Financial Law Institute

Working Paper Series

WP 2005-02

Michel TISON

Do not attack the watchdog !
Banking supervisor's liability after *Peter Paul*)

April 2005

WP 2005-02

Michel TISON

Do not attack the watchdog !
Banking supervisor's liability after *Peter Paul*

Abstract

Banking supervisory liability has recently received much attention both from supervisory authorities themselves as from academics, thanks to the preliminary proceedings brought by the German Supreme Court before the European Court of Justice (ECJ) in case C-222/02, Peter Paul*. In its judgement of 12 October 2004, the ECJ has refused to apply* Francovich *type Member State liability to the obligations incumbent on Member States to exercise a prudential supervision over credit institutions pursuant to the various EU banking directives.*
After providing a general overview of banking supervisory liability in the laws of different EU Member States, we analyse and proceed to a critical assessment of the Peter Paul *judgment. We submit that the Court has been too restrictive in refusing to find in prudential supervision a clear depositor protection oriented dimension. In our view, the Court has overreacted to the potential financial consequences of holding the State liable for negligence in the exercise of prudential supervision. We demonstrate that Francovich type liability allows to strike a fair balance between the rational expectations from depositors as to the quality of supervision on the one hand, and the need to take account of the complicity and discretion of the prudential supervisor in the assessment of liability on the other hand.*

To be published in

Common Market Law Review, 2005/3

Do not attack the watchdog !

Banking supervisor's liability after *Peter Paul*[(*)]

Michel TISON
Financial Law Institute, University of Ghent (Belgium)

INTRODUCTION **5**

I. CAUSES AND RISKS OF SUPERVISORY LIABILITY: THE SUPERVISOR'S DILEMMA **6**

A. LIABILITY TOWARDS DEPOSITORS 6

B. LIABILITY TOWARDS THE SUPERVISED FINANCIAL INSTITUTIONS 7

C. THE SUPERVISOR'S DILEMMA 7

II. OVERVIEW OF LIABILITY REGIMES IN SELECTED EU COUNTRIES **8**

INTRODUCTION 8

A. GENERAL OVERVIEW OF BANKING SUPERVISORY LIABILITY REGIMES ACROSS EUROPE 10

1. First category: no specific liability rules *10*

2. Second categroy: regulatory limitation or immunization from supervisory liability *10*

3. Third category: limitations on liability stemming from general case law *13*

(B). A CROSS-COUNTRY ANALYSIS OF SUPERVISORY LIABILITY 13

1. Supervisory action as regards illicit banking activities *14*

2. The grant or refusal to grant a banking licence *14*

3. Ongoing prudential supervision and intervention measures *15*

III. EU BANKING LAW AND SUPERVISORY LIABILITY **17**

A. SUPERVISORY LIABILITY IN A HOME COUNTRY CONTROL PARADIGM 17

B. FOUNDING SUPERVISORY LIABILITY ON EU LAW: FROM FRANCOVICH TO PETER PAUL 19

1. The jurisprudential context: Francovich liability *19*

a. Serious beach of an obligation imposed by EU law 19

b. Breach of a rule which is intended to grant rights to private individuals 20

d. Causation 22

2. Peter Paul: cutting back Francovich as regards banking supervision ? *22*

(*) This paper updates and extends previous research on this subject by the author. See, *inter alia*: M. TISON, "Challenging the prudential supervisor – Liability versus (regulatory) immunity" in M. BALLING, F. LIERMAN AND A. MULLINEUX (eds.), *Financial Markets in Central and Eastern Europe. Stability and Efficiency Perspectives*, London, Routledge, 2004, p. 133-165

3. A critical appraisal of Peter Paul *26*

a. Francovich-liability narrowed by Peter Paul ? 26

b. The arguments to fend off Member State liability in Peter Paul: valid or flawed ? 28

4. The case for Fancovich-liability in banking supervision *29*

CONCLUSION AND OUTLOOK **30**

Introduction

In recent years, bank failures in different EU-countries have very often been followed by court actions in damages introduced by depositors against the banking supervisor for alleged negligence or improper conduct in the performance of their duties. As deposit guarantee systems, with a view to avoiding moral hazard, usually do not provide for complete compensation of depositors in the event of a bank failure[1], depositors have an incentive to try to shift their residual losses[2] onto the banking supervisor through liability actions. More exceptionally, liability claims originate from shareholders of the bank or the bank management itself, alleging unlawful conduct of the supervisory authority.

Although in some EU countries cases on supervisory liability have been reported for a long time, the phenomenon has substantially gained in importance in recent years across Europe: at present, most banking failures seem to be followed by liability claims directed against the supervisory authority. Different explanations for the growing "popularity" of the supervisory liability issue can be put forward. First, the increasing formalization of banking regulation, mainly as a consequence of the adoption of European directives and the need to implement these directives into formal rules at national level, concurrently diminishes the discretion that supervisors traditionally enjoyed in the exercise of their powers. Today, supervisory action is strongly embedded into formal, often very detailed rules, pertaining to both authorisation requirements and ongoing supervision. It makes supervisory action more challengeable by the different stakeholders. Furthermore, the European directives also stress the need to provide for adequate legal protection to the supervised entities, allowing them, to a large extent, to challenge decisions of the supervisory bodies in court.
Second, the increased litigation risk run by supervisory authorities should be put in the broader context of the increased assertiveness of the financial consumers, who in general experience less burdens in taking recourse to court actions. Financial consumers will use court action as a natural way to seek redress by finding in the State or the supervisory authorities a "deep pocket" to compensate for their losses. It is submitted that the multiplication of liability claims may also in part be caused by the (mis)perception of depositors as to the capacity of prudential authorities to actually avoid banking failures.
The basic assumption of this paper is that integrated markets within the European Union should function under more or less similar rules as regards possible supervisory liability. As prudential law in the EU-countries is to a large extent based on European directives, which intend to create a level playing field between EU-Member States, there is an argument for promoting more convergence as regards supervisory liability as well. This is the more important as credit institutions in an integrated market operate under the supervision of their home country, and therefore under possibly different liability regimes as the local supervisor. Until now, EU lawmakers have deliberately refrained from including in any of the financial regulation directives express provisions on liability issues. The subsidiarity principle will undoubtedly constitute a powerful argument to resist regulation of supervisory liability at EU level. Specific regulation might indeed be superfluous, if EU law itself, namely *Francovich* liability, could constitute the foundation for a uniform supervisory liability regime. The recent

---

[1] See Directive 94/19/EC, according to which Deposit protection systems put in place in the Member States should provide for compensation of deposits for at least EUR 20,000.

[2] These may result from the fact that their deposits with the failed bank exceeded the maximum compensation provided for by the protection system, or concern claims for which no compensation is provided for (e.g. claims in non EU-currency).

ECJ's judgment in *Peter Paul* seems to fend off any hope for depositors in this respect. The Court decided that the EU banking directives could not be interpreted in such a way as to granting rights to private individuals, and therefore cannot give rise to *Francovich* liability of a Member State for deficient prudential supervision over credit institutions. We will argue that the ECJ's reluctance to accept *Francovich* liability in the field of banking supervision is based on the wrong arguments, and that the judgment has probably been inspired by a fear for over-litigation and its potential impact on state finances. More generally, the decision in *Peter Paul* seems to be a step backwards in the development of Member State liability for non-observance of EU law.

This paper will be structured as follows. In Part I we will in general discuss the causes of supervisory liability. In Part II, we will first briefly overview the present legal situation as regards banking supervisory liability in some EU-Member States. We then attempt to make a cross-country analysis of possible situations where liability may arise, based on cases brought before the courts in the Member States examined. In Part III, we analyse the implications of EU banking integration, and in particular the harmonisation of banking supervisory standards, on supervisory liability. We submit first that home country control in EU banking leads to a shift of liability to the home country supervisor and home country liability laws as well. Further, we will examine how the ECJ in *Peter Paul* closed the door for a possible application of *Francovich* liability in the field of banking supervision. Finally, we will formulate some critical remarks on the ECJ judgment in *Peter Paul*.

I. Causes and risks of supervisory liability: the supervisor's dilemma

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

A. Liability towards depositors

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

failed to closely follow and monitor a financially distressed bank through periodical verifications and assessment of the intervention measures it has taken.

B. Liability towards the supervised financial institutions

The potential cases of supervisory liability towards the supervised institution itself or its shareholders do not relate to alleged passivity or negligence in exercising prudential supervision, but more to the opposite situation of 'overreaction' by the supervisor or unlawful conduct. Indeed, a financial institution bears primary responsibility for the management of its business, and therefore cannot blame the supervisor for having been negligent or too passive in detecting or reacting to its own shortcomings. By contrast, a financial institution could suffer damages following a proactive or harsh intervention by the supervisory authority, which might affect its reputation and frustrate depositors' confidence. For instance, the supervisor could be blamed for having intervened too severely following indications of financial difficulties of the supervised financial institution (e.g. prohibition of certain activities or withdrawal of the banking licence in reaction to limited financial difficulties). Furthermore, the supervisor could incur liability for infringing specific prohibitions, such as the violation of its professional secrecy obligations.[3]

C. The supervisor's dilemma

The abovementioned liability risks are illustrative of the delicate situation the prudential supervisor is confronted to in exercising its supervisory duties, in particular when dealing with a financially distressed credit institution. In the latter case, the supervisory authority has to find a balance between often conflicting interests, which are intrinsically connected with the basic objectives of prudential regulation: on the one hand, maintaining the safety and soundness of financial institutions and the financial system as a whole; on the other hand, protecting the depositors and other creditors of financial institutions. A proactive attitude of the prudential supervisor towards the supervised institution may be beneficial for (prospective) depositors of the individual bank, but could harm the financial institution itself as a consequence of loss of reputation or credibility in the market, and even produce destabilising effects on the financial system as a whole. By contrast, adopting a cautious attitude, though protecting the financial institution, could subsequently expose the supervisory authority to claims from depositors, when it has enabled the financial institution to further accumulate, under an apparent solvency, losses to the detriment of (existing or new) depositors and other creditors.[4] The supervisor's dilemma is very similar to the situation of a credit institution in discharging loans to a business enterprise: when the borrower is in financial distress, the creditor has to find a balance between on the one hand the risk of liability towards other creditors of the failing borrower for having created an apparent solvency by maintaining a credit line, and on the other hand the risk of liability towards the borrower itself for abruptly putting an end to the credit relation.[5]

---

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

[4] J.-W. VAN DER VOSSEN, "Supervisory Standards and Sanctions", in *Banking and EC Law Commentary*, M. VAN EMPEL, R. SMITS (eds.), Amsterdam Financial Series, Deventer: Kluwer, looseleaf, (March 1992), pp. 48-49.

