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MICHAL JANOVEC

INTEGRATION OF FINANCIAL MARKET SUPERVISION

UNIVERSITAS-GYŐR
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List of abbreviations

BSCS - Basel Committee on Banking Supervision;

ČNB – Czech national bank

EBA – European banking authority;

ECB – European central bank;

EEA – European Economic Area;

EFTA – European Free Trade Association;

EIOPA – European insurance and Occupational pensions authority;

ESA - European Supervisory Authorities;

ESBR – European systemic risk board;

ESFS – European system of financial supervisors;

ESMA – European securities and markets authority;

EU – European Union

FSB – Financial Stability Board;

G-SIB - global systemically important banks;

IGA - Intergovernmental Agreement; signed in May 2012 dealing with Single resolution fund

MAD – Market abuse directive; 2014/57/EU

MAR – Market abuse regulation; nr. 596/2014

MREL - Minimum Requirement for own funds and Eligible Liabilities;

NRF - National resolution fund;

SRB – Single resolution board;

SRF – Single resolution fund;

SRM – Single resolution mechanism; 2nd. Pillar of banking union

SSM – Single supervisory mechanism; 1st. Pillar of banking union

TFEU – Treaty on the Functioning of the European Union**;**

TLAC - Total loss-absorbing capacity;

Abstract:

This book analyses the integration of financial market supervision at the international level, particularly focusing on EU law and the actual processes taking place in this area (system). Currently legislative action at the EU level has a significant impact on legislation in the Czech Republic, with which this work is also of concerned together with where the integration of supervision takes place. This book seeks among other things to find the causes increasingly ongoing process of integration of financial market supervision and determine whether the direction in which the international integration is going, is the right way. The main objective of this book is to determine, whether the process of integration increases itself the efficiency of financial market supervision, while simultaneously reducing systemic risk to financial market stability. The research in this book also seeks to determine whether the functional of regulation of the financial market has been significantly integrated into the financial market supervision and has become to a certain extent preventive - primary supervision.

Key words: Integration; supervision; financial market; Banking Union; single market; institutions of the financial market;

INTRODUCTION

This book aims to introduce, analyse and investigate the integration of supervision of financial markets, particularly from the European and global perspective, whilst a comparison with the situation in the Czech Republic is offered, too. This topic has been hotly debated for a considerable amount of time now as the process of integration has intensified in the past few years. The word *integration* refers to unification, assimilation, amalgamation, or synthesis into a whole of a higher order. [1] The collocation *the integration of supervision* includes integration of regulation for there is no supervision without regulation, and vice versa (supervision itself includes regulation); that is the reason why this book also deals with integration of regulation together with integration of supervision of financial markets. In my opinion, regulation is in fact preventive (primary) supervision and that is why supervisory authorities are not 'solely' supervisory any more—they are regulatory at the same time. In this respect I approach, to a certain extent, integration of supervision from the functional point of view—the function of regulation has been integrated into that of supervision (though not exclusively since the crucial role of a regulator is performed by the legislative body).

Integration of supervision of financial markets can be approached from two angles. The first sees it as the unification of supervision into one institution (or sometimes two)—that is how the term is understood in EU member countries, for instance the Czech Republic or Slovakia, where supervision has been integrated into only one institution (institutional integration). The second views it as the harmonisation of supervisory practice and cooperation at a supranational level—that is the usual meaning applied to integration internationally, e.g. the EU (functional integration). This work covers both angles but I personally prefer the latter view as I interpret the term *integration of supervision of financial markets* as the unification of supervisory practice across international borders and mutual cooperation among the countries involved. It seems that this interpretation of the term is a more comprehensive one and also a more widely accepted one.

The integration of supervision itself may take various forms and may involve various processes and it is thus vital to study not only the possibilities offered and the current state of integration itself but, above all,

[1] Slovník cizích slov [online] [qtd. 19. december. 2017]. Available at <http://slovnik-cizich-slov.abz.cz/web.php/slovo/integrace>.

to delineate the integration of supervision as such in order to leave as little doubt as possible as to the accepted interpretation of the term here. In this book, as the title suggests, I am concerned with institutional integration and the integration of other areas of regulation and supervision of financial institutions, in particular the unification of diverse ways of supervision—my approach is therefore functional.

Integration of supervision is an ongoing process which, from the international point of view, has been under way for thirty years[2]; in fact the process of integration has been going deeper and deeper. There are a number of reasons for integration: the chief one appears to be the very nature of a financial market and its liberalisation as well as changes in its structure, its functioning and, more generally, in the overall development of economy. Furthermore, the appearance of big national and international groups of financial institutions has played its role, as has the subsequent need for the harmonisation of entrepreneurial rules for these financial institutions. These basic theses are a prerequisite for supervision of financial markets, and they also offer the reason for its existence. The basis of regulation itself lies in individual national financial systems and it reveals a determined effort to ensure the stability of a financial system and financial institutions alike. To put it simply, regulation of supervision exists with the primary aim of setting such rules for the establishment and functioning of financial institutions as to minimise the threat of weakening their stability.

It is, beyond doubt, impossible for legal norms concerning financial market regulation and supervision to cover fully financial markets in all their complexities. As financial markets develop, new problems arise and, in order to find a solution it may be necessary to redefine existing norms and to add something to reach the desired regulatory aims. What is crucially important is the protection of consumers together with the persecution of illegal practices and the maintenance of financial markets and their effectiveness. [3]

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[2] The first country that integrated supervisory mechanisms was Singapore (1984), then followed by Norway (1986), Denmark (1988), Malta (1988), Sweden (1991), Great Britain (1997/98), Japan (1998), Iceland (1999), South Korea (1999), Hungary (2000), Estonia (2001), Lithuania (2001), Germany (2002), Austria (2002), Ireland (2003), Belgium (2004), Lichtenstein (2005), Slovakia (2006), the Czech Republic (2006), Poland (2008), Switzerland (2009), Finland (2009). Source: MOSS, N. Integrated supervision in Norway: Organisational structure, history and experience. Presentation of Finanstilsynet, the Financial Supervisory Authority of Norway at a conference in Sofia, 3rd May 2010. p. 29.

[3] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 51.

In this book I would like to find, among other things, the causes of the ongoing supervisory integration of financial markets. Moreover, I would like to determine whether international integration is going in the right direction or not.

De lege ferenda proposals are of considerable importance as well, for I intend to use them to discover a way of financial market supervision that is as good as possible and, at the same time, reasonably practical to implement. The ultimate goal is to create a truly unified financial market that is also easily understandable for those involved in it.

It is still rather questionable, however, whether it is feasible to create such a strongly unified system of supervision anchored in one clearly laid-out legal norm and one supervisory body. Or is a hybrid model more realistic? Is integration like this a step in the right direction at all? I firmly believe that answers to these questions can be found by means of a theoretical analysis of foreign financial systems where integration has been under way for some time. Moreover, it appears worthwhile to analyse any deficiencies the process of integration has been hampered by there.

For an academic piece of work such as this it is, needless to say, vital to opt for methods and methodology that ensure that the work meets the expected standard. Methods are understood here as objective and proper ways of finding and clarifying pieces of information, principles and patterns that lead to a more comprehensive understanding of the matter under investigation. Methods need to be described thoroughly so that the findings can then be verified. The methods used in this work vary considerably on the basis of the given part.

Analysis, description and synthesis are the most common methods applied here. In addition, various methods of induction and deduction are present. With regard to the selected topic and its international focus I also apply a comparative method while analysing existent legal bases in a number of countries.

The method of analysis leads to a general understanding of the issues within the field, in particular the current legal basis, not only in the Czech Republic but also in foreign countries (in the EU, above all). Basic notions that analysis discovers enable a description of the issues under investigation, while these are also compared. Having acquired a sufficient amount of theoretical information about the issues, I attempt to offer conclusions by means of synthesis.

The analytical method is also applied when studying the current legal basis, including the historical development which preceded it. The current

legal basis is assessed in connection with its implementation into practice and, further, I interpret a selected set of legal norms within the field, which I later apply by means of logical, teleological and systematic methods of doctrinal statutory interpretation.

Induction is reasoning that derives general principles from specific observations. It thus enables to get to the very basis of a phenomenon and to determine its principles and patterns. A conclusion based on inductive reasoning may be considered a hypothesis, since it offers one explanation even though in reality there might be a number of them. Such conclusions are always influenced by subjective reasoning (experience, knowledge) and are therefore of limited validity. The core of induction is a statistical analysis of the gathered data which then form the basis of newly-formulated general principles. Deduction is a reverse process: one moves from the less general to the more general. It is a process by means of which it is tested whether the promulgated hypothesis is able to explain the given fact. Induction and deduction are intertwined—induction helps to reach theoretical generalisations based on the analysis of real phenomena and deduction enables to verify the theoretical conclusions in reality. [4]

Thanks to the aforementioned methods it is possible to reach valid findings and conclusions, which is exactly what I set out to do in this work. I am convinced that via the right application and combination of these methods I can achieve my aim.

The text combines an original theoretical essay, a qualified essay and a treatise.

Important sources of information include academic papers and essays but my aim is to create an original piece of work as required for a dissertation (an original theoretical treatise, as defined by Šanderová[5]). It is in full accordance with academic practice to quote existing publications if needed for argumentation and the creation of hypotheses.

In my book I combine the German and Anglo-Saxon styles of writing.

My work focuses on (though not exclusively) the legal basis of the field in question, which is later supported by a theoretical analysis and an overview mixed with a considerable amount of real-life experience connected with the latest development. By means of abstraction I attempt to transform specific observations into universally applicable findings. My research

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[4] LORENC, M. Závěrečná práce – metodika. [online]. *Lorenc info* [qtd. 14th November 2016]. Available at http://lorenc.info/zaverecne-prace/metodika.htm.

[5] ŠANDEROVÁ, J. *Jak číst a psát odborný text ve společenských vědách : několik zásad pro začátečníky*. 1st ed. Praha: Sociologické nakladatelství, 2005.

centres on the European Union as a whole but I do not disregard certain national particularities, especially noteworthy from the perspective of the Czech Republic.

Another point of interest is the integration of supervision in Scandinavian countries, particularly in Norway, for Norway was the first European country to have initiated the process of integration (in 1986; 20 years before it took place in the Czech Republic). I intend to describe the Norwegian way of supervisory regulation and to compare it with the other countries within the EU (incl. the Czech Republic) with a view to suggesting de lege ferenda changes and to amending regulatory and supervisory frames of financial markets in the Czech Republic.

Solely to describe the issue would not suffice for a book like this, the benefit of which should also include the motivation for integration and a general overview of basic concepts and existing ways of supervisory integration of financial markets and their subsequent comparison. The conclusion should ideally try to define the best approach based on up-to-date observations and it should also provide suggestions and possible changes to the legal basis anchored in the EU and Czech legal systems now. What is of utmost importance is the up-to-the-minute acquaintance with the issue and real-life experience as financial markets are such a dynamically developing environment—what used to be the case a year ago might now be true only partially, if at all.

The main aim of this book is the confirmation or refutation of the following leading hypotheses together with partial ones.

The main hypothesis

a) The process of supervisory integration itself supports and increases the effectiveness of supervision over a financial market and decreases the systemic risk of destabilising the system.

b) The function of financial market regulation has been deeply integrated into that of supervision and has thus become, to a certain extent, a preventive measure—primary supervision.

Partial hypothesis no. 1

The process of supervisory integration of a financial market is from both the institutional and functional perspective a step towards a more concentrated set of regulatory powers in the hands of a narrow range of supervisory institutions in a centralised way.

Partial hypothesis no. 2

The process of supervisory integration of a financial market was initiated so as to create a more effective way of reacting to a rapidly and continually developing world of financial markets, which are due to the increasing financial globalisation no longer of national interest only.

Partial hypothesis no. 3

The process of supervisory integration of a financial market is influenced by the enormous importance of the financial market in the national economy as the basis of international economic stability, and it helps to create the single market in the EU.

These hypotheses (in particular the main one) should lead towards a number of partial conclusions. Given the selected approach, it seems apposite not to expect only one conclusion. The research does not aim to determine whether the integration of supervision is beneficial or not, it rather hopes to reveal the motivation behind the process of integration, to estimate when we might expect results of the process, to determine what exactly is going on and why, and, last but not least, to analyse whether a positive outcome is possible at all. If a partial conclusion is reached and if it is not considered to be the best solution, I will try to come up with a more suitable option by means of international comparison or de lege ferenda proposals.

As far as the organisation of this book is concerned, Introduction is followed by a chapter discussing financial markets and their supervision in general, including theoretical frameworks and models that specific approaches stem from; this chapter then also classifies financial market supervision within the system of financial law. The next chapter discusses the crucial notion of financial market supervision in the European Union. The very position of this chapter reveals my methodological stance: from the general to the specific—the more general and wider legal basis is the European one at the moment and the more specific is the Czech one, which is derived from the European one. Thus, it seems more appropriate to start with the European legal basis, all the more so since the process of financial market supervision at the European level is now a hotly-debated matter with continuous development. This work also includes an analysis of financial market supervision in Norway; it was added for two reasons: firstly, Norway was the first country to implement an integrated model of financial market supervision (in 1986) and, secondly, Norway is not part of the EU, which seems to make such an analysis worthwhile because it

enables a comparison of legal bases between a non-EU country with those countries which belong to the EU (the Czech Republic, for example). It is also immensely interesting to discuss the integration of supervision and its legal basis in Norway because of the existence of the EEA Agreement and because of the relations between EFTA members participating in this agreement and all EU member countries. The purpose of the EEA Agreement is the creation of a free single market. It logically follows that the legal basis and regulatory and supervisory requirements are similar or even identical in the EU and EFTA member countries. These are the chief reasons why I included the chapter about Norway and why I try to verify the hypothesis about legal similarities and to discover any potential setbacks of such Europe-wide cooperation and harmonisation. Supervisory integration in the Czech Republic is dealt with in chapter number six. Moreover, I included two texts about potential failures of financial market subjects. The last part is Conclusion, which sums the whole book up and it also offers the assessment of all the hypotheses stated in Introduction.

Further research possibilities

The topic chosen for this book is a relatively new one and therefore its consequences and real-life effectiveness are perhaps just beginning to emerge. That is why potential research areas mentioned here are rather a guessing game or, better still, a prognosis as to what might happen in the field of financial market supervision and regulation in the future.

I agree with Kubíček, [6] who claims that the primary objective of supervision and regulation is the maintenance and further development of a fully functional financial market in all its specific forms and types, thereby making sure it can fulfil its raison d'être. Supervision and regulation are secondary factors surrounding financial markets because only after these markets have existed for some time is it possible to come up with regulatory and supervisory interventions based on real-life experience with the aim of maintaining fully functional financial markets.

Outlooks are only possible if one is fully acquainted with the current state of affairs. One of the richest sources of the latest information in this field is the vast number of regulatory and supervisory changes in the area of integration itself but also in the organisation of it at various levels: regional, national, global. These processes continually seek to harmonise the rules of

[6] KUBÍČEK, A. Regulace a dozor nad finančními trhy – rozcestí, scestí nebo ještě něco jiného? In *Sborník z mezinárodní konference Regulace a dozor nad finančními trhy*. Praha: Vysoká škola finanční a správní 2003. p. 27.

operation and enterprise for financial institutions and conglomerates in Europe and, indeed, the whole world.

It is however crucial to sustain the right balance between regulation and free enterprise, because overregulation is as harmful as little or no regulation at all. Overregulation inevitably leads to useless administrative burden for everyone involved: the body of supervision and all financial market entities.

If supervision and regulation should bear fruit, there is another point to bear in mind: it is vital to maintain a certain degree of specificity in the ongoing processes of harmonisation. It is hardly desirable to immediately and fully harmonise a rather less developed financial market in a Third World country as if it were an economically developed part of the world, where financial markets (as well as their regulation and supervision) have gone through the phase of initial difficulties and their environment is consequently far more stable for companies involved in the financial market and, also, for the financial system as such.

The title of this work suggests that I focus not only on institutional integration (though it is a subject of primary interest) but also on its functional aspect. Functional integration is the setting of supervision from the point of view of its subject—it is a way of harmonising supervisory functions so that they are in accordance with the objective: the maintenance and support of thriving financial markets. In other words, the term refers to the unification of supervisory rules influencing the effectiveness of supervision. Functional integration logically follows institutional integration, which is the basis of this work. My hypothesis holds that institutional integration necessarily brings about concurrent functional integration—there are not specific functions for insurance, capital markets, credit unions, banks etc.; there is only one function (to maintain financial market stability) encompassing the whole field.

Further research could verify the expected link between institutional and functional integration and it could also determine whether the change is purely theoretical or with real-life consequences. To put it another way, has the probable existence of one 'big' supervisory function (which has emerged from various parts of financial markets) brought about any real change in terms of its functional focus and of the way supervision works or is it simply a matter of terminology?

It is truly intriguing to entertain the idea that financial market regulation has been significantly integrated with financial market supervision (as the second part of the main hypothesis states). I firmly believe that it is the case as the reverse process is not taking place and, logically, it even cannot take

place. One can hardly assume that supervision could integrate with regulation because it would then mean that the main regulator (the legislator) also has the function of supervision, which clearly is not and cannot be true. The legislator is exclusively the main regulator whereas the body of supervision (apart from the very supervisory function) maintains significant regulatory powers, be it in the form of decrees, instructions and statements addressed to those who participate in a financial market, but also by providing licences to individual participants. Given the fact that the supervisory body is, when compared with other state and private institutions, the closest to financial markets, it works with first-hand experience and information. The supervisory body is also the most active supplier of initiatives and it keeps the role of the consultant as far as legislative proposals are concerned. These proposals come from the Ministry of Finance,[7] which confirms the hypothesis that regulation is integrated with financial market supervision.

It needs to be answered whether the introduction of integrated supervision with a dominant functional model[8] has any bearing upon the effectiveness of supervision itself. Taken at face value, it seems to me that it does not as I am convinced that what is essential is the setting of the rules in the given financial market, effective sanctioning if the rules are broken, and the extent to which financial institutions identify with the imposed rules. The very existence of regulation and supervision is a preventive measure against potential threats to the whole financial system, while regulatory and supervisory bodies also need to take into account potential risks.

In connection with the crucial role of lawmakers and their part in the process of regulatory and supervisory integration, Palat comes to the conclusion that financial market regulation must unavoidably be regulated and, at the same time, it is essential to supervise this regulation and make sure it is objective.[9]

To sum up, further research will, in all likelihood, include up-to-date analyses of the systems and ways of supervisory integration of financial markets and their mutual comparisons. It is only possible to evaluate the

[7] In actual fact the main source of legislation are European regulations.
[8] The functional model is based on the vertical mechanism of supervision—individual supervisory institutions usually supervise all financial entities but only from a certain perspective: according to the type of market failure. These most frequently include systemic risks, investor and consumer protection, prudential regulation and supervision, and also the supervision of economic competition.
[9] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 209.

pros and cons and offer improvements in the field of supervisory integration if one takes into account the current practice, positive and negative experience of supervisory bodies and regulators along with theoretical implications.

FINANCIAL MARKET AND ITS SUPERVISION

This chapter introduces the concept of a financial market and its supervision. In addition, it considers its position within the system of law and society alike. It deals with general legal norms and it also analyses the reasons for financial market supervision including its actual realisations. Considering the fact that the next chapters are concerned with specific ways of supervision (including existing systems), it is important to analyse the theoretical possibilities and arrangements first. Only after having done this, may I apply this information in the following chapters about the current state of financial market integration in the Czech Republic and in Europe, too. First, I attempt to classify financial market supervision within the system of law to make absolutely clear at the very beginning of the chapter where the topic selected for this dissertation finds itself within the legal system and which part of the system is being dealt with here.

The position of financial market supervision in the system of law

In this chapter I try to classify financial market supervision in the system of law; in other words, I want to find and delineate the place it occupies there. This is a vital thing to do with every legal norm and financial market supervision is no exception whatsoever. Norms that occupy the same position in the system of law share a number of common features. The classification within the system of law itself reveals common features that the norm under investigation shares with the others in the same position—that is the right platform for deeper understanding and a more accurate analysis of the system and the norms within. It goes without saying that financial market supervision is directly linked to financial law, but financial law is not such a small field to make unnecessary the exact placement of the norms within the system. Financial law is a rather young discipline which has broken free from administrative law with which it still

maintains the closest bond. Its independence and its exact classification are described below.

It would theoretically also make sense to place financial market supervision into the system of administrative law not only because financial law separated from administrative law but also because financial market supervision processes are, since they are in fact administrative procedures, under the authority of Administrative Procedure Code. Thus, supervision becomes part of administrative law (e.g. an administrative procedure to acquire a banking licence)

Nonetheless, there is one strong argument for the inclusion of financial market supervision into the system of financial law: the subject of legal regulation of financial markets is social relations connected with the creation and distribution of funds, which is in accordance with the subject of legal regulation of financial law (as is discussed below). There is a small anomaly though: the subject of legal regulation of financial law is social relations created and maintained through those funds which are in the public interest. That is not always the case when it comes to legal regulation of financial markets. This anomaly is compensated with the fact that it is undoubtedly in the public interest to regulate and supervise financial markets due to their importance for the integrity of the economic system. Given the fact that money relations are not the focal point of legal regulation of administrative law, it is, in my view, demonstrated (by finding the common core in the subject of legal regulation of financial markets and financial law) that financial market supervision falls within the realm of financial law.

Another necessary step is to delimit the notion of financial market supervision (from now on also just 'supervision'), for its correct placement within the system of financial law is unthinkable without realising what supervision actually entails.

1. The system of financial law

Before delimiting the system of a legal discipline, it is necessary to defend the independence of the given discipline. Financial law undoubtedly is an independent discipline as it fulfils the establishing criteria which generally justify the existence of an independent legal discipline.

According to Mrkývka[10] these criteria include

[10] MRKÝVKA, P. PAŘÍZKOVÁ, I. RADVAN, M. et al. *Finanční právo a finanční správa*. 1. díl. Brno: Masarykova univerzita, 2004. p. 32.

- independent and specific subject of legal regulation
- methods of legal regulation.[11]
- internal cohesion of legal norms.
- social acceptance of the discipline

All these criteria are met by the discipline of financial law, thereby setting itself free from other legal disciplines.

The subject of financial law is specific social relations involved in various financial activities and reflecting a number of financial phenomena. Financial law governs in particular those relations in which the state is involved and which indirectly or not affect the base money or its parts[12]. To put it simply, financial law is not concerned with relations with a contractual basis—these rather belong to civil or commercial law[13].

Financial law is a specific public-law discipline with close bonds with administrative law; in fact it broke free from it. But financial law also has a lot in common with private-law disciplines, which deal with legal relations involving payments and money—the contractual positions of the subjects are, however, equal.

Experts and the lay public alike accept and respect financial law as an independent discipline. Discussions surrounding its position are a thing of the past and to cast doubt on this discipline as public-law part of the Czech legal system is now virtually unheard-of.

For the purpose of the classification of supervision within the system of financial law is crucial the discipline-defining criterion of internal cohesion of legal norms—the uniqueness of the system of financial law. The defining systemic features are:

- a higher rate of mutual legal norms in contrast with norms from other legal disciplines.

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[11] Mrkyvka states the specific methods of legal regulation of financial law, the public-law character of regulation, the attributive share of public authority, the dominant power character of legal relations, an independent specification of financial law obligations, financial law acts, and the imperative character of legal regulation Cf. MRKÝVKA P., PAŘÍZKOVÁ, I. *Základy finančního práva*. Brno: Masarykova univerzita, 2008. p. 30.

[12] BAKEŠ M. et al. *Finanční právo* 6th ed. Praha: C.H.BECK 2012. p. 12.

[13] This does not apply without exception, however, because financial law also deals with state loans and the sale of the state property.

- a relative autonomy of the given set of legal norms from the norms of the other disciplines[14].

Despite the unquestionable existence of the system of financial law, financial law is not codified in a unified way and is instead fragmented into several independent acts. As a result, there is a wide range of norms with not so rigid links between them. I hold that financial law as a whole defies entire codification, mainly due to the vast scope of interest of all its subdisciplines.

The closest bonds exist between individual subdisciplines of financial law and then also between mutually close subdisciplines which form two different systems on the basis of their purpose and their character: fiscal and non-fiscal parts of financial law. The system of financial law is defined by the internal differentiation of its branches into coherent groups of financial-law norms as regards their content and the similarity of the social relations that they govern[15]. With the increasing rate of globalisation the range of public financial activities changes, thereby creating new limits to the scope of financial law.

The scope of financial law naturally increases with the increase in financial activities of the public sector and with the increasing number of state interventions into economy. It means that financial law has a wider scope in those countries where economic interventions are frequent; this subsequently influences the system of financial law there, too.

Most experts in financial law divide the system into two parts: the general and the specific[16] part, though there is hardly a consensus about the existence of the general part because it is only with great difficulty that one can find a common core for all subdisciplines of financial law. Likewise, there are no common sources of law in the technical meaning of the word; yet, I am convinced that the general part of financial law can be accepted—chiefly because of the fact that there is a common characteristic for all financial-law norms: they govern financial relations.

The main division within the system of financial law is to be found in the specific part, namely the division into the fiscal and non-fiscal parts. The former is defined by those social relations in which the primary interest is to regulate the cash flow in the public budgets. The non-fiscal part, on the

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[14] PRUCHA P. : *Základy správního práva a veřejné správy - obecná část* . MU Brno 1994. p. 34.

[15] MRKÝVKA, P. PAŘÍZKOVÁ, I. RADVAN, M. et al. *Finanční právo a finanční správa*. 1st vol. Brno: Masarykova univerzita, 2004. p. 56.

[16] E.g. Bakeš M. In BAKEŠ M. a kolektiv: Finanční právo 6th ed. Praha: C.H.BECK 2012. p. 12.

other hand, regulates social relations in which the cash flow is only secondary because the main point of interest is the regulation of money itself and of the monetary system as well. This division is essential for those common notions and principles on which the general basis of both subdisciplines is formed. This in turn enables a better and a more transparent interpretation and application of financial-law norms. The fiscal part of financial law includes the arrangement of budget law, tax law, and customs law. The non-fiscal part then deals with currency law, foreign exchange law, public banking and insurance law, the legal regulation of supervision of the capital market and credit unions, and, finally, the hallmarking law.

Financial law can also be divided (apart from the abovementioned division into the general and specific parts) into procedural financial law (norms of procedurally legal character[17]), administrative financial law and criminal financial law. These subdisciplines however exceed the scope of this work and will not be discussed in any greater detail.

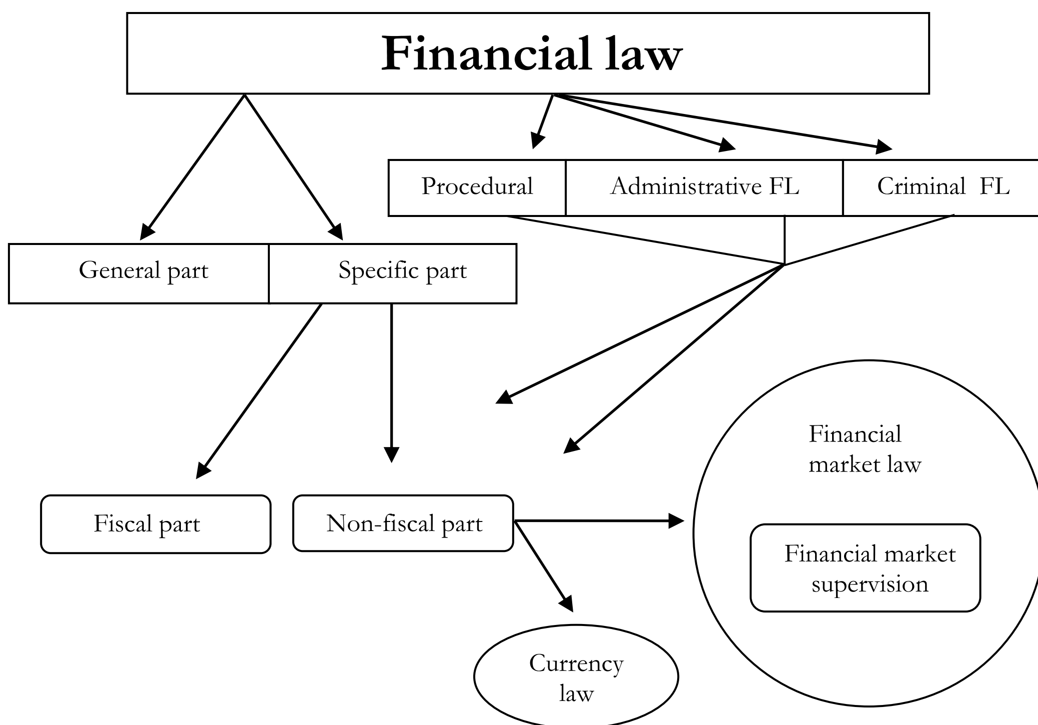
If we accept the idea that financial market supervision entails supervision of the banking sector, credit unions, the capital market, insurance industry, pension savings companies, pension funds, exchange offices and, finally, institutions in the area of payments, then it is, beyond any doubt, true that financial market consists of basically the same areas as the non-fiscal part of financial law, the only exception being the presence of financial market law in place of currency law (for more information see the subchapter below). Yet, it would be wrong to claim that the financial market is the same entity as the non-fiscal part of financial law; however, it is possible to say that financial market law falls within the realm of the non-fiscal part of financial law. This statement hints at the independence of financial market law; it indeed meets the discipline-defining criteria of independence and specificity of the subject of legal regulation. The subject of legal regulation here is legal relations which are formed within financial markets, i.e. within their various branches. The other discipline-defining criteria of financial market are identical with those met by financial law. Therefore, I do not think that it would be correct to call for a complete independence of the discipline of financial market law; it is nonetheless not erroneous to accept the existence of financial market law within the realm of financial law, i.e. in its non-fiscal part. Financial market supervision is then conceived of as a branch of financial market law. This theoretical assessment of financial market law

[17] The procedural position of subjects, the procedural actions when deciding the matters of superiority and inferiority and the procedural actions of subjected entities—e.g. self-application within the system of tax law and the legislative process, too.

enables a more transparent and easier understanding of the structure of financial law, but it also enables a more accurate classification of what this book deals with, namely the issue of financial market supervision. If it is clearly stated what financial market law is and where it belongs within the legal system, it is then much easier to delineate the area of financial market supervision and to determine by which means it is performed and what is the nature of the legal relations under supervision.

It is now time to turn our attention to a branch of financial law which comprises the subject of this book: financial market supervision, which is a section of legal regulation in the non-fiscal part of financial law as the following diagram illustrates.

Diagram no.1 –A schematic classification of financial market supervision within the system of financial law



Source: the author

2. *Financial market supervision and its position in the system of financial law*

Financial market supervision can be described as a role performed by a public authority. It is a power supported by the state which guarantees potential sanctioning of subjects if financial market rules set by the regulatory bodies are broken.

Supervision and regulation set rules which protect the stability of the banking sector, the capital market, the insurance industry and pension funds. These entities are systematically regulated, subsequently supervised and, if need be, sanctioned if the rules are not properly observed. I dare say that in the Czech Republic regulation is in fact a subset of supervision since the former has been largely integrated into the latter. I view supervision as a process that consists of three stages: 1/ regulation, 2/ proper supervision and 3/ possible sanctions. To justify this bold claim I would like to point out that all three stages have been integrated into one authority, namely the CNB (Česká Národní banka/Czech National Bank).

Legal norms in connection with financial markets comprise acts prepared by the Ministry of Finance or the Ministry of Justice, as well as implementing regulations and orders issued typically by the CNB. The same institution also provides help to those involved in financial markets by means of interpretative and explanatory materials (e.g. official notices and answers to questions). Obligatory rules and interpretative materials are more and more often issued directly by the EU authorities.[18]

Financial market supervision in the Czech Republic is performed by the CNB.[19] Owing to the fact that the supervision covers a wide range of areas, powers and duties in individual sectors are modified within sectoral laws.[20] The main supervisory objective and supervisory principles are very similar in all those areas; yet, there are some particularities stemming from the diversity of activities in individual institutions of the financial market. It thus seems apposite to shed more light on them now.

To maintain the perfect working order, credibility and stability of the financial market is not and cannot be just a question of free marketing

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[18] CNB. Legislation and methodological materials of the CNB in the field of financial market. [qtd. 26th May 2017]. Available at https://www.cnb.cz/cs/dohled_financni_trh/legislativni_zakladna/index.html.

[19] On the basis of Act no. 6/1993 Coll. on Česká národní banka, as amended (from now on just 'CNB Act').

[20] The capital market and its supervision is also regulated by Act no. 15/1998 Coll. on Supervision in the Capital Market Area and on the Amendment of other Acts.

mechanisms; thus, there are a great number of regulatory and prescriptive rules—mainly in the form of legal norms. The range of legal norms is rather diverse and to supervise the whole system of rules and to reach conclusions and administer sanctions (if the rules are broken) is called financial market supervision. This supervision covers all institutions within a financial market.

Financial institutions are supervised so as to maintain the stability of the financial system in the Czech Republic. Other top priorities include: support of development, discipline and competitiveness of financial institutions, prevention of crisis, protection of investors and clients and strengthening public credibility, in particular as regards the banking system, the credibility of which seems to be of vital importance to the entire system.

Banking regulation is a preventive measure consisting of the creation and enforcement of conditions, rules and limits for the activities of banking institutions.[21] Supervision of financial market institutions is not motivated by a desire to interfere in private-law relations between institutions and their clients, nor is it motivated by a wish to substitute the work of courts and criminal justice. It is not to be expected that supervision will prevent institutions from making some poor strategic or investment decisions. It cannot prevent the failure of an individual either. What it can do, though, is to regulate and examine the effectiveness and functionality of the governing and inspecting systems of financial institutions, for which are responsible the leading authorities in those financial institutions. There are a lot of demands placed on them regarding their professionality, expertise, and experience. The main function of supervision is to use its public-law bodies to intervene in case there are some imperfections—it can impose receivership or revoke the licence. Above all, it offers protection of the system of financial institutions and the financial market in its entirety as well as prevention of future failures or illegal conduct.

Supervision of a financial market and its institutions involves decisions about requests and granting licences, permissions, registrations and prior consents according to special legal norms, the inspection of rules observing in accordance with the issued licence or permission, the inspection of obedience to the law (to which the CNB is authorised through acts or special legal norms), the inspection of obedience to the regulations and orders issued by the CNB, the acquisition of information necessary for supervision and its subsequent enforcement, but also checking its

[21] MRKÝVKA, P., RADVAN, M. Veřejné bankovní právo In MRKÝVKA, P. et al. *Finanční právo a finanční správa,* 1st vol. Brno: Masarykova univerzita, 2004. p. 219.

credibility, completeness and topicality, the infliction of corrective measures and sanctions and procedures about administrative offences and misdemeanours.[22]

The supervision of credit institutions

The main task in this area is to supervise banks, savings banks and credit unions.[23] These operate in almost the same way as banks, although there are a few notable exceptions: they offer their services to their members only and their mandatory registered capital is only 35 million (unlike 500 million for banks). As far as rules are concerned, the supervisory ones are set in the same way.

It goes without saying that the stability and optimal working order of the banking sector, perceived as worthy of public trust, are the fundamentals of a healthy economy. Credit unions undoubtedly play an important role as well, but it is the banking sector whose role, from the point of view of the whole system, is absolutely crucial.

Having been granted legal authorisation[24], the CNB issues regulations and public notices that state the conditions on which licences can be obtained and they also set prudential rules in the individual sectors of credit institutions' enterprise.

Banking regulation is generally focused on the maintenance of financial market stability; that is why it is clear that supervision of this specific area constitutes the very basis of supervision of the entire financial market—credit institutions, banks in particular, are in fact the most important institutions where finances are cumulated and redistributed. Any collapse of an individual bank can seriously destabilise the entire financial system—not only because banks (as credit institutions) manipulate large sums of money, but also because banks often influence other areas of financial markets, above all that of the capital market.

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[22] CNB. Dohled nad úvěrovými institucemi. Online [qtd. 2nd June 2017]. Available at https://www.cnb.cz/cs/dohled_financni_trh/vykon_dohledu/postaveni_dohledu/uverove_instituce/index.html.

[23].The scope of banking activities is regulated by Act no. 21/1995 Coll. on banks as amended. The scope of credit unions is based on Act no. 87/1995 Coll. on savings and credit unions and some other regulations connected with it, as amended.

[24] CNB. Dohled nad úvěrovými institucemi. Online [qtd. 2nd June 2017]. Available at https://www.cnb.cz/cs/dohled_financni_trh/vykon_dohledu/postaveni_dohledu/uverove_instituce/index.html.

Capital market supervision

Service providers and their enterprise in capital markets are supervised by the designated part of financial market supervision. Namely these are institutions that arrange capital market trading[25] and the ones specialised in collective investment[26]. Legal authorisation gives the CNB the authority to issue public notices that specify conditions allowing entrance to the capital market, prudential rules, codes of conduct with investors and client, and last but not least, the rules of market transparency.

I firmly believe that from the point of view of the whole system this part of financial market, along with credit institutions and supervision of insurance companies, is the most significant for the overall economic stability. However, in comparison with banking institutions the danger of failure or just a drop is not of such importance, which can be demonstrated by contrasting the regulation of a bank and a trader in securities, as the main figure in the capital market. Unlike banks, traders in securities do not play such a crucial role especially because of their relative unimportance in payments. An imminent bankruptcy of a trader does not pose a major threat to the entire system of finances.[27] Moreover, funds (money and investment instruments) which have been entrusted to a trader are still in the customer's possession and are kept separate from the trader's possessions; there is no such separation as far as banks are concerned. Traders with securities are also in possession of liquid assets, so if there happen to emerge some financial difficulties, they can sell the assets at the current market value.

There is, however, one feature common to both credit institutions supervision and capital market supervision, namely the fact that the role of supervisory and regulatory activities should be preventive (forbidding entrance where necessary and issuing prudential rules) with the aim of minimising the danger of bankruptcy.

Supervision in insurance

In this area supervision is focused on the activities of insurance and reinsurance[28] companies, insurance dealers, and also insurance adjustors. [29]

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[25] Regulated in particular by Act no. 256/2005 Coll. on capital market enterprise, as amended.

[26] Regulated by Act no. 240/2014 Coll. on investment companies and trusts, as amended.

[27] MAYER, C. The Regulation of Financial Services: Lessons for the UK for 1992, in DERMINE, J., ed *European Banking in the 1990s*, Oxford: 1993. pp. 41-61.

[28] Act no. 277/2009 Coll. on insurance, as amended.

The main institutions under supervision here are insurance and reinsurance companies, but supervision applies, of course, to individual dealers and adjustors as well. The supervisory authority checks whether all legal obligations are fulfilled, prudential rules are observed and whether the body is provided with all the information it demands.

Supervision of pension institutions and pension funds

Credibility and stability of the pension scheme is one of the prerequisites for the well-being of every society, and economy as well, naturally. There is supervision of pension funds[30], pension institutions[31] operating transformation, participation and retirement funds, and foreign institutions operating employment pension schemes.[32] Legal regulation in this area concerns primarily pension schemes and supplementary pension insurance, retirement savings, supplementary and employment pension savings. The CNB acts in accordance with the law on capital market supervision.[33]

Supervision over payment and electronic money institutions

The CNB performs supervision of the activities of payment and electronic money institutions as well as the activities of small-scale electronic money issuers and small-scale payment service providers. Typically, supervision is carried out by means of regulations[34] and public notices which stipulate the conditions of entrance and prudential rules for the range of institutions within the field.

Supervision over exchange offices

From the macro-economic point of view, exchange offices do not pose a significant threat to the system; hence the main objective is to strengthen the credibility and safety of exchange-office services, for example via

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[29] Act no. 38/2004 Coll. on insurance dealers and insurance adjustors, as amended.
[30]According to Act no. 42/1994 Coll. on supplementary insurance with contribution from the state and on amendments to acts linked with its implementation
[31] According to Act no. 426/2011 Coll. on pension savings, and Act no. 427/2011 Coll. on supplementary pension savings
[32] Rules introduced for employment funds according to Act no. 340/2006 Coll. on employment pension schemes, which thanks to the orders from the EU enables foreign employment pension schemes to operate in the Czech Republic.
[33] Act no. 15/1998 Coll. on capital market supervision and on amendments to other acts.
[34] Under Act no. 284/2009 Coll. on payments.

complete transparency of exchange rates. More importantly though, exchange offices are often used to legalise proceeds of crime; consequently they are under considerable supervisory attention, because these activities are of interest not only from the perspective of economy and financial law, but also criminal law.

Exchange offices, provided they are not credit institutions, can only be run by legal or natural persons registered at the CNB. As far as supervision is concerned, part of the process is to make sure that officers abide by the demand for information when serving clients. It is thus vital that clients have all the available information when doing business with exchange offices.

The activity of the CNB is, to a certain extent, restricted[35] to declaring public notices in which there are registration forms to exchange-office activities and also the contents of supplements.

Financial market supervision within the system of law - summary

Financial market supervision has its firm place not only within the system of financial law but in the entire legal system of the Czech Republic, and, indeed, globally as part of financial market law. I am convinced that to integrate supervision into the system of financial law (and financial market law) is logical and hardly to be disputed; equally, it makes it possible to stabilise the economic system by means of supervising the institutions active in the financial market, their entrance to the market and their activities there, but also by means of increasing the credibility of the financial market (and its individual segments) in the public eye.

The financial market is an area into which enter not only a high number of financial institutions, but also members of the public (equipped with varying degrees of professional knowledge): these include investors, individual savers or one-time participants. Therefore, any instability or frequent threats in the form of possible bankruptcies of some major institutions in the financial market could have devastating economic consequences for individuals and the whole system and its stability, too.

The classification of financial law may not appear standard in comparison with some other (older) legal disciplines, but it has long defended its independent position within the system of law thanks to its clear classification, its acceptance by the public and its possibilities to react to

[35] Under Act no. 219/1995 Coll. on foreign exchange law, as amended.

emerging public needs. The system of financial law is a necessary prerequisite for further academic exploration and for moving financial-law theory into practice, often with up-to-date modifications to ensure that current societal and economic demands are met. Supervision is firmly anchored in this system and it is hard to imagine that there should be any significant changes or shifts regarding its position in the system of financial law, which in turn enables its development and stabilisation, thereby strengthening not only the credibility of supervision itself, but also of the existence of financial law as an independent legal discipline.

Financial market

The financial market in almost all its areas (including that of the capital market in the form of money and capital) has developed rapidly in the past decade. The effects can be seen in the increasingly more and more interwoven web of national markets and the diminishing differences between individual financial sectors. Big financial groups' importance and influence has been on the increase and, in general, the world has witnessed international financial globalisation. This all called for gradual changes to financial supervision and its organisation. For example in the Czech Republic there used to be four supervisory authorities—conceivably too many for such a small financial market. [36]

The financial market is a system of relations, instruments, entities and institutions that enable the accumulation, distribution and allocation of temporarily available financial funds on the basis of supply and demand. The financial market makes it possible to redistribute available funds on a voluntary contractual basis.[37]

The financial market is primarily used to trade financial instruments, most notably securities and other entities. Most of the trade deals with financial instruments with a long payback period—more than a year. In this case we talk about the capital market. Scheffrin has it that the capital market is a

[36] It was a supervisory model divided into sectors—each sector took charge of a different segment of the financial market. The CNB was responsible for banks, the Commision for Securities for the capital market, the Ministry of Finance for insurance companies and pension funds, and the Office for Supervision over Credit Unions for savings and credit unions.

[37] KOTÁB, P., KARFÍKOVÁ, M, VONDRÁČKOVÁ, P. Základní finančněpravní instituty. In BAKEŠ, M. et al. Finanční právo, 6th rev. ed. Praha: C. H. Beck, 2012. p. 102.

market where money is provided for a period longer than one year.[38] Finances from the capital market are obtained with a view to financing long-term investments of trading companies, households but also governments. Typical financing instruments include long-term bonds, bank and consortium loans, mortgage loans and mortgage bonds. The capital market also makes use of equity securities (shares and profit participation certificates), which have basically no fixed payback date. Short-term markets are those financial markets where instruments have paybacks periods of days, months or the maximum of one year. Typical instruments include short-term securities, loans, credits and deposits to be paid back within one year, e.g. bills of exchange, short-term bonds, deposit certificates (deposit slips), interbank deposits, short-term bank deposits etc. Sheffrin[39] concludes that financial markets are used for short-term financing, sometimes for loans to be paid almost 'overnight'. Capital markets, on the other hand, are used for long-term financing, such as the purchase of shares or credits where the payback date is not expected in less than a year.

This is, indeed, the division proposed by Kotáb,[40] namely the division of financial market into the capital and money markets according to the character of traded instruments (financial claims) and the period of their validity. I consider money markets and capital markets parts of financial law, which is a view confirmed by Zucchi[41], who is convinced that the money market and the capital market are not the only branches of financial market, although they are the most important ones and the most frequently employed as well.[42]

It is extremely important to distinguish between securities and financial instruments, for these are most certainly not the same notions. Financial instruments are the most general types of assets which can be traded. Apart from securities financial instruments also include futures, forwards, swaps and other instruments, clearly different from securities.

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[38] SULLIVAN, A., SHEFFRIN S. M. *Economics: Principles in action*. Upper Saddle River, New Jersey: Pearson Prentice Hall, 2003. p. 283.

[39] SULLIVAN, A., SHEFFRIN S. M. *Economics: Principles in action*. Upper Saddle River, New Jersey: Pearson Prentice Hall, 2003. p. 283.

[40] KOTÁB, P., BAKEŠ M. Základní finančněpravní instituty. In BAKEŠ, M. et al. *Finanční právo*, 6th rev. ed. Praha: C. H. Beck, 2012. p. 103.

[41] ZUCCHI, K. Financial Markets: Capital Vs. Money Markets [online]. *Investopedia* [qtd. 14th November 2017]. Available at http://www.investopedia.com/articles/investing/052313/financial-markets-capital-vs-money-markets.asp.

[42] Financial markets often include other disciplines belonging to the financial sector, including those which are not directly connected with the acquisition of finances, e.g. the commodity market.

Financial markets consist of seven parts, for which I suggest the term 'the classification of financial market disciplines': [43]

- money market (including payments, electronic money and systems of payments)
- foreign exchange market
- banking and co-operative banking
- insurance and supplementary pension insurance
- capital market
- precious metals market (the legal discipline is usually called hallmarking).[44]

This classification has one disadvantage, namely the fact that there seems to be a big overlap with the content and classification of non-fiscal part of financial law (excluding currency law). As a result, there might arise a certain amount of confusion over what belongs to the financial market and what does to the non-fiscal part of financial law. This can be avoided if one reminds oneself of the diagram no. 1 above: it is clear that the non-fiscal part of financial law is a broader concept than the financial market, which is, in fact, its (i.e. the non-fiscal part of financial law) subset.

Classification of Šoltés and Kulhánek [45] offers an alternative view—it seems to be, in my opinion, a criteria-based classification:

- primary and secondary markets
- bond markets, stock markets, commodity markets, and foreign exchange markets
- spot markets and terminal markets
- national financial markets and international financial markets (further divided into foreign markets and euromarkets)

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[43] KYNCL, L. Sjednocení dozoru nad finančními trhy v rámci reformy veřejné správy. *In Sborník z konference Dny veřejného práva*, Právnická fakulta, Masarykova univerzita, 2007, pp. 1 - 8.

[44] Personally, I feel that a better label is 'commodity market' because I would include here also commodities which do not belong to precious metals.

[45] ŠOLTÉS, V., KULHÁNEK, L. Finanční trhy. In POLOUČEK, S. et al. *Peníze, banky, finanční trhy*. Praha: C.H.Beck, 2009. p. 210.

In primary financial markets there are traded primary issues of financial instruments whereas secondary markets trade financial instruments which have already been issued. The second group takes into account the nature of the instrument, which is being traded.[46] Kotáb[47] adds that the foremost function of primary markets is the acquisition of financial capital for new investment, while secondary markets focus on the sale of already-issued financial instruments where the main objective is to ensure liquidity for investors, i.e. to make it possible to convert financial instruments into liquid finances. The third group mentioned here is centred on the time elapsed; it distinguishes between spot markets (business is realised within several days after it is sealed[48]) and terminal markets[49] (the day of realisation, including the derivatives, is put back to a stated date in the future). The concept of the national financial market is, of course, a relative one: for entities based in the Czech Republic the national market is the Czech one while all the others are, naturally, foreign markets. International financial markets in the currency valid for the given state are foreign markets whereas international financial markets in a foreign currency (from the point of view of the country in which the market is based) are euromarkets. [50]

From the above-mentioned classifications I prefer the discipline-based one, even though it is, taken at face value, a carbon copy of the classification of the non-fiscal part of financial law (with the exception of currency law). This is discussed here in the chapter on the classification of supervision within the system of law. Nonetheless, this does not diminish, I believe, the plausibility of the classification, for it offers an accurate division of the financial market into individual subfields. One cannot deny the fact that the second classification is also valid but it focuses on criteria rather than disciplines, which (when applied) means that each discipline could appear—according to the selected criterion—in a number of groups.

I find the discipline-based classification of financial markets more appealing also because I deal with supervision of the entire financial market including some particularities in individual disciplines. Still, I offer

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[46] ŠOLTÉS, V., KULHÁNEK, L. Finanční trhy. In POLOUČEK, S. et al. *Peníze, banky, finanční trhy*. Praha: C.H.Beck, 2009. pp. 209 – 214.

[47] KOTÁB, P., BAKEŠ, M. Základní finančněpravní instituty. In BAKEŠ, M. et al. *Finanční právo*, 6th rev. ed. Praha: C. H. Beck, 2012. p. 104.

[48] For example, it is typically 3 working days for the SPAD business system at Prague Stock Exchange, plc.

[49] A specific example here could be the purchase of some shares with the delivery taking place in six months—the so-called forward transaction.

[50] KOTÁB, P. BAKEŠ, M. Základní finančněpravní instituty. In BAKEŠ, M. et al. *Finanční právo*, 6th rev. ed. Praha: C. H. Beck, 2012. pp. 214 - 215.

a further modification of the discipline-based classification to make it even more fitting:

- credit market (including banking and co-operative banking)
- capital market
- monetary market
- insurance market
- foreign exchange market
- commodity market

Banking and co-operative banking can be labelled as credit institutions since their common distinctive feature is the provision of credits (loans)—hence the collective name 'credit market'. The notion of banking also includes financial services provided by banks; unless these services (though provided by banks) belong to a different financial market discipline. The basic banking activity is the accumulation of temporarily available finances of the depositors; these finances are then made available again in the form of loans. This enables the flow of money in economy and the amount of temporarily available finances in circulation is multiplied.[51] Co-operative banking is realised via credit unions—they differ from banks in the legal form (credit unions may only be founded in the form of a society), the amount of the required basic capital (CZK 35 million as opposed to CZK 500 million for banks), and the range of clients for whom credit unions may offer their services (members only). In all other respects, especially as far as prudential enterprise rules are concerned, credit unions need to meet the same requirements as banks.[52] For this activity it is, of course, necessary to possess a licence issued by the relevant state authority.

The capital market is a place where the capital is traded by means of securities and their derivatives. One can say it is a subset of the financial market.[53] Out of all financial market disciplines the capital market is the most interesting for this book and its main topic (supervisory integration)

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[51] Wikipedia.org, Banka [online]. Wikipedia [qtd. 14th November 2014]. Available at http://cs.wikipedia.org/wiki/Banka#cite_note-1.

[52] CNB. Dohled nad úvěrovými institucemi [online]. CNB [qtd. 14th November 2014]. Available at https://www.cnb.cz/cs/dohled_financni_trh/vykon_dohledu/postaveni_dohledu/uverove_instituce/index.html.

[53] Wikipedia.org. [qtd. 23rd May 2017]. Available at http://cs.wikipedia.org/wiki/Kapit%C3%A1lov%C3%BD_trh.

because the capital market's basis is the transfer of money (in the form of issues) and the purchase of securities from subjects in surplus (investors, often as consumers) to subjects in deficit (issuers—those who issue securities). The capital market is part of the financial market in every country. There are two types of capital markets, namely regulated and unregulated ones. Regulated markets are mainly stock markets (in the Czech Republic it is the Prague Stock Exchange, plc. and RM- System Czech Stock Exchange, plc.). The majority of European capital cities and developed countries have their own regulated market, chiefly in the form of a stock exchange. Unregulated markets trade with securities and other financial instruments; however, they are not regulated (e.g. multilateral commercial systems which can only be run if certain conditions set by the state are met).

Despite being interconnected, these two parts of the financial market must be kept apart since they perform different activities and they behave in a different way when it comes to handling finances.

In the past, highly developed and dynamic capital markets often brought about financial innovations and newly-emerged segments of the market, with which countries had to deal by means of regulation and supervision. Owing to the considerable administrative burden and the sheer complexity of the task, the problem used to be solved by establishing a new institution that took care of those new supervisory and regulatory duties. Thus, a range of specialised institutions gradually emerged, each of which only took care of a certain part of regulation and supervision. It was impossible for it to cover the entire spectrum. Even though this specialisation enabled closer inspection of the securities market, it, of course, also led to a gradual loss of the overall view. This happened for instance in Great Britain or the USA.[54]

The notion of monetary market was discussed above when I talked about the differences between monetary and capital markets. These financial market disciplines are, to my mind, the most dynamic disciplines and their supervision is, therefore, subject to constant changes and modifications which attempt to react to the current situation in the world, both politically and economically speaking.

The insurance market is supposed to secure the most important values (like health or life) often threatened by a number of external factors. Insurance helps to minimise the risks of both economic and non-economic

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[54] PAVLÁT, V. Regulace a dozor nad finančními trhy ve světě: současný stav a výhled do budoucna. In *Sborník z mezinárodní konference Regulace a dozor nad finančními trhy*. Praha: Vysoká škola finanční a správní 2003. p. 17.

activities. There are specialised institutions which offer insurance services, for which they need a licence issued by the state authority; these institutions are called insurance companies.

The foreign exchange market is a market where foreign currencies are traded in a cashless way. Money only figures here in the form of deposits on foreign currency accounts. The foreign currency market, on the other hand, is a market where foreign currencies are traded in cash. An ordinary foreign exchange office is an example of the clients' form of the foreign currency market. Anybody willing to enter the business may do so without any restrictions.[55] Foreign exchange markets are the sphere of activity for dealers (who are end consumers), brokers (who arrange deals for others; particularly if the dealer in the transaction wishes to remain anonymous), and market makers. A market maker is a dealer who on a working day has the obligation of revealing (on request) the foreign exchange rates. It is a person who seals business with dealers; thus they are, as a matter of fact, foreign exchange officers in a cashless form. The same role of a market maker in a foreign currency market is performed by a foreign exchange officer, who exchanges cash. Regulation and supervision in this area is carried out over both the foreign exchange and foreign currency markets. Any activity can only be performed if one possesses a licence issued by the given state authority.

