Importance of Effective Regulation and Supervision for Banks' Corporate Governance: European Integration Context

Maria-Cristina Ungureanu

University of Genoa, Italy

European Corporate Governance Training Network

ABSTRACT

The significant role of banks in stabilising the financial systems of countries and in spurring their economic growth explains the particularities of their own corporate governance. The specificity of banks, the volatility of financial markets, increased competition and diversification expose banks to risks and challenges. Managing financial risk is a key element for improving corporate governance in the banking sector. Banks are heavily regulated and supervised in all countries, which sets a particular corporate governance framework for the banking industry. This paper examines some key factors which contribute to ensuring an effective regulatory and supervisory framework for banks, in the context of financial integration. I place emphasis on the importance of consolidated bank supervision.

Keywords: Banks, corporate governance, risk management, bank regulation, consolidated supervision, international coordination

OVERVIEW OF BANK REGULATION AND SUPERVISION

The specificity of banks, the volatility of financial markets, increased competition and diversification expose banks to risks and challenges.

The observed forms of corporate governance of banks emerge in the course of their operations as entities having to respect the private interest of owners, on the one hand, and the public interest in the overall stability of the system, on the other hand (Visentini, 1997). An increased market orientation of banks has lead to changes in authorities' approach to regulation and supervision.

Financial risk is a key factor for improving corporate governance in the banking sector. Banks must set their corporate objectives and risk profile with the aim of protecting not only the interest of shareholders, but also the interest of depositors and other stakeholders. Most banks' stakeholders are involved in the risk management process – regulators, supervisors, shareholders, directors, executive managers, internal and external auditors and the general public.

The integration of financial markets, the developments in cross-border banking activity, the diversification and complexity of financial activities have addressed systemic implications at the European Union (EU) level.

These frameworks lead to the banking industry being heavily regulated and supervised in every country. This, in turn, establishes a unique corporate governance system for banks, different from the traditional corporate governance of non-bank firms. Will these circumstances develop to the point where corporate governance codes are modified in order to make provisions for the banking industry? Recent financial market developments put pressure on authorities to place higher importance on banks' systemic environment, which include reforms in corporate governance.

International coordination of regulation and supervision is increasingly important for financial stability. Banking regulation establishes prudential rules for achieving an effective operational framework and risk management, as well as disclosure rules for promoting market discipline. Banking supervision is aimed at ensuring that in practice institutions monitor and manage effectively all relevant risks.

Research finds a positive correlation between the transparency and the efficiency of bank supervision. Moreover, supervisors' accountability and integrity practices are associated with the independence of bank supervision, in response to better compliance with the Basel Core Principles (Arnone et al., 2007).

REGULATION - KEY ELEMENT OF BANKS' CORPORATE GOVERNANCE

As banks became more important for the overall success of the economy, in addition to using banks to finance expenditures directly, governments find it important to control them through regulation, imposing several restrictions on their activity. In the corporate governance context, a regulatory framework represents a guide to the context, meaning, objectives and implementation of specific regulations. It designs regulations that assist banks in achieving principles of best practice, enhancing their corporate values and ethics.

Main regulatory provisions are related to the following aspects: i) entry of new domestic and foreign banks; ii) restrictions on bank activities; iii) safety net support; iv) disclosure of accurate comparable information; v) government ownership.

Depending on the approach taken by various states, the regulatory approach is prescriptive or market-orientated (Barth et al, 2006). Regulators adopting a prescriptive approach limit the scope of activities conducted by financial institutions, allowing the risk that regulations do not follow market developments and prevent financial innovation. Regulators subscribing to a market-orientated policy encourage financial institutions to operate more freely in a market that is believed to function effectively, through controlling any risks. In this case, financial institutions are the entities regulating the market; the regulator's role is to facilitate the process of monitoring risk management.