[5] There is, however, an important difference between both situations, which makes the supervisor's dilemma even more acute: while the bank-borrower relationship stems from a contract, the prudential supervisor embodies the public

II. Overview of supervisory liability regimes in selected EU countries

Introduction

The present legal situation as regards banking supervisory liability in the EU-Member States is extremely heterogeneous, due to a combination of factors. First, not all Member States do have regulation, and the extent to which possible regulation protects supervisory authorities from liability varies considerably. The diversity of general tort law regimes amongst EU Member States further adds to the fragmentation of supervisory liability regimes. Illustrative in this respect is the concept of 'relativity' or 'proximity' that exists in some countries (e.g. Germany, United Kingdom, Netherlands), but is inexistent in others (e.g. Belgium). According to this concept, the breach of a legal rule will only lead to liability towards persons claiming damages as a consequence of this breach if the said rule is intended to protect the interests of the latter. In the context of supervisory liability, this requires an enquiry into the rationale of prudential supervision: liability towards depositors will only come into play if prudential regulation is considered to protect the interests of (individual) depositors, and not (only) the interests of the financial institutions or, more generally, the financial system. This issue has been at the centre of debates for a long time in different jurisdictions, and is also crucial in assessing possible *Francovich* liability (see later).

Finally, diversity also appears as regards who bears financial responsibility. While in most countries examined, liability will rest upon the supervisory authority, some liability regimes will allow to sue the State directly. The imputation of liability to the (independent) supervisory authority itself could be potentially problematic, as those authorities are often funded exclusively through contributions and fees paid by the supervised entities. The question then arises what would happen if, the supervisor's financial resources were insufficient to pay out damages once liability is established. It seems unconceivable that the supervised entities should ultimately bear the costs of liability through (increased) contributions to the supervisory authority. Therefore, it is submitted that, notwithstanding the supervisor's legal and financial autonomy, the cost of liability should ultimately be borne by the State.

It goes without saying that prudential supervisors themselves favour some immunity from liability in the discharge of their duties, as appears from the Basle Committee's *Core Principles for Effective Banking Supervision*.[6] Core Principle 1, which lays down the essential preconditions for effective banking supervision, stresses *inter alia* the need to provide for "legal protection for supervisors". The explanatory memorandum to Core Principle 1 further specifies in this regard that supervisors should enjoy "protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of

---

interest in discharging its legal duty to supervise. Nevertheless, it should be noted that the existence of lender liability also rests on the assumption that banks are 'special' in relation to other creditors, and sometimes have (wrongfully) been considered exercising a public interest duty in granting loans.

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

performing supervisory duties". The Core Principles are not, however, in any respect to be regarded as legally enforceable rules, but are merely recommendations. Moreover, it should be stressed that the *Core Principles* as adopted by the Basle Committee primarily emanate from the supervisory authorities themselves, who have an evident self-interest in promulgating (partial) immunity from liability as a good standard for prudential regulation.

The next section will provide a brief overview of the main patterns of supervisory liability regimes encountered in selected EU jurisdictions. A comparative summary is provided in Table 1.

Country	**Who is liable ?**		**Liability criteria ?**		**Source**
		Negligence	**Gross Negligence**	**Bad faith**	
Basle Committee	Not specified	N	N	Y	Core Principle 1
United Kingdom	Financial Services Authority	N	N	Y	Schedule I, section 19(3) Financial Services and Markets Act
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht	N	N	N	§ 6 III Kreditwesengesetz
Poland	Commission for Banking Supervision	N	N	N	Art. 133(4) Banking Act of August 29, 1997
France	State	N	Y	Y	Case law of Conseil d'Etat
Belgium	Commission for Banking, Finance and Insurance	N	Y	Y	Art. 68 Law 2 August 2002
Luxembourg	Commission de Surveillance du Secteur Financier	N	Y	Y	Art. 20 Law of 23 December 1998
Ireland	Central Bank of Ireland	N	N	Y	Section 25A Central Bank of Ireland Act 1997
Malta	Financial Services Authority	N	N	Y	section 29 Financial Services Authority Act
Italy	Banca d'Italia	Y	Y	Y	Case-law
Austria	State	Y	Y	Y	Case-law
Netherlands	De Nederlandsche Bank	Y	Y	Y	General tort law (subject to relativity requirement)

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

A. General overview of banking supervisory liability regimes across Europe

Leaving aside the specificities of general tort law regimes, one can roughly distinguish between three categories of banking supervisory liability regimes across Europe.[7]

1. First category: no specific liability rules

.In a first group of Member States, no specific liability rules exist with respect to the exercise of prudential supervision, but general tort liability rules apply. Very often, this situation appears not to be the result of a deliberate policy choice, but may be explained by the lack of any precedents in jurisprudence. This is in particular true for many of the new Member States. However, in a few Member States supervisory liability has effectively been established by case-law, though often not specifically in banking matters, while no legislative initiative to counter this liability risk has been taken. Illustrative for this group are Italy and the Netherlands. In **Italy**, the Corte di Cassazione decided in a landmark judgment of March 2001 that the Consob, who is responsible for the approval of public offering prospectuses, could be held liable to toward investors for its negligence in vetting a prospectus.[8] The case, decided on general rules of tort law, can be transposed to banking supervision. Likewise, a liability case involving the insurance supervisor ('Verzekeringskamer') in **the Netherlands** has been decided according to normal liability rules, and can apply accordingly to banking supervision.[9] Finally, the **Austrian** supreme court has held the Austrian state liable for the negligence committed by bank auditors, who in part assist the banking supervisor in the discharge of its duties.[10] The case entails large liability risks for public authorities, as it extended liability to all functions performed by the bank auditors as well. Therefore, a bill has been introduced in Parliament in order to further circumscribe the situations in which a bank auditor will be deemed to act under the responsibility of public authorities.[11]

2. Second category: regulatory limitation or immunization from supervisory liability

A second, and still increasing, group of EU Member States has enacted specific rules as regards banking supervisory liability, with a view to contain or exclude possible liability risks. Through specific laws, liability is either confined to the situation of gross negligence or bad faith from the part of the supervisory bodies, or even proclaim total immunity from liability.

---

7 See for a detailed overview: M. TISON, "Challenging the prudential supervisor – Liability versus (regulatory) immunity" in M. BALLING, F. LIERMAN AND A. MULLINEUX (eds.), *Financial Markets in Central and Eastern Europe. Stability and Efficiency Perspectives*, London, Routledge, 2004, p. 139-147.

8 Corte di Cassazione, 3 March 2001, case n. 3132. See, for a detailed analysis: F. Rossi, "Tort Liability of Financial Regulators", *European Business Law Review*, 2003, (643), p. 660-668.

9 Gerechtshof Den Haag, 27 May 2004, *Nederlandse Jurisprudentie*, 2004, p. 470.

10 OGH, 11 June 2002, Case 1 Ob 103/02g, *not reported*.

11 See Government Bill No. XXII-819, introduced in the Nationalrat on 17 February 2005 (see <http://www.parlament.gv.at>).

Very often, the intervention by Parliament to grant (partial) immunity from liability follows specific court decisions where judges have accepted the principle that the (banking) supervisory authority could be held liable for deficiencies in the discharge of its duties. These immunity regimes therefore are specifically aimed at neutralising possible future liability claims (e.g. Germany, United Kingdom, Luxembourg).

Germany was the first European jurisdiction to have introduced regulatory immunity for its financial regulators, following two judgments of the German *Bundesgerichtshof* that had been favourable to establishing liability of the banking supervisor towards depositors.[12] In 1984, an amendment to the German *Kreditwesengesetz* specified that the banking supervisor fulfils its statutory tasks exclusively in the general interest. The objective of the law was clearly to fend off future liability claims, by indicating that prudential supervision did not serve the protection of individual creditors.[13] Similar provisions were enacted in the field of investment firm supervision and insurance supervision.[14] They have been maintained after the recent reform of the structures of financial supervision.[15] As a result, the supervisor finds itself totally shielded from civil liability.

The **United Kingdom** witnessed a roughly similar evolution with respect to supervisory liability: only very few cases were brought before the courts and the latter appeared quite reluctant as to accept supervisory liability.[16], Nonetheless, Parliament sought to neutralise a possible liability risk through the introduction, in the Banking Act 1987, of a provision according to which neither the Bank of England nor any of its staff members or board members could be held liable for any act or negligence in discharging the Bank of England's statutory duties, unless it appears that the act or omission was done in bad faith. At present, the *Financial Services and Markets Act 2000*, which has unified supervision over financial services providers in the hands of the *Financial Services Authority* (FSA), provides for a

---

12 BGH 15 February 1979 (*Wetterstein*), *Neue Juristische Wochenschrift*, 1979, p. 1354; BGH 12 July 1979 (*Herstatt*), *Neue Juristische Wochenschrift*, 1979, p. 1879, *Juristenzeitung*, 1979, p. 683, *Wertpapier-Mitteilungen*, 1979, p. 632.

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

14 See § 1, para 4 *Börsengesetz*; § 4, para 2 *WertpapierHandelsGesetz*; § 81, para 1, 3rd sentence *Versicherungsaufsichtsgesetz*.