The commodity market enables the purchase and sale of commodities. The principle operating here is the very same as the one in the capital and monetary markets, but the subjects of transactions are, needless to say, commodities. Commodities are goods which are traded in the market regardless of quality. The supplies from various suppliers are mutually replaceable. Thus, cars cannot be called a commodity, because they are made in many versions at different prices. By contrast, copper is a homogenous product which can be traded at a unified price at global markets. [56]

The overview of financial market disciplines above discussed the characteristic features of the disciplines themselves—the segments and their subjects which operate there. When assessing the importance of the financial market and its segments' influence on the economic situation, I would like to express my conviction that they affect society and economy

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[55] MIKOLÁŠOVÁ M. Co je to devizový trh a jak vlastně funguje? [online]. Dům financí [cit. 14th November 2017]. Available at http://dumfinanci.cz/clanky/48-co-je-to-devizovy-trh-a-jak-vlastne-funguje.

[56] Wikipedia.org, Komodita [online]. Wikipedia [qtd. 14th November 2014]. Available at http://cs.wikipedia.org/wiki/Komodita.

enormously; that is why their proper working order and their correct setting play a key role in achieving economic stability and prosperity. Given the fact that the workings of the financial market (and its segments) are not merely customary—the financial market is regulated, i.e. it is delimited by legal norms and then through legal norms supervision is carried out over its activities—it is therefore crucial to set the 'rules of the game' and to anchor them in the system of law. In practice, it means delimiting regulation (the rules for entrance into the market and the code of behaviour there as well as the subsequent application of supervision and inspection). All segments of the financial market have existed for some time; they keep developing and so do regulatory and supervisory mechanisms. The very fact that individual segments have evolved, separated and, to a certain degree, standardised in various forms (in particular as part of legal norms) to be later accepted by society is a relevant justification of the existence of regulation and supervision of the financial market. If the financial market existed without regulation and supervision, it would be nothing more than a mere chaotic grouping of entities and their activities without proper rules; this would, no doubt, result in a system of total economic instability.

Financial market regulation and supervision

It seems apposite now to define properly the notions of regulation and supervision, including the related terms control and inspection. While regulation is an independent term, control, inspection and supervision are intertwined and, to all intents and purposes, basically synonymous. Control is a generic term for 'making sure that the law is observed' and it comprises both supervision and inspection. Inspection refers to a monitoring activity carried out by the state; it makes sure that entities abide by generally binding orders, internal orders, and individual acts towards entities under control. Supervision refers to the same activity; however, crucially, this activity is not performed by the state but by a delegated authority independent of the state (in the Czech Republic it is the Czech National Bank). In this book I use the term supervision in this sense: it is not an activity carried out by the state, but by an independent supervisory authority.

The meaning of the words regulation and supervision implies that regulation is a legal framework stipulated in a legislative process. This framework regulates financial market rules for all the entities involved so as to reach the objectives of regulation (discussed below).

Supervision is one of the subsets of regulation; or rather, it is one of the manifestations of regulation—supervision is always determined by regulation. More specifically, supervision entails the monitoring of the regulatory process and its results as well as the monitoring of processes and activities of financial market entities in accordance with legal norms and with defined conditions for lawful conduct in the financial market. To put it simply, supervision is control delegated to another authority. What is interesting is the fact that supervision displays some regulatory aspects. We could say that it is secondary regulation, i.e. regulation by means of secondary[57] (subordinate) legislative norms as opposed to primary (legal) legislative norms. It needs to be admitted that this secondary regulation is for the majority of financial market entities closer, more detailed and also more important for everyday business.

The crucial thing for this book is financial market supervision, which also integrates the subordinate financial market regulation within the borders set by legislation. The relation between regulation and supervision is determined by their common objectives and purposes. This is hardly any ground-breaking observation because regulation and supervision necessarily must share the direction and goals. Regulation makes supervision and it also delimits the way for supervision entrusting it its powers and authority with a view to reaching the goals in mutual cooperation as well as independently.

Pavlát[58] adds that regulation in the financial sector is usually understood as the creation of principles and rules for entities active in the sector. Regulation is legal in its character and it regulates economic processes taking place in the financial sector. In other words, it issues legal norms which help the regulatory authority to exert its influence on the financial sector. Part of the activity of the regulatory authority is also supervision of supervised entities.

At the moment the main focus of regulation is placed on the preventive approach; the regulatory authority warns against potential threats and consequences if legal norms[59] were not observed. In fact, the regulatory authority stipulates a range of conditions and obligations to be met at the very entrance of an entity into the financial market. Then, there are a number of conditions regarding compulsory administrative steps and

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[57] Public notices, measures, directives, guidance notes etc.

[58] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 18.

[59] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 20.

registration processes, which need to be observed constantly while doing business in the financial market. The regulatory and supervisory authority prevents potential prosecution and any potential greater financial losses connected with acts of non-compliance with the legal norms. The preventive approach unavoidably requires a higher amount of administrative work and more time and higher financial demands, both on the part of the regulatory authority and the regulated entities; yet, this approach seems to be beneficial as far as the entire system is concerned, for problems are prevented and their occurrence in the form of bankruptcies is far less common.

1. Reasons for regulation and supervision

The very nature of the financial market has always called for regulation and supervision. In my view, every honest financial market participant welcomes the existence of certain rules to ensure protection against dishonest conduct in the financial market. Every human activity involving more people requires some rules to be observed so that each individual has the same (or comparable) options and conditions; this absolutely holds true for financial activities like the ones going on in the financial market.

The basic protection from crime and illegal activities in the financial market has always been entrusted to the state authority; however, some rules created (and they still do) certain self-governing associations ensuring that ethical standards are maintained and that financial market enterprise is secure. This self-regulation always strengthened whenever there were periods of weakened (or not detailed enough) state protection.

Llewellyn[60] mentions a few very interesting reasons why financial markets should be regulated:

a) potential threats to the system in connection with externalities (certain forms of market failures).

b) correction of certain imperfections and market failures.

c) the need to monitor financial institutions and economies of scale existing in this area.

d) the need for a certain degree of consumer confidence, which is also a positive externality.

[60] LLEWELLYN, D. The Economic Rationale for Financial Regulation, *Occasional Paper No.1*. London: Financial Services Authority. 1999.

e) the space for 'Grid Lock'[61] together with problems of negative choice and moral hazard.

f) Moral hazard connected with the displayed governmental preferences to create security networks such as lender of last resort, the systems of deposit insurance, compensation funds, other compensation schemes.

g) The consumer's interest in regulation as a way of increasing confidence and ensuring lower transactional costs.

One of the chief incentives for higher regulation and supervision is the economic interest of participants—they desire a problem-free environment. This desire has only increased in the past decades due to the growth of capitalism. There is no way to ensure the right working order for the financial market without a certain amount of regulation and supervision. In economically developed areas financial markets play an important role in sustaining proper economic growth, which is ensured by an effective financial market creating suitable conditions for making profit and for macroeconomic prosperity, too.

Benston[62] is of a different opinion though: he claims that regulation is only beneficial for those institutions for which it was created: namely governments, legislative bodies and regulated financial institutions. According to him, regulation is in direct opposition to consumer interests and financial institutions are the main beneficiaries because they face less competition due to a much more difficult entrance into the market.

That is why experts often distinguish between: a/ the objectives of regulation (what the objectives of regulation are), b/ the justification for regulation as such (why regulation is necessary to achieve the objectives),

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[61] SLAVÍČEK, Ján. *Porovnanie dohľadu finančného trhu v Českej a Slovenskej republike*. Praha, 2005. 100 p. Diplomová práce. Univerzita Karlova v Praze, Fakulta sociálních věd. Grid Lock is understood by Jiří Havel, the supervisor of this work, as follows: financial institutions know how to behave towards consumers, but if the time span for a decision is short, then they are more likely to accept a more hazardous strategy, since, in the short term it is more beneficial. Even if one of the institutions were inclined to accept a long-term strategy, it would face serious problems because its competitors will probably opt for a short-term strategy. So even a 'good' financial institution will behave 'badly' under such circumstances—it is quite rational and the potential loss connected with the selected strategy will probably be covered by consumers.

[62] BENSTON, G. J., Regulating Financial Markets. A Critique and Some Proposals, *Hobart Paper No.135*, London: Institute of Economic Affairs, 1998.

and c/ reasons for regulation (why regulation is put into practice). [63] In the broadest sense I put forward the following division of reasons for the existence of regulation and supervision: reasons connected with internal and external protection.

External protection refers to society and the systemic (macroeconomic) protection of the financial market against crime and other negative effects of externalities, which is undoubtedly very much in the public interest. Externalities are activities which positively or negatively influence other entities, while these entities do not pay for them and are not compensated for their consequences, i.e. they are not reflected in the pricing mechanism. A classic example of an externality is air pollution. The state attempts to minimise the negative effects of externalities, which of course requires expenses[64]. Other important externalities include, for example, insufficient awareness, information asymmetry etc.

It is often mentioned in academic literature[65] that negative externalities often include instability of banks and the so-called bank runs[66], which result in great instability in the whole banking sector.

Internal protection refers to protection of entities in the financial market—mainly consumers/investors. The aim is regulation of the power of oligopoly and monopoly (imperfect competition).

The most pressing financial market problems (which appear to justify the motivation for high quality regulation and supervision) are financial crime (within the external protection of the financial market) and information asymmetry (the main 'Achilles heel' of consumers/investors within the internal protection of the financial market).

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[63] LLEWELLYN, D. The Economic Rationale for Financial Regulation, *Occasional Paper No.1*. London: Financial Services Authority. 1999.

[64] Cf. PAVLÁT, V Regulace a dozor nad finančními trhy ve světě: současný stav a výhled do budoucna. In *Sborník z mezinárodní konference Regulace a dozor nad finančními trhy*. Praha: Vysoká škola finanční a správní 2003. p. 13.

[65] Cf. DOCKING, D.S. et al. Information and Contagion Effects of Bank Loan-Loss Reserve Announcements, Journal of Financial Economics, 43(2), February 1997, pp. 219-240 nebo SCHÖNMAKER, D. Contagion Risk in Banking, *LSE Financial Markets Group Discussion Paper*, no. 239, London: London School of Economics, March 1996.

[66] Cf. ROTHBARD, M. *Peníze v rukou státu*. Praha: Liberální institut, 2001. p. 55 : Bank run is a situation in which customers lose confidence in the bank because they think it might be or shortly will become insolvent. As a result, they start to withdraw their money from their deposit accounts. If the bank run is caused by incorrect information, it may result in bankruptcies of even problem-free banks, because a bank with partial reserves can never pay out all the deposits.

Naturally, financial crime does not concern just financial markets; it is a problem of the whole system of economy. The most common instances are tax evasion, financial frauds and other unlawful manipulation (e.g. credit frauds, the infringement of prudential enterprise rules, traders with securities often fail to observe the best execution rule—they do not always act in the best interest of their customer), money laundering etc.

Moral hazard

Moral hazard is one of the reasons for regulation and supervision as part of internal protection of the financial market. It is hard to find an exact definition of the term; the Czech Dictionary of Foreign Words[67] states that moral hazard is a danger that someone might behave in an immoral way and jeopardise other people's interests if there is no threat of punishment for their misconduct. In this book moral hazard is linked with various compensation schemes that operate in the financial market—they provide some kind of psychological comfort in cases of unsuccessful investment. Compensation schemes may reduce the loss partially or even totally. Since investment is insured (for instance deposit insurance funds within credit institutions), financial institutions and consumers may venture into more risky business, which is something they perhaps would not undertake if there were no insurance. Expenses are thus shared out among other consumers because compensation schemes are financed by all financial market participants; though, of course, only those who take more risks benefit from the schemes. Moreover, if the risky investment comes off, the investor receives all the profit, whereas other participants remain empty-handed. The objective of regulation here is prevention of compensation schemes abuse by consumers or financial institutions.

The issue of information in the financial market

It seems that a lack of information on the part of consumers and information asymmetry in the financial market are things that have always existed and always will exist. Insufficient information influences the decision-making process by not enabling a full appreciation of the deal with all its benefits but potential risks, too. Information asymmetry displays differences in the amount of information between a financial service provider and a consumer—the latter is always worse off.

[67] Slovník cizích slov [online]. Slovnik-cizich-slov.abz.cz. [qtd. 20th October 2017]. Available at http://slovnik-cizich-slov.abz.cz/web.php/slovo/moralni-hazard.

It is inconceivable that financial markets could exist without information, so whoever possesses high quality information always gains significant advantage. Naturally, the crucial matters are the following ones: where the given piece of information is from, how it is spread and, above all, interpreted, and what steps are taken on the basis of the available information. Information is essential for basically all financial market activities and if the amount of information is uneven, it creates one of the most fundamental barriers to an ideal working order of the financial market. It goes without saying that not all financial market participants have equal access to information (or the same quality of information), therefore it is not a new thing to trade with information, the acquisition of which may prove to be relatively costly. I propound the idea that there are three types of information:

- public information (accessible to the general public)
- private information
- secret information

As far as the first type is concerned, this information is accessible through the media, in particular the internet, and it is usually free of charge. The range of information now publicly available has dramatically increased thanks to the advancement of technology (the internet). Public information nevertheless represents only a fraction of all the information relevant to decision-making processes in the financial market.

Private information originates in private entities and it may be promulgated by means of advertising, promotion, mandatorily publicised information etc. It may also be available to only a certain group of people or to individuals; such information may be labelled internal.

A certain part of non-public information is information protected by the state (it is secret), the rest is information not secret from the point of view of public protection; they are, however, secret due to private protection.

As it has been said, it is vital to have high quality information at one's disposal during negotiating transactions in the financial market. Regulatory and supervisory bodies attempt to minimise insufficient awareness and information asymmetry. In other words, they try to make sure that the highest possible number of participants has the same information (or the same access to relevant information). That is why financial institutions are required to provide their clients with the widest possible range of information not only about the financial market itself, but also about

various products that can be purchased there. Llewellyn[68] points out, however, that no range of provided information can do away with information asymmetry when a particular financial service is being purchased.

Other goals that supervisory bodies pursue are the prevention of misuse of internal information (i.e. information not available to all participants) and subsequent sanctioning if any misuse occurs. In this way, the supervisory body helps to maintain equal opportunities for all financial market participants.

2. *The objectives of regulation and supervision*

Pavlát[69] asserts that the main objective of financial market regulation and supervision is the protection of investors and, at the same time, the maintenance of a perfectly working financial market.

The International Organisation of Securities Commisions (IOSCO) ranks regulatory and supervisory objectives as follows: 1/ the protection of investors, 2/ the provision of fairness, effectiveness, and transparency of the markets, 3/ the reduction of systemic risks. [70]

Di Giorgio[71] also specifies three regulatory and supervisory objectives. According to him, these include:

- The attainment of macroeconomic stability.
- The attainment of microstability of financial institutions (prudential supervision)—this objective can be divided into two smaller parts, namely a/ general rules that help to maintain the stability of financial institutions and their entrepreneurial activities[72] and b/ more specific

[68] LLEWELLYN, D. The Economic Rationale for Financial Regulation, *Occasional Paper No.1*. London: Financial Services Authority. 1999.

[69] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 32.

[70] DELESPAUL, J. C. Accountability and Transparency . In *Chalanges for the Unified Financial Supervision in the new millennium conference*. Talin: 2001. s.1. nebo také IOSCO. *Objectives and Principles of Securities Regulation*. 2003. p. 2.

[71] DI GIORGIO, G. et. DI NOIA, C.. ‚Financial Market Regulation And Supervision: How Many Peaks For The Euro Area. In *Brooklyn Journal of International Law 28*. Hanover, Pennsylvania: Sheridan Press, 2003. p. 469.

[72] For example through law-enforced capital management requirements, loan limits, integrity demands etc.

rules that take into account the particularities of financial service provision. [73]

- The transparency of financial markets and financial institutions, which results in a higher protection of investors/consumers. There are rules to deal with information asymmetry and some more general rules for enterprise management, for example equal treatment of clients.
- The effectiveness of supervision aimed to enforce financial market competition.[74]

According to Kubíček, the primary goal of supervision and regulation is the maintenance and further growth of a perfectly working financial market in all its specific types and forms so that it can fulfil its main role. The role can be, in a rather simplified way, defined like this: 'top effectiveness in the reallocation of the maximal amount of temporarily available funds so that at the right time, in the right amount, at the right place and in the right hands they are able to guarantee maximal appreciation and then the return to their original owner with a prearranged or usual appreciation'. [75]

Jílek[76] adds that regulation and supervision aim to restrict problems and bankruptcies of financial institutions and to protect their ordinary clients.

I would now like to express my dissatisfaction with one of the objectives stated by Di Giorgio, namely with 'the effectiveness of supervision aimed to enforce competition in the financial market'. I can only half agree with this objective. While it is indisputably necessary to avoid the existence of cartels and the abuse of one's dominant position, the enforcement of competition could imply excessive liberalisation, which could well prove to be rather harmful. I would suggest a more suitable wording: the attempt to maintain and secure healthy competition. The other objectives mentioned by Kubíček and Di Giorgio are well-defined and topical, too.

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[73] For example the ratio between the risk and the capital, the reduction of portfolio investment, the regulation of off-balance sheet activities, the management of deposit insurance or the compensation schemes for investors.

[74] To be achieved by means of inspection of market force and structure of financial institutions and, also, at the micro level by inspection of mergers and acquisitions, the avoidance of cartels and abuse of a dominant position.

[75] KUBÍČEK, A. Regulace a dozor nad finančními trhy – rozcestí, scestí nebo ještě něco jiného? In *Sborník z mezinárodní konference Regulace a dozor nad finančními trhy*. Praha: Vysoká škola finanční a správní 2003. p. 27.

[76] JÍLEK, J. Finanční trhy a investování. Praha: Grada Publishing, 2009. p. 137.

I am convinced that the most basic objective, to which other objectives lead, is the maintenance and strengthening of a stable financial system as the foundation of a healthy economy not only in every country but also in the international economic system. To put it another way, the objective aims to achieve macroeconomic stability, as described by Di Giorgio. As I have already stated above, the financial market and its segments play a crucial role in the system; it is therefore equally important to achieve, thanks to financial market regulation and supervision (the segments included), the right setting of rules, restrictions and options connected with regulation and supervision whilst maintaining the freedom of enterprise and healthy competition. It is thus important to strike the balance: what seems desirable is effective regulation and supervision, not over-regulation and excessive supervision which hinder economic prosperity and the stability of financial market entities, thereby adversely affecting the stability of the system at the macroeconomic level as well.

3. *The content of regulation and supervision*

As has been suggested above, regulation and supervision entail several individual phases, which can be called the system of regulation and supervision.

The basis is a sum of conditions and rules that must be met and observed to be granted permission to enter the financial market. The basic rules are the same (or very similar) for all financial market segments[77]; there are nonetheless also some rules specific to individual segments. These rules are characteristic in so far as they anchor fundamental conditions for the establishment of a financial market institution and for its termination, too. Another set of rules govern existing institutions and their activities and behaviour in the financial market.[78]

It seems to me that while the set of entrance rules is more or less standardised and is not subject to change in time, the other set (for existing institutions) is under constant revision with the aim of long-term harmonisation at both the European and the global levels. These rules for prudential enterprise aim to stabilise financial institutions and to protect clients/consumers from the risks and dangers in the financial market. Furthermore, they protect the entire system, which could be jeopardised (or at least weakened) in case more institutions suffer from serious problems.

[77] Banking, the capital market, insurance, credit institutions and credit unions.
[78] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 20.

Supervision in this area helps to create the environment in which rules and prudential enterprise conditions are observed, thereby increasing the effectiveness of the financial market. Supervision does not apply only to entrepreneurial activities as such but also to products offered at the market and the ways these products are advertised; it also inspects the types of contracts, the risks involved (entrepreneurial as well as investment risks), the observation of payment rules etc.

Banks often serve as an example of how the system of supervision and regulation works in practice. There are four basic areas.

Pavlát[79] distinguishes the following areas: entrance into the banking sector, basic rules of banking activities, mandatory deposit insurance, and the role of the central bank as the lender of the last resort. Jurošková[80] asserts that the four areas include: entrance into the banking sector, basic rules for banking activities, control and enforcement of rules observation, and the financial safety network.

The two systems are similar; the only differences we can find lie in the last two areas. The two areas, labelled by Pavlát as mandatory deposit insurance and the role of the central bank as the lender of the last resort, are lumped together by Jurošková, for whom one term suffices (the financial safety network) and who then recognises one more category: control and enforcement of rules observation. I find this enlargement by one area of the system very fitting because conditions anchored in the legal system are insufficient if there are no mechanisms of their enforcement, control and supervision with possible sanctions for those who fail to comply. This area completes the system, for it is this area that enables off-location and on-location supervision[81], and in case of a breach of rules[82], sanctions may be imposed.

Given the fact that regulation and supervision are generally accepted without objections, the main point of interest seems to be their scope and extent. Firstly, it is important to set ideally the scope of activities under regulation and supervision and secondly, it is equally important to set the scope of regulation and supervision of the selected activities. The scope of regulation is influenced by a number of aspects such as its place, historical development and habitual practice, the level of economic advancement etc.

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[79] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 20.

[80] JUROŠKOVÁ, L. *Bankovní regulace a dohled*. 1. vyd. Praha: Auditorium, 2012. p. 21.

[81] Cf. from § 26 to § 35 Act no. 21/1992 Coll. on banks, as amended.

[82] Cf. § 26 Act no. 21/1992 Coll. on banks, as amended, where failures in banking activities are dealt with.

Regulatory and supervisory objectives, as analysed above, seem to be universal; thus, the systems of regulation and supervision differ mainly in their structures—the numbers, powers and methods of application.

Individual segments of the financial market have evolved separately for a long time. Mutual relations emerged gradually, often in connection with failures, breakdowns of market mechanisms, unfavourable circumstances etc. The need for quicker and better reactions to problems which had originated in various segments revealed the necessity to opt for a more integral approach to financial market supervision. One example of its manifestations have been (and still are) changes to the structure of the system and to the institutional fixation of regulatory and supervisory bodies[83]. The past few decades have seen a vast amount of integration of supervision—regulatory and supervisory powers over the entire financial market have been integrated into one body or several closely-knit bodies. Gradually, individual financial market segments displayed more and more common features and their mutual relations got revealed. It most certainly does not suffice to merely enumerate reasons for financial market supervision and to state its advantages and disadvantages; it is also vital to highlight differences between various approaches and to discuss the results achieved in those countries which have undergone the process of integration.

The tenets of financial market regulation and supervision

Tenets are academic postulates that create a model for the area of public finance and the relations that constitute the subject matter of financial law. Postulates accepted by legislation become legal norms, which govern all the other norms. [84]

Tenets are sometimes mixed up with principles and both expressions are sometimes perceived as synonyms[85]; other times the notion of principle seems to be broader—it refers to more general ideas which apply to the whole system of law. Although the terminological difference does not appear to be enormous, I would like to stress that I use the term tenets (and

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[83] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 23.

[84] MRKÝVKA, P. PAŘÍZKOVÁ, I. RADVAN, M. et al. *Finanční právo a finanční správa*. 1st ed. Brno: Masarykova univerzita, 2004. p. 46.

[85] Tenets and principles are treated as synonyms e.g. in HURDÍK, J. *Zásady soukromého práva*. Brno: Pr.F.MU,1998, p. 11.

not principles) here since this expression is more fitting for more specific rules of behaviour typical of individual segments of the financial market, to which financial market law belongs. Admittedly, some tenets sometimes exceed the field of financial market and can be valid in a more general sense. Yet, principles are broader still, as they are valid for the entire legal system or for public/private law.

All tenets are determined by from the goals to be achieved. The goals of financial market supervision and regulation have been discussed above—we could sum up that the primary goals are growth of the financial market and increase in its effectiveness. This can be attained by means of stability and security of the financial system and its individual institutions as well as by market transparency and its right working order. It is now apposite to explain what tenets actually are and what their roles are in the system of financial law.

The tenets of regulation can be seen either as general tenets (those of the regulator/legislator) or tenets in a wider sense (those of the regulatory and supervisory authority). In the Czech Republic this authority is the Czech National Bank (from now on just the CNB).

The International Organisation of Securities Commisions (IOSCO)[86] has stated crucial regulatory and supervisory tenets with regard to the proclaimed objectives. These tenets might be specific for a particular segment of the financial market, but they also reflect more general tenets valid for the entire financial market. The tenets include:

- tenets connected with the regulator
- tenets for self-regulation
- tenets for enforced regulation
- tenets for co-operative regulation
- tenets for financial institutions offering financial products
- tenets for collective investment schemes
- tenets for investment brokers and tenets for the secondary market[87]

[86] IOSCO. *Objectives and Principles of Securities Regulation*. 2003. pp. 2-4.

[87] Secondary markets are those markets where issued financial instruments are traded, e.g. shares, options or futures.

1. General tenets

One could say that general tenets are those tenets that have their roots in international standards; they should contribute towards the creation of a general legal framework aimed to achieve the objectives of regulation and supervision. Tenets that the regulatory and supervisory authority should follow are more or less their specification.

Internationally, general tenets of regulation and supervision are set by means of various recommendations in the preambles of European directives and decrees. The most important documents were drawn up by the Basel Committee on Banking Supervision, in particular the Core Principles for Effective Banking Supervision (issued in 1997[88]) and the Core Principles Methodology (published two years later in 1999), which revises the original text. In spite of the fact that the materials deal with regulation and supervision in the banking sector, the majority of principles and tenets is valid for the regulation of and supervision over the whole financial market.

These two documents contain 25 principles globally agreed upon as the minimum standards for banking regulation and supervision. They cover a whole range of aspects such as powers and objectives of the supervisory authority, permitted activities, licencing criteria, consent to a change of ownership and to large-scale acquisitions, capital adequacy, risk management, consolidated supervision, problem tackling in the banking sector, distribution of tasks and responsibility between local and host supervision, etc.[89]

A great deal of focus is placed on those tenets that help to secure and sustain a safe, honest, effective and transparent financial market. Other extremely important tenets are those that aim to maintain stability of the whole system, especially through diminishing systemic risks. Likewise, it is essential to ensure that financial service providers are able to fulfil their obligations towards their clients/consumers. Another set of tenets deals with information asymmetry—it protects clients and investors by providing them with a sufficient amount of information in order that they can adequately manage their own financial matters.

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[88] Core Principles for Effective Banking Supervision.

[89] Basilejské základní principy efektivního bankovního dohledu (v rozsahu metodiky). Basilejský výbor pro bankovní dohled. [online]. 1999 [qtd. 11th October 2017]. Available at: <https://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/dohled_financni_trh/souhrnne_informace_fin_trhy/ostatni_analyticke_publikace/download/bcp_-_revidovane_-_cj_ts.pdf>.

An overwhelming majority of these tenets can be found in the legal precepts of the EU and the Czech Republic. For example, in the Czech Republic the tenet about the stability of the entire financial system including the need for financial service providers to fulfil their obligations to their clients was expressed by means of a legal provision which states that the CNB, in accordance with its main objective, supervises people active in the financial market, analyses the development of the financial system, maintains the right working order and growth of the Czech financial market and contributes to the stability of the Czech financial system as a whole. [90] This provision was later amended[91], though, and now it only says that the CNB carries out supervision of people in the financial market.

2. *Tenets in a wider sense*

The supervisory authority must meet several criteria, one of which is the independence of governmental control. We can distinguish three types of independence[92]:

- personal – the appointment of top executives is not affected by the politics
- financial – supervision is not financed from the state budget
- operational – the supervisory body is authorised to issue sublegal norms. Supervision is carried out independently of governmental control and political and executive power has no say in the decisions made by the supervisory body.

Similarly, Delespaul[93] observes that there are several proofs of the independence of the regulatory body: the way the executives are appointed, its financial autonomy, and independent decision making.

These of tenets can be found in the regulatory and supervisory tenets issued by the CNB.

[90] Cf. § 2 par. 2 section. d) Act no. 6/1993 Coll., on Czech National Bank, as amended till 16/8/2013.
[91] Act no. 227/2013 Coll.
[92] MAŠINDOVÁ, V. Institucionální uspořádání regulace a dohledu nad finančním trhem v ČR z pohledu CNB. In *Sborník z mezinárodní konference Regulace a dozor nad finančními trhy*. Praha: Vysoká škola finanční a správní, 2003, p. 50.
[93] Srov. DELESPAUL, Jean Claude. Accountability and Transparency . In *Chalanges for the Unified Financial Supervision in the new millennium conference.* Talin: 2001. p.1.

3. *The CNB tenets*

The CNB has issued the following tenets for its regulatory and supervisory activities.[94] They stem from—or rather correspond to—the tenets issued by IOSCO (described above).

Single supervisory policy

a) consistency and integrity of regulation – unified rules for granting licences to enter the financial market; the same risk regulation in different segments of the financial market, thereby ensuring equal competitive environment for financial market entities active in more segments.

b) taking into account individual customer risk profiles – despite the unified policy, the supervisory authority must take into consideration individual risk profiles of financial market entities under supervision.

c) co-operative rule-making – making sure that there is close co-operation between the Ministry of Finance (as the main legislative body in this area) and professional corporations that represent financial market participants.

I believe that a unified supervisory policy is significant even from the international perspective since the goals of supervision are the same at all levels. Thus, policies should also be identical (or at least highly similar). The European Union issues a single policy for its member countries, which is sometimes interpreted as a loss of sovereignty. On the other hand, such tendencies towards a unified supervisory policy should ideally lead to a level playing field for international institutions in all member countries.

Adequacy of regulation

a) preference of general tenets over more detailed rules – if various methods reach the goal, there will not be any need of detailed secondary regulation.

b) adequate amount of regulation – regulation should not pose a threat to a healthy competitive environment and to the services and products which are offered.

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[94] Poslání České národní banky při dohledu nad finančním trhem České republiky. [online]. CNB, 2008 [qtd. 17th October 2017]. Available at <http://www.cnb.cz/cs/dohled_financni_trh/poslani_cnb_dohled_FT.pdf>.

This tenet calls for introspective self-analysis on the part of the regulatory and supervisory authority, which needs to ask itself whether its activities really help to achieve the objectives and whether they may not be excessive. It is always extremely important to strike the balance between the fulfilment of goals and the maintenance of sufficient entrepreneurial freedom.

Effectiveness of supervision and regulation

a) Taking into account the costs of regulation and supervision – the need to assess sensibly the running costs of supervisory and regulatory activities with regard to the objectives.

b) Effective communication – frequent and open communication with entities under supervision helps to remove undesirable obstructions, for example bureaucratic ones.

All activities of the institutions run and financed by the state must be effective. This demand holds naturally true for the supervisory and regulatory authority as well—the finances expended in supervision and regulation must be used effectively to achieve the objectives, but, at the same time, regulated and supervised entities should not be burdened with useless or ineffective administration. This could lead to higher expenses on the part of these entities, and, consequently, their worse economic results, which in turn would reduce their tax liability and less finance would return to public budgets.

Adequate consumer and investor protection

a) European law transposition – regulation and supervision in accordance with European law; not an excess of demands imposed by European law.

b) professional codes – co-operation among state authorities, professional corporations of financial service providers and client protection organisations that leads to codes of conduct for financial institutions towards their clients.

This tenet must not be enforced too hard to avoid excessive protection of the client or the investor. That could result in such a high number of restrictions and administrative obstructions that the environment could be left completely devoid of healthy competition. As a result, financial institutions then would have no other choice but to offer very similar

products at very similar prices and under very similar conditions—the client or consumer is then deprived of real choice.

Measures to protect the financial market from financial crime

a) measures to prevent the misuse of the financial market and money laundering—special attention paid to impend the financing of terrorist organisations.

b) The sound operation of payment and settlement systems – the promulgation and support of high standards of security regarding payment and settlement systems and their potential failure and misuse.

To prevent financial crime is not only a tenet and an objective of financial law, but, of course, of criminal law, too. It is one of the most general and basic regulatory and supervisory tenets, for it spreads right across the entire legal system.

Support of market discipline

a) issued information in accordance with risk management – the focus placed on the issued information and its reflection of the true financial situation, thereby enabling objective assessment and management of risks.

b) market effectiveness and the reduction of the danger of its misuse – compulsory information issued by the entities should increase the effectiveness of the financial market, thereby reducing the risk of market misuse and misuse of non-public internal information.

This tenet is concerned with the support of the sound operation of economy—it sets out to maintain the adequate operation of competitiveness and consumer protection. Further, this tenet applies to financial executives whose duties (if properly fulfilled) also prevent improper competition, examples of which include the concealment of information or the acquisition of non-public information, which, naturally, might provide the guilty parties with an unfair advantage over their competitors.

Co-operation among home entities involved

a) self-regulation – the support of self-regulation by means of professional corporations of the regulated entities and also by means of necessary legislation.

b) co-regulation –transfer of some powers from the supervisory authority to professional corporations with simultaneous supervision of the execution of the newly-transferred powers.

Both self-regulation and co-regulation seem to be relatively effective and democratic tenets, because it is reasonable to expect that self-regulation might ensure the attainment of some objectives in the same way as regulation performed by the state authorities. It is, however, crucial to establish limits for self-regulation and co-regulation so that any abuse of the transferred powers does not result in endangering or destabilising the financial market, or any of its segments.

International co-operation

a) integration of the European financial service market – the intensification of integration of the single European financial service market, including the convergence of supervisory rules and mechanisms.

b) balanced relation between the home and host supervisory authorities – the goal is balanced supervision of international financial groups while maintaining an appropriate relation between the home and host supervisory authorities and sufficient powers for supervisory authorities to perform their legal obligations.

c) crisis management – European international co-operation when handling financial crises.

This tenet is more of an obligatory issue rather than a proper tenet, because in a large number of regulatory and supervisory cases there is hardly any possibility for the CNB to divert from the EU course. Thus, it is rather a compulsory acceptance of current attitudes and mechanisms that arise from the international commitments the Czech Republic (hereinafter 'the CR') has.

Employees and their professionalism and expertise

professional approach and high internal standards when carrying out supervision—even higher than what is required of the supervised entities.

Supervisory ethics

the employees of the CNB are required to observe the code of ethics and universally accepted ethical norms.

The last two tenets might seem to be rather minute with little or no practical manifestations. It does not appear possible to find out whether they are fulfilled or not because, to a large extent, these tenets present categories, the fulfilment of which remains considerably subjective.

All the tenets above, set by the CNB as the supervisory and regulatory authority of the financial market in the Czech Republic, reflect, to a large extent, the supervisory and regulatory objectives which have been discussed above. Furthermore, I find them similar to the tenets found in the Administrative Procedure Code[95], which is undoubtedly linked with the fact that the CNB is an administrative body as well and the Administrative Procedure Code tenets apply to the CNB, too. Whilst all the tenets are important, I find the first three (the single supervisory policy, the adequacy of supervision and the effectiveness of regulation and supervision) to be of crucial importance, since these are the main tenets that should ensure the maintenance and strengthening of a stable financial system as the basis of a healthy economy. They are tenets that decidedly copy also other regulatory and supervisory objectives. However, can tenets differ from universally accepted objectives at all? It does not seem possible because tenets are one of the ways to achieve the desired goals, as is clear from the above-mentioned list of tenets issued by the CNB.

The tenets of regulation and supervision are both internationally and nationally largely standardised and widely accepted by financial market entities. Of course, it remains to be seen whether the tenets are applied and observed in real life, be it in the form of international recommendations, preambles to legal norms, acts, or declarations issued by the supervisory authority. It is clear that theory is one thing, but practice might be a completely different thing. For example, it is no secret that in some cases the CNB demands more information and obligations than what it should according to the European rules—more specifically it applies to some mandatory questionnaires that financial institutions need to submit at

[95] Cf. §2 - §8 Act no. 500/2004 Coll. on the Administrative Procedure Code, as amended.

certain times. At first glance, the CNB seems to be breaking the tenet concerning the adequacy of regulation. Yet, a high number of tenets are assessed by each entity rather subjectively, and what seems to be within the tenet to one entity, might not appear so to a different financial market entity (particularly if their positions in the financial market are different, e.g. an institution, a consumer, the supervisory authority).

In conclusion, we might sum up that supervisory and regulatory financial market tenets are relatively accurately and correctly defined rules which, ideally, secure the attainment of regulatory and supervisory objectives.

The systems of financial market regulation and supervision

This subchapter aims to define and analyse ways to carry out financial market supervision and regulation; in other words, it analyses the systems that can potentially be applied to supervision and regulation. Since the objectives that the systems pursue are largely identical, the differences tend to lie in the structure of the supervisory mechanisms and they are determined by other factors such as the historical development, habitual practice, and the level of economic advancement.

Pavlát is convinced that a unitary model of regulation and supervision is not likely to happen even in the long-term future. Universal models of financial market regulation and supervision do not and even cannot possibly exist. It is nonetheless almost certain that a certain amount of unification of the existing systems is going to take place with the aim of exerting a higher amount of pressure to solve problems, revealed via inspection, faster. This is the current trend in banking supervision, internal systems of control and risk monitoring in banks.[96]

Regulatory and supervisory authorities issue sublegal norms; their other tasks involve continuous supervising, inspecting, and also sanctioning if rules are not observed. Moreover, these institutions are, to a large extent (and together with a given ministry), responsible for primary legal norms. Supervisory and regulatory institutions differ in fundamental as well as marginal matters from country to country. As a consequence, there are various systems of regulation and supervision applied in practice. First, I deem it necessary to set certain criteria and characteristic features, according

[96] PAVLÁT, V. Regulace a dozor nad finančními trhy ve světě: současný stav a výhled do budoucna. In *Regulace a dozor nad finančními trhy. Sborník z konference*. Praha: Vysoká škola finanční a správní 2003. p. 18.

to which it is possible to classify regulatory and supervisory systems. These criteria are set differently within individual systems.

There are various classifications of the systems;[97] here I apply the ones found in Pavlát:[98]

- subject of regulation and supervision: institutional, functional, objective-based regulation.
- scope of regulation and supervision: universal ('mega-system'), specialised.
- number of regulatory and supervisory bodies: a single body, a couple of collaborating bodies, multiple bodies.
- position within the state authorities: centralised, decentralised, mixed.
- powers and responsibilities: autonomous (independent), subordinate (to a higher-level authority).
- democratic character of operation: involving self-regulation or without self-regulation.
- way of financing: from the regulated entities, from the state budget, a combined way of financing.
- way of performing regulation and supervision: formally bureaucratic v. factual; rigid v. flexible; transparent v. non-transparent.

As far as I am concerned, the crucial classification is the one based on the subject of regulation and supervision, which I would rather call the way of executing regulation and supervision. These days the models found most often are the institutional one (also called the sectoral) and the functional model.

The sectoral model deals with financial market regulation and supervision according to the institutional arrangement based on separate regulatory sections for individual segments of the financial market.[99]

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[97] E.g. DELESPAUL, Jean Claude. Accountability and Transparency. In Challenges for the Unified Financial Supervision in the new millennium conference. Talin: 2001. p. 1. He defined criteria such as power, independence, responsibility towards other institutions and transparency of the regulator's activities.

[98] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 40.

[99] There are 3 variants of this model: 1/ separate regulatory institutions for the banking sector, the capital market and investment services, the insurance industry and supplementary pension insurance. 2/ partial integration of the banking sector, which is

In comparison, the functional model is based on the potential types of market failures. This model is linked with the existence of regulators or specialised bodies for the protection of investors and consumers, for prudential regulation and supervision, for economic competition and for the stability of the financial system. It is nevertheless possible that these regulators might be represented by individual departments or divisions within one institution.[100]

The CNB in its text about the institutional arrangement of financial supervision[101] mentions some possible arrangements of the integrated system, based on two fundamental models – the sectoral one and the functional one. The former model entails an institutional arrangement of regulation and supervision based on the fundamental sectors of financial intermediary activities.

Both functional and sectoral models have the following variants:[102]

- **complete sectoral and functional integration** – supervision carried out by a single institution in all three basic financial sectors: from the functional perspective this single institution supervises financial market transactions, the observation of prudential rules (the attitude to clients/consumers and investors). Complete sectoral and functional types of integration are, to all intents and purposes, identical.

- **the model of separate regulators –** the sectoral model keeps the institutions for various branches separate (banking, the capital market and investment services, insurance and supplementary pension insurance); the

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united with supervision and regulation of insurance companies; alternatively, there can be the so-called 'two-pillar' system, where banking supervision is performed by the central bank and a completely different institution entrusted with regulatory powers carries out supervision over all non-banking institutions and the capital market alike. 3/ complete integration of supervision – all financial service institutions and the capital market are supervised by a single supervisory institution.

[100] The CNB created the functional model consisting of three sections: the financial market supervision section, the regulation and financial market analysis section, and the licence and sanction section. It is a functional model with several sections, all integrated into one institution.

[101] CNB. Institucionální uspořádání finanční regulace a dohledu v Evropské unii. [online] CNB [qtd. 3rd October 2017]. Available at <http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/dohled_financni_trh/souhrnne_informace_fin_trhy/ostatni_analyticke_publikace/download/fin_regulace_eu.pdf>.

[102] CNB. Institucionální uspořádání finanční regulace a dohledu v Evropské unii. [online] CNB [qtd. 3rd October 2017]. Available at <http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/dohled_financni_trh/souhrnne_informace_fin_trhy/ostatni_analyticke_publikace/download/fin_regulace_eu.pdf>. pp 2-3.

functional model also makes use of several institutions, each of which supervises a different area according to the function; i.e. one institution supervises protection of investors and consumers and observation of fair-play rules in the market, another one takes care of prudential supervision and regulation, the central bank is responsible for maintaining stability of the whole financial system, and there is also a regulator for economic competition.

- **partial integration of supervision** – the sectoral model employs a 'two-pillar' system: it unites banking supervision with that of securities traders (possibly with some involvement of the central bank); the functional model unites several institutions for supervision of more areas (e.g. the supervision of financial stability and prudential enterprise), often with some involvement of the central bank.

Table no. 1: The institutional organisation of financial market supervision in the EU member countries.

	Sectoral model			**Functional model**	
EU countries	Complete integration	Partial integration	Separate supervisory institutions	Complete integration	Partial integration
27	12	1	8	3	3
100%	44%	4%	30%	11%	11%

Source: PÁNEK, D., Proces integrace regulace a dohledu nad finančními institucemi[103]

A different approach to financial supervision classification is found in Shoenmaker, who distinguishes three models: sectoral, functional, integrated. I am convinced that there is no essential conflict between the two authors and their tables in which they assign countries to different models of supervision. Their choice is more likely to be influenced by the application of different structural models. As a result, Shoenmaker's

[103] PÁNEK, D., Disertační práce. Proces integrace regulace a dohledu nad finančními institucemi. Brno, 2012. 129 s. Masarykova Univerzita, Fakulta ekonomicko – správní. Vedoucí práce . Eva Horvátová. p. 10 Based upon the available information from the CNB.

sectoral model only includes those countries which Pánek considers to be sectoral-like with separate supervisory institutions. Given the fact that there is a considerable time gap between the two tables, there took place another change: Belgium and Great Britain joined the functional 'twin peaks' model in 2011.

Table no. 2. Organisational structure of financial supervision

Basic models				
Countries	Sectoral model	Cross-sector model-functional model (twin-peaks – two supervisory bodies)	Cross-sector model-integrated without the central bank	Cross-sector model-integrated with the central bank
EU	Bulgaria, Cyprus, Greece, Lithuania, Luxembourg, Romania, Slovenia, Spain	Belgium, France, Italy, the Netherlands, Portugal, Great Britain	Denmark, Estonia, Hungary, Latvia, Malta, Poland, Sweden	Austria, the Czech Republic, Finland, Germany, Ireland, Slovakia
Non-EU		Australia, the USA, Canada	Japan	

Source: SHOENMAKER. D.: Financial Supervision in the EU[104]

Schoenmaker's typology is, in my view, correct; yet, I would label all cross-sector models which carry out supervision in the functional way as functional, because the adjective is linked with financial market supervision according to the typology of market failures. Further, within the functional model we may distinguish three submodels: 1/ twin peaks, 2/ integrated with the central bank and 3/ integrated without the central bank. Personally, I would find it simpler and more fitting if the supervisory models were divided into the sectoral and functional types with further subdivisions based on the existence of just one or more supervisory institutions. That is the model in the Czech Republic, where there is the functional model with a

[104] SHOENMAKER, D. Financial Supervision in the EU [online]. In CAPRIO, G. (ed.), Elsevier Amsterdam, Encyclopedia of Financial Globalization, April 2011. [qtd. 17th November 2017]. Available at http://personal.vu.nl/d.schoenmaker/Encyclopedia_Financial_Supervision_in_the_EU_v1%20%2828-4%29.pdf.. p. 14.

single institution; in Shoenmaker's typology this model is to be found in the cross-sector integrated model with the presence of the central bank.

The basis of the functional model is the typology of market failures. In the field of financial intermediation there are four types of market failures: information asymmetry, market abuse, systemic instability and anti-competitive behaviour. [105]

There are four main domains of financial supervision and regulation based on the aforementioned types of market failures:

- prudential regulation and supervision of financial institutions' enterprise focused on their financial health, liquidity, and solvency.
- financial market supervision and regulation aimed at market abuse (both the capital market and over-the-counter markets). The chief objective is consumer protection.
- systemic regulation and supervision of the financial market and its stability. The objective is minimising systemic risks of the concatenation of bank insolvencies (or of other financial institutions).
- The regulation of the competitive environment and its supervision. The objective is to eradicate anti-competitive behaviour.[106]

Shoenmaker[107] adds that EU member countries gradually leave the sectoral model and adopt the functional one instead in reaction to the cross-sectoral nature of financial markets and financial institutions.

I do not deem it vital whether the sectoral or functional model is applied. It is true that in Europe the functional model prevails, having been adopted in many countries recently. Both models have their advantages and disadvantages, naturally, and there seem to be several factors affecting the choice of the right model. I am far from convinced that one model is superior and thus generally recommended; yet, it appears that for several

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105 CARMICHAEL, J.: Experiences with Integrated Regulation, [online]. Australian Prudential Regulation Authority [qtd. 1st September 2017]. Available at http://www.apra.gov.au/Insight/Documents/APRA-Insight-1st-Quarter-2002-Experiences-with-integrated-regulation.pdf. p. 3.

106 LLEWELLYN, D.: The Economic Rationale for Financial Regulation, FSA, Occasional Paper No.1, 1999.

107 SHOENMAKER, D. Financial Supervision in the EU [online]. In CAPRIO, G. (ed.), Elsevier Amsterdam, Encyclopedia of Financial Globalization, April 2011. [qtd. 17th November 2017]. Available at http://personal.vu.nl/d.schoenmaker/Encyclopedia_Financial_Supervision_in_the_EU_v1%20%2828-4%29.pdf.. p. 25.

reasons the functional model is more suitable, modern and flexible. If the supervisory authority focuses on market failures, which are almost identical in all financial market sectors, this model allows almost identical problem-solving mechanisms regardless of in which sector the problem originated. Seeing that the financial market sectors are, to a large extent, intertwined, there usually are, in my view, legislative changes taking place across them. The application of legislative changes is then much quicker and more accurate in the functional model, since if there is a change in the attitude to a market failure, the change sweeps across all sectors. As far as the sectoral model is concerned, every sector must react separately and adopt the changes, whereas in the functional model only one supervisory section reacts across financial market sectors.

Shoenmaker[108] goes on to say that EU member countries gradually adopt the functional model due to the cross-sector nature of financial markets and financial institutions.

Australia is a very interesting example of a country with the functional model of supervision. This model was adopted in the 1990's[109] and there are several supervisory institutions—hence, we talk of partial integration within the functional model here. The Australian Securities and Investments Commission[110] supervises the financial market and all the transactions therein, and it also supervises financial services offered by financial institutions, thereby protecting financial market investors and clients. This body is also a financial market regulator that assesses financial market effectiveness in accordance with its fair and transparent operation. Every entity willing to do business in the financial market must possess a licence issued by ASIC, or to fulfil the conditions of a licensing exemption. The other body is APRA (Australian Prudential Regulation

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108 SHOENMAKER, D. Financial Supervision in the EU [online]. In CAPRIO, G. (ed.), Elsevier Amsterdam, Encyclopedia of Financial Globalization, April 2011. [qtd. 17th November 2017]. Available at <http://personal.vu.nl/d.schoenmaker/Encyclopedia_Financial_Supervision_in_the_EU_v1%20%2828-4%29.pdf> s 25.

109 CNB. Institucionální uspořádání finanční regulace a dohledu v Evropské unii. [online] CNB [qtd. 17th November 2017]. Available at <http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/dohled_financni_trh/souhrnne_informace_fin_trhy/ostatni_analyticke_publikace/download/fin_regulace_eu.pdf>. s. 4.

110 ASIC: Our role [online]. Australian Securities & Investments Commission [qtd. 17th November 2017]. Available at <http://www.asic.gov.au/about-asic/what-we-do/our-role/>.

Authority),[111] which supervises prudential regulation of financial institutions.[112]

I am convinced that the Australian functional model of supervision (with all the years of successful operation) or a model closely matching the one found in Australia could be one of the viable options or sources of inspiration for other countries. One authoritative body focuses solely on the system, its operation, and the protection of consumers and investors whereas the other authoritative body deals with economic vitality of the most important financial market institutions. These two authoritative bodies together form the framework of the financial market supporting macroeconomic stability. This model could be improved by merging the two bodies into one (with two sections), which would enhance communication and co-operation (for instance passing important information from one section to the other one), and, ultimately, the effectiveness of financial market supervision, too.

1. Types of financial market regulation and supervision systems

If anyone wants to find the common features of various systems, they should start by defining the types of systems. We could say that there are basically three types of systems of financial market regulation and supervision:

a) unitary system (also called the mega – system), in which there is only one regulator for the entire financial sector performing regulation and supervision of all financial sectors including the capital market

b) system with two regulators, each of which is responsible for a part of the tasks involving regulation and supervision of the capital market (or, possibly, the whole financial market)

c) system of financial market regulation and supervision performed by one or more specialised regulators.[113]

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[111] APRA: Supervison [online]. Australian Prudential Regulation Authority. [qtd. 17th November 2017]. Available at <http://www.apra.gov.au/AboutAPRA/Pages/Supervision.aspx>.

[112] Australian banks, building societies and credit unions (with the permission to accept deposits), insurance and reinsurance companies, associated companies and pension funds (excluding self-governing funds).

[113] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 40

The so-called mega-systems need to be internally differentiated, which means that within one body there operate individual sections which, in effect, copy the function of independent small-scale institutions that regulate and supervise a certain set of institutions (in the sectoral model of supervision and regulation these include banks, securities traders, investment companies, funds, and insurance companies) or a set of activities (if the system of regulation and supervision is a functional one). The crucial difference lies in the fact that the mega-system brings about unitary and central management, which seems to be far more flexible and rids the system of imperfect and often also very complicated coordination of small-scale regulatory and supervisory institutions.[114]

To assign the right amount of independence to supervisory and regulatory bodies is one of the crucial conditions for modern systems of financial market supervision and regulation if they are to work properly. Also, it is essential to enforce the highest possible deal of financial market transparency.[115] These are the most important tasks for a regulator, which/who needs to set the basic mechanism that can further influence other stabilising features in the financial market.

It goes without saying that the system of regulation and supervision is vital for the attainment of regulatory and supervisory objectives—therefore it needs to be optimised according to the current needs of a particular country and the local conditions. The main criterion of success must be the results a particular system brings. Because EU member countries use different systems (many countries still use the sectoral model as opposed to the functional one- cf. tables no. 1[116] and 2 above), it is rather tricky to assert that one system is better than the other one; no system is universal in this respect. It seems to me, though, that the functional model is more flexible and allows quicker reactions if problems occur. Furthermore, it appears to enable easier communication within the supervisory body as well as more closely-knit procedural mechanisms, e.g. when granting licences or during on-location and off-location supervision. It remains true, however,

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[114] PAVLÁT, V. In PAVLÁT, V., KUBÍČEK, A. *Regulace a dohled nad finančními trhy*. VŠFS Praha: EUPRESS, 2010. p. 41.

[115] PAVLÁT, V. Regulace a dozor nad finančními trhy ve světě: současný stav a výhled do budoucna. In *Sborník z mezinárodní konference Regulace a dozor nad finančními trhy*. Praha: Vysoká škola finanční a správní 2003. p. 9.

[116] Cf: CNB. Institucionální uspořádání finanční regulace a dohledu v Evropské unii. [online] CNB [17th November 2017]. Available at <http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/dohled_financni_trh/souhrnne_informace_fin_trhy/ostatni_analyticke_publikace/download/fin_regulace_eu.pdf> p. 4.

that if the system works and bears fruit as far as its objectives are concerned, the particularities of the system might not be of such great importance.

Scandinavian countries serve as an intriguing example of countries with 'small' financial systems, where occurred, at different times, integration of supervision into one supervisory authority. The very existence of such small financial systems made this possible. The Scandinavian example showed how beneficial the change was as there was an emergence of highly-specialised professionals within the sphere of the supervisory authority.[117]

The first integration of financial market supervision in Europe took place in Norway in 1986 (the first one ever had happened only two years before in Singapore). It seems apposite now to analyse the reasons behind the Norwegian decision to make this step so early on.

The chief incentives included increase in effectiveness of supervision in the banking and insurance sectors (where take place similar changes in the market and also even within the field of economic competition), strengthening of the securities market supervision and administrative rationalisation (IT systems and the recruitment of experts).[118]

The motives for integration in Norway were manifold. Due to the liberalisation and deregulation of financial markets, there was an urgent need to provide better financial supervision. In addition, it was desirable to prevent financial instability and to encourage higher effectiveness in the financial markets—this was connected with earlier problems with qualified and knowledgeable people. Last but not least, the boundaries between the banking sector, securities and insurance were rather hazy and there were also initiatives to set up large financial conglomerates.

The system of financial stability in Norway is based on three pillars—apart from the supervisory authority, responsibilities are shared by the Ministry of Finance and the central bank (Norges Bank). Together, these organisations form a tripartite institution, the representatives of which meet regularly at least twice a year. The Ministry of Finance supervises financial stability and financial regulation. The central bank is responsible for the monetary policy and the supervisory authority (called Finanstilsynet) takes

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[117] TAYLOR, M. FLEMING, A. Integrated financial supervision, Lessons of the Scandinavian experience. *Finance & Developement* vol. 36. Washington: International Monetary Fund. December 1999. No. 4. p 44.

[118] MOSS, N. Integrated supervision in Norway: Organisational structure, history and experience. Presentation of Finanstilsynet, the Financial Supervisory Authority of Norway in conference in Sofia 3rd May 2010. p. 27.

charge of supervision of financial institutions and it is also active in the legislative process (it helps to create and propose relevant bills). The functional model of supervision was adopted in Norway, too; it adheres to the principle which maintains that the same risks should be regulated in the same way, regardless of which financial institution carries the risk.

The supervisory authority is also responsible for supervision of auditors and external accountants, claims management companies and also for supervision at the macroeconomic level.