Following recent principles and guidelines issued by economic and financial authorities, the developments in financial markets and the changing of market conditions, the industry trend is towards a market-orientated approach. Politics, culture and traditions also influence the approach of regulators, which makes it difficult to harmonise the regulatory process across certain economic areas, such as the EU. In addition to a flexible legal framework, regulators also encourage a market attitude towards bank supervision, which proves effective when problems or major crisis in the banking system occur. These cannot always be prevented or controlled. The objective is to optimise the risk management process exercised by banks. Inherent banking risk should be recognised, monitored and controlled. In most countries inadequate regulation permitted risky lending and ineffective supervision allowed banks to ignore their losses. Prudential regulations are necessary for preventing systemic failures and reoccurrence of banking problems.

SUPERVISION - MONITORING BANKS' CORPORATE GOVERNANCE

Regulators also have a role in establishing a market-based approach for bank supervision. The traditional rule enforcement to banks has, at times, been detrimental to their operational environment, discouraging them to comply with regulations and, often, hide defects by creating innovative products that are harder to control through regulation. Evolutions in financial markets lead to changes in bank supervision.

- Regulators and banks have embraced a new, modern approach to supervision, which is market-orientated. The supervisory role has become more important and complex, with the objective of encouraging banks to optimise risk management.
- Supervisory authorities are confronting themselves with a complex and costly function, which is shared with the management of the bank and the external auditors; the latter have an increasing role in the corporate governance of banks.
- The strengthening of requirements for information disclosure to all stakeholders has changed the approach towards bank supervision, enhancing the importance of a market-orientated approach by banks and relevant authorities.

- As a consequence of the mix between banking and non-banking financial institutions, the traditional regulatory and supervisory process for banks has become more homogenous and consistent. This is also a reaction to financial markets consolidation.

The importance of bank supervision for the corporate governance framework relates to its mission: creating a regulatory environment in which the quality and effectiveness of risk management can be optimised in order to contribute to a sound and reliable banking system.

Risk management is one of the key drivers for banks' compliance with corporate governance principles. Risks must be measured consistently and aggregated, and efficiently managed through a process operated on a wide-system basis. The Basel Committee acknowledged this aspect by applying three pillars of the Basel Accord (minimum capital requirements, supervisory review and market discipline) at a consolidated level. Pillar 2 alone is designed to help both institutions and supervisors to better understand and manage risks. The Basel Accord is currently applied at the EU level. There is, however, great uncertainty over how Pillar 2 will work in practice at a global level.

The EU addresses this issue through recent amendments made to the fourth and seventh company law directives[1]. These amendments stress the importance of the application of corporate governance practices, by requiring listed companies to publish a corporate governance statement, as part of their annual report or in a separate report. The statement should include the reference to the corporate governance code, the "comply or explain" relating to the corporate governance code and information on internal controls and risk management systems.

[1] The Fourth and Seventh Directives on the annual accounts of public limited liability companies belong to the family of "accounting directives" that form the arsenal of Community legal acts governing company accounts. Fourth Directive: annual accounts of companies with limited liability – this Directive coordinates Member States' provisions concerning the presentation and content of annual accounts and annual reports, the valuation methods used and their publication in respect of all companies with limited liability. Seventh Directive: consolidated accounts of companies with limited liability – this Directive coordinates national laws on consolidated (i.e. group) accounts.

Depending on their nature, risks may or may not fall within the scope of supervisory authorities. In the case of operational risks, there are clear guidelines established by regulators, that banks are expected to follow. A bank's strategy has major risk implications and therefore its supervision is more complex and ongoing, especially in the case of large banks, where management has regular discussions with supervisory authorities. Risks that are related to a business environment are usually monitored on an ongoing basis by supervisory authorities. Central Banks play a major role in the supervision of business risks as monetary authorities. Supervisory authorities may not be involved in certain business areas that have risk implications, such as macroeconomic policies, tax environment and financial sector infrastructure. They may still contribute to the setting of the overall business environment. Supervisory authorities have a very important role in managing event risks. They evaluate the impact of such events, ensure that appropriate banking systems are in place and that negative consequences of such events are minimised.