15 § 4, para 4 of the *Finanzdienstleistungsaufsichtsgesetz* (FinDAG) dated 22 April 2002 (*BGBl* I, 2002, p. 1310) states that the integrated supervisor (Bundesanstalt für Finanzdienstleistungsaufsicht) may exercise its functions and use its powers solely in the general interest.

16 See *Yuen-Kun-yeu and others v Attorney General of Hong-Kong* [Privy Council], [1987] 2 *The All England Law Reports*, p. 705, where the Privy Council held that liability could only be conceived when a sufficient *proximity* existed between the supervisory authorities and the bank creditors, such as to legitimate a duty of care of the former towards the latter. The Privy Council held that this condition was not met under Hong Kong law, given the limited instruments of supervision, which did not allow a continuous monitoring over the bank's daily management, and the consideration that supervision did not intend to offer to individual creditors any guarantee as to the bank's creditworthiness.
In *Minories Finance Ltd v Arthur Young* and *Johnson Matthey plc v Arthur Young*[16] the *Queen's Bench Division* added that the existence of a duty of care, the breach of which could give rise to supervisory liability, had to be "fair and reasonable". As a consequence, the court held that no supervisory liability could exist towards the supervised bank itself: or towards the its parent company. On the contrary, the court did not make a firm statement as to possible liability of the Bank of England as supervisory authority towards bank creditors.

similar immunity regime, safe for one exception: beside bad faith, liability of the FSA can also be based on breach of the Human Rights Act.[17]
The situation under **Irish law** is largely similar to the present statutory regime in the United Kingdom.[18]

In **Luxembourg**, the implementation of the 1989 Second Banking Directive into national law brought Parliament, probably bearing in mind a liability risk following the BCCI-failure[19], to include in the law a limitation of liability of the banking supervisor towards the supervised credit institutions and its creditors. This provision was subsequently copied into the 1998 law shifting banking supervision to the Commission de Surveillance du Secteur Financier (CSSF)[20]: the supervisory authority can only be held liable towards either a supervised financial institution, its clients or third parties, when it is established that the damage incurred by the victims is caused by a gross negligence in the choice and use of the methods deployed for the exercise by the supervisory authority of its public duty.[21]

Belgian law did not until 2002 know any specific statutory regime as regards supervisory liability, nor did it face supervisory liability claims brought before the courts in the field of banking supervision.[22] It was generally accepted that under Belgian law the prudential supervisor could be held liable for negligence according to the normal liability standards of general tort law (article 1382-1383 *Code civil*).[23] As a consequence, the supervisor could be held to damages for its normal negligence.
This situation has been modified under the reform of the supervisory system by Act of 2 August 2002. Article 68 Law 2 August 2002 states that the Banking, Finance and Insurance Commission (CBFA), its bodies and personnel are not liable for any decision, act of

---

17 See Schedule I, Section 19(3) Financial Services and Markets Act 2000.

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

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

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

21 It should be stressed that, absent any case law, the scope of the statutory liability regime still remains unclear, as the explanatory memorandum of the law underlined that the statutory regime did not preclude the application of the general rules of law as regards liability of public authorities (See A. ELVINGER, "Histoire du droit bancaire et financier luxembourgeois", in *Droit bancaire et financier au Grand-Duché de Luxembourg*, Brussels: Larcier, 1994, vol. 1, pp. 44-45, para 144; E. DE LHONEUX, M. CROMLIN, op. cit., *supra* note 19, p. 234).

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

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

behaviour in the exercise of their statutory tasks[24], except in the event of fraud or gross negligence. Government justified the inclusion of the provision with reference to the Basle Committee's *Core Principles* on the one hand, and the circumstance that prudential supervision under a normal liability regime would entail disproportionate financial risks for the supervisory authority.[25]

3. Third category: limitations on liability stemming from general case law

The situation of banking supervisory liability is **France** is peculiar in the sense that some limitation on liability follows from general, case-law built principles of tort law. The French judiciary has traditionally applied less stringent standards with respect to liability of public authorities when, due to the complexity of their duties, these authorities should not be held liable for normal negligence (*faute légère*).[26] In that case, public authorities can only be held liable for their gross negligence (*faute lourde*) in exercising their duties. The *Conseil d'Etat* has consistently applied this specific liability standard to prudential authorities[27], without ever clearly justifying its position.[28] This specific liability regime as applied by the courts probably explains why Parliament has refrained until now from introducing specific legal provisions limiting supervisory liability.

B. A Cross-country analysis of supervisory liability in banking

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

---

[24] Through the reference to the CBFA's statutory tasks in general, the limitation of liability will encompass all functions taken up by the CBFA, including its supervision over public offer prospectuses and take-overs. This clearly exceeds the justification for partial immunity advanced by Government, which referred only to the supervisor's prudential functions.

[25] It is submitted, however, that the inclusion of the statutory limitation of liability was at least in part also provoked by the liability claim introduced by a number of depositors of the failed Bank Fisher against the supervisory authority.

[26] For an overview of the relevant case-law, see: F. MODERNE, note under Conseil d'Etat 29 December 1978, *Recueil Dalloz*, 1979, I.R., p. 155.

[27] See, most recently, d'Etat 30 November 2001, *Kechichian*, *Juris-Classeur Périodique*, 2002, édition Générale., II, No 10042, note J.-J. MENURET, *Petites Affiches*, 2002, No 28, p. 7, with opinion of A. SEBAN.. The judgment is the more important as it is was decided in full court, and not merely in one of the Conseil's chambers.

[28] See for the first case: Conseil d'Etat 12 February 1960 (2 cases), *Banque*, 1960, p. 320, note X. MARIN. For an overview of the case-law, see D. FAIRGRIEVE, K. BELLOIR, "Liability of the French State for Negligent Supervision of Banks", *European Business Law Review*, 1999, p. 17; M. ANDENAS, D. FAIRGRIEVE, "To Supervise or to Compensate ?", in M. ANDENAS, D. FAIRGRIEVE (eds.), *Liber amicorum Lord Slynn of Hadley: Judicial Review in International Perspective*, London: Kluwer, 2000.

1. Supervisory action as regards illicit banking activities

According to the EU Coordinated Banking Directive[29], all credit institutions should prior to taking up a banking activity obtain an authorisation from the competent authority in their home Member State. The directive does not oblige Member States to entrust supervisory authorities with investigation powers in order to track the possible illicit taking-up of banking activities by non-authorised firms. To the extent supervisory authorities only have supervisory powers as regards duly authorised credit institutions, as is the case e.g. in France[30], they may not be held liable for losses incurred by creditors of non-authorised firms. By contrast, when individual Member States have granted investigative powers to supervisory authorities, as is the case in Belgium[31] and Germany[32], the existence of such powers may be important for possible liability cases, to the extent depositors might suffer damages as a result of illicit deposit-taking business by non-authorised enterprises.[33] The precise scope of such investigative powers should be taken into account when assessing supervisory liability: generally, the investigative powers cannot be analysed as a legal obligation to actually prevent any illicit banking business, but more as a duty to duly monitor possible irregular situations. Liability could for instance occur when the supervisory authority, after having been informed of possible illicit activities (e.g. advertisements in newspaper, complaints from customers,...), failed to accurately investigate and follow up the indications it possessed. The supervisor should take all reasonable action in order to put a halt to overt irregular situations, or enquire for situations that cast doubt as to their legality.

2. The grant or refusal to grant a banking licence

As a rule, the decision to grant a banking licence is not discretionary for the banking supervisor: the supervisory authority cannot make its decision dependent on the economic needs of the market[34], and it is normally obliged to grant a licence to every applicant that satisfies the authorisation conditions laid down by law. This is not to say that the banking supervisor has no leeway at all in deciding how to apply the authorisation requirements: most of the authorisation requirements are very generally worded, and leave room for discretion to the supervisor (e.g. the requirement of adequate internal organization and internal controls within the credit institution). The Coordinated Banking Directive provides for adequate legal remedies for the applicant when the banking supervisor refuses to grant a banking

---

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

30 Cass. Com., 30 November 1999, *Revue de droit bancaire et financier*, 2000, p. 98; See also Ch. GAVALDA, J. STOUFFLET, *Droit du crédit*, vol. I: *Les institutions*, Paris: Litec, 1990, p. 253, para 366.

31 See Article 78 Law of 2 August 2002.

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

33 According to article 4 of the Coordinated Banking Directive, Member States should normally only allow credit institutions to collect deposits or other reimbursable funds from the public or solicit the public with a view to deposit-taking.

34 See Article 9 Coordinated Banking Directive.

authorization (e.g. judicial review).[35] The possibility for judicial scrutiny also implies that the banking supervisor should indicate the reasons for its refusal to grant a licence.[36]
Apart from the possibility to quash the supervisor's refusal through a judicial review, a decision to refuse a licence could lead to supervisory liability towards the applicant, to the extent the latter has been deprived of a commercially profitable opportunity.[37] Equally, the banking supervisor that does improperly consider a bank manager as not being 'fit and proper' (e.g. confusion with other person), runs a liability risk towards the latter.

The reverse situation — the banking supervisor is blamed, mainly by depositors, for having granted a banking licence to a credit institution that did not satisfy the legal requirements, has been repeatedly invoked before the courts in different countries.[38] The courts are understandably reluctant to accept liability for this reason[39], as they have to judge on the facts at the moment of granting the authorization, and should avoid the pitfall of an *a posteriori* assessment of the situation. The courts should only examine whether, at the time of applying for a banking licence, the applicant satisfied the legal requirements for it, and whether any indications were present which could possibly justify to subject the authorization to certain conditions or even refuse it. If the bank satisfied the legal authorization requirements at the time of granting the licence, the supervisor has not acted improperly. In reality, most difficulties in financial institutions only appear during their existence, and cannot be reduced to unjustified decisions from the part of the supervisor when granting the licence.