The body in charge of the Norwegian financial market (not in charge of the monetary policy in Norway, though) is called Finanstilsynet (formerly Kredittilsynet) and it came into existence in 1986 following a merger between two regulatory and supervisory institutions. The first was The Bank Inspection (founded in 1900), which included from the year of 1983 the Brokers Control Agency as well. This body also used to supervise estate agents. The other body was The Insurance Council, which was established in 1911 and it carried out supervision of insurance companies up until 1992.[119]

Naturally, there are several reasons why financial supervision and regulation should involve the central bank, as there are several reasons why it should not. In Norway the reasons against the central bank involvement prevailed and they opted for a dual structure—the supervisory authority acts independently of the central bank. In the past, one of the soundest arguments against the integration of supervision and regulation into one and only body was the theoretical conflict between the monetary-political objective and the performance of banking supervision on the part of the central bank. This argument has been refuted, though, since this conflict did not manifest itself in real life at all.[120]

I would argue that it is not such an important issue whether the supervisory organ involves the central bank or whether they are separate, thereby creating a two-pillar system of financial stability within the given country (as in Norway). Every country has gone about the process of integration in a different way, but the goal remains the same: the creation of integrated bodies (or an integrated body) that perform(s) supervision more effectively.

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[119] MOSS, N. Integrated supervision in Norway: Organisational structure, history and experience. Presentation of Finanstilsynet, the Financial Supervisory Authority of Norway in conference in Sofia 3rd May 2010. p. 26.

[120] BRIAULT, C.: Revisiting the rationale for a single national financial services regulator, FSA, Occasional paper 16th February 2002, p. 27.

INTEGRATION OF SUPERVISION IN EUROPE

In Europe, integration of regulation and supervision is a long-term ongoing process which accompanies the growth of the financial market itself. This process has always reacted to the contemporaneous political and economic situation in the countries of Europe, but it has also been affected by international economic features, as was demonstrated during the financial crisis in 2008. Needless to say, the process of integration had already been under way by then, but the financial crisis in 2008 intensified it and it also set the course of action for the future, aiming to prevent any more crises or, at least, to reduce the damage inflicted by them.

International financial conglomerates offer a wide range of financial products that penetrate various financial market segments. Thus, the areas of supervision overlap, which creates a burden not only for the financial conglomerate (more legislation awareness and administration), but also for the supervisory body or bodies (more communication and administration). Integration significantly simplifies the process of supervision, for it provides a clear legislative basis, all financial market segments are covered and there is no needless administration between the supervisory bodies. As big financial companies do business in many countries (often rather diverse), there is a clear signal for globalisation of supervision—it is desirable that conditions in all countries should be as similar as possible. This not only liberalises business possibilities and reduces administration, but it also leads to equal opportunities and makes it harder for entrepreneurs to be selective on the basis of how demanding and detailed supervision in other countries is.

In Europe (but globally as well) motives for integration include attempts to create a single financial market with increasingly more and more interconnected supranational European financial groups, and also with more close-knit relations between financial market segments. I am not sure if the EU countries right from the beginning desired the current form of financial regulation and supervision, i.e. the creation of a supranational level of supervision which should ensure safety and stability of the financial market (which, of course, in turn influences international economic stability).

The European Parliament adopted many resolutions[121] (even before the outbreak of the financial crisis and then during the crisis as well) calling for transformation towards an integrated system of supervision in Europe, which would ensure equal treatment for all entities involved at the EU level and which would also reflect the growing financial market integration within the EU.

In reaction to the financial crisis in 2008, the European Commission initiated a range of measures to create a safer and healthier financial sector for the single market[122].

These measures are being adopted gradually in various forms. Given the fact that globally as well as Europe-wide the most important role in the financial sector is played by banks, the majority of these measures entail stricter prudential demands for banks, better consumer/investor and depositor protection, and management rules for insolvent banks. As a result, these measures led to 'The Single Rulebook', a single set of rules for all financial entities in all 28 EU member countries, which also serves as the basis for the Banking Union as the current peak of supervisory integration tendencies in the EU (further discussed in a separate chapter below). [123]

The system of prudential supervision in the EU is based on the so-called 'home country principle'—supervision of an international financial institution is carried out by the supervisory authority from the home country, i.e. the country in which the parent company is registered or in which it was granted the licence (as opposed to its branches opened in other countries – 'host countries'). The EU law enables financial institutions to open and run branches without legal personality in other EU countries without consent from the host country. This principle of opening branches without consent is called the 'single passport'. If the parent company, however, establishes subsidiaries or any other legal entities with legal

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[121] For example the resolution of 13th April 2000 on the Commission's statement on the making-up of financial market framework: action plan; the resolution of 21st November 2002 on prudential supervision rules in the EU; the resolution of 11th July 2007 on the financial service policies (2005-2010): the white book and others.

[122] The global financial crisis certainly indicates the necessity for changes in the paradigm of the regulation and supervision of financial institutions. Thus in response to the financial crisis, changes were made on an EU level in the regulatory and supervisory architecture of the single financial market. The following publication present details: JURKOWSKA-ZEIDLER, A. The architecture of the European financial market : legal foundations, Gdańsk ; Warsaw : Gdańsk University Press : Wolters Kluwer, 2016, pp. 53-117.

[123] Adapted from: EU single market, Banking union. *European commission*. [online] 2014 [qtd. 25th October 2017]. Available at <http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm>.

personality, the host country (its supervisory authority) automatically assumes supervisory powers. In addition, the parent company has to obtain any permission or licence (required for its activity) issued by the authoritative body of the host country.

It is generally accepted[124] that the home country principle should increase the effectiveness of supervision at the international level and it should also bring about the reduction of costs when compared with double supervision (i.e. if it were carried out both by the home and the host countries). The home country principle thus represents an effective solution to the problem of supervision of financial branches from other countries.

It must be conceded, though, that this seems to be a rather theoretical and, to a certain extent, a trivial purpose, which is evident and not worthy of an in-depth analysis. The crux of the matter rather lies in different attitudes towards branches and subsidiaries in host countries. Legally, the difference is crystal clear; it is not so from the functional point of view, though, since branches and subsidiaries operate in a similar way and their failure has a very similar impact on the system in the host country. I therefore deem the single passport principle rather flawed and buck-passing as well. Who will pay out financial compensation to clients with insured deposits in case of branch insolvency in the host country? Given the fact that it is an entity without legal personality, it should be the home country authority, but this seems extremely hard to enforce in practice.[125]

A clear deficiency in the system of mutual acknowledgement is the focus on entities with legal personality (branches or cross-border services), hence the exclusion of financial institutions' subsidiaries from the system of mutual acknowledgement. As a result, it is harder to assign activities to legal persons, on which the division of supervisory duties is based. The profound difference between legal and organisational structures complicates supervision, since supervision is based on the power to supervise legal persons (legal structure), which, however, may not fully

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[124] Např. GOORIS, J., PEETERS, C., *Ecore Discussion Paper, Home-Host Country Distance and Governance Choices in Service Offshoring*. 2009 [online] 2013 [qtd. 9th November 2017] Available at http://www.ecore.be/DPs/dp_1328618572.pdf , p. 24.

[125] To illustrate this let us look at the Icelandic bank Icesave, an internet branch of Landsbanki bank in the Netherlands and Great Britain. The lost deposits were refunded from the host countries' funds, but the costs were left unpaid for by the Icelandic government. This outcome was sanctioned by the EFTA court. Available at: Novinky.cz. *Soud podržel Island ve sporu s Británií a Nizozemskem o vklady*. 2009 [online] 2013 [qtd. 11th August 2017] Available at http://www.novinky.cz/ekonomika/291523-soud-podrzel-island-ve-sporu-s-britanii-a-nizozemskem-o-vklady.html.

correspond with where the given activity took place (organisational structure). There seems to be a great deal of political challenge in tackling the discrepancy between operationally integrated financial groups in search of synergies and legally-bound supervisory authorities in search of effective ways to deal with these financial groups and their practices.[126]

International financial groups with subsidiaries are supervised by more authorities (unlike branches), which necessarily results in applying national supervisory mechanisms to institutions offering international financial services. This is hardly compatible with the model of integration in the EU. Admittedly, what determines whether an international company decides to set up a branch or a subsidiary often remains undisclosed and it probably depends on more criteria.

Still, it seems extremely beneficial not to apply different criteria to branches and subsidiaries, for these are very similar entities from the functional point of view and are therefore highly comparable as far as the systemic risk is concerned.[127]

One of the most problematic issues surrounding the home country principle is the distribution of responsibilities and subsequent problem-solving between the home and the host supervisory authority. The host country may not be familiar enough with the parent company and its operation. Also, the host country's main responsibility is the supervision of liquidity—a problem may arise when the host country authority, in its bid to maintain the stability of the financial system, needs information about a particular branch beyond the area of liquidity. The host country authority actually cannot possibly demand information from the home country authority; consequently, supervision of branches without legal personality becomes extraordinarily difficult without close co-operation needed for effective supervision.

The scheme of supervision of financial institutions in the EU is based on the principle of local jurisdiction. In accordance with this principle, national supervisory authorities exercise their power within the borders of their country and leave foreign activities of local financial institutions to the

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[126] SCHOENMAKER, D., OOSTERLOO, S. Financial supervision in Europe: A proposal for a new architecture. in: L. JONUNG, L. – WALKNER, C. – WATSON, M. Building the Financial Foundations of the Euro – Experiences and Challenges. London: Routledge, 2008. pp. 337-354.

[127] HERTIG, G. – LEE, R. – MCCAHERY, J.A. Empowering the ECB to Supervise Banks: A Choice-Based Approach. ECGI Working Paper Series in Finance. WP no. 262/2009 [online] 2009 [qtd. 8th November 2017] Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327824, p. 35.

supervisory authority of the relevant country (with the exception of their branches). This traditional local jurisdiction principle is, however, hardly compatible with the conditions of a single internal market, because it submits entities of the same financial institution to various mechanisms of supervision according to where these entities are located. Such a principle complicates free movement of capital and free provision of financial services. As a consequence, the introduction of rules for the mutual acceptance of financial service licences within the EU has fallen short of general expectations. Moreover, I hold the view that the different approach to subsidiaries and branches is not correct, since their influence and potential danger to the financial system is more or less equal—they should therefore be treated identically.

The process of integration of the European financial market

One of the biggest challenges for EU politics is creating the single market, not just formally (in 1993) but factually as well. This can only be achieved through integration and harmonisation of European (i.e. the EU) financial markets.[128]

The first important step was the so-called Financial Services Action Plan (FSAP[129]), which identified three basic priorities: 1/ to create a single

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[128] The financial markets have become much more international in recent decades, while their regulation and supervision still remain under the domestic jurisdictions. Thus, the issue of common responsibility for the financial market stability is still a basic challenge for the European Union especially after the experience of the recent global financial crisis. See more: JURKOWSKA-ZEIDLER, A. EU financial market law : from minimal harmonization to federalization, in: Radvan, M., Gliniecka, J., Sowiński, T., Mrkývka, P. (eds.): The financial law towards challenges of the XXI century : (conference proceedings): Brno : Masaryk University, 2017; Publications of the Masaryk University, theoretical series, edition Scientia, file no. 580, pp. 379-393, Web of Science: https://www.law.muni.cz/sborniky/Radvan_Financial_challenges.pdf

[129] The first incentive to the creation of the Action Plan was the European Council meeting in Cardiff in June 1998. Next, a European Commission statement called 'Financial Services: Building a Framework for Action' was issued on the 28th October 1998, which was presented upon the European Council initiative in December 1998 in Vienna. This document built a framework for the future action plan with all the particular regulations and with a timeline for their gradual implementation into the legal systems of the EU member countries. The following step saw the creation of the action plan according to the European Commission Directive called 'Implementing the framework for financial markets: action plan' from 11th May 1999, approved at the Cologne summit in June 1999,

market in the financial services area, 2/ to open and secure the retail financial services market, and 3/ to strengthen prudential supervision rules.[130]

This plan aimed to restrict institutional, regulatory, and tax barriers and to support financially the development of small and medium-sized enterprises.[131] The approval of the Action Plan was supported by discussions of the specially-formed expert group called the Financial Service Policy Group (FSPG), which consists of representatives from the council of ministers of finance ECOFIN and representatives of the European Central Bank.

In 2000, the Action Plan became a priority of the Lisbon process and its final version was passed in April 2000 in Lisbon with 42 legislative regulations[132] aiming to integrate national financial markets into a single European market. [133] The introduction of the euro in 1999 also greatly facilitated the process of integration, especially in the money market.

One of the most important achievements of the FSAP is the Financial Conglomerate Directive[134], drawn up in December 2002. It created rules that should help the leading supervisory body in a financial conglomerate decide how to close loopholes in existing supervisory mechanisms. The Directive also called for closer co-ordination and a more effective exchange of information between supervisory bodies of individual financial market sectors. The FSAP initiated the establishment of a securities commission. In

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during which the European Council also encouraged the European Commission to continue the action plan work.

[130] Adapted from: Financial Services Action Plan (FSAP). *European Commission*. [online]. European Commission [qtd. 9th November 2017]. Available at http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/l24210_en.htm.

[131] KAŠSOVIČ, J., Lamfalussy proces, *Finančné trhy*. [online]. Finančné trhy, březen 2008. [qtd. 9th November 2017]. Available at: http://www.derivat.sk/index.php?PageID=1436. p.2.

[132] These regulations concerned a whole range of financial market entities such as investors, brokers, issuers, and national financial market authorities.

[133] KAŠSOVIČ, J., Lamfalussy proces, *Finančné trhy*. [online]. Finančné trhy, březen 2008. [qtd. 9th November 2017]. Available at: http://www.derivat.sk/index.php?PageID=1436. p.3.

[134] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

reaction to this, an entirely new structure of commissions was created, later to become known as the Lamfalussy process.[135]

The Lamfalussy process

In 2000 ECOFIN set up the so-called Committee of Wise Men with Alexandre Lamfalussy (a famous banker and economist) as the chair of the newly-established organisation. Later, the process was named after him. The main task of the committee was to analyse financial market regulatory mechanisms and to put forward a proposal for a more flexible, effective and transparent legislative framework for capital market regulation, ensuring at the same time that the legal basis was adaptable to the global financial market situation.

The committee concluded its efforts by issuing the Lamfalussy Report[136] on 15th February 2001. The report suggested steps necessary for the creation of a new legislative framework. The suggestion involved a four-level mechanism of accepting, approving and controlling the implementation of financial market regulations in the EU. It can be viewed as a process of integration of European financial institutions and EU member countries. What is interesting about this report is the fact that the committee was initially supposed to deal with the capital market industry only (indeed, in March 2001 it led to the approval of a new legislative framework for the securities market); yet, the overall impact of the report and its legislative proposals affected the entire financial market.

Each of the proposed four levels focused on a specific stage of implementation of legislation within the EU and the final version of the document was ratified by the European Parliament in February 2002.

1st level: Legislative framework

EU legal norms are proposed by the European Commission and approved by the European Parliament and the Council of the European Union via the

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135 FITZGERALD, S. The reform of financial supervision in Europe. Institute of International and European Affairs, Dublin [online] 2009 [qtd. 9th November 2017] Available at http://www.iiea.com/publications/the-reform-of-financial-supervision-in-europe.

136 Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets [online] 2000 [qtd. 30th December 2014] Available at http://ec.europa.eu/finance/securities/lamfalussy/report/index_en.htm.

usual legislative procedure. This is the way regulations and directives are also approved.

2nd level: Implementing measures

Four committees were established to collaborate in negotiating and passing secondary legislation, which should promptly react to the dynamically developing financial market. This legislation was supposed to be implemented into national legal norms. The four committees were: the European Securities Committee, the European Banking Committee, the European Insurance and Occupational Pensions Committee, and the European Financial Conglomerates Committee.

3rd level: Facilitation of convergence of regulatory practice by supervisory committees

The next step was implementation of primary and secondary legislation into national legal systems of member countries. The co-operation among member countries was facilitated by three committees under the European Commission, all of which were composed of representatives of member countries' supervisory authorities. This level was supposed to increase the exchange of information, legislation and directives so that financial market supervision gradually became more and more unified. A considerable source of problems was the fact that these committees' powers were rather limited—they were not allowed to issue legally binding acts.

The three committees were the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors, and the Committee of European Securities Regulators.

4th level: The enforcement of directives

The European Commission not only checks the accordance between EU legislation and national legislation in member countries, but it also takes enforcement action if the implementation of EU legislation is imperfect or inconsistent.

Lamfalussy's conception is based on the subsidiarity principle, i.e. it prefers effective institutional organisation of financial market supervision at

the national level. It means that the European Commission does not recommend any specific solutions in this respect.[137]

Having formulated this plan, the European Commission revealed the 'Green Paper on Financial Services Policy (2005-2010)' in 2005, aiming to deepen the process of integration and to harmonise financial market services. This paper envisaged the creation of an internal market, the existence of which would boost economic growth in member countries. Companies, particularly international ones, were supposed to gain easier access to the capital and to some new ways of financing owing to a wider range of financial products and services and also owing to the fact that the state debt and payments were supposed to go down in price significantly. The Green Paper brought forward a number of directives grounded in the Lamfalussy institutional framework, which was designed to intensify the process of national financial markets supervisory integration and harmonisation. This period also saw the introduction of the single European passport and the principle of the home country primary competence in supervision (based on the location of the regulated entity). The underlying assumption here was closer co-operation among national supervisory authorities, which, however, has not always been sufficiently effective.

In 2004, the Council of the European Union praised this process stating that it had succeeded in increasing harmonisation of the preparatory process as well as in the subsequent implementation in individual member countries. The quality of supervision was assessed in the 'White Paper on Financial Services Policy (2005-2010)', but also in later (largely positive) evaluative reports.[138]

It is not an easy task to offer an overall assessment of the Lamfalussy process because of the main obstacle: the global financial crisis and its negative impact, which the supervisory mechanisms did not prevent. Following the crisis, the Lamfalussy process came in for a lot of criticism. Nevertheless, the International Monetary Fund issued a report in 2007, in which it asserted that '[o]n the financial stability framework, progress is being held back by the continuing tension between the impulse toward

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[137] JAKUB, F. Disertační práce. Analýza modelů regulace a dozoru nad finančním trhem. Praha, 2011. 179 p. Vysoká škola ekonomická v Praze, Fakulta financí a účetnictví. Vedoucí práce . Petr Musílek. p. 67.

[138] IIMG, AKERHOLM, J., SCHACKMANN-FALLIS, K-P., et al. Final Report Monitoring the Lamfalussy Process. 260 [online] 2007 [qtd. 9th January 2017] Available at: http://ec.europa.eu/internal_market/finances/docs/committees/071015_final_report_en.pdf.

integration on the one hand and the preference for a decentralized approach, in particular for supervision, on the other. Specifically, under the EU's home-host supervision model, supervisors are accountable only to their national authorities, informational asymmetries between home and host supervisors are large, and actions by one supervisor have potentially large effects on the jurisdiction of another. Especially when applied to large cross-border financial institutions (LCFI), this setting largely precludes progress toward efficient and effective crisis management and resolution, thus fostering moral hazard and unnecessary risks for national taxpayers.' [139]

The flaws of the Lamfalussy process combined with the financial crisis brought about increased focus on three areas crucial to revitalisation of the financial system, as expressed in a European Commission report, issued on the 29th October, 2008. The first area mentioned in the report concerned a new/different organisational structure of financial supervision which took into account systemic risks and was resistant to financial crises and to the domino effect sweeping across all member countries. The second area involved suggesting better ways of overcoming the consequences of financial crises by means of adjusting monetary and fiscal policies of EU member countries. The third area aimed to strengthen international regulatory measures and to increase co-ordination among supervisory bodies and macroeconomic policies of the member states.[140]

Implementation of the suggested improvements was rather lengthy and laden with complications. The purpose was to make member countries approve fast high quality legislation. The process of implementation, however, faced numerous problems because of insufficient political support, which, in turn, adversely affected the quality of the entire process of supervisory integration and ratification of the norms. As a result, the process also often took far longer than initially envisaged. I also believe that the subsidiarity principle, adopted for the Lamfalussy process, is not the best option, because it presupposes an institutional organisation of supervision at the national level—that can hardly lead to real harmonisation. The process of implementation was further hampered by fears of destroying the balance among European bodies due to the distribution of power during the process of implementation.

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[139] Euro Area Policies: 2007 Article IV Consultation—Staff Report International Monetary Fund Country Report No. 07/260 [online] 2007 [qtd. 9th January 2017] Available at http://www.imf.org/external/pubs/ft/scr/2007/cr07260.pdf, p. 27.

[140] JAKSON, J., Financial Market Supervision: European Perspective. Congressional Research Service. [online] 2010 [qtd. 17th May 2017]. Available at http://assets.opencrs.com/rpts/R40788_20100204.pdf. p. 13.

The main benefit of the Lamfalussy process can be seen in the incentive for the creation of integrated legislative framework of financial market supervision in Europe. It initiated proper co-operation among member countries and European supervisory and regulatory bodies through the creation of the abovementioned commissions and it also brought closer the single framework for European financial market supervision.

De Larosière report

Following the financial crisis, there was a need to reassess the previous measures adopted in the area of financial market supervision. A new reform of significant proportion with Europe-wide application was called for. This reform began in 2008 with the aim of analysing the main causes of the financial crisis and it also strove to put forward plans for strengthening the supervisory demands, which would provide more protection for European citizens and which would also help people to regain confidence in the financial system. The then chair of the European Commission Jose Manuel Barosso put together an expert group led by an ex-president of the International Monetary Fund Jacques de Larosière. Its task was to analyse systemic deficiencies and propose suggestions, recommendations, and measures to strengthen the system of supervision in the EU and to restore confidence in the financial system as a whole. The objective was thus clear right from the outset: to create a more effective and sustainable system of supervision in the EU. The question remained, however, whether to opt for a centralised approach or rather leave the power and responsibility to national supervisory authorities while insisting that their mutual co-operation be better and more intense.

In February 2009 this expert group published a report called 'The High-Level Group on Financial Supervision in the EU'[141], later to be known as the 'De Larosière report'. Apart from the analysis of deficiencies in the system used at that time (mentioned above), it came up with 31 recommendations that should attain the objectives. This report also included proposals to create a new supervisory structure with a view to increasing effectiveness of the European supervisory framework, thereby positively affecting the stability of the system, too. Ultimately, this was

[141] The High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière: Report [online] 2009-02-25 [qtd. 17th May 2017]. Available at : <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf>.

supposed to lead to a dramatic reorganisation of the institutional structure of financial regulation and supervision in the EU. The principal change concerned the fact that the newly-established institutions were to be given authority to issue legally-binding directives to national regulatory bodies and specific financial institutions as well. The De Larosière report also justified the handover of authority by explaining that there was essentially no conflict with the basic principles of subsidiarity and proportionality[142] and by pointing out the need to promote some supervision to the European (rather than national) level due to the ever-increasing integration and consolidation of the European financial market.

The European Commission agreed with De Larosière's conclusions and in September 2009 it adopted five legislative proposals (financial supervision package), which were then referred to the European Parliament and the Council of the European Union for acceptance. In October 2009 the European Commission submitted a proposal for the Omnibus I[143] directive, which introduced basically a new system of supervision by means of 11 amendments to council directives. These legislative proposals were approved by the Council of the European Union and the European Parliament in September 2010, and the European System of Financial Supervision came into existence. The negotiations lasted for more than a year and the new supervisory body was founded thanks to a number of regulations from the European Parliament and the Council of the European Union[144]. The new system of supervision

[142] These principles also guaranteed that everyday supervision was in the hands of national supervisors.

[143] Directive 2010/78/EU of the European Parliament and of the Council of 24th November 2010, amending directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC.

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- Regulation (EU) No. 1092/2010 of the European Parliament and of the Council of 24th November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (hereinafter the 'ESRB Regulation')
- Regulation (EU) No. 1093/2010 of the European Parliament and of the Council of 24th November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/78/EC (hereinafter the 'EBA Regulation').
- Regulation (EU) No. 1094/2010 of the European Parliament and of the Council of 24th November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/79/EC (hereinafter the 'EIOPA Regulation').

took effect on January 1st 2011. It established a two-pillar structure of supervisory bodies in the whole of the European Union—macro and micro-level supervision.

In spite of the fact that the legislative proposal from the European Commission in many aspects copied De Larosière's report, it was also hugely influenced by pressure from some member countries which vigorously opposed far-reaching reforms. The transfer of responsibilities to the proposed European authorities and their potential intervention in everyday supervision were not accepted because of a lack of political will—the prevailing attitude saw this transfer as a breach of the national sovereignty principle.[145]

The effect of the De Larosière's report was far from revolutionary or unique; we can say it was more or less an inevitable outcome of the prevailing trends, brought about by the needs to deal with the financial crisis. Although the report as a whole was not novel (admittedly, there were a few novel features and specific details), it summarised and politically united the contemporary opinions and tendencies.[146] It needs to be admitted that nobody could possibly have expected a radical U-turn—that would have been impossible due to the financial market needs. Moreover, completely revolutionary ideas would never have gathered enough political support. Thus, the main task was to choose, after a careful analysis of the unsatisfactory situation, the optimal conception to achieve the objective: the systemic stability of the financial market. Owing to the fact that the proposal put forward by the expert group and the political will are two different things, it was clear right from the outset that the centralising proposal would be watered down by many compromising modifications; yet, there were some significant changes to the system of financial regulation and supervision. At the end of the day, this was another step towards Europe-wide integration of financial market regulation and supervision. It is not such an important matter that the report was not radically novel; the importance lies in the fact that it

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- Regulation (EU) No. 1095/2010 of the European Parliament and of the Council of 24th November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/77/EC (hereinafter the 'ESMA Regulation'; the EBA, EIOPA a ESMA regulations together referred to as the 'ESA Regulation').

[145] JUROŠKOVÁ, L. *Bankovní regulace a dohled*, Praha: Auditorium.2012. p. 91.

[146] A similar reform was proposed by e.g. SCHOENMAKER, D. – OOSTERLOO, S. Financial supervision in Europe: A proposal for a new architecture. in: L. JONUNG, L. – WALKNER, C. – WATSON, M. Building the Financial Foundations of the Euro – Experiences and Challenges. London: Routledge, 2008. pp. 337-354.

gradually intensified and strengthened the process of integration. It goes without saying that all novel ways eventually succumb to compromise and it is very unlikely that there will ever appear a one-step radical solution. What initially seemed to be hugely controversial and radical was (after some revision process) finally approved as a compromise.

The system of financial supervision in Europe

This system is based on two pillars defined by the De Larosière's report. The pillars were defined after a careful analysis of the previous supervisory mechanisms and their deficiencies and after identifying the best remedial approach to the problems that the financial crisis had exposed.

The first pillar is represented by supervision at the macroeconomic level performed by the *European Systemic Risk Board* (hereinafter the ESRB). This board is composed of members with voting rights (i.e. the General Council of the European Central Bank, the chairs of the European Banking Authority -EBA, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority, the European Commission representatives, the chairs and vice-chairs of the ASC and the ATC) and non-voting members (representatives from national supervisory authorities and the chair of the EFC).

The second pillar is microeconomic supervision called the *European System of Financial Supervisors* (hereinafter the ESFS), for which are responsible three bodies: the *European Supervisory Authorities* (the ESA), the *ESA Joint Committee* and national supervisory authorities. [147] Completely new institutions were the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA).

ESA consist of new bodies transformed from the former third-level Lamfalussy commissions (the CEBS, the CESR, and the CEIOPS). These new bodies have legal personality and are subject to legal regulation from national supervision according to the location. Their objective is protection of the public interest by means of increasing stability and effectiveness of the financial system. More specifically, their tasks included ways of strengthening the integrity and increasing the transparency of the European financial market—this can be achieved, among other things, through

[147] JANOVEC, M. Současná integrace dohledu na finančních trzích. obchodněprávní revue, Praha: C. H. Beck, 2013, year 2013, issue 6, p. 161.

financial market supervision and regulation. Regulatory and supervisory changes first saw improvement of quality and status of the existing European supervisory bodies and only then did the abovementioned transformation of commissions into the new institutions take place.

The establishment of the ESFS was only the first step in the reform of supervision in the EU. In connection with the EU legal system, this was not an attempt to centralise supervisory competences at the European level, because it could not make legally binding decisions and ESA did not hold direct supervisory power within the EU. Thus, their main task was to supervise supervisory authorities of the member countries. There is, however, one interesting exception to this rule: ESA can perform direct supervision of financial market participants in three cases, if the necessary conditions are met. This will be discussed below.[148]

Another crucial step towards a full-scale reform of the system of financial supervision in the EU was the foundation of the Banking Union, again discussed in a separate chapter below.

1. Macro-prudential supervision- The European Systemic Risk Board

This type of supervision centres on prevention and problem-solving within systemic risk of the whole financial market. Systemic risk is defined as 'a risk to the stability of the financial system and therefore [it] has an impact on the internal market and the real economy'.[149] The goal is clearly predominantly preventive. The ESRB is concerned chiefly with monitoring, preventing and softening potential systemic risks to the financial stability in the EU; these risks stem from the ongoing processes within the financial system and general macroeconomic development. The ESRB and its activities should keep the internal market in the right condition and should also ensure a sustainable share of the financial sector as far as economic growth is concerned.[150]

The ESRB does not have legal personality or legal competences and, as a result, it cannot be considered a European body; it is rather a soft-law organisation. [151] As a matter of fact, it is an organisation that should use its

[148] KÁLMÁN, J. The reform of financial supervisory system of the European Union. International relations Quarterly, Vol. 5. No. 2 (Summer 2014). p. 3.
[149] Art. 2 (c) ESRB Directive.
[150] Art. 3, par. 1 ESRB Directive.
[151] VERHELST, S. Renewed financial supervision in Europe – Final or Transitory. In Egmont paper No. 44. 2011 p. 28.

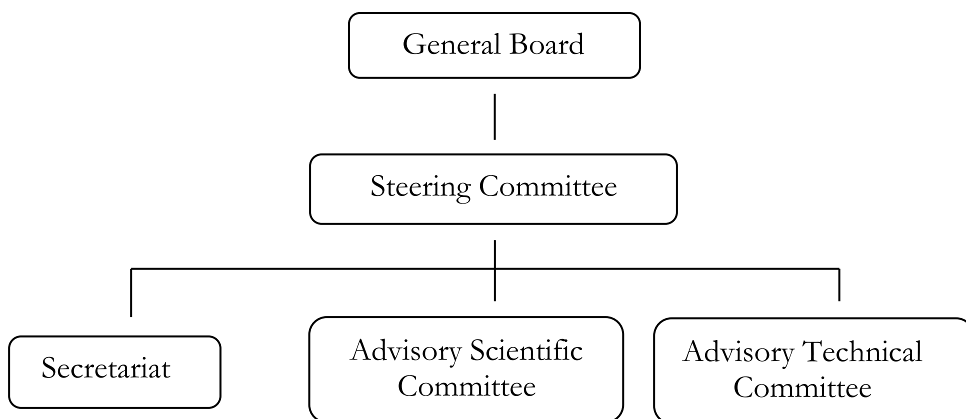
credit and expertise to positively influence top politicians and supervisory authorities in their decision-making process. This body should, above all, ensure with its expertise and the right setting of internal processes confidence in its ability to a/ make independent decisions, b/ produce high quality analyses, and c/ to reach firm conclusions.[152]

The ESRB is linked with the European Central Bank (hereinafter 'the ECB') within the EU structure. One proof of the close bond can be seen in the fact that the tasks of the Secretariat of the ESRB are undertaken by the ECB, which provides basic operational assistance to the ESRB; furthermore, members of the General Board are appointed by the central bank governors and the chair is the ECB president. One could thus conclude that the ESRB is, to a large extent, an organisational unit of the ECB with its own legal status and specific competence.

The organisational structure of the ESRB

The ESRB is located in Frankfurt upon Main and it is composed of five units: the General Board, the Steering Committee, the Advisory Scientific Committee, the Advisory Technical Committee, and the Secretariat.

Table no. 3: The structure of the ESRB



Source: VERHELST, S. (2011) p. 21.

[152] GOLDBY Miriam; KELLER, A. The Commission's proposal for a new European Systemic Risk Board: an evaluation. Law and Financial Markets Review, Volume 4, No 1, January 2010, p. 51.

The *General Board* is the main decision-making body of the ESRB; it takes decisions which are necessary for accomplishing the tasks the ESRB has been entrusted with.[153] The Board has 67 members, 38 of whom have voting rights: the president and vice-president of the ECB, 28 national central bank governors, a European Commission representative, 3 chairs of the ESA bodies, the chair of the Advisory Scientific Committee and his two deputies, and the chair of the Advisory Technical Committee. Non-voting members include experts from each member country (nominated from national supervisory authorities—28 people) and the president of the EFC (Economic and Financial Committee). The first chair of the ESRB is the president of the ECB. He is elected for a term of five years.[154] In the future it is expected that the ESRB should be completely independent of the ECB, especially after the introduction of the single supervisory mechanism. In addition, the institution's independence is further strengthened by the fact that the chair of the ESRB should always be someone with no political affiliation and a high level of expertise so as to make sure that the person enhances the credit of the ESRB. Such a person should not be the president of the ECB—it could, for instance, the ex-governor of a central bank or a top executive from a national supervisory authority.[155] Except for the chair, there are also two vice-chairs, one of whom is also a member of the General Board of the ECB and is elected by all its members, while the second vice-chair is the chair of the Joint Committee.

The Steering Committee helps in the decision-making process of the ESRB by preparing meetings, revising the documents under discussion and assessing the progress of ESRB activities.[156] This body is composed of the chair and the first vice-chair of the ESRB, the vice-president of the ECB, four other members of the General Board, a European Commission member, the chairpersons of the three ESA bodies, the president of the EFC, the chair of the Advisory Scientific Committee, and the chair of the Advisory Technical Committee.

153 Art. 4, par. 2 of the ESRB Regulation.

154 Art. 5 par. 1 the ESRB Regulation.

155 In the revision process of the ESRB were issued several recommendations by means of the Directorate General for Internal Policies towards European legislators. Cf. MCPHILEMY, S. ROCHE, J. Review of the New European System of Financial Supervision. Part 2: The Work of the European Systemic Risk Board, Report [online] EU 2013 [qtd. 24th May 2017]. p.86. Available at <www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507490/IPOL-ECON_ET%282013%29507490_EN.pdf>

156 Art. 4 par. 3 The ESRB Regulation.

The Secretariat is in charge of everyday business of the ESRB, supported by the ECB, which offers analytical, statistical, logistic and administrative help to the ESRB.[157] The Advisory Scientific Committee offers scientific support and the Advisory Technical Committee provides advice and support necessary for the task fulfilment of the ESRB, including the assessment of financial stability in the EU.

The main tasks and powers of the ESRB

As it was mentioned above, the main tasks include making analyses and monitoring risks with their timely idnetification. This is achieved by means of warnings and recommendations—measures taken to reduce the risks. Among other things, it issues recommendations regarding a quarterly setting of the level of 'countercyclical buffer'[158] in all member states. This is followed by close monitoring of the warnings that have already been issued. Further, a new system 'Early Warning Exercises' (EWE) has been introduced—together with the MMF it represents of the analytical instruments at the ESRB's disposal[159]. The EWE system is composed of a number of tests carried out every six months with the aim of establishing to what extent the international financial market is prone to systemic risk.

Warnings and recommendations can be general or specific and they can be addressed to the EU as a whole, to individual countries or groups of countries, to one or more ESA bodies, or, finally, to one or more national supervisory authorities. They are never aimed at individual financial institutions for such a step would go beyond the macroeconomic focus. The main aim is to warn against possible systemic risks, which could, in turn, provoke political responses.

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[157] The Council Regulation (EU) No. 1096/2010 of 17th November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board 1096/2010.

[158] Setting a limit for the capital of credit institutions and demands for liquidity are one of the main instruments of macro-prudential supervision as stated in Regulation CRD IV (see below). Liquidity demands consist of liquidity coverage ratio Tier 1 (LCR) and net stable funding ratio (NSFR). The former states the desired amount of liquid assets a particular bank needs to possess in order to survive financial market downturns. The latter is concerned with the sources of financing or its stability. These demands for the capital are being implemented gradually and their full implementation is only expected after January 1st 2019.

[159] The IMF-FSB Early Warning Exercise: Design and Methodological Toolkit. The International Monetary Fund [online] 2010 [qtd. 24th May 2017] Available at z:<http://www.imf.org/external/np/pp/eng/2010/090110.pdf>.

The crucial question to be answered here is whether the ESRB possesses enough advisory and analytical competence. In my opinion, it does—not every single body or organisation must necessarily possess legally binding power. I am convinced that the ESRB is not a body that provides 'only' advice and recommendations about risks. Even though recommendations from the ESRB are not legally binding, they represent a certain way of regulation that is endowed with mechanisms such as the 'act or explain'[160] or 'naming and shaming' ones—aimed to ensure rules observation. The 'naming and shaming'[161] mechanism is known from the OECD. In certain cases this mechanism brings negative publicity. Having informed the Council in advance, the General Board of the ESRB can decide to publicly announce their warnings and recommendations; sometimes there might even be a public hearing in the European Parliament. [162]

These mechanisms try to make the addressees abide by the recommendations; if they do not, they are then asked to explain their decision—in certain cases this explanation must be released to the public. [163] This is, in itself, a relatively powerful instrument at the ESRB's disposal, despite not being legally binding. The institutional division between macroeconomic and microeconomic supervision is, I believe, correct—although the two influence each other, their supervision is rather specific with high qualification demands on people who perform the supervision. In addition, if the two types of supervision were integrated into one and only body (the ECB), there might be a conflict of interest, particularly because of the ECB's other important competences.

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[160] This mechanism comes from art. 17, par. 1 of the ESRB Regulation. The addressee (the Commission, one of more member states, one or more ESA bodies, one or more national supervisory authorities) is obliged to inform both the ESRB and the Council of the measures taken after receiving a recommendation, or it must explain its inactivity. If the ESRB is not content with a specific reaction or explanation, it may instantaneously inform the Council or ESA.

[161] The OECD uses this mechanism to identify tax heavens and to fight money laundering. Cf. e.g. "Name and shame" can work for money laundering. *OECD Observer* No 223, October 2000 [online] 2000 [qtd. 25th May 2017] Available at http://www.oecdobserver.org/news/archivestory.php/aid/358/_93Name_and_shame_94_can_work_for_money_laundering.html.

[162] For more information see: PFAELTZER, J. W, Naming and Shaming in Financial Market Regulations: A Violation of the Presumption of Innocence? In *Utrecht Law Review*, Vol. 10, No. 1, pp. 134-148.

[163] FERRAN, E., ALEXANDER, K. Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board, in University of Cambridge Faculty of Law Research Paper No. 36/2011. [online] 2010 [qtd. 24th May 2017] Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1676140. pp 30-31.

Conversely, one can also come to the conclusion that supervision at the macroeconomic level should be integrated in the ECB's competences—this opinion rests on some decisive legal factors[164] which call for unification of the micro and macroeconomic levels of supervision; naturally, the only institution suitable to perform both types of supervision is the ECB. [165] As far as I am concerned, the very existence of the ESRB and its competence is beneficial to the financial market. It adds value to the financial system from the macroeconomic point of view and it also fills a void in the system of supervision; a void that got fully exposed during the financial crisis.

It is true that the ESRB cannot make legally-binding decisions, but it is endowed with natural authority springing from its good reputation and of its representatives (highly respected central bankers from the member states). This should ensure that their recommendations will be accepted. Yet, this unenforceability could prove to be the Achilles heel of the body, because I am not sure that the EU is integrated to such an extent as to permanently and voluntarily accept and implement whatever the ESRB comes up with.

A weak point of the ESRB is the fact that it gathers data from national databases which might not include all the (correct) information. This, of course, influences identification of possible threats—these might not be detected or they might be interpreted in the wrong way, which ultimately lead to such catastrophic consequences as the ones caused by the financial crisis. It could therefore make the ESRB analyse a certain situation as a threat, although there is no threat whatsoever. Every warning issued by the ESRB that turns out to be completely false will result in a loss of credibility; all the more so since it entails higher costs for some financial market participants. It is a matter of sensitive application, which the ESRB must always bear in mind to be successful. I believe it is something this organisation is capable of.

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[164] The fact that macro-prudential supervision under the ECB is supported by art. 127 of the SFEU (former art. 105 of the EC Treaty).

[165] OTTOW, A.T.- VAN MEERTEN, H. The Proposals for the European Supervisory Authorities: The Right (Legal) Way Forward? Tijdschrift voor Financieel Recht, Vol. 1, 2010 [online] 2010 [qtd. 25th May 2017] Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1517371>. p. 43.

2. *Micro-prudential supervision—the European Supervisory Authorities*

Micro-prudential supervision existed in Europe in the form of the three committees based on the Lamfalussy report (discussed above). The ESA bodies are essentially the biggest change brought about by the establishment of the ESFS.

The reform enormously increased the competence, responsibility and autonomy of ESAs (when compared with the previous committees), supported by the possibility to make use of legally binding instruments.[166] Generally speaking, financial market supervision moved much closer to the level of the EU primary law.

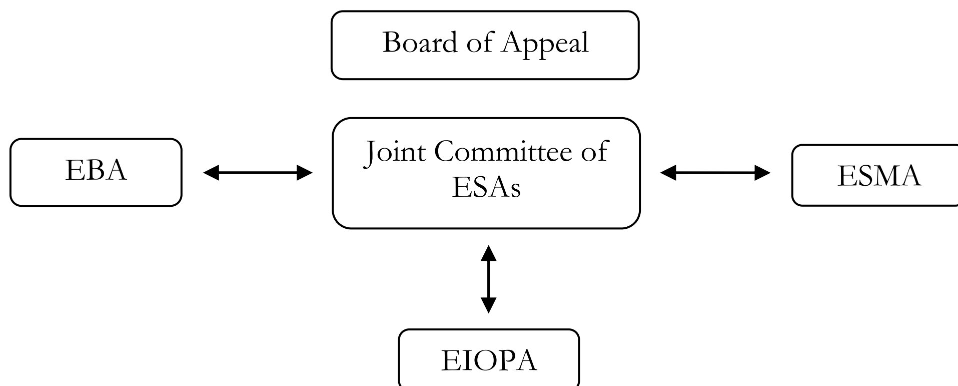
Newly-established bodies replaced the previous ones and the main point of difference lies in the aspect of legal personality—they can issue legally-binding decisions addressed to supervisory authorities in member countries, and, under special circumstances, addressed to specific financial institutions as well.

The structure of ESAs

ESAs are endowed with legal personality and in every member country their scope of legal personality is determined by the local legal system. At the European level, micro-prudential supervision entails three ESAs, the Joint Committee, and the Board of Appeal.

[166] RODRIGUEZ, P.I. Towards a New European Financial Supervision Architecture In *Columbia Journal of European Law* Online, Vol. 16, No. 1, 2009. s 3. [online] 2010 [qtd. 26th May 2017] Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1518062>. p. 6.

Table no. 4: The structure of micro-prudential supervision in the EU:



Source: VERHELST, S. (2011) p. 35.

The three ESA institutions are practically identical in terms of their organisation: a/ *Board of Supervisors*, b/ *Management Board*, c/ *Chairperson*, d/ *Executive Director*, e/ *Joint Committee*, f/ *Board of Appeal* (the last two are institutionalised in the ESA structure as the common ESA units), and g/ *Stakeholder group*.[167]

The main decision-making body is the Board of Supervisors, whose voting members are the chairs of national supervisory authorities and they reach decisions according to the simple majority principle. Given the high number of members, this body is not sufficiently flexible; that is why there is the Management Board, consisting of the chair and six other members. The Management Board carries out the tasks ESAs are entrusted with. The voting members of the Board of Supervisors are the ones who elect members of the Management Board as well as the Chairperson and the

[167] For example the Securities and Markets Stakeholder Group (a participating group for securities and markets), with which ESMA should consult norms and technical instructions while forming a common rulebook. Such a group is composed of 30 members, who evenly represent the EU financial market participants, their employees, as well as consumers, investors and people who use financial services. The same applies to EBA and EIOPA and their stakeholder groups. Cf. art. 37 of the ESA Regulation and EMMENEGGER, S. Procedural Consumer Protection and Financial Market Supervision. *EUI Working Papers Law* No. 2010/05. [online] 2010 [qtd. 26th May 2017] Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616322 p.7.
The participating group for the EBA is the Banking Stakeholder Group, while for EIOPA there are two groups, namely the Insurance and Reinsurance Stakeholder and Occupational Pensions Stakeholder Group.

Executive Director of ESAs—in this way national supervisory authorities retain some of their former influence.

ESA is represented by the Chairperson, who should be a person of high professional as well as personal integrity with impeccable knowledge of the world of financial markets and with much experience of their supervision and regulation. He or she presides the Board of Supervisors' and the Management Board's assemblies and is responsible for preparing the activities of the Board of Supervisors. The Executive Director is in charge of ESAs.

The Joint Committee works as a kind of a forum through which the ESA bodies regularly and intensely co-operate to ensure cross-sector consistency. The Board of Appeal is a body in charge of appeals and it consists of six members and their six substitutes, all of whom demonstrate a high level of expertise and experience.

The establishment of the Stakeholder groups is a major step towards better consumer protection because the groups can be involved in the decision-making process, at least in the form of consultations. They can officially take part in making decisions[168] and, since they are institutionalised now, they can see to the fact that democratic principles are observed—in the past a lot has been left to desire in this area. These groups operate in a similar way as the Advisory Technical Committee within the ESRB. One can see their existence as an interesting and beneficial move since discussions with the leading representatives of financial markets can bring up intriguing topics and proposals which might balance regulatory and supervisory pressure. These groups as the addressees of regulation and supervision can intervene in cases of 'over-regulation'.

The tasks and competence of ESAs

Before one analyses the individual tasks ESAs perform, it is worth stating what tasks it certainly does not have and why ESAs were not founded—this could enhance the comprehensibility of the following part. ESAs do not perform day-to-day supervision of financial institutions; this task is still in the competence of national supervisory authorities.[169] What ESAs have at their disposal is soft law instruments as well as competence to issue binding decisions, although these can be challenged. All three ESA

[168] EMMENEGGER, S. Procedural Consumer Protection and Financial Market Supervision. *EUI Working Papers Law* No. 2010/05. [online] 2010 [qtd. 26th May 2017] Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616322>. p. 7.

[169] Recital no. 9 of EBA and ESMA Regulations, and Recital no. 8 of EIOPA Regulation.

supervisory bodies have almost identical tasks, only ESMA has some extra supervisory responsibility and also the power to ban certain financial activities, if need be.

The tasks and instruments of ESAs might be divided into three sections: the quasi regulatory power, supervisory power, and legally-binding decisions in the form of legal norms enforcement. The crucial part is the last one—these instruments were the main benefit of the supervisory reform.

Table no. 5: Tools and tasks of the ESAs.

Quasi-regulatory competences		Preparation of technical standards – regulatory and implementing
		Recommendations and guidelines for identical and correct application of EU law
Supervisory competences	Micro	Supporting and monitoring the efficient, effective and consistent functioning of colleges of supervisors
		Support coordination between supervisory authorities in specific situations
		Carrying out regular analyses of the mutual evaluation (peer reviews) some or all of the activities of international supervisors
		Monitoring and assessment of market developments and, if necessary, informing other ESAs, the ESBR, the European Parliament, the Council and the Commission on the current micro-prudential trends, risks and vulnerable areas
		Building of and support for common EU supervisory culture
	Macro	Cooperation with the ESRB and the follow-up to its warnings and recommendations in the matter of systemic risk (risk dashboard)
		Indicators and criteria for assessing systemic risk and an adequate stress testing regime
		Making the necessary supplementary guidelines and recommendations for key financial institutions while taking into account the systemic risk they pose
		Inquiry of financial activities, type of product or conduct and subsequent recommendations for action to the competent authorities concerned
	Legally binding decisions (law enforcement)	In the case of a breach of EU law, issuing specific recommendations to the national supervisory authorities
		Action in critical situations addressed to financial institutions
		Legally binding decisions made during the settlement of disagreements between competent authorities in cross-border situations
		The enforcement powers of ESMA's for Credit Rating Agencies (CRAs) and Trade Repositories (TRs)

Source: author's own processing. (based on the ESA Regulation).

The Single Rulebook

One of the main objectives of the ESAs is to work on the single rulebook. The ESA Regulation does not define exactly what is meant by such a code. The Council of Ministers described the single rulebook as a basic set of rules and standards across the EU that are directly applicable to all financial institutions operating in the single market.[170] However the fact remains that even this statement is not an unequivocal determinator of what a single rulebook is, and for this reason, there is ample room for interpretation by the ESAs, which on the other hand, can also bring contradictions between supervisors.

However, the single rulebook does not include a complete harmonization of the rules applicable to financial institutions that should lead to less contradictory financial legislation in all member states. This results in fewer opportunities to resolve the regulatory dispute (regulatory arbitrage)[171] and the reduction of gold-plating[172] issuess. [173]

In general, supervisory practices vary from one member state to another and Regulatory arbitrage in cases when a contradiction between member states brings efficiency losses for a single market. The ESAs should, therefore, have the necessary powers to effectively coordinate supervisory actions carried out by national supervisory authorities both when authorising or registering an undertaking and as part of an ongoing review of supervisory practices.

A possible solution for avoiding Regulatory arbitrage is to centralise powers to the hands of ESAs. One of the first steps could be found in the enforcement powers ESMA's for CRAs and TRs. When there are more financial market institutions under the direct supervision of ESAs, there is no place for conflicting legislation in Member states. One possible way

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[170] The Council of the European Union, Agreed Council Conclusions on Strengthening EU Financial Supervision, 10th June 2009, 10862/09, p. 5.

[171] 'Regulatory arbitrage' – The differences in financial regulation led to regulatory arbitrage, i.e. a situation in which financial institutions strive for the most friendly supervisory framework possible. Member states afraid of regulatory arbitrage (or keen to make us of it) are inclined to restrict regulatory demands. For more info cf. TABELLINI, G., Why did bank supervision fail? In *The First Global Financial Crisis. of the 21st Century*, VoxEU Publication, Centre for Economic Policy Research, 193p., [online] 2008 [qtd. 28th May 2017] Available at <http://www.voxeu.org/sites/default/files/First_global_crisis.pdf>. pp. 45-47.

[172] It is a situation in which member states can introduce stricter regulatory rules if they want to.

[173] VERHELST, S. Renewed financial supervision in Europe – Final or Transitory. In *Egmont paper* No. 44. 2011 p. 40.

could be seen in the new proposed practice of ESMA considering certain types of prospectuses with a cross-border dimension, where their approval is centralised at the level of ESMA.[174] The centralisation of their approval, as well as all related supervisory and enforcement activities at the level of ESMA, will enhance the quality, consistency and efficiency of supervision in the Union, create a level playing field for issuers and lead to a reduction of the timeline for approvals. It will eliminate the need to choose a 'Home Member State' and prevent forum-shopping.[175]

The other possible solution is to produce more detailed harmonization of the rules applicable to financial institutions for the single rulebook. These rules should allow less space for conflicting financial legislation in member states and therefore fewer Regulatory arbitrages.

ESAs have two tools to reach the goals mentioned above. The first tool is non-binding regulatory recommendations and guidelines.[176] ESA can address these recommendations and guidelines to national supervisors as well as individual financial institutions. These recipients should comply with such recommendations and guidelines. In cases where they fail to do so, it is necessary for the supervisor to sufficiently justify such action. However, this only applies to financial institutions and only if the recommendation or guideline explicitly expresses such a request.

The second tool is the regulatory and implementing technical standards.[177] Implementing standards ensure uniform implementation of EU law without legislative changes. Regulatory standards supplement or amend legislation, but only elements that are nonessential.[178]

ESAs make "only" draft standards for the European Commission, which is the body which decides on their approval. By the same token, the recommendations and guidelines are not legally binding, and from this we

[174] These are the wholesale non-equity prospectuses offered only to qualified investors, the prospectuses which relate to specific types of complex securities, such as asset backed securities, or which are drawn up by specialist issuers and the prospectuses drawn up by third country issuers entities in accordance with Regulation (EU) 2017/1129.
[175] European Parliament. Proposal for a regulation of the European parliament and of the council. Com (2017) 536 final. Brussels 20.9.2017. p. 8.
[176] Article 16 of the ESA Regulation.
[177] Article 10-15 ESA Regulation.
[178] Article 290-291 of Treaty on the Functioning of the European Union (TFEU), OJ C 83, 30.3.2010, p. 1-388.

can deduce its "quasi" nature, because ESAs do not in fact have regulative competences.[179]

On the other hand, the possibility of the European Commission in relation to draft standards is limited in terms of their change. The European Commission may intervene in drafts only if ESAs fail to provide adequate drafts within the stipulated deadline. In practice, the Commission does not endorse the drafts of ESAs only in exceptional cases, and it therefore gives added value to the quasi-regulative competence of ESAs.

It follows from the above that the drafts of technical standards have a greater impact on the harmonization of legislation in the financial market than guidelines and recommendations (as a soft law tool). At first sight, quasi-regulative competences seem almost powerless, but upon closer examination, it is indeed a regulative competence. Especially the fact that the European Commission in the case of ESAs technical standards drafts practically do not interfere shows that the entity which forms these standards is currently ESAs.

Supervisory colleges and their support

Supervisory colleges with cross-border activities within the given sector used to be formed ad hoc and the first were established in the 1980s'. They are thus not a novelty brought about by the financial crisis or supervisory integration.[180] In spite of the Lamfalussy process helping to institutionalise the colleges, the nature of co-operation was rather voluntary, involving the home supervisor (as the main supervisor within a particular college) and the other members of the college for one institution.[181] There were problems

[179] Cf. MOLONEY, N. The European Securities and Markets Authority and institutional design for the EU financial market – a tale of two competences: Part (1) Rule-Making. European Business Organization Law Review, Vol. 12. No 1 (2011), pp. 41-86.

[180] The first supervisory college to be established was the college for the Bank of Credit and Commerce International, advocated by the supervisory authorities from Britain, Luxembourg and other countries. After its fall in 1991 European supervisors called for improving international co-operation among supervisors that are in charge of supervision of global banks. There were a number of colleges established in an ad hoc manner supervise international financial institutions. Also, there emerged colleges for the exchange of information regarding institutions such as Citigroup, HSBC, and the Deutsche Bank. Cf ALFORD, D. Supervisory Colleges: The Global Financial Crisis and Improving International Supervisory Coordination [online] 2010 [qtd. 18th June 2017] Available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1545291>, pp. 5-7.

[181] E.g. the Federal Reserve Bank of New York is the main supervisor in Citigroup, BaFin fulfils the same role for the Deutsche Bank in Germany, and the Financial Services Authority (FSA) is the main supervisor in HSBC in Great Britain. Supervisory authorities

concerning the division of powers and responsibilities within colleges and there was no coercive instrument to settle disputes between national supervisory institutions in relation to one financial institution; sometimes there were also disputes about who should be the main supervisor in cases of international mergers.

A relatively important change for supervisory colleges was the modification of relations between home and host supervisory authorities brought about by the amendment to the CRD III directive. [182] National supervisors are obliged to close co-operation within colleges. Such colleges are established mandatorily for all major financial institutions. To put in a different way, the authority which is in charge of European consolidated groups[183] as the main supervisor must found a supervisory college and inform ESAs of its activities. The colleges are not composed solely of supervisory authorities from the countries where major financial institutions have their subsidiaries, but also of supervisory authorities from countries where major institutions have their important branches.