CIRCUMSTANCES FOR CONSOLIDATED SUPERVISION

European banking supervision is undergoing important changes, and the key issue addressed by legislators and banks relates to the most appropriate structure that can achieve an efficient integrated financial market. Taking into account the consolidation of financial markets, the increased cross-border banking activity and the growing complexity of financial institutions, consolidated supervision is a mechanism that can accomplish an efficient environment for banks operating across the EU. Consolidated supervision, though not the perfect solution, could be the model for helping international banks deal with the growing complexity of financial institutions in Europe[2]. Consolidation is a key aspect in the EU context, but it must be approached from the wider global financial perspective. Although it is neither the only solution nor the simplest one, consolidation is a viable approach that stimulates the banking industry to evolve and confront obstacles in the market.

[2] Speech: Michel Pébereau, President of the European Banking Federation.

I emphasise three circumstances that require the need for consolidated supervision: consistency and coordination in regulation and supervision, cross-border activity and financial market concentration.

Consistency and coordination in regulation and supervision

The increasing financial market integration blurs the distinction between various types of financial institutions, enhancing competition in the market. Accordingly, regulatory and supervisory authorities must ensure competitive equality through prudential requirements, avoiding arbitrage, which increases systemic risk (Greuning and Bratanovic, 2003). This is possible through the following approaches:

- Consisting regulatory philosophies for different types of financial institutions that avoid potential conflicting views;
- Consistency in defining and managing risks and prudential requirements for different types of financial institutions;
- Establishing consistent prudential requirements for different types of financial institutions;
- Eliminating differences in the cost of regulation for the respective financial institutions;
- Coordination between regulatory and supervisory authorities in the financial sector.

At the EU level, there is a trend towards *convergence of the supervisory practices* across member states, which would accomplish the aforementioned aspects. Convergence in supervision is closely linked with the *harmonisation of regulations*. The regulatory and supervisory regimes in various countries are harmonised by virtue of their common membership in regional unions or international organisations. EU member states agree to a minimum harmonisation of rules for banks based on the principle of mutual recognition and home country control.

A topic that acquired interest is the evaluation of the current supervisory structures. Coordinated bank supervision requires a *consistent structure of the national supervisory authorities* within certain economic areas and *full cooperation between supervisory authorities* established in those areas.

The euro area, the UK and the US are three zones with different financial operational experiences, thus having different financial supervisory models. Policy makers are addressing two aspects with regard to banking supervision: whether there should be a single banking supervisory authority or a system with multiple supervisors, and whether central banks should play a role in banking supervision. Financial market internalisation requires cooperation between central banks, financial supervisory authorities of various countries and international banking authorities in establishing effective and coordinated bank supervision. Efforts have been made towards harmonising national supervisory arrangements through exchanging information and establishing Memoranda of Understanding between international financial authorities. Cross-border communication is important at the formal and informal level.

In Europe, following the introduction of the euro, arguments in favour of a separation of prudential supervision and central banking have lost most of their force, while those in favour of combining them have become even more prominent. In particular, an institutional framework in which the ECB's responsibilities for monetary policy in the euro area are coupled with extensive supervisory responsibilities of central banks in domestic markets and with reinforced co-operation at a wider level would seem appropriate to tackle the changes triggered by the introduction of the euro. ECB's position is that central banks operating in the euro area are carrying out supervisory tasks in an effective way. Meanwhile, UK's model based on a single financial authority has shown little experience regarding its performance thus far[3].

Cross-border activity

Recent developments in cross-border banking activity have increased the efficiency of international markets. Policy makers recognise that problems with global institutions and markets could undermine the stability of the financial systems where banks operate. Home country authorities want to ensure a bank's overseas operations meet their

[3] In the UK, self-regulation by function was replaced with a single financial supervisor, the Financial Services Authority. While the Bank of England gained its independence over the conduct of monetary policy, it lost its role as prudential regulator of UK banks. With regard to financial supervision, a Memorandum of Understanding is established between the Bank of England, the Financial Services Authority and the Treasury.

supervisory standards because foreign operations that could affect the parent bank are difficult to monitor. Host country authorities are concerned with the implications of a possible failure of a foreign bank on its own banking system. They may also lack information about the parent bank. Accordingly, effective international coordination will be achieved through an appropriate communication flow between supervisory authorities. This provides an efficient framework, because, if all multinational banks are required to meet the same global regulations, compliance costs will be consistent, thereby improving the competitive field for banks with international operations.