3. Ongoing prudential supervision and intervention measures

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

In all legal systems examined, it is clear that the supervisory instruments and means created by law do not enable to continually exercise supervision through on-site verifications. Supervision is basically exercised on basis of reporting requirements imposed on credit

---

35 Article 33 Coordinated Banking Directive.

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

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

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

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

institutions, whether periodical reports or specific reports on certain issues commissioned by the supervisory authority to the credit institution itself or to its auditors. On-site verifications are mainly intended to verify from time to time the data gathered through the reports. When the reports provided to the supervisory authority contain indications of irregularities, inconsistencies or financial difficulties, it may however reasonably be expected from the supervisory authority to adopt a more proactive attitude towards the supervised financial institution. This may, depending on the circumstances, lead to the request for additional information from the part of the bank or even to an on-site verification.[40] The case law indicates that this is considered a critical element in assessing 'reasonable care' by the supervisory authority: it is crucial to adequately follow up and monitor problems which the supervisor has discovered through its normal supervisory activity or through information received form third parties[41], and to take measures which are adequate to the situation. Moreover, in choosing the intervention measures that the law offers to the supervisor, the latter should act proportionately to the gravity of the situation. For instance, in case of indications of serious fraud within the institution, taking measures towards bank management will be more appropriate than in case of a deteriorated financial situation caused by inadequate internal controls. As supervisory authorities enjoy a large degree of discretion in the choice and use of intervention measures, the judge should refrain from "taking the supervisor's seat", and substitute its judgment to the supervisor's decision. The judge should merely assess whether the supervisory authority, after having put in balance the interests of both the bank itself and its stakeholders, could reasonably decide as it actually did. This implies, for instance, that the mere fact that the banking supervisor did not react to problems discovered within a financial institution, does not in itself lead to liability.[42] Basically, the courts will have to decide whether, at that time, the supervisor's action was adequate to deal with the situation, taking account of its seriousness[43], without being too stringent as to unduly frustrate the depositors' confidence.

The case law indicates that liability may in these circumstances occur when the supervisor failed to take any action notwithstanding the knowledge of serious difficulties within the financial institution, or when the measures taken were inadequate in view of the seriousness of the problems (e.g. by giving an 'ultimate warning' only, without further action, despite the existence of serious irregularities[44]). Equally, the supervisor should be consistent in its action: liability could arise when the supervisor first ordered a credit institution to recapitalise and take other redress action, but subsequently softened its demands without objective

---

40 See the allegations of the plaintiffs in the German supreme court referral decision in *Peter Paul* (BGH, 16 May 2002, III ZR 48/01, *ZIP – Zeitschrift für Wirtschaftsrecht*, 2002, p. 1136): the supervisor is blamed for not having taken adequate measures, such as promulgating a moratorium on deposits, after having discovered serious financial difficulties in a supervised credit institution. Moreover, the plaintiffs considered that the supervisory authority should have taken adequate prudential measures in order to make sure that the supervised bank would join a deposit guarantee scheme.

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

42 Conseil d'Etat 13 June 1964, *d'André*, *La Semaine Juridique*, 1965, Edition Générale, II, No. 14416, *Revue de droit public*, 1965, p. 84.

43 See also X., note under Conseil d'Etat 13 June 1964, *d'André*, *La Semaine Juridique*, 1965, Edition Générale, II, No. 14416.

44 Conseil d'Etat 24 January 1964, *Achard*, *La Semaine Juridique*, 1965, Edition Générale, II, No. 14416, *Revue de droit public*, 1965, p.43.

justification.[45] In some circumstances, the supervisor may be blamed for not having withdrawn the bank's authorization when it appeared that the depositors' interests were seriously under threat.

III. EU Banking Law and Supervisory Liability

Although the various EU directives aimed at creating an integrated EU banking and financial services market do not directly touch upon supervisory liability, the ongoing process of financial integration nevertheless indirectly influences the issue of supervisory liability. Two elements deserve further attention: first, the implications of the system of home country control for supervisory liability as regards (i) the identification of the responsible body, (ii) the law applicable to liability claims and (iii) the court competent to decide on such claims. Second, the Europeanisation of supervisory law raises the fundamental question whether supervisory liability could be based directly on EU law. This could allow depositors to circumvent immunity regimes existing in their national laws.

A. Supervisory liability in a home country control paradigm

With the creation of a European passport and home country prudential supervision, the Coordinated Banking Directive leads to a shift of supervisory powers to the home country supervisor, except for liquidity supervision over foreign branches. Hence, liability will as a rule follow the allocation of supervisory responsibilities: liability will be borne exclusively by the home country supervisor. There is little room for any residual liability incumbent on the host state authority, as a defective liquidity supervision over a foreign branch is unlikely to harm branch depositors without difficulties at the level of the parent company and deficiencies in supervision at that level. As a consequence, depositors with the branch of a credit institution having its head office in another EU Member State will as a rule have to direct their liability claims against the home state supervisory authority.

Indirectly, this shift in allocation of supervisory powers will also influence the determination of the law applicable to a liability claim. Considered from the perspective of the aggrieved parties — whether the supervised institution itself or depositors — the issue is to be decided according to the private international law rules on non-contractual liability. Absent any common rules across EU in this field, the private international law of the forum will have to be applied. In most cases, it will result in application of the law of the home country supervisor, but application of the law of the host country is not totally excluded when deficient supervision has harmed depositors located in other Member States.[46]

The most complex issue probably is to determine the competent judge for a liability claim against the supervisory authority or the state, in particular when the plaintiffs are depositors

---

[45] Conseil d'Etat 30 November 2001, *Kechichian*, op. cit., *supra* note 27.

[46] See for instance the situation in France, which applies the law of the country where the damage has been caused: see Cass. 8 February 1983, *Clunet*, 1984, p. 123, note G. LÉGIER. In German law, the so-called *Gunstigkeitsprinzip* will apply, according to which the judge will choose between home and host country for the law which offers the best compensation for the victim (see G. KEGEL, *Internationales Privatrecht*, 6th ed., C.H. Beck, 1987, p. 455). For more details, see M. TISON, *De interne markt voor bank- en beleggingsdiensten*, Antwerp, Intersentia, 1999, p. 717-720, para 1414-1420.

with an out-of-state branch or under cross-border free provision of services. Although at first glance, these depositors could, according to the Brussels II Regulation[47], bring their action for damages before a local court in their country of residence, it can be doubted whether the Regulation actually applies. Indeed, in view of the autonomous meaning of the expression "civil and commercial matters"[48], used to delimit the scope of application of the Brussels II-Regulation, and the exclusion of "administrative matters" in article 1(1) of the Regulation, it is submitted that the sphere of application does not encompass disputes between a public authority and a private individual where the former is acting in the discharge of a public function.[49] The competent jurisdiction will therefore have to be determined according to national laws. Their application may, however, be further hampered by the principle of State immunity before foreign courts, which allows a State to invoke immunity of jurisdiction when an action is brought against it before a foreign court. This rule, which is a general customary principle in public international law, could theoretically also be invoked by a banking supervisor when it is faced with a liability claim brought before a foreign court by depositors.[50] However, it is debatable whether the principle of State immunity would actually apply in the context of cross-border banking supervision, as Member States have agreed to give up part of their sovereignty in favour of home state supervisors; conversely, in their capacity of home state, they have accepted to exercise public powers beyond their national boundaries, by including out-of-state branches and cross-border provision of services within the ambit of prudential supervision. It could be argued that this situation leads, at least implicitly, to waiving the privilege of State immunity when the competent authorities are sued in court in relation to their extra-territorial scope of competence.

It appears from the foregoing that the legal protection depositors enjoy as regards supervisory action may lead to reverse discriminations: to the extent the home state supervisor enjoys (partial) immunity from liability, this regime will often equally affect depositors of foreign EU branches, while depositors with local banks in the host country could possibly be better protected. However, this risk of inequality is not unique, as it also appears in other aspects connected with the home country rule and mutual recognition, such as deposit guarantee.[51] But contrary to the latter situation, transparency as to the foreign supervisor's possible (immunity from) liability is virtually inexistent. Further convergence as regards responsibility for supervision in a home country control paradigm and the legal effects of it as regards

---

47 See Art. 5.3 of Regulation 44/2001/EC ("Brussels II"), *OJ* L 12 of 16 January 2001, p. 4. According to the case law of the Court of Justice under the 1968 Brussels Convention which preceded the Regulation, an action can be brought before the courts of either the country where the acts were committed or the country where the damage was provoked. The latter would allow the depositors, who allegedly have suffered damages in their country of residence, to bring the liability claims before the courts of their country of residence. See also ECJ, 19 September 1995, *Marinari*, case C-364/93, *E.C.R.*, 1995, p. I-2719.

48 See ECJ, 14 October 1976, *LTU vs Eurocontrol*, cae 26/76, *E.C.R.*, 1976, p. 1541.

49 Compare J. KROPHOLLER, *Europäisches Zivilprozessrecht*, Heidelberg, Verlag Recht und Wirtschaft, 1982, p. 22. Hence, the exclusion covers the exercise of public authority *de iure imperii*, in contrast with the acts of a public body *de iure gestionis*, for which the public body will be assimilated to a private body: See also ECJ, 16 December 1980, *Rüffer*, case 814/79, *E.C.R.*, 1980, p. 3807, where the ECJ excluded from the scope of the Brussels Convention the action brought by a government agency against a private person in the discharge of its public function.

50 CH. PROCTOR, "Financial regulators – Risks and Liabilities", *Butterworths Journal of International Banking and Financial Law*, 2002, p. 78.

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

liability, with respect to both applicable law and international jurisdiction, should be welcomed. It is likely to increase, both for depositors and for the supervisory bodies themselves, certainty as to the legal framework of supervisory action. Moreover, further EU convergence as regards supervisory liability would be more consistent with the aim of an integrated market, where decisions to allocate deposits should not be influenced by possibly diverging liability regimes.[52] This is not to say that more European regulation is required, if other means can achieve the same objective. However, the attempts to apply *Francovich* liability in the field of banking supervision have been quashed by the ECJ in its *Peter Paul* judgment.

