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**Who's Afraid of *Peter Paul*?
The European Court of Justice to Rule on
Banking Supervisory Liability**

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Abstract

For many years, courts in various EU Member States have been confronted to liability claims directed against banking supervisors for alleged negligence in exercising prudential supervision over banks. In view of the increasing "Europeanization" of banking supervision, it is not surprising that depositors attempt to circumvent limitations of liability under domestic law, by invoking "Francovich-type" Member State liability for negligent supervision.
In case C-222/02 (Peter Paul and others), the German supreme court has referred the issue to the ECJ, in order to ascertain whether Francovich-liability could be applied in the field of prudential supervision. The opinion of Advocate-general Stix-Hackl in this case is negative. In this paper, we analyse the arguments set forth by the advocate general to sustain this conclusion, and formulate a few critical remarks in the opinion.

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Who's Afraid of *Peter Paul*?

The European Court of Justice to Rule on Banking Supervisory Liability

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Introduction

Over the last years, banking failures in various EU-Member States have increasingly led to court actions directed against the banking supervisor, where the latter was blamed by depositors with the failed bank for having negligently discharged its supervisory duties. As depositors' claims on the bank usually are unsecured, and the deposit guarantee systems put in place pursuant to the 1994 Deposit Guarantee Directive only provide for partial coverage of the losses incurred following the bankruptcy, depositors have an evident interest in attempting to shift their residual losses onto the banking supervisor or the state. Given the purposes of banking supervision, it is clear that the banking supervisor or the state should not automatically bear the risk of a banking failure: prudential supervision is devised to contibute to avoiding banking failures, without offering any guarantee as to eliminating altogether the risk of a bankruptcy. Whenever a bankruptcy occurs, its costs should be borne primarily by the various stakeholders of the bank (shareholders, creditors including depositors). On the other hand, these stakeholders may reasonably expect form the banking supervisor to exercise its functions in a proper manner, when it comes to monitoring the financial soundness of the entities under supervision. Hence, it should be possible for depositors to claim damages whenever the banking supervisor has failed to take approppriate action when confronted to a financially distressed credit institution, provided there is a sufficient link of causation between the alleged improper conduct from the part of the banking supervisor and the damages suffered by the depositors.

By contrast, the laws of an increasing number of EU Member States contain provisions the aim of which is to fend off or at least to severely limit liability of the banking supervisors for possible shortcomings in the discharge of their supervisory functions (see Part I). It is not surprising, therefore, to see that attempts have been made to avoid the effects of these legal provisions in national law, by invoking EU law as a basis for holding supervisory authorities liable. This is the background of the *Peter Paul*-case, which is currently pending before the European Court of Justice (ECJ), and which will be commented in Part II. We will conclude with some remarks on the desirability of a liability regime for banking supervisors under EU law.

Part I: Supervisory Liability in EU Member States

As is illustrated in Table 1, the present legal situation as regards supervisory liability in the EU-Member States is characterised by its large diversity. The diversity of general tort law regimes between EU member states further adds to the fragmentation of supervisory liability regimes. Illustrative in this respect is the concept of 'relativity' or 'proximity' that exists in

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some countries (e.g. Germany, United Kingdom, Netherlands), but is inexistent in others (e.g. Belgium). According to this concept, the breach of a legal rule will only lead to liability towards persons alleging damages as a consequence of this breach if the said rule is intended to protect the interests of the latter. In the context of supervisory liability, this implies that liability towards depositors will only come into play insofar as prudential regulation is considered to protect the interests of (individual) depositors, and not (only) the interests of the financial institutions or, more generally, the financial system. This issue is also crucial in the debate on supervisory liability under EU law (see further).

Different general patterns with regard to supervisory liability can be observed in the EU Member States. In a first group of Member States, no specific liability rules exist with respect to the exercise of prudential supervision, and general tort liability rules apply. The absence of specific provisions as regards supervisory liability also appears to be the dominant pattern in the 10 new EU Member States.[1] Very often, this situation appears not to be the result of a deliberate policy choice, but may be explained by the lack of precedents in jurisprudence as regards liability claims directed against supervisory authorities. In some countries however, judges have applied normal liability rules to supervisory action, in the (provisional ?) absence of regulatory immunity regimes. In Italy for instance, an important 2001 supreme court judgment involving the liability of the Consob in scrutinising a public offer prospectus has applied the normal liability standard of negligence. The case could be transposed to banking supervision as well. Likewise, an Austrian supreme court judgment of 2003 has held the Austrian State liable towards depositors for the negligence of bank auditors, whose task also consists of assisting the banking superisory authority in discharging its functions.[2] The judgment is based on the application of normal liability standards to the banking supervisor.

