money growth than would be desirable from the perspective of price stability. A second rationale for institutional separation arises from the bad publicity and the loss of confidence attached to financial failures or rescue operations by an NCB, with a resulting loss of reputation and of the credibility of monetary policy.

[183] See ECB, The Role of Central Banks in Prudential Supervision, 2001, p. 8; and Mathieson and Schinasi, p. 37.

A variation of the 'floodgates argument' seems a more valid objection to the imposition of supervisory liability on central bank supervisors. If an NCB were to be liable for damages for the deficient performance of its supervisory tasks, could it not also be held liable for its monetary policy decisions? In theory, these decisions could generate much more substantial losses than those caused by supervisory failings. For this author this objection is not valid[184].

Even if the above arguments are not sufficient to lead to the conclusion that central bank supervisors should enjoy total immunity from liability, they certainly bring to light the challenge of applying the 'traditional' analysis of supervisory accountability to central banks without exposing them to risks to their independence. Ultimately, the main reasons why central banks that act as banking supervisors cannot enjoy full immunity for any and all supervisory faults by invoking their independence are that: (i) CBI is not a goal in itself; (ii) the ECJ has accepted the principle of state liability for other independent authorities; and (iii) there is at least one fundamental difference between banking supervision and other non-supervisory central bank activities that militates in favour of NCB liability for the performance of banking supervision. Each of these three issues is touched on below.

First of all, CBI is only a means by which an NCB can achieve its legitimate objectives, not an end in itself. If those objectives cannot be achieved in the area of supervision due to negligence, an NCB should be liable for its failings, but within reasonable limits. As for the second of the above points, given that the ECJ has already accepted that the decisions of *par excellence* independent bodies, such as national courts or tribunals against whose decisions there is no right of appeal under national law, can expose a State to liability, it is difficult to accept that central banks would be exempt from third party liability on the basis of the principle of CBI. Finally, regarding the third of the above three points, it has been observed that: '[w]hen banking supervisors revoke a failing bank's licence, they are using the coercive power of the state against private citizens. When central banks conduct monetary policy, they have no such coercive power.'[185] The coercive nature of the powers of financial supervisors, and thus the governmental flavour attaching to their supervisory activities, explains why, whatever the guarantees of CBI in connection with the pursuit of their monetary policy or financial stability objectives, central banks can still be held accountable for their acts or omissions so that errors of omission or appreciation causing losses to third parties can be sanctioned. This also explains why, in contrast to liability

[184] If it were otherwise, should there not be yet another, higher instance (judicial or otherwise) to validate the decisions of judges? *Quis custodiet ipsos custodes*?
[185] Quintyn and Taylor (2004), p. 4.

for supervisory faults, it would be inconceivable for central banks to be held liable for miscalculations in the monetary policy field.

3.3 Conclusions

Although supervisory liability for losses need not be the only means of ensuring the accountability of central banks (or any other financial sector supervisor) for their supervisory acts or omissions[186], our analysis suggests that a certain measure of liability, especially in egregious cases of negligence or bad faith, would be conceptually defensible, to preserve public confidence in the accountability of central banks as supervisors[187]. For lesser forms of fault, a certain measure of protection from liability would be both acceptable, as a matter of law, and advisable, as a matter of public policy, so as to preserve the central banks' margin of appreciation from judicial scrutiny when they act as supervisors, and to avoid the risk of constraining banking supervision to an extent that would be inconsistent with the public interest[188].

4. Final remarks

At a time when the national allocation of prudential supervisory tasks is in flux, with several Member States shifting from independent non-central bank supervisors to central banks, the findings of this paper throw open a number of questions.

The first question is whether, to avoid being exposed to civil liability, central banks should not reduce their involvement in supervision. As suggested earlier in this paper, there is a strong interest in central banks having an active say in supervision. This is all the more so in the case of *Eurosystem* central banks, where several of the arguments in favour of the separation of prudential supervision from central banking have lost much of their force, while those in favour of combining these tasks have gained force since the introduction of the euro[189]. These considerations, together with the relatively high standard for liability applicable in most Member

[186] The fact that a body is accountable does not necessarily mean that it has to be so before a court of law, as there are other forms of accountability that do not endanger independence but which are nonetheless effective. For instance, the risk of the loss of credibility and reputation can be a strong enough incentive for a supervisor to take its job seriously, or risk suffering consequences similar to those that the FSA suffered which, while not liable for damages for the Northern Rock fiasco, has nevertheless been deprived of a substantial part of its powers in the aftermath of the crisis.