B. Founding banking supervisory liability on EU law: *from* Francovich *to* Peter Paul

1. The jurisprudential context: Francovich *liability*

Since its landmark *Francovich*-judgment[53] the European Court of Justice has consistently held that a Member State could be held liable for non-fulfilment of its obligations under EU law, and that this liability could be legally based on EU law, not on the law of individual Member States. The Court considers that the legal protection of individuals against Member States could not differ from the protection that is granted to them under Article 288, para 2 EC (formerly: Article 215 (2) EC-Treaty) against the institutions of the European Union.[54]

Since the obligation for national banking supervisors 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 basis for a liability claim directed against the Member State for the acts or omissions of its supervisory authority. However, according to the Court's case law, a number of conditions must be satisfied in order to establish *Francovich*-liability:

a. There must be a serious breach by a Member State of an obligation under EU law
b. The allegedly breached obligation is intended to grant rights to private individuals
c. There is a direct causal link between the breach of Community law and the damages suffered by the victims

.

a. Serious beach of an obligation imposed by EU law

The Court's case law witnesses a flexible approach as regards the first condition for Member State liability: both the source of the breached rule (EC Treaty or provision of secondary

---

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

[53] ECJ, 19 November 1991, *Francovich and Bonifaci*, cases C-6/90 en 9/90, *E.C.R.*, 1991, p. I-5357.

[54] ECJ, 5 March 1996, *Brasserie du pêcheur/Factortame III*, cases C-46/93 en 48/93, *E.C.R.*, 1996, p. I-1029.

legislation, such as directives) and the originator of the breach (executive power, independent agency, Parliament[55] or judiciary[56]) are irrelevant in order to establish Member State liability. Furthermore, the case law suggests that liability not only follows from legal acts, whether normative[57] or at individual level.[58] Also, Member States may incur liability due to a factual act or negligence that can be attributed to a public body.[59] The latter conclusion also flows from the analogy between *Francovich*-liability and non-contractual liability of the Community under Article 288 EC Treaty, which also encompasses liability for factual acts.[60] Supervisory liability could fit into the latter situation of Member State liability: is not related to a normative incompatibility of national law or of an individual legal act with EU law, but concerns the alleged improper application, in the facts, of obligations under national law which originate in EU law, where the former is assumed to be compatible with the latter. The circumstance that supervisory liability is not concerned with a normative breach of EU law therefore does not preclude the application of the *Francovich*-doctrine.[61]

The requirement of *seriousness* as concerns the breach of EU law enables the judges to further petrify Member State liability by taking account of specific circumstances (e.g. discretion enjoyed by the Member State; lack of clarity of EU law etc.). In *Dillenkofer* , the ECJ made clear that the seriousness-requirement applies in general to Member State liability, irrespective of the breach at hand (non compliance with directly applicable EU rules, late implementation of directives, etc.).[62], Thus, in situations where a Member State enjoys a large degree of discretion in applying its obligations under EU law, liability will only be established if the public body has manifestly and gravely disregarded the limits of the exercise of its discretionary powers.[63]

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

---

55 See ECJ, 5 March 1996, *Brasserie du pêcheur/Factortame III*, cases C-46/93 en 48/93, *E.C.R.*, 1996, p. I-1029.

56 ECJ, 30 September 2003, *Gerhard Köbler v Austria*, case C-224/01, *E.C.R.*, 2003, p. I-10239.

57 E;g. where a Member State has failed to implement a EU directive within the prescribed implementation period.

58 ECJ, 23 May 1996, *Hedley Lomas*, case C-5/94, *E.C.R.*, 1996, p. I-2604 (the case concerned the refusal by UK authorities to grant an export licence for the export of sheep to Spain).

59 Thus, in *Schmidberger*, the ECJ examined whether the decision of the Austrian authorities not to ban a demonstration by environmental activists, which resulted in the complete closure of the Brenner motorway for almost 30 hours, was compatible with free movement of goods under the EC Treaty, and if not, could entail liability of the Austrian State towards private individuals who claimed to have suffered damages following the road closure. The Court concluded in the case that the demonstration, as giving expression to fundamental rights recognized in the EU legal order, did not restrict in an undue manner free movement. However, the judgment illustrates that individual decisions (or omissions) of a public authority, even if that authority enjoys a wide discretion, are not by their nature immune for Member State liability: ECJ, 12 June 2003, *Schmidberger*, case C-112/00, *E.C.R.*, 2003, p. I-5659. See also ECJ, 9 December 1997, *Commission v France*, case C-265/95, *E.C.R.*, 1997, p. I-6969.

60 See, e.g. ECJ, 8 October 1986, *Leussink/Brummelhuis*, cases C-169/83 and 136/84, *E.C.R.*, 1986, p. I-2801; P. GILSDORF and P. OLIVER, "Artikel 215", in VON DER GROEBEN/THIESING/EHLERMANN (eds.), *Kommentar zum EU-/EG-Vertrag*, 5th ed., Baden-Baden, Nomos, 1997, vol. V, p. 5/235, para 30; W. VAN GERVEN, J. LEVER, P. LAROUCHE, *Tort Law*, Series: Ius commune casebooks for the common law of Europe, Oxford, Hart Publishing, 2000, p. 891

61 Compare also M.H. WISSINK, "Staatsaansprakelijkheid voor falend banktoezicht; het oordeel van de House of Lords in de Three Rivers-zaak", *Sociaal-Economische Wetgeving*, 2002, p. 97.

62 See ECJ, 8 October 1996, *Dillenkofer*, cases C-178-179/94, C-188-190/94, *E.C.R.*, 1996, p. I-4867.

63 See *Brasserie du pêcheur/Factortame III*, op. cit., *supra* footnote 54, p. I-1029, para 55.

Critical in applying *Francovich*-liability to supervisory liability is the condition that the breached rule, in particular the prudential requirements imposed by the EU directives, are intended to confer rights to private individuals. Traditionally, the case law of the European Court of Justice witnessed a quite flexible approach as to this requirement: while directly applicable EU rules will *per se* satisfy the 'conferring rights'-test[64], the opposite does not necessarily hold true: the EU rule concerned can be considered to confer clearly identifiable rights to private individuals, and hence trigger *Francovich*-liability, even if it does not satisfy the conditions of direct applicability, i.e. worded in a precise and unconditional way such as to allow private individuals to invoke them directly before the courts. Under this broad interpretation, the "conferring rights"-test was generally understood as incorporating the *Schutznorm*-concept into EU liability law: the breach of an obligation under EU law could only give rise to compensation if the victim belonged to the group of persons which the breached provision of EU law was intended to protect.[65]
In the field of banking supervision, this broad interpretation of the "conferring rights"-requirement would lead to the conclusion that depositors do fall within the protective scope of prudential rules.

Not surprisingly, national courts have been reluctant to open the "floodgates" of *Francovich*-liability in the field of banking supervision. Illustrative for this attitude are the judgments delivered in the tort actions directed against the Bank of England in the aftermath of the BCCI-failure: with a view to circumventing the statutory immunity granted to the Bank of England, the plaintiffs invoked *Francovich*-liability, stating that the alleged improper supervision by the Bank of England constituted a breach of the obligations arising from the then applicable First Banking Directive 77/780/EEC.
In the Court of Appeal, two out of the three judges dismissed the plaintiffs' argument, considering that the First Banking Directive regulation was not intended to grant rights to private individuals.[66] The third judge, however, expressed a strongly motivated dissenting opinion.[67] Upon appeal, the House of Lords confirmed the Court of Appeal's decision, following the opinion expressed by Lord Hope of Craighead[68]: the latter strongly advocated that the First Banking Directive[69] was intended primarily to harmonize prudential regulation with a view to creating a single banking market, without imposing a general obligation to exercise prudential supervision or conferring rights in this respect to individuals.[70] In his

---

64 See *Brasserie du pêcheur/Factortame III*, op. cit., *supra* footnote 54, p. I-1029, para 23.

65 See, *inter alia*, W. VAN GERVEN, J. LEVER, P. LAROUCHE, *Tort Law*, *cited supra* note 60, p. 894.

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

67 See the opinion of Lord Justice Auld in *Three Rivers District Council and others v Bank of England),* [1999] 4 *The All England Law Reports*, p. 800 [CA].

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

69 The opinion left the question whether the same conclusion would have applied under the 1989 Second Banking Directive, undecided. In view of the extremely narrow interpretation of the "conferring rights"-concept by their lordships, a different outcome under application of the Second Banking Directive, notwithstanding its stronger orientation towards protection of depositors, would have been doubtful.

70 Lord Hope adopted a very narrow approach of the "conferring rights"-requirement, which in fact came down to requiring that the conditions for direct applicability applied. See also critically: M. ANDENAS, "Liability for Supervisors and Depositors' Rights — The BCCI and the Bank of England in the House of Lords", *Euredia*, 2000/3, p. 407; H.M. WISSINK, op. cit., *supra* note 61, p. 94.

Lordship's view, the protection of depositors was just one element that had been taken into account in the harmonization process amongst others, such as the establishment of competitive equality between credit institutions. Surprisingly, however, the House of Lords did not deem it necessary to refer this important issue related to the interpretation of the First Banking Directive to the ECJ for a preliminary ruling, arguing that the directives were *acte clair*. It leaves the impression that the refusal to submit the issue to the Court of Justice may in part be inspired by a desire of the supreme jurisdiction to keep control over the case in 'national' hands and to preserve the statutory protection from liability granted to the Bank of England. [71]

A similar reluctancy could be witnessed in the German lower court decisions in *Peter Paul* (see *infra*)*:* both in first instance and upon appeal, the plaintiff's argument based on *Francovich*-liability of the German State for the alleged negligence in the exercise of prudential supervision over the failed bank were simply dismissed without further justification: the courts found that the regulatory immunity from liability enjoyed by the German banking supervisor under domestic law did not contravene European law. By contrast, the German supreme court (*Bundesgerichtshof*), contrary to the English House of Lords, found the issue worth a preliminary referral to the ECJ, in order to determine whether the "conferring rights"-requirement is satisfied as regards various EU banking directives (see *infra)*.

c. Causation

A Member State will only be held for damages when there is a direct link of causation between the serious breach of EU law and the damage suffered by private individuals. Applied to the situation of deficiencies in prudential supervision, the requirement of a *direct* causal link can function as a further limit on effectively holding a Member State liable to compensate depositors for deficient prudential supervision: the Member State will only be held to compensate the victims for those damages which are directly connected to an alleged shortcoming in exercising prudential supervision. In addition, when awarding compensation, a Court can take into account the depositors' own behaviour towards the failed credit institution: the existence of banking supervision does not totally preclude depositors from acting prudently and cautiously when entrusting funds to a bank.