By contrast, a second — increasing — group of EU Member States has enacted specific legal provisions limiting supervisory liability. The law either confines liability to the situation of gross negligence or bad faith from the part of the supervisory bodies, or even results in total immunity from liability. It is interesting to notice that, very often, the intervention by Parliament to grant (partial) immunity from liability followed specific court decisions where judges had held the supervisory authority liable towards depositors, or at least paved the way for potential liability. For instance, the German supreme court (*Bundesgerichtshof*) held in two judgments of 1979[3], that the German Banking Act did not only serve the public interest, but also the interests of private depositors, allowing them to sue the supervisory authority in damages. Though no damages were eventually awarded in these cases, the risk of future liability claims brought Parliament to amend the Banking Act in 1984, by introducing a provision which stated that banking supevison exclusively served the public interest. In view of the relativity requirement prevailing in German tort law (see above), the effect of the amendment was to grant full immunity from liability to the supervisory authority. Equally, the amendment of the UK Banking Act in 1987, which limited liability of the Bank of England to acts committed in bad faith, followed different judgments that could have led to accepting supervisory liability under common law. The provision was subsequently copied in Ireland. Likewise, Luxembourg amended its banking law in 1993, following the BCCI-failure, limiting liability of the banking supervisor to gross negligence or fraud. More recently, the

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1 Though some exceptions exist: see, e.g. in Malta, where section 29 of the Malta Financial Services Authority Act contains a statutory limitation of supervisory libility to case of bad faith, worded in a very similar way as in the UK.

2 OGH, 25 March 2003; see the summary by M. Heidinger in *J.I.B.L.R.* 2004, No. 2, p. N-12.

3 One of which was delivered in the aftermath of the *Herstatt*-failure

Belgian financial reform of 2002 went along with the introduction of a partial immunity regime in favour of the Commission for Banking, Finance and Insurance, limiting liability, as in Luxembourg, to situations of gross negligence and fraud.

Finally, in a third group of Member States, some limitation of liability stems from general tort law, which to a certain extent protects state bodies from excessive liability claims. This is the case in France, where well-establshed case-law of the *Conseil d'Etat* requires gross negligence ('faute lourde') for holding the banking supervisor liable, given the complexity of its duties.[4]

It is interesting to note that the Basle Committee's *Core Principles for Effective Banking Supervision*[5] favour some immunity from supervisory liability as well. Core Principle 1, which lays down the essential preconditions for effective banking supervision, stresses *inter alia* the need to provide for "legal protection for supervisors". The explanatory memorandum to Core Principle 1 further specifies in this regard that supervisors should enjoy "protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties". Beside the fact that they cannot be regarded as legally binding rules, it should be stressed that the Core Principles basically emanate from the supervisory authorities themselves, who have an evident self-interest in promulgating (partial) immunity from liability as a good standard for prudential regulation.

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[4] See e.g. Conseil d'Etat 30 November 2001, *Kechichian*, *Juris-Classeur Périodique* 2002, édition Générale., II, No 10042, note J.-J. MENURET, *Petites Affiches* 2002, No 28, p. 7, with opinion of A. SEBAN.

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

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

Table 1: Comparative overview of supervisory liability of banking supervisors in different EU Member States, compared to the Basle Committee *Core Principles* recommendation*Part II: the* Peter Paul *case: attempting to circumvent regulatory immunity under national law*

The currently pending *Peter Paul* case must be seen against the background of the existence of regulatory immunity under German law. The plaintiffs (Peter Paul and others) held a bank account with the Dusseldorf based BVH Bank für Vermogensanlagen und Handel AG, which had obtained a banking licence in 1987 on the condition that it would join a deposit guarantee system. Between 1987 and 1992, BVH Bank repeatedly tried to join the deposit guarantee system of the German Banking Association, but the applications were dismissed for failuire to comply with the admission requirements. In the meantime, the unsound financial situation of BVH Bank prompted the German banking supervisor (*Bundesaufsichtsamt für das Kreditwesen*) to proceed to several specific bank audits between 1991 and 1997. In August 1997, the supervisor imposed a moratorium on banking activities to BVH Bank, followed shortly by the withdrawal of the banking licence and a petition for bankruptcy in Autumn 1997. As BVH Bank still had not joined any deposit guarantee system, the depositors were not able to obtain any coverage of their deposits, but would have to wait for an unsure dividend distribution in the bankruptcy proceeding. A number of depositors therefore instituted legal proceedings against the German State, and basically invoked two grievances: (1) the German state was liable for not having properly implemented the 1994 EU Deposit Guarantee Directive on, which obliged credit institutions to join a deposit guarantee system offering a coverage of deposits for up to 20,000 EUR; (2) the plaintiffs had suffered damages as a consequence of negligence in exercising prudential supervision by the *Bundesaufsichtsamt*.