Consequently, one of the main tasks was the definition of what constitutes the notion of an 'important branch'. A host supervisory authority can use this label, thereby becoming part of the supervisory college established by the main supervisor for the given international financial institution. Simultaneously, the home supervisory authority is obliged to inform others of any exceptional situations regarding the financial institution. The home and host supervisory authorities also need to reach an agreement when they determine the capital requirements of European consolidated groups and their members above the minimum level.

Formerly, there used to be problems with settling disputes within colleges of one financial sector (within the competence of ESAs now). To settle

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from Great Britain, the USA, Canada, France, Hong Kong and Switzerland used to meet regularly in order to exchange information about HSBC. The Federal Reserve, the FSA and the Swiss Federal Banking Commission meet every six months to discuss the transactions in the UBS and Credit Suisse. Cf. MCCARTHY, C. How should international financial service companies be regulated? [online] 2004 [qtd. 18th June 2017] Available at: <http://www.fsa.gov.uk/library/communication/speeches/2004/sp196.shtml>.

[182] Directive 2009/111/ES of the European Parliament and of the Council of 16th September 2009 amending Directives 2006/48/EC, 2006/49/EC, and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, par. 3

[183] European consolidated group is a group in charge of European banks and European financial holdings.

cross-sector disputes (financial conglomerates doubling as banks and securities traders are no exception) there is the Joint Committee of ESAs.

If one national supervisory authority disapproves of another authority's conduct, ESAs intervene as a mediator setting a time limit to find an agreement. If the negotiations fail, ESAs issue a binding decision stating what a given authority must do or what it must refrain from doing. Only then can ESAs issue a decision addressed to a specific financial institution, providing that the national authority again fails to comply with the previous decision.

Solving problems is the major point of the current legal basis that filled a void in the Lamfalussy process. Co-operation with supervisory colleges does restrict itself to just that, though. ESAs' role includes maintenance of consistent and coherent functioning of colleges – ESAs' representatives can be present at college meetings as observers, they can demand all relevant information, they can ask a college for revision of a decision that results in incorrect application of Union law or does not contribute towards supervisory convergence, they can initiate and co-ordinate stress tests, etc.[184]

Union law enforcement – binding individual decisions

As I suggested above, the main point of the reform was the newly-acquired power to issue binding decisions—an instrument of law enforcement. This competence is the first to give EU bodies the possibility of functional supervisory power over supervisors and market participants.[185] It is worth pointing out that this competence is about supervision of member states' supervisors and it is only possible to issue binding decisions in more serious cases.

Similarly, one needs to realise that these decisions do not overturn decisions of national supervisors; they employ the direct impact effect (as is characteristic of Union law) as, according to the ESA Regulation, they are given priority over all the previous decisions made by relevant bodies in that particular case.[186]

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[184] HUSAR, M. Diplomová práce. Dohled Finančních institucí v EU. Brno, 2013. 117 p. Masarykova univerzita, Ekonomicko – správní fakulta. Vedoucí práce . Dalibor Pánek. p. 56.

[185] MOLONEY, N. I. Reform or revoluton? The Financial Crisis, EU Financial Markets law, and the European Securities and Markets Authority. *International and Comparative Law Quarterly*, 2011, Vol. 60, Issue 2. p. 532.

[186] ESA Regulation, art. 17 par. 7; art. 18 par. 5.

As regards the Czech Republic, we might ask whether the CNB should enforce the decisions it did not make (they were made by ESAs). 'To solve this we should look at art. 291, par. 1 of the Treaty on the Functioning of the European Union (hereinafter as the 'TFEU'), which says that member countries are obliged to take any internal legal measures necessary to adopt binding Union acts. Decisions issued by ESAs are, as a matter of fact, specification of obligations stated in the Union directive on the basis of which it is issued. In other words, to breach this decision is simultaneously a breach of the directive, the observance of which the CNB checks. If individual ESAs' decisions are breached, the CNB is authorised to impose sanctions according to Czech law'.[187]

Every addressee of ESAs' decisions can ask for their revision; that is why the Board of Appeal was established (as demonstrated in the table above showing the structure of ESAs). The right to appeal belongs not only to addressees but to anyone who is directly affected by the decision. The Board of Appeal can then return the case to the relevant ESA body with a legally binding resolution or it can uphold the decision. The second way to defend oneself is to lodge a complaint with the Court of Justice of the European Union pursuant art. 263 of the TFEU; or, in case of inaction on the part of ESAs, one can lodge a complaint pursuant art. 265 of the TFEU. The appellate procedure is relatively weakly regulated; e.g. there is no definition of grounds for appeal to the Board of Appeal, which, in my view, means that one can use any reason (if sufficiently relevant).

It is exactly the chance to appeal against ESA decisions or to lodge complaints to the Court of Justice that represents a considerable step towards fully fledged supervision with a considerable amount of judicial responsibility.

Generally speaking, if a national supervisory authority infringes Union law (if the directives are not applied properly or are not applied at all), the relevant state is held responsible for it. If this infringement is not rectified or set right in line with Union law even after the European Commission has issued a statement, there is no other option for the Commission but to bring the matter before the Court of Justice of the European Union pursuant art. 258 of the TFEU (lawsuit for inaction). Only a member state can be sanctioned.

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[187] HERBOCZKOVÁ, J. Dohled nad evropskými finančními trhy v rukou Evropské unie. *Dny práva* – 2010 – Days of Law [online] 2010 [qtd. 2nd August 2017] Available at: <http://www.law.muni.cz/sborniky/dny_prava_2010/files/prispevky/04_finance/Herboczkova_Jana%20_(3664).pdf>. p 12.

The chance to issue legally binding individual decisions is an interesting and highly innovative federal feature, one of the first of its kind in this area. The ESA bodies, however, face the problem of binding restrictions which restrict the field of activity for making decisions. Consequently, we should not overrate this new instrument of Union law enforcement. On the other hand, since I consider myself to be a supporter of federalism in the EU, I entirely count on the fact that the means of Union law enforcement will be enlarged, at least by slimming down the limits restricting the use of binding individual decisions.

Union law infringement

If such a situation happens (Union law infringement by a national supervisor[188]), ESAs have, before the European Commission lodges a complaint, one more mechanism at their disposal to enforce the law. Firstly, they investigate the alleged law infringement and then they suggest measures to be taken by the given national supervisor. If this fails to bear fruit, the European Commission can issue a formal statement about the matter. If the supervisor's measures are still inadequate, ESAs can demand proper reaction from the given financial institution. This can only happen if Union law is, in the given case, directly applicable to financial institutions (especially as far as regulations and technical norms are concerned) and what ESAs demand is necessary for the maintenance of competition in the market or of the financial system stability.

In this particular case I hold the view that the conditions for the use of this instrument (i.e. that ESAs can actually demand adequate response from a specific financial institution) are too restrictive and should partially be done away with. To restrict this instrument to directly applicable law and, at the same time, to protection of competition or the stability of the financial system is so limiting that the use of this instrument is practically purely theoretical. In my opinion, it would be beneficial to leave out the condition of direct applicability of Union law to financial institutions, which would open the door for the instrument.

Mediation between national supervisory authorities

Another reason for issuing a binding decision is mediation between national supervisory authorities.[189] After the initial phase of conciliation, ESAs have

[188] Art. 17 of the ESA Regulation.
[189] Art. 19-20 of the ESA Regulation.

the power to take measures that are binding for national supervisors. If these measures are ignored, ESAs can address them to financial institutions directly. These measures are given priority over those adopted by national supervisors. Nonetheless, the main task for ESAs is to fulfil the role of a mediator rather than to issue a wealth of binding decisions.

Disputes between national supervisory authorities often occur within supervisory colleges, when host supervisory authorities unsuccessfully attempt to make home supervisory authorities act. In this respect, one may entertain the interesting idea of prompt corrective measures, for example in favour of colleges of regulators.

In the USA this practice has been in existence for two decades in the field of banking supervision. Prompt corrective measures can be defined as regulations which are to be adopted if there is a slump in the bank capital. Their application in the EU was advocated for example by David Mayes[190], who stated that the introduction of prompt corrective measures would provide an answer to a breach of the capital adequacy directive. Mayes also expressed his view that this type of action would be useful if prudential management in banks showed fundamental defects. It was suggested that the adoption of prompt corrective measures should be within the competence of supervisory colleges and that their main beneficiaries would be countries where foreign banks dominate. Host authorities would not need to fear that that their own banking system would break down because of a home supervisor's passivity, since the home supervisor would have to intervene in case the health of a banking group deteriorated.[191]

Decisions in emergency situations

Effective problem solving may be realised upon the initiative of a body co-ordinating national supervisory authorities; among others it may be a recommendation from the ESRB. An emergency situation may be declared by the ECOFIN Council after it has received a request from one of the following institutions: the European Commission, the ESRB, or a national supervisory authority. Also, the ECOFIN Council may not declare it without having consulted the case with the particular institution that submitted the request.[192] After the emergency situation is reported to the

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[190] MAYES, D., G. Early Intervention and Prompt Corrective Action in Europe. Bank of Finland Research Discussion Papers, No 17/2009.

[191] JUROŠKOVÁ, L. *Bankovní regulace a dohled*, Praha: Auditorium.2012. pp. 96-97.

[192] WYMEERSCH, E. The institutional reforms of the European Financial Supervisory Systém, an interim report. In *Ghent Univ. Financial Law Institute Working Paper No. 2010-01.*

European Parliament and the European Commission, the decision is then revised every month: it might be renewed or cancelled by the ECOFIN Council or it might expire.

Emergency situation decisions[193] are individual decisions addressed to national supervisory authorities asking for specific response. If the response from the given national supervisory authority is not adequate and if no explanation (demanded by ESAs) is offered, the subsequent procedure is the same as in case of a breach of Union law (cf. above).

Binding decisions in the abovementioned cases are only applicable in cases of ensuring compliance with EU law or when an emergency situation has been declared. This rather restricts the applicability of these measures. The process of an emergency declaration may appear overly complicated; on the other hand, it is a non-standard case with possible interventions into national sovereignty so the complicated process of declaring an emergency situation is understandable. There's no denying that binding decisions are another step to strengthening centralised supervisory powers in the EU: a step from national to European supervisory authorities.

Supervisory limits

Every member country can make use of protective measures if it thinks that an ESA decision threatens its fiscal power. This limit to the application of direct decisions is motivated by attempts to maintain and protect the crucial principle saying that member countries have exclusive power in their fiscal policies.

It is possible to apply this protective measure if ESAs make a decision in an emergency or in its role of a mediator. A member country can then claim that the decision makes an impact on its fiscal responsibility; it must let ESA know that it is not going to obey the decision, thereby suspending the decision. If there is uncertainty surrounding the case and if the given national supervisory authority and the European authority dispute over it, it is the Council that issues a final verdict binding for both parties. The verdict is reached through a qualified majority. Of course, the Council is composed of member countries; therefore the power of ESAs might be endangered since the Council's verdict may be based on politics rather than expertise.

[online]. 2010 [qtd. 29th May 2017]. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1541968> p. 17.

[193] Art. 18 of the ESA Regulation.

'Many analysts agree that this is a cumbersome procedure, and one in which national interests are likely to prevail against the common good'.[194]

A general problem (mentioned here a few times already) is the limits to the use of individual decisions in all three cases of Union law enforcement, which are, to my mind, extremely restrictive. Again, it is a compromise in need of revision to make it meaningful (i.e. to make it applicable in practice). Presently, it is not very likely that these decisions will ever be applied; they will remain purely theoretical unless their applicability becomes far easier and the limits to their use are significantly deregulated. Only then will it be possible to say that the EU is on the way to federalism.

The assessment of the ESFS reform

With the benefit of hindsight after the reform based on the De Larosiere's report started, it is now easier to assess the pros and cons of it. I dare say that because of the immense scope of several dozens of international financial institutions and because of their influence not only in the area of financial markets, it is in the public interest that the supervisory powers become centralised. Initially, it was a bold move executed shyly, largely due to some member countries and their political interests which prevented full centralisation of supervision. The reform does introduce flexible identification of problems of international financial institutions, but it somewhat ignores the conditions for prompt and co-ordinated intervention on the part of regulators and supervisory authorities. I am convinced, though, that had it not been for the financial crisis, this reform would have been realised in a far less centralised way, if at all. Hence, we might say that the financial crisis, along with the great number of problems it caused, was also beneficial to a certain extent, in so far as it triggered a move that should ideally enhance economic stability in the future. Possible future crises shall never be prevented completely; yet, the establishment of the ESFS should increase readiness and enable quicker reactions to problems, thereby softening the negative consequences (even though the main instrument to achieve this remains the same: more effective international communication and co-ordination). Without a doubt, this is a big benefit of this system of international supervision.

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[194] FITZGERALD, S. The reform of financial supervision in Europe. Institute of International and European Affairs, Dublin [online] 2009 [qtd. 29th May 2017] Available at :<http://www.iiea.com/publications/the-reform-of-financial-supervision-in-europe>. p 11.

The establishment of the ESFS can be considered the initial step towards creating a 'supervisory architecture' package in the area of finance.[195] It is one of several steps taken in reaction to the financial crisis. Generally speaking, with the ESFS having been created, supervision was directed towards a more dynamic and centralised form in the whole of Europe; still, the reform was to continue: the next step was the realisation of direct financial market supervision in the EU.

The first step in creating a new form of supervision saw the introduction of supervisory authorities within the ESFS with only that competence which allows direct intervention in financial market activities as a last-resort instrument only.[196] The reasons behind this were chiefly political and legal.

Daily financial supervision was left in the hands of national authorities on a decentralised basis in accordance with the principles of subsidiarity and proportionality. The new European authorities do not replace the national ones; they merely supplement them. At this stage of the reform, the centre of direct supervision is still in the competence of national supervisory authorities, including international disputes, which are conducted via the liability of home and host supervisory authorities and a supervisory college (even though ESAs now have a new power regarding settling disputes). This is a rather sensitive area and to reach a consensus between the European Commission and member states is far from easy; that is why we should consider the first step as a positive one, in spite of the absence of direct supervisory power. Thus, I believe that the result brought by the ESFS is the maximum that could possibly have been reached—it was the first curtailment of sovereignty and exclusive powers that supervisory authorities, up until then, had had. It was later possible to carry on and, in the public interest, centralise supervisory powers even more (though not completely).

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[195] FAHEY, E. Does the emperor have the financial crisis clothes? Reflections on the Legal Basis of the European Banking Authority. In *Modern Law Review*, 2011, vol 74(4), pp. 581-595. [online] 2011 [qtd. 29th May 2017] Available at:<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1715524> p. 581.

[196] FERRAN, E. Understanding the New Institutional Architecture of EU Financial Market Supervision. In FERRARINI, G., HOPT, KJ and WYMEERSCH, E. (Ed), *Rethinking Financial Regulation and Supervision in Times of Crisis.* Oxford University Press, 2012. p. 151. Also in University of Cambridge Faculty of Law Research Paper No. 29/2011. [online] 2010 [qtd. 31st May 2017]. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1701147>. p. 41.

Capital adequacy as the pivotal area of macro-prudential supervision.

Although this book does not aim to analyse individual regulatory rules, it is necessary to include a small digression into the area of regulatory integration, namely into capital adequacy, which will complete the picture of supervisory integration. This will centre on the banking sector as it is the most important part of the financial market. Moreover, banks are those financial institutions that often get involved in the other areas of the financial market as well. In other words, there is a universal model of banking (sometimes together with securities traders), whose regulation is an intriguing supplement. The reason why capital adequacy regulation is so vital is the fact that supervisory authorities (whether it is at the European or national level) supervise the pre-set rules for the amount of capital in individual institutions, thereby carrying out macro-prudential supervision and reducing the danger of failure of one or more financial institutions—with some likely impact on stability of the entire system, too.

The capital adequacy principle aims to eliminate risks which every financial institution unavoidably faces and which can never be eliminated completely. Risks may potentially lead to losses; it is, however, crucial that a loss does not affect the creditors and that each institution should be able to cover it using its own sources only, i.e. its capital. Each risk is quantified and its possible loss is assessed—the size of the loss is called a capital requirement. The aggregate of capital requirements thus corresponds with the amount of risk the given institution faces and the aggregate must be equal to or lower than the capital of the financial institution.[197] Capital adequacy thus refers to the demands for the amount and quality of the capital with regard to the risk undertaken by the financial institution.

As far as law is concerned, capital adequacy is dealt with by means of three pillars. In mutual co-operation they should enhance the financial stability of the system. The first pillar states the formula for calculating capital adequacy along with minimum capital demands. These include the minimum credit risk, market risk and operational risk that financial institutions undertake. The second pillar involves supplementary supervisory activities for individual financial institutions. Each institution should assess the risks it undertakes and set the capital demands accordingly. This is revised and checked by the supervisory authority that can order higher capital demands than what the first pillar orders. The third

[197] ZEMAN, D. Regulace bank. Prezentace na kurzu příprav na zkoušky zvláštních insolvenčních správců. Praha: 24.2.2015. pp. 4-5.

pillar aims to strengthen market discipline by determining what information must be made publicly available.

1. Basel I

Since the middle of the 20th century there have been inequalities among banking institutions because of various legal bases of regulation in individual countries (not only European ones). Because the competition is international, banks from countries with less strict regulatory rules gained an unfair advantage—their operational costs, for instance, were lower.

These inequalities were the reason why the Basel Committee on Banking Supervision (BCBS)[198] was created. It was comprised of central bank governors from the G-10 countries.[199] This committee reached its ultimate goal in 1988 when it issued the Basel Capital Accord (Basel I) signed by all G-10 governors. It was the first international agreement as far as financial risks and their regulation were concerned. This document determined capital adequacy: banks were asked to hold capital equal to 8% of their risk-weighted assets. This concept only involved credit risk, therefore a proposal to add market risk was approved in 1993. Market risk involved three kinds of risk: interest rate risk, currency risk, and equity risk.

Having been instructed in a series of recommendations, the EU issued directives that member countries gradually incorporated into their legal systems. The most important directives seem to be the Capital Adequacy Directive[200] and the Investment Services Directive,[201] in effect from 1st January 1996, whose aim was creation of the single capital market.[202] Capital adequacy was later imposed on investment companies and securities traders as well—they had had less strict regulatory rules than banks up until then. A

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[198] It is rather an informal institution that should provide a discussion forum to promote co-operation among financial supervision institutions (central banks). It operates under the BIS (the Bank for International Settlements). Also shortened to the Basel Committee. Cf. Wikipedia. [online] [qtd. 22nd July 2017]. Available at

<https://cs.wikipedia.org/wiki/Basilejsk%C3%BD_v%C3%BDbor_pro_bankovn%C3%AD_dohled>.

[199] Comprised of the following countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, Great Britain, and the USA.

[200] The Capital Adequacy Directive (CAD I) 93/6/EEC

[201] The Investment Services Directive (ISD) 93/22/ EEC

[202] In the CR the ISD was implemented by Act No. 256/2004 Coll., Capital Market Undertakings Act.

new directive called Capital Adequacy Directive II (CAD II) [203] was issued in 1998 and it also took into account market risk.

2. *Basel II*

Gradually (mainly with new technologies having been invented) Basel I turned out to be insufficiently flexible; furthermore, new risks emerged with increasing influence on financial markets (e.g. the operational risk) which cannot possibly have been accounted for in Basel I.

It was necessary to draw up a new document to remove the imperfections in Basel I. A new Basel accord was approved in 2002.[204] Apart from credit and market risks it also mentioned the need of a capital requirement for the operational risk. In addition, the mechanism of individual ratings prevailed, allowing banks and traders to choose the best method for calculating their capital requirements according to investment services they offer.

Basel II increased the demands for risk management and also enhanced market discipline by stipulating certain demands on banks and traders regarding information to be made publicly available (e.g. information about shareholders, strategies and mechanisms of reducing risks etc.). Basel II was implemented into Union law by two directives, known as the CRD,[205] affecting banks, credit unions, electronic money institutions and securities traders. The directives were to be implemented by 1st January 2007. In reaction to the financial crisis the CRD was revised and later replaced by the CRD II, which is comprised of three directives.[206] Apart from some

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[203] CAD II consists of three directives: 98/31/EC, 98/32/EC, and 98/33/EC.

[204] Implemented into the legal system of the CR by regulation no. 123/2007 Coll., stipulating prudential rules for banks, credit unions, investment firms.

[205] Capital Requirements Directive was comprised of the Directive 2006/48/EC of the European Parliament and of the Council of 14th June 2006 relating to the taking up and pursuit of the business of credit institutions and the Directive 2006/49/EC of the European Parliament and of the Council of 14th June 2006 on the capital adequacy of investment firms and credit institutions.

[206] Directive 2009/27 / EC of the European Parliament and of the Council amending certain Annexes to Directive 2006/49 / EC of the European Parliament and of the Council as regards technical risk management provisions

Directive 2009/83 / EC of the European Parliament and of the Council amending certain Annexes to Directive 2006/48 / EC of the European Parliament and of the Council as regards technical risk management provisions

Directive 2009/111 / EC of the European Parliament and of the Council amending Directives 2006/48 / EC, 2006/49 / EC and 2007/64 / EC as regards banks affiliated to

technical amendments, the new document amends the relations between home and host supervisory authorities (by establishing supervisory colleges—see above), it makes use of hybrid calculations of Tier 1 capital[207], it changes the rules for involvement and, last but not least, it amends the demands for securitisation and liquidity risk management.

The CRD III[208] later introduced an increase of demands for the capital, implementation of suitable mechanisms of remuneration and possible interventions from supervisory authorities.

A new set of rules created by the BCBS was announced on the 16th December 2010 and it came to be known as Basel III.[209] Demands for capital adequacy were increased, new rules for weighting risk of assets was introduced, countercyclical banking activities were regulated, the leverage ratio was introduced, and banking liquidity management was strengthened. The definition of Common Equity Tier 1 (CET 1), Tier 1 capital[210] and supplementary capital Tier 1 were made stricter. Capital buffers were introduced (the build-up of capital reserves in good times that may be used

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central institutions, certain capital items, large exposures, supervision and crisis management

207 These are financial instruments falling under Non-core Tier 1 capital with hybrid characteristics of stock and debt instruments marking the boundary between the capital and the debt. What is necessary is their long-term character and its ability to cover losses while maintaining complete serviceability.

208 Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.

209 This set of regulations aims to improve the existing regulation, supervisory rules and mechanisms of risk management in the banking sector. The first version of Basel III was issued by the BCBS at the end of 2009 and it left a three-year period to fulfil all the demands. Originally, the implementation process was supposed to take place between 2013 and 2015; yet, changes in effect of the 1st April 2014 put the process back to the 31st March 2018. Cf. Česká asociace pro finanční řízení (CAFIN), Basel III (zvýšená regulace bank) CAFIN.CZ [online]. 2014 [qtd. 8th June. 2015]. Available at < http://news.cafin.cz/slovnik/basel-iii-zvysena-regulace-bank>.

210 According to art. 4 par. 1 section 118 of the CRR Directive the term 'capital' refers to the total of Tier 1 and Tier 2. Tier 1 is part of the bank's capital, it is a total of: paid-up core capital listed in the List of Company Registers, paid-up share premium account, mandatory reserves, other profit reserves (without those with a special purpose), retained earnings brought forward after taxation, the profit in the process of approval minus the expected dividends, normal period profit minus the expected dividends and tax deductions. Tier 2 is part of the bank capital comprised of reserves (up to 1.25% of the risk-weighted assets /RWA/), the subordinated debt A (up to 50% of Tier 1), and other capital funds. Cf. CNB. Slovník pojmů [online]. [qtd. 27th June 2017]. Available at https://www.cnb.cz/cs/obecne/slovnik/t.html.

in periods of stress) as well as intensification and improvement of banking supervision with more effective ways of releasing information.

It was not only the BSCB that played the key role in finding solutions to the financial crisis and subsequently influenced the revision process of Basel II. Other important players were supranational entities like G20 representatives and the Financial Stability Board (FSB), which is an international organisation, authorised to promote financial stability by observing and issuing recommendations concerning the global financial system.[211]

3. Basel III

According to Basel III standards, the minimum capital requirement does not change: it remains at 8% of risk-weighted assets. The standards, however, do change two other requirements: the minimum level for Common Equity Tier 1 (CET 1) increases from 2% (Basel II) to 4.5% of RWA and the minimum level for Tier 1 increases from 4% (Basel II) to 6% of RWA. Other Tier 1 capital and Tier 2 capital are not given any minimum limits; nevertheless, it is clear that the total of Tier 1 (CET1 + other Tier 1) and possibly also Tier 2 is min. 8% of RWA.

Basel III introduces two new capital buffers: fixed and variable. The fixed Capital Conservation Buffer should reach 2.5% of RWA. The variable Countercyclical Capital Buffer should always remain in the region of 0% to 2.5% of RWA depending on the economic cycle.

The capital conservation buffer demands require that the banks should keep the core Tier 1 capital at least at 2.5% of RWA and it should also be higher than the minimum capital requirement (8% of RWA).

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[211] The FSB was established in April 2009. It was transformed from the Financial Stability Forum (FSF). (Financial Stability Forum) under the authorisation of the G20 countries. It consists of the representatives of national supervisory authorities, ministers of finance, international financial institutions, central banks representatives from developed countries and big developing countries alike. Its members include economically influential countries (the USA, Great Britain, Spain, Germany, Italy, France, Switzerland, the RSA, China, Hong Kong, Canada, Australia, South Korea, Saudi Arabia, Singapore, Japan), big developing countries (Argentina, Brasil, Russia, India, Turkey, Indonesia), the EU represented by the European Commission and the ECB, international institutions (the BIS, the MMF, the OECD, the World Bank), institutions authorised to set standards (the BCBS, the CGFS, the CPSS, the IASB, the IAIS, the IOSCO). Cf FSB. Member Institutions Financial Stability Board [online] [qtd. 22nd July. 2017] Available at <http://www.financialstabilityboard.org/about/fsb_members.htm>.

The Countercyclical Buffer is used to reach a macro-prudential goal: it should protect the banking sector from periods of excessive indebtedness (credit financing). This capital buffer is only applied in cases of heavy indebtedness, which leads to extensive accumulation of systemic risk. If applied, the Countercyclical Buffer is seen as an extension to the scope of the Conservation Buffer. Its height may change over time and its implementation depends on 'national' circumstances.[212]

The protection of the banking sector does not entail only making sure that banks remain solvent even during periods of stress—with the help of the minimum capital requirement and the capital conservation buffer. The main aim seems to be making sure that the banking sector has enough total capital at its disposal to sustain the credit flow in economy without casting doubt on its solvency even during periods when the entire financial system goes through much stress and indebtedness is rapidly increasing. This should help reduce the risk of credit loans restricted by regulatory capital requirements, which could put economy in jeopardy and result in further credit loss in the banking system.[213]

As far as liquidity is concerned, Basel III introduces two new indicators, the aim of which is to ensure that banks have enough liquid assets. The first one is called the Liquidity Coverage Ratio (the LCR) and it assesses short-term liquidity. It means that banks need to possess enough high-quality liquid assets to cover their total net cash outflows over 30 days. The second one is called the Net Stable Funding Ratio (the NSFR) and it assesses liquidity for more than one year. The value of these ratios should never be lower than one. The new leverage ratio introduces the ratio of Tier 1 capital to the total of on- and off-balance sheet items. The final value should be higher than three. The objective is to prevent an excessive increase in on- and off-balance sheet leverage.[214] The final configuration of the LCR and the NSFR has not been stated yet—the European Commission should determine the NSFR by the end of the year 2016 (with the demands coming

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[212] Basel Committee. Press release, 12th September 2010: "Group of Governors and Heads of Supervision announces higher global minimum capital standards".

[213] Basel Committee, 16th December 2010: "Guidance for national authorities operating the countercyclical capital buffer".

[214] Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011. Bis.org [online]. 2011 [qtd. 27th June 2017]. Available at: http://www.bis.org/publ/bcbs189.htm

into effect at the beginning of 2018) and the final calculation[215] of the LCR is expected during autumn 2015 (in June 2016 it is still not known though).

In accordance with Basel IIII new requirements are being implemented gradually and they should not come into full effect before the 1st January 2019, when the capital adequacy should reach the total of 10.5%. The capital which does not meet the conditions for Tier 1 capital or supplementary Tier 1 capital should be eliminated by the end of 2023.

On the 8th December 2011 EBA issued a recommendation to all EU member countries in which it asks that the 71 top banks in the EEA should have the CET 1 capital at the level of 9% by the 1st July 2012.[216] According to this recommendation member countries themselves can, to a certain degree, determine the basis for the calculation of this demand.[217] The European Commission stated that the two special demands (for systemically important banks) and other special demands springing from the evaluation from supervisory authorities according to Pillar II will be placed above the minimum regulatory demands and the demand for the capital reserve. This is illustrated in the diagram below.

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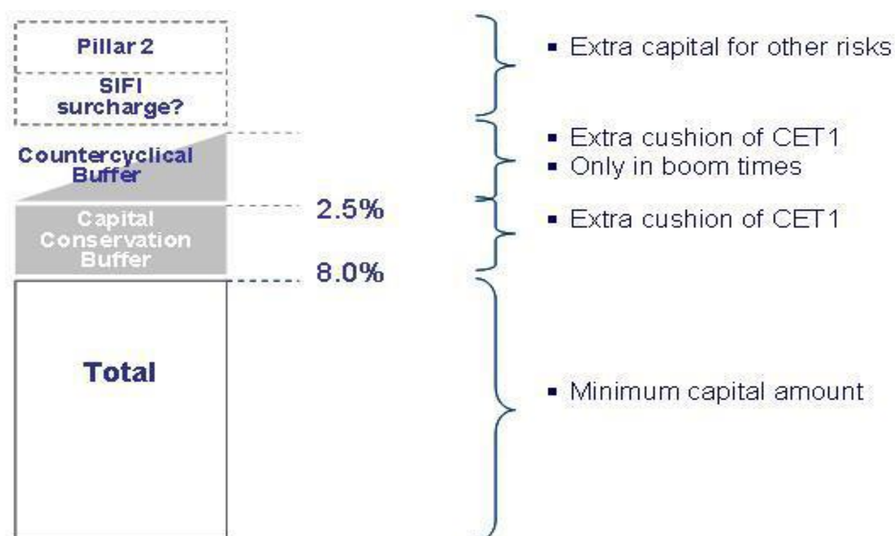
[215] The minimal LCR requirements will be implemented gradually according to the CRD IV. They should reach the maximum on the 1st January 2018. Cf. Finanstilsynet. Risk outlook and Financial Trends for 2015. April 2015. p. 30.

[216] EBA press release – a formal recommendation by the Board of Supervisors of EBA, of 8th December 2011, which asserts that national supervisory authorities should require that the biggest banks strengthen their capital position by building exceptional and temporal capital reserves in comparison with the state debt evaluation so that they reflect market prices in September that year. In addition, banks will have to create exceptional and temporal capital reserves to ensure that the ratio of Tier 1 capital reaches the 9% level by June 2012.

[217] EBA Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA/REC/2011/1) (London, 8th December 2011) Annex II.

Diagram no. 2. The overview of the structure of the capital in Basel III and CRD IV



Total represents min. 8% of the capital comprised of the total of Tier 1 (CET 1 min. 4.5% RWA + other Tier 1 = min. 6% RWA) and possibly Tier 2.

SIFI is an abbreviation for 'systemically important financial institutions'. SIFI surcharge may be added to the capital requirement for these institutions.

Pillar 2 represents the national supervisory authority's possibility of increasing the height of capital requirements.

Source: European Commission (CRD IV – Frequently Asked Questions, MEMO/11/527, 20th July 2011).

The CRD IV directive is implementation of Basel III standards for credit institutions and investment firms[218] into Union law. It is actually the third revision of the Union directive on capital requirements. This new legal basis consists of demands concerning financial health, liquidity management in financial institutions (the Capital Requirements Regulation[219]), and also rules including the national regulation of

[218] The CRD IV uses the general term 'institution'—in the definition found in art. 3, par. 1, section 3 it refers to the art. 4, par. 1 section 3 of the CRR, where institution is defined as a credit institution or an investment firm.

[219] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, which forms the basis of the single European aggregate for all institutions (capital requirements, capital ratios, the mechanisms for

certification for would-be credit institutions together with capital requirements for credit institutions and investment firms (the Capital Requirements Directive IV). The way of harmonisation stated in the directives was always seen as the minimum; in other words, member countries were given the freedom to toughen up rules along with the option to choose from different variations of rules or to avoid the application of some rules. This may lead, to a certain degree, to considerable inconsistency of capital requirements across member states and to emergence of obstacles for international credit institutions and investment firms. This was done away with thanks to the Banking Union (see below) and the implementation of the Single Rulebook. It must be stressed though that the EU is still relatively young and not homogenous enough; therefore, it is hardly possible to eliminate all the national differences across the EU.

This directive also asserts that if an institution fails to meet the requirements of capital buffers[220], the national supervisory authority may take action, e.g. it might restrict the institution's right to pay dividends to its shareholders or bonuses to its employees. Among other things, institutions are also asked to create a capital conservation plan if they do not satisfy the demand of combined capital buffers.[221] The actual amount of countercyclical capital buffer is determined by the national supervisory authority, which must present an instruction how to calculate the buffer every three months. The amount of countercyclical buffer is based on the credit-to-GDP ratio and its deviation from the long-term trend; alternatively, other indicators might be used, but all the data must be released to the public. These rules apply to all financial institutions active in the given country, including bank branches licensed in a different country.

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calculating capital requirements, liquidity rules, mechanisms for calculating leverage ratio). Capital Requirements Regulation (hereinafter the 'CRR Regulation').

[220] Art. 142, CRD IV asserts that if institutions do not meet the combined capital buffers demands, within five days they must submit a capital conservation plan, which must be approved by the home supervisory authority. The plan must provide an estimate of earnings and expenses, the expected accounting balance, measures to strengthen the capital shares, and, finally, it must state by when it expects to meet the capital requirement demand. If the authority does not deem the plan adequate, it may order the institution to increase its capital to a certain limit for a certain period of time; alternatively, it may also order a more restricted pay-out of dividends than art. 141, CRD IV maintains. The government's task is to intervene in the initial phase if the institution breaks (or is likely to break) the rules stated in the CRD IV directive.

[221] The CRD IV directive explains the combined buffer requirement in chapter 4, section 1, article 128, part 6. It says that the combined buffer requirement 'means the total Common Equity Tier 1 capital required for the capital conservation buffer extended by an institution-specific countercyclical buffer, other buffers, or a systemic risk buffer'.

If the home country's countercyclical capital buffer is higher than 2.5%, the host supervisory authority will decide whether the given institution will observe the higher figure or whether it will only have to meet the 2.5% level (like all domestic institutions). The ESRB assesses the amount of capital buffers and the instructions for their determination (including the necessary materials for it); the ESRB is also the body that issues recommendations as to how to determine the quarterly amount of countercyclical capital buffer in individual EU countries.

Among other things, Pillar II gives national supervisory authorities considerable power to stipulate other requirements than the minimum capital requirements for national institutions or conglomerates of institutions which undertake a high amount of risk. They may take such action based on their supervisory activities which assess whether individual institutions are in accordance with Union banking law; they also assess the risks undertaken by financial institutions and the risks these institutions pose to the financial system. Having assessed the situation, the authority decides, for example, whether the sources and their quality is sufficient to ensure healthy risk management regarding the risks undertaken by the institution and the risks the given institution poses to the system. If the supervisory authority finds out that an institution faces higher risk, it may order the institution to hold more capital. When making such decisions, the national supervisory authorities should take into account the impact of their decision on the entire financial system and its stability (not only in the particular country but in all the other member states). The supervisory authorities may extend their demands to other types of institutions whose activities fall into the same category or whose activities undertake or pose similar risks.[222]

Foreign bank branches must comply with the Pillar II demands stated by the home supervisory authority. It is also possible to introduce special supervisory demands within Pillar II (including capital requirements) for institutions that face or pose similar risks. This enables national supervisory authorities to introduce special requirements for bank groups that have a low risk weight for mortgage loans.

As far as other non-credit institutions are concerned, this area underwent a similar process of harmonisation by means of the MiFID directive[223] and,

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[222] European Commission, 20th July 2011: "CRD IV – Frequently Asked Questions, MEMO/11/527).

[223] The Directive 2004/39/EC of the European Parliament and of the Council of 21st April 2004 on markets in financial instruments. (MiFID- Markets in Financial Instruments Directive).

also, the MiFID II[224] directive for capital markets and the Solvency II directive[225] for insurance.

In the field of capital market regulation the two documents the MiFID II and the MiFIR[226] regulation— implemented in 2017[227] can be seen as another resolute attempt to promote uniformity on the part of the EU; this time the aim is to create the European Capital Market Union (the CMU). The European Commission presented a consultation material for the CMU (called the 'green book') on the 18th February 2015. The European Commission has long tried to build a single market; likewise, another of its priorities is the creation of the capital market union for all member countries. The reason behind these attempts is the fact that the industry and commerce (particularly in small or medium sized businesses) is largely dependent on the finances coming from the banking sector—unlike in the USA, where the capital market is more developed. The Capital Market Union is a big project involving a high number of regulations, many of which have already been approved. These include, above all, the MiFID II, the Market Abuse Directive[228]/MAR[229] directive, and the EMIR directive.[230] [231]

At present, there is a lot of work going on to implement the directives and regulations, often called the 'level 2 rules'. A novelty is the existence of more organised markets for financial instruments with a view to increasing their transparency and effectiveness. Securities traders that have internal

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[224] Directive 2014/65 / EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directives 2002/92 / EC (hereinafter „MIFID II").

[225] The Directive 2009/138/EC of the European Parliament and of the Council of 25th November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

[226] Regulation (EC) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

[227] The obligation to implement MiFID II for EU Member States was established by 3.1.2017 and effective from3.1.2018. MiFIR is directly effective from 3.1.2017. In the Czech Republic, this Directive and the Regulation were implemented by Act No. 204/2017 Coll., Which amended in particular Act No. 256/2004 Coll. on the capital market business with effect from 3.1.2018.

[228] The Directive 2014/57/EU of the European Parliament and of the Council of 16th April 2014 on criminal sanctions for market abuse (Market Abuse Directive).

[229] Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16th April 2014 on market abuse (Market Abuse Regulation).

[230] Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4th July 2014 on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation).

[231] Fynanstilsynet Risk outlook and Financial Trends for 2015. April 2015. p. 47.

pairing systems for orders at their clients'accounts will have to possess a license like a multilateral trading system. There is also a new type of organised market places to trade other financial instruments than those of the actual capital, e.g. bonds and derivatives. Since trading derivatives of commodities is frequent (especially as far as electricity is concerned), new definitions of financial instruments are invented along with new licensing exemptions in order that entities trading this way are forced to possess the securities trader's license. Furthermore, information prior to and following a transaction must be released for all types of financial instruments in organised markets with a view to increasing transparency. There are also limits to the size of a transaction in derivatives of commodities—the limits are stated by national supervisory authorities along with ESMA. MiFID II enhances protection of investors—they have wider access to information, particularly prior to entering the business. There are also special requirements for independent consultancy—the testing procedure for would-be investors has been made stricter and there are special requirements that govern receiving rewards from other parties (than the client). Higher demands have been introduced to ensure the best possible conditions are offered at the current market price. National supervisors and ESMA have been authorised to ban or restrict the distribution of certain financial instruments. The ban can be temporary or permanent. The sale of structured products is governed by requirements for proper performance of activities according to the MiFID II directive.

Apart from capital adequacy for financial institutions, the new regulation brought about new rules in accounting, remuneration, and paying dividends; it also affected rating agencies and introduced new prudential rules. None of these, however, appear to be as significant as capital adequacy regulation, which is, in my opinion, the crucial feature of macro-prudential regulation and supervision—consequently, it has been covered in such a detail in this chapter. Its significance is well illustrated also by the amount of Union legislation in reaction to the financial crisis and to the ongoing development of financial markets in general.

What also appears to be positive is harmonisation of private-law relations, in particular as regards the provision of credit loans—up until 2014 only short-term consumer credit loans were regulated in legislation[232]; there was, however, no harmonisation of mortgage loans. The situation improved in 2014 with the directive on credit agreements for consumers

[232] Directive of the European Parliament and of the Council of 23rd April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC.

relating to residential immovable property.[233] Member countries are obliged to implement this legislation into their own system by 21st March 2016. Mortgage loans are an important part of economy particularly as regards financial market stability. Their significance was acutely felt during the financial crisis in the USA, where loans were covered by immovable properties which were impossible to sell or were strongly overvalued. The profit from their sale was therefore not big enough to cover the loans.

This directive is also of great importance because it provides the stepping stone for member countries to create standards for granting loans to acquire residential immovable property. It is also important because of its impact on supervisory and prudential requirements, including requirements for the establishment of credit intermediaries, appointed representatives and non-credit institutions, and for their supervision.[234] Among other things, it introduces the obligation to assess the client's creditworthiness before a loan is granted. The standards required are the minimum that member countries must accept—they may approve even stricter ones.

To assess the Basel standards (Basel I, II, and III), which brought about the abovementioned European legislation, is to a great extent a rather broad question that aims to set regulation in such a way as to maintain protection

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[233] Directive 2014/17/EU of the European Parliament and of the Council of 4th February 2014 on credit agreements relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No. 1093/2010; in effect since 20th March 2014. The preamble states that member countries' laws are in this area (including that of supervision) radically different, thereby creating obstacles and lowering the quality of cross-border activities (both supply and demand). As a result, competition is limited and the providers' loan costs are higher. The financial crisis showed that if financial market participants behave irresponsibly, it may shake the very foundations of the financial system and it may result in a total loss of confidence in it on the part of consumers. Needless to say, the social and economic consequences of this are very grave. Many consumers lost their confidence in the financial sector and loans became unbearable for a lot of debtors, which in turn increased the number of delayed payments and enforced sales. Better rules for the provision of loans to acquire residential immovable properties should help to eliminate such negative features. The European Parliament and the Council of the European Union are convinced that it is highly desirable to create a perfectly harmonised legal framework in this area, the benefits of which should be a smoothly functioning internal market with a solid consumer protection in mortgage loans and a great deal of certainty that institutions providing such services (i.e. mortgage loans) behave professionally and responsibly.

[234] GLOGAR, M. Směrnice o smlouvách o spotřebitelském úvěru na nemovitosti určené k bydlení. Právní prostor [online]. 2014 [qtd. 26th June 2017]. Available at http://www.pravniprostor.cz/zmeny-v-legislative/z-uredniho-vestniku-eu/smernice-o-smlouvach-o-spotrebitelskem-uveru-na-nemovitosti-urcene-k-bydleni>.

for the whole financial system and, at the same time, to avoid over-regulation.

The initiatives behind the Basel agreements are absolutely clear: initially, the aim was to set right the imbalance between banks from countries with a lot of regulation and countries with little regulation. The first international financial risk regulation took place. Gradually, a need to cover a wider spectre of risks placing higher demands on risk management occurred along with the need to promote market discipline. Regulatory rules were then toughened up by Basel III, which is currently still in use.

Basel I was too shallow—it did not reflect the true state of financial market affairs and we might say its imperfections can be attributed to the fact it was the very first attempt. Basel II's impact on the financial market and its needs was more significant and Basel I did not really bear comparison with it in terms of quality and improvement. Unfortunately, Basel II still displayed some gaps—e.g. a complete lack of liquidity management rules, which is truly important as the financial crisis fully revealed in 2007 and 2008. Though Basel III did away with the gaps and imperfections found in the two previous documents, we need to ask whether its regulation is still feasible and whether it is not too demanding and complicated. Needless to say, Basel III entails higher demands on banks and their capital, which might eventually lead to an increase in price of banking products and fees. All in all, though, I am sure that Basel III is still a transparent and feasible enough way of regulating capital requirements. It might not guarantee automatic financial stability, but it does lower the risk of economic and financial instability. It is possible, indeed quite likely, that Basel III will be updated in the future as new times always bring new innovations to which regulation must react. It is, nonetheless, necessary to respect the naturalness of an economic cycle which can never be fully regulated and each regulatory rule should always maintain enough freedom for free enterprise, though admittedly not without any boundaries whatsoever.

THE BANKING UNION

The process of integration of financial market supervision could be viewed as a process of changes in the system of financial market supervision following the financial crisis. The first step was the de Larosière report (analysed above). I would call the report just a preparatory document for the real integration, because the powers of the ESFS bodies were rather restricted and the direct application of supervisory competence on financial market activities was perceived as the ultimate goal (and, frankly, a rather extreme one as well). Nonetheless, this first step provided the momentum for more dynamic, real and direct supervision in Europe. The reform of the system is going on, though—the second step is now under way, in which direct supervision across Europe is being constituted: it is called the Banking Union.[235]

Attempts to establish the Banking Union can be interpreted as a reaction to a growing feeling of distrust of the banking system in the Eurozone brought about by the collapse of a number of important international banking groups from the Eurozone, whose recovery during the recent financial crisis turned out to require substantial public expenditure.[236] The Banking Union was the main answer to financial problems in Europe that the field of financial policies offered; yet, it can never be considered a true union or an association of banks. I use the capital letters in the phrase as I consider it the official name of a project for long-term and intensive activities of the EU in the field of financial market supervision.

The financial crisis in the Eurozone gradually turned into a debt one. It was clear that a deeper integration of the banking system is desirable particularly in those EU countries that had accepted the euro as their currency, since these countries were even more close-knit and dependent on each other. That was the main reason why the Banking Union was established according to a plan devised by the European Commission. The

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[235] The establishment of the European Banking Union with single oversight and resolution of banks in the Member States of the euro area created the new legal framework of the European financial safety net and European financial market law. See more JURKOWSKA-ZEIDLER, A. Banking union: European Union's impact on system of financial law in: System of financial law : financial markets : conference proceedings, ed. Jiří Blažek, Brno : Masaryk University, 2015, Publications of the Masaryk University, theoretical series, edition Scientia, file no. 516, pp. 130-147, Web of Science: https://www.law.muni.cz/sborniky/system-of-financial-law/financial-markets.pdf

[236] Ministerstvo financí ČR. Studie dopadu účasti či neúčastí České republiky v bankovní unii – shrnutí. 9th February 2015. p. 1.

EU bodies reached an agreement to create a single supervisory mechanism and a single banking mechanism. The Banking Union concerns mainly the Eurozone countries, but countries outside it can also join in.[237]

As I have stated above, the Banking Union is the second (and far more important) step towards integration of supervision, because before it was established, prudential supervision had been carried out by member countries; consequently, supervisory mechanisms and rules differed substantially, which was a major obstacle to establishing a single internal market with a genuine chance to deal with possible risks.[238]

The financial crisis incurred considerable public money expenses to recover banks and other financial institutions or to deal with their complete bankruptcy. As member countries dealt with the crisis on their own, they naturally did so in a number of different ways, thereby increasing fragmentation of the single market of financial services. This subsequently contributed towards the disruption of real economy. The public support of 'bail-out' from the public funds was an unprecedented attempt to save what could have been saved, but the EU now endeavours to disrupt the links between the solvency of banks and the indebtedness of individual member states, thereby doing away with public financing of financial institutions' debt. From October 2008 to October 2011 the European Commission approved a 4.5 trillion euro's worth of help for financial institutions.[239] Even at the very start, the Banking Union did include joint insurance of deposits, a single supervisory mechanism, joint rules for the supervisory authority and a rescue fund in case a systemically important banking institution is threatened with insolvency.

In June 2012 the then President of the European Council Herman Van Rompuy delivered a report called Towards the Genuine Economic and Monetary Union,[240] in which he calls for more attention to be paid to three

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[237] EU single market, Banking union. *European commission*. [online]. European Commission [qtd. 25th October 2017]. Available at <http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm>.

[238] WYMEERSCH, E., The European Banking Union, a first analysis, In *Financial Law Institute Working Paper Series* WP 2012-07, [online]. 2012 [qtd. 31st May 2017]. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2171785>. p. 3.

[239] MACHELSKI, T. Banking resolution as an economic intervention. Dny práva 2012. Sborník z vědecké konference. Brno: Masarykova Univerzita 2013. p. 2.

[240] Towards the Genuine Economic and Monetary Union. Ecb.europa.eu [online]. 2012 [qtd. 31st May 2017]. Available at < www.consilium.europa.eu/cs/workarea/downloadasset.aspx?id=17220>. pp. 5-17.

areas (or visions): the integrated financial framework, the integrated budgetary framework, and the integrated economic policy framework.

The Banking Union is essentially an integrated financial framework resting on three pillars.

- The first one is the *Single Supervisory Mechanism* (hereinafter the 'SSM'),
- the second is the *Single Resolution Mechanism* (the 'SRM'),
- the third one is the *Common Deposit Guarantee Scheme* (the 'CDGS').

They are based on several European directives and regulations.[241]

These pillars are supplemented by the Single Rulebook, which provides a single set of harmonised prudential rules that must be respected by all institutions within the EU. It is, in fact, a unified aggregate of norms for the

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[241] Council Regulation (EU) No. 1024/2013 of 15th October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (hereinafter the 'SSM Regulation')

- European Parliament and Council Regulation (EU) No. 1022/2013 of 22nd October 2013 amending Regulation (EU) No. 1093/2013 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No. 1024/2013.

- Regulation (EU) No. 468/2014 of the European Central Bank of 16th April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (hereinafter the 'SSM Framework Regulation')

- Directive 2014/59/EU of the European Parliament and of the Council of 15th May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/30/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council. Bank Recovery and Resolution Directive (hereinafter the BRRD Directive')

- Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15th July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a single Resolution Fund and amending Regulation (EU) No. 1093/2010 (hereinafter the 'SRM Regulation').

- CRR Regulation.

- Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, which implements Basel III into Union law. Fourth Capital Requirements Directive (hereinafter the 'CRD IV Directive').

- Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes. Deposit Guarantee Scheme Directive (hereinafter the 'DGSD Directive')

banking sector. It consists of Union regulations and directives accompanied by harmonising and implementing technical norms approved by the European Commission and prepared by EBA.[242]

The Single Rulebook prudential rules are evident, in my opinion, in several areas of the Banking Union. They include capital requirements for banking institutions (in particular the CRR, CRD IV, and Basel III), the aim of which is to strengthen the ability of the EU banking sector to survive periods of economic uncertainty, to improve risk management, and to ensure standard lending during periods of economic recession. They also include recovery and resolution mechanisms of crisis management of credit institutions according to the BRRD Directive. Last but not least, there is also a system of deposit insurance, which is compulsory in all EU member states. All the rules are accompanied by technical norms (the RTS and the the ITS) drawn up by EBA and approved by the European Commission, along with general rules of EBA and supplementary documents. These are arguably the most important European rules applied in all EU member countries (i.e. not only in the Eurozone or just the Banking Union). Needless to say, the single aggregate of rules is one method of ensuring consistent application of the legislative framework of banking regulation across the EU. Ideally, it should ultimately bring about financial (economic) stability within the EU.

I do not consider the Single Rulebook another (fourth) pillar of the Banking Union[243]; it seems to be a structure of rules applicable inside as well as outside the three other pillars of the Banking Union.

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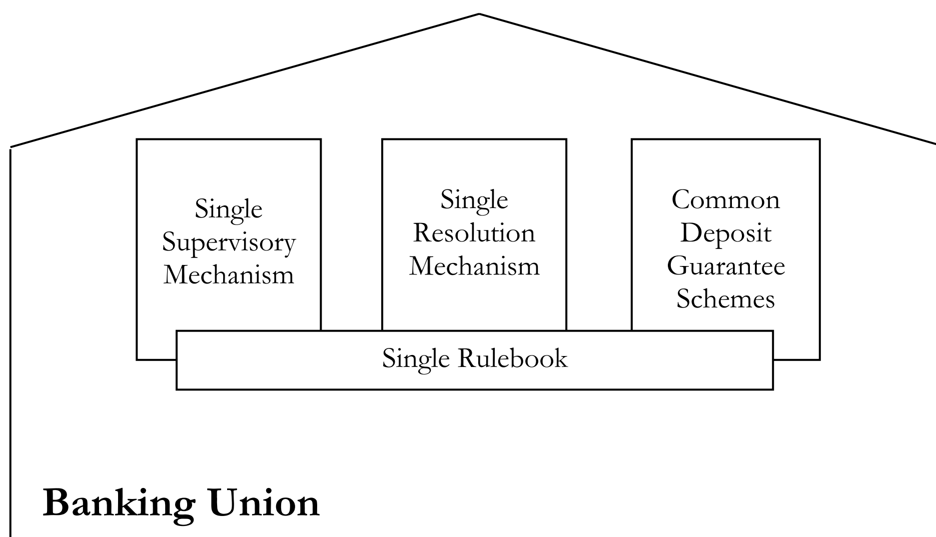
[242] KÁLMÁN, J. The reform of financial supervisory system of the European Union. International relations Quarterly, Vol. 5. No. 2 (Summer 2014). p. 9.

[243] A different opinion is voiced by e.g.. TOMŠÍK, Vladimír. Bankovní unie: „One Size Fits All?“. Cnb.cz [online]. 2012 [qtd. 9th June 2015]. Available at: <http://www.cnb.cz/cs/verejnost/pro_media/konference_projevy/vystoupeni_projevy/download/tomsik_20121029_cep.pdf>. p. 13. He says here that the Single Rulebook created by EBA is the fourth pillar of the Banking Union. I believe, though, that it includes more rules than just those created by the EBA and all these rules blend with the other three pillars.

Diagram no. 3: The Banking Union and its pillars



Source: the author.

Union law and the legal framework for the Banking Union

As far as the Banking Union and its legislative framework according to Union law are concerned, the SSM Directive is based on article 127(6) of the TFEU, which within the Maastricht Treaty enabled the assignment of supervisory authority to the ECB. [244] The SRM Regulation is then based on article 114 of the TFEU, i.e. the common core of internal market legislation.[245] The SRM Regulation is crucial in so far as it establishes a supranational authority: the Single Resolution Board. Since EU primary law does not recognise such a body, there were some serious reservations raised concerning article 114 of the TFEU as the legal basis for the Single Resolution Board. These reservations were dealt with by the statements of 11th September 2013 and of 7th October 2013 of the legislative commission of the Council of the European Union along with the decision of the Court of Justice of the EU C 270/2012 of 22nd January 2014. It was eventually proposed to drop the decision making power originally envisaged in two

[244] This article of the TFEU was, as a matter of fact, first used as late as in 2011, when it was used as the legislative basis for the establishment of the ESRB.
[245] This article of the TFEU was also used to establish the ESA bodies.

ways: decisions would either be made by a primary-law EU body (i.e. the European Commission or the Council of the EU) or there would be further specification of the powers of the Single Resolution Board (which would curb its wide margin of discretion). Ultimately, the real decision-making body is the Single Resolution Board and primary-law EU bodies can raise objections to individual decisions.