In the EU, relationships among bank supervisors are governed by the Second Banking Directive[4], which establishes a *home country supervisory system* for banks incorporated in a member state. Home country supervision is one of the main principle of global supervision. Under this arrangement, (i) the banking license for a bank from a member state permits the bank to brand throughout the EU without obtaining approval of the host country; and (ii) the supervisory authority of the country where a bank is incorporated (i.e. the home country) has primary responsibility for the operations of the bank throughout the EU. An EU member state can apply the home country principle applied to EU banks in whole or in part to banks from non-EU countries if there is reciprocity, close cooperation between the supervisory authorities of both countries and a high standard of home country supervision. Alternatively, the EU member state makes its own assessment of banks from non-EU countries and applies capital standards consistent with EU standards.

Cross-border responsibilities of bank supervisors are set out in 'The Basel Concordat and Minimum Standards[5], which is based on several provisions related to home country and

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[4] The Second Banking Directive (1989, effective 19939) was passed in response to the 1986 Single European Act. It remains the key EU banking law and sets out to achieve a single banking market through application of the principle of mutual recognition. Credit institutions are granted a passport to offer financial services anywhere in the EU, provided member states have banking laws which meet certain minimum standards. The passport means that if a bank is licensed to conduct activities in its home country, it can offer any of these services in any EU state, without having to seek additional authorisation from the host state. The financial services covered by the directive include the following. 1) Deposit taking and other forms of funding; 2) Lending, including retail and commercial, mortgages, forfeiting and factoring. 3) Money transmission services, including the issue of items which facilitate money transmission, from cheques, credit/debit cards to automatic teller machines. 4) Financial leasing. 5) Proprietary trading and trading on behalf of clients, e.g. stockbroking. 6) Securities, derivatives, foreign exchange trading and money broking. 6) Portfolio management and advice, including all activities related to corporate and personal finance. 7) Safekeeping and administration of securities. 8) Credit reference services. 9) Custody services.

[5] Volume Three, Chapter I of the Basel Committee on Banking Supervision Compendium. Principles:

host country bank supervision. i) The home country authority should supervise internationally active banks and banking groups on a consolidated basis; ii) A cross-border banking establishment should receive the prior consent of both home- and host-country supervisory authorities, specified in the Memorandum of Understanding; iii) Home country supervisory authorities should possess the right to collect information concerning the cross-border establishment of the banks that they supervise, based on the principles of reciprocity and confidentiality; iv) The host country supervisory authority can prohibit the cross-border operation or impose restrictive measures, when home country supervisory arrangements do not meet minimum standards; v) Home country supervisory authorities should inform host country authorities of changes in supervisory measures that have an effect on the relevant bank's operations.

While the home-host country framework will alleviate some of the uncertainties in the cross-border activity of the banking sector, it is not a solution on its own.

Financial market concentration (conglomerates)

Developments in financial markets led to an increase in the number of financial conglomerates; consolidated supervision is key to these groups. The *universal bank* entity demands a complex supervisory process. An international financial group active in banking, securities, fund management and insurance may be subject to several regulatory regimes and supervisory authorities in various countries. Bank supervision must consider the coordination of approaches at the level of developed and emerging markets, the transparency of group structures, the assessment of capital adequacy and risk control in order to prevent the contagion effect.

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1) The legal responsibilities of national supervisors for the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place by the Basel Committee on Banking Supervision; 2) The home country supervisor is responsible for the oversight of the implementation of the Concordat for a banking group on a consolidated basis; 3) Host country supervisors, particularly where banks operate in subsidiary form, have requirements that need to be understood and recognised; 4) There will need to be enhanced and pragmatic cooperation among supervisors with legitimate interests. The home country supervisor should lead this coordination effort; 5) Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on banks, and conserve supervisory resources. 6) In implementing the New Accord, supervisors should communicate the respective roles of home country and host country supervisors as clearly as possible to banking groups with significant cross-border operations in multiple jurisdictions. The home country supervisor would lead this coordination effort in cooperation with the host country supervisors.