In first instance, the Landgericht Bonn held the German State liable for a breach of its obligations to implement the Deposit Guarantee Directive, and awarded damages of 20,000 EUR per depositor to the plaintiffs, corresponding to the coverage level imposed by the European directive. The judgment was based on the so-called *Francovich* liability, according to which a Memer State may incur liability for a serious breach of EU law which has caused damages to a private individual when the rule of EU law at stake is intended to protect the interests of the victims.

As for the second argument, both the Landgericht Bonn and the Oberlandesgericht Köln upon appeal dismissed the plaintiff's argument, as the *Bundesaufsichtsamt* enjoyed a regulatory immunity from liability under the German Banking Act. The plaintiffs did not manage, therefore, to recover the part of their deposits exceeding 20,000 EUR.[6] The courts did not consider this legal immunity to be contrary to the German constitution or EU law.

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

As the plaintiff's argument raised matters of interpretation of the banking directives, the *Bundesgerichtshof*, by judgment of 16 May 2002, suspended the proceedings and submitted different questions to the European Court of Justice, which can be roughly summarized as follows.[7]

- First, the *Bundesgerichtshof* asked whether the provisions of the Deposit Guarantee Directive, which provided for adequate measures to be taken by the Member States'

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

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

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competent authorities with a view to ensuring that credit institutions joined a deposit guarantee scheme, were directly applicable, and hence could be invoked by depositors against a Member State. In addition, the court asked whether in that case, the absence of measures thus taken under the Deposit Guarantee Directive could enable depositors to claim compensation from the Member State beyond the amount of 20,000 ¤ specified in the directive.
- Second, the court asked whether various banking directives, taken either individually or in combination, confer on the saver and investor rights to the effect that the competent authorities of the Member States must take prudential supervisory measures, with which they are charged by those directives, in the interests of that category of persons and therefore must incur liability for any misconduct, in the discharge of supervisory duties.

Not less than five Member States made submissions in the proceedings before the ECJ, which is illustrative for the importance of the issue for Member States' (financial) interests. All Member States' submissions were opposed to finding any legal basis for Member State supervisory liability in the banking directives. This position was also backed by the European Commission.

Advocate General Stix-Hackl also formulated a negative opinion as to the questions submitted by the*Bundesgerichtshof*.

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

More debatable is the opinion of the Advocate General on the liability issue. According to the case law of the ECJ, as first applied in the mentioned *Francovich*-case, a Member State may incur liability for breach of an obligation under EC law when three conditions are met:

(1) The breached rule of EU law is intended to grant rights to private individuals
(2) There must be a serious breach of EU law
(3) There is a direct causal link between the breach of EU law and the damages suffered by the victims

The first condition is the most critical in this context. It raises the question whether the EU banking directives, when imposing the obligation on the Member States to exercise prudential supervision over credit institutions, have intended to confer rights to private individuals, notably depositors. In the opinion of the Advocate General, the answer is negative, not only in the framework of the Deposit Guarantee Directive, but also as far as the First or Second Banking Coordination Directive[8] are concerned. Joining the arguments developed by the Member States and the European Commission before the ECJ, the Advocate General stresses that, notwithstanding the reference to the protection of depositors and investors in the First and, even more, in the Second Banking Directive, this is not in itself sufficient to conclude

[8] Both directives, together with the Own Funds and Solvency Directive, have been codified into a ingle directive by Directive 2000/12/EC (hereinafter refrred to as: 'Coordinated Banking Directive').

that these directives 'confer rights' to depositors, in the sense that the latter could claim the right to have specific supervisory measures taken in respect of a credit institution. The protection of depositors in these directives should merely be regarded as part of the more encompassing objective of the harmonisation efforts, namely to create conditions of equal competition between credit institutions across Europe with a view to realising the principles of free provision of services and freedom of establishment.

In conclusion, the opinion of Advocate General Stix-Hackl, if followed by the ECJ, would allow to maintain the systems of partial or full immunity of banking supervisory liability in the laws of the Member States, without any possiblity to find a legal basis for supervisory liability in EU law.