Interestingly enough, the supranational resolution board is not stipulated explicitly in EU primary law. It is anchored in the SRM Directive, i.e. in a set of regulations for legislative harmonisation. Article 114 of the TFEU is a legal anchor of harmonisation—it does not include regulation of the European Commission's authority over the internal market; it only discusses health, safety, environment protection and consumer protection issues. That is why it does not seem apposite to consider this article the legal basis for delegation of authority from the European Commission to the Single Resolution Board, providing this body should, together with the Commission, participate in crisis management of banks or banking groups in a way enabled by administrative discretion.[246]

The SRM Regulation also establishes the Single Resolution Fund (under the Single Resolution Board but financed via a special document called the Intergovernmental Agreement of 21st May 2014; hereinafter the 'IGA').[247] The SRM Regulation was supplemented by more harmonising EU legal norms approved during the same period (although some of them were originally produced even before the establishment of the Banking Union). Article 114 of the TFEU also served as the legal basis for the CRR Regulation, the CRD IV Directive, the DGSD Directive and the BRRD Directive, which stipulates and harmonises special rescue schemes for banks in all EU member countries and it also sets up national resolution authorities and national resolution funds.[248]

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246 ČUNDRLÍK, L. Právny rámec riešenia krízových situácií úverových inštitúcií v EÚ jako bazálny inštrument predchádzenia finančnej nestability. In Finančné a sociálne aspekty dlhovej krízy z pohľadu ekonómie a práva. Bratislava: Ekonomický ústav SAV, 2014. S 204-226. p. 7. [Makroekonomické aspekty dlhovej krízy – pripravenosť krajín čeliť novým výzvam vedecká konferencia. Bratislava, 18th September 2014].

247 The Intergovernmental Agreement was signed by 26 member countries (all EU countries with the exception of Sweden and Great Britain). In the accompanying declaration they stated that they intended to ratify the agreement in such a way as to enable the establishment of the Single Resolution Fund by the 1st January 2016. Member countries outside the Eurozone that signed the agreement will have to accept the rights and obligations only when they join the Single Supervisory Mechanism and the Single Resolution Mechanism.

248 VÉRON, N. Europe´s radical banking union. *Bruegel essay and lecture series*. Brussels: Bruegel. 2015. p. 11.

I am certain that the main benefit and the main raison d'etre of the Banking Union is not actually supervisory integration but rather creation and maintenance of the single market. The former is, of course, an absolutely indispensable instrument that facilitates reaching the goal to which the EU and its economic policies direct the effort: the creation of a real and effective single market. Supervisory integration (also in the form of the Banking Union) aims in particular to maintain stability of the single market, which can only really work after its protective measures have been implemented and tested in real life—one of such measures is also supervisory integration via the Banking Union. Solvency and confidence in banks are undermined by disruption in economic competition and by political excesses in member countries—the Banking Union is determined to eliminate such negative phenomena.

Pillar 1 – The Single Supervisory Mechanism

The proposition to create the Single Supervisory Mechanism was officially presented on the 12th September 2012 and later approved by the Council comprised of the ministers of finance ECOFIN on 12th December 2012. It was called the Banking Union, which was not supposed to come into existence in one single step but it was supposed to be built gradually. That is what happened.

The SSM proposition presumed that the complete banking system of the Eurozone countries will be realised under the direct supervision of the ECB, which would, however, have been unacceptable for the majority of the countries involved. There was a compromise to be arrived at—the direct supervision of the ECB will be realised only over systemically important financial institutions, or rather important[249] credit institutions

[249] The notion of importance is linked with the size of the bank—the number of assets, its influence on the EU as well as the national economy, the importance of cross-border transactions, etc. More specifically direct supervision will be realised in case one of the following criteria is met: the total number of assets is worth 30 billion EUR; the ratio of total assets to the GDP of an EU member is higher than 20% (not applicable if the total number of assets is worth less than 5 billion EUR); Having notified the national supervisory authority, the ECB labels a particular bank as important; the ECB upon its own initiative labels a bank as important if the bank has subsidiaries in more EU countries and cross-border assets or bonds form the majority of their assets or bonds; if a bank has asked for or received financial support from the EFSF or the ESM; or, regardless of the criteria above, a bank is one of the three biggest banks in a particular member country.

(banks), which, however, cover over 85% of the banking assets[250] in the Eurozone through 123 banking groups[251], anyway. Supervision of the other banks will be carried out by national supervisory authorities with the option to delegate the power to the ECB, if it accepts it. EU emergency funds are supposed to offer help to banks in trouble directly and the ECB assumes the main supervisory tasks such as granting and revoking the licence, supervising risk transactions, issuing directives and recommendations, issuing binding decisions along with effective supervision, monitoring and enforcing the observation of capital requirements for banks according to the CRD Directives[252], performing supervision on a consolidated basis and sharing supplementary supervisory tasks over financial conglomerates. The ECB also possesses a relatively wide range of investigative competence as it can impose administrative sanctions, assess mergers and credit institutions acquisitions.[253]

National supervisory authorities are responsible for the less important supervisory tasks such as everyday supervision, consumer protection, supervision of money laundering, payment services and setting up branches from third countries—they must comply with directives and regulations issued by the ECB.

The newly-established Supervisory Board was created as the executive body supposed to fulfil tasks and to perform decision-making activities within the SSM, supported by a completely new administrative structure. The ultimate decision maker within the SSM is, however, the Governing Council of the ECB as is stipulated in the TFEU treaty. The Supervisory Board does not have decision-making power as such; it rather does

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[250] The criterion of total assets suggests that 32% of the banks are French, 22% are German, 14% are Spanish, 10% are Italian and Dutch and 13% are from the remaining Eurozone countries. There are 3520 less important banks, 48% of which are German (1688), 16% are Austrian, and 15% are Italian. Source: VÉRON, N. Europe´s radical banking union. *Bruegel essay and lecture series*. Brussels: Bruegel. 2015. p 15.

[251] NOUY, D. The European banking landscape – initial conclusions after four months of joint banking supervision and the main challenges ahead, speech delivered at '*SZ Finance Day*' in Frankfurt, 17th March 2015.

[252] The setting of higher or supplementary capital buffers according to Basel III or the CRD IV: systemic risk buffer and counter-cyclical buffer.

[253] More info about the SSM is in ELLIS, F. , VALIA SG B., The European Single Supervisory Mechanism. In *University of Cambridge Faculty of Law Research Paper* 10/2013, [online]. 2013 [qtd. 2nd June 2017]. Available at <http://ssrn.com/abstract=2224538>, or NIKNEJAD, M. European Union Towards the Banking Union, Single Supervisory Mechanism and Challenges on the Road Ahead In *European Journal of Legal Studies*, 2014, 7(1) EJLS 92 [online]. 2014 [qtd. 2nd June2017] Available at <http://www.ejls.eu/15/186UK.htm>

preparatory work in supervisory issues of the ECB and it prepares draft decisions for the governing Council of the ECB. Apart from the aforementioned activities, the SSM Regulation also introduces detailed rules for separation of the supervisory function from the execution of monetary policies—the Governing Council of the ECB is actually the main decision-making body in both.[254] We can liken its position to that of the CNB with its monetary and supervisory (financial market) tasks.

The Supervisory Board started its activities at the beginning of 2014; as it is part of the ECB, its place of residence Frankfurt upon Main. It is to be found in a different building, though—a clear signal of its separation from the remaining parts of the ECB. The Supervisory Board consists of the Chair and the Vice-Chair, four ECB representatives and 19 representatives of national supervisors (1 from each country).[255]

EBA also plays an important role within the SSM because it ensures effective and consistent implementation of the single set of rules in the banking sector. Moreover, it co-prepares stress testing for banks, carried out by the ECB, which co-ordinates stress testing in the whole of the EU.

Pillar 2 – The Single Resolution Mechanism

Unlike the USA, most European countries did not have any special crisis mode before 2008. Such modes were introduced in reaction to the crisis and they are now being modified so that the BRRD Directive can be implemented.[256]

The single set of rules harmonised, to a certain extent, internal legal norms in member countries and there are now common instruments and powers that member countries can make use of. National supervisors,

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254 See the following for more information about the separation of monetary policy and supervisory functions: KÁLMÁN, J. Towards the European Federation Reform Processes in the Financial Stability System of the European Union, especially to the early concept of European Bank Union, In *US-China Law Review*, Vol. 10. No. 1. 2013, pp. 46-67.

255 At the moment (January 2018) the Chair is Daniele Nouy, a former secretary general of the French Prudential Supervision and Resolution Authority (the ACPR); the Vice-Chair is Sabine Lautenschläger, who is also a member of the executive board of the ECB, other members are Ignazio Angeloni, and Penti Hakkarainen. Two positions are vacant.

256 VÉRON, N. Europe´s radical banking union. *Bruegel essay and lecture series*. Brussels: Bruegel. 2015. p. 11.

nevertheless, do have some freedom to decide how they will use them and in what way they will use domestic mechanisms of financing.[257]

In comparison with the traditional insolvency proceeding, which is governed by national legal norms, Pillar 2 offers a more flexible and quicker way of tackling problematic situations during a crisis of financial institutions. The resolution approach to crisis management also takes into account the fact that it may take place before legal conditions for bankruptcy are fulfilled, thereby incurring less damage to creditors in the resolution mechanism (if compared with the insolvency proceeding). Having accepted the SRM, the EU had to reorganise and liquidate some credit institutions (in connection with the Directive 2001/24/EC of the European Parliament and of the Council of 4th April 2001 on the reorganisation and winding up of credit institutions).

Insolvency (bankruptcy) proceedings are part of civil lawsuit and its legislation is part of civil procedure. Its distinctive feature is the fact that it combines action and execution proceedings; it settles disputes and it results in the settlement of assets among a number of entities, which is typical of some non-contentious suits. The objective of the proceeding is to settle property (asset) relations to entities affected by the debtor's bankruptcy or insolvency and to satisfy proportionally the bankrupt's creditors.[258]

In the insolvency proceeding is employed either the principle of reorganisation (to put it simply, there is an agreement with the creditors to lower the debt burden) or the institution is liquidated (liquidation outside an insolvency proceeding or bankruptcy within an insolvency proceeding) and the losses are divided among creditors, or both. In any case, the creditors and shareholders do not get full coverage of their claims. Nonetheless, experience from several crises (e.g. the Lehman Brothers bankruptcy—the biggest bankruptcy ever) suggests that insolvency laws are not an effective way to deal with failures in financial institutions. They do not take into account the necessity to avoid disrupting the financial stability; they do not ensure the basic services nor do they provide enough protection for depositors. An insolvency procedure takes more time and if reorganisation is opted for, it entails lengthy negotiations and agreements with creditors

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257 The Single Resolution Mechanism. *The European Council. The Council of the European Union*. [online]. [qtd. 7th June 2017]. Available at < http://www.consilium.europa.eu/cs/policies/banking-union/single-resolution-mechanism/>.

258 WINTEROVÁ, A. a kol. Civilní právo procesní. 6th revised ed. Linde Praha, 2011. pp. 592 – 598.

concerning potential losses of debtors and creditors connected with the delay, the costs and the outcome.[259]

I would add that I consider reorganisation the most economical way of solving the problem of insolvency of financial institutions because it promises higher or equal satisfaction of creditors of the same rank when compared with bankruptcy (which is only a liquidating solution of a failure). Yet, the resolution mechanism of crisis management is overall more suitable and effective if it is actually applicable and applied in time.

The traditional mechanism of insolvency could disrupt the bank's capacity to provide clients with payment services, which could potentially lead to far-reaching economic consequences.[260]

The Single Resolution Mechanism, created by this pillar of the Banking Union, is comprised of two crucial documents and one intergovernmental agreement. The IGA agreement has been discussed above in connection with the legislative framework of the Banking Union and its relation to the resolution fund. This intergovernmental agreement of May 2014 regulates some special rules including the system of operation and financing of this fund—it is primarily financed by the banking sector. The two documents are the BRRD Directive supplemented by the SRM Regulation. These two documents determine the basic operation of the Single Resolution Mechanism (planning, well-timed interventions, resolution objectives – remedial solution to crises, a set of instruments to be applied in order to achieve the objectives etc.) with its adequate organisational-institutional arrangement. This pillar consists of the Resolution Board and the Resolution Fund, established by the SRM Regulation. The BRRD Directive, on the other hand, opened the door to the establishment of national resolution authorities and national resolution funds.

National resolution authorities are endowed with powers to apply resolution instruments and to execute resolution power. They can be set up within the central bank, a ministry or even another public institution established with the same aim. Resolution funds are established as bodies that should finance the resolution policy. The resolution board is authorised to decide which resolution instrument to apply in a particular emergency situation.

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[259] Services of European Commission Directorate General Internal Market, Discussion paper on the debt write-down tool – bail-in (A working document), Brussels 2011, p. 2.

[260] MACHELSKI, T. Banking resolution as an economic intervention. *Days of Law 2012*. Conference Proceedings. Brno: Masarykova Univerzita 2013. p 3.

EBA play an important role, too, for its task is to create binding technical norms, instructions and reports regarding the main areas of remedial mechanisms and the crisis management of banks.

1. *Single Resolution Board (the SRB)*

It is an institution with legal personality, which is located in Brussels and was established at the beginning of 2015. It became fully operational on 1st January 2016. The head of the board is the Chair and there are also the Vice-Chair and 4 other members.[261] The SRM is responsible for centralisation of most of the decision-making process and powers of resolution (rescue) measures for insolvent credit institutions (or for those credit institutions where insolvency is about to happen). This board plays a key role if insolvency has happened or is about to happen because it accepts decisions to ensure resolutions of failing banks with minimum costs to taxpayers. It is essentially an administrative parallel of a judicial ruling declaring insolvency. The SRB is directly responsible for creating and realising resolution plans for important banks and is also responsible for all resolutions (regardless of the size of the bank) if it is necessary to use money from the SRF. It is ultimately responsible for all banks in the Banking Union and it can therefore exercise its powers towards any bank. In the true sense of the word they are not single and separately acting bodies (unlike the Supervisory Board within the SSM) since they must co-exist with domestic measures to organise and finance the process of resolution; in other words, they must strongly co-operate with national resolution authorities.

The resolution board has completed the first phase (January 2015-1st January 2016) [262] of creating resolution plans, gathering information and co-operating with national resolution authorities. At present, it is in the second phase, which started on the 1st January 2016 and the SRB is now fully operational with a complete set of resolution powers and responsibilities.[263] The final stage will be completed when the transfer and mutualisation of contributions to the SRF are applicable according to the Intergovernmental

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[261] At present, the Chair is Elke König, the former president of the German supervisory authority (BaFin), the Vice-Chair is Timo Löyttiniemi and other members are Antonio Carrascosa, Mauro Grande, Joanne Kellermann and Dominique Laboureix.

[262] Cf art. 99 par. 3 of the SRM Regulation, which says: the provisions relating to the power of the Board to collect information and cooperate with national resolution authorities in order to create resolution plans shall apply from 1st January 2015.

[263] A provision relating crisis management, timely interventions, regulations and instruments to solve crises, including the involvement of shareholders and creditors.

Agreement, which must, however, be ratified by all the participating countries first.[264]

Mutualisation refers to the process of making use of financing mechanisms in member states when solving a crisis at the level of a group. A general contribution is paid first through the financing mechanism, which is then divided among individual domestic financing mechanisms. The financing mechanism is then a system consisting of the national resolution fund, other states' financing mechanisms, possibilities of lending money between financing mechanisms of member countries and mutualisation of financing mechanisms of member countries.[265]

2. *The supranational Single Resolution Fund (the SRF)*

This institution is going to be used to solve crises in banks which find themselves on the verge of bankruptcy with all the other options having been tried. Another condition is that the shareholders and private creditors have contributed to the recovery attempts. This authority is financed by banking institutions and its whole creation takes eight years (i.e. it started in 2016 and the end is scheduled to 2024). The funds available in the SRF should reach at least 1% of covered deposits of all credit institutions of the Banking Union member countries. It is expected that the fund will have about 55 billion EUR at its disposal. Individual contributions of each bank will be calculated according to the ratio of the total amount of its liabilities (excluding the capital and covered deposits) to the aggregate liabilities (again excluding the capital and covered deposits) of all the credit institutions authorised in the participating member countries. The calculation process will also take into consideration the risks taken by the given institution.[266]

Contributions from banks will be received by the participating member countries via their national funds and then transferred to the SRF, which

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[264] The Agreement will come into effect once it has been ratified by member countries taking part in the Single Supervision Mechanism and the Single Resolution Mechanism, representing 90% of the total of votes of all participating member countries. This agreement has been ratified by all member countries apart from Sweden and Great Britain.

[265] ČUNDRLÍK, L. Právny rámec riešenia krízových situácií úverových inštitúcií v EÚ jako bazálny inštrument predchádzenia finančnej nestability. In Finančné a sociálne aspekty dlhovej krízy z pohľadu ekonómie a práva. Bratislava: Ekonomický ústav SAV, 2014. S 204-226. pp. 22-23. [Makroekonomické aspekty dlhovej krízy – pripravenosť krajín čeliť novým výzvam vedecká konferencia. Bratislava, 18th September 2014].

[266] Single Resolution Mechanism. *European Council* [online] 2014 [qtd. 6th June. 2017]. Available at < http://www.consilium.europa.eu/cs/policies/banking-union/single-resolution-mechanism/>.

will be activated only if the principles stipulated in the BRRD Directive and the SRM Regulation are observed and if shareholders and private creditors take part in the recovery plans. These national funds should gradually, during the eight-year transition period, merge, while the contributions collected by each national fund will be shared as well. This transfer and sharing of finance from the national resolution funds is regulated by the abovementioned Intergovernmental Agreement (the IGA). Before the SRF has enough finance, the system of financing is ensured by thanks to domestic funds based on banking contributions, alternatively from the European Stability Mechanism. Another option is to transfer money from one national resolution fund to another; if that happens, the help is financed from the contributions coming from the banking sector.

Since the beginning of 2016, 1/4 of the contributions has been transferred to the SRF. All countries participating in the Banking Union have contributed.[267]

3. *The resolution mechanism*

As far as the resolution mechanism is concerned, it is a co-operative effort of several bodies within the SRM: the ECB as the supervisory body within the SSM, the SRB consisting of national resolution authorities' representatives from the participating countries (it prepares and issues resolution decisions), the European Commission and the Council of the EU (these two can raise objections to decisions made by the SRB; if the decision grants state support or support from the SRF, the Commission must supply a positive answer), and, last but not least, the SRF, which provides finance for the resolution policy.[268]

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[267] The SRF has a total of 17.4 billion euros. See. Single Resolution Board. Press Release - Banking Union - Single Resolution Board collects € 6.6 billion in annual contributions to the Single Resolution Fund, now reaching € 17 billion in total. [online]. Published 19.7.2017. Available from <https://srb.europa.eu/en/node/362>.

[268] Cf. art. 19, par 1 of the SRM Regulation: 'Where resolution action involves the granting of State aid pursuant to Article 107(1) TFEU or of Fund aid in accordance with paragraph 3 of this Article, the adoption of the resolution scheme under Article 18(6) of this Regulation shall not take place until such time as the Commission has adopted a positive or conditional decision concerning the compatibility of the use of such aid with the internal market.' According to art. 19, par. 3, subparagraph 4 of the same document: 'The Commission shall adopt a decision on the compatibility of the use of the Fund with the internal market, which shall be addressed to the Board'; (subparagraph no.7 deals with negative decisions by the Commission). According to art. 19, par. 10 of the same document

The ECB informs the SRB that there is a credit institution on the verge of bankruptcy. Even the SRF can make such a decision if it informs the ECB and the ECB does not react in any way. The SRB decides whether it is in the public interest to apply the resolution mechanism and whether it is possible to solve the crisis within the private-law sector. If the conditions are not met, the bank is forced into liquidation according to the local legal norms. In the opposite case, the SRB accepts a resolution mechanism deciding on the instruments to be used and deciding also whether to ask the SRF for help. If the European Commission or the Council of the EU do not raise any objections and if it is not necessary to raise the finance stated in the mechanism, the decision comes into force within 24 hours of approval.

The Council of the EU appoints the SRB members; it determines which way the banking-sector contributions to the SRF are made and it raises objections to proposed resolution schemes that are supposed to deal with a crisis.

The European Commission confirms decisions made by the SRB or it may raise an objection to some of their aspects, which the SRB was supposed to consider on its own. If the criterion of the public interest of the resolution is not met, or if the amount of finance to be used from the SRF has changed, the Commission suggests that the objection should be raised by the Council of the EU. If the resolution entails granting state aid pursuant to Article 107 of the TFEU or aid from the SRF, it can only be accepted once the Commission has adopted a positive or conditional decision regarding the compatibility of this aid with the internal market.

National institutions of the participating member states are responsible for creating and accepting resolution plans of those banks which do not fall under the scope of the SRB. Decisions made by the SRB are addressed to national resolution authorities that put them into practice according to instructions issued by the SRB; in case these instructions are not followed properly, the SRB can address its decisions to failing banks themselves—in other words, the decisions affect the private sector directly.

This way of solving crises originates in the fundamental principle of the Banking Union—it result to the fact that any negative consequences of bankrupt credit institutions will be borne by the credit institutions and the financial sector rather than by taxpayers.

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the SRB may adopt a different decision from the one of the Commission if exceptional circumstances justify it. In other cases the link to the Commission is not required.

The crucial aspect of the abovementioned mechanism is the creation of a single procedure to follow when dealing with international and systemically important banks. If there is a crisis, it is undoubtedly more appropriate to act identically and to apply the same procedure in all the countries where the institution is active—thus, one can avoid disparate decisions within the EU which result in longer delays and higher costs. Other benefits include restoration of confidence in the financial sector, less panic among depositors and, to a certain extent, prevention of diffusion of the crisis to those states which do not participate in the Banking Union. The mechanism ensures that banks are only a little dependent on the states and their budgets; as a result, any resolution adopted should only exert a marginal impact on the economy of the given state—in the past, the public method used to harm the real economy much more noticeably. The Supervisory Board is supposed to link the supranational resolution system with the system of supervision of the ECB with a view to centralising and unifying supervisory activities and potential trouble solving, which should bring considerable benefits to the single internal market and its financial services.

The establishment of the Single Resolution Board (after the SRM Regulation came into effect on the 19th August 2014) and the coming into effect of the BRRD Directive (which, from January 2015 onwards provided the impetus to establish national resolution authorities) coincide, which creates the opportunity to find out the best way of co-operation between these two systems and to take into account the tried and tested methods for the establishment of national resolution authorities.[269]

The SRM Regulation[270] also anticipates the establishment of an Appeal Panel, which will arbitrate appeals against decisions made by the SRB.

4. *The BRRD Directive*

As it was mentioned above, it was no longer acceptable for failing banking institutions to receive support from public budgets since such support was essentially provided by taxpayers and it constituted a very heavy burden to the economy of a particular country. Naturally, the situation greatly undermined economic competition because the state provided unprecedented support to only those private institutions that had problems; problem-free institutions did not receive any finance and were thus disadvantaged, to put it another way, they were 'punished' for having

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[269] Deposit Guarantee Schemes. *European commission*. [online]. European Commission [qtd. 5th June. 2017]. Available at < http://srb.europa.eu/>.

[270] Cf. art. 85 and 86 of the SRM Regulation.

behaved more responsibly. This financial support is colloquially referred to as a 'bailout'—financial help from the outside. Such help is, however, unacceptable and from the macroeconomic point of view also unbearable even if there is a real danger of systemic failures in economy potentially resulting in even greater public expenses should large financial institutions become insolvent (for instance the finance accumulated in deposit insurance funds would not suffice to ensure mandatory payments and states would have to support these insurance funds from public budgets again).

These are the reasons for the resolution mechanism and the regulatory framework for crisis management of credit institutions[271] (mainly banks, credit unions and securities dealers). The objective of the use of resolution instruments according to the BRRD Directive is the maintenance of vital functions of credit institutions. These vital functions include sets of indispensable services and operations whose disruption would upset financial stability in one or more EU countries and would disturb the services of macro-economic importance. Furthermore, the instruments are supposed to prevent negative systemic consequences of problems of credit institutions, such as crisis contagion. They strive to protect public financial funds, the clients' finances, credit depositors and investors. As banks are, without doubt, the most important credit institutions, I from now on talk about banks even in cases where I talk about all credit institutions.

This directive does not affect only the participating countries of the Banking Union—some provisions apply to all member countries (e.g. the obligation to set up national resolution authorities that are supposed to create resolution plans for crisis management, the obligation to set up national resolution funds, the obligation for all EU banks to prepare recovery plans).

The BBRD introduces one extremely important instrument, namely the 'bail-in'—financing the resolution plan from the inside, sponsored by the shareholders and the main creditors. It is a way of motivating them to conduct business in a less hazardous manner as well as a way of forcing them to monitor the bank and to prevent any potential financial problems, which could possibly lead to financial loss for taxpayers.

The underlying principle of this instrument is the involvement of certain people in sharing financial loss of the bank and in the subsequent

[271] 'Credit institution' is defined in point (1) of Article 4(1) of the CRR Regulation. A credit institution means an undertaking, the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account

resolution, too—the recapitalisation of internal sources of the bank through a very detailed hierarchy of loss bearers: the first are shareholders followed by creditors (the priority is assigned according to the size of their claims, at the top are senior creditors). Creditors of the same rank are treated in the same way (as far as bearing the loss is concerned)—no creditor can receive less than what they would receive in an insolvency proceeding and insured deposits are fully protected. The shareholders' share may be partially or fully reduced (the so-called 'haircut'); another option is to reduce the creditors' claims (partial or full debt remission); alternatively, the claims may be transferred into business shares for the benefit of creditors, which actually results in that reduction of business shares of the shareholders. Only then can the national resolution fund step in, and it can finance the costs on its own; or, possibly, the finance may come from the SRF for the Banking Union members. The last resort is a theoretical possibility of finding financial support from public budgets if several criteria are met, as specified below. Typically, the statutory bodies and top executives are replaced, if their presence is not necessary for the objective of the resolution plan. The obligation to cooperate towards reaching the goal of the resolution plan applies to the original as well as the newly-appointed executives of the credit institution.

International co-operation is an absolute must in case of banking groups whose activities reach beyond the EU. In this case there must be bilateral and multilateral agreements regulating co-operation among national resolution authorities and their opposite numbers in non-EU countries. The proposals for co-operation are submitted to the Council of the EU by the European Commission.

The BBRD Directive deals with three phases:

- the *preventive* phase,
- the *early intervention* phase and
- the *recovery* phase (in case of a failing bank) or the *resolution* phase (in case of an already insolvent bank)

As for **prevention**, the newly-adopted feature maintains that all banks in the EU must prepare their own **recovery plans** which must be updated every 12 months. These plans include a detailed analysis of methods and regulations to be accepted in an unfavourable financial situation; they work with several variants of macro-economic and financial problems. These model situations include the conditions of early intervention and recovery measures.

The authorised bodies together with supervisory bodies keep creating **resolution plans**. A resolution plan stipulates regulations that a particular body can adopt when dealing with a crisis; part of it is also an analysis of conditions on which a bank can apply for the use of central bank facilities and determine assets that should serve as insurance (not as a bailout, though).[272]

As far as the **early intervention and recovery plans** are concerned, these are sets of regulations and powers given to a national resolution authority, which should intervene before the actual insolvency takes place. The situation is still solvable—for example via the so-called 'soft-law' instruments. In order to stabilise and recover an institution, the national resolution authority can ask for a reform or debt restructuring in co-operation with the creditors. An early intervention is often used if a credit institution does not fulfil certain criteria of prudential business (e.g. capital requirements, liquidity rules, etc.) or if it is very probable that the rules will soon be violated because the liquidity situation is getting worse, the loans are not being repaid and there is a significant increase in other sources of financing. An early intervention and recovery plans attempt to keep the key banking transactions in operation and quickly stabilise the credit institution.

It is also possible to appoint a so-called **special manager**, who is essentially one of the crisis management instruments, but it is not a resolution instrument, which is why it is considered to be an early intervention instrument. Also, there is a question whether this would actually be a case of receivership for the given credit institution (the kind that a national supervisory authority can impose) or whether it would be parallel receivership; the question, in other words, might be: would the legal concept of receivership not lose some of its importance? While it is evident that these are two different instruments to deal with failing banks (the appointment is performed by two different bodies); yet, in some ways the activities of the special manager and the receiver overlap. It cannot probably cause any problems in the Czech Republic, where the local resolution authority is, admittedly, an independent body, but it exists within the CNB, and in that case it hardly matters whether it is receivership based on the current legal norms or an instrument imposed by the national resolution authority based on the BRDD Directive.

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[272] NĚMEC, L., TORNOVÁ, J. BRRD: Nová regulace krizového řízení bank. *Bankovnictví online* [online]. 2014 [qtd. 9th June 2017]. Available at < http://www.bankovnictvionline.cz/banky-finance/brrd-nova-regulace-krizoveho-rizeni-bank>.

The resolution phase[273] is applicable if the problem of the bank is so grave that any recovery attempt is doomed; the national resolution authority may proceed in one of the following ways depending on the plans the bank in question has. It may:

- **sell part of its business activities** – in the resolution phase it is possible to sell a partial or a complete number of shares or assets, rights, or third-party liabilities even without the consent of the statutory bodies or the bank's shareholders. The profit from the transaction is paid, after the expenses have been deducted, to the shareholders involved; alternatively, in case of assets, rights and liabilities, the proceeds from the transfer are used to the benefit of the bank in the resolution phase.

- **set up a bridge bank** –a bridge bank maintains the most important functions within the resolution phase (i.e. it must carry out a temporary transfer of assets to a public-owned entity—owned by one or more public authorities of the given country) so that the bank can fully recover or its liquidation may happen. What needs to be resolved, though, is the issue of the public-owned bank. Is the bridge bank supposed to have been established prior to the resolution process or can it be established ad hoc? The former seems to be the only viable option but this is hardly a popular choice. On the other hand, it is not possible to establish a bridge bank within a very short period of time due to all Union as well as national legal norms and regulations that must be observed so that an institution can receive a banking licence. This process typically takes at least a few months.

- **separate good from bad assets** - depreciated assets of the institution in the resolution phase or in the bridge bank scheme can be transferred to an entity for asset management—this entity is again a public-owned one that 'consumes' bad assets so that the bank can fully recover or it may be sold. This instrument is only to be used in combination with other instruments to avoid unfair competitive advantage for the failing bank.

- **opt for a bail-in instrument** - as described above, the idea is to get shareholders and creditors involved in the process of resolution; to convert the debt to shares or to write the debt off. The loss should primarily be absorbed by the MREL capital reserve (see below). Subsequently, the loss affects the shareholders, whose shares are cancelled, transferred or their value is lowered. If the measures turn out to be insufficient, the debt may be converted and written off (primarily the subordinated debt) as the capital.

[273] Cf. Title IV of the BRRD Directive, where can be found resolution instruments.

The process of recapitalisation should involve as wide a spectre as possible of unsecured debts of the failing bank—exceptions include secured deposits, debts towards the employees, debts for goods, services crucial for the operation of the bank, and debts from the pension system.[274]

The national resolution fund

It is a body which comes into action as an instrument of prevention, early intervention as well as resolution. Every member country must create its own resolution fund financed by credit institutions. It can be used if these institutions experience serious problems. Each institution contributes to the fund according to its obligations and the risks it takes. The total amount of finance in the fund is the same as in the SRF: at least 1% of covered deposits of all credit institutions in a particular country until the 2024. The fund is maintained through regular contributions, one-off contributions, gaining money in the financial market, loans from other mechanisms of financing the process of resolution, provisions of recoverable financial help, and public budget grants.

- National resolution funds provide temporary support to failing banks (loans, collaterals, the purchase of assets or provision of the capital for bridge banks);
- They can only be used to compensate shareholders and creditors if the involvement of resolution creates a higher loss than what would have been caused in an insolvency proceeding according to national legal norms.
- Under exceptional circumstances the fund can be used to absorb losses or to recapitalise banks.

Financial help from this fund can actually be used only after the shareholders and creditors have incurred losses of at least 8% of the total liabilities of the bank. The help is then restricted to not more than 5% of the total liabilities of the bank. Only then, if the support proves to be insufficient and if the bail-in instrument has been used as well, is it possible to look for alternative ways of financing; e.g. in a situation where a wide

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[274] NĚMEC, L., TORNOVÁ, J. BRRD: Nová regulace krizového řízení bank. *Bankovnictví online* [online]. 2014 [qtd. 9th June 2017]. Available at < http://www.bankovnictvionline.cz/banky-finance/brrd-nova-regulace-krizoveho-rizeni-bank>.

recapitalisation on the part of the creditors would lead to financial instability. It is also possible to apply for public support (a bail-out) but only if all the other options have been tried and the amount of bail-in cover has reached 8%. Also, it can only happen under extraordinary circumstances and the approval from the European Commission is mandatory.

The minimum requirement for own funds and eligible liabilities - MREL

In November 2014 EBA initiated a public consultation on draft regulatory technical standards (RTS) which lay down the minimum requirements for own funds and eligible liabilities (hereinafter 'MREL'). MREL has been set up to prevent institutions from structuring their liabilities in such a way as to restrict the effectiveness of the bail-in instrument or any other instruments introduced by the BRRD Directive, in which it says that banks are obliged to fulfil 'robust' minimum capital and eligible liabilities requirements.[275] The proposals made by the RTS also take into account the impact of the deposit insurance system and expenses on the resolution plan.

Technical standards clarify how the capital requirements on institutions should be linked with MREL needed to absorb losses, and, if need be, to recapitalise banks after the resolution process has finished. National resolution authorities base their activities on the supervisor's assessment of the amount of loss (to be absorbed by the bank) and the capital (needed by the bank to operate).

National resolution authorities are supposed to lay down MREL in such a way as to ensure the execution of the resolution plan of a given bank. The crucial questions connected with this are how robust MREL should be and whether adequate MREL is to be determined by trial and error or rather via an expert analysis of a specific bank. It is the resolution plan that may state when (for which liabilities) it would not be feasible to opt for a bail in (albeit it would be legally possible). In cases like this national resolution authorities must increase MREL or adopt other measures (e.g. a measure to change the order of liabilities in insolvency).

It remains to be seen what change MREL is going to cause because specific requirements and rules for its calculation have not been issued yet and, naturally, there is less and less time for the institutions to create it

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275 EBA. EBA consults on criteria for determining the minimum requirement for own funds and eligible liabilities (MREL) [online]. 2014 [qtd. 9th June 2017]. Available at < https://www.eba.europa.eu/-/eba-consults-on-criteria-for-determining-the-minimum-requirement-for-own-funds-and-eligible-liabilities-mrel->

(the deadline is 2019). It is not possible to start working on it, though, without more specific instructions from the SRB.

It is rather unnecessary that MREL is, to a certain extent, so specific; essentially, the document deals with what the FSB in co-operation with the BCBS[276] stated for global systemically important banks (G-SIB)[277] in the form of TLAC minimum standards (total loss-absorbing capacity) concerning the adequacy of the capital capacity for loss absorbing and recapitalisation. The TLAC standards should instil confidence into home and host supervisory authorities that the G-SIB has enough capacity to absorb loss—both prior to or during the resolution phase. They also allow resolution authorities to realise a resolution plan with minimum impact on financial stability while ensuring the continuity of basic economic functions. It is an instrument rather similar to MREL—the build-up of higher capital buffers with the aim of being ready to react to a crisis. Despite both capital requirements being rather similar and relying on identical principles, their realisation is different and they hardly overlap. European banks whose activities are global (e.g. Deutsche Bank, Barclays, Santander) need to build the capital buffer twice, thereby accumulating a really vast amount of capital that should see them through difficult periods.

The BRRD Directive brings new and highly effective instruments and ways to solve problems. To a certain extent it destroys the traditional image of public financing as a means of being rescued if the situation gets from bad to worse. The traditional way of dealing with crises did not force leading representatives of credit institutions to behave responsibly enough. In other words, it did not provide enough motivation to ensure that the credit institutions maintain a balanced budget and they refrain from entering too risky business.

Coppola[278] has it that shareholders and creditors will always try everything they can to avoid using the bail-in instrument since they will not accept the loss connected with it. Coppola is convinced that the BRRD Directive, which imposes the loss on creditors rather than taxpayers, will eventually lead to a high number of lawsuits. In addition, there seem to be a lot of gaps

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[276] Based upon the initiative of G-20 representatives at the summit in St. Petersburg in 2013.

[277] At the moment there are 30 such banks, most of which are from Europe (or whose licence is based in an EU country). Cf. BIS. G-SIBs as of November 2014. [online] [qtd. 22nd July 2017] Available at <http://www.bis.org/bcbs/gsib/gsibs_as_of_2014.htm>.

[278] COPPOLA, F. When bad banks fight each other. *Forbes*, 22.5.2015 [online]. 2015 [qtd. 10th June 2017]. Available at <http://www.forbes.com/sites/francescoppola/2015/05/22/when-bad-banks-fight-each-other/>.

and exceptional circumstances as far bonds and shares are concerned which will undoubtedly prolong the lawsuits. This all will turn to be a very heavy burden for the structure of the EU. There have already been some cases where the bail-in instrument with cross-border application[279] was used and, in all likelihood, there will soon be others (Italian and Greek banks). The biggest danger for the EU thus might be lawsuits following the application of the BRRD Directive and its bail-in instrument.

I do not think, though, that the situation is going to be that serious. It is clear that every new regulation and every new instrument, particularly if it demolishes the good old ways, must necessarily arouse a great deal of indignation and an increase in media coverage and legal activity. It seems to me that these problems are nothing more than an unavoidable reaction surrounding the introduction of a new concept. It is all the more problematic since a certain group of people might incur substantial losses. This regulation, however, appears to be truly necessary in order to maintain a stable financial system in the EU and to support the existence of a single market. Once the European Court of Justice has been made a major decision surrounding the use of the bail-in instrument (particularly if the case is international and the practice of the courts clear up any hazy areas in the BRRD Directive), the practice will eventually absorb and establish this new piece of legislation. This new legal regulation will gradually be accepted by both credit institutions and the public and the amount of the shareholders' displeasure connected with the bail-in instrument will eventually subside. The instrument will hopefully become so universal that creditors and shareholders will always bear it in mind when deciding on the next step in investment. Ultimately, the number of lawsuits should decrease and financial market stability should move the opposite direction.

[279] E.g. the Dexia Group, a bank owned by French and Belgian owners, and KA Finanz AG, an Austrian bank owned by the Dexia Group. The Dexia Group tried to make Austrian taxpayers cover its losses by refusing the bail-in instrument for its subsidiary in Austria, which was rejected by the Austrian Supreme Court. Another example is an Austrian bank called Hypo Alpe Adria: the Austrian Ministry of Finance announced a debt moratorium on the bank's creditors, most of whom were German and Austrian banks and other financial institutions including the World Bank. There is also a great amount of pressure from German banks which want their own state to offer as much support as possible in their lawsuit against Austria.

Pillar 3 – The Common Deposit Guarantee Scheme

Deposit insurance exists to reimburse a limited amount of deposits to individual depositors whose bank went bankrupt. For depositors it is a way of protecting their property against the consequences of bank failures. As regards financial stability, this instrument prevents depositors from panic withdrawals from their bank, which would have very serious economic consequences.[280] This pillar does not attempt to centralise powers, it 'only' harmonises the rules.

At the moment the schemes of deposit insurance come from the DGSD Directive, which came into effect in June 2014 and cancelled the Directive 94/19/EC of 1994, which was amended in 2009 in reaction to the financial crisis. There was a one-year time limit for the implementation of the DGSD Directive for member countries.

Membership in the scheme of deposit guarantee is compulsory for all credit institutions and the aim is to pay out any kind of deposit of all clients[281] (depositors of credit institutions) in case of bank liquidation or failure with the deposits no longer being disposable. The coverage level is EUR 100,000 per depositor (a natural or legal person) from the insurance system whose member the given credit institution is. The original 1994 directive set the limit of EUR 20,000, which was later increased to that of EUR 50,000 before the limit reached the current level.[282]

These schemes are compulsory in all member states and they are financed from credit institutions. The level of contributions depends on the risk profile and other decisive factors of a specific institution. The higher the risks, the higher contributions must be sent to the scheme. In the Czech Republic the Financial Market Guarantee System is in charge of the scheme. It is an institution that holds the collected money in trust and in case of a bank failure or liquidation it reimburses insured deposits.

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[280] Translated from: Single Resolution Board - Activities. *Single Resolution Board*. [online]. 2014 [qtd . 4th June 2017]. Available at <http://ec.europa.eu/finance/bank/guarantee/index_en.htm>.

[281] Other covered deposits include pension schemes of small and medium-sized companies, deposits of public entities with budgets up to EUR 500 000, deposits over EUR 100 000 aimed to provide service in housing or social benefits.

[282] Deposits insurance schemes. *European Council, The Council of the EU* [online]. 2014 [qtd. 21th June 2017]. Available at < http://www.consilium.europa.eu/cs/policies/banking-union/single-rulebook/deposit-guarantee-schemes/>.

Depositors are to be reimbursed within 20 working days (with the possibility of prolonging the deadline by ten days), but by 2024 the time limit should shrink to just 7 days (it is already 7 days in the Czech republic since 2016). Originally, reimbursement was supposed to be paid within three months (with the possibility of prolonging the time limit by another six months).

The funds accumulated in the deposit guarantee scheme of each member country should amount to 0.8% of covered deposits by 2025. Deposit guarantee schemes must undergo stress tests at least every three years to ensure that their performance is up to the required standard. It is also possible to use deposit guarantee schemes as a source of finance for resolution of banks, subject to strict conditions.

As far as the deposit guarantee scheme in the Czech Republic is concerned, Financial Market Guarantee System was founded 1.1.2016. Its tasks includes management of the national resolution fund (called the Crisis Management Fund), which collects finance for resolution of banks. The Financial Market Guarantee System plays the role of a caretaker institution that administers the Deposit Insurance Fund, the Crisis Management Fund and in the future most probably also the Investor Compensation Fund. It seems quite logical given the fact that deposit guarantee schemes can also be a source of financing resolution—that is an option introduced by the DSGS Directive. It should be easier to create and administer one central guarantee scheme comprised of all funds that cover endangered or already insolvent financial institutions; even though this is an issue of organisation rather than function.

A deposit guarantee scheme is a very useful institution that has justified its existence on numerous occasions. What seems to be debatable, though, is the specific level of protection and the way of paying out finance in case of emergency. The EUR 100,000 limit is, in my opinion, sufficient and there are no problems with it these days; the 7-day time limit for reimbursement appears, however, rather exaggerated. The CNB does not agree with such a radical shortening of the time limit.[283] I do not think that such a tight deadline is necessary either. While it is true that a healthy credit institution should be able to reimburse the majority of deposits immediately, I do not think that the 20-day time limit is too long given the

[283] TOMŠÍK, V., CNB. Regulace a dohled nad finančním trhem v EU – aktuální otázky. Available at: <http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/verejnost/pro_media/konference_projevy/vystoupeni_projevy/download/tomsik_20101122_komora_auditoru.pdf>. p. 17.

complexity of the task, often accompanied by a kind of public chaos that occurs any time an institution is declared insolvent. I doubt that a 20-day wait for money should pose an insurmountable problem; even though some small difficulties are possible. What one needs to bear in mind is the systemic nature of the problem: it is a systemically negative situation and the solution must be equally systemic while the operational reality of the institution is respected, as is the pressure exerted by the public and other financial and public institutions. I am certain that the 20-day time limit is sufficient and adequate.

The Banking Union - summary

Even in its current (i.e. incomplete) form the Banking Union presents a radical change that profoundly modifies the nature of European integration and the balance between member states and European institutions. Its full impact has not been appreciated due to a weird mixture of healthy scepticism, improper cynicism and indolent inattention.[284]

The basis of the Banking Union can be seen in the 2013-2014 European legislation. The first step was the assessment of 130 banks in the Eurozone and the subsequent takeover of the basic supervisory authority by the ECB on the 4th November 2014. The process of transition of supervision has not yet finished and it is thus very difficult to assess the Banking Union now—any attempt to do so must inevitably be rather incomplete. The process reached the peak in January 2016—the resolution board acquired the power to issue binding decisions including the discretion power to impose a specific resolution instrument; further, the bail-in instrument of the BRRD Directive became applicable: the instrument that makes shareholders, creditors and uninsured depositors carry the burden of financial loss of an insolvent bank. Even after this date it will take some time before things settle down and we can assess the structural organisation of the Banking Union. Moreover, a supranational single resolution fund is still being built from the original form of equal national resolution funds—this process should have finished by 2024. Although the process of building the Banking Union started three years ago, it is early days yet.

Every financial crisis (or even an unpleasant situation) in a way purifies the system from undesirable features. How negative the impact of a crisis

[284] VÉRON, N. Europe´s radical banking union. *Bruegel essay and lecture series*. Brussels: Bruegel. 2015. p 10.

is seems to be a question of legislation, preventive measures and the public attitude to it. What it surely brings about is a reaction in the form of new instruments and measures that aim to cushion the damage already caused and to prevent such a crisis in the future. This chapter on European integration of regulation and supervision leading to the foundation of the Banking Union describes processes that clearly exemplify it. The Banking Union is by far the deepest and most comprehensive legal framework of the entire financial market, not only in terms of regulation and supervision. As to imperfections, one of them is the lack of fiscal union in the EU. Such a union would bring the single market project much closer to its ultimate goal.

To evaluate the Banking Union and its effectiveness is not possible yet and it will remain so at least until the SSM and the SRM become fully operational and until they are given enough time to show some results of their activities. The trend that had been set before the Banking Union was established has now intensified thanks to the Banking Union and its involvement in the area of regulation and supervision of financial institutions—the issue to be resolved is the ideal proportion of regulation and supervision to administrative demands and expenses for financial institutions, which is then reflected in the services and their prices (e.g. banking fees). In the area of supervision and regulation we have not witnessed any liberalising attempts; i.e. attempts that would make legislation less strict (or at least not stricter any longer). Is it possible at all that we see a complete reversal of the trend, though? To my mind, general liberalisation of supervision and regulation is not really viable; yet, I am convinced that legislation will steady itself as the effects of the recent financial crisis wear off and economic growth becomes stable as well. If this stabilisation comes after the Banking Union becomes fully operational is uncertain; I presume that it will take a little longer and it will probably 'only' last until another crisis arises—this crisis is bound to happen but we might feel optimistic that its impact will be much less severe.

THE PROCESS OF INTEGRATION OF FINANCIAL MARKET SUPERVISION IN NORWAY

The reason why this book includes a chapter on integration of supervision in Norway is quite simple and I discussed it briefly in Introduction. Norway is the first European country to have introduced integrated supervision of the financial market, so it is interesting to find out whether their pioneering decision resulted in some specific features or differences in comparison with the method or the system of supervision in the EU or the Czech Republic. The second reason why I deal with the issue of supervision in Norway is the fact that Norway is not an EU member state, but it is a member state of the Agreement on the European Economic Area[285] (the EEA) and it also participates in the European Free Trade Association[286] (EFTA). Moreover, Norwegian banks are very busy in cross-border business with EU members, particularly in Scandinavia. The FSB list mentions Nordea[287] as a global systemically important bank (see below for more information). All these reasons, including the closely intertwined business relations, make the comparison between Norway and the EU (the Czech Republic) worthwhile.

Because of the existence of the Agreement on the EEA and because of the fact that the single financial market evidently falls within the four

[285] The Agreement was signed on the 1st January 2004 by the European Commission, EU member countries and three EFTA countries that wished to participate in the European Free Trade Association. The main objective of the EEA Agreement is to ensure in all 31 states free movement of goods, persons, services and capital—the 'four freedoms'. As a result of this agreement, Union law is, as far as the four freedoms are concerned, implemented into the national legal system of EFTA countries. All new relevant EU legal regulations are also implemented into the EEA Agreement so they apply to the entire EEA area (not just the EU) and they ensure a unified application of legal norms relating to a single market. In this case, we refer to the norms as EEA relevant. EFTA countries are, however, not fully responsible, unlike the EU member countries.

[286] European Free Trade Association 'EFTA' includes Norway, Iceland, and Lichtenstein.

[287] It is a Nordic financial group active mainly in the North of Europe. This bank is a product of mergers and acquisitions of Finnish, Danish, Norwegian and Swedish banks Merita Bank, Unibank, Kreditkassen (Christiania Bank) and Nordbanken, which took place from 1997 to 2000. The Baltic countries and Poland are today also considered to be part of the domestic market. The largest shareholder of Nordea is Sampo, a Finnish insurance company with around 20% of the shares. Nordea is listed on the stock exchanges in Copenhagen, Helsinki, and Stockholm. Nordea's headquarters is in Stockholm and it has more than 1400 branches. The bank is present in 19 countries all over the world and it operates through full service branches, subsidiaries and representative offices. Source: wikipedia.org.

freedoms this agreement helps to establish, it is clear that financial market regulation and supervision in Norway is legislatively extremely similar to the system in the EU—in fact, the Norwegian system is based on the system used in the EU.

Essentially, EU regulations become part of the Norwegian legal system only after they have become integrated into the Agreement on the EEA. All three supervisory authorities in Norway are part of the EFTA Working Group on Financial Services, which is a group coordinating opinions of EFTA countries on integration of basic financial legal norms into the Agreement on the EEA.

The basic tenet of the Agreement on the EEA is its flexibility and, to a certain extent, homogeneity with the EU single market. Amendments made to EU legislation and relevant to the EEA are gradually implemented into the Agreement on the EEA via decisions of the EEA Joint Committee[288] and subsequent ratification of these decisions in national legal systems. Since 1994 more than 7000 EU legal regulations have been implemented in this way.[289] It is immensely interesting that the legal system in Norway is very pragmatic as far as foreign languages and legislation are concerned—a large number of EU regulations become part of Norwegian law even before they have been translated into the Norwegian language.[290]

In this part I focus on macro-prudential supervision in Norway; the hypothesis I put forward is that macro-prudential supervision in Norway is

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[288] The EEA Joint Committee is in charge of the execution of the EEA Agreement. It holds regular meetings six (or eight) times a year. It is a forum where problems are discussed and decisions are accepted on the basis of a consensus regarding the implementation of EU norms into the EEA Agreement. Before the Treaty of Lisbon was signed, the EEA Joint Committee was comprised of representatives of EEA and EFTA countries and the European Commission. In agreement with the Treaty of Lisbon, responsibility for the co-ordination of EEA issues was transferred from the European Commission to the European External Action Service after this institution was created on the 1st December 2010.

[289] FREDRIKSEN, H.H, FRANKLIN, C.N.K. Of pragmatism and principles: The EEA Agreement 20 years on. In *Common market law review*. Vol 52, No. 3. June 2015. pp. 629-684. p. 631.

[290] In view of the fact that such norms are at that time published in English and Swedish; both languages are well understood by everyone in Norway. In Norway the only legal language is not Norwegian. The EEA Agreement lacks a provision as the one found in Article 297 of the TFEU (procedure for the adaption of acts), so decisions made by the EEA Joint Committee can come into effect even before their legal translation is published in Norwegian or Icelandic in the EEA Official Journal, where all new legislation of the EEA is published (like EU norms).

based on the same principles as in EU member countries including the supranational (European) level.

It would substantially exceed the scope of this book to analyse legal regulation of the entire Norwegian financial market. Since this chapter aims to analyse Norwegian law in this area and compare it with Union law, the following part will compare regulation and supervision in banking law, including the most important parts of general financial market regulation and supervision.

In Norway the process of integration is conceived of as the performance of supervision by one main authority, despite the fact that there are three bodies looking after financial stability: the Ministry of Finance, the Norges Bank and the supervisory authority Finanstilsynet.

Up until the mid-1980s regulation in Norway had been characterised by a high number of very strict rules for the provision of loans. In the 1980s financial markets underwent substantial deregulation of credit controls—political micro-management was replaced by market mechanisms and major changes occurred in the area of regulation of financial institutions. The past two decades have seen the introduction of an increasing number of EU / EEA laws into the legal system in Norway. The important areas of regulation display minimum differences if compared with the system in the EU; nonetheless, Norway developed an independent national type of regulation. The 2007-2009 financial crisis exposed a lot of deficiencies in financial market regulation in many countries; global financial markets were immediately subjected to stricter regulation, which, of course, left its mark in Norway, too.[291]

Regulation

As far as financial market regulation is concerned, on the 10th April 2015 a new act on financial institutions was approved (*Finansieringsvirksomhetsloven*), which introduced new EU rules for all financial institutions. This act is the first one to genuinely integrate regulation and supervision into one norm—regulation of all financial institutions is governed by this act. Some European norms had already been present in the Norwegian legal system, though: for example the CRD IV Directive and the CRR Resolution had

[291] Macroprudential supervision of the financial system – organisation and instruments. Report from a working group consisting of representatives from Norges Bank, the Financial Supervisory Authority of Norway – Finanstilsynet and the Ministry of Finance. January 2012. p. 13.

been implemented by the 30th September 2014[292] while regulation concerning the identification of systemically important financial institutions[293] had been adopted on the 12th May 2014. With the adoption of Basel III (and the CRD IV Directive), more specific (stricter) rules were approved to identify systemically important financial institutions particularly as regards the conservation capital buffer while determining the capital requirements. Having received a recommendation from the Finanstilsynet, the Norwegian Ministry of Finance identified (by means of legislative regulation) three institutions[294] that from the 1st July 2015 to the 1st July 2016 had to maintain the capital buffer at the level of 1%; on the 1st July 2016 the level doubled to the current level of 2%.[295]

To put it simply, we might say that a financial institution is systemically important if problems it encounters may have profound consequences for the entire financial system and the real economy. Norwegian law gives two criteria, either of which must be met if an institution is to be labelled a systemically important one: the total assets reaches at least 10% of Mainland Norway's GDP or a share of credits in non-financial private sector reaches at least 5% of all credits into this sector. Apart from the two main criteria, Finanstilsynet also takes into consideration the size of the institution, the scope of its mainland as well as foreign business, its comprehensiveness, its role in the financial infrastructure and the amount of interconnection with the remaining parts of the financial system.[296]

Regulation of insurance in Norway is governed by the same directive as in the EU: the Solvency II Directive and its supplement Omnibus II. Norway implemented these European regulations and they came into full effect in January 2016.

The capital market and its legislation are determined by two regulations implementing the MiFID Directive: the Securities Trading Act (Verdipapirhandelloven) and the Stock Exchange Act (Børsloven). A number of changes are expected with the implementation of the MiFID II Directive and the MiFIR Regulation, which were in the EU countries already implemented. The main aim of the MiFID II Directive is the

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[292] The overarching capital and reserve requirements were incorporated in June 2013. Cf. Finanstilsynet. Annual Report 2014. Published on the 9th June 2015. p. 36.

[293] Basel III and the CRD IV Directive stipulated certain specific rules for these institutions including duties for national supervisors so that such institutions could be identified and could meet stricter rules—EBA published recommendations for the identification of such institutions.

[294] DNB ASA, Nordea Bank Norge ASA and Kommunalbanken AS.

[295] Finanstilsynet. Annual Report 2014. Published on the 9th June 2015. p. 8.

[296] Fynanstilsynet. Risk outlook and Financial Trends for 2015. April 2015. p. 42.

provision of further support to create a capital market union, which is one of the top priorities of the European Commission. As the future EU rules leading to the establishment of a capital market union are also relevant to the EEA, they could also greatly influence the Norwegian capital market. The situation in Norway provides further justification of the opinion that financial market regulation is, barring a few minor exceptions, identical in all countries and even Norway is, in a way, on its way to the single market within the EU.

Credit market regulation had systematically been deregulated from its heyday in 1965 to the year 1988, when the remaining regulation was basically done away with. This was caused by the development of the credit market itself, but also by the rapid development of information technology that sped up as well as reduced payment expenses.