At the heart of the Second Banking Directive and the home-host principle is the requirement of a *single license* along with an agreed-on list of banking activities that this license covers. The single license implies that, once a banking group has obtained a license in one of the EU member states (the home country), it can operate freely in all other member states (host countries), both through establishment of a local bank office and cross-border provisions of banking services. The home state principle of supervision stipulates that the supervision of a bank and its activities performed by a branch will be subject to the competent authorities of the home member state. The host country has to allow non-domestic EU banks the agreed-on list of banking activities free access to its market. The list covers all major commercial and investment banking activities, thus endorsing universal banking. The Directive harmonises supervisory requirements related to sound administrative and accounting procedures, the initial capital necessary for authorisation and execution of activities, and the supervision of holdings of banks in sectors outside the banking business.

Financial conglomerates are also subject to the regulatory framework set forth in the *Financial Conglomerates Directive* (FCD)[6], which provides for supplementary supervision of the regulated entities comprising a financial conglomerate operating in the EU. The FCD contains a number of significant provisions of relevance to coordinated supervision, providing for the identification of the “coordinating supervisor” that coordinates the supplementary supervision of the financial conglomerate and manages the information-sharing and cooperation among supervisors of the regulated entities in the financial conglomerate. The FCD also lays down a structured way for the coordinated supervisor to exercise its responsibilities[7].

[6] 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.
[7] See ECB Monthly Bulletin, February 2007.

THE CURRENT STATE OF CONSOLIDATION IN SUPERVISION

European banking supervision is undergoing important changes, and the key issue addressed by the legislators and banking institutions relates to the most appropriate structure that would achieve an efficient integrated financial market. Consolidated supervision is a mechanism that can accomplish an efficient environment for banks operating across EU borders.

The process is related to the banking legislation at a global level, and mainly to the implementation of Basel II[8]. The Basel Accord has been implemented in the EU pursuant to the Capital Requirements Directive, which became effective on January 1, 2007, although the effective date was delayed by one year for banks following the most advanced approaches[9]. Throughout the past year, the Basel Committee's Accord Implementation Group continued to focus on Basel II cross-border issues, and increasing attention was devoted to the application of Pillar 2 requirements[10].

Consolidation in banking supervision is a key aspect in the EU context, but it must be approached within the wider global financial system. Consolidation is not yet fully applied because the legal framework only allows limited delegation of responsibilities between supervisors. The boundaries of the legal framework need to be extended in order to deliver a more efficient banking system.

The coordination of bank supervision at a global level is influenced by several regulatory aspects. i) The decision made at the end of 2005 by US market agencies to delay the implementation of Basel II, which has implications on the home-country and host-country supervision. ii) There is still a possibility that the US could seek significant changes to the Basel Accord, in which case EU must adjust in a short time to

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[8] Opinion also expressed in "Future Banking", published in association with the European Banking Federation"

[9] In Japan, the implementation dates are 1 April 2007 and 1 April 2008 for banks applying the simpler and most advanced approached, respectively. In Canada, the guidelines implementing Basel II became effective on 1 November 2007 for banks with 31 October year-ends.

[10] The Basel Committee Accord Implementation Group (AIG) was established to share information and thereby promote consistency in implementation of Basel II. While the AIG provides a forum for discussing members' approaches to implementing Basel II, it is not intended to mandate uniformity of application of the Revised Framework.

accommodate the changes[11]. Because of the significant cross-border relationships between US and EU, EU must react swiftly through a supervisory coordination at a global level, to avoid serious difficulties for international banking groups. The Basel Committee Accord Implementation Group has an important role in this regard.

Table 1 presents the results of the survey conducted by the Institute of International Bankers (IIB) with regards to the approach countries take towards consolidated supervision of domestic and non-domestic operations.