2. Peter Paul: *cutting back* Francovich *as regards banking supervision ?*

a. Facts and preliminary reference

The facts of the case for which a preliminary reference was made to the ECJ, can be summarized as follows: The plaintiffs (Peter Paul and others) held a bank account with the Dusseldorf based BVH Bank für Vermogensanlagen und Handel AG, that had obtained a banking licence in 1987 on the condition that it would join a deposit guarantee system. Between 1987 and 1992, BVH Bank repeatedly tried to join the deposit guarantee system of the German Banking Association, but the applications were dismissed for failure to comply

[71] This attitude of 'legal protectionism' has been highly highly criticized : see X., "European banking law as applied by the House of Lords: Overshadowing the *acte clair* doctrine", *Euredia*, 2000/3, p. 305-302; M.H. Wissink, op. cit., *supra* note 61, p. 96.

with the admission requirements. In the meantime, the unsound financial situation of BVH Bank prompted the German banking supervisor (*Bundesaufsichtsamt für das Kreditwesen*) to proceed to several specific bank audits between 1991 and 1997. In August 1997, the supervisor imposed a moratorium on banking activities to BVH Bank, followed shortly after by the withdrawal of the banking licence and a petition for bankruptcy. As BVH Bank still had not joined any deposit guarantee system, the depositors were not able to obtain any immediate compensation, but would have to wait for an unsure dividend distribution in the bankruptcy proceedings. A number of depositors therefore filed an action in damages against the German State, and basically invoked two grievances: (1) the German state was liable for not having properly implemented the 1994 EU Deposit Guarantee Directive, that obliged credit institutions to join a deposit guarantee system offering a compensation for deposits of at least 20,000 EUR; (2) the plaintiffs had suffered damages as a consequence of deficient prudential supervision by the *Bundesaufsichtsamt*.

At first instance, the Landesgericht Bonn made application of *Francovich* liability as regards Germany's failure to implement the Deposit Guarantee Directive, and awarded compensation of 20,000 EUR per depositor to the plaintiffs, corresponding to the minimum level of compensation imposed by the European directive.[72]

As for the second argument, both the Landesgericht Bonn and the Oberlandesgericht Köln[73] upon appeal dismissed the plaintiff's argument, as the *Bundesaufsichtsamt* enjoyed a regulatory immunity from liability under the German Banking Act. The plaintiffs did not manage, therefore, to recover the part of their deposits exceeding 20,000 EUR.[74] The courts did not consider this legal immunity to be contrary to the German constitution or EU law.

The plaintiffs appealed against the judgment of the court of appeal before the supreme court (*Bundesgerichtshof*). In order to circumvent the effects of regulatory immunity from liability under German law, the plaintiffs invoked *Francovich*-liability again, and argued that the liability of the German state could be based directly on the breach of various EU banking directives that allegedly contained obligations as to the proper exercise of prudential supervision over credit institutions.

As the plaintiff's argument raised matters of interpretation of the banking directives, the *Bundesgerichtshof*, by judgment of 16 May 2002[75], suspended the proceedings and submitted different questions to the European Court of Justice, which can be summarized as follows.[76]

- First, the *Bundesgerichtshof* asked whether the provisions of the Deposit Guarantee Directive, which provided for adequate measures to be taken by the Member States' competent authorities with a view to ensuring that credit institutions joined a deposit guarantee scheme, were directly applicable, and hence could be invoked by depositors against a Member State. In addition, the court asked whether in that case, the absence of measures thus taken under the Deposit Guarantee Directive could enable depositors to claim compensation from the Member State beyond the amount of 20,000 ¤ specified in

---

72 LG Bonn, 16 April 1999, *ZIP – Zeitschrift für Wirtschaftsrecht*, 1999, p. 959, *Entscheidungen im Wirtschaftsrecht*, 2000/5, p. 233. See also LG Bonn, 31 March 2000, *not reported* (cited by R. SETHE in *Entscheidungen im Wirtschaftsrecht*, 2001/20, p. 861).

73 OLG Köln, 11 January 2001, *Neue Juristische Wochenschrift*, 2001, o. 2724, *Wertpapier-Mitteilungen*, 2001, p. 1372, ZIP - *Zeitschrift für Wirtschaftsrecht*, 2001, p. 645, *Entscheidungen im Wirtschaftsrecht*, 2001/20, p. 962, note R. SETHE.

74 The claims declared in the bankruptcy proceeding by the three main plaintiffs amounted to 67,212 ¤, 51,979 ¤ and 34,244 ¤ respectively.

75 BGH, 16 May 2002, *Neue Juristische Wochenschrift*, 2002, p. 2464, *Juristenzeitung*, 2002, p. 371.

76 See *OJ* C 202/9 of 24 August 2002.

the directive.

- Second, the court asked whether various banking directives, taken either individually or in combination, confer on the saver and investor rights to the effect that the competent authorities of the Member States must take prudential supervisory measures, with which they are charged by those directives, in the interests of that category of persons and therefore must incur liability for any misconduct in the discharge of supervisory duties.

Not less than five Member States made submissions in the proceedings before the ECJ, which delivered its judgment in full Court. Both circumstances are illustrative for the importance of the issue, both for Member States' (financial) interests and as a matter of application of EU law in general. All Member States' submissions were opposed to finding any legal basis for Member State supervisory liability in the banking directives. This position was also backed by the European Commission and Advocate-General Stix-Hackl in her opinion of 25 November 2003.[77]

b. Opinion of Advocate-general Stix-Hackl

With respect to the first question, the Advocate General examined in detail whether Articles 3.1 to 3.5 of the Deposit Guarantee Directive satisfied the requirements of direct applicability, as formulated in the ECJ's case law. The Advocate General rightly concluded that the provisions were not sufficiently precise, clear and unconditional as to be invoked directly by a private individual before a national court: the supervisory measures prescribed or enabled by the Deposit Guarantee Directive in situations where a credit institution has failed to join a deposit guarantee scheme, leave a large degree of discretion to the supervisory authority, where the latter should take into consideration not only the interests of depositors, but also of the credit institutions and of the financial system as a whole.

More debatable was the opinion of the Advocate General on the liability issue. Joining the arguments developed by the Member States and the European Commission before the ECJ, the Advocate General first of analysed in detail the abovementioned provisions of the Deposit Guarantee Directive. The Advocate General considered that these provisions essentially concerned the relationship between the supervisory authorities and the supervised credit institutions that failed to join a deposit guarantee system. They could not confer rights to depositors to have specific measures taken by the supervisory authorities, and therefore, could not lead to *Francovich*-liability.[78] In a surprisingly succinct way, the Advocate General reached the same conclusion as regards the supervisory obligations imposed by the First and Second Banking Directives: notwithstanding the reference to the protection of depositors and investors in the First and, even more, in the Second Banking Directive, this in itself was not sufficient to conclude that these directives 'confer rights' to depositors, in the sense that the latter could claim the right to have specific supervisory measures taken in respect of a credit institution. The protection of depositors in these directives should merely be regarded as part of the more encompassing objective of the harmonisation efforts, namely to create conditions of equal competition between credit institutions across Europe with a view to realising the principles of free provision of services and freedom of establishment.[79]

---

77 Not yet reported in E.C.R.

78 Opinion of AG Stix-Hackl, para 94-101.

79 See opinion of AG Stix-Hackl, para 121-127.

c. The ECJ's judgment in *Peter Paul*

In its judgment of 12 October 2004[80], the ECJ roughly followed the Advocate General's opinion as regards both questions submitted to it. First, the Court did not find that the Deposit Guarantee Directive, with respect to the supervisory obligations imposed on Member States to take adequate measures when a credit institution fails to join a guarantee system (Articles 3(2) to 3(5)), conferred on private individuals the right to have certain measures taken in their interest. For the Court, Member State liability ends where it has taken care of instituting or recognizing deposit guarantee systems that satisfy the minimum criteria of the Directive. This conclusion is corroborated by the Preamble to the Deposit Guarantee Directive.[81]
The Court then examined the same question — can a depositor claim the right to have certain supervisory measures taken in his interest — under the First and Second Banking Directives and the Own Funds Directive.[82] The Court first observes that all directives contain obligations to exercise prudential supervision *vis-à-vis* credit institutions, and repeatedly refer to the protection of depositors in their preambles. However, this in itself is not sufficient for the Court to conclude that these directives "confer rights" to depositors with the effect to trigger *Francovich*-liability in the event of deficient prudential supervision (para 40). Four further considerations are advanced by the Court to conclude that the mentioned banking directives do not satisfy the "conferring rights" requirement in order to establish *Francovich*-liability in the event of deficient banking supervision:

(i) the banking directive do not expressly grant rights to depositors as to having certain supervisory measures taken (para 41)

(ii) the ambit of the harmonization achieved in the banking directives, since it is based on Article 57(2) EC Treaty, is limited: it only concerns the harmonization deemed necessary but sufficient to come to a system of mutual recognition of banking authorizations and prudential supervision in a system of home country control. However, the coordination of national rules relating to supervisory liability does not appear to be necessary to attain this objective (para 42)

(iii) The ECJ observes that supervisory liability is excluded in different Member States, such as Germany, and that these regulatory immunity regimes are based on considerations relating to the complexity of banking supervision and the plurality of interests to be pursued in the exercise of it (para 44).