As far as the DGSD Directive (the third pillar of the Banking Union) is concerned, Norway has already implemented some of its elements into its legal system. For instance, individual depositors' finance is temporarily (till the end of 2018) covered up to NOK 2 million (almost three times as much as in the EU).[297]

Likewise, the BRRD Directive is being implemented under the supervision of the banking law commission; a proposal for its implementation was created in 2016, but real implementation is expected in 2018.[298] Two main banks (the DNB and Nordea) have prepared recovery plans already before BRRD implementation and other major banks should follow suit. Medium and small banks will assess which recovery requirements they should fulfil according to the adequacy rule of the BBRD Directive—although this will not be done before the proposal has been revealed. A draft crisis management rules document for other financial institutions (i.e. other than banks) is still eagerly anticipated as the European Commission has not issued it yet.[299] It seems very likely that once the wait is over, the Norwegian legal system will implement this European legislation, too.

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[297] At the end of 2016 the Banks' Guarantee Fund had more than NOK 32,47 billion at its disposal. Cf. Bankenes Sikringsfond Annual Report 2016. Published on the 7th March 2017. p. 15.

[298] The implementation will be carried out in a Act called the Lov om finansforetak og finanskonsern (finansforetaksloven) / The Act on Financial Undertakings and Financial Groups ("Financial Undertakings Act"), effective as of January 1, 2016.

[299] These rules are likely to be inspired by a consultation document of the European Commission from October 2012. It deals with crisis management of central counterparties, securities repositories and systemically important insurance institutions.

The institutional structure of supervision

The Ministry of Finance is responsible for monitoring financial stability and it creates legal framework in the financial sector. The other two authorities help to maintain a stable and effective financial system by monitoring financial institutions, the capital market and payment systems, discovering features that could potentially pose a threat to financial stability. The main task Finanstilsynet has is micro-prudential supervision (i.e. supervision of individual financial institutions). It can intervene by means of issuing demands and instructions for institutions in case a crisis comes (or is about to come). Norges Bank is in charge of macro-prudential supervision—it monitors the financial system in its entirety and it is also given the role of the creditor of last resort.

Norway has long attempted to make legislation stable and strong, covering the entire financial market (including all institutions that are active there) and, at the same time, enhancing reliability and resistance of the financial sector. The entire financial market is supervised by a common authority that ensures consistent regulation for various types of financial institutions while observing the 'equal risk-equal regulation' principle. In order to decrease the probability of liquidity and insolvency problems in financial institutions, new comprehensive requirements were introduced—they should ensure financial stability, sufficient liquidity, and the right amount of supervision of financial institutions. Real-life experience confirms that financial stability (even in countries with comprehensive regulation and supervision) is threatened by low liquidity ratio and insufficient resistance to crises; the situation naturally worsens if there is no intervention or if the measures are not applied early enough. That is why the Norwegian legal system also pays attention to creating resolution plans in case financial stability is under threat. A good way to achieve stability is an effective operation of financial markets.[300] It is worth pointing out again that despite not being an EU member country, Norway closely co-operates with EU countries and the EU itself in the area of financial stability owing to a lot of cross-border activities of Norwegian financial institutions in the EU and vice versa and, of course, owing also to the fact that Norway is part of the EEA.

Financial stability policies are determined by tripartite discussions which involve all three authorities responsible for maintaining stability; the main

[300] Macroprudential supervision of the financial system – organisation and instruments. *Report from a working group consisting of representatives from Norges Bank, the Financial Supervisory Authority of Norway* – Finanstilsynet and the Ministry of Finance. January 2012. p. 9.

reasons for the meetings are exchange of information, determining a financial stability outlook and co-ordination of reaction to crises (which corresponds with the resolution schemes as envisaged by the BRRD Directive). The tripartite meetings usually take place twice a year, but in case there are problems with the financial market, their frequency may increase. The Finanstilsynet Board and the executive board of Norges Bank also meet twice a year; more frequent are the meetings of the Banking and Insurance Supervision department of Finanstilsynet and of the Financial Stability department of Norges Bank—they meet every six weeks. These meetings result in harmonisation of policies in this area and also in a number of reports and analyses. Norges Bank's representative is, moreover, a permanent observer in the Finanstilsynet Board.

Finanstilsynet and Norges Bank are the two main institutions in charge of financial market supervision. As for monetary, credit or foreign exchange policies, if Norges Bank finds out that other authorities should intervene, it informs the Ministry of Finance. It is, however, Norges Bank that is ultimately responsible for financial market and financial stability supervision. It sends (twice a year) the Ministry of Finance a statement concerning a financial stability outlook along with recommendations concerning the elimination of systemic risks. It is, of course, also in charge of the monetary policy, it supervises liquidity and it provides banks with loans. As the creditor of last resort, it plays the most important role in case of a liquidity crisis.

Finanstilsynet prepares all the materials needed in case a crisis is looming, but the ultimate decision is made by the King or the Ministry of Finance. The latter is the decision-making body in particular in matters of financial stability; its decisions are based on recommendations and reports made by Finanstilsynet or Norges Bank.

1. Prudential supervision

The Ministry of Finance in Norway does not differ from its counterparts in other countries in so far as it continuously analyses both international and local economic development. It issues a report on the financial market annually. It goes without saying that also here the financial crisis showed how fast financial market problems spread internationally; likewise, it showed how important an effective financial market is for the economy as such—the financial crisis demonstrated the consequences of an imbalance between indebtedness and the value of assets. Economic and financial market analyses are based on a detailed examination of international as well

as local resources while a vital source of information is also the other two supervisory authorities.

While assessing the entire financial sector, one must pay particular attention to future macro-economic development with possible risks and threats linked with it. To a large extent, such an assessment is dependent on on-the-spot monitoring that financial institutions are subjected to—it is there that many potential risks can be spotted. Macro-economic supervision, on the other hand, provides information that serves as an important source of information for on-the-spot checks. Typically, macro-economic stability is based on capital requirements and the assessment of one's capital is based on the risks undertaken by the institution in question as well as risks that the economy faces. Capital adequacy requirements should help financial institutions gain sufficient financial resistance so that they can carry on offering loans even during a several-year-long period of recession, which is also a criterion according to which financial institutions are assessed by the supervisory authority.

Macro-economic regulation focuses on two crucial areas: it stipulates minimum requirements for capital adequacy to maintain financial stability and minimum requirements for capital liquidity. In addition, there are also rules stipulating standards of professional conduct for financial institutions and investment brokers—their observation is supervised by Finanstilsynet. One of the characteristic features of supervision is financial market uniformity which manifests itself through identical regulation and supervision while taking the same risks regardless of what institution takes the risk and regardless of the economic situation in the given country. Legislation is thus adopted consistently with the aim of avoiding less strict regulation during periods of economic stability and stricter regulation during periods of instability. While it undoubtedly contributes towards preventing risk accumulation and it helps to maintain financial stability, there seems to be a fine line between regulation and overregulation. Since there is practically only one supervisory authority, regulation and supervision are highly consistent within the entire financial market including all its sectors; furthermore, there is a full awareness of the services offered in the financial sector as well as a sound basis for assessment and management of risks in the whole financial sector.

Originally, capital adequacy requirements were based on the CRD and CAD directives[301] that follow the rules set by Basel II. In Norway their

[301] Directive of the European Parliament and of the Council of 14th June 2006 relating to the taking up and pursuit of the business of credit institutions and the Directive of the European Parliament and of the Council of 14th June 2006 on the capital adequacy of

transposition resulted in legislative changes in the area of capital adequacy[302] of financial institutions—more specifically, changes concerned calculation of risk involvement influencing capital requirements. Other legislative changes were made with a view to minimising the amount of loss incurred by a financial institution whose counterparty cannot fulfil their obligations.[303] Finanstilsynet stipulates stricter requirements for banks that calculate their capital adequacy according to risk-based internal models—these institutions must create countercyclical capital buffers in economically favourable periods in such a way as to form a financial gap between the minimum capital requirement and the actual capital. It is a certain type of a safeguard that should ensure a financial envelope even in less favourable periods.

Norway, as a member of the EEA Agreement, is subject to regulation based on Basel III (or rather the CRD IV Directive), which was added to the EEA Agreement (and each EFTA state subsequently implemented it into their legal systems[304]). Therefore, also capital requirements in Norway are based on this directive as well as capital conservation buffers and countercyclical capital buffers. The supervisory authority is, in the Norwegian legal system[305], authorised to require

- maintenance of capital requirement higher than the legal minimum (according to capital adequacy)
- restriction or change of business activities
- reduction of the risk associated with business activities, products and systems
- restriction of the scope of performance-related remuneration
- disclosure of other information along with a higher frequency thereof

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investment firms and credit institutions. Both these directives were cancelled and replaced by the CRD IV Directive of 26th June 2013, which enabled transposition of current rules into the Norwegian legal system.

302 Act no. 1506 of 14th December 2006 on capital adequacy for commercial banks, savings banks, finance companies, mortgage credit institutions, parent companies in financial groups, investments firms, management companies for securities funds etc. (the Capital Adequacy Regulations).

303 Act no. 1615 of 22nd December on large exposures of credit institutions and investment firms.

304 Through the Financial Undertakings Act with effect from 1.1.2016. The CRD IV and CRR legal framework has been in force in Norway already, although formal implementation has not yet been done.

305 Finansieringsvirksomhetsloven - Financial-Institutions Act, sections 2-9b, § 4 and section 2-9, which implement Article 64 of the CRD IV Directive.

- reduction of the difference in maturity between the liabilities and the assets

Financial and banking supervision promotes stable financial institutions, acutely aware of the risks, their management and checks. The provision of financial services must be in full accordance with the regulatory framework and in the best interest of the society and of financial service consumers.[306]

The banking sector in Norway displays the following particularities:

- the net profit of a bank is very often used to increase the bank's capital, thereby helping the bank overcome economic obstacles and meet the higher capital requirements following the 2008 financial crisis.

- Norwegian banks find the capital market very important as the biggest of them get most of their funding there. Market instability and insecurity often lead to an increase in the price of products in financial as well as bond markets and it also results in a stock market fall, which might increase banking expenses and make funding more difficult.

- the debt burden of Norwegian households is at an unprecedented high, as are property prices. Households are more susceptible than before to higher credit rates of mortgages, loss of income and a decline in property prices. Consequently, they tend to be more economical and not to consume much, which adversely affects commerce and industry. This does not seem to be unique to Norway, though—we have seen a similar scenario (barring a few irregularities) in basically the whole of Europe. Likewise, another universal feature was strengthening of regulation in the area of capital and liquidity requirements[307] (the CRD IV Directive) while more attention was drawn to systemically important banks and resolution schemes.

In Norwegian law the requirements based on the CRD IV are stipulated in the following way: the common equity Tier 1 capital is 4.5%, the whole Tier 1 capital is 6% and own sources of finance are 8% in total. The capital conservation buffer is 2.5%, the systemic risk buffer is 3%. Moreover, systemically important institutions (the DNB and Kommunalbanken, it used to be also Nordea, but since 2nd January 2017 it is only branch) have exceptional 2% capital buffer requirement since the 1st July 2016. Furthermore, a counter-cyclical capital buffer of 1.5% is still in excess of the Tier 1 equity ratio, the capital buffer, the systemic risk

306 Finanstilsynet Annual Report 2014. Published on the 9th June 2015. p. 31.

307 By 2014, all Norwegian banks, for instance, met the minimum requirements on CET1 capital (within the capital adequacy requirements) including buffers at the level of 10%.

reserve and, where applicable, the reserve for systemically important institutions. This requirement has been raised from the original 1%, because of the increasing risk of financial instability caused by increasing household indebtedness and property prices (while the banks' profits increase as well). In addition, since December 31, 2017, this counter-cyclical capital buffer has been raised to 2%. This additional increase is a response to the rise in the financial imbalance for the national economy, resulting from the rising ratio of loans to GDP, which goes beyond the long-term trend and high property price levels.

The liquidity coverage ratio (LCR) requirements were also implemented into the legal system in Norway. The Net Stable Funding Ratio (NSFR) requirements will only be adapted when they will be introduced in the EU.

It is, nonetheless, necessary to point out that Norwegian investment firms are exempt from the obligation to create capital buffers according to the capital adequacy as stipulated in the CRD IV Directive and its transposition into Norwegian law. In addition, on August 2014 the Ministry of Finance transposed beyond the obligations more macro-prudential regulatory rules[308]; Finanstilsynet later revealed (in its 15/2014 circular) that it expected financial institutions to abide by the rules in spite of the fact that they were not yet (in 2014) part of the EEA. This illustrates a relatively frequent situation where Norway implements many relevant directives even though they have not been incorporated into the EEA Agreement. Finanstilsynet issues a quarterly (called the Risk Outlook report) for financial institutions with analyses of national as well as international economic conditions in credit risk, liquidity risk and financial positions. Moreover, it publishes analyses of financial institutions, markets and the economy in general twice a year, including all other tendencies that could undermine financial stability in the Norwegian financial market (the Financial Trends report).

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[308] Commission delegated regulation (EU) No. 604/2014 of the 4th March 2014 supplementing Directive Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile.
Commission Delegated Regulation (EU) No 527/2014 of 12 March 2014 supplementing Directive (EU) No 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration

Norges Bank

Norges Bank issues recommendations based on detailed analyses of weak points in the financial system and the risk factors outside the financial system while using statistical compilations and data from balance sheets, financial positions of firms and households and, lastly, from indicators of the real economy and financial market development in Norway as well as abroad. Recommendations issued by Norges Bank help introduce measures against the increase in systemic risk. Regular (quarterly) surveys of bank credits provide information about the current situation in the credit market whilst liquidity surveys in banking institutions offer information about the sources of finance banks use and their quality.

What appears immensely interesting is the way of analysing national and international economic situation on the basis of various models. Norges Bank produced a special set of models to analyse interaction between the financial sector and the real economy as well as to analyse resistance of the banking system to shocks. These models involve interaction between prices of assets, indebtedness of households and the real economy. From the macro-economic perspective they present a projection of property prices, household indebtedness and their interest burden. This model also projects the capital adequacy of banks and it includes micro-prudential schemes in banking, household and company sectors. The models help to carry out macro stress tests of the banking system against undesirable situations that may occur.

Finanstilsynet

This body performs micro-prudential supervision of individual financial institutions with particular focus on analyses of economic shocks that may wreak havoc on the financial sector. Currently the biggest risks are connected with the so-called 'bubbles' in credit and property markets. Supervision is predominantly based on a group of indicators and analyses covering six main categories and capturing micro as well as macro factors.[309]

[309] Macroprudential supervision of the financial system – organisation and instruments. *Report from a working group consisting of representatives from Norges Bank, the Financial Supervisory Authority of Norway* – Finanstilsynet and the Ministry of Finance. Januray 2012 p. 12.

1. Economic development in Norway and abroad.
2. Market development, particularly in housing and commercial properties, commodities, currency and securities.
3. Development in local and corporate sectors.
4. The financial sector (banking and life insurance) with analyses of profitability, liquidity and solvency of individual institutions, groups of institutions and the industry as a whole.
5. Structural and competitive elements in the financial sector and the financial markets.
6. Ad hoc studies, stress tests, etc.

Finanstilsynet states four strategic supervisory instruments that include: supervision and monitoring, issuing licences, regulatory development, information and communication. The release of information is primarily aimed at financial institutions and the areas of supervision, but it also includes the media and the general public.[310]

Finanstilsynet devises four-year-long strategies in its annual reports and 2015 was the first year of the 2015-2018 period. Regardless of strategic aspects of specific periods, the general aim is the maintenance of fully operational financial markets and their financial stability, which is a necessary part of consumer protection. It naturally follows then that the elementary goal is consumer protection achieved by means of financial stability. The new strategy places particular emphasis on a/ healthy and liquid financial institutions, b/ resistant infrastructure, c/ investor protection, d/ consumer protection, e/ effective crisis management.

a/ Finanstilsynet assesses financial systems and their risk of instability and it uses political instruments to reduce systemic risk. Further, it compares information from inspections of financial institutions with that from macro-prudential monitoring, taking any necessary action based on the comparison. Through licensing requirements it makes sure of high-quality personnel in financial institutions and it precludes credit, liquidity and operational risks. It contributes to maintenance of adequate capital and of a wide range of financial sources, which helps to preserve confidence in

[310] Finanstilsynet Annual Report 2014. Published on the 9th June 2015. p. 24.

capital markets—credit institutions must maintain standard credit activities even during periods of capital and/or money market instability.

b/ It promotes strong infrastructure ensuring fully operational systems of payment, trade, price setting and agreements in this area. It makes sure that any risks and potentially weak points in the system are covered via maintenance of high management and control standards in financial institutions.

c/ It contributes towards maintenance of sufficient and regular information available to investors and towards high-quality annual audits and financial statements. It promotes appropriate market discipline by means of effective and prompt enforcement of compliance with rules.

d/ As far as consumer protection is concerned, it promotes maintenance of sufficient information for providers and consultants while also supervising them. It checks whether financial products and property are sold traded in the proper manner taking into account the capability of customers to understand the risks and details thereof. Proper consumer protection is as important for individual customers as it is for public confidence in financial institutions.

It is noteworthy that as regards consumer protection in Norway, Finanstilsynet co-operates with the Consumer Ombudsman, the Consumer Council and the Norwegian Competition Authority to ensure better consumer protection in the financial sector. The Ministry of Finance even had a competition policy forum established—it is comprised of representatives of the abovementioned bodies and its objective is better consumer protection achieved by means of an open exchange of information and views on financial market competition. It deals with both specific and general issues within the competence of each member of the forum. In addition, Finanstilsynet closely co-operates with the public information portal for financial services—consumers can find advice and warnings there concerning financial markets. They are issued by the supervisory authority, which also provides (via the portal) information about any breach of rules, e.g. the obligation to disclose prices for services. Such strong consumer protection in Norway clearly reveals the primary regulatory and supervisory orientation of the country with the top priority being reliability of financial institutions. Furthermore, new regulatory and supervisory rules are being drawn up so that the position of financial market consumers and customers is increasingly better and better.

Strong consumer protection is undoubtedly present in EU member countries as well; yet, I am convinced that in the EU there is not such a

widely and firmly integrated primary goal of consumer protection as there is in Norway. On the other hand, the EU lays down new requirements regarding concise and precise information about risks and expenses that various investment products involve (the so-called 'key information'). Key information must be enclosed with invitations to investment in securities funds and similar requirements will soon apply to other products, too.

I would like to mention that legislation ensuring a certain amount of consumer protection has existed in the EU for some time. Provision of investment financial services in the capital market, in particular, is accompanied by standardised investment questionnaires which must be adhered to by financial institutions in their relation to customers and their (i.e. customers') capability to comprehend investment financial products and the issues involved. It seems to me that in other financial market areas (except for the capital market) there are few problems and provision of services, including relevant information, is more than satisfactory. I think that both the European and the Norwegian legislation is too elaborate, stipulating an overwhelming number of detailed duties that financial institutions must fulfil; this, however, will never offer perfect protection—when a customer admits (in the investment questionnaire) to being a professional in this area or when he agrees with risky investments, there is no way of defence against a loss and they then cannot accuse the financial institution of improper conduct because the institution followed the investment questionnaire and provided the customer with all the information. The problem is that a completely lay customer can hardly fully appreciate the possible loss they might incur if they entrust the institution with full power to manage their portfolio after just a single face-to-face meeting with a professional who helps the customer to fill in the questionnaire and assures them that the financial institution knows best what to do and what the best option for the customer is. Nevertheless, everyone who is involved in investment has legal capacity and it is hard to envisage even more regulation (providing more information still) in this area.

e/ It maintains alertness to deal with crises in such a way as to prevent harmful consequences of a domino effect and subsequent permanent problem consumers might experience in the financial sector. Moreover, it ensures the ability to face unpredictable problems in individual institutions, markets and the infrastructure including more general crises of the financial system as a whole.

Macro-prudential rules for financial institutions are set here (e.g. the capital adequacy rule) as the rules stated in the BRRD Directive, which

order the given resolution authority and financial institutions as well to create resolution and recovery plans—this is also going to be implemented into the Norwegian legal system.[311]

Norway, in particular via Finanstilsynet, is a member country of several global organisations whose activities involve financial markets. As far as international supervision is concerned, apart from its participation in the Agreement on the EEA and in EFTA, Norway also co-operates with the EU via ESA bodies—a number of internationally valid norms (including EU ones) are being implemented into the legal system in Norway. These activities were deferred a little due to the fact that it was necessary for Norway to give up part of its sovereignty in favour of EU financial bodies, which possibly was dealt with in the agreement of October 2014. The agreement states that the competence to adopt binding decisions concerning supervision of financial institutions of the EEA Agreement countries is delegated to the EFTA Surveillance Authority; yet, the decision will be subject to subsequent legislative process because of the constitutional order in Iceland and Norway. Having reached this agreement, the EU as well as EEA/EFTA countries initiated the process of clarifying technicalities—a necessary step enabling full implementation of the three ESA bodies into the EEA Agreement.

In my opinion, this does not improve the situation at all, for EU norms are primarily implemented into legal systems through the EEA Joint Committee, which issues a decision that later becomes part of the EEA Agreement and EEA countries implement it into their own legal systems. Thus, the competence has been transferred from the Joint Committee to the EFTA Surveillance Authority and the only benefit it may bring is that binding decisions issued by the ESA authorities will not have to become part of the EEA Agreement since the ESA authorities will be part of the EEA Agreement. That is not the end of the problem, though, because the constitutional orders of EFTA countries are rather sensitive and there is also the potential risk of the European Commission or the European Council intervening in the decision-making process of the ESA authorities (the former could be solved by the EFTA Surveillance Authority's decision on the same thing)—there might then be an infringement of the EEA Agreement due to influence of an outside body (the European Council). This issue will be further dealt with below.

Since the establishment of the ESA authorities in 2011, Finanstilsynet has been invited to take part (as an observer) in the meetings of the ESA

[311] The Bank Law Commission was entrusted with the proposal of legal changes to the transposition of the BRRD Directive.

Management Boards (except the ESBR) and it actively takes part in activities of the boards and its subgroups—the activities are concerned with regulatory development and financial market supervision including financial institutions. Since 2013 Finanstilsynet has also been involved (as an observer again) in the meetings of the ESRB Advisory Scientific Committee.[312] Furthermore, Finanstilsynet participates in activities of the European Commission and ESA working groups (especially with a view to facilitating the process of transposition of European norms to the legal system in Norway) while also identifying and enforcing Norwegian interests and playing not an insignificant role in preparing those legal norms. Thanks to participating in the EU bodies and working groups, unification of regulation is achieved in Norway as well as the right setting of supervisory mechanisms. Of course, one needs to bear in mind that we talk of participation here, not a full membership with the right to vote.

There is also close co-operation among countries in the Nordic-Baltic Stability Group, which consists of representatives of ministries of finance, central banks and supervisory authorities from nordic-baltic countries. This group has already adopted, for example, a legal framework for co-operation among international financial institutions when dealing with a crisis. Generally, all the countries in this region closely co-operate in order to ensure financial stability and fully operational markets—to achieve this, they supervise financial institutions, monitor potential risks to financial stability, development of regulation, enforcement of law and development of supervisory mechanisms. Another group is the Nordic-Baltic Macroprudential Forum, whose members are senior management representatives of central banks and supervisory authorities. Its aim is to discuss macro-prudential supervision and other supervisory activities in the Nordic-Baltic region.

Problems related to participation of EFTA countries in EU authorities

As it was mentioned above, a lot of problems arise in connection with the fact that Norway is not an EU member state and it, nonetheless, participates in EU authorities, such as the highly relevant ESA authorities. The reason is that the secondary legislation of the EU (which is, among other things, produced by the ESA authorities) is incorporated into the

[312] Finanstilsynet Annual Report 2014. Published on the 9th June 2015. p. 71.

EEA Agreement through a rather complicated procedure in case the legislation is relevant to the principles and rules stipulated in the Agreement (in other words, if it is EEA relevant). There is no denying that in the financial market area most regulations are EEA relevant—they then get through the EEA Agreement into the legal system of EFTA countries, including Norway.

In the financial market area co-operation between EFTA countries and the EU is extremely close since both parties are keen to make sure that the financial market is as effective as possible. The ESA authorities are essentially fundamental European authorities producing relevant regulations and the fact that Norway does not have full membership of these authorities causes considerable problems. These authorities adopt various EEA relevant decisions and regulations that are later adopted by Norway as well, but, crucially, Norway has no fully-fledged representative there (it only has a kind of an observer) and it therefore cannot voice its opinion regarding the adopted acts—the capacity of Norwegian representatives is solely advisory. Another obstacle is the fact that once the EEA Joint Committee decides to implement an act into the EEA Agreement, it must then be adopted via a legislative procedure into Norwegian law—the Norwegian Constitution does not allow any other option. Such a process of implementation is rather awkward and it causes a significant number of problems. The biggest problem, however, is the delay in implementing Union acts into the EEA Agreement and, subsequently, into individual national legal systems—this may lead to considerable overload of the EEA Joint Committee; more often than not, the delay is caused by one country that obstructs or intentionally impedes the process of transposition in the EEA Joint Committee.[313] EFTA Countries have attempted to solve the problem several times by accepting unilateral transposition of some regulations into their national legal systems, but these are nothing more than provisional solutions with a rather unclear legal foundation.[314]

The easiest option is accepting EFTA countries' representatives (including those representing Finanstilsynet) as fully-fledged members of

[313] EFTA countries can delay the effect of the implementation of Union norms even after an agreement has been reached in the EEA Joint Committee. The can do so by claiming that they need to implement the norm into their own constitution (e.g. by means of parliamentary ratification). Subsequently, the transposition deadline is six months; yet, if it is announced that the time needed is going to be longer than six months, the EEA Joint Committee's decision remains ineffective.

[314] Mainly because they do not guarantee that the EU and member countries accept such acts as equal to the legally binding EU/EEA norms; likewise, they do not grant economic entities from EFTA any rights they could claim within the EU pillar regarding the EEA.

the ESA authorities including the right to vote and co-decide. From the perspective of Norwegian constitutional law, this enables to transfer sovereignty to these authorities that could be accepted as joint EEA authorities.[315] [316]

This solution appears to have been applied on 30 September 2016 when the EEA Joint Committee decided to implement the directives establishing the ESA Authorities (EBA, EIOPA, ESMA and ESRB);[317] that used to leave Norway, to a certain extent, in a tight spot. However, the parallel structures (the EU and the EEA) have not created problems only for Norway and the other EFTA countries, but also for the financial institutions in those EU countries that make business with EFTA countries.

In June 2017, the EEA Joint Committee adopted a package of decisions to incorporate 31 EU legal norms establishing the European Financial Supervisory Authorities, including the regulations establishing ESA authorities.

The issues surrounding the EEA Agreement and European legislation (and its implementation in EFTA countries) is naturally a much deeper phenomenon that far exceeds the scope of this book. It seems that the solution to the most pressing problem outlined above has perhaps been found. I am certain that there was no possible solution other than to make EFTA countries representatives equal to their European counterparts to prevent any delays in the transposition of EU norms into national legal systems while enabling EFTA representatives to take part in the very creation of these norms (issued by authorities like the ESA ones). Secondary problems of the constitutional orders of EFTA countries are, however, within the competence of individual countries—so Norway, as well, needs to tackle the problem of setting the system of accepting EU norms once its members are fully-fledged members of the ESA authorities.

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[315] In this case, there would have to be a solution to the problem concerning what to do in cases when the European Commission or the Council can influence decision making of the EU authorities; most probably the best option is to transfer this competence to the EEA Joint Committee. Even this would be far from ideal, particularly in urgent situations when national interests at are stake—yet, one can hardly find a better alternative in the structures of the EEA.

[316] FREDRIKSEN, H.H, FRANKLIN, C.N.K. Of pragmatism and principles: The EEA Agreement 20 years on. In *Common market law review*. Vol 52, No. 3rd June 2015. pp 629-684. p. 680.

[317] However, this solution addresses to a certain extent only the problems associated with ESA authorities, but the EU authority is far more. A more comprehensive solution is needed—one that involves all EU authorities that make decisions and is EEA relevant.

All EEA Agreement countries are interested in a fully operational single market to which the EEA Agreement contributes; that is why all parties involved (including EU member countries) benefit from co-operation as effective as possible. I am convinced that just the close cooperation and the relatively prompt implementation of the regulations relevant to the EEA will be effective enough to bring Europe (closer) to a single market.

Supervision in Norway – summary

The 2014 report of Finanstilsynet talks about a steady economic growth but it also warns that decreasing investment in oil and natural gas industry and falling prices of oil make the prognosis a little uncertain and, as a result, Norwegian economy might actually suffer a decline. Similarly, the report warns of increasing indebtedness of households and an increase in property prices.[318] The supervisory authority concludes that Norwegian banks should increase the ratio of long-term financing and build more liquidity buffers. The trend of capital adequacy requirements is satisfactory and all banks in Norway fulfil the minimum requirements—they should be able increase the capital adequacy providing the economic growth is not disrupted. The credit growth of retail customers keeps exceeding the income growth, which underlines the need of a prudential credit policy.[319]

It is also interesting to take a closer look at the conflicting opinions of Finanstilsynet and The Competition Authority in Norway—the dispute over bank profits. Finanstilsynet as the supervisory authority approves of high financial profits for banks since they ensure financial stability; the Competition Authority, on the other hand, expresses its disapproval—it does not like high bank profits at the expense of customers because it is certain that high fees and high rates of interest impede competition and banks could do with a lower income from these sources. It is a prime example of conflicting views of two different authorities in two different areas, which, however, very often get blurred as far as the public is concerned. Such disputes are difficult to settle—one can only try to find (and recommend) a reasonable compromise in order to sustain financial market stability and, at the same time, to prevent potential threat to rules of economic competition or excessive financial burden on customers.

If supervision is to be carried out properly, it crucially relies on data from individual institutions—relevant data requirements were stipulated in the

318 Fynanstilsynet Risk Outlook and Financial Trends for 2014. April 2014.
319 Fynanstilsynet Risk Outlook and Financial Trends for 2015. April 2015. p 20.

binding technical standards of the CRD IV Directive, adopted by Norway, too. All financial institutions must perform standard reporting; in addition, all credit institutions must report their capital adequacy and liquidity position to the ORBOF database[320] (collecting accounting information about banks and financial institutions, which report capital adequacy and liquidity position). This information from Norwegian financial institutions is then passed on to EBA by Finanstilsynet.

As far as EU supervisory colleges are concerned, what is worth pointing out is the intersection of Union law with Norwegian supervision, because Finanstilsynet is the main supervisory authority in the DNB supervisory college—the DNB is a Norwegian bank operating internationally including the EU (the majority shareholder is the state, which is, given the bank's rating, an enormous advantage). The main task of the college is the preparation of a common assessment of risk and capital of the entire DNB Group and the college is also responsible for the application of recovery plans that deal with capital adequacy and liquidity failures, proposing measures in compliance with the BRRD Directive. Recovery plans and their application must be assessed by the college, resulting in further comments and statements. Also, this supervisory authority is involved in nine supervisory colleges for foreign banks active in Norway.

We can see the evident interconnection among member and non-member EU countries. Financial market (and its institutions) is so interconnected internationally that it is not of such importance whether or not a specific country is an EU member—a financial institution licensed in a country like that is usually active in other countries as well, and that is why it is beneficial to co-operate internationally and to unify supervisory rules to a certain extent. In this case a supervisory authority outside the EU is the main authority in one supervisory college and a member of other supervisory colleges whose other members are predominantly from the EU, which brings about acceptance and harmonisation of EU rules in a non-EU zone as well. The crucial aspect is the existence of the EEA Agreement between EFTA and EU countries, which means that most financial market regulations are EEA relevant; as a consequence, EFTA countries are obliged to implement such regulations into their own legal systems.

[320] Financial Market Statists. They contain monthly financial reports from banks and financial institutions since 1987 "Offentlig regnskapsrapporting for bankers and financial intermediaries (ORBOF)".

The interconnection also manifested itself during the stress tests of the biggest European banks in 2014[321], which was carried out by national supervisors together with EBA and the ECB (the EU-wide stress test in 2014), who simultaneously checked the asset quality of these banks. The DNB Group and the Nordea Bank Group along with many Norwegian branches of foreign banks underwent these tests, too. This fact (Norwegian banks taking part in activities organised by EU authorities with the Norwegian supervisory authority involved as well) bears testimony to the real participation of financial institutions licensed outside the EU in the single market, which seems to be a direction that the EU with its activities in the area of supervision and regulation is very keen to see. If the markets in the EU and Norway are intertwined to such an extent as sketched out above, it is evident that supervision of the local market must be performed in a way harmonised with the EU, because all the countries involved long for financial stability that is best achieved via identical or very similar rules and mechanisms while making allowances for some national differences that, needless to say, will never disappear completely.

To conclude this chapter, I would like to say that the hypothesis put forward at the beginning of this chapter has been confirmed. Whilst Norway is not an EU member country, it is a European country nevertheless and its geographic location (sharing a common border with both Sweden and Denmark) cannot isolate Norway completely in any area—the economy is no exception. The financial market has long been global in its character, all the more interconnected within individual continents like Europe—it is surely in the best interests of all European countries (EU members or otherwise) to make sure that financial market rules are, at least in its most fundamental aspects, unified. Only by enabling local institutions to enter global markets without barriers can we achieve a better and a more stable economic environment, and it is exactly the process of harmonisation of the legislative environment that removes legal barriers to make it easier for companies to do business in other countries than just their home country or the country where they got the licence/permission.

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[321] These tests involved, among other things, an estimate of future losses of credit revenues, changes in revenues and expenses of interest rates and the market risk. The DNB Banking Group showed the smallest change of the CET 1 capital in these stress tests. The conclusions from these stress tests were interpreted by Finanstilsynet and it advised Norwegian banks to increase their capital adequacy by keeping hold of their net income, thereby allowing them to offer loans also in periods of economic pressure. Cf. Finanstilsynet Annual Report 2014. Published 9th June 2015. p. 38.

Another point stressing the interconnection even more is the EEA Agreement[322] that defines the form and mechanism of acceptance and subsequent application of EU norms and regulations in Norwegian law (if they are EEA relevant). Of course, a prerequisite to the transposition of European norms (EEA relevant ones) is a decision-making process in the EEA Joint Committee. It is true that in most areas under the supervision of Finanstilsynet Norwegian legislation largely includes a transposed EU legislation (since it is mostly EEA relevant), which is yet another proof of international harmonisation even outside the EU and it stresses the importance of a Europe-wide (not just EU-wide) single market. Moreover, Norway goes in some areas even one step further than the EU in terms of strictness. We might say that a national financial market does not really exist (given the intertwined international structure of the economy and the financial market as its part, too), hence the need to see the financial market as a global entity that is comprised of national financial markets. I am sure that any other way of regulation and supervision in member as well as non-member countries (other than Norway) is neither suitable nor feasible, because a national financial market presently cannot operate in a way isolated from financial markets in other countries. Norway (in spite of some problems that I deal with above) is a relatively successful example of international co-operation, implementation and harmonisation of 'external' or supranational legal norms that deal with financial market regulation and supervision. Norway thus contributes not only to its own financial stability but also to international financial stability, too, due to the high number of supranational interconnections in the financial market that, we might say, seems to fail to respect borders completely —whether those of the EU, Europe or, indeed, the entire world.

[322] I am certain that one of the greatest incentives for the EEA Agreement is strong European interconnection and close co-operation as well as existence of a supranational financial market (mentioned in the previous paragraph) and an enormous Europe-wide demand for a single market in accordance with the four freedoms of the EEA Agreement.

INTEGRATION OF SUPERVISION IN THE CZECH REPUBLIC

Like in almost all developed countries, the financial market (in particular money markets and capital markets) in the Czech Republic underwent rapid development during the 1990's, which was caused by a growing interconnection of national markets and a gradual reduction of differences between individual financial sectors. Due to international financial globalisation, big financial groups' influence and importance grew even bigger. Attempts to integrate the regulation of credit and non-credit financial institutions have been apparent for some time now. One can assume that such attempts are spurred especially by the development of information technology and overall globalization that has naturally affected financial markets as well. It remains to be seen whether this approach is the most suitable one—whether it is, indeed, desirable to integrate the supervision of credit and non-credit financial institutions or whether there should some degree of independence in the area of regulation as well as supervision of non-credit institutions, given the fact that their status is, in comparison with credit institutions, rather different.

Since the Czech Republic is an EU member and its financial market is, to all intents and purposes, wholly connected with the European market, it is hardly surprising that the current trends in financial market supervision in the Czech Republic reflect the trends set in the EU. Further, the overwhelming majority of financial institutions operating in the Czech financial market are part of big international financial groups. One could say that the Czech financial market is a subset of the international financial market (particularly the European one), which only allows a few national differences.

Historical Overview

1. 1990-1998 period

At the beginning of the 1990's, the Czech financial market with its banking entities supervised by the Ministry of Finance was born. In the period prior to this, banking entities (or rather just one banking entity) did exist, but one could hardly call this environment a financial market. Gradually, in the 1990's, supervision was being carried out by the Czechoslovak State Bank

(latter changed to the CNB), where a specialised department for banking supervision was established in 1994. As regards the creation of the capital market, it was a rather slower and more complicated process because it was, to a certain extent, a transformation tool; therefore, the creation of the Czech capital market was a product of the voucher privatisation. The following points in this historical overview concern the capital market since it seems that capital market supervision in the Czech Republic is the most interesting type and it truly illustrates the process of creation of financial market supervision—in the other financial market sectors the process was not as dramatic.

Capital market regulation is an area which has undergone rapid development. From the legislative point of view, the situation in the Czech Republic was truly interesting. In 1993, shortly after the capital market had been established, there were five acts, three regulations and one governmental order regulating the capital market. Today, there are as many as 19 acts, 20 regulations, 3 governmental orders, 35 Official Comments of the CNB and other orders from the Ministry of Finance.[323]

When the Czech Republic was founded in 1993, the stock market in the Czech Republic was regulated by the Securities Act, the Commercial Code, the Act on Investment Companies and Investment Funds, the Stock Exchange Act, and the Bonds Act. These constituted the main part of financial market regulation as such. The chief regulator at that time was the Ministry of Finance, which also performed the role of the administrative body. The capital market area was governed by Division 10, also called the Securities Authority. All these legal norms were adversely affected by insufficient knowledge of this sector and an acute lack of experience; that is why they have all been amended or replaced by new legislation.

The Ministry of Finance carried out state supervision over the emission and trade of publicly tradeable bonds and the activities of the Securities Authority. In addition, it also performed the role of an organiser of the public market, a trader, a broker, the operator of the state printer of tokens of value and the institution that settles deals with securities.[324] However, the ministry's authority was limited and rather ineffective, largely due to the fact that the officers dealing with this agenda lacked experience. As a result, this

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[323] The Ministry of Finance. Právní předpisy upravující kapitálový trh v ČR [online] [qtd. 11th July 2015]. Available at < http://www.mfcr.cz/cs/soukromy-sektor/regulace/kapitalovy-trh/pravni-ramce>.

[324] HLÚBIK, M. *Aplikace Basel II na obchodníka s cennými papíry*, Praha, 2008. 67 pages. MA thesis. University of Economics, Faculty of Finance and Accounting. Supervisor Petr MUSÍLEK p. 12.

period saw the establishment of many obscure companies in the capital market—their business practices were somewhat dubious and they often led to financial scandals especially in the area of investment funds. These problems could not be prevented even though the supervisory body gained more authority: it could impose sanctions up to CZK 10 million, proclaim enforced administration or replace the executives in investment companies and funds. Real supervisory authority, however, came with the establishment of the Czech Securities Commission.

As it was stated above, the Czech capital market as a source of finance is not as important as credit from credit institutions. This is a rather usual thing in Europe in comparison with the USA, where the capital market plays a far more important role in money acquisition for further development of individual companies.

2. 1998-2004 period

The crucial event in the financial market in this period was the establishment of the Czech Securities Commission (hereinafter just 'the SC') on the 1st April 1998 under Act no. 15/1998 Coll., the Securities Commission Act. The SC became the major administrative body with all the powers previously held by the Securities Authority (within the Ministry of Finance), from which it essentially broke free.

When the Securities Commission Act was proposed, it was stated that the then situation in the Czech capital market had proved beyond doubt the institutional, procedural and substantive inadequacy of the legislation as well as of the supervision carried out by the Ministry of Finance. Therefore, the Securities Commission was proposed as a flexible institution endowed with extra authority to immediately and expertly deal with problems in the capital market.[325]

From the very beginning, the SC declared its desire to bring Czech legislation into line with European legislation, which can be illustrated in the Securities Act in the form of an increasing number of demands on securities traders (hereinafter also just 'traders').

The SC with its regulatory and supervisory authority over financial market participants intended to increase the credibility of the financial

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325 KLÁŠTERECKÝ, J.D. Dohled nad kapitálovým trhem…dnes ČNB. [online] [qtd. 11th June 2017] Available at <http://trhy.mesec.cz/clanky/dohled-nad-kapitalovym-trhem-dnes-cnb/?_ga=1.143564661.1130367641.1403871224>.

market. It could sanction participants if they failed to fulfil obligations arising from the financial market legislation. Equally, it was supposed to cooperate with the police and courts and, in certain cases, it could also exert its authority to block a transfer of securities or money from one account to another.

Originally, the SC did not have the power to issue statutory instruments. It could impose interim measures, i.e. it could freeze money or securities, it could impose sanctions up to CZK 100 million, and, crucially, it could also revise all the licences granted by the Ministry of Finance within one year of their existence (the so-called 'relicensing'). Relicensing led to a number of licences being revoked—licences belonging either to companies no longer in operation or to companies that had done harm to customers and/or the capital market. The requirements issued by the SC were much stricter than those of the Ministry of Finance—the aim was to maintain the standards of conduct found in the countries of the European Union. Overall, relicensing dramatically decreased the number of companies active in the capital market.[326]

Note

The number of traders with securities had dropped from 131 (1st January 2000) to 112 (1st January 2001) and further down to 97 (31st December 2001). A similar decrease also occurred in collective investment, where the number of active investment companies had dropped from 79 (31st December 1999) to 65 (31st December 2001). Likewise, the number of investment funds had changed from 85 to 74. As of 30th September 2003, the number of traders was 72 (21 banks, the others non-banking ones), 6 investment funds and 17 investment companies operating 78 open common funds; there were also 12 pension funds.[327]

A significant benefit was expected from the SC's activity against the misuse of insider (i.e. publicly inaccessible) information. Furthermore, the SC was asked to follow and check suspect deals, to punish offenders and to initiate prosecution against them. Gradual integration was supposed to

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[326] JAKUB, F. *Analýza modelů regulace a dozoru nad finančním trhem*, Praha, 2011. 179 pages. Dissertation thesis. University of Economics, Faculty of Finance and Accounting. Supervisor Petr MUSÍLEK p. 108.

[327] PAVLÁT, V. KUBÍČEK, A. Regulace a dohled nad finančními trhy. 2nd rev. ed. Praha: University of Finance and Administration, o.p.s., 201,. p. 154.

broaden the scope of activity of the SC, which would eventually change its name to the Financial Market Commission.[328]

The new legislation settling the regulation of traders contained (for the first time) especially the obligation to set up the registered capital worth CZK 10 million and to maintain the capital adequacy. Also, it stipulated more requirements regarding the inner organisation of the trader and stricter separation of customer accounts so that these could not be used for transfers on one's own account.

The capital adequacy regulations[329] were only issued by the SC in 2003, and it included the so-called Basel Capital Accord, often labelled as Basel I. It ordered the Czech Republic to incorporate Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions.

Prior to joining the EU, the Czech Republic was forced to bring its legislation into accord with EU law—it had to adopt European directives[330], i.e. to transpose them into the Securities Act.

Investment services were divided into primary and secondary ones. According to Council Directive 93/6/EEC on the capital adequacy of investments firms and credit institutions traders were divided into three categories based on the investment services provided and on whether they were entitled to accept financial funds or investment instruments from customers. Depending on which category the given trader found themselves in, the registered capital was at least CZK 2 million (the trader could not accept financial funds or investment instruments), CZK 5 million (the trader could offer some investment services and accept financial funds), or CZK 27 million (the others).

The SC defined, in accordance with the directive[331], insider information and it forbade people to use such information directly or indirectly.

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[328] Klášterecký, J.D. *Dohled nad kapitálovým trhem…dnes ČNB*. [online] [qtd. 11th July 2017] Available at< http://trhy.mesec.cz/clanky/dohled-nad-kapitalovym-trhem-dnes-cnb/?_ga=1.143564661.1130367641.1403871224>.

[329] Regulation no. 64/2003 Coll., on the capital adequacy of securities traders that is not a bank or a branch of a foreign bank on an individual basis and Regulation no. 73/2003 Coll., on announcing the capital adequacy of securities traders that is not a bank or a branch of a foreign bank.

[330] Council Directive 88/627/EEC of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of, Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions. Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes.

Another milestone in this period was the establishment of the Investor Compensation Fund based on both Council Directive 97/9/EC on investor-compensation schemes and the amendment[332] of Act no. 591/1992 Coll, on securities.

The Fund's main task is to create a guarantee system that can be used to pay compensation to customers of those securities traders that cannot fulfil obligations to their customers. It essentially safeguards customers against improper conduct from traders, which could otherwise result in the loss of all the funds entrusted to a particular trader.

It is worth pointing out that the most important hedge fund is the Deposit Insurance Fund. This independent legal person was established according to Act no. 156/1994 Coll., which amends and supplements Act no. 21/1992 Coll., on banks; the main task is to insure deposits (receivables of depositors, both legal and natural persons) at banks, buildings societies, and savings and cooperative banks [333]. It is the end of the Guarantee Fund of Cooperative Banks and the transfer of its agenda within the Deposit Insurance Fund that can be seen as a sign of integration; in this case it is the unification of the guarantee system within the financial market, which reached its climax in the form of the Financial Market Guarantee System, which comprises both the Deposit Insurance Fund and the Crisis Resolution Fund. On top of that, in the future the Investor Compensation Fund should be added as well.

The main role of the Deposit Insurance Fund is the protection of bank deposits, thereby increasing the credibility of the banking system, particularly in economically insecure periods.

3. *The Czech Republic in the EU*

When the Czech Republic had joined the EU, new legislation linked with capital markets came into effect; it saw the transposition of virtually all EU directives.

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331 Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing.

332 Act no. 362/2000 Coll., amendment of act on securities.

333 The Guarantee Fund of Cooperative Banks was an independent legal person according to Act no. 87/1995 Coll., on savings and cooperative banks. However, on 1st April 2006 came into force Act no. 57/2006 Coll., on amendments in connection with integration of supervision over the financial market; from then on deposits in active cooperative banks are treated according to Act no. 21/1992 Coll., on banks, as amended and they are insured at the Deposit Insurance Fund.

The rules stipulated in the Securities Act were transferred into a new legal norm, namely Act no. 256/2004 Coll., on capital market undertakings. The Securities Act was only left with the rules stipulating contractual aspects of securities. Among other things, a host of regulations were cancelled and the Act on Investment Companies and Investment Funds was replaced by Act no. 189/2004 Coll., on collective investment.

More changes were brought in with Basel II directives. [334] They were made via amendments to the Act[335] that stipulates capital requirements of banks, savings and cooperative banks, securities traders and via the institution of electronic money along with a statutory instrument[336], which resulted in unified regulation for banks and traders alike.

When Act no. 57/2006 Coll. came into effect, the SC ceased to be. Naturally, the term in office ended for the head and the members of the executive board. The previous agenda stemming from the acts and other legal regulations was passed on to the CNB. This institution was also entrusted with the unified supervisory role over the entire financial market.

From the legislative point of view, I am convinced that the financial market has gone through a series of major changes that, by means of transposition of European directives, identified Czech legislation with that of the EU, thereby increasing the credibility of the Czech financial market. The capital market, in particular, needed such a boost given its more dramatic development marked by a high number of legal norms connected with supervision. Had the regulation of capital market institutions not intensified, such a high degree of credibility and transparency could not have been reached, even though the number of tradeable securities lowered and the development of the securities market slowed a little.

At the present time, there seems to be a lot of effort to stabilise capital markets and this can be demonstrated on the legislation adopted after the Czech Republic had joined the EU. Before the Czech Republic became an EU member country, the regulatory aim had been to stipulate rules for investors and increase market transparency. Now that the aim has been reached (in my opinion, the rules and norms for the operation of capital market institutions and customer protection are wholly satisfactory), the

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334 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

335 Act no. 120/2007 Coll., on amendments to some acts.

336 Decree no. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms.

effort has shifted towards the enhancement of capital market stability, cf. the latest EU attempts to create the Capital Markets Union and the Banking Union. All this helps to reach the ultimate goal of the EU economy, namely the existence of a single market.

Institutional development of the system of supervision

From the beginning of financial market supervision in the Czech Republic, it was carried out by means of a sectoral model, in which each sector of the financial market had its own supervisory authority. For banks it was the CNB, for non-banking financial institutions and dealers (such as investment companies, investment and common funds, securities traders, financial dealers, securities registers and securities market organisers) it was the Securities Commission. Supervision of pension funds and insurance companies remained within the authority of the Ministry of Finance (from 1st September 2000 in the 'State supervision in insurance and supplementary pension insurance' department). In 1997 the 'Supervision in credit unions' was founded, while, as a matter of fact, credit unions had existed for a year—this delay in supervision brought about bankruptcy of some institutions, thereby weakening the credibility of the whole sector.

The sectoral model was no longer tenable owing to the costs it required as well as due to the ever-increasing financial market. Yet, it was still true that the biggest share of the market was occupied by the banks, which in 2004 possessed almost 75% of all assets; even though the share and importance of non-banking institutions had been on the increase (see the table below).

Table no. 6: The share of financial institutions in assets of the financial sector

Financial institution/Share of assets of the financial sector in % per year	1996	1997	1998	1999	2000	2001	2002	2003	2004
Banks	78.8	82.1	81.4	80	81	77.5	75.9	74	74.1
Credit unions	0	0.1	0.2	0.2	0.1	0.1	0	0	0.1
Insurance companies	5	4.8	4.9	5.4	5.8	6.3	7.2	7.6	8.3
Investment companies, investment and common funds	8.1	6.3	4.2	4.8	3.4	2.8	3.9	3.3	3
Pension funds	1	0.9	1.1	1.3	1.4	1.7	2.1	2.4	2.9
Financial leasing companies	4.1	3.9	4.6	4.5	4.1	5.5	5.8	6.1	6.3
Other non-banking financial institutions	3	2	3.6	3.7	4.2	6.1	5.1	6.5	5.4

Source: CNB, Erbenová M.: Globalizace finančních trhů a integrace dozoru nad finančním trhem České republiky, Sborník z mezinárodní konference VŠFS 2005, Aktuální vývoj finančních trhů, jejich regulace a dozor, p. 26.

Originally, integration (as it is understood at the level of individual member countries, i.e. the unification of supervision within one institution) was supposed to be realised in two separate stages. This was the governmental strategy from May 2004: from 1st July 2004 the CNB was asked to start supervising credit unions whilst the SC (under the name of the Financial Market Commission) would supervise insurance companies and pension funds. The second stage in the form of complete integration would follow along with the admission of the Czech Republic to the European Monetary System. Supervision would either be carried out by the CNB or the Financial Market Commission.

The door was open to accept either of the two options: integration of supervision within one independent and separate supervisory authority was only possible if the issue of its proper financing was dealt with while its integration within the agenda of the CNB was only feasible providing the issue of autonomous supervision of the capital market was addressed.[337] The laws vital for this reform were passed by the government in June 2005 and they were sent to the Chamber of Deputies of the Czech Parliament for further discussion and eventual approval. The main motivation behind this

[337] HOLLMANN, P. *Aktuální vývoj finančních trhů, jejich regulace a dozor,* Conference Proceedings, VŠFS 2005, pp. 34 a 35.

reform was the desire to increase the effectiveness of supervision over big financial groups and to minimise the dangers that threatened the financial stability of the system. The supervisory approach would be identical in all the financial sectors and any supervisory overlaps in the sectors would be prevented. There was considerable hurry to solve the following problem: insurance companies and pension funds were supervised by the Ministry of Finance while the international obligations of the Czech Republic and the requirements of foreign institutions called for an independent supervisory authority. Last but not least, the reform was expected to reduce costs of supervision and to be financially beneficial for the supervised as well as their report obligations would be dealt with more effectively using the latest information technology.

In June 2005 there was a dramatic change as the Ministry of Finance announced its decision to cancel the first stage. Instead, there would only be one stage and supervision would be integrated within the CNB. It was, without any doubt, a political decision because an expert assessment insists that it was all announced and realised far too hastily and without sufficient reasons for such a radical step. The legislative process, including the preparation of a complex amendment, was extremely quick and the whole process of integration only took 7 months; as a consequence, some issues were only dealt with ex post, e.g. the shift towards the functional model of supervision, which took place in January 2008.

Integration of supervision within one single institution also took place in Slovakia roughly at the same time. Nonetheless, the period from the acceptance of the proposal (March 2002) to its actual realisation (January 2006) lasted almost 4 years. Such a radical reform clearly needs some time for the preparation of legislation, the setting of its organisation and of the system of finance so that everything runs as smoothly as possible and problems are not tackled ex post. It is not entirely clear why such a dramatic change happened in the first place, particularly when so much money, time, and effort had been spent on preparing the reform of supervision. I believe that the two-stage model of integration would have made a more effective and quicker impact in the long run. In this way, it would have been possible for everybody concerned to get ready for the reform. The outcome, i.e. integration within the central bank, was naturally always one of the options because of the infrastructure, a stable source of finance, the personnel, but also due to the fact that it is typical of the financial system in the Czech Republic (the financial market) that the dominant position is occupied by the banks. The Ministry of Finance remained the regulatory body, i.e. the proposer of primary legislation, while the CNB became the producer of secondary legislation. The CNB also got help from the newly-created

Financial Market Committee—an advisory body of the CNB Bank Board, incorporated within the structure of the central bank. Its job is to discuss the strategic and conceptual aspects of regulation, supervision and the financial market as such. Moreover, it can issue recommendations in the report on financial market supervision, which is created by the CNB and it is submitted to both chambers of the parliament.

The entire integration reform was thus carried out in a single step and since 1st April 2006 the single supervisory authority in the Czech Republic is the CNB.[338]

The following are the chief reasons why supervision was integrated within one authority only:[339]

- greater transparency of the system of integration and supervision
- reduction of overlapping competence among supervisory bodies
- creation of suitable conditions for a more effective financial market monitoring
- application of equal regulatory requirements in all sectors of the financial market
- reduction of costs thanks to sharing the working infrastructure
- removal of competition among individual supervisory bodies

Although such an institutional arrangement (i.e. where one institution has such a vast scope of authority) may pose some risk, I am convinced that such fears have been allayed by the present model and its activities, especially given the fact that the supervisory policy of one single body is more unified and effective. Furthermore, another advantage is that reactions to problems in one part of the financial market may lead to immediate prevention in another part.

As it has been said before, in January 2008 the up-to-then sectoral model with three sectors (supervision of banks, insurance companies and the capital market) was replaced by a functional model with three supervisory departments that acquired new competence. The newly-created departments were: the Financial Market Regulation and Analyses Department, the Licensing and Enforcement Department, and the Financial Market Supervision Department.