[187] Much the same conclusion is reached by Quintyn and Taylor (2004), p. 14.

[188] This cap may well correspond to the amount guaranteed at any given time under the national deposit guarantee scheme.

[189] See ECB, The Role of Central Banks in Prudential Supervision, 2001, pp. 7-10.

States, suggest that, to forego the benefits of NCB involvement in prudential supervision (including where sole responsibility for banking supervision has been given to an NCB) merely because there is remote risk of liability for negligence, would be an unwarranted precaution, and not commensurate with the uncertainties of litigation arising from claims for damages for supervisory failure[190].

A second, no less intractable, question is how to foster convergence towards common standards of supervisory liability, so as to avert the injustices for depositors and shareholders that result from the different liability regimes to which supervisors are currently subject in different Member States. In purely conceptual terms, there is more than one way to achieve this objective. One possibility might be to establish a single European financial supervisor, responsible for policing the implementation of a European rule book and operating under a single European liability regime[191]. While a discussion of the merits of a single European supervisor lies outside the scope of this paper, to the extent that it would require the harmonisation of the substantive law of tort the proposal would be unworkable, despite the costs of regulatory fragmentation in this context. Another means to overcome the current fragmentation of supervisory liability, but without necessarily having to establish a single European supervisor with a single rule book, would be through the ESAs. Although the ESAs could prove instrumental in promoting a certain degree of convergence in European supervisory liability standards, for the reasons explained earlier, they would appear to lack the legal authority to provide a harmonised liability regime across the EU. In any event, it remains to be seen what their impact will be in helping bring about the desirable degree of convergence of standards in the field of supervisory liability.

The unpalatable truth is that supervisors will always make errors and that their liability will always be an issue, as disgruntled depositors or shareholders search for a 'deep pocket' from which they can recover their losses. As one commentator has observed, '[t]he issue of supervisory liability will ultimately always be a matter of national law, to be determined by national courts in concrete situations and in the context of national tort law'[192]. Without some form of external intervention to harmonise national supervisory liability regimes, the likelihood of legal

[190] This is without prejudice to the need to ensure that their human and material resources are such as to provide basic guarantees against the risk of failure in their supervisory duties, so as to help avert the reputational and credibility risks attaching to supervisory failures involving central banks.
[191] On the broader issue of a European Supervisor as an answer to the fragmentation of national supervisory liability schemes, see Dragomir, pp. 323-324.
[192] Dragomir, p. 323.

convergence in this field is limited.[193] The solution may ultimately lie as much in simplifying financial business and its underlying rules, so the likelihood of supervisory faults can be reduced, as in readjusting or rethinking supervisory liability arrangements[194]. The complexity of the contemporary financial universe is conducive to supervisory errors and to failures of oversight that can damage public confidence both in the banking system as a public good, and in the mechanisms to monitor it and in particular in the ability to protect investors and depositors from harm. Rules that are simpler, and hence clearer, and stricter are one possible means of achieving this objective. The outright banning of certain other activities, which have proven adverse effects on financial or wider systemic stability, may well be another. The sheer complexity of financial rules is one of the root causes of supervisory errors, and addressing this could be a more worthwhile exercise than fine-tuning standards of supervisory liability to deal with errors of appreciation or supervisory omissions.

What should not be forgotten is that supervision is an issue with geopolitical implications. It is key to avoiding future difficulties similar to those that Europe and the US have been faced with since September 2008, and their associated legacies. If the European and US financial systems are not to lose their position in the world, the issues of financial market supervision and of the supervisors' liability for 'getting it wrong' should continue to occupy the minds of policy makers, as a means of helping ensure the quality of supervision. At the same time, supervisory liability cannot be allowed to have an inhibiting effect on those entrusted with the task of supervision. A balance needs to be struck. Given their attributes of independence, central banks have an interest in claiming a central role in discussions about what is the right balance and where the line should be drawn, so that neither the reputation nor the independence of central bank supervisors suffers, either through a lack of accountability, in the name of CBI, or through saddling central banks with a measure of liability that negates the independence and discretion they need to pursue their public interest tasks. This is all the more so at times of crisis, when the public looks to central banks for responsible and urgently needed answers to pressing questions affecting the livelihoods of many now and for some time to come.

[193] Even though Article 340 TFEU recognises that the EU can incur non-contractual liability, its obligation to make good the damage caused by its institutions or servants in the performance of their duties is circumscribed by 'the general principles common to the laws of the Member States'.

[194] The author has earlier made this point in Athanassiou (2010), pp. 279 and 281-282.

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