(iv) Finally, the Court underlines that depositors are protected under the Deposit Guarantee Directive 94/19/EC, even in situations where the banking failure is (in part) caused by defective banking supervision (para 45).

---

80 ECJ, 12 October 2004, *Peter Paul*, case C-222/02, *not yet reported in E.C.R.*

81 See *Peter Paul*, para 31. The 24th recital of the Preamble to the directive states that the directive may not result in the Member States' or their competent authorities' being made liable in respect of depositors if they have ensured the compensation or protection of depositors under the conditions prescribed in the directive. The provision was clearly introduced in the (preamble to) the directive out of fear that the costs of a banking failure would in an excessive manner be shifted to the State. As a consequence, a Member State could not incur *Francovich*-liability for non observance of the Deposit Guarantee Directive if it had made sure to set up or recognize a system which *reasonably* should be able to compensate depositors according to the minimum requirements of the Directive. It is clear that the deposit protection funds of most Member States would not be able to cope with a major banking crisis. In this context, the 24th recital rightly leads to protecting the Member State from *Francovich*-liability. Similarly, a Member State should not incur *Francovich*-liability when it has recognized a deposit guarantee system that eventually cannot provide for adequate compensation because of mismanagement of its assets, while the funding arrangements imposed by the Member State were adequate.

82 It is noteworthy to underline that the Court went much more in details than the Advocate General as concerns the analysis of these directives.

The Court concludes that the banking directives examined do not satisfy the "conferring rights" requirement in the event the losses suffered by depositors were caused by deficiencies in prudential supervision, if the compensation of depositors as prescribed by the Deposit Guarantee Directive is ensured. As a consequence, the banking directives cannot be construed as giving rise to liability on the part of the State on the basis of Community law (para 50-51). Hence, limitations or full immunizations from supervisory liability in national law will not frustrate the *effet utile* of the banking directives.[83]

3. A critical appraisal of Peter Paul

The ECJ judgment in *Peter Paul* can, in our view, be criticized in two respects: first, it seems to depart from, and narrow the scope of previous case-law on Member State liability, by attaching quite strict conditions to the "conferring rights" requirement under *Francovich* (a). Second, we submit that the specific arguments used by the ECJ to deny *Francovich* liability in banking supervision are flawed (b). Finally, we conclude that there should be no "fear" for applying *Francovich*-liability in banking supervision, as the conditions attached to it allow to counter excessive liability claims and to take account of the complexity of banking supervision (c).

a. *Francovich*-liability narrowed by *Peter Paul* ?

At first sight, the ECJ has made a consistent application of its now established jurisprudence as concerns the conditions attached to Member State liability for non observance of EU law. It is true that the ECJ in *Francovich* stated as first condition for Member State liability that only provisions of EU law which are intended to 'confer rights' to private individuals could enable the latter to claim compensation in case of breach of these provisions. As was rightly acknowledged by AG Stix-Hackl, 'conferring rights' is not a synonym to 'direct applicability'.[84] Neither should the condition of "conferring rights" in our view be interpreted as "conferring legally enforceable rights". This is, however, the approach adopted by the ECJ, when it examines whether the banking directives confer a right to depositors to have prudential measures taken in their interests by the competent supervisory body. This seems to depart form previous case law of the ECJ, which suggested that the first condition for *Francovich* liability should be read more flexibly: until now, the Court seemed to be satisfied with the demonstration that the EU rules are intended to protect the *interests* of private individuals , without it being required that the said rules confer by themselves enforceable rights.[85] In the field of banking supervision, the difference between both approaches can be

---

83 The final judgment of he German *Bundesgerichtshof* of 20 January 2005 (BGH, 20 January 2005, III ZR 48/01, see <http://www.bundesgerichtshof.de>) merely takes over the analysis of the ECJ as to the issue of Member State liability in the context of banking supervision. In addition, the *Bundesgerichtshof* does not find the regime of regulatory immunity to be contrary to the German constitution. The supreme court thus puts an end to the longstanding disputes amongst German academics on this issue as well, without having referred the issue of constitutionality to the Constitutional Court.

84 See, however, the abovementioned judgment of the House of Lords in the BCCI-case (*supra*, note 68), where Lord Hope of Craighead considered that the provisions of the First Banking Directive lacked direct applicability in favour of depositors, and therefore could not entail *Francovich*-liability.

85 See T. TRIDIMAS, "Liability for breach of Community law: growing up or mellowing down?", *Common Market Law Review* 2001, p. 328.

summarized as follows:

- In a narrow approach of the "conferring rights"-requirement, the directives should confer the right to depositors to require from the banking supervisor that certain measures be taken in respect of a supervised entity. The non-observance of that right by the prudential supervisor— which would suppose that depositors have effectively claimed specific measures — would then create a right to compensation for depositors.
- In a more flexible approach, it would be sufficient to demonstrate that the banking directives (also) aim at protecting the *interests* of depositors, in the sense that prudential authorities, when exercising supervision, should pursue that protected interest. Depositors would, under this approach, not necessarily have a legally enforceable right to claim certain measures from the supervisory authority, but the lack of adequately taking into account the depositors' interests could *post factum* open a right to compensation.

It is submitted that the condition of "conferring rights" is more connected with the latter flexible approach. This does not only seem to follow from the Court's case law on Member State liability before *Peter Paul*. A further argument can be derived from the foundations of Member State liability. Indeed, the ECJ has consistently stressed that Member State liability should be similar to Community liability under Article 288(2) EC, which in turn requires to assess liability "in accordance with the general principles common to the laws of the Member States". Viewed as a "common denominator" for the various liability regimes across Member States, it is indeed possible to fit the flexible approach of the "conferring rights" requirement into these general principles, as they can be attached to the *Schutznorm*-rule which prevails in different Member States, amongst which Germany.[86]: *Francovich* liability will only come into play when the supervisory obligations imposed by the banking directives have been enacted in the interests of depositors, i.e. have the purpose of protecting depositors.

Under this approach, it will be difficult to maintain that the banking coordination directives are not intended to "confer rights" to depositors, as far as prudential supervision is concerned: first, the preamble to the Coordinated Banking Directive 2000/12/EC[87] clearly identifies the protection of depositors as a major rationale for subjecting credit institutions to authorization requirements and prudential supervision. Furthermore, the case law of the ECJ in the area of banking has repeatedly stressed the importance of the provisions on banking authorization and prudential rules in terms of protection of the consumer.[88] The objective of creditor and depositor protection is finally also embodied in Article 4 of the Coordinated Banking Directive, which as a rule allows only credit institutions subject to prudential supervision to accept deposits from the public.[89]

It remains to be seen whether the ECJ has effectively made a step backwards in *Peter Paul* as regards Member State liability in general. On the one hand, the judgment has been delivered

---

86 See also W. VAN GERVEN, J. LEVER, P. LAROUCHE, *Tort Law*, *cited supra* note 60, p. 894.

87 *OJ* L 126, 26 May 2000, p. 1. The Directive has codified into a single text the main directives on credit institutions, with the exception of the 1994 Deposit Guarantee Directive.

88 See, in particular, ECJ, 12 March 1996, *Panagis Pafitis*, case C-441/93, *E.C.R.*, 1996, p. I-1347, para 49; ECJ, 9 July 1997, *Parodi*, case C-222/95, *E.C.R.*, 1997, p. I-3899, para 22; ECJ, 11 February 1999, *Romanelli*, case C-366/97, *E.C.R.*, 1999, p. I-862.

89 And if a Member State would allow other actors to collect deposits from the public, Article 4 requires them to provide for adequate rules for the protection of depositors.

in full court, and can therefore not be regarded as a mere "incident de parcours". On the other hand, one could argue that the outcome of the case has been influenced by different specific considerations: first, the preliminary questions referred to the Court were specifically phrased in the sense of determining whether depositors could claim the right to have measures taken by the prudential authorities, as a condition for Member State liability, and may therefore have influenced the analysis made by the ECJ.[90] In addition, it is not excluded that the judges have taken into account the policy and financial implications of using *Francovich*-liability in the sphere of banking supervision.

b. The arguments to fend off Member State liability in *Peter Paul:* valid or flawed ?

Some critical remarks can be formulated as regards the additional arguments the ECJ put forward to hold that the "conferring rights" test was not satisfied in banking supervision.

- First, the ECJ held that, given the legal basis for the banking directives (Article 57(2) EC), supervisory liability rules did not appear to be necessary to realize the Treaty freedoms. This argument is not convincing to put aside *Francovich*-liability: although it could be invoked to determine whether specific regulation is needed at EU level as regards supervisory liability, it cannot, in itself, exclude the possibility that the prudential obligations laid down in the directives open a right to compensation for those persons in whose interest these obligations have been formulated.
- Further, the ECJ states that various Member States have excluded supervisory liability. This statement is basically wrong: it is true that different Member States have limited, but not altogether excluded liability. Our comparative analysis has shown that total immunity from liability only exists under German law. The argument therefore is purely circular: the immunity regime under German law is right, because Germany law has totally excluded supervisory liability !
- Finally, the ECJ rightly considers that compensation under the Deposit Guarantee Directive will be provided irrespective of the behaviour of the banking supervisor. It should be noted, however, that the ECJ, in linking the absence of supervisory liability to the existence of a deposit guarantee system, concluded that the exclusion of supervisory liability under national law was allowed *if* the compensation under the Deposit Guarantee Directive was ensured. Would this mean, *a contrario*, that the exclusion of supervisory liability by a Member State would be incompatible with EU law when that Member State has not correctly implemented the Deposit Guarantee Directive ? This conclusion would have been the more important in *Peter Paul*, as the facts of the case showed that there was no deposit protection system in place. This does not seem to be the intention of the ECJ when making a linkage between the existence of a EU compliant deposit guarantee scheme and supervisory liability: to the extent that the rights to compensation provided by the Deposit Guarantee directive have been effectively granted — even as a consequence of *Francovich*-liability[91] — the ECJ finds depositors sufficiently protected in a bank failure.