The choice of the CNB as the body with the complete authority over the Czech financial market seems perfectly logical as even in the period before

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338 By means of Act no. 57/2006 Sb., on amendments of acts in connection with integration of supervision over the financial market.

339 JENÍK, I. *Dohled a regulace finančního trhu*. 1st ed. Prague: Vyšehrad, 2011, p. 81.

supervision was integrated, the CNB (with its supervisory authority over the banks) had had, compared with the other supervisory bodies, by far the biggest share of supervision in the financial market.

A necessary part of every integration process is the revision of the present legislation with vital changes being made so that the existence of a single supervisory body is enabled. The process of integration is linked with unavoidable implementation of European directives—annually, there are several of them and they set the legislative framework in this area.

The biggest change within the ongoing process of integration was the organisational shift from the sectoral model to the functional one in January 2008—the change was motivated by the aim to achieve better results in the integration process. This is demonstrated by the attempt to integrate supervision in all parts of the financial market (not only in supervisory and control activities, but also in administration).

The main motivation behind the change of the organisational structure of the supervisory departments was the need to do away with conflicts between different legislative norms. These were acts that applied to one sector only and they dealt with things separately despite the fact that the things could be dealt with in the same way. Prior to this, there had been some conflicts that then had to be settled at the level of the Bank Board. Today, the change has resulted in them being tackled at several levels lower than before, e.g. at the level of CNB officers.[340]

This is exactly the chief benefit of the functional model, i.e. problems are dealt with at the lower levels of both legislative and executive power within the authority of the CNB. In addition, the next big benefit is the wider scope of functional supervision within one institution—it is no longer effective to have several supervisory bodies due to the ever-increasing globalisation and a wide range of activities of global financial corporations.

The drawbacks of the previous model appear to be linked with the sectoral orientation of the supervisory bodies. Now that every big banking group comprises entities belonging to all sectors of the financial market, it is not viable any longer to pursue just a single goal while performing supervision. Banks perform all the activities under one roof and the supervisor must reflect this trend. The supervisory authority should take charge of all the entities operating in the market, which the new model

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340 KUCHTA, D. SINGER, M. Podle MiFIDu jsem...´babička z Orlických hor´, *Investujeme.cz* [online] 2008 [qtd. 20th June 2017]. Available at <http://www.investujeme.cz/clanky/miroslav-singer-podle-mifidu-jsem-babicka-z-orlickych-hor/>.

enables. The functional model can thus be interpreted as a reflection of the outside world, the activities of which call for an integrated system of supervision within a single supervisory authority[341].

More changes were made on 1st March 2011 with a view to making the system even more effective. The individual supervisory departments are now defined by their functional specialisation and within their own competence they supervise all the financial institutions across all the sectors of the financial market. The previous number of five divisions was reduced by one, the existing four are: the Prudential Supervision Division, the Conduct of Business Supervision Division, the Prudential Control Division, and the Conduct of Business Control Division. This change of the structure of financial market supervision reflects the long-term positive experience of the functional model in the CNB.[342]

What benefits does (or should) the integrated model bring about? Firstly, one can expect a more effective detection of possible risks against the stability of the financial system. Other benefits include better coordination, more effective communication, prompter reactions to changes in the financial market and more responsibility within a single institution. While the risks (mentioned above) have been present ever since the very start of integration, the advantages have only been made visible slowly, and several years must elapse before it is possible to say whether it was a step in the right direction. Arguably the biggest danger of integrated supervision is the aforementioned concentration of authority in one single institution. This danger has always been manifest, but the expected benefits of simpler and more effective supervision integrated in a single institution outweighed the doubts and dangers.

Integration of supervision in a single authority, however, is not the only step—it is rather a factual and external sign of integration. Other important aspects include the unification of supervisory rules applied in various sectors of the financial market and a higher quality of supervision over big international institutions of the financial industry.

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341 KUCHTA, D. SINGER, M. Podle MiFIDu jsem...´babička z Orlických hor´, *Investujeme.cz* [online] 2008 [qtd. 20th June 2017]. Available at <http://www.investujeme.cz/clanky/miroslav-singer-podle-mifidu-jsem-babicka-z-orlickych-hor/>.

342 Nové uspořádání dohledu nad finančním trhem. Cnb.cz [online]. 2011 [qtd. 14th July 2017]. Available at: <http://www.cnb.cz/cs/verejnost/pro_media/tiskove_zpravy_cnb/2011/20110211_dohled_ft.html >.

Another important feature is the unification of existing as well as future legislation—the current system should prevent undesirable duplications and gaps whilst increasing the transparency and effectiveness of supervision and reducing the costs. The ultimate objective of single-authority integration should be national as well as global integration across financial market sectors.

The desirable goal of integration is not unification within a single authority[343], but rather (as it has been stated in the chapter about integration of supervision in Norway or as integration is understood in the EU) unification of supervisory activities, practices and methods including mutual cooperation not only at the national level, but at the global level as well. Supervision must thus be maintained in the hands of a limited number of institutions (ideally just one or two) to ensure that it is unified and very effective, too.

Supervision of the CNB over financial market entities

The status of the CNB is stipulated in Act no. 6/1993 Coll., on the Czech National Bank, which asserts in Article 1, par. 3 that the CNB is entrusted with the competence of a supervisory authority as defined by this Act and other legal norms.[344] The CNB supervises the entire financial market in the Czech Republic—at the moment, supervision is performed over 276 entities, cf. the following table.

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[343] Integration of supervision in a single institution is what integration is usually understood in individual member countries.

[344] E.g. Act no. 21/1992 Coll, on banks, as amended (hereinafter also just the Bank Act, or the BA), Act no. 219/1995 Coll., the Foreign Exchange Act, Act no. 256/2004 Coll., Capital Market Undertakings Act, Act no. 87/1995 Coll., on credit unions, as amended, Act no. 240/2013 Coll., on investment companies and investment funds, Act no. 277/2009 Coll., on insurance, Act no. 426/2011 Coll., pension saving, Act no. 427/2011 Coll., on supplementary pension saving.

Table 7: Number of financial market entities as of 30th March 2020.

Entity	Number
Banks and branches of foreign banks	49
Savings and credit unions	9
Investment companies	36
Investment funds with legal persons	164
Securities traders and branches of a foreign securities trader	79
Insurance companies and branches of foreign insurance companies	48
Reinsurance companies	1
Pension companies	8

Source: Own processing based on CNB data statistics

The exact numbers in the table above are purely illustrative because they keep changing, of course. Admittedly, the changes are not as dramatic though as they were some twenty years ago.

The CNB also has its say in planning long-term strategies of regulation and supervision in the EU, whether it is the capital adequacy directive (including the implementation of Basel II and III), Solvency II rules, the regulation of credit rating agencies and collective investment, or the new framework of financial market supervision, including the Banking Union.

The basic rules vital for the maintenance of financial stability (especially the macro-prudential ones in the form of capital adequacy) are observed in accordance with CRD IV.

The banking sector as the crucial part of the Czech financial market keeps making profit and is in good shape. Singer[345] claims that the capital adequacy of the banking sector is sufficient and its capital is of a high quality; further, he says that the liquidity of the banking sector is excellent and this sector does not pose any risk. As regards the new framework of supervision in the EU, the CNB is convinced that the structural changes of supervision in the EU must keep the balance between authority and responsibility. Whilst authority in the process of integration of supervision in the EU is now in the hands of the European supervisory authority, responsibility is still with the national supervisors. According to the CNB, the biggest danger in the area of supervision lies in mistakes made while introducing new supervisory rules or, alternatively, in their hasty implementation without the consequences having been properly discussed.

[345] SINGER, M. *Dohled nad finančním trhem*. Paper delivered at Den otevřených dveří ČNB. Prague 12th June 2010.

The CNB is rather sceptical about some of the proposed changes in supervision—the reason for its scepticism is the possible appearance of systemic risks and uncertain results of some international proposals.

Granting and taking away licences and permits at the financial market

It is clearly believed that one of the most important parts of financial market regulation and supervision is the stipulation of conditions on which one may gain access to the financial market as a financial market entity with subsequent monitoring ensuring that the conditions are met and business is conducted in the proper way. These are macro-prudential rules stipulated for the entire financial market—if one wants to become a financial market entity, a licence (banks) or a permit (all the other financial market entities) must be gained. It is far beyond the scope of the present book to analyse the licencing procedure for all financial institutions so only two are discussed here: banks and securities traders, arguably the second most important financial market entity after banks.

This subchapter aims to confirm or refute the hypothesis that a proper and consistent procedure of taking away licences supports the general objective of regulation and supervision, namely the maintenance of financial market stability. The hypothesis only applies to the termination of financial market entities because when licences are being granted, it is crystal clear that a proper procedure observing all the conditions necessary for the licence to be granted helps to maintain financial market stability.

There are two reasons why only two entities (banks and securities traders) are discussed here in connection with licences and permits. Firstly, the two are undoubtedly the most important institutions conducting business in the financial market (especially banks and their conduct is essential for the stability of the entire system). Secondly, legal norms linked with these entities are rather specific (this is especially true of banks) and they thus illustrate the issue very well.

Taking away licences and permits is further analysed here at a more general level, i.e. in connection with all financial institutions, and not just banks and securities traders. This is justified by the fact that the end of licences and permits is more or less the same (barring a few irregularities), regardless of which financial institution's licence or permit is cancelled.

1. *Licencing procedure for banks*

If anybody wants to offer banking services (i.e. conduct business as a bank in the Czech Republic), there are two options according to Act no. 21/1992 Coll., on banks (hereinafter the Banks Act).

- The first option is to gain a banking licence from the CNB or a permit to offer banking services, i.e. accept deposits from the public and offer credit.
- The second option is to offer banking services in the Czech Republic by banks whose headquarters is in another EU member country by means of a branch thanks to the so-called single licence in the banking market; two conditions are necessary: the foreign bank must own a valid licence from the country of its headquarters and it must follow the procedure stipulated by EU law.

In accordance with the international contract, the CNB can issue a directive raising the number of countries whose banks have the same advantages while doing business in the Czech Republic as banks that are from EU countries. Whoever conducts business under the single licence in another country, is supervised by the domestic supervisory body, with the exception of a few clearly defined legal norms of the home country. If a bank wants to offer services via its branch, it must go through the so-called notification procedure, in which it presents information regarding its business plan, its list of services, its headquarters, its organisational structure, and its head. These branches only need to comply with the registering obligation of taxable entities stipulated in a special legal norm[346]. Banks with the headquarters in EU member countries are entitled to conduct business even without setting up a branch if their business is not permanent.

However, this book only goes on to discuss the granting of a banking licence (hereinafter just 'licence') in a licensing procedure—when a new banking institution under the supervision of the CNB is established.

The licence application (the required form) is submitted to the CNB along with a proposal of the association articles. The minimum capital for would-be banks is CZK 500 000 000, and this is also the required minimum amount of money gathered by deposits on a pre-arranged account. The licence requirements are stipulated by the CNB directive no. 233/2009 Coll. The application must be submitted in writing and it must include basic information about the applicant, the reason(s) for the application, the

[346] Cf. § 33, Act no. 337/1992 Coll., on tax and fees administration, as amended.

objective of the bank, a business plan and a market analysis, plus a number of other documents. All of these are considered in the licensing procedure.

The licensing procedure formally begins when the CNB informs the applicant that the procedure has commenced. This is, of course, only possible once the application form has been submitted. Along with the commencement of the licensing procedure, the CNB asks the applicant to comment on/make a complaint about the documents submitted in the application form or the method of their assessment. Typically, the licensing procedure lasts 6 months unless it is interrupted because the CNB requires supplementary information. In such a case, the licensing procedure can last up to 12 months. The CNB assesses especially the capacity of the main shareholders regarding their financial stability and power, but is also looks into the level of expertise and the moral standards of persons proposed to form the statutory and executive boards of the bank. Moreover, technical and organisational equipment necessary for the services to be offered is examined as well as the feasibility of the economic plans for the future liquidity and profitability of the bank. The applicant must pay an administrative fee of CZK 200 000.[347]

Provided that all the necessary conditions are met, the CNB grants the licence. Typically, the category of administrative discretion is applied here because while some aspects and conditions affecting the decision to grant the licence may be objective, others appear rather subjective and their assessment is thus left to the discretion of the assessor. For instance, in some cases it might be disputable whether a given person reaches the required level of expertise or moral behaviour, or whether the technical background is appropriate enough for the type and range of services that the banking institution plans to offer. In order to prevent such unclear situations that may result from some rather vague categories, the CNB issues official notices that provide more information about the categories and they specify the requirements that applicants should meet. The assessment of such categories as expertise or credibility is thus hopefully clearer and more predictable.[348]

If the application is successful, the licence is given for an indefinite period. The licence stipulates the activities that the bank is allowed to perform; alternatively, it provides a list of conditions that must be met before another type of activity is initiated or that must be observed during the performance of this activity. Some activities present in the licence may

[347] Item. 65/1, letter a) of Act no. 634/2004 Coll., on administrative fees, as amended.

[348] Based on the CNB Official Notice, issued on the 3rd December 2013, explaining the notions of credibility and expertise.

be conditioned by the granting of a special permit (e.g. a permit for services in the investment industry which is granted under Act no. 256/2004 Coll., Capital Market Undertakings Act).

In a nutshell, before a bank comes into existence, there must first be a joint-stock company which, sooner or later, manages to meet the requirements of the Banks Act; only after the company has been granted a banking licence, can the company call itself a bank[349]. The purpose of business activities listed in the List of Company Registers is banking services or all the services that the applicant is entitled to perform according to the licence.

If the CNB's decision is negative, the applicant may file a remonstrance, which is a regular remedial measure present in the administrative order; the decision (which is irrevocable) is then made by the Bank Board of the CNB. The remonstrance, however, has no suspensory effect and the provision about the possible conclusion of the remonstrance proceeding cannot be applied.[350]

2. *Granting permits according to the Banks Act*

In a number of cases the Banks Act demands that banks, prior to making a certain step, ask for permission or inform the CNB of what they are going to do. A prior permission is required in the following cases:

a) a person intends to obtain direct or indirect share of the bank worth at least 20%, 30%, or 50% of the voting rights of the bank, including a person who wants to reach the above-mentioned limits of the basic capital of the bank, including a person who will become an executive member due to a contract to control the bank. This obligation also applies to persons acting in compliance,[351]

b) prior to a contract about the sale of the bank ort its part,[352]

c) prior to a bank merger, a division of a bank, or a transfer of funds to another bank as a shareholder,[353]

[349] Cf. Article 3, par. 1 of the Banks Act.
[350] Cf. Article 152 par. 5 Act no. 500/2004 Coll., the administrative order.
[351] Cf. Article 20 par. 3 of the Banks Act.
[352] Cf. Article 16 par. 1 letter a) of the Banks Act.
[353] Cf. Article 16 par. 1 letter c) of the Banks Act.

d) when a decision to terminate a bank is reached at the level of the general meeting or when the decision affects the activities which can only be performed by a licence holder,[354]

e) when the basic capital is reduced, unless it is a case of loss compensation,[355]

f) when an auditor is about to chosen.[356]

Within two days after receiving the application, the CNB must confirm in writing its acceptance, and it must inform the applicant of the deadline by which the CNB must reach a decision. The CNB must do so no later than 60 working days after sending the confirmation notice. If this deadline is missed, the applicant can act as if the licence has been granted.

It should be stressed, though, that if there is an increase in the qualified interest in the bank or if there is a takeover without the consent of the CNB, this does not mean that such a legal act is automatically nullified. Yet, the voting rights linked with this act cannot be exercised until the permission from the CNB is granted. Legal acts and resolutions of the general meeting made without a prior consent are invalid.

The participant in the prior consent proceeding is only the requesting bank; in the following cases it is also the second contractual party: when the bank or its part is transferred according to letter b), or when there is a bank merger or a bank division, or the funds are received according to letter c) .[357]

The notification duty is applicable in the following cases:

- the reduction of the direct or indirect share of the bank under 20%, 30%, or 50% of the voting rights—this duty also applies to persons acting in compliance. After the Banks Act amendment, the duty also applies when the share in the basic capital is reduced below the above-mentioned limits or when there is a loss of control over the bank; further, if there is a proposal to transfer such an amount of share or other rights that constitutes qualified interest in the bank,[358]
- a change in the association articles,[359]

[354] Cf. Article 16 par. 1 letter b) of the Banks Act.
[355] Cf. Article 16 par. 1 letter d) of the Banks Act.
[356] Cf. Article 22 par. 4 of the Banks Act.
[357] Cf. Article 16 par. 1 of the Banks Act.
[358] Cf. Article 20 par. 14 of the Banks Act.
[359] Cf. Article 16 par. 2 letter a) of the Banks Act.

- a change of personnel in the statutory body of the bank or in the executive board,[360]
- an intent to open a branch abroad[361]--having received the notification about the branch abroad, the CNB decides in an administrative proceeding whether the conditions stipulated by EU law are met (according to Article 5c – 5m of the Banks Act)[362] and if the decision is negative (the conditions are not met), it is reviewable in court.
- the acquisition of qualified interest of another legal person.[363]

3. Licensing procedure for securities traders

The establishment and conduct of business of securities traders is governed by Act no. 256/2004 Coll., the Capital Market Undertakings Act (hereinafter just 'the CMUA'). Before the application is submitted, it is necessary for the applicant to clarify its business intent since it is a key aspect in determining the line of business, particularly as regards the scope of investment services. This also determines the minimum capital requirements, the capital adequacy requirements and other material, personnel and organisational requirements.

The only participant in a permit procedure is a joint-stock shareholder or a limited liability company with its headquarters in the Czech Republic; the application must be submitted in the form prescribed by the CNB including all the compulsory supplements. The application can be submitted by a company even before the company is listed in the List of Company Registers, but it must meet all the criteria required for the permit before its entry in the List—the company must be able to prove them in a trustworthy manner. During the permit procedure it is possible to order a hearing in which the CNB officers specify what additional information is needed to complete an imperfect application. The CNB decides whether the permit is granted or not within 6 months from the day it received the application, unless there have been delays caused by an incomplete or imperfect form. This deadline became stipulated by law in accordance with the MiFID Directive.

[360] Cf. Article 16 par. 2 letter b) of the Banks Act.
[361] Cf. Article 16a par. 1 of the Banks Act.
[362] It is a provision connected with the principle of a single licence, i.e. the possibility to provide banking services in the member countries of the EU, without the need to acquire the licence in every single one of them.
[363] Cf. Article 16 par. 2 letter c) of the Banks Act.

In case an existing securities trader plans to make a change in their scope of business, there needs to be a new permit procedure, which is, to a certain extent, similar to the original procedure. The CNB must assess all the lawful requirements as when a new permit is about to be granted; though in this procedure the applicant only provides that information which is relevant for the change in question. Of course, the applicant may refer to the documents that have been submitted in the past three years, providing the relevant data have not changed.

The application seeking to gain a permit or a permit expansion (including all the relevant documents) is purely the responsibility of the applicant and the CNB is in no way obliged to look for documents that are necessary for the applicant to meet the legal requirements.

The administrative fee, payable before or along with the application, is CZK 100 000[364] for a permit, or CZK 10 000 for a permit extension. If the fee is not paid, the CNB informs the applicant and sets an extended deadline; if even this deadline is missed, the CNB terminates the administrative procedure.

It is interesting to note that along with a permit application (or even later), the applicant may apply for the registration of another business activity (i.e. other than investment services). Such a registration is for free and it is not decided in an administrative procedure[365]. If the conditions linked with this business activity are met (i.e. they do not prevent the offer of investment services and they do not prevent efficient supervision of the securities trader), the CNB registers the activity and issues a registration notification[366]. This registration certifies that the conditions stipulated by law have been met. Yet, such a registration can 'modify' itself into an administrative procedure, if the applicant fails to give evidence that the lawful conditions have been met—the CNB then initiates an administrative procedure with the applicant and cancels the registration application providing the applicant does not meet the criteria even during the administrative procedure.

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[364] Item 65/2 letter b) of the Tariff of administrative fees, amendment to Act no. 634/2004 Coll., on administrative fees, as amended.

[365] Registration in the administrative procedure does not follow part two of the administrative code, but it follows part four (Articles 154 to 158); more specifically it is a different act according to Article 158 of the administrative code.

[366] If the trader's activity which should be registered involves a direct link to their own property (Article 8a, par. 1 to 3 of the CMUA), the CNB dismisses the application unless there extraordinary circumstances (Article 6a, par. 6 of the CMUA).

4. Taking away licences and permits of financial market entities

Miroslav Singer, the CNB former governor, asserted[367] that by close of observation of liquidation rules the CNB helps to increase the transparency of the financial market for its participants, which is why I deem it apposite to include the matter of taking away licences and permits in this subchapter. I attempt to analyse what happens when a financial institution is being liquidated or when it is declared insolvent; in other words, when preventive measures and lawful requirements aiming to prevent the bankruptcy of financial institutions fail.

The licence to conduct business in the financial market is revoked in the following ways:

- revocation of a licence or a permit as a sanction.
- revocation of a licence or a permit at the request of a financial market entity.
- revocation of a licence or a permit resulting from the decision of a financial market entity to close down.
- revocation of a licence or a permit resulting from the decision of a financial market entity to terminate the activities for which the licence or the permit is needed.
- revocation of a licence or a permit after it has expired.

Once the licence or the permit has been revoked, the institution enters liquidation unless it enters a different type of market where the licence (permit) is not required; alternatively, an insolvency proceeding may also be initiated.

5. A company in liquidation

Generally, liquidation of a legal person is treated in Act no. 89/2012 Coll., the Civil Code (hereinafter also just 'the CC'), which states that the primary objective of liquidation is to settle and distribute the property of the legal person, to settle its debts to creditors and lawfully dispose of the property that remains after liquidation.[368] The ultimate objective of liquidation is the expungement of the institution from the Commercial Register. A legal person enters liquidation the day it is cancelled or declared invalid. Once the

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[367] SINGER, M. *Dohled nad finančním trhem*. Paper delivered at Den otevřených dveří of the CNB. Prague 12th June 2010. p. 40.

[368] Cf. Article 187 and the following of Act no. 89/2012 Coll., the Civil Code.

legal person has entered liquidation, the liquidator, without unnecessary delay, makes an entry about it in the public register.[369]

As far as the liquidation of a financial institution is concerned, the crucial thing is the appointment of a liquidator. There are only a few particularities in comparison with general legal norms. Natural or legal persons can become potential liquidators for all financial institutions apart from banks, where the liquidator must only be a natural person.[370] Such a provision is motivated by the unquestionable importance of banks and the extremely high level of responsibility that their liquidation entails—a natural person is liable for unprofessional conduct with all their property as collateral. What is important is the fact that the liquidator is appointed or removed by the court, which follows the proposal of the CNB—the court has 24 hours to announce its decision.[371] The CNB plays a prominent role in the process of liquidation since it is not only a supervisory authority—it actually also determines who will be appointed or removed as the liquidator (the court is the institution ultimately responsible for the decision but it always follows the proposal from the CNB). Furthermore, the CNB also determines the liquidator's remuneration, which is paid from the property of the liquidated institution. If the property does not cover the total remuneration, it is covered by the state. The liquidator is obliged to act with *due managerial care*[372], hence their liability for any damage; an exception is the liquidator of an investment company or an investment fund—they must act with *professional care*[373]. The liquidator's obligation to act with due managerial care can be inferred from Article 159, par. 1 of the Civil Code, which maintains that whoever 'accepts the office of a member of an elected body undertakes to discharge the office with the necessary loyalty as well as the necessary knowledge and care. A person who is unable to act with due managerial care although he must have become aware thereof upon accepting or in the discharge of the office and fails to draw conclusions for himself is presumed to act with negligence'.[374]

What is the difference between the two notions? Professional care is generally perceived to entail a higher level of expertise, higher requirements

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369 KURKA, R., PAŘÍKOVÁ, A. Subjekty finančního trhu, Vybrané aspekty likvidace a insolvence. 1st ed. Prague: C.H.Beck, 2014. p. 60.
370 Cf. Article 8 par. 9, the Banks Act.
371 Cf. e.g. Article 36 par. 1, the Banks Act.
372 It can be inferred from Article 159 par. 1, the CC.
373 Cf Article 348 Act no. 240/2013 Coll., on investment companies and investment funds, as amended.
374 KURKA, R., PAŘÍKOVÁ, A. Subjekty finančního trhu, Vybrané aspekty likvidace a insolvence. 1st ed. Prague: C.H.Beck, 2014. p. 62.

and, inevitably, a higher amount of liability for a breach of the *professional care* rule. If the rule is violated, it is a case of an administrative offence with all the administrative and legal consequences (administrative punishment) with the CNB acting as the administrative body. If the *due managerial care* rule is violated, the consequences are 'only' in the area of civil procedure—the given institution can only demand a loss compensation via a lawsuit. With the exception of the liquidator of investment companies and investment funds, the CNB does not currently have the power to sanction liquidators who fail to adhere to the rules.

As for the liquidators of financial institutions, the CNB chooses them from persons who are on a special list of trustees in bankruptcy; these persons have passed a specific exam for trustees and they are expected to possess a high level of expertise in this area. The same requirements that apply to the choice of trustees in bankruptcy also apply to the choice of liquidators, which seems wholly logical.

Once it is known who the liquidator is going to be, the CNB submits a proposal of their appointment to the relevant Commercial Court in charge of the Commercial Register. The court then officially appoints the liquidator and the appointment comes into effect the moment it is disclosed either on the official noticeboard of the court or on its electronic noticeboard. When this happens, the liquidator acquires the competence of a statutory body and one of their main duties is to announce in the Official Business Journal that the institution has entered liquidation. The announcement also contains an appeal to potential creditors of the institution to submit their claims. The deadline for the creditors cannot be shorter than three months.[375] A problem may arise if there are more creditors than previously expected and the financial situation of the institution reveals that there is, in fact, no other option but to initiate an insolvency proceeding of the financial institution. In my opinion, it is reasonable not to conclude the process of finding out creditors too soon, and the insolvency proceeding submission should also be considered carefully. The reason is that liquidation is closely supervised by the CNB (the CNB can even remove the liquidator, i.e. it submits such a proposal and nominate another liquidator). In contrast, an insolvency proceeding is not supervised to the same extent because the CNB can only demand information from the trustee in bankruptcy; this, however, is not even enforceable. I am convinced that liquidation is fairer, more carefully controlled and more transparent because of the CNB's intervention and because of the requirements placed on liquidators.

[375] Cf. Article 198 of the Civil Code.

6. *Insolvency proceeding of financial institutions*

There are several substantial differences that apply to financial institutions in insolvency proceedings compared to other entities. Financial institutions are not even subject to the same legislation; or rather, the type of insolvency proceeding is determined by the fact whether it concerns a credit institution or not. It is worth highlighting that unlike in a typical list of financial institutions, Act no. 182/2006 Coll., the Insolvency Act, as amended, states that a financial institution is a bank, a savings or credit banks, an insurance company or a reinsurance company.[376] The bankruptcy of financial institutions is dealt with in the Insolvency Act (Article 2, section IV), which explicates the differences in comparison with a 'regular bankruptcy'. While there are, admittedly, certain differences between banks and (re)insurance companies, these seem to be rather minute and I thus treat the insolvency of all financial institutions as one group here.

A big difference from the usual insolvency proceeding under the Insolvency Act, is the fact that for financial institutions the trustee in bankruptcy may only be a trustee with a special permit.[377]

What has been mentioned so far clearly suggests that there are, as a matter of fact, two schemes of bankruptcy. On the one hand, there are financial (credit) institutions, on the other hand, there are other institutions such as securities traders, investment companies, investment funds, pension companies and pension funds. If these non-credit institutions go bankrupt, they are dealt with in the 'regular bankruptcy' scheme. It is not even necessary that their licence or permit be revoked; unlike with financial institutions where licence revocation is a prerequisite for the application of the Insolvency Act.

What is then the main difference between the two schemes? Apart from the above-mentioned necessity to revoke the licence before an insolvency proceeding may begin, it is also people who can submit the insolvency proposal—for financial institutions, the proposal may be submitted by, except for creditors and debtors, the CNB as well. Another unique option is a solution via liquidation. Yet another important option is the announcement of the crucial parts of the insolvency decision in the Official Journal of the European Union as well as the fact that the claims of creditors resulting from the accounting of the debtor are registered

[376] KURKA, R., PAŘÍKOVÁ, A. Subjekty finančního trhu, Vybrané aspekty likvidace a insolvence. 1st ed. Prague: C.H.Beck, 2014. p. 150. See also Article 2 letter k) of the IA.
[377] Cf. Article 3 par. 2 of Act no. 312/2006 Coll., on trustees in bankruptcy, as amended.

automatically, of which the creditor is informed by the trustee in bankruptcy within 60 days of the company going into liquidation.

These exceptions are quite logical and straightforward. As the CNB supervises these institutions and it has a large amount of highly relevant information about them, it is desirable that it should have the right to lodge an insolvency proposal. It is also wholly logical to include automatically all the creditors present in the accounting because the insolvency of a financial institution is always of such a scope and magnitude that one cannot expect all the creditors to be informed of the insolvency and to submit their claims; this is especially true of foreign creditors. This would also undoubtedly result in an immense administrative overload for the trustee in bankruptcy and the insolvency court—it would be neigh impossible to process such a vast number of documents. Naturally, problems may arise if the accounting is badly kept or even missing—this means a considerable load for the trustee in bankruptcy that must do their best to obtain the relevant information. If the information is still unavailable, there is no other option but to include those creditors that have been found out—either from the accounting or by means of applications submitted after the announcement in the Official Journal of the European Union.

I have suggested above that liquidation is more favourable for creditors than bankruptcy. What happens, though, if, theoretically speaking, these two clash? The CNB may revoke a licence or a permit and suggest a liquidation entry while submitting a proposal to the relevant Commercial Court with a proposal as to who the liquidator should be. The court has 24 hours to decide and in this interval a debtor or a creditor may submit an insolvency proceeding proposal. The insolvency proceeding commences the day the proposal physically appears at the court.[378] The insolvency proceeding is thus opened and, a few hours later, the court opens liquidation and appoints a liquidator. Thus, the two clash and the institution is both insolvent and in liquidation. Insolvency is, of course, stronger and the court must deal with the insolvency proposal and possibly declare a bankruptcy. If the court dismisses bankruptcy, the insolvency proceeding is cancelled and liquidation may go on. However, if the insolvency proposal is justified, then the institution is declared insolvent and liquidation is put on the back burner—the role of the liquidator is purely formal. I believe that liquidation is beneficial for all the parties involved. One of the reasons why I think so is the fact that if the decision is based on a proposal made by such an institution as the CNB, then there should be no problem with loss compensation. One may assume that if the CNB proposes liquidation, it

[378] Cf. Article 97 par. 1 of the IA.

knows very well why, and it is then up to the liquidator and his integrity to submit an insolvency proposal if need be. Of course, there is still the court that assesses whether all the requirements for declaring bankruptcy have been met; if the court decides so and the requirements have actually *not* been fulfilled (i.e. it would have been possible to deal with the situation by means of liquidation), then the state must compensate the loss.

7. Termination of financial market institutions--assessment

The CNB performs the role of an administrative body as far as investment and banking services are concerned; a bank that also wants to offer investment services according to the Capital Market Undertakings Act, can thus submit only one application and the CNB only makes one decision—if it is a positive one, it enables the bank to offer the services. Banks present in the Czech banking market take part in other financial services by means of creating financial groups that might include, for example, an insurance company, a pension fund, an investment company, an investment fund, a financial leasing company, a factoring company, etc.; the CNB carries out supervision over the whole group. The dangers that a bank faces may be caused by its presence in the financial group. That is why some rules of prudential business (especially the capital adequacy, the commitment, and the inner control system) are applied to the group as a whole.

It may be concluded that it is a correct decision to entrust a single body with administrative procedures permitting an activity or granting a licence as well as subsequent supervision of financial institutions owing to the fact that financial services are globalised to such an extent that many financial institutions are active in a number of financial areas. If supervision were carried out separately (including the granting of licences and permits), it would take more time and there would be a greater danger of imperfections because the administrative bodies would have to share information and the decision-making process would be more complicated and time-consuming. This is hardly acceptable these days.

As regards the termination of business activities, it is clear that the current legislation (based on EU law) considers liquidation and insolvency of financial institutions a serious issue; it is, after all, to everyone's benefit to make sure that these proceedings affect the stability of the economic system as little as possible. Except for the specific issues of liquidation and insolvency, there are also 'buffers' such as the Deposit Insurance Fund and the Financial Market Guarantee System, which provide a certain form of

guarantee that deposits or other entrusted finance will be paid out should financial institutions be declared insolvent.

In case there is a potential clash between liquidation and insolvency, I am convinced that liquidation should be given preference (the reasons are outlined above); all the more so because, occasionally, insolvency proposals are submitted without a proper reason. I also believe that the liquidator, carefully chosen by the CNB, provides a sufficient guarantee of an objective assessment of the debtor's financial situation—the insolvency proposal will be filed if the conditions stipulated by law are met.

I can certainly confirm the hypothesis set at the beginning of this subchapter, namely that the right and consistent method of terminating the activities of financial institutions supports the general objective of regulation and supervision: the maintenance of financial market stability. It is evident that without clear rules and their consistent application the financial market can barely be kept transparent. If there were any doubt surrounding the end of a financial institution (whether it be an enforced or a voluntary decision) by means of liquidation or insolvency, financial institutions would be left in relative uncertainty as to how to conduct business in the financial market. Without realising and accepting the negative consequences of improper conduct of business activities (e.g. taking excessive risk without sufficient safety measures), financial institutions might find it difficult to avoid such conduct that could result in terminating their business.

Attitude of the CNB towards the European system of supervision

In the process of integration supervision and its future shaping, the CNB is, like the supervisory authorities from other countries, rather active in helping to shape international processes that stabilise the financial market and make it more transparent. The CNB is known to be among the more conservative ones regarding the European single supervision system, and it has published its viewpoints as reactions to individual steps that the EU proposed with a view to integrating supervision. The majority of the views mentioned below are connected with the establishment of the Banking Union, so it is not surprising that some of them have been revised as more information and more experience became available. Generally speaking, the CNB is not an advocate of a quick entry into the Eurozone or the Banking Union, largely because of the fact that the main supervisory authority will be centralised under the ECB.

As far as the coordination of functions via ESA authorities is concerned, the CNB accepts and then approves their recommendations, it also agrees with sharing the information, but it rejects extensive data collection. The CNB supports the attempts to increase financial market transparency, to harmonise rules and to reduce discretion in the EU, and it calls for more detailed impact analyses that should justify the proposed changes, measures or even completely new regulatory frameworks. On the other hand, the CNB does not support the transfer of authority to the European level, nor does it want interventions in the fiscal sovereignty of the member countries. However, the main point of criticism of the new system of European supervision is the gradual transfer of authority from the national supervisory authorities to the level of the EU, with the EU authorities having little responsibility for the approved course of action. Such a system could easily lead to the Czech Republic not being able to control properly its own financial market.[379]

I think that this fear of not being able to control one's own financial market is rather unfounded—I actually believe that there is no longer such a thing as a fully independent national financial market anyway. Financial markets are more European than national in their character, in spite of some national particularities. I cannot see a more efficient way than to centralise and harmonise regulation and supervision (especially as regards macro-prudential rules) with the national supervisory authorities maintaining their positions at the micro-prudential level, i.e. when controlling individual financial institutions.

The CNB does agree with both the implementation of the common equity Tier 1 capital and the core Tier 1 capital as well as with strengthening the regulatory capital and its quality with the aim of simplifying the structure of capital and of increasing the importance of Tier 1 capital. Further, the CNB supports the plans to strengthen the liquidity risk and to implement new liquidity standards with liquidity being supervised at the national level. The CNB does not refuse the leverage ratio to supplement risk-based minimum capital requirement; yet, the CNB would like to see it as one of the tools for the supervisory review within Pillar II.[380]

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379 TOMŠÍK, V., ČNB. Regulace a dohled nad finančním trhem v EU – aktuální otázky. [online] 2010 [qtd. 15th July 2017] Available at: <http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/verejnost/pro_media/konference_projevy/vystoupeni_projevy/download/tomsik_20101122_komora_auditoru.pdf.>

380 TOMŠÍK, V., ČNB. Regulace a dohled nad finančním trhem v EU – aktuální otázky. [online] 2010 [qtd. 15.7.2017] Available at: <http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/verejnost/pro_media/konf

The CNB, of course, fully cooperates with the central banks of other member countries as well as with other supervisory authorities; moreover, it is part of the European system of financial market supervision and it closely collaborates with the ESBR and ESA authorities.

What is also interesting is the negative attitude of the CNB towards risk management in the financial sector, where it opposes the integration of risk management at the level of the EU, the establishment of compulsory risk management funds and the European stability fund, and, finally, the harmonisation of insolvency rules. One may think that this attitude is justified insofar as it could lead to a potentially more hazardous behaviour; i.e. such funds could make financial institutions believe that possible financial loss in the future is, in a way, pre-paid. While this is a valid argument, I do not believe that the management of a financial institution should feel encouraged by the existence of resolution funds to behave more irresponsibly—future loss may be pre-paid but at what cost? The cost could be a change of personnel in the statutory bodies, enforced receivership, or far more thorough supervision. Last but not least, there could be substantial damage to the reputation of the institution. In my view, the resolution funds are, without doubt, beneficial and there is not much danger of their being misused; they serve the role of a safety net for the periods of economic crisis. In Pillar III of the Banking Union the CNB supported the harmonisation of disbursed sums and insured persons, but, as it has been mentioned before, it protested against the reduction of the period for compensation payments to just 7 days—this is, indeed, an absurdly short period, which in most cases cannot really be observed. The CNB also disliked the option to use money from the fund for early intervention, crisis resolution or the calculation of fund contributions from credit institutions on the basis of risk susceptibility, where, according to the CNB, member countries should be given the freedom to determine the reputational risk.

1. Attitude towards European integration and the Banking Union

The Czech Republic is not part of the Banking Union and it does not seem likely that it will become a member country of the Union in the foreseeable future. Naturally, the Czech Republic, as an EU member country, does implement all the norms of Pillar II and III of the Banking Union, but it is not a fully-fledged part of the Banking Union as it does not participate in

erence_projevy/vystoupeni_projevy/download/tomsik_20101122_komora_auditoru.pdf>. p. 16.

the Supervisory Board in Pillar I or the Single Resolution Board in Pillar II. The moment the Czech Republic joins the Eurozone, it will automatically become part of the Banking Union as well; however, it is possible to join the Single Supervisory Mechanism even before joining the Eurozone. Since 2015 the Czech Republic has been issuing annual reports on its readiness and willingness to join the Banking Union before its admission into the Eurozone, but this option has not been taken yet. This is, nonetheless, no exception as no country outside the Eurozone has done it yet.

Because of some unique mechanisms in the Eurozone, those countries that are outside it do not have the same conditions in the Banking Union as the other ones, which have already accepted the euro. With the aim of disrupting the internal market as little as possible, the system was set in such a way as to enable even countries outside the Eurozone to join it on comparable conditions. Still, the position of these countries does not seem to be equal, especially because of the fact they are not represented in the Governing Council of the ECB. This may play an important role for the Czech Republic and its representatives, who insist on observing equal opportunities principles in the internal market.[381]

I dare say that as far as Pillar II of the Banking Union is concerned (i.e. the Single Resolution Mechanism), the CNB approves of the BRRD as the guiding document in crisis resolution—the experience in this area has been largely positive, e.g. in Portugal, where this mechanism along with the SRM and some public money helped to save Banco Espirito Santo. The CR as yet does not participate in international crisis resolution, nor does it make any contributions to the Single Resolution Fund. Thus, the CNB has the advantage of being essentially the only decisive body in the crisis resolution of credit institutions in the Czech Republic. There is the other side of the coin, needless to say: if a decision needs to be made regarding a financial institution with a subsidiary active in the Czech Republic, the CNB cannot influence the decision at all and its supervisory power is therefore extremely limited.

The CNB has already established the Resolution Department, which represents the third sector of the CNB authority (along with monetary stability and financial market supervision). Essentially, it is an administrative body with the authority of first-instance decisions, while second-instance decisions are in the hands of the Bank Board of the CNB.

[381] The Ministry of Finance of the Czech Republic. Studie dopadu účasti či neúčastí České republiky v bankovní unii – shrnutí. 9th February 2015. p. 2.

The Resolution Department makes resolution-related decisions in administrative proceedings against financial market entities and issues general provisions. Its other functions include carrying out activities relating to the resolution of crises in relevant financial market entities separately from the performance of supervision by other CNB bodies, the preparation and a regular update of resolution plans on a solo or a group basis, and cooperation with European resolution and supervisory authorities. Last but not least, this department also decides on the use of appropriate resolution instruments and procedures. In case the Czech Republic joins the Banking Union, the majority of essential resolution powers will be passed to the central body, namely the Single Resolution Board.

This department also takes charge of the national resolution fund, called in the Czech Republic the Resolution Fund. The fund was established on 1st January 2016 (Act no. 374/2015, Coll., Act on Recovery and Resolution in the Financial Market, which transposed the BRRD directive) and it receives contributions from credit institutions. The amount to be paid into the Resolution Fund is determined by the institution's size and the risk profile[382]. The calculation, prescription and exaction of these contributions is within the competence of the CNB.[383]

The finance in the Resolution Fund is managed by the Financial Market Guarantee System and it can be used to finance resolution of financial institutions (e.g. to top up their capital, to purchase their assets or to provide a loan). It can also be used to pay compensation according to the "no-creditor-worse-off" principle if the results of the application of resolution tools lead to the institution's owner (or creditor) being entitled to lower payment compared to liquidation or insolvency. As the funds are public, their use is subject to prior approval by the European Commission under the public support rules.[384]

The Ministry of Finance has assessed a number of international studies and it seems that there is no incentive for the Czech Republic to enter the SSM now; it appears advisable to wait until more information and data is available, then assess the new data again and decide what should happen

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382 This is specified in Commission Delegated Regulation (EU) 2015/63 of October 21st 2014 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to *ex ante* contributions to resolution financing arrangements.

383 In 2016 the total sum gathered was CZK 3 024 946 568, in 2017 CZK 2 958 854 930. and in 2020 it is CZK 3 763 175 596 Kč. Source: www.cnb.cz.

384 Czech National Bank. Stanovení příspěvku do mechanismu pro financování krize [online]. 2017 [qtd. 30th October 2017]. Available at: <https://www.cnb.cz/cs/reseni_krize_FT/reseni_krize_FT_stanoveni_prispevku/>

next. According to a number of pre-selected criteria, the Czech banking sector is more stable than the banking sectors in many EU countries; hence the recommendation to stay out of the Banking Union and avoid sharing the burden of financing resolution plans in other countries.[385]

There are three main reasons why this hesitant policy has been favoured: firstly, it is the loss of supervisory authority over big credit institutions; secondly, one may fear the danger of financial problems abroad affecting Czech subsidiaries of big financial groups with the CNB having no effective measures to adopt its own solution; thirdly, the Czech Republic seems reluctant to participate in financing supervision at the level of the ECB.

Joining the Banking Union involves centralisation of supervision especially over important credit institutions in the EU and a major administrative shift—if the Czech Republic does join the Banking Union eventually, a large amount of administration will be transferred under the ECB, and the CNB will only carry out the remaining duties in close cooperation with the ECB. This change of supervisory authority would concern primarily large and influential credit institutions. The supervision over medium-sized and small-sized institutions would remain in the hands of the CNB, which would, however, have to follow the instructions and directives of the ECB in order to maintain the integrated approach to supervision in the Czech Republic, and with special attention paid to potential danger in the periods of instability. If the Czech Republic joined the Banking Union before becoming part of the Eurozone, the ECB would carry out supervision via the CNB because the ECB does not have direct power over institutions outside the Eurozone. This means, among other things, that every country outside the Eurozone must take such adequate legislative steps to ensure that its national supervisory authority acts in accordance with the directives of the ECB.

From the political point of view, joining the Banking Union would be of a considerable benefit for the Czech Republic as it would officially declare and support Czech participation in the process of integration, from which follows a better chance to enforce one's own (i.e. national) interests at the level of the EU. Furthermore, it would also increase the competitiveness of Czech credit institutions in the European financial market and, possibly, there could be a positive impact on the stability of the Czech financial market. As far as the countries outside the Eurozone are concerned, the SSM has been joined by Bulgaria and Romania, whilst

[385] The Ministry of Finance of the Czech Republic. Studie dopadu účasti či neúčastí České republiky v bankovní unii – shrnutí. 9th February 2015, pp. 3–4.

Denmark has been talking about its intention to join in for a long time as well (perhaps even more so after Brexit).

Taking into consideration the above-mentioned points, the Ministry of Finance stated in 2015 that the current conditions prevent joining the Banking Union from being beneficial. Some features of the Banking Union had not been completed and only the following months and years would reveal whether the single supervisory mechanism really worked as expected and hoped. Another important aspect was the political side of the problem, including the attitudes of the EU countries outside the Eurozone[386]. The pros and cons were assessed again in May 2016. A rather large report stated that, compared with 2015, 2016 had not brought any significant improvement in the areas that had been followed and analysed. The study repeated the points that had been made in the 2015 study: the Banking Union with its conditions did not make the entry worth it, it was necessary to keep monitoring the Union and a new assessment would be made at the end of 2017.[387]

Conclusion

Some people claim that the Banking Union does not solve the real problem and only partially eliminates the danger of moral hazard. Indeed, it may seem that stable and profitable banks will cover the losses of less successful banks. The Czech banking structure, albeit governed by foreign capital, is in the long run one of the most stable and profitable banking structures in Europe.[388]

Despite all the doubts and negatives, the Banking Union seems an inevitable destination for the Czech Republic, and one that is overwhelmingly positive. I believe that political interests outweigh the economic ones and greater financial costs linked with the membership will be more than matched by the equal position in international partnerships not only in the area of financial markets, but in all areas of the EU. Czech

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[386] The Ministry of Finance of the Czech Republic. Studie dopadu účasti či neúčastí České republiky v bankovní unii – shrnutí. 9th February 2015, p. 12.

[387] The Ministry of Finance of the Czech Republic. Aktualizace studie dopadu účasti či neúčasti české republiky v bankovní unii. 30th May 2016, p. 29.

[388] KOVANDA, L. Vstup do bankovní unie není pro Česko výhodný, varuje ministerstvo financí. *E15* [online]. 2015 [qtd. 20th July 2017]. Available at: < http://zpravy.e15.cz/byznys/finance-a-bankovnictvi/vstup-do-bankovni-unie-neni-pro-cesko-vyhodny-varuje-ministerstvo-financi-1160077>

credit institutions are, in the vast majority, subsidiaries of big international financial groups, therefore the influence of the Banking Union is now profound anyway—we could even say that it is more important than the influence of the national supervisory authority, which may be of great importance as well, but globally it is rather relative.

Admittedly, the Czech financial market is stable and the profit from joining the Banking Union would not be as great as it would be for countries where the situation is far less stable. The current situation of stability would probably not improve through the funds available in the Banking Union; on the contrary, it seems likely that Czech credit institutions would be asked to provide financial help to less stable institutions abroad. From this point of view, it appears logical to adopt a hesitant stance. What will happen if the financial market in the Czech Republic gets hit by a crisis, though? In case there is such a crisis, are we going to ask for immediate admission to the Banking Union so that we can apply for resolution funding to save our own credit institutions? Problems may arise even if the Czech financial market remains stable and in good shape, though. Given the fact that the international financial market is so interconnected, what is the point having a stable financial market in the Czech Republic if the rest of the EU is in a state of deep crisis? It would not help at all even if all the credit institutions active in the Czech Republic had Czech owners and even if they were not linked (through their capital or owners) with foreign institutions because national financial markets do not operate in a vacuum and they are heavily dependent on the international market. There is little chance that there can ever be a stable financial market in a particular country surrounded by international instability. Joining the Banking Union at the time of financial stability may be relatively disadvantageous, expensive, administratively demanding and linked with all sorts of fears regarding the transfer of authority to a federal level, but the key word is always *prevention*. Possible losses in tougher times are far worse, more difficult to deal with and more permanent than the disadvantages which go hand in hand with admission to the Banking Union. Naturally, once the Czech Republic is part of the Banking Union, it will have the chance to influence its agenda and help to identify its priorities.

I recommend joining both the Banking Union and the Eurozone—the crucial question seems to be when. It should not be later than 3-5 years from now particularly because of political reasons: it seems apposite to confirm the Czech government's pro-European stance by showing genuine willingness to cooperate in European issues, thereby becoming yet firmer part of European integration.

POTENTIAL FAILURE OF FINANCIAL MARKET ENTITIES

This chapter is present mainly owing to the fact that I would like to carry out not only an analysis of what regulation and supervision aims to achieve, but also of some negative phenomena that regulation and supervision aims to eliminate. There are naturally other types of failure that might happen to a financial market entity, but the ones I chose for this book are, in my view, immensely interesting even for readers who are not familiar with financial markets at all. Every entity doing business in the financial market assumes a certain amount of responsibility—general legal responsibility or specific financial-law responsibility. This chapter deals with two negative phenomena connected with financial markets: market abuse. The former is defined in a more general framework of financial law—law abuse.

Responsibility in financial law

Legal responsibility is defined in the general theory of law as the application of unfavourable legal consequences stipulated by a legal norm against anyone who violates a legal obligation.[389]

In private law responsibility is delineated as unfavourable legal consequences, stipulated by a legal norm, that arise on legally defined conditions as a result of illegal action or an illegal state.[390]

These definitions make it clear that legal responsibility is a new legal relation that comes into existence whenever a legal obligation is violated. Apart from the fact that it is new, it is also a sanction for the entity involved. Responsibility is not only about negative consequences but also about possible enforcement of it (e.g. by the state), because responsibility without the possibility of enforcement is undoubtedly rather toothless. Responsibility is also preventive since it determines, to a large extent, acceptable behaviour (i.e. behaviour within legal norms) for an unspecified group of people. Responsibility is not just a legal term, though; it is present in a wide range of various social relations of various entities and, therefore, we might approach the notion of responsibility also from a sociological

[389] HARVÁNEK, J. a kol. *Právní teorie*. Brno: Masarykova univerzita, 2000, p. 234.
[390] FIALA, J. a kol. *Občanské právo hmotné*. 3rd ed. Brno: Masarykova univerzita, 2002, p. 346.

and/or political perspective. The latter is very important in the fiscal part of financial law as the systems of tax and social burden are always crucial topics for every political party; they are, after all, topics that are of some importance to all of us. There are two types of responsibility: primary (legal responsibility here coincides with primary obligation) and secondary (this responsibility appears once a legally binding primary obligation is unfulfilled). Because of the legal character of responsibility that we discuss here, primary responsibility is of relatively little interest (it is less legal than moral, actually); secondary responsibility, on the other hand, is very relevant. It constitutes a new relation—a commitment as a result of an unfulfilled primary obligation. Legal responsibility performs several functions: prevention, protection, sanction, repressive satisfaction, reparation, and education. Every legal order consists of several branches and responsibility is divided systemically according to these branches. Individual branch responsibilities form a whole as demonstrated e.g. by linking the responsibility in case of a theft when there is some material damage. The damage would be very difficult to prove and, therefore, the person in question is referred to a civil lawsuit. As far as financial and legal responsibility is concerned, some financial-law offences are, if they demonstrate a certain level of gravity, considered criminal offences within the framework of criminal law—then, for example, tax evasion is not dealt with in a tax proceeding where the sanction is a fine.

Financial and legal responsibility is defined for individual branches of the system of financial law both in the fiscal and the non-fiscal part. The former deals with responsibility at the level of tax regulations, the latter involves insurance (insurance fraud), banking, currency, and foreign exchange law. All these responsibilities shade into one another in financial law, administrative law and criminal law—the last is needed in case of gross misconduct violating obligations stipulated in financial-law regulations.

Since the whole book is concerned with financial markets (which, as was demonstrated above, belong to the non-fiscal part of public financial law), then responsibility in this part of financial law is, above all, of public-law character, with only some overlap with private law—it is linked with financial-law, civil, administrative and criminal regulations.

Market abuse as law abuse

This subchapter attempts to answer the question whether market abuse can be viewed as law abuse. Is law abuse the right label in cases of market abuse;

in other words, does market abuse entail law abuse as defined by the theory of law and judicial practice? Before I can classify the specific part of financial law dealing with market abuse under a more general term 'law abuse', I need to clarify first what the two expressions (law abuse and market abuse) refer to.

1. *Law abuse*

Law abuse is a rather general legal term related to both private and public law. In the realm of private law it is defined by legal theory and case law.

Relevant judicial decisions of the Supreme Court of the Czech Republic suggest[391] that law abuse can be defined as behaviour that is admittedly in compliance with law but in reality it is only seemingly so: the purpose is not to observe law but to do harm to another person. Such behaviour is contrary to good manners and is a direct attempt to inflict harm on the other participant, while the legal norm and its purpose and objective remain secondary—the offender completely disregards them.

Law abuse refers to a situation in which someone exercises his own rights and causes unjustified harm to another person or the society; such behaviour is only seemingly lawful, for it brings about an unlawful result. We must call it 'seemingly lawful behaviour' because law does not recognise behaviour both lawful and unlawful at the same time. The lex specialis derogat legi generali doctrine maintains that prohibition against law abuse prevails over what is permitted by law—therefore, such behaviour cannot be interpreted in any other way but unlawful conduct. It holds that if a legal norm permits a certain type of action and another norm (if abused in the way shown above) prohibits it, then this action cannot be accepted as the exercise of a right, but it must be labelled as unlawful action.[392] Such exercise of a right, which is, as a matter of fact, an example of law abuse, cannot be condoned by the court.[393]

Judicial decisions of the Supreme Court of the Czech Republic[394] specified law abuse—it no longer refers to and includes the term 'good

[391] Cf. Judgement of the Supreme Court of the Czech Republic of 28th June 2000, case no. 21 Cdo 992/99 and Judgement of the Supreme Court of the Czech Republic of 22nd April 2003, case no. 21 Cdo 1893/2002.
[392] Cf. KNAPP, V. Teorie práva. C. H. Beck, Praha: 1995, pp. 184-185.
[393] Cf. Judgement of the Supreme Administrative Court of the Czech Republic of 10th November 2005, case no. 1 Afs 107/2004.
[394] Judgement of the Supreme Administrative Court of the Czech Republic of 10th November 2005, case no. 1 Afs 107/2004-48.

manners' as the necessary element of what constitutes law abuse. It goes without saying that good manners cannot work as a magic formula and that is what influenced another decision of the Supreme Court, which says that a corrective of good manners cannot be a detriment to the principle of legal security and it also cannot unfairly weaken participants' rights guaranteed by legal norms.[395]

It is clear that law abuse is not only part of private law but also of public law; the difference lies in the fact that the focus widens to include not only harm caused to another entity but also to the society.[396] This is particularly relevant to tax law—every taxable person tries to achieve a lower tax burden by means of tax optimisation. It is, of course, logical that everyone tries to save as much money as possible on taxes; it was also decided by the Court, though, that this cannot be the only goal of tax optimisation. In other words, tax optimisation is permitted but a taxable person must pursue other significant business goals.[397]

Together with the law abuse principle there are also two other principles that counterbalance it: namely, legal certainty and protection of legitimate expectations, both of which are enshrined in article 1, paragraph 1 of the Constitution of the Czech Republic. These principles may have a direct bearing on specific cases because each legal entity, while pursuing its cause, is entitled to a certain amount of legal certainty and legal expectations—typologically very similar activities of such legal entities should thus bring about very similar results; in other words, it is extremely important to

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[395] Cf. Judgement of the Supreme Court of the Czech Republic of 22nd August 2002, case no. 25 Cdo 1839/2000.