Part III. The case for Francovich liability in banking supervision

Should the ECJ follow the opinion of Advocate General Stix Hackl ? In our view, some doubts may be expressed as to the legal reasoning developed in the opinion. It is true that the ECJ in *Francovich* stated as first condition for Member State liability that only provisions of EU law which were intended to 'confer rights' to private individuals could enable the latter to claim compensation in case of breach of these provisions. As the Advocate General acknowledged, 'conferring rights' is not synonymous to 'direct applicability'. In other words, the obligations under EU law which have been allegedly breached should not satisfy the criteria for direct applicability in order to trigger *Francovich* liability.[9] Neither is the condition of "conferring rights" in our view synonymous for "conferring legally enforceable rights". This approach, however, seems to underpin the opinion of the Advocate General, when she examines whether the banking directives confer a right to depositors to have prudential measures taken by the competent supervisory body . More recent case law of the ECJ suggests that the first condition for *Francovich* liability should be read more flexibly: the Court seems to be satisfied with the demonstration that the EU rules are intended to protect the *interests* of private individuals, without it being required that the said rules confer by themselves enforceable rights.[10] In fact, the condition of "conferring rights" may be assimilated to the "relativity" rule which prevails in tort law of various Member States, amongst which Germany: *Francovich* liability will only come into play when the supervisory obligations imposed by the banking directives have been enacted in the interests of depositors, i.e. have the purpose to protect depositors. The mere circumstance that the rules protect a multiplicity of interests, should not in itself preclude *Francovich* liability, but could have an influence on the assessment of a 'serious' breach (see further).
Under this approach, it will be difficult to maintain that the banking coordination directives are not intended to "confer rights" to depositors, as far as prudential supervision is concerned:

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9 See, however, the highly criticized judgment of the House of Lords in the BCCI-case, where the similar issue was raised whether the First Banking Coordination Directive, which was applicable at the time of the BCCI-failure, could lead to *Francovich*-liability, to the extent that the Bank of England had not properly fulfilled the obligations to exercise prudential supervision as imposed by that directive: in his opinion in the case, Lord Hope of Craighead considerd that the provisions of the First Banking Directove lacked direct applicability in favour of depositors, and therefore *Francovich*-liability should be rejected. His lordship considered this interpretation of the banking directive to be *acte clair*, and did not deem it necessary to submit the issue to the ECJ by way of preliminary ruling.

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

first, the preamble to the Coordinated Banking Directive clearly identifies the protection of depositors as a major rationale for subjecting credit institutions to authorization requirements and prudential supervision. Furthermore, the case law of the European Court of Justice in the area of banking has repeatedly stressed the importance of the provisions on banking authorization and prudential rules in terms of protection of the consumer.[11] The objective of creditor and depositor protection is finally also embodied in Article 4 of the Coordinated Banking Directive, which as a rule allows only credit institutions subject to prudential supervision to accept deposits from the public.[12]

Does application of *Francovich* liability to banking supervision create a risk of overlitigation and hence, of shifting unduly the costs of banking failures to the State ? We consider it doesn't, given the requirement of a 'serious' breach of EU law as a condition for *Francovich* liability. [13] It is clear that banking supervisors enjoy a wide discretion in applying the often generally worded provisions of EU banking law in day-to-day supervision, both as regards authorization requirements[14] and for ongoing prudential requirements[15]. As already indicated, the decision-making process in banking supervision often is the result of a balancing of various, sometimes conflicting interests. This amplifies the discretion that the banking supervisor enjoys, as it should not exclusively serve the depositors' interests to the detriment of other legitimate interests (systemic protection, interest of the supervised entities). The case law of the European Court of Justice is in line with these concerns: a "serious" breach will only occur when the supervisory authority has manifestly and gravely disregarded the limits on the exercise of its discretionary powers.[16] This leads to the conclusion that *Francovich*-liability effectively allows to counter the risk of excessive liability claims.

Conclusion: why be afraid of Peter Paul

The position defended by the European Commission, the Advocate General and the Member States in the pending *Peter Paul* case are illustrative of an underlying concern that banking failures would almost automatically lead to holding the State liable for minor shortcomings in the exercise of prudential supervision by the competent authorities. It is clear that such a situation would not only threaten the financial interests of governments, but also seriously undermine the philosophy of banking supervision. A well-balanced application of the conditions attached to *Francovich* liability should however severely limit the occurrence of succesful liability claims. It will then be up to the (national) courts to rigourously apply the ECJ case law and to avoid the pitfall of the 'deep pocket' of the State in granting compensation to depositors.

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

[12] And if a member state would allow other actors to collect deposits from the public, Article 4 requires them to provide for adequate rules for the protection of depositors.

[13] See European Court of Justice 8 October 1996, *Dillenkofer*, cases C-178-179/94, C-188-190/94, *European Court Reports* 1996, p. I-4867.

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

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

[16] See European Court of Justice 5 March 1996, *Brasserie du pêcheur/Factortame III*, cases C-46/93 and 48/93, *European Court Reports* 1996, p. I-1029, para 55.

This leaves open the question whether supervisory liability is needed at all. We believe that granting total immunity from liability would entail a moral hazard risk on the part of the prudential authorities, as the accountability for their own actions would be reduced. By contrast, a liability regime which takes due account of the nature of prudential supervision and the need for sufficient discretion in taking supervisory measures could have a sound disciplining effect on the banking supervisor, and eventually benefit the financial system as a whole. But it is clear that this debate is far from closed.

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