---

[90] See also J-H. BINDER, "The Advocate-General's Opinion in *Paul and Others v Germany* – Cutting back State Liability for Regulatory Negligence?", *European Business Law Review* 2004, (463), p. 67-468.
Ideally, if the Court had been consistent with its previous case-law, it could have rephrased the questions in order to analyse whether the various banking directives conferred rights to depositors in the sense that they were entitled to a right to compensation for non-observance of their interests in the exercise of prudential supervision.

[91] In *Peter Paul*, the plaintiffs had obtained compensation up to 20,000 EUR by way of damages from the German state, precisely based on *Francovich*-liability. See above, footnote 72.

In sum, there seems to be no conclusive legal argument to exclude *Francovich*-liability in the area of banking supervision. This leaves open the concluding question whether policy arguments should lead to excluding, or at least limiting, supervisory liability under EU law.

4. The case for Fancovich*-liability in banking supervision*

The issue of supervisory liability, and whether or not or to which extent to accept it as a matter of principle, is essential in the design of banking regulation and policy. Exposing supervisory authorities to a high liability risk could in fact lead to shifting to a large extent the costs of banking failures to the State. This would run contrary to the very purpose of prudential regulation in a market economy: the ultimate objective of prudential regulation should not be to avoid banking failures altogether at any cost, but to leave primary risks for banking failures to the shareholders and creditors of the failed banks.
The foregoing does not imply, however, that supervisory liability should be banned altogether. The rationale for prudential regulation, i.e. maintaining depositor confidence through specific integrity and financial control mechanisms, indeed generates - within certain limits - a legitimate expectation from the part of depositors and other bank creditors as to the effectiveness of supervision, i.e. diminishing to some extent the likelihood that bank failures occur, without completely eliminating them. Under this approach, bank supervisors are expected to exercise supervision with reasonable care, taking into account the instruments of supervision at their disposal. Banks cannot, however, be totally prevented to fail, and banking supervisors cannot be expected to prevent fraud or unforeseeable losses within the bank.[92] Submitting prudential supervisors to liability rules therefore is not in itself incompatible with the interests pursued by prudential regulation, as it does not automatically shift the cost of banking failures to the state, but only sanctions negligent or unreasonable behaviour from the part of the supervisory authority.[93]

Finally, submitting prudential authorities to a liability regime might even be regarded as an element of strength of the financial system, as it will discipline the supervisor itself. Conversely, granting total immunity from liability could entail a moral hazard risk on the part of the prudential authorities, as the accountability for their own actions would be reduced. By contrast, a liability regime which takes due account of the nature of prudential supervision and the need for sufficient discretion in taking supervisory measures (see below), will function as a monitoring mechanism with respect to the exercise of supervision, and eventually benefit the financial system as a whole. In this regard, it is of critical importance to find the right balance between the legitimate expectations of depositors as to the quality of prudential supervision, and the need to allocate primary responsibility for bank failures to the banks themselves and their stakeholders. We believe that systems which generally eliminate liability or limit it to bad faith from the part of the supervisor, do not strike a fair balance between the interests at stake, and may fail to sufficiently discipline supervisory authorities to exercise due care in their tasks. On the other hand, courts should take into account the nature and complexity of prudential supervision in assessing possible liability.

---

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

93 Compare H.-P. SCHWINTOWSKI, "Schlechte Vorzeigen für Kapitalanleger", <http://www.VuR-online.de/beitrag/66.html>, who considers that the "public interest" component of banking supervision also encompasses the duty to compensate individual depositors or investors in the event of deficient banking supervision.

Does the possible application of *Francovich* liability to banking supervision create a risk of over-litigation and hence, of shifting unduly the costs of banking failures to the State ? We do not think it does, given the requirement of a 'serious' breach of EU law as a condition for *Francovich* liability.[94] It is clear that banking supervisors enjoy a wide discretion in applying the often generally worded provisions of EU banking law in day-to-day supervision, both as regards authorization requirements[95] and for ongoing prudential requirements[96]. Only exceptionally will prudential requirements in the banking directives prescribe a clear obligation, the non-compliance with which would constitute in itself a "serious" breach.[97] Furthermore, decisions of a banking supervisor often require the balancing of various, sometimes conflicting interests. This amplifies the discretion that the banking supervisor enjoys, as it should not exclusively serve the depositors' interests to the detriment of other legitimate interests (systemic protection, interest of the supervised entities). The case law of the ECJ is in line with these concerns: a "serious" breach will only occur when the supervisory authority has manifestly and gravely disregarded the limits on the exercise of its discretionary powers.[98] In other words, the concerns that have led some national courts to incorporate the complexity and limited means of supervision into their liability assessment can be equally met when basing liability on *Francovich*.

Finally, some have expressed the risk that a liability risk would influence the attitude of prudential supervisors in the exercise of their duties ("inhibition risk").[99] The situation in those Member States that have experienced liability claims (e.g. France) does not provide evidence for this proposition.

A well-balanced application of the conditions attached to *Francovich* liability should therefore severely limit the occurrence of successful liability claims. It will then be up to the (national) courts to rigorously apply the ECJ case law and to avoid the pitfall of the 'deep pocket' of the State in granting compensation to depositors. The experience in many Member States has shown that only a minority of liability cases actually leads to awarding compensation to the plaintiffs.

Conclusion and outlook

It is still difficult to fully assess the consequences of the ECJ judgment in *Peter Paul* on the development of Member State liability in general, and on liability of financial supervisors in particular. While on the one hand *Peter Paul* may just have been the result of a very specific case, which will not substantially affect the jurisprudence on Member State liability in general, the effects on financial regulation may be more important. First, it is not excluded that *Peter Paul* will induce some Member States to introduce regulatory immunity regimes for their domestic banking supervisors, or at least to clarify the liability rules in an express

---

94 *Supra*, footnote 62.

95 E.g. the requirement of a sound administrative organization of the credit institution and adequate internal controls.

96 E.g. the obligation to take adequate measures with regard to irregularities, without specifying the means or instruments to take action.

97 One could e.g. imagine the situation where a credit institution is being granted an authorization without satisfying the initial capital requirement of EUR 5 million.

98 See ECJ, 5 March 1996, *Brasserie du pêcheur/Factortame III*, cases C-46/93 and 48/93, *E.C.R.,* 1996, p. I-1029, para 55.

99 See F. ROSSI, *op. cit.*, cited supra note 8, p. 669.

legal provision. At least in one Member State a bill to this effect has already been laid down in Parliament.[100]

A more intricate issue is to determine the effect of *Peter Paul* in other areas of financial supervision. In view of the similarities of the system of prudential supervision as concerns investment firms and insurance undertakings, it is submitted that *Peter Paul* will fully apply, even if no compensation system, comparable to the 1994 Deposit Guarantee directive has (yet) been put in place at EU level.[101] Transposing *Peter Paul* to other areas, such as the supervision of financial information, seems more problematic. Thus, the 2003 Prospectus Directive[102] clearly assigns obligations to Member States' competent authorities as to the approval of a prospectus in the event of a public offering of financial instruments. More than is the case for prudential supervision over financial institutions, the obligations incumbent on the competent authorities are devised to protect the end-users of the system, i.e. the investors, through the supervision of the quality of financial information provided by issuers and offerors. Unlike the "prudential" directives for financial institutions, the quality of the prospectus is critical in the investment-decision. Therefore, it seems unlikely that *Peter Paul* will apply to the Prospectus Directive. This creates a risk for those Member States who at present limit or exclude liability of their competent authorities as regards the vetting of prospectuses.[103] Undoubtedly, a similar argument could be developed for collective investment undertakings, regulated under the 1985 UCITS Directive.[104]

Finally, the discussions about prudential supervisory liability should be put in a wider context of the debate about the role and liability of public authorities in economic life. Most probably, *Peter Paul* and other "defensive" reactions from the part of Member States as regards prudential liability are an attempt to counterweight the growing emancipation of, and associated over-litigation, by private individuals against public authorities. If expectations from the public as to the capacity of the State to maximize their (financial) well-being are too high, such a defensive attitude can be fully understood. There will be a large responsibility for judges to assist in restoring a fair balance between public and private interests in this regard.

To be continued …

---

100 E.g. in Austria Government Bill No. XXII-819, cited *supra* note 11. Surprisingly, although express references are made to the ECJ judgment in *Peter Paul*, the Bill does not purport to limit supervisory liability, but merely wishes to clarify that liability is to be assessed according to normal liability rules.

101 As regards investment firms, the 1997 Investor Compensation Directive (97/9/EC, *OJ* L 84, 26 March 1997, p. 22) has instituted a system of compensation offering up to 20,000 ¤ for money or financial instruments entrusted to a failed investment firm. In the field of insurance undertakings, no similar arrangements exist at present, but the European Commission has been examining for some time the possibility to introduce a directive on insurance guarantee schemes. See EUROPEAN COMMISSION, *Working Paper on Insurance Guarantee Schemes*, document MARKT/252905/EN, available at <http://europa.eu.int/comm/internal_market >.

102 Directive 2003/71/EC of 4 November 2003, *OJ* L 345 of 31 December 2003, p. 64.

103 See e.g. in Belgium Art. 68 Law 2 august 2002, which limits the liability of the CBFA to situations of fraud or gross negligence as regards its supervisory functions with respect to prospectuses as well.

104 Directive 85/611/CEE of 20 December 1985, *OJ* L 375 of 31 December 1985, p. 3.

Financial Law Institute

The **Financial Law Institute** is a research and teaching unit within the Law School of the University of Ghent, Belgium. The research activities undertaken within the Institute focus on various issues of company and financial law, including private and public law of banking, capital markets regulation, company law and corporate governance.

The **Working Paper Series**, launched in 1999, aims at promoting the dissemination of the research output of the Financial Law Institute's researchers to the broader academic community. The use and further distribution of the Working Papers is allowed for scientific purposes only. Working papers are published in their original language (Dutch, French, English or German) and are provisional.

More information about the Financial Law Institute and a full list of working papers are available at:
http://www.law.UGent.be/fli