Table 1. The Approach Countries Take to Consolidated Supervision of the Operations of Domestic and Non-Domestic Financial Groups

Consolidated Supervision Applied to Bank Subsidiaries and Affiliates of Domestic Financial Groups and to Unincorporated Branches/Agencies and Affiliates of Non-Domestic Financial Groups	**Consolidated Supervision Applied to Bank Subsidiaries and Affiliates of Domestic Financial Groups But Not to Unincorporated Branches/Agencies and Affiliates of Non-Domestic Financial Groups**	**Consolidated Supervision Applied to Bank Subsidiaries and Affiliates of Domestic Financial Groups But Not to Bank Subsidiaries and Affiliates or Unincorporated Branches/Agencies and Affiliates of Non-Domestic Financial Groups**	**Consolidated Supervision is Not Applied to Either Domestic or Non-Domestic Financial Groups**
Argentina Brazil Canada China France India Indonesia Ireland Israel Italy Japan Luxembourg The Netherlands Panama Philippines South Africa Spain Sweden Switzerland Unites States	Australia Austria Bahrain Belgium Bermuda Cayman Islands Finland Hong Kong Korea Latvia Norway Poland Romania Singapore United Kingdom	Czech Republic Denmark Germany Turkey	Chile

Source: IIB – "Global Survey 2007. Regulatory and Market Developments". The Survey covered some EU countries and non-EU countries.

[11] In September 2006, the federal banking agencies in the United States jointly issued for public comment proposed rules to implement Basel II Capital Accord for large, internationally organizations ("core banks"). The agencies also sought comment on the so-called "Basel I-A" proposal which would have given non-core banks the option to apply a risk-based regime more discriminating than Basel I but not as complex as the various approaches provided for under Basel II. The proposals raised substantial questions regarding the compatibility of certain aspects of the US standards with the international accord."

A report issued by the International Monetary Fund (IMF) proposed the increase in ECB's role in EU's banking supervisory system. EU's objective to build an integrated regulatory system is hampered by its fragmented supervisory regimes, and this has negative consequences in times of financial crisis. An industry that increasingly operates across borders needs unified supervision. A better-integrated supervisory system would strengthen information flows and accountability and keep better pace with market developments. Such framework needs to be complemented with a wider system that is driven by ECB's initiatives. Europe's supervisory system, based on national regulators, is "running behind market developments and holding up financial integration" according to the IMF report.

CONCLUSIVE REMARKS

Regulation at the global level in the EU and in the three countries with key financial centres – the UK, the US and Japan underwent substantial reform in the 1990s. The changes have had major implications on the banking systems of these areas. A view of individual bank structure illustrates considerable differences in the respective banking systems and their supervision approach.

In Japan, the "Big Bang" (1996) marked the beginning of the end for segmented markets. A new rule-driven single financial regulator was created, with an independent Bank of Japan assuming responsibility for monetary policy.

By contrast, the US has a unique structure that is currently undergoing changes. US continues with a system of multiple regulation, but recent reform has created the opportunity for the development of a nation-wide (albeit restricted) universal banking system (Heffernan, 2005).

In the UK, self-regulation by function was replaced with a single financial supervisor. While the Bank of England gained its independence over the conduct of monetary policy, it lost its role as prudential regulator of UK banks. The Memorandum of Understanding between the Bank of England, the Financial Services Authority and the Treasury in the event of a crisis is still being tested, and the first major test was been the financial crisis that hit global markets in August 2007. The UK financial system is being questioned, and the main accusation is that there are “just too many conflicts inherent in a system where three different institutions, with three different priorities, have to come together to tackle a fast-moving crisis”[12].

The EU faces numerous challenges in the new century. Monetary union is now a reality in most of the EU, but is not sufficient to achieve a high degree of financial integration or a nation-wide banking system. The issue of an integrated approach to banking supervision in the EU addresses the primary issue of national legal frameworks, which still apply to various degrees in the European financial systems. Also, there is the issue of whether a single EU regulator should be created; if not, how to ensure the information flow between numerous authorities. Regardless of the framework, the involvement of the ECB is essential, because only the ECB can supply liquidity in the event of a crisis in the euro area, which can also occur as a result of a crisis outside this area. Coordination among multiple regulatory and supervisory authorities is an enormous challenge, especially as the EU and the euro area expand.

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