[396] Cf. Judgement of the Supreme Administrative Court of the Czech Republic of 23rd August 2006, case no. 2 Afs 178/2005-64, which says that law abuse is a situation in which someone exercises their own rights causing groundless harm to another person or the society.

[397] Ibid. There are two cumulative conditions that constitute law abuse:

a) relevant economic activity has no other objective explanation than gaining claim to the tax administrator [judgement Halifax (-Judgement of the Court (Grand Chamber) of 21st February 2006., C-255/02 - Reference for a preliminary ruling: VAT and Duties Tribunal, London - United Kingdom)-Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise], this condition is, contrary to the opinion of the general advocate, softened by claiming that the main objective of realised performance is gaining a tax advantage, cf. in particular section 86 of the Opinion) and

b) legal adjudication would go contrary to the sense and purpose of the relevant legal norms on the GDP. Economic activity satisfying both conditions a/ and b/, even if it were not illegal, would not merit any protection based on the principle of legal predictability and certainty, because the only likely purpose is to undermine the objectives of the legal system as such.

standardise interpretation of the term 'law abuse' for legal frameworks and entities active in them. For example in tax law, a given entity has the right to know what its taxation is going to be—it must exercise its right to rely fully on the legal norms regulating this area. From the description follows that law abuse has some general notions but in every specific case there must be a deep legal analysis in which are weighed up individual legal principles and tenets; to put it another way, one must as objectively as possible assess whether a particular activity constitutes an example of law abuse or not.

2. *Market abuse*

Generally, market abuse is a forbidden and intolerable activity in the financial market. Such activities are banned as a way of ensuring a level playing field for all economic entities that enter the business. While it is certain that an absolute equality is imaginary, it is desirable to make every effort to get as close to this imaginary ideal as possible.

Market abuse legislation applies in particular to issuers of financial instruments, including new investment instruments regulated under MiFID II, i.e. emission allowances, commodity derivatives, investment instruments traded on over-the-counter markets and the use of benchmarks (reference rates / indicators).[398]

Market abuse is dealt with in two ways.

- The first way deals with the treatment of inside information about people whom the information concerns (issuers). This way is, as a matter of fact, preventive in its character.
- The second way deals with actual market abuse by someone who has or could have access to inside information.[399]

Today, market abuse is regulated by MAR – Market Abuse Regulation,[400] which has modified the legal framework in particular by repealing the

[398] HUSTÁK, Z. Nové nařízení o zneužívání trhu – záplava povinností v parném létě. In: Epravo.cz [online]. Published June 20th 2016. Available from https://www.epravo.cz/top/clanky/nove-narizeni-o-zneuzivani-trhu-zaplava-povinnosti-v-parnem-lete-101826.html.

[399] According to Art. 7 of MAR: Inside information is information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.

MAD.[401] A directive on market abuse[402] was published and approved together with MAR—it harmonises criminal law in connection with market abuse (hereinafter also as the Market Abuse Directive). This legislation including implementing measures has been in effect since 3rd July 2016.[403] In the Czech legal regulation, we find the appropriate legal regulation in the Capital Market Undertakings Act, Part IX, Title IV.

There are generally three conditions that constitute market abuse. We can talk about market abuse if someone directly or indirectly inflicts damage on investors. It is someone who:

- used inside information (i.e. information that is not publicly available)—it is a case of insider dealing with insiders being people who have access to inside information
- manipulated the mechanisms of price setting of financial instruments
- spread incorrect or misleading information

Such behaviour can undoubtedly ruin the general level playing field principle for investors. It goes without saying that investors in possession of inside information have a much better starting position than the others, hence the need to use public instruments to redress the imbalance, even though a complete equilibrium remains purely theoretical.

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400 Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse and repealing Directive 2003/6 / EC of the European Parliament and of the Council and Commission Directives 2003/124 / EC, 2003/125 / EC and 2004 / 72 / EC.

401 Directive 2003/6 / EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (Market Abuse Directive).
Commission Directive 2004/72/EC of 29th April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions.
Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation.
Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest.

402 Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive).

403 Act No. 204/2017 Coll., which amended in particular Act No. 256/2004 Coll. on the Capital Market Undertakings Act with effect from 3.1.2018.

Market abuse can be divided into several areas:

- insider dealing – it is a situation when an insider[404] (a person in the know) has a piece of inside information that is not known to the public (e.g. before a big acquisition is made with which only the company management are familiar, and it is more than likely that such an acquisition will increase the price of the company's shares because it solidifies its financial position; a member of the management then uses the information to their own benefit and buys, for instance, a significant number of shares). This person uses such an information and gains a certain advantage by negotiating a transaction (purchase or sale) with a financial instrument on his / her own account or someone else's. This also applies to the situation where an insider has already issued an instruction for a market transaction and has changed or canceled the instruction as soon as he has learned the inside information. The special regulation of insider trading deals with the trading of persons with managerial authority (who are also supposed to be consecrated persons), which is discussed below.
- market manipulation – again, it is a situation when an insider spreads untrue or misleading information about, for example, the financial situation of a company while (s)he is in such a position that other people treat the information as completely reliable (it is, for instance, a member of the company's management); the insider can thus influence the share price of the company to their own benefit. These include the closing of transactions and related negotiations, the dissemination of false information through mass media, and the transmission of false or misleading information to benchmarks.[405] The MAR appendix lists indicators that suggest manipulative behaviour associated with false or misleading signals, pricing, use of

[404] According to art. 8 of MAR is an insider person possessing inside information is presumed as a member of the administrative, management or supervisory bodies of the issuer, or has a share of the issuer's capital, or has access to inside information in connection with the performance of a job or in connection with the performance of duties. It could also be a person involved in crime.

[405] A list of activities that are understood to be market manipulation is given in Article 12 MAR

fictitious means and other forms of misleading or misleading behaviour.[406]

- Illegal disclosure of inside information - This is a situation, where a person with inside information makes this information available to others if it is not a job or fulfilling the duties. This is regulated by Articles 10 and 14 c) MAR. It can also be a recommendation or guidance by an insider.

In all examples of market abuse people seek their own benefit. They use information that is true but unavailable to others or it is untrue information but from a person who could have access to it.

The fundamental point of the ban on information abuse is at least partial redress of the inequality of access to information; it should help an 'ordinary investor' to improve their position (i.e. their access to relevant information). It is not really possible to forbid employees as well as executives from companies that issue financial instruments to trade in financial instruments; nonetheless, since they could have (and often certainly do have) inside information, their business should be transparent by making it public.

Market abuse refers to an advantage gained because of better access to inside information. EU regulations and legal regulations in member countries attempt to redress this imbalance—there are rules for using, handling and treating inside or misleading information, which constitutes the first legislative way to tackle market abuse, as was stated above.

As far as the proper treatment of information about issuers of financial instruments is concerned,[407] they must, without delay,[408] disclose information about themselves.[409]

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[406] A detailed definition is set out in Commission Regulation (EU) 2016/522 of 17 December 2015 supplementing Regulation (EU) No 596/2014 of the European Parliament and of the Council as regards an exemption for certain public authorities and third country central banks, market manipulation indicators, disclosure thresholds, competent authority for notifying postponement of disclosure, authorization of trades during the closed period, and types of trades of regulated entities subject to reporting.

[407] A financial instrument is according to Article 124, par. 1 of the Capital Market Undertakings Act defined as an investment instrument admitted to trading on a regulated market of a Member State of the European Union or the admission of which to trading on a regulated market of a Member State of the European Union has been applied for.

[408] 'without delay' is according to the accepted interpretation by the courts seen as a sufficient period of time in which the issuer of a financial instrument is able to announce the inside information under the given circumstances and while remaining operational. Cf. the Constitutional Court decision of 15th August 2005, case no. IV. US 314/05 and the Judgement of the Supreme Administrative Court of 2nd April 2008, case no. 3 As 2/2008-152.

In addition to such information, the issuer prepares and regularly updates the list of insiders, which it provides to the relevant authority (in our case, the CNB). The reason for this obligation is quite clear and serves in particular to trace and investigate individual violations of MAR, as it contributes to the identification of persons with access to internal information and the time from which they have access to such information. Using this tool, issuers can also generally control the flow of internal information, and thus streamline internal processes such as communication.

Each person on the list confirms in writing his / her familiarity with the duties he / she has through access to inside information, including the acceptance of possible sanctions resulting from violations related to insider trading, or the unauthorized disclosure of inside information.[410]

The European Securities and Market Authority (ESMA) publishes implementing and recommending technical standards also in relation to the publication of insiders' lists in order to ensure that acts adopted by the European Commission are applied under the same conditions.[411]

Given that only some persons come into contact with inside information, the rationale for the existence of the obligation to publish lists of such persons is quite clear.

If an issuer shares inside information with a third party while performing the usual business related to the job, this information must be disclosed to the public. The requirement for immediate disclosure of inside information significantly reduces the risk of its abuse; there might, however, be a delay before the information available to someone is announced publicly—that is why there is a legal regulation for insiders regarding inside information.

The regulation says that each person in possession of inside information

- is forbidden on insider trading or attempting to do so
- is strictly forbidden to share the inside information with someone else unless it is part of the person's practice of profession.

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[409] Publication is mainly on the issuer's website. Then, certainly, the requirement of Article 17 (1) MAR will be a rapid approach to correct and timely assessment of information by the public.

[410] See Art. 18 par. 2 of MAR

[411] The format of the Insider List and its update was prepared by ESMA: ESMA / 2015/1455 Final Report on draft technical standards on Market Abuse Regulation. [on-line]. 2015. [cit. 3. 11. 2017] 330 pp. Available from <https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1455_-_final_report_mar_ts.pdf>.

- is forbidden to recommend the acquisition or disposal of financial instruments related to the information,
- is also forbidden to manipulate the market or attempting to do so.

These bans do not apply to trading own shares within buy-back schemes, nor do they apply to measures aimed to stabilise financial instruments.

Every member country is asked to nominate one regulatory and supervisory authority with a common minimum set of obligations. These authorities apply convergent methods to fight market abuse and they should be able to help one another with adoption of preventive measures, especially in cross-border cases. Subsequent administrative co-operation could represent a positive contribution to the fight against terrorism. These authorities are also supposed to co-operate with ESMA.[412]

It is important to mention here also sanctions that can be imposed for market abuse. The European Union attempts to enforce equal sanctions in all its member countries; therefore, in 2014 was adopted a market abuse directive.

By accepting MAR and market abuse directive, the EU laid down a common definition of *actus reus* of crime related to market abuse, e.g. insider dealing, market manipulation and illicit disclosure of information. A new set of criminal sanctions is being created: heavy fines and imprisonment for at least four years are possible sanctions for insider dealing or market manipulation while imprisonment for two years is the punishment for illicit disclosure of confidential information. Furthermore, legal persons are fully liable for market abuse. Member countries are also required to conduct the judicial proceedings for these crimes if the crime is committed inside their borders or if the offender is their citizen.[413]

3. *Market abuse as law abuse*

If someone buys a big number of shares of a particular company, it is completely within the rules and it is not illegal; if it turns out, however, that

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[412] Europa.eu. *Market abuse* [online]. Europa.eu. [qtd. 10th May 2017] Available at <http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_transactions_in_securities/l24035_en.htm>.

[413] První zprávy. *EU stanoví trestní sankce za zneužívání trhu, a může to bolet!* [online]. Prvnizpravy.cz [qtd. 22nd November 2017] Available at <http://www.prvnizpravy.cz/zpravy/byznys/eu-stanovi-trestni-sankce-za-zneuzivani-trhu-a-muze-to-bolet/>.

the person bought the shares having learned that the price of the shares would go up, then it is a case of inside (private) information abuse (since other investors do not have access to this piece of information) and it can be viewed as law abuse, too. It might, of course, be quite difficult to prove that the person did have the information at their disposal (they might have followed their instinct for good investment); hence the legal obligation to make insiders' transactions public (i.e. those people who are somehow related to a specific issuer of financial instruments).

Law abuse is generally not easy to prove (all the more so if it is in the form of market abuse), so every case is hugely specific and one cannot honestly say whether it is a case of law abuse unless there has been an in-depth examination of the case and of all the relevant circumstances.

Market abuse is characteristic by the use of special and private information to one's own benefit. Generally speaking, everyone can treat information in any way they like if the information was obtained legally; in a way, the person exercises their own right. However, if the nature of the information handicaps the others of the same rank (other investors in this case) and if the use of the information is legally restricted, we have a case of general law (the use of legally acquired information) against specific law (maintenance of a level playing field for all investors and a proper and fair operation of a financial market).

Law abuse refers to permissible behaviour with a prohibited/unintentional result to the detriment of another person or another company. At the same time, it is maintained that if one legal norm permits a certain type of behaviour while another norm forbids it, then the behaviour in accordance with the first norm is not an exercise of a right, but it is actually unlawful conduct. Market abuse, to my mind, could also be seen as permissible (disregarding, for the sake of the argument, the fact that it is prohibited by legal regulations); yet, a deeper analysis reveals that though it seems permissible, it brings about unlawful results to the detriment of other financial market participants—it is thus an unlawful operation. We can conclude that market abuse appears to correspond with the theoretical elements and the definition of law abuse; in other words, law abuse can be applied as a theoretical foundation introducing analyses of market abuse.

Director’s dealing – dealing of managing persons

The term directors dealing with so-called managerial deals are terms that the current European regulation does not use, but I believe that they still express what the MAR is referring to as a trading of the managing persons, and for this reason I will use these terms for the purposes of this chapter. This adjustment is based on Article 19 of the MAR and was implemented in 2017 do the Czech legal system, as well as in the law of other EU countries.

No one would surely like to trade in securities if the trading could be influenced from the inside. Equal treatment of capital market participants is, therefore, an inevitable condition for its successful operation. The legal regulation of directors dealing notification duty is a specific adjustment in the context of anti-market abuse measures, because in many cases, insider trading is just about the director's dealing. The difference is that insiders are those who have the inside information, whereas the directors/managers are only very likely to receive inside information. Director’s dealing without inside information is therefore not insider trading and is subject to certain obligations.

Legal regulation regarding director’s dealing primarily attempts to do away with unfair dealing in the capital market. This unfair activity consists in using (or rather misusing) inside information that is not available to all capital market participants. Director’s dealing refers to an obligation that applies to people with a specific relation to the issuer of securities, who must notify others of dealings related to the issuer and their securities, including details thereof. Information that people with managing power,[414] as amended are required to make public, supplement the notification and information duties that issuers have in general.

Regulation regarding director’s dealing is supposed to ensure availability of information about transactions with securities and their derivatives made by people related to a securities issuer. These people have access to inside information about the issuer that is not freely available. While they do not necessarily have to use the information they have got to get some benefit in the securities market, they do have an advantage that can potentially be used in investment dealings.

[414] In the Czech legislation, the group of persons with managerial authority is mentioned in § 2 par. b) Capital Market Undertakings Act

1. *Roots of regulation abroad*

The director's dealing regulation comes from the United States.[415] Managers or other employees of the issuer that also possess at least 10% of the issuer's shares are required to register their name and their position at the issuer with the Securities and Exchange Commission. In case they make any securities transaction, they must report it by the end of the second working day following the day of the transaction. They report the transaction to the Commission and the relevant stock market. The report includes, among other things, the type of transaction, the number of traded securities, the price at which the transaction was realised, and the number of securities that remain in the possession of the person who files the report. Both the report and its subsequent announcement are done electronically. Any profit made from the purchase or the sale of securities—if they have been in possession of the director, the officer or the major stockholder for less than six month—belongs to the company, regardless of the reason behind the transaction. There is one exception, though: if the transaction is made in *bona fide*, i.e. in good faith.[416]

In the EU law was director's dealing regulated within directive 2003/6/EC (cf. art. 6, par. 4), which has since been replaced by MAR (cf. art. 19) and the market abuse directive. Persons with managerial powers at an issuer and persons closely associated with them are supposed to notify the competent authority of transactions on their own account relating to the securities of that issuer. Individual states must announce this information and make it accessible as quickly and as easily as possible.

2. *Obliged persons*

Notification duty applies to the managing persons listed in § 2 par. 1 b) of Capital Market Undertakings Act:

- A managing person, defined in § 2 par. 1 a) as a member of the statutory body, statutory body itself, executive director of the company or other person actually directing the activities of the legal entity. When the statutory body or member of statutory body is a legal person, than managing person is the person, representing the legal person at statutory body.

[415] Section 16 (a) Securities Exchange Act. 1934 (SEA). This is followed by the Securities and Exchange Commission (SEC) Rule 16a-3. The Securities and Exchange Commission was created on the basis of the Securities Exchange Act. 1934.

[416] Goldstein, E. Corporations – Securities Exchange Act. 1934. In Michigan law review, vol. 51, No.1, 1952.

- supervisory body or member of the supervisory body;
- member of the statutory body, statutory body itself, executive director of the company or other person actually directing the activities of the legal entity. When the statutory body or member of statutory body is a legal person, than managing person is the person, representing the legal person at statutory body;
- a person who, within the issuer, makes a decision that may affect the issuer's future development and business strategy and who has the access to inside information

Before the CNB took over supervision of the capital market[417], this area had been under control of the Czech Securities Commission (hereinafter the CSC), which was heavily involved in these activities at that time. The classification of persons who have the notification duty (according to art. 125, par. 5 of the Capital Market Undertakings Act) was dealt with by the CSC in its statement no. 12/2005. The statement followed Article 6, Section 4 of the 2003/6/EC directive[418], which maintains that the notification duty applies to persons discharging managerial responsibilities within an issuer of financial instruments and persons closely associated with them.

Persons discharging managerial powers are specified in MAR (Art. 3 par. 1, pt. 25):

- a member of the administrative, management or supervisory bodies of the issuer;
- a senior executive who is not a member of the bodies referred to in previous point, who has regular access to inside information relating directly or indirectly to the issuer and power to take managerial decisions affecting the future developments and business prospects of this issuer.

Persons discharging managerial powers have also notification duty for their closely associated persons. According to MAR (Art. 3 (1), pt. 26) are persons closely associated with persons discharging managerial powers:

- the spouse of the person discharging managerial responsibilities, or any partner of that person considered by national law as equivalent to the spouse;

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[417] The CNB took over the agenda of the Securities Commission on the 1st April 2006.

[418] The Securities Commission followed the European legislation in view of Article 1 of the Capital Market Undertakings Act, which says that law regulates capital markets in harmony with Union norms.

- dependent child in accordance with national law;[419]
- other relatives of the person discharging managerial responsibilities, who have shared the same household for at least one year on the date of the transaction concerned;
- a legal person, trust or partnership the managerial responsibilities of which are discharged by a person discharging managerial responsibilities. It could be also the case, when these entities are set up for the benefit of such a person, or whose economic interests are substantially equivalent to those of such persons. The provisions also apply to persons referred to previous points

3. *Which transactions must be made public and how?*

Obliged persons according to art. 19 of MAR shall notify to the issuer or the emission allowance market participant, and to the competent authority at the same time, every transaction conducted on their own account relating to the issuer's shares or debt instruments or derivatives or other financial instruments linked thereto; It is also an obligation to notify the suspension or lending of investment instruments.

Previous mentioned shall apply to any subsequent transaction once a total amount of EUR 5 000 has been reached within a calendar year.[420] This amount includes all the trades of a person with managerial powers, including trades of closely associated persons. Such notifications shall be made promptly and no later than three business days after the date of the transaction. This obligation is also extended to the suspension or lending of financial instruments by a person with a managerial powers or by a closely associated person.[421]

[419] The term 'dependent children' should be interpreted according to Article 20, par. 4 of Act no. 155/1995 Coll. on pension insurance, as amended. The dependent child is defined here until the end of compulsory education and after, not exceeding 26 years of age, if the person is continually preparing for their future profession, or cannot prepare for their future profession or cannot perform employment activities due to a disease or an injury, or due to an unfavourable long-term state of health.

[420] A competent authority may decide to increase the threshold set out in paragraph 8 to EUR 20 000 and shall inform ESMA of its decision and the justification for its decision, with specific reference to market conditions, to adopt the higher threshold prior to its application.

[421] The Trade Notice should contain the elements set out in Article 19 (6) MAR.

If an issuer trades on multiple markets, the competent authority is the place of the issuer's registration. The way in which director's dealing is to be reported is again based on the MAR.

The issuer or emission allowance market participant shall ensure that the information that is notified is made public in a manner which enables fast access to this information on a non-discriminatory basis in accordance with the implementing ESMA technical standards. The issuer or emission allowance market participant shall use such media as may reasonably be relied upon for the effective dissemination of information to the public throughout the Union.[422] Alternatively, national law may provide that a competent authority may itself make public the information.

Issuers and emission allowance market participants shall notify the person discharging managerial responsibilities of their obligations in writing. Persons discharging managerial responsibilities shall notify the persons closely associated with them of their obligations under this Article in writing and shall keep a copy of this notification.

This provision is a bit skewed in my opinion, but on the other hand, the transfer of the obligation to a particular person is certain administrative relief for both the competent authority and the issuer himself, who already keeps lists of insiders.

Besides above mentioned MAR states, that a person discharging managerial responsibilities within an issuer shall not conduct any transactions during a closed period of 30 calendar days before the announcement of an interim financial report or a year-end report which the issuer is obliged to make public. There is an exception of such a ban on a case-by-case basis due to the existence of exceptional circumstances, such as severe financial difficulty, which require the immediate sale of shares; or due to the characteristics of the trading involved for transactions made under, or related to, an employee share or saving scheme, qualification or entitlement of shares, or transactions where the beneficial interest in the relevant security does not change. Clarification of these exemptions is provided by the European Commission Implementing Regulation.[423]

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[422] See art. 19 (3) MAR.

[423] Exceptions to this obligation are specified in the European Commission's Implementing Regulation. Specifically, it is the European Commission's delegated Regulation (EU) 2016/522 of 17 December 2015 supplementing Regulation (EU) No 596/2014 of the European Parliament and of the Council as regards an exemption for certain public authorities and central banks of third-countries, market manipulation indicators, disclosure thresholds, competent authority for notifying postponement of disclosure, authorizing trades during a closed period, and types of trades of regulated entities subject to reporting.

The duty to notify managerial dealings enables, at least partially, to erase the differences between various levels of inside knowledge about securities issuers. Legislators thus try to create equal opportunities for all capital market participants.

A possible benefit gained unfairly from inside information cannot be eliminated completely, though. Such a situation could occur if there were a ban for certain people on the purchase or sale of an issuer's securities; this would, however, curtail the freedom of enterprise and such people would rightly feel discriminated against.

Another measure adopted in this area is the fact that insider trading has been made punishable by criminal law. This is closely related to managerial dealings. Yet, if obliged persons properly and in due time notify the competent authority of any securities transactions of the issuer, they reduce suspicion of insider trading. The existence of and strict adherence to legal regulations concerning managerial dealings is in everybody's interests, whether it be capital market participants or the obliged persons that are to notify certain securities transactions. Currently, market abuse is regulated by MAR and the market abuse directive. Without any doubt we might say that we can hardly expect anything completely new and ground-breaking by the MAR implementation in the notification duty—rather, the existing regulation is going to be extended, specified and updated. What is new and very important, though, is the market abuse directive. It is concerned with the elements constituting market abuse and its criminalisation—the aim is the identical interpretation of what market abuse is, including potential punishment for such activities.

I am convinced that new market abuse legislation in Europe definitely fulfils the requirements for the maintenance of fair access to the financial market and its activities there. Among other things, it represents a formal execution of a previously established and promoted strategy to ban strictly any form of market abuse with equal punishment throughout the EU. Such a step appears to be eminently desirable due to frequent cross-border activities of big financial institutions whose impact is truly international. Only by fixing the interpretation of what constitutes market abuse and by agreeing on what punishment can be meted out to the offender in member countries of the EU, can rules regarding the ban on market abuse be internationally standardised, thereby making the international financial market better equipped to provide equal opportunities for investors and consumers.

CONCLUSION

The integration of financial market supervision is a relatively broad topic that can be approached in two ways. The first way sees supervision integrated into an institution or two (that is how this issue is approached in the Czech Republic and also in individual member countries of the EU) while the second way aims to harmonise and integrate supervisory mechanisms at the supranational level (that is the form preferred by the EU as a supranational organisation). Both these ways are intertwined insofar as they integrate supervisory mechanisms regardless of the number of institutions (and the level of integration) and also as they integrate supervision with the aim of a better and more effective execution of supervision, which should, ultimately, bring about more financial stability. While only one supervisory is not such a crucial condition, it is probably hardly acceptable if there are many supervisory authorities—to my mind, three is the maximum.

The process of integration of supervision is rather a long-term one; whilst there have been various attempts (and of various intensity) at supervisory integration for more than twenty years, the process really speeded up after the financial crisis in 2007 – 2008. During that period commenced processes that laid a foundation for the current state of things in supervision. These processes are still going on and it is going to take a few years before they are concluded. It remains to be seen whether the conclusion is going to be identical to the one envisaged now, or whether we are in for some more changes in the area of supervision.

The issue of financial market supervision was also discussed by the former Czech president Vaclav Klaus, who said that 'the transition countries of central and eastern Europe face regulation and giving up sovereignty. When they started, the dominant slogan was "deregulate, liberalize, privatize". Now the slogans have changed to: "regulate, […] listen to the partial interests of the NGO's and follow them, get rid of your sovereignty and put it into the hands of international institutions and organizations" '.[424] Is it not true though that such an act of giving up one's sovereignty can be the way to achieve a more stable economic situation both at home and abroad? I am sure it is true since it is better to enjoy a more stable economy with part of your sovereignty gone than to have a

[424] KLAUS, V. Speech delivered at the meeting of Institute of International Finance. IIF. Berlin. 4th June 2003.

completely independent and self-governing state with economic problems that, ultimately, cannot be solved in any other way than thanks to some international help, which is basically a kind of sovereignty loss as well.

There are several reasons that support the idea of integration and the course of action the process of integration has taken. The state of the financial market and the latest development with its globalising structures and international interconnections demonstrated the need (to a certain extent continuous) for the integration of supervision over this area. National (member countries) supervisory models leg behind financial globalisation and the current state of integrated and mutually intertwined financial markets in Europe, where, moreover, many financial institutions are involved in cross-border business. There were blatant deficiencies regarding mutual co-operation, co-ordination, single enforcement of Union law, and confidence among domestic supervisory authorities.

Financial market integration poses a real threat fully revealed during the financial crisis in 2008. The domino effect influenced basically all financial markets and it could be said that this interconnectedness (globalisation) is now a general risk that financial markets involve. For instance, fluctuations in the value of money significantly affect securities markets; a drop in the value of securities in stock markets modifies the interest rates on credits, since the biggest investors include investment companies and banks. One might ask then whether supervision in an unintegrated form could possibly slow down this domino effect or even reduce the financial loss incurred. I believe that it could not, for supervision performed separately in individual member countries would have a minimal impact on the negative aspects of globalisation.

The integration of supervision and its result—integrated supervision—is a general term; its final form is largely determined by the preconceived model of integrated supervision. A very important aspect when creating a model of supervision is the non-separation of active bodies that solve problems from bodies in charge of supervision, which is what the model envisaged in the de Larosière report included (it separated the national authority from the national responsibility for approved decisions). Such a separation can lead to gaps in supervision and it can ultimately result in the national supervisory authority's refusal to perform supervision in a certain area, since the responsibility for prospective decisions would be disproportionately high. Authority must go hand in hand with responsibility because it is important to maintain the balance between domestic and European authorities of supervisory bodies.

Čihák a Podpiera[425] conclude their analysis of 2006 by saying that integrated supervision shows better results and it is able to keep them up for a longer period of time. If supervision of the banking sector can show good quality thanks to the economic development of that particular country, the same does not hold true for securities where integration can play a positive role. Their conclusion also suggests that the position of supervision either inside or outside the central bank has no bearing on the quality of supervision and regulation. As far as costs reduction is concerned, there is no exact data—on the one hand, the number of employees might not necessarily go down as a result of new responsibilities that an integrated institution takes on; on the other hand, in a number of countries integration is a new phenomenon and it is probable that not all of them have undergone a slimming procedure. Lastly, they identified integration as a useful tool that lead to the restriction of redundant duplications and overlaps in supervision.

The principal focus of this book is on the integration processes involving supervision at the European level, nowadays especially in the form of the Banking Union. As I stated in the conclusion of the Banking Union chapter, I am convinced that the attempts at integration are a step in the right direction for the EU and its member countries alike (including countries that are not in the Eurozone such as, of course, the Czech Republic). Countries that have become part of the process protect their domestic financial stability, which results from global financial stability.

In my view, the most important benefit of the Banking Union is the second pillar, namely the resolution mechanism with the BRRD Directive and its bail-in instrument, which is being implemented by all member and many non-member countries (such as Norway, discussed in detail here, and other EEA countries). Non-member countries do not even have to become part of the Banking Union. Public interventions made during the crisis in 2008 to save some credit institutions were instances of unprecedented financial support offered to public entities that deeply influenced the right setting of economic competition and, in addition, helped to efface, to a certain extent, the negative consequences of some highly hazardous decisions made by top executives of these institutions. Those institutions that behaved more responsibly did not need any help (nor did they get it, naturally), which created a highly unequal environment. Yet, the financial stability would have been in far greater danger had the credit institutions not

[425] ČIHÁK M., PODPIERA R.: Is one watchdog better than three? International experience with integrated financial sectoral supervision, Working Paper No. 57, International Monetary Fund 2006, p. 26-27.

been helped (they would, no doubt, have been forced to file for bankruptcy). Thus, for the sake of maintain financial stability some private-law entities received financial support from public sources. Now that the bail-in instrument has been adopted, such public support is virtually unattainable—it remains in effect as the last resort after several unsuccessful attempts to get help from other (i.e. non-public) sources and on very strict conditions.

The rating of credit institutions, which is an increasingly important criterion for measuring stability and competitiveness of financial institutions, got worse after the bail-in instrument had been implemented—it basically ruled out the possibility of public support for financial (in particular credit) institutions. It is only logical now that credit institutions' risks are not covered by public support. The risks remain, but there is no public safety net.

A good example of how the BRRD Directive should work is Banco Espírito Santo in Portugal. In 2014, a large part of its liabilities was written off and EUR 5 billion was offered the Portuguese resolution fund to save the good assets (that is why Portugal did not make its contribution to the SRF). The bank was practically divided into two parts: the good bank and the bad bank; the former was saved by writing off some liabilities and transferring them into the bad bank. Investors (led by those from the hedge funds) initiated proceedings before the European Court of Justice so as to enforce compensation for the loss from the subordinated debt. The debt was brought about owing to the unjust creation of the 'bad bank' of Banco Espírito Santo without any possibility of acquiring more private capital. To put it simply, those investors whose claim/investment had been placed into the bad bank, and subsequently reduced or totally erased, did not like such a step for which they had incurred the loss. Predictably, this is something that is going to take place every time the BRRD Directive is applied; there are, nonetheless, no other options and it is vital that the risks and potential losses should be taken and shared by shareholders and investors, since it is them who are responsible for the correct operation of a specific institution, and they must be well aware of the fact that a particular investment entails some risk, possibly leading to a loss. There have been more examples, but the only true resolution case so far was Andelskassen J.A. K. from 2015 in Denmark. Here, however, is the question of whether the resolution mechanism should be applied to an institution with a market share of less than 1%.

The next development of the transfer of finance from national resolution funds to the SRF is going to be very interesting. The contributions are

supposed to be 1/8 of the target level of finance expected there. Will the payment practices of the up-until-now non-paying countries improve or not, and what is the European Commission going to do about it?

What remains open in the second pillar is the robust MREL. Member countries are supposed to implement it by 2019; however, no exact method or rule for its calculation has been announced yet.[426] The MREL, as another capital buffer, will only be implemented by systemically important credit institutions and those institutions that will be ordered to do so by the national supervisory authority. Ideally, the creation of MREL should consist in issuing subordinated bonds, but no one can say now what their price will be. How much is an investor willing to pay when he knows that if the institution is in trouble, the resolution mechanism will be applied, thereby reducing his investment, or rather the value of the bond, half of which may be written off and the other half transferred to stock (a share in a company in the resolution process). Another problem with the MREL is that it entails capital requirements that are very similar to TLAC (Total Loss-absorbing Capacity) minimum standards created by the Financial Stability Board in co-operation with the BSCS, which was laid down for global systemically important banks (G-SIB). Over the course of the next few years the problem should alleviate when global systemically important banks will create only TLAC, while those systemically important in Europe will create MREL, which will, in time, move closer and closer to TLAC.

It is important to bear in mind that for resolution the crucial principle is '*no creditor should be worse off than in the case of an outright liquidation*'. Articles 36 and 74 of the BRRD the application of a resolution mechanism is preceded by double valuation of the institution (one of which simulates insolvency). If there is a difference between the two valuations to the detriment of the creditors, they will be compensated during the course of the resolution mechanism. This could cause problems in a number of countries in case the capital reserve is implemented according to MREL; the same holds true for some G-SIBs if they use TLAC. The thing is that MREL does not always copy the insolvency hierarchy, which means that creditors might not actually always get the same or more than in an insolvency proceeding. This potential problem was aptly solved by Sweden where the TLAC method was adopted mandatorily for all credit institutions. TLAC introduces a

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426 The only exception is the Bank of England with its "Purple Book", where the MREL values are actually set. In the rest of the EU, the SRB is expected to determine the MREL. For more see: The Bank of England. The Bank of England's approach to resolution. Published October 2017. [online]. Available from <http://www.bankofengland.co.uk/financialstability/Documents/resolution/aproct17.pdf >

mandatory subordination of the capital reserve or debt in such a way as to match precisely the insolvency hierarchy. As the capital is expensive, in most cases bonds will be issued, thereby raising the capital reserve for financial institutions. There is a condition attached to these bonds though: in case of a resolution mechanism they can become worthless. Who is going to buy such bonds? I think some people will, for it is only (as usual) a question of the right price.

This mandatory capital reserve for credit institutions is extremely expensive; in countries with a high number of deposits relative to the GDP, like Great Britain, Sweden or Denmark, there is no other option since a lot of banks have grown too big and the state cannot save them in case of a problem. There must, therefore, be a big capital reserve to cover the potential failure, possibly to such an extent that the resolution bail-in instrument (involving cutting off selected liabilities/creditors) will not be necessary.

Unlike the first and the second pillar of the Banking Union, the third pillar is a single securing system with a unifying legal framework. As yet, we cannot speak here of a federalisation in the form of a supranational system or supranational bodies with centralised powers relating to this area.

The existence of a safety system of deposit insurance brings about, in a way, a moral hazard in case of rational 'economic behaviour'. In the Czech Republic, an example of this is the existence of credit unions that are, to a certain extent, unique in Europe as far as their form and methods of business are concerned. They offer their members high return on their savings and they (the members) would, of course, be rather foolish not to take up the offer knowing that if the credit union suffers financial problems, the Guarantee system of financial market (deposit insurance fund) will pay out deposits of up to EUR 100,000. So the investors (depositors) risk, up to this figure, very little and they can only reap benefits unless the credit union is declared insolvent. If it does declare insolvency, the investors get their investment back. There is a disproportion between an increase in moral hazard and economically rational behaviour; there is no direct proportionality because it does not hold true that the higher the moral hazard is (deposits made with a promise of high return), the higher is the risk of loss. Depositors do not risk at all so nothing prevents them from the moral hazard—which might be called the economically rational behaviour. At the moment, Czech credit institutions which make a profit do not want to contribute to the deposit insurance fund because they know it for certain that they will not be the ones needing the money. In all likelihood the money will be used by credit unions which undergo far greater risks and

often promise the impossible (or something possible but far from profitable for the credit union). It seems positive that credit unions will not be part of the SRM and will be liquidated in a standard way—the deposits will be paid out from the Guarantee system of financial market and the unions will then go through the insolvency proceedings and, finally, will be removed from the Commercial Register. It can be viewed as a positive circumstance because if credit unions were able to seek help from the SRM, their executives would behave even less responsibly.

This is the main problem relating to safety systems and that is also the reason why they do not exist at the central level. The main are of opposition is in Germany because German banks (like Czech banks, probably) would predominantly contribute while Greek or Spanish banks would predominantly make use of it. Although it is a Banking Union pillar, one can hardly expect federalism here. The third pillar of the Banking Union has so far dealt only with harmonising rules for securing system of member countries, which are going to solve their problems on their own, i.e. at the national level. It is possible that the prevailing attitude may change over time, but at the moment this seems to be completely out of question.

At the beginning of the book I constructed two main hypotheses and three partial hypotheses that I can now, having analysed and evaluated the aspects of the problem, confirm or refute.

The main hypotheses

c) *The process of supervision integration itself supports and increases the effectiveness of supervision over a financial market and decreases the risk of destabilising the system.*
d) *The regulatory functional over a financial market has been deeply integrated into that of supervision and has thus become, to a certain extent, a preventive measure—primary supervision.*

Most probably one cannot reach the conclusion that the very process of integration makes supervision more effective, because it is a process that is always accompanied by other process such as changes in regulation or in mechanisms of supervisory authorities etc. I am sure that the process of integration does support the effectivity of supervision as well as financial stability and the reduction of systemic risk. Supervision is carried out more flexibly and consistently and, as a result, it is perceived as a more transparent system, which is a big advantage for supervisory authorities and

supervised entities alike. If we look at the process of integration as the unification of supervisory practices across the international financial market, then integrated supervision is more predictable for individual financial institutions and, to a certain degree, it enables enter business in various countries more easily since the chief supervisory differences have been obliterated. All of this also affects financial stability—the main goal of all regulatory and supervisory mechanisms, irrespective of whether the current economic period is stable or whether the economy is in recession. This part of the main hypothesis has not been refuted, but I cannot really claim it has been confirmed either; although, if forced, I would rather agree with the latter than the former.

The second part of the main hypothesis might seem a bold statement that makes supervision a kind of a set, part of which is regulation. I am certain that regulation was, indeed, implemented as one of supervisory functions, though not exclusively so. Initially, there is always regulation which is crucial and which delegates individual powers to supervisory authorities along with the rules of conduct for supervised institutions. This primary and basic regulation entails entrusting certain powers to supervisory authorities, one of which is (apart from the fundamental one, i.e. daily as well as long-term supervision) part of regulation in several forms. The first option is to issue sublegal and implementing legal norms with general applicability; another option is to issue statements specifying potentially ambiguous passages in acts, or to provide more details regarding statutory rules. Another regulatory power that supervisory authorities have is the provision of consulting activities in the preparation of regulation. In the Banking Union integration is in this respect even noticeable since the representatives of regulatory bodies sit on the Supervisory Board of the ECB within the SSM, or they constitute the Single Resolution Authority within the SRM. I hold the view that regulation is a fundamental preventive instrument of supervision—the experience of supervisory authorities (now even supranational ones) helps to adopt adequate legislation (i.e. regulation). I am thus utterly convinced that this hypothesis has been confirmed.

Partial hypothesis no. 1

The process of supervision integration over a financial market is from both the institutional and functional perspective a step towards a more concentrated set of regulatory powers in the hands of a narrow range of supervisory institutions in a centralised way.

This hypothesis has also been confirmed, for I have not noticed any indication that integration should prove to distribute supervisory powers to a wide range of institutions. The main task of integration, as this book has stressed several times, is not the unification of powers into one single body, but rather the unification of supervisory mechanisms at the supranational level, and mutual co-operation aiming to achieve this task. It logically follows that such integration must concentrate powers in the hands of only a few institutions. It is only possible to unify supervisory mechanisms if supervision in individual countries is performed flexibly with high quality and intense international co-operation among individual supervisory authorities—that is something that many supervisory institutions in a given country have not reached yet. In the EU this distribution of powers into a very narrow range of institutions is even perceptible thanks to the centralisation of powers, mainly thanks to the Banking Union. My analysis of the execution if supervision in individual countries (in Europe as well as outside it) shows that in a large majority of countries supervision is not executed in the sectoral way, but rather in the functional way. The latter is based on the area of market failures of financial institutions and is thus much more suitable for an integrated supervisory framework. Consequently, I may assert that this hypothesis has been thoroughly confirmed.

Partial hypothesis no. 2

The process of supervision integration over a financial market was initiated so as to create a more effective way of reacting to a rapidly and continually developing world of financial markets, which are due to the increasing financial globalisation no longer matters of national interest only.

This hypothesis is confirmed several times in various chapters of this book, including the conclusion. The international integration of supervision and its mechanisms into one single authority (or a few authorities) can be seen as the result of the necessity for flexible and effective responses to changing financial markets and the current needs of regulation always aiming to maintain financial stability.

Partial hypothesis no. 3

The process of supervision integration over a financial market is influenced by the enormous importance of a financial market in a national economy as the basis of international economic stability and it helps to create the European single market.

There is little doubt that the financial market is a vital strategic element of the national as well as the international economy. This became especially evident during the financial crisis in 2007-2008, when particularly financial market problems caused massive financial losses and a precipitous worldwide economic decline. Financial stability was in peril and it decreased considerably. The integration of supervision is one of the possible ways to achieve and maintain a prosperous national economy and international financial stability. These are also the goals to achieve via various instruments—among them, the integration of supervision is of crucial importance.

One of the main goals of the EU and its economic policy is the creation of a single market. For many years, the EU has been putting a lot of effort into attempts to achieve this goal; the process of integration, especially in its form of unifying international supervisory practices, is one of the instruments the EU uses to create a single market. A single market without unified and harmonised supervisory rules is hardly conceivable—this confirms the hypothesis that integration (unification) of supervision really does lead to a single market. Nowadays one can see it very clearly in the Banking Union project, which helps the most to create a single EU market. What has been demonstrated here decidedly confirms the hypothesis.

A single market is needed not only in the EU but in the whole of Europe. The Agreement on the EEA enables it, as does the way the EU legislation is implemented even in non-member states such as Norway. The EU naturally encompasses a much wider range of areas of harmonisation and interconnectedness than just the economic area, like the financial market area. It is the financial markets that provide clear evidence that EFTA countries outside the EU are, thanks to the EEA Agreement, regulated and supervised almost identically when compared with EU member states. Its creation and existence are entirely logical and all the parties concerned benefit from it. It might appear that EFTA countries only pick from the EU whatever they need to achieve economic stability—this may very well be true, but it does not do any harm. While a single market with EU countries surely is very convenient for Norway, it is extremely beneficial for all EU countries as well; hence the need to view the idea of a single market from the European (rather than just the EU) perspective.

It remains to be seen what the relations between the Banking Union and EFTA countries are going to be because in many areas covered by the Banking Union they are under a regime similar to countries outside the Eurozone. It is clear that the voice of the countries outside the Eurozone and the EFTA countries will not be negligible as far as the Banking Union

is concerned. They are very happy in Norway that their negotiating position is similar not only to that of Iceland and Lichtenstein, but also Denmark, Sweden or Great Britain; especially as regards the first pillar of the Banking Union- the Single Supervisory Mechanism. It is likely that countries from outside the Eurozone might come under considerable pressure to join the Eurozone, thereby strengthening and stabilising the position of the EU in relation to EFTA countries. If, however, the pressure is exerted to no avail and there are still many EU countries outside the Eurozone in the future (as there are now), it is not totally out of question that there might be another agreement signed in some part of the Banking Union—an agreement that is similar to the EEA Agreement and that involves the EU as the representative of the Eurozone, EU member countries outside the Eurozone and EFTA countries so that the objective of the Banking Union could be accomplished. Then we would find ourselves in a hotchpotch of several agreements with rather confusing procedural issues. I sincerely hope that this hypothetical situation will never materialise and that all the current and future issues and problems relating to the Banking Union (including the single European market above the framework of the EU) will be solved systematically within the EU, or within the EEA Agreement. That seems to be the only way of achieving real integration of financial market supervision and, ultimately, of creating and maintaining a single market.

It is going to be very interesting to monitor upcoming actions connected with Brexit in relation to the banking union. Great Britain is not part of the Eurozone, so the SSM is not very relevant, but SRM is in some aspects. Great Britain, however, proceeds in accordance with the Single Resolution Authority, and the National Resolution Fund fills up in the same way as the other member states. Formally, Great Britain is still part of the EU, and individual obligations must be respected.

The future is, however, very uncertain and still unpredictable, and it is also very possible that Great Britain will join the current EFTA countries with economic collaboration (no longer politically) with the EU. When Great Britain becomes one of the EFTA countries, some of the issues in EFTA countries under the EEA Agreement mentioned above will become topical for Great Britain.

What are the other options for Great Britain from the economic point of view? One of them is certainly a complex group of multilateral contracts with EU or other countries, like Switzerland. There are some differences compare to the EEA Agreement, but basically, the goal is the same – easier cross-border economic collaboration. The costs of this way might be higher

(longer administration procedure including acceptance and implementation of the local government), but there should be greater legislative freedom.

The other option which was recently raised is Nafta (North American Free Trade Agreement), but in the author's opinion, it would not make sense to join the North American Agreement given that Great Britain is geographically somewhere else. What could the advantage of such an agreement be? It is hard to find any, especially in a situation where the reality and future of Nafta is very unstable.

The question regarding economic collaboration between the EU and Great Britain is not "IF AT ALL", but rather "HOW and WHEN".

However, this is unlikely to be known until the Great Britain leaving of the EU becomes the final fact and reality. Then, we might find the way for economic collaboration and the legal framework of it between the EU and Great Britain. It is certainly needed for both parties. Based on the author's opinion, the best solution for both parties is a situation in which Great Britain becomes an EFTA country.

It is very difficult to predict the development of integration of financial market supervision in Europe, let alone the whole world; we cannot, though, expect some radical changes to the chosen direction towards more intense interconnections, co-operation and harmonisation, including the unification of supervisory mechanisms. This book places particular emphasis on integration in Europe, as this process (and all the accompanying activities) is both geographically as well as politically the closest to the Czech Republic—the local legislation (not only in this area) is based on the European legislation. Integration of supervision in Europe is and will be affected by what is going on in the EU, which is largely influenced by its inner problems. At the moment, the biggest problem is the issue of the Greek debt—a hotly-debated problem affecting the economy of the EU. Three years ago Greece was provided with financial help that was supposed to solve the problem. The thing is that a large majority of the finance was immediately used to pay off state bonds, most of which were in the hands of French and German banks. Thus, these banks received financial support from public funds, thereby rescuing their unfortunate investment in foreign state bonds. Is that not a problem of integration in the EU? The fact that despite the proclaimed attempts to create a single market (including single supervision over it), there are states whose representatives in the EU defend their national interests rather than the interests of the whole union?

A very fitting comment was made by Jurgen Habermas, who said: 'Without a common financial and economic policy, the national economies of pseudo-sovereign member states will continue to drift apart in terms of productivity. No political community can sustain such tension in the long run. At the same time, by focusing on avoidance of open conflict, the EU's institutions are preventing necessary political initiatives for expanding the currency union into a political union. Only the government leaders assembled in the European Council are in the position to act, but precisely they are the ones who are unable to act in the interest of a joint European community because they think mainly of their national electorate. We are stuck in a political trap. […] Over the course of the crisis, the European executive has accrued more and more authority. Key decisions are being taken by the council, the commission and ECB – in other words, the very institutions that are either insufficiently legitimated to take such decisions or lack any democratic basis. […] The currency union must gain the capacity to act at the supra-national level. In view of the chaotic political process triggered by the crisis in Greece we can no longer afford to ignore the limits of the present method of intergovernmental compromise.' [427]

One could not agree more with this statement that extremely aptly describes the problems that European integration is endowed with. The integration of supervision is a very important part of European integration since it contributes to the establishment of a single market, which is one of the major goals of the EU economy, if not the biggest of all. There are, however, other areas in which integration is going on and will keep going on to enable the creation of something that strongly resembles a federation. It is desirable that activities and trends in the EU should focus on what Habermas mentions: in particular, the currency union must become a political union and individual representatives must act in the interest of the whole community rather than of their electors. How to achieve this goal is no easy question; the fundamental step seems to be the acceptance of the EU as a joint community, rather than something that provides a lot of benefits although we feel little community solidarity and we do not co-operate to ensure benefits for all. In other words, I would like to see the EU as a real federation, for without a political union cannot be attained all the economic goals the EU has been pursuing, including a single market and its indispensable element: integrated financial market supervision. The

[427] OLTERMANN, P. Jürgen Habermas's verdict on the EU/Greece debt deal – full transcript. THE GUARDIAN. Interview with HABERMAS, J. published 16th July 2015 [online] [qtd. 23rd April 2017]. Available at <http://www.theguardian.com/commentisfree/2015/jul/16/jurgen-habermas-eu-greece-debt-deal>.

dominance of the EU in this book is caused not only by geographical proximity, but, more importantly, also by the dominant role occupied by the EU globally; thus, financial stability in the EU contributes greatly to global stability and affects it significantly. This is the reason, along with the fact that I am an EU citizen, why I entertain the opinion that it is first necessary to set and stabilise properly functional supervision at the local level (he level of the EU, in this case) and only then is it possible to analyse and determine supervision at the global level—even though there is quite a lot of overlap, of course.

By way of conclusion, I would like to state that, having carried out considerable research, I am now utterly convinced that the integration of supervision is a process tried and tested to a large extent over the years, and it is also the right trend in supervision in view of the interconnectedness of international financial markets. New activities in the EU (the creation of the Banking Union, in particular) represent more concentrated efforts to integrate supervision. It is still early days yet and not every detail has been specified and successfully dealt with; it is going to take some time before the Banking Union is in its final form and fully operational (in a few years' time, presumably). Before that, it would be unfair and unprofessional to pass judgement.

The reasons outlined above justify the continuation of the process not only in the EU, but also globally; it is in our best interests to keep supporting and developing the integration of financial market supervision and to keep harmonising the practices and mechanisms of supervision. Ideally, we should take active part in it, too.

RESUME

This book analyses the integration of financial market supervision at the international level, particularly focusing on EU law and the actual processes taking place in this area. Currently legislative action at the EU level has a significant impact on legislation in the Czech Republic, with which this work is also of concerned together with where the integration of supervision takes place. Within the comparison this paper has included a treatise of Norway, which is not an EU member, but a member of the European Economic Community (EEA), however it is interest to make a comparison of such countries with EU regulations.

This topic is relevant for an extended period of time, while in the past few years, the integration has become even more intense. The word integration means unification, completion, fusion, the joining process in a higher unity. The phrase integration of supervision also implies the integration of regulation, because there is no supervision without regulation and vice versa, respectively supervision includes regulation itself and for this reason, this work also addresses the integration of regulation together with the integration of financial market supervision. The opinion of this paper is even such that regulation is effectively preventive (primary) supervision. For that reason the supervisory authorities of the financial market are not "only" supervisors, but also regulators. This paper perceives integration in

terms of functionalal way – regulation functional significantly integrated into supervisory functionals (but of course not exclusively because a fundamental role of the regulator remains in power of legislator).

Integration of financial market supervision can be understood in several ways. Either it is a unification of supervision within one or two institutions, as it is understood as the meaning of integration in individual EU member countries e.g. in the Czech Republic and the Slovak Republic, where Financial Supervision was unified (integrated) into a single institution (institutional integration) or it is the harmonization – unification (integration) of supervisory practices and transnational cooperation for this purpose and in this way it is understood as the process of integration at the international (EU) level (functionalal integration). This book deals with both ways of understanding of integration, but, however the view of this paper is that the international way is more significant in determining the meaning of supervision integration of the financial market.

Integration of supervision is a process that from the international perspective has been in process for three decades and is still in development, respectively methods of integration are constantly increasing. There are several reasons for integration and perhaps the most important is the very essence of the financial market and its liberalization, the change in its structure, its functionaling and overall economic development. Furthermore, the emergence of large national and multinational groups, financial institutions and the related international harmonization of rules of business of financial institutions.

These basic tenets are a prerequisite and also reason for financial market supervision. The basis of regulation itself should be sought in the individual financial systems of individual states and represent a high commitment to ensure the stability of the financial system and financial institutions. It could be simply said that regulation of supervision is primarily aimed at establishing rules of establishment and functionaling of financial institutions, so that the potential threat to the stability of the financial system will be as minimum as is possible.

In the first part of this book the paper deals with financial markets and supervision in general, including theoretical foundations of approaches and models of supervision, classification of the financial market supervision within the system of financial law. This includes the scientific – theoretical part of the book and there is a treatise of the reasons for the regulation and supervision of financial market and its objectives, contents and principles.

A significant section of this chapter is an explanation of the systems of supervision and their models. In general, there are two basics models of the supervision, sectoralal and functionalal. The sectoralal model was previously used more frequently in many countries, but it has been changed in the last decade to a functionalal model, which has a theoretical basis, since it is based on the typology of market failure.

In the second chapter there is a analyses of the integration of the supervision in the EU, with all current legislature and trends in this area. This is the key part of this book, because of its importance and effect for member countries and also for the international process of the integration especially because of the Banking Union as the newest standard of the integration and centralization of the powers of the supervision of the financial market.

The third chapter deals with integration of the supervision in the Czech Republic as a member state of the EU, but not a member country of the monetary union and Banking union. The rules of this area are implemented in Czech law through the EU directives and regulations; therefore there are many important parts of Banking Union valid in Czech Republic, even though there is no membership of the Banking Union. The fourth chapter is about Norway and its integration of the supervision. Norway is a country without membership to EU, but as a part of the EEA agreement, Norway accepts and implements most of the rules and standards to their national law. This demonstrates that there is no more national financial market, but an international market, because/due to of the influence of national financial markets to each other. In this point of view harmonization and collaboration of the all countries is vitally necessary for the stability of the financial market not only because the centralization of the powers to the international level supervisors, especially in the EU, but mostly because of the supervised entities. Countries will have an increased knowledge of the conditions for the conduct of business in this area, because these conditions will be harmonized, unified and in general similar, thereby facilitating the ease with which to conduct similar business in other countries, or globally and it also facilitates international competition.

Within the EU, there are minimum problems, which should be solved, thus the supervision will be well integrated and therefore support financial stability and also one of the aims of the economic policy of EU, which is to build up real single market in Europe. The problem is that only the government leaders assembled in the European Council are in the position to act, but precisely they are the ones who are unable to act in the interest of a joint European community because their main consideration is their

national electorate. Thus the result is a political trap. The view of this paper is that the currency union must gain the capacity to act at the supra-national level and the currency union should expand into a political union, such that the process of integration will in all ways be complete.

Research in the context of this book, concludes that the integration of financial market supervision is a process that is established by years of practice and very well set direction of the method of supervision relative to interconnection of the international financial market. Harmonization of work and practice of supervision of the financial market together with the strengthening of cooperation in this area should be continuously supported and developed, in which, ideally, we (the Czech Republic and maybe all citizens of EU) should actively participate.

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98/78/EC and 2000/12/EC of the European Parliament and of the